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THE ECONOMIC PROBLEMS OF THE INCOME TAX SYSTEM

HEARING

before the

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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Thursday, March 13, 1997

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D.C.

The Committee met, pursuant to notice, at 10:05 a.m., in Room 2220, Rayburn House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton, Thornberry, Hinchey and Doolittle, and Senator Bingaman.

Staff Present: Christopher Frenze, Amy Pardo, Brenda Janowiak, Colleen J. Healy, Juanita Morgan, Mary Hewitt and Roni M. Singleton.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. In the interest of getting started on time and moving through the process here, let me just say that it gives me great pleasure to welcome each of you as witnesses here today before the Joint Economic Committee. This Congress, we have tried to make this a Committee that discusses issues in a substantive and less political way than has been the custom over the many years the JEC has been in existence.

Our job is, essentially, to look at Federal programs and try to determine how they positively or negatively affect the economic performance of our free-market system, or a system that we like to refer to as a free-market.

The Federal income tax system was introduced in 1913, and it makes me smile each time I think of its top marginal rate of 7 percent, and its personal exemptions that excluded the vast majority of Americans from paying income tax.

To many Americans these days, this kind of income tax structure would not sound so bad. However, our current tax system features much higher income tax rates and lower real exemption levels.

Furthermore, the current income tax continues the systematic bias against savings common to all tax systems. The general problem is that savings is taxed once as income and then the return on savings is taxed once again. This multiple taxation of savings has a variety of forms that can cascade upon one another.

It is true that the current income tax system attempts to soften the extent of this bias by curtailing some of this multiple taxation in a variety of ways, including limited Individual Retirement Account treatment of some personal savings. Nonetheless, the current system remains stacked against personal savings. By undermining personal savings, it also undermines investment and long-term economic growth as well as personal responsibility.

The rate structure and multiple taxation of savings and investment of the Federal income tax also hinders the entrepreneurship, innovation and creativity which are vital to the flexibility and the dynamism of a market economy. The incentive for entrepreneurial discovery leads to unforeseeable breakthroughs and innovations that would not occur in an adverse tax environment. The Federal income tax in a variety of ways impedes entrepreneurship and innovation in the economy seriously enough to limit long-term economic growth.

I often reflect back on discussions we have had about our country's income tax system. Until the early part of this century, we did not have an income tax system. Our country went through approximately 140 years without an income tax system. I wonder how the basis for our free-market system was encouraged during that period of time when we were free from the income tax system that we have come to apparently view as an inevitable part of American life.

A neutral tax system would not discriminate against savings or on the other hand, consumption in either case. It would not tax savings more heavily than consumption, but would tax them both in an unbiased manner. The additional layers of multiple taxation on savings would be stripped away to establish an unbiased tax treatment of saving and consumption. The larger pool of personal saving would increase the amount of capital available to finance capital formation and economic growth.

Recently I introduced legislation to address this imbalance. My bill increases the deduction ceilings for IRA accounts, raises income caps for deductible IRA contributions, and liberalizes withdrawals for all education and medical expenses, first-time home ownership, unemployment, and adoption.

This legislation would go a long way toward correcting the current defects in our current tax system. Much more would need to be done in the longer term, but this IRA liberalization would certainly be a good place to start.

This morning we are fortunate to have a distinguished panel of tax experts testifying before the Committee. Dr. Lawrence Lindsey, a former Governor of the Federal Reserve Board, served as a White House advisor and also a Harvard University professor. Dr. Norman Ture, currently President of the Institute of Research on the Economics of Taxation (IRET), has served as a high official in the Treasury Department, and also for many years on the staffs of the Joint Economic, and Ways and Means Committees. Dr. Barry Rogstad is chairman of the American Business Conference. And Dr. Lawrence Chimerine is managing director and chief economist of the Economic Strategy Institute.

I would like to welcome each of you here, and at this time I will turn to Representative Hinchey for any opening statement he may have. Maurice.

[The prepared statement of Representative Saxton and the IRA bill appear in the Submissions for the Record.]

OPENING STATEMENT OF REPRESENTATIVE MAURICE D. HINCHEY

Representative Hinchey. Well, thank you very much, Mr. Chairman.

First of all, I want to join you in welcoming this distinguished panel before the Committee today; and, also, I want to express my appreciation to you, Mr. Chairman, and, frankly, admiration for the way that you have conducted the business of this Committee during the brief time that you have been Chairman.

I say that because I think that you are really working with this Committee in the proper way and focusing attention on some of the most important issues currently confronting the Nation, and that, frankly, was what this Committee was established to do; and I really appreciate working with you in that vein.

This is a very important issue before us today, the influence of tax policy on the overall economy. There are some lessons, I suppose, to be derived from history, both recent history and that which is gone now by some several decades.

There is some contention that people are paying more taxes today than they were some years ago, but when you look at the facts related to the income tax particularly, what you find is that back in 1975, for example, people were paying -- an average family, median-income family, was paying about 12 percent of their income in income taxes. And today that is down to about 12 percent -- or down to about 10 percent, as a matter of fact. It is lower than it was in 1975 right now, and 1976.

However, payroll taxes, of course, have gone up very, very dramatically. They represented something in the neighborhood of 17 percent of income. Now they are up around 50 percent, or the increase is about 50 percent. It is very, very substantial, and that is what is taking a big chunk out of people's ability to maintain a reasonable standard of living.

