

Testimony of Daniel N. Shaviro
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Mister Chairman, Ranking Member Hatch, and Members of the Committee, I would like to thank you for the opportunity to appear today to discuss the fairness issues posed by the distribution of tax burdens between people at different income levels. I will address three specific topics. The first is how income distribution has changed in our country since the passage of the landmark Tax Reform Act of 1986, and why this might matter to the design of tax reform. The second is how tax expenditures, as opposed to tax rates, affect the distribution of tax burdens. The third is whether economic concern about imposing excessive tax burdens would imply that the budgetary gain from tax expenditure repeal should be offset by reducing tax rates.

Distributional Changes Since 1986

In 1986, Congress enacted comprehensive income tax reform through the cooperation of leaders in both parties. The core feature of the 1986 Act was that it combined tax rate cuts with base-broadening, in a manner intended to be both budget-neutral and distribution-neutral. Since 1986, however, not only have our long-term budgetary problems grown far more serious, but income distribution in the U.S. has significantly changed.

To appreciate the extent to which things have changed since 1986, I believe it is useful to consider the following two tables, both derived by me from research that was conducted by leading economists. The first shows rising income distribution at the top since 1986 without regard to capital gains (which can be misleading when taxpayers realize a big gain that actually accrued over many years), while the second includes capital gains (since ignoring them altogether would also be misleading).

TABLE 1TOP DECILE (AND ABOVE) INCOME SHARES WITHOUT CAPITAL GAINS¹

Year	Top 10% Income Share	Top 5% Income Share	Top 1% Income Share	Top 0.1% Income Share	Top 0.01% Income Share
1986	34.57	22.59	9.13	2.87	1.00
2008	45.60	33.36	17.67	7.77	3.34
% Increase in Share Since 1986	31.9	47.7	93.5	205.6	234

TABLE 2TOP DECILE (AND ABOVE) INCOME SHARES WITH CAPITAL GAINS²

Year	Top 10% Income Share	Top 5% Income Share	Top 1% Income Share	Top 0.1% Income Share	Top 0.01% Income Share
1986	40.63	29.49	15.92	7.40	3.34
2008	48.23	36.52	20.95	10.40	5.03
% Increase in Share Since 1986	18.7	23.8	31.6	40.5	50.6

A theoretically better income measure than either of these would measure economic gain without regard to whether it was realized or not. Such a measure would show, for example, that Steve Jobs is economically well-off, despite his \$1 annual salary, given that he owns close to \$2 billion worth of Apple stock.³ Nonetheless, the tables offer powerful evidence of a substantial increase in high-end U.S. income inequality since 1986.⁴

¹ From Shaviro (forthcoming), using data from Facundo Alvaredo, Tony Atkinson, Thomas Piketty and Emmanuel Saez, *The Top Incomes Database* (data for U.S.), <http://g-mond.parisschoolofeconomics.eu/topincomes/>

² *Id.*

³ See, e.g., Castillo (2011). If Apple pays tax at a suitable effective rate, one could argue that this results in adequate “proxy taxation” of Jobs’ economic gain as an Apple shareholder.

⁴ Alan Reynolds, who is also a witness at today’s hearing, has written skeptically about this data. See, e.g., Reynolds (2006). His criticisms have been convincingly rebutted, however. For example, (1) Reynolds’ treatment of Census Bureau survey data as more reliable than reported taxable income data is misplaced, (2) his effort to show that the data is upward-biased by reason of its excluding a significant component of “personal income” from the National Income and Product Accounts reflects his ignoring that the latter measure includes government transfers

The substantially greater concentration depicted by Table 1 (which excludes capital gains) as compared to Table 2 helps to demonstrate a further point. As Emmanuel Saez notes, the key change has been “an explosion of top wages and salaries [T]op income earners today are not ‘rentiers’ deriving their incomes from past wealth but rather are ‘working rich,’ highly paid employees or new entrepreneurs who have not yet accumulated fortunes comparable to those accumulated during the Gilded Age.”⁵ He adds that the “dramatic increase in top wage incomes has not been mitigated by an increase in mobility at the top of the wage distribution . . . [Instead], the probability of staying in the top 1 percent wage income group from one year to the next has remained remarkably stable since the 1970s.”⁶

Millions of Americans have noticed these changes, which affect broader social and political attitudes. In illustration, a recent survey of more than one thousand millionaires (defined as people with at least \$1 million in investable assets, *excluding* real estate and retirement accounts) found that a full 42 percent did not regard themselves as wealthy, largely because they were comparing themselves to people who were wealthier still.⁷ In a society where the median cash income for a full-time adult worker barely exceeds \$40,000 per year,⁸ evidence such as this helps to show that rising high-end income concentration, whether or not one regards it as a problem, is inescapably an important social fact in people’s minds.⁹

Views will inevitably differ regarding whether, and if so how, Congress should use tax policy to address rising high-end income concentration. One point worth noting, however, relates to the still-powerful influence of the 1986 Act as a tax reform model. A fundamental aim

but not taxes, and (3) in emphasizing taxpayer responses to changing marginal tax rates, Reynolds conflates mere timing shifts from one year to another with permanent shifts. See Piketty and Saez (2006).

⁵ Saez (2011) at 4 (footnote omitted).

⁶ *Id.* at 4 n. 4.

⁷ See Reuters (2011).

⁸ See Scheve (2010) at 13, noting that, in 2007, the median cash income for an adult who worked full time was \$41,425.

⁹ For other similar evidence, see Shaviro (forthcoming)

that was shared by both the Reagan Administration and the Congressional leaders from both parties who spearheaded enactment of the 1986 tax reform was to ensure that the Act would be roughly distribution-neutral over the five-year period following enactment. Tax rate cuts were therefore considered necessary to offset the distributional effects on high-income taxpayers of tax expenditure repeal (as well as the budgetary effects).

The changed circumstances of 2011 might lead one both to question whether tax reform should still be distribution-neutral, and to examine its distributional effects with a finer comb than was thought necessary in 1986. During the 1986 process, the use of two top income groups in measuring tax reform's distributional effects – those earning from \$100,000 to \$200,000, and those earning \$200,000 or more – was widely accepted, without any evident concern about the difference between those who were barely in the top group and those who were millionaires or the super-rich.¹⁰ In 2011, by contrast, the Report of the President's Fiscal Commission (henceforth, the "Fiscal Commission Report"), proposing dramatic tax and other budgetary changes to assure long-term U.S. fiscal solvency, addressed its main proposal's distributional effects on each of the following high-income groups: the 80th to 90th percentile, the 90th to 95th percentile, the 95th to 99th percentile, the top 1 percent, and the top 0.1 percent.¹¹

In a similar spirit of concern about high-end income concentration, Congress could consider adding new income tax rate brackets, beginning at higher levels than any under present law, at which marginal rates above 35 percent would apply. The 2010 debate concerning extension of the expiring marginal tax rate cuts from 2001 revealed widespread sentiment that people at the very top of the U.S. income distribution face very different circumstances than those earning, say, "only" \$379,150 (the income level at which the 35 percent top rate for

¹⁰ See, e.g., Treasury Department Report to the President (1984) at 47-49.

¹¹ See National Commission on Fiscal Responsibility and Reform (2010) at 32.

individuals starts in 2011). Higher rates and added rate graduation do indeed raise efficiency issues that require careful consideration, but there are significant arguments in their favor as well as against them.¹²

Distributional Effects of Tax Expenditures, as Compared to Tax Rates

In evaluating how the U.S. income tax system distributes tax burdens, tax rates are only one of the two important variables. The other is the tax base, and in particular the distributional consequences of departures from taxing economic income.¹³ While some departures (such as not taxing unrealized appreciation) are primarily administratively motivated and would be difficult to address even if there were a consensus that this ought to be done, for the most part no such problem exists with respect to tax expenditures, which narrow the tax base by targeting favored activities for generous treatment. Among the most important items that unambiguously are tax expenditures are home mortgage interest deductions and the exclusion from income of the value of employer-provided health insurance.¹⁴

In assessing such items' distributional effects, two main points are clear. First, the benefits that they provide rise sharply with income as one goes from the bottom of the income distribution to roughly the 99th percentile. Thus, consider the itemized deduction for home mortgage interest. As income rises, one is more likely to be a homeowner, and the value of one's home (as well as of the mortgage debt that it can secure) rises. One also is more likely to

¹² See Shaviro (forthcoming) for discussion of how the academic debate concerning high rates and rate graduation has changed in the years since the passage of the Tax Reform Act of 1986.