We note also that in the last couple of decades, there has been an extraordinary increase in the disparity of not only income, but also wealth of people in this country. It is, in my view, frankly, a shocking condition, one which not only threatens the economic condition of -- economic prosperity of many Americans, but also, I think, threatens the foundation of our democratic society, because no democratic society has been able to sustain itself without a very strong middle class, and our middle class is shrinking as this great disparity of income and wealth decreases, and we see a greater concentration of both wealth and income in the hands of fewer and fewer people.

Whatever we can do with regard to tax policy in the Congress, obviously, Mr. Chairman, to address this problem would be helpful, and it is something that we ought to do; and I look forward to initiatives under your leadership which would attempt to address these problems. And I thank you very much.

Representative Saxton. Thank you very much for your very kind statement.

I also would like to welcome Representative John Doolittle to his first official hearing of the Joint Economic Committee. John was one of the Members who has consistently come up to me over the last few years and complimented us on our reports. So when we began to organize the Committee this year, he became a Member, and I would like to give him a very warm welcome.

Thank you all for being here, once again, and we are anxious to hear your thoughts this morning. Dr. Lindsey, would you like to begin.

STATEMENT OF DR. LAWRENCE B. LINDSEY, AMERICAN ENTERPRISE INSTITUTE

Dr. Lindsey. My pleasure, Mr. Chairman, and it is a pleasure to be here today.

I have one objective, if I could, and that is to try and clear up a very important but widely misunderstood confusion about the analysis of taxation. That is the confusion between the so-called revenue maximizing rate of tax and the so-called optimal rate of tax. I think that the confusion which exists in the minds of most people actually is leading tax and budget policymakers to legislate tax systems with rates which are excessive from the point of view of economic growth.

Oddly enough, I think it is many of the people who were most instrumental two decades ago in pointing out the problems that excessively high marginal tax rates had for both revenue and for the economy that may have contributed to this confusion between revenue maximization and optimal taxation.

I have a few figures here. If we could just look at Figure 1. This is one that is probably familiar to you all. It is called the Laffer Curve. It is named for economist Arthur Laffer. I think Laffer elegantly depicted an economic reality that economists since Adam Smith have recognized. That is, higher tax rates might not necessarily produce higher revenue. He noted what is good common sense: that at a tax rate of either zero or of 100 percent, the government would not collect anything; zero because there is no tax, and 100 percent because no economic activity would take place. He reasoned correctly that at some point between those two figures, revenue would be maximized.

Now, although Laffer never claimed that the revenue maximizing rate was the best one, or the optimal one, the construction of the Figure in the way the human mind works naturally leads one to think there is something good about being at the very top of the curve, the revenue maximizing point.

I think that Laffer's actual point was that being on the right side of that mountain that is beyond the point of revenue maximization is really just plain foolish. Not only were taxpayers worse off over there, but so was the government. The point had real policy relevance when he stated it because then we had tax rates up to 70 percent, and it is quite clear in retrospect that the top portion of the U.S. tax system was on that right-hand portion of the Laffer Curve.

Some analysts who also supported lower rates actually, I think, contributed to further confusion. For example, Jude Wanniski argued regarding the revenue maximizing point, and I want to quote, "It is the point at which the electorate desires to be taxed. It is the task of the statesman to determine the location of the maximum and follow its variations as closely as possible."

Well, on this issue Jude was completely wrong. Far from being desirable, the revenue maximizing rate is actually one which any statesman would want to avoid like the plague. As I want to show, only those individuals who care solely about the well-being of the Treasury and not a bit about anybody else would want to be at the revenue maximizing point.

If you will bear with me, I am going to revert to professor mode in order to suggest a different way of looking at the issue. I want to introduce the concept of the excess burden of taxation, and I do so on Figure 2. The figure depicts what I am going to term the demand for taxable income. It is like any demand curve in economics: it slopes downward. The idea is that as the price of getting taxable income falls, people want more of it. Well, what is the price of getting taxable income? It is how much tax you have to give the government in order to put the money in your pocket.

Now, note that at a rate of 100 percent, the taxpayer will choose to earn zero taxable income, just like the Laffer Curve suggestion, and at the zero tax rate, we would depict the amount of taxable income that a taxpayer would choose in the absence of any taxation.

Now, this, I think, is a useful analytic tool because it leads to an easy illustration of two important considerations regarding tax policy. The first is the idea of revenue. The government sets a tax rate, and the demand for taxable income curve shows how big the base will be at that rate. So the amount of revenue the government collects is simply a rectangle; it is the tax rate times the size of the tax base, and the rectangle is depicted there.

The second concept, and it is one that I would like to call to the attention of the Committee, is the excess burden of taxation. Excess burden is a very important concept in economic analysis. It is different from tax revenue. After all, paying taxes is a burden to the taxpayer. But from society's point of view, that burden is not really a loss in economic well-being. It is a loss to the taxpayer, but it is a gain to the Treasury.

Excess burden is the loss to the taxpayer above and beyond what he pays in taxes, and there is no offsetting gain to the government from this loss in well-being. The excess burden of taxation is shown by the triangle to the right of the revenue rectangle. And let me explain why we think of that as an excess burden.

What a demand curve shows is how much a taxpayer values a good. For example, if you have the demand curve for cars, the point of $5,000 would show how many cars taxpayers value at least $5,000. Well, the demand curve for taxable income shows how many dollars of taxable income taxpayers value at least as much as, say, a willingness to pay a 20 percent tax for.