¹³ Given the subject matter of today's hearing, I ignore the question of whether income is the best tax base. In Shaviro (2004a), I sympathetically explored the case for replacing the existing income tax with a progressive consumption tax.

¹⁴ See Joint Committee on Taxation (2010). A number of other items that regularly appear on official tax expenditure lists arguably should not be so classified. For example, tax benefits for retirement saving address the bias of the income tax against saving, and would not be classified as tax expenditures if one applied a consumption tax baseline. Taxing dividends at a lower rate than other income may reduce the otherwise existing tax bias against equity-financed corporate income. I have also argued elsewhere that a proper definition of tax expenditures, based on their serving primarily allocative rather than distributional objectives, would exclude such items as child tax credits and the earned income tax credit. See Shaviro (2004b).

claim itemized deductions, and one's marginal tax rate, which determines the tax saving per dollar of deductions, gradually rises. A similar analysis applies to the employer-provided health insurance exclusion (except that one need not itemize deductions in order to claim it). For these reasons, both items raise after-tax income more for higher-income than for lower-income taxpayers.¹⁵

Second, however, individuals at the very top of the income distribution typically gain less from tax expenditures, relative to income, than those immediately below them.¹⁶ This reflects two main factors. First, at very high income levels, expenditures on the subsidized activities tend to decline as a share of income. For example, someone who is earning \$10 million per year is unlikely to own a home ten times as expensive (or with a mortgage ten times as high) as that owned by someone earning \$1 million per year. Second, in some cases the tax law places relevant dollar ceilings on the amount of benefit that a given taxpayer can claim. For example, Internal Revenue Code section 163(h)(3) places a \$1.1 million limit on the mortgage loan principal that can generate deductible interest expense.

Given the decline at the very top of the income distribution in relative utilization of tax preferences, tax reform legislation that combined (i) tax expenditure repeal with (ii) marginal rate reduction, with an eye to achieving general distributional neutrality, could not easily avoid redistributing after-tax income towards those at the very top of the distribution. As it happens, the main plan discussed in the Fiscal Commission Report avoided this effect, and imposed a greater negative percentage change in after-tax income on the top 0.1 percent of the income distribution than on any other group.¹⁷ This, however, reflected such changes as its eliminating the lower tax rates that currently apply to dividends and capital gains (including on corporate

¹⁵ See Toder, Harris, and Lim 22 (2009).

¹⁶ See *id.*

¹⁷ See National Commission on Fiscal Responsibility and Reform (2010) at 31-32.

stock), which arguably are not true tax expenditures insofar as they reduce the tax bias against equity-financed corporate investment. Moreover, the Fiscal Commission proposal probably would redistribute after-tax income to people at the very top of the distribution who primarily earn salaries, rather than receiving dividends and capital gains.

There are means available by which Congress could, if it chose, reduce the regressivity of tax expenditures up to the 99th percentile without repealing them altogether. For example, it could reduce the \$1.1 million cap on home mortgage loan principal that generates deductible expense, and/or (as proposed in the President's budget) convert the deduction into a percentage credit at a fixed rate that is lower than the top marginal rate. Likewise, it could cap the value of employer-provided health insurance that is excludable from income, and/or require its inclusion with the offsetting allowance of a fixed-rate credit. Such ideas are worth considering on multiple grounds: to increase economic efficiency, to reduce the disproportionate benefit that high-income taxpayers currently derive from these items, and to reduce the budget deficit.

Would Repealing Tax Expenditures Suggest That Tax Rates Need to Be Reduced?

Proponents of tax expenditure repeal often propose accompanying such repeal with a second, distinct proposal: that of simultaneously lowering marginal tax rates. The aim is to prevent overall tax revenues, as officially measured, from rising as sharply as they would from stand-alone tax expenditure repeal. This combination of base-broadening with tax rate reduction was, of course, a hallmark feature of the Tax Reform Act of 1986, which was designed to be budget-neutral (and ostensibly revenue-neutral, although, as I explain below, this was a fallacy), in addition to distribution-neutral.

It should be obvious that packaging tax expenditure repeal with tax rate reduction, so that the overall set of changes enacted is merely budget-neutral, loses considerable appeal when we

face massive budget deficits with no end in sight, and thus the prospect of an unsustainable rise in our public debt that could trigger a disastrous fiscal collapse.¹⁸ Proponents of such packages argue, however, that the offsetting tax rate cuts are necessary to prevent undue tax increases.

In so arguing, they forget the very point that often motivates calls for tax expenditure repeal, which is that items actually are actually “spending through the Tax Code,” as the Fiscal Commission Report puts it.¹⁹ Likewise, in the words of the House Committee on the Budget’s Fiscal Year 2012 Budget Resolution, tax expenditures “are similar to government spending – instead of markets directing economic resources to their most efficient uses, the government directs resources to politically favored uses, creating a drag on growth.”²⁰

A simple hypothetical example, made famous by the late, great economist David F. Bradford (who served in two Republican Administrations) can help make clear the fundamental equivalence between tax expenditures and overt government spending. To illustrate this point, Bradford described a pretended “secret plan” to eliminate the budget deficit by formally cutting spending rather than taxes. In Step 1, all defense spending on weapons procurement would be eliminated. Suppose this saved \$50 billion, but would deprive the military of vitally needed items if nothing else were done. In Step 2, therefore, a new \$50 billion “weapons supplier tax credit” (WSTC) would be enacted. “To qualify for the WSTC, manufacturers will sign appropriate documents prescribed by the Secretary of Defense (looking much like today’s procurement contracts) and deliver to appropriate depots weapons systems of prescribed characteristics. The

¹⁸ See, e.g., Burman, Rohaly, Rosenberg, and Lim (2010).

¹⁹ National Commission on Fiscal Responsibility and Reform (2010) at 15.

²⁰ House Committee on the Budget (2011) at 51. See also Feldstein, Feenberg, and MacGuineas (2011) at 10, noting that tax expenditures are a “substitute for direct government outlays.”

WSTC, which may be transferred to other taxpayers without limit, may only be used in payment of income tax. Step 2 is, apparently obviously, a [\$50 billion] tax cut.”²¹

Steps 1 and 2 would leave absolutely everything unchanged. The military would have the same weapons as previously, and the companies that supplied the weapons would have exactly as much money as previously. As officially measured, however, both “tax revenues” and “spending” would have declined by \$50 billion. Thus, the accompanying enactment of a \$50 billion tax increase, such as via higher rates, would mean that deficit reduction – officially, but not in economic substance – had been accomplished purely by cutting “spending” in the amount of \$50 billion.

If tax expenditures are equivalent to government spending – as the WSTC example makes clear, and as seems unmistakable with respect to items such as the home mortgage interest deduction and the exclusion for employer-provided health insurance²² – then repealing them is in economic substance a spending cut, not a tax increase. Indeed, the House Committee on the Budget’s Fiscal Year 2012 Budget Resolution, although a bit circumspect in its tax expenditure discussion, clearly recognizes this. It describes tax expenditure repeal as good in itself, despite the fact that it would increase total tax revenues as officially measured, and argues that simultaneously lowering income tax rates would provide a second and distinct benefit by increasing “incentives for economic growth.”²³ The only claimed relationship in the Budget Resolution between the two proposed changes is that tax expenditure repeal would help make the rate cuts affordable – a point that would equally hold if direct spending were being further reduced instead.

²¹ Bradford (2003).

²² As noted above, however, the “disguised spending” label may be inapt as to other items commonly listed as tax expenditures.