Well, what do I mean by that? If I have -- I have a lot of choices about whether or not to take taxable income. I can work or not work, for example. And at some point I would rather spend time with my family than earn an extra dollar, so that extra dollar may not be worth a full dollar to me, it may be worth, say, 75 cents. Well, if I have to pay the government 30 or some other number, then all I am left with is 70 cents, and, gosh, earning that dollar may not have been worth that amount to me. And that is the idea behind the downward sloping demand for taxable income.

Well, what the excess burden shows is that if we set a tax rate, as we have here -- sorry not quite yet -- all those dollars that you valued less than the tax rate you are not going to earn, they are lost. You would have valued them at some amount if you had been able to earn them, but the tax rate was too high and discouraged you from earning them. You do not value them as much as the full value of your earnings.

So from the point of view of an economist, this is different than the loss to the economy. What the economy loses on that area of excess burden is dollar for dollar. So we are looking at something smaller than the foregone earnings of people, the foregone GDP; we are looking at how much people would value those earnings compared to what they did with their time otherwise.

Now if I could turn to Figure 3, I want to extend this to one other concept, and this is how to use the concept of excess burden in thinking about a tax. Now, suppose we were going to raise tax rates from T1 up to T2. We all know the government is going to collect more on whatever base remains. Now that is given by the box labeled A in the picture. We also know that the size of the tax base is going to shrink, and the government is going to have to give up some revenue because the tax base is going to shrink, and that is given by box B in the Figure. So how much more is the government collecting? Well, it is gaining box A and losing box B, and note the way I have drawn the picture -- actually the staff has drawn the picture. Box A is bigger than box B. So here is a tax rate hike that actually makes money for the Treasury.

Does that mean that it is optimal to raise those taxes? Well, that is an open question, because let's see how much the taxpayer is better or worse off. The taxpayers had to give up box B, sending that money to the government, but now the excess burden triangle has grown by box B, which goes to the Treasury, and that little triangle up there, box C.

So let's put it all together for some simple math. The Treasury has gained A and lost B. The taxpayer has lost B and lost C. Well, that is all we have to know. Is it a good idea or bad idea? It depends on your judgment. Depends on how desperate you think the government is for revenue.

What I suggest you use for tax analysis is the concept of marginal excess burden of collecting another dollar of revenue. How much does the taxpayer really give up in order for Uncle Sam to get another dollar in tax collections? In this case, the taxpayer has given up B and C for Uncle Sam to get A minus B.

Generally, this is going to mean -- in fact, this is almost always going to mean that social welfare has changed more, at least -- excuse me, private welfare has changed at least a dollar for every dollar gained in revenue.

Well, that is the theory. And as a former professor I always used to look for great examples to give my class of wrong-headed thinking, and I found one, and you have it in the testimony I sent up. It is from *The Washington Post*. I am not going to say whether I think *The Post* is often guilty of wrong-headed thinking, but this is a good example because it illustrates a point well.

The editorial says the Treasury -- they are talking about cutting rates -- the Treasury would lose from lowering the rates, but gain from higher volume. Well, so far they talked about this picture. They said the Treasury, by cutting rates, going from T2 to T1, would lose A but gain B. So far, so good. They understand the triangle very well -- excuse me, the picture very well.

The editorial goes on to talk about the Joint Committee of Taxation's estimate of the burden of the tax. That is what we were talking about before. They cite $100 billion as the amount the taxpayers would be better off over five years. And the JCT -- that is the JCT's estimate of areas B and C that we were talking about. They also estimate in the editorial foregone revenue of $11 billion. This is the JCT's estimate of area A minus area B.

Well, let's put it all together. The marginal excess burden per dollar of revenue collected in the tax change talked about by *The Washington Post* is nine dollars of burden for every dollar the Treasury collects, $100 billion worse off for the taxpayer for Uncle Sam to collect $11 billion more.

Now, *The Post* argues that this is a good idea. They argue that because these taxpayers who would have seen their burdens reduced are largely well-to-do, the government was smart to keep tax rates high. In *The Post*'s reasoning, it was sensible to make these taxpayers nine dollars worse off in order for the Treasury to collect an additional dollar of revenue.

The Post is entitled to its opinion, and it is a political judgment. I disagree with *The Post*'s conclusion. If the Congress genuinely is interested in improving economic well-being and fostering economic growth, taxes which make society nine dollars worse off to collect an additional dollar of revenue are luxuries we simply can't afford. But again, that is my political judgment. The more important issue, I think, is the analytical point. If Congress is going to consider how to build a better tax system, it must begin to consider this trade-off explicitly.

Note that this is going to be radically different than looking at the Laffer Curve. If you thought that the revenue maximizing rate was where you should head, then you have to agree with *The Post*. After all, the Treasury did gain from the higher rate. The revenue maximizing rate argument does not factor in the costs to society of collecting revenue.

It is a mathematical point, but at the very top of the Laffer Curve, it turns out the excess burden of dollar revenue collected is infinite. Literally by picking the revenue maximizing rate, Congress is saying it is willing to impose any cost on the taxpayer, any cost on the economy in order to collect more revenue, and, frankly, I don't think that is economically defensible, nor do I think any of you would care to defend such an argument in your district.

So my request today is for you to change your analytic approach and begin to consider how much you are imposing at the margin for maintaining today's higher rate structure. I think if you make such calculations the basis of your analysis, you will be doing the best job you can in maximizing economic welfare, and in the end, I think you will end up with a broader tax base and a lower tax rate.

Thank you, Mr. Chairman.

Representative Saxton. Dr. Lindsey, thank you very much.

[The prepared statement of Dr. Lindsey and the charts appear in the Submissions for the Record.]

Representative Saxton. As I had noted earlier, Dr. Ture at one time was a member of the Joint Economic Committee staff, and the JEC has benefited, from his wisdom over the years; therefore, we want to be sure you know how pleased we are to have you back with us today, Dr. Ture.

STATEMENT OF NORMAN B. TURE, PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. Ture. Thank you, Mr. Chairman. Let me return the kind words. When I was on the staff of the Joint Economic Committee, there were five of us, and we were not just in theory, we were literally nonpartisan because we had a Committee to serve, and there simply were not enough of us to be Majority or Minority, and on any randomly selected day we did not even know who Majority or Minority were. But I found my experience with the Joint Economic Committee to be one of the most fruitful in terms of passing my career as an economist of all the years that I have spent in the field, and I always look back on that time as one of enormous gain in my productivity, and I am very thankful for what the Committee did then for me, and I hope in some way, shape or form I reciprocate it.

Before I get into an oral summary of my statement, I want to call attention to some submissions to the Committee. One is a pre-published, pre-edited publication produced by my colleague Michael Schuyler. Dr. Schuyler has provided an evaluation of roughly 10 of the President's 50 -- 50 some corporate tax increase proposals. He has entitled this paper "Tax Increases By Any Other Name." The Administration, as you know, has called these proposal efforts to shut down corporate subsidies. What Dr. Schuyler shows in this paper is that subsidies are mostly in the eye of the beholder. But with respect to the substance of these provisions, each one of them will raise the effective marginal rate of tax on the returns on savings committed to one or another type of corporate activity and will raise the service price of capital, and therefore will have a deleterious effect on saving and investment.

This document, like all others produced by IRET, automatically goes to every Member of Congress and to select groups in the

Administration. And, so, when you receive this probably a week, a little bit hence, I invite your attention to it. You may not find it easygoing, but it should be helpful in evaluating the proposals that the Administration has laid before you in the budget document.

The second set are two little charts that were produced by my colleague Steven Entin while he was working with Jack Kemp on the Kemp Tax Reform Commission. They are efforts to illustrate in a very highly compressed form the application of the so-called -- what we were calling it at the time, inflow/ outflow tax, more familiarly known, I think, in the profession as a cash flow tax. I think the term "cash flow" is inappropriate because as virtually every businessman I ever talked to thinks of tax flow, it is what I have left after taxes plus my accumulated depreciation and capital recovery allowances, and that is not what we are alluding to here.

In any event, these charts illustrate the kind of tax which is developed in the formal statement that I have submitted to the Committee and Mr. Entin and/or I would be delighted to be responsive to any questions the charts may provoke, and we will try to answer -- to be helpful about the advantages of the kind of tax that we are proposing.

I want to, if I may, depart both from the formal statement that I had submitted and the summary of it. I don't want to give you an oral summary of my written statement. I want to talk to a different set of points.

I hope you will share with me my ongoing surprise about the fact that there is so little concern being reflected either in the media or in the daily activity of the Congress about the need, the urgent need, for tax restructuring. If you think back just a relatively short period of time, Mr. Thornberry, you had a splendid hearing a short while ago about why we need to address the deficiencies in the existing tax structure and why this is not something to be thought of as sort of a casual undertaking; this is big-time stuff.

What has happened? I do not have an answer for that, but I would say that nothing that I know of in the tax policy area that has occurred in the last six months or so has suggested that the tax law has become better. If anything, in the normal process of events, every passing day erodes a little bit more of the goodness of our tax system.

So if one were to identify, as I do in my daily work, what are the guiding principles that should tell us whether we have an appropriately acceptable tax system for an economy like ours that relies very heavily on the operations of a free market in essentially a free society, our question would be what is it that we should be doing to address the deficiencies in the existing system? Well, we ought to start out by saying what are those deficiencies? What are the principles with respect to which we should evaluate what we now have in hand?

Well, I would come up with the following conclusion. The core function of any tax in a free society is to tell all of us what government expects us to pay for the activities and services government will provide us. If government can't provide us that information, if our tax system can't tell us at the margin we want another unit of this, that or the other thing from us, or some Federal agency or something of that sort, if they cannot tell us that, they cannot give us any information about the price that we have to pay for it, it is a freebie.

The ultimate freebie, of course, is when the government finances by borrowing. Nobody wakes up in the morning and says, gee, I just incurred another "X" number of dollars of government debt. I wonder if it was worth it in terms of what I am going to get from the government for this, that or the other kind of activity. You don't know it. You just don't know it.

And even more, here is this bundle of taxes that we pay. We do not even know what they are. I defy anybody in this room to anybody in any room to tell me how much Federal gasoline excise tax did you pay last year. Did you buy gasoline recently? How much excise tax did you pay? You know, you are not allowed to know that? You cannot find that. How much payroll tax did you pay last year? How much income tax did you pay last year? And the real scorcher is how much corporate income tax did you pay last year? You did. How much?

So you have this whole bundle of taxes that comes to a substantial sum in the aggregate, and none of us have any idea how much we are paying in the aggregate and how much we are paying, each one of us, out of that total. So we have a tax system that gives us no really effective information about what the government says it wants us to pay for the activities it provides. That is deficiency number one.

Deficiency number two, everybody comes out on this, the tax system is unfair. In what respect is the tax unfair? I can never find anybody who will define fairness for me in a rigorous, operational way so that I know whether, if you gentlemen come up with some initiative to change the tax law, we are moving in a pro-fairness, anti-fairness, or who-cares way.

Well, as you all recognize, mostly the acid test of fairness that you rely on is if we adopt this initiative, how will it change the distribution of tax liabilities by income level? If it will shift more of those tax liabilities to the affluent, it is a fair move. If it will shift less or more to the poor, it is unfair. I find that completely analytically without basis and operationally invalid.

Number three, everybody complains about how complex, how enormously difficult it is and expensive it is to comply with the tax laws. There is no question about the fact that for a great many taxpayers, that is certainly true. The estimates of the dollar value of the time, paper and so forth that has to be dedicated to tax compliance, tax enforcement, tax administration runs into the -- depending on who is doing the estimating -- hundreds of billions of dollars. I don't have any idea whether the number is correct.

I do know that, almost without exception, the responsibility for this very high cost is assigned to the Internal Revenue Service, who are regarded as mischievous imps, or who are simply lying in wait to confiscate our property because we are trying to cheat.

The fact of the matter is, of course, that the source of complexity is the kind of legislation that the Administration and the Congress collectively put together, legislation which, for the most part, is so ambiguous and so difficult to interpret that the efforts of the Internal Revenue Service to make this implementable so that each one of us as a taxpayer can comply with the law, those efforts become just absolutely enormous.

What, in fact, the legislation does is try to particularize tax liability to every conceivable little variant in the situation, in the kinds of transactions of every kind of taxpayer you can think of. If you are talking about the vast majority of individuals who receive most of their income in the form of one or another kind of compensation, it is a relatively small matter. Their compliance costs are relatively small. Two-thirds, roughly, of individual tax returns do not claim itemized deductions, and most of the information that is needed to file that return can be easily taken from the W-2 that the employer provides, with some minimal amount of additional information.

If, on the other hand, you have as part of your compensation arrangement some sort of retirement income provisions, or if some substantial part of your income is derived from business activity, from your savings and investment, then complexity comes on you because, forthe reason I suggested, the law as legislated aims at every single differentiating detail and tailoring the tax liability thereto.

Finally, would anybody look at the existing law and say it even-handedly treats us in terms of our economic lives, how we conduct our economic affairs? We have a tax system which from the word go violates the neutrality standard. Let me define "neutrality" because it is a word that is thrown around a lot. It is much easier to throw it around than to define it.

When I used to give courses in public finance theory, sometime fairly early in the course I would put a challenge to my class: "Tell me what a neutral tax is." Design for me a neutral tax. Blank stare. A neutral tax by definition is one that does not alter any of the price or cost relationships that otherwise would prevail in an efficient free market.

Now, can you tell me a tax that would be perfectly neutral? A lot of head scratching. And by the time the term was over, we still had no neutral tax. The closest people would come would be a poll tax. That is on your head. Well, I said, you know, that does alter the cost of being alive or not. I did not ask you what your responsiveness would be to this change in relative prices, but you tell me a tax that does not affect the relative price. Can't do it. The question is not really, therefore, whether or not we have a tax system that violates neutrality. Every tax that has ever been designed does so.

The objective for policy is to make sure that that violation is minimized in terms of the law that you put together and that the economic consequences of those violations of neutrality are as little adverse as you can possibly construct.

What we have is a tax system that is so violently biased against saving and investment, against entrepreneurship, against risk-taking, against virtually everything that you could identify as one of the wellsprings of economic progress as to make you wonder, how did we stumble into this?

Well, I think the answer to that is the answer to how did we manage to get a tax system that is so unfair, that is so complicated, that is so this, that, and the other thing, and that so completely fails to do what taxes are supposed to do, price out government. The answer to that, I think, is we never came up with a definition of income.

From the time of the 16th Amendment to this very day, no legislative effort has produced a workable concept of income, not because that is impossible, not because you cannot conceive what income is in the abstract and how that abstraction can be applied in the design of taxable income. And indeed a huge amount of the effort that is summarized in my formal statement is directed at this very question.

We are in the process of trying to produce a new kind of tax which relies on a concept of income which is both common sense and practicable. It is not because we have never tried it, it is because we have never wanted to. We have always preferred ad hockery, and what ad hockery has given us is a tax system which when we look at it, we say is in every single respect, measured against every single one of the fundamental criteria and principles, unacceptable for a free society.

What I am suggesting is there is still the same urgency, if not even an accumulating greater urgency, than addressing the need for fundamental restructuring of our tax system. And, of course, I see occasion for coming here and urging that you get to work on it. Thank you.

Representative Saxton. Thank you very much Dr. Ture. Your statement was very thought-provoking, and I have a few questions for you, which I will wait until later to ask.

[The prepared statement of Mr. Ture, information and charts appear in the Submissions for the Record.]

Representative Saxton. Dr. Rogstad, please.

STATEMENT OF BARRY K. ROGSTAD, PRESIDENT, AMERICAN BUSINESS CONFERENCE

Mr. Rogstad. Thank you, Mr. Chairman. I appreciate the opportunity to appear before you this morning, and I really applaud the purpose of this hearing today.

As you have noted, our tax system, as configured today, has a major impact on the behavior of all households and businesses. It is essential that we understand the nature of those impacts as we look at near-term improvements as well as the more fundamental restructuring options in our tax system. And while these issues have been on your agenda and the national agenda for a long period of time, I would suggest that this is only the beginning of a very significant national discussion that I hope leads to a tax restructuring movement.

My remarks today are very much influenced by the fact that I spent the last eight years working with former Senator Sam Nunn and Senator Pete Domenici in the development of the USA, Unlimited Savings Allowance tax system. This has been the only fully articulated tax reform proposal. We rewrote the entire tax code in that process. This experience has caused me to focus on the main problems resulting from the current income tax system.

I share Norman Ture's frame of reference that when you are going to enter into this discussion, you really must start with enactment of the principles of fundamental tax reform. They provide the discipline to all of us as we seek to design replacement tax proposals or near-term changes. They give us some indication of the order of magnitude and direction of the issues that we ought to look at. And I find them particularly useful as we assess interim and marginal changes to the Tax Code to know whether, in fact, we are moving in the right direction or not. Let me just add some points to a couple of these attributes.

I think that, first and foremost, our tax system must raise the revenue that is sufficient to finance the government that we as citizens demand. We just have to have that. The notion that it is important in pricing out government services, as Norman noted, I share totally.

And I also think it is a very interesting question that that tax system has to include as many taxpayers as possible. Some of the tax alternatives that we are looking at have huge zero brackets. We must ask ourselves whether we want a tax system where 100 percent of our citizens are determining the size and scope of government, and a significantly smaller number are involved in paying the taxes for that government? I think this is a very core issue in our democratic system.

I think that Norman has fully defined the whole question of neutrality. It is terribly important. When we raise taxes, the objective here is to bring about the minimal amount of distortion to the behavior that would exist among households and businesses in the absence of a tax system; and it is really the issues of neutrality which I think are of primary importance as we look at the reasons for fundamental tax restructuring.

In my opinion, and you mentioned it, Mr. Chairman, the most important violation of that neutrality criterion in our current income tax system is this double taxation of the saving versus the consumption uses of our income. This highlights the importance of making sure we get the tax base correct. What it is that we are taxing? There is also no question that the neutrality criterion also applies when we tax income at different rates as well.

There are large neutrality issues that arise when we tax similar economic activities differently. I think a prime example is obviously the way we choose to tax residential owner-occupied real estate versus the consumption of real estate services of a renter. We need to ask ourselves what are we really doing in these areas from a fundamental tax policy design standpoint.

Norman mentioned that a good tax system should be simple to administer. I would add to that a bit and say it has to be understandable to our taxpayers. Our current tax system fails this test, and is scoring lower and lower with the passage of time.

There is intense anger among taxpayers. About 70 percent, of taxpayers are not taking deductions. And the statistic that I find most amazing is that within those 70 percent, 5 percent of those who file 1040-EZs and 27 percent of those who file 1040-As use paid preparers. These citizens have got to be frightened as the devil of the tax system, and they are looking for comfort here. I think we would all agree on the need to address this situation.

The real complexity on the code falls most heavily on businesses and upper-income Americans. Insofar as that complexity applies to wealthier Americans, there is a common perception among taxpayers of more modest means that that complexity favors the rich and near-rich by allowing them to lower their tax bill. We don't think everybody is playing by the same rules. And if that perception festers, it will undermine the willingness of citizens to participate in the philosophy of our current tax system, which is one of voluntary compliance. I think that is a huge issue.

We can talk about estate planning which is a particularly significant problem area, but I will defer in the interest of time.

I would like to comment on areas of complexity in the business tax code. The major issue in the income system arises from the current tax treatment of income from capital. When we begin to look at this with respect to the business income tax standpoint, you are comparing depreciation and expensing. The whole question of timing in the business tax system adds as much as 70 percent to the cost of compliance of business taxes. If, in fact, you removed accrual accounting largely by moving towards expensing of capital outlays, I think we would make substantial progress.

I think the taxation of foreign source income is another huge complexity in the system that is not offset by the revenues derived, and I have talked about that in my formal statement.

Fairness and equity are obviously the attributes of our tax system that are most difficult for our society to agree on. We all seem to share the view that the current tax system is not fair, but the reasons for that differ.

As an economist, I am very concerned about the efficiency of our market economy. I hold the view that from an efficiency (and neutrality) standpoint, all incomes should be taxed alike and at the same rate. Increasing marginal rates of taxation at higher income levels exacerbate the double taxation on saving and investment, and discourages additional work effort by our citizens.

The degree of our progressivity in our income tax rate structure is largely a political determination, however, and involves significant trade-offs among these attributes. And I would plead with you that as it is these trade-offs -- and we all have to make them -- where the debate needs to become much more focused and informed.

Let me now return to the core problem in our current income system: the double taxation of saving and investment. Mr. Chairman, you talked a little bit about the source of that double taxation. It applies to all forms of return on saving. It is particularly onerous in the sense that it is subject to multiple levels of taxation when, the uses of saving are placed in corporate equities. In this case, we have taxes not only at the personal level, but also the corporate income tax and the capital gains tax.

The question of do we want to double tax savings has its own answer to it. Saving is the tool in which people are controlling their own future and are going to achieve a higher standard of living. Saving is the activity that permits investments in new plant equipment technology as well as the development of skills in our citizens through investment in human capital education and training. It is the key to sustained economic growth. We don't want a tax system that is biased against saving, pure and simple.

I think we can obviously make short-term changes that help remove that double taxation on saving. As you pointed out in your opening remarks, we have many tax advantage vehicles in terms of IRAs and favorable treatment on pension plans and other tax-deferred saving vehicles. I think this is an important step, and I applaud your recent legislation in broadening the treatment of IRAs.

To me, a major goal, and indeed perhaps the major component of fundamental tax restructuring, is what I called an unlimited and universal IRA. Your bill is on a moving continuum, and as you said, it is a first step. In my world, I say we ought to have an unlimited deferral for the saving uses of income. When we put resources in the national saving pool, do not tax them. It is not in anybody's interest to tax them at that point. When we as citizens finally take that saving out of the national saving pool, that is the time at which it ought to be taxed, and the notion of an unlimited universal IRA does precisely that.

Advocating a deferral of tax on all saving raises issues of fairness and understandability. I think that every dollar of saving is important here regardless of who does that saving. It finances the capital that raises every worker's productivity and therefore worker's wages and standard of living. Everyone has a large stake, in fact, in the national stock of saving whether or not they personally own any of that saving at the present time.

There is a study that was just conducted by John Shoven on the question of the penalties of doing "too much" saving in IRAs, penalties in the form of the 15 percent excess accumulation and distribution taxes. I find it astounding that as we move towards removing some of the double taxation on saving through IRA-type vehicles, we are still legislating penalties for responding too favorably. I think that is an issue that I would ask you to look at further.

Let me, in the interest of time, just focus on one other issue: effectively removing the double taxation on saving under our current income tax system requires significant changes because the problem exists both at the individual level and at the business level. This raises the whole issue of integration.

The tax base is essentially net factor payments to labor and capital that are generated by businesses and received by households. You can conceptually tax all of those sources of income at the business level; collect 100 percent of the tax, and all distributions to households are then net of tax. You can, on the other hand, recognize that a business is not a taxpayer. It is a place where, in fact, citizens come together to bring their resources and produce goods and services for themselves. From this perspective, you can tax all of the factor incomes at the household level when they are received. Again collect 100 percent of it, and get the exact same revenue that you would at the business level.

Notice that this essentially eliminates the corporate income tax. If, in addition, you allowed an unlimited deferral for saving by individuals, there would be no merit to the argument that businesses saved and invested to escape income taxation.

You can, on the other hand, as we did in the USA tax system, struggle mightily to keep a tax collection point at both the businesses and the individual level. Attempting to maintain a business level tax provides very little net economic benefit, results in no greater revenues than either of the other options and is the source of tremendous complexity.

It is a rhetorical point. If we were starting over from the Garden of Eden, what is the kind of tax system we would have? Would we develop today on the basis of good tax criteria a business-level tax? I think it is a point I will leave with you.

Let me just finally add a sense of urgency to your proceedings. The major drive for tax reform to me is this question of the double tax on saving. I believe that Americans are becoming increasingly convinced that there is a saving problem. They are beginning to get this message both at the family and at the national level. They are realizing that the economic security of themselves and of all of our citizens, in part, depends on solving that saving problem. They are becoming more aware that the current tax system inhibits national saving and investment as well as their own capacity to assemble a nest egg. I think as this happens we are going to see increased pressure and advocacy for fundamental tax reform.

I think the increase in public awareness is happening while we are also discussing the "privatization" of social security, growth of non-means-tested entitlements. The message that is coming to our citizens is one of increased personal responsibility, which translates directly to saving behavior. In this environment, making our tax system more saver-friendly will become a top congressional priority.

I don't think there is a silver bullet to answering the questions we are talking about today. I think there is a huge opportunity to make some real progress in improving the tax regime of our nation. And personally, speaking for myself and members of the American Business Conference, we look forward to working with you and your colleagues in Congress to achieve this goal. Thank you.

Representative Saxton. Thank you very much, Doctor.

[The prepared statement of Mr. Rogstad appears in the Submissions for the Record.]

Representative Saxton. Dr. Chimerine.

STATEMENT OF LAWRENCE CHIMERINE, MANAGING DIRECTOR AND CHIEF ECONOMIST, ECONOMIC STRATEGY INSTITUTE

Mr. Chimerine. Thank you, Mr. Chairman. And I, too, offer my congratulations to you on assuming the chairmanship of this Committee and the bipartisan approach that you are taking. It is nice for me to be back in front of the Committee.

I have prepared a fairly lengthy statement which I hope will be included in the Record. I would like to be very brief this morning, and particularly avoid repetition and not cover some of the same ground that has been covered by my colleagues here on the panel. So what I would like to do is to focus on some of the current issues and also some of the current considerations and conditions which I think are most relevant for setting tax policy and making the decisions you are going to have to make, particularly as part of the budget process, but on all tax issues during the next several years. I think in some sense some of these have been misunderstood, and as a result I think a review of these might be useful to the Committee.

First, I would like to put in perspective what is happening now in the macroeconomy, because some people who are advocating huge tax changes, huge tax cuts, have done so based on the argument that economic growth is now anemic, to use a word that has been used by others. The comparison is frequently made that over the last several years the economy has been growing at somewhere in the 2-1/2 percent range, which is below the rate of increase in previous recovery periods, and is certainly below the 4 percent plus underlying rate of growth in the 1950s and 1960s. And this point is driven home regularly as a reason why the economy is underperforming, or as an indication the economy is underperforming. Some claim we need to change things dramatically, and big tax cuts frequently become the recommendation.

I think that this is a very misleading comparison. And while I agree we certainly have some economic problems, and we probably can do a little bit better, nonetheless a significant part of this slowdown in economic growth that we have recently experienced is explainable by demographic and other factors, and it is going to be awfully difficult, if not impossible, to go back to the 4 percent growth that we had in the immediate post-World War II period.

First of all, what has happened in the 1990s is not just a 1990s phenomenon. The rate of economic growth has slowed on a trend basis for the last 20 years or so, and, in fact, the 1980s was the slowest growth decade since World War II, even though we had a fairly long expansion in the middle of that decade. So this is a phenomenon that has been in place now for about 20 years.

As I mentioned a moment ago, there are some factors that explain it that have nothing to do with taxes. Population growth has slowed dramatically. Labor force participation rates, particularly for women and other demographic groups, after rising dramatically for many years have now leveled off. Average educational attainment levels seem to have leveled off after growing rapidly in the earlier postwar years. In my opinion, this is one of the reasons why productivity growth has slowed down.

When you take these and similar kinds of factors into account, had everything been the same, economic growth in the last 20 years would be at least 1 to 1-1/2 percent lower than it was earlier, again having nothing to do with other factors that affect macroeconomic performance.

Plus, evidence is accumulating that we are understating the rate of economic growth right now. In fact, the issue of whether we are overstating the Consumer Price Index at the same time is an issue of whether we are understating economic growth. And the anecdotal evidence, such as the rise in the stock market, the growth of corporate profits, and a number of other factors suggest in particular that productivity growth, while perhaps not as strong as it was 20 and 30 years ago, nonetheless in reality is greater than the rates that are being estimated as part of the government's statistics, and overall economic growth is also doing somewhat better than estimated.

So while I believe we need some tax changes, and I will get to my recommendations in a moment, I think it would be a mistake to believe that things are so bad that, you know, we should do anything and take any kind of risks, because that is not the case. As I did mention a minute ago, there are some economic problems, particularly slow growth in wages and the income inequality that Congressman Hinchey mentioned, and I will get back to those in a moment. But overall, economic performance is not anemic and certainly does not warrant drastic policy changes.

Secondly, the biases in the tax system against saving and investment are well-known. They have been stated by my three colleagues here this morning, and some of the other biases in the system and problems in our tax system again have been discussed over and over. However, I think it is also important to recognize that the impact of tax changes on economic behavior are frequently overstated, and it is a problem. All of us in this profession have probably done it from time to time.

I think that if you look carefully at the experience of the last 30 or 40 years, you conclude that at the margin tax changes can have an impact, but some of the huge impacts that have been predicted by many just don't square with actual events and actual performance, and there are a number of examples.

For example, my own view very strongly is that most of the supply-side effects in the 1980s were hugely overstated, and I think that a review of that period clearly demonstrates that. I can also remember 3-1/2 years ago, when the Clinton economic plan was put in place with the increase in the top marginal tax rate, and doom and gloom forecasts were commonplace that this would trigger a downturn and lower saving and lower investment. Exactly the opposite has happened. In fact, we have had the strongest investment-led recovery in the last 3-1/2 years than we have had at any time in at least 30 years. Investment has been rising very rapidly. The stock market seems to reach a new record every day, or at least the days on which Alan Greenspan does not give a speech or testify.

New business formations have been setting records. Even the saving rate has edged up in the last three years after trending down for 12 or 13 years. So it is hard to make the case right now that tax rates are so high that they are discouraging investment and innovation in view of how the economy is performing. And, of course, marginal tax rates were much higher in the 1950s and 1960s when the economy grew much more rapidly than it is now.

So we have to be careful about not overstating the impact of tax changes, particularly broad tax changes. And along those lines, and I think my colleagues here would agree, we have to be especially careful about not claiming that tax cuts pay for themselves. Very few tax cuts pay for themselves. Most of them do not even come close, and we have to accept that.

Third, I think we have learned in recent years that deficits matter and that the decline in the deficit, by helping to bring at least nominal interest rates down. In recent years, and increasing national savings (and reducing the budget deficit, is still the most reliable way we have for increasing national savings) has contributed to the investment boom we have had in recent years, and we should not ignore the affect of tax changes on the deficits.

I think it is particularly important now because despite the debate on whether we should balance the budget in the year 2002, the really important deficit issue right now is the longer-term problem, because even if we balance the budget in five or six years, the deficit outlook in 15 or 20 years deteriorates very, very badly. We are going to be looking at huge deficits at that time. It will make the last 15 years look quite small by comparison because of the increase in the health and pension entitlements being driven by baby boom retirees during that period. So the deficit outlook is extremely poor, and we should avoid doing anything that is going to increase those deficits in the long term.

We are going to need huge spending cuts to come even close to addressing those as it is, and the last thing we can afford now is more revenue loss from a long-term perspective.

Fourth, just two comments about spending. Cutting spending is fashionable, and I am a big supporter of reducing deficits by cutting spending. But not all spending is equal. There are some spending programs that are important for investment programs. Unfortunately the ones we have been cutting most in the last five or 10 years, education, infrastructure, research and development, export promotion and so forth, do impact productivity and economic growth, and it is counterproductive in some cases to cut tax rates and pay for that in spending cuts in these areas when, in fact, the net impact might be unfavorable for economic