²³ See House Committee on the Budget (2011) at 51-52.

In sum, while stand-alone tax expenditure repeal would increase officially measured tax revenues, it would not make the government “larger” in any meaningful economic sense. Indeed, to exactly the same extent as cutting direct spending, it would both reduce government intervention in the economy and make our long-term fiscal path more sustainable, thus easing economic uncertainty and lowering the risk of a future fiscal catastrophe. Given the economic equivalence between tax expenditures and direct spending, it is simply nonsense to say that reducing the former, as compared to the latter, should have any effect on whether one simultaneously chooses to reduce income tax rates.

The fundamental point about form versus economic substance that tax expenditure analysis helps to make clear shows that, when Congress enacts simultaneous tax base and tax rate changes, as it did in 1986, “revenue neutrality” is merely a semantic goal, having no definite relationship to the economic substance of what has been done. Thus, suppose for simplicity that all Congress did in 1986 had been to (a) repeal unambiguous tax expenditures and (b) reduce tax rates, with the overall package being budget-neutral since the budgetary gain from (a) equaled the budgetary loss from (b). Calling these changes “revenue-neutral” as well as “budget-neutral” would be literally correct, in terms of the effect on officially measured post-enactment revenues. However, it would not be an economically meaningful description, given that, if the eliminated tax expenditures had instead been structured as identical direct spending rules, the 1986 changes, while still budget-neutral, would instead have been described as substantially *reducing* both taxes and spending. The latter description would be economically more accurate, however, since “spending,” in this context appears really to mean rules that, as in the case of tax benefits for

home ownership or health insurance, primarily address resource allocation (i.e., the economic quantity of alternative activities and assets) rather than income measurement.²⁴

One could still argue for rate cuts, on the view that they are sufficiently desirable to be worth the potentially substantial budgetary loss relative to stand-alone tax preference repeal.

However, in assessing such arguments, the following points should be kept in mind:

(1) Base-broadening, such as through the repeal of tax expenditures, generally weakens, rather than strengthens, the efficiency case for lowering tax rates. This reflects that a more comprehensive tax base is generally less avoidable. In the income tax setting, as base-broadening increasingly eliminates devices for reducing one's taxable income *other* than by actually working or saving less, empirical evidence strongly confirms that avoidance responses significantly decline.²⁵ To put the point more generally, from a strict economic efficiency standpoint, a higher rate and a broader base function as complements, whereas 1986-style tax reform treats them as if they were substitutes.²⁶

(2) No serious analyst today believes that cutting individual income tax rates, given their present levels, has any chance whatsoever of raising net revenue. While the well-known Laffer curve correctly posits that any given tax base is likely to have a revenue-maximizing rate below

²⁴ See generally Shaviro (2004b). In illustration, consider the income tax expenditure for municipal bond interest, which is excluded from taxable income. While, from a consumption tax standpoint, *neither* municipal bond interest nor other interest income should be included in the tax base, no sane person could argue that municipal bond interest isn't "income," whereas other interest *is* income. Thus, only an allocative goal of favoring state and local government borrowing relative to other borrowing could be used to rationalize excluding municipal bond interest from income in an income tax framework, or distinguishing between the two types of interest receipts in *any* reasonable tax framework.

²⁵ See, e.g., Kopczuk 2005 (empirical study of the aftermath of passage of the Tax Reform Act of 1986). Kopczuk finds that the 1986 Act significantly "reduced the marginal cost of collecting a dollar of tax revenue, with roughly half of this reduction due to the base broadening and the other half due to the tax rate reduction," and concludes more generally that "behavioral elasticity is not an immutable parameter but rather ... [is] to some extent controlled by policy makers. One implication is that base broadening reduces the marginal efficiency cost of taxation."

²⁶ However, as I discuss in Shaviro (forthcoming), this is not to deny that enactment of a package in which base-broadening accompanied rate reduction both (a) made considerable political sense in 1986, though much less so today, and (b) can be a huge policy improvement where one has fixed revenue needs, and has been using a higher rate than would otherwise have been needed to offset the budgetary effects of an unduly narrow tax base.

100 percent, there is no serious dispute that the U.S. individual income tax is currently well below any such rate.²⁷ Again, base-broadening through the repeal of tax expenditures would make this even more clearly true.

(3) Relatedly, there is considerable consensus among economists that taxpayers' labor supply elasticity (i.e., work decisions' responsiveness to the tax rate) is generally extremely low. To be sure, there are specific groups whose labor supply can be highly tax-responsive – for example, married women, and people who still work at age 70 or above. However, the economics “profession has settled on a value for this elasticity that is close to zero for prime-age males.”²⁸ This makes it hard to argue that raising current income tax rates at the top of the distribution, whether or not good policy all things considered, would make people below the top rate bracket worse-off by reason of any indirect effects on them of reduced high-end labor supply.

(4) There is strong evidence in the economic literature that enacting tax rate cuts, even when fully financed by the repeal of tax expenditures or direct government spending, generally does not lead to a substantial increase in the rate of economic growth.²⁹ To be sure, well-executed and fully financed tax cuts can have small positive effects, reflecting the improvement in taxpayers' incentives.³⁰ However, unfinanced tax cuts that increase long-term budget deficits can actually reduce economic growth, due to the drag imposed by public debt issuance and the

²⁷ See, e.g., Saez, Slemrod, and Giertz (2009), reviewing the literature on the elasticity of taxable income. One of the best-regarded recent studies found that the revenue-maximizing tax rate would be as high as 80 percent if the income tax base were broadened. Gruber and Saez (2002).

²⁸ Saez, Slemrod, and Giertz (2010) at 1.

²⁹ See Gale and Orszag (2004) at 1193-1206 for a comprehensive literature review and discussion of theoretical issues.

³⁰ See, e.g., Auerbach (2002), finding that a tax cut that was immediately financed by reducing government consumption could induce a long-term 0.5 percent increase in the capital stock; Dennis et al (2004), reaching similar results in a similar scenario.

fact that economic actors generally are not stupid, and can see that future adverse changes are likely to be in the offing.³¹

More generally, U.S. “historical data show huge shifts in taxes with no observable shifts in growth rates.”³² For example, the extremely low-tax era of 1870 to 1912 had the same 3 percent annual growth rate as the relatively high-tax era from 1947 through 1999. Likewise, event studies of particular episodes when tax rates sharply increased within a short time generally fail to find any significant effect on the rate of economic growth. This lack of empirical verification is of course consistent with there being (as one would expect) *some* tendency of taxation to reduce economic growth, that merely has been drowned out by other “noise” in the comparisons that are being made. Nonetheless, “if taxes were as crucial to growth as is sometimes claimed, the large and permanent historical increases in tax burdens and marginal tax rates might be expected to appear in the aggregate growth statistics.”³³

Conclusion

My testimony has emphasized three main points. First, high-end income concentration has greatly increased since the passage of the Tax Reform Act of 1986. If one considers this trend undesirable, it could influence one’s views about tax rates at the high end of the income distribution. Second, tax expenditures often benefit higher-income relative to lower-income taxpayers, although, at the very top of the income distribution, usage tends to decline as a percentage of income. Thus, 1986-style reform, in which tax rate reduction accompanies tax expenditure repeal, has a tendency to redistribute after-tax income to the very wealthiest individuals. Third, tax expenditure repeal (if it occurs) should not be viewed as strengthening the case for tax rate reduction, even if one wants to limit the size of government. From an

³¹ See, e.g., Auerbach (2004), Dennis et al (2004); Elmendorf and Reifschneider (2002).

³² Gale and Orszag (2004) at 1206.

³³ Id.

economic standpoint, tax expenditures are spending through the tax code, even though they are scored as reducing “revenues.” Moreover, while tax rate reduction (if fully financed) can have efficiency benefits, base-broadening tends to reduce these benefits. The claim that Congress could raise revenue by cutting current income tax rates is clearly wrong, and the economic growth dividend that such a policy change would yield is probably modest at best.

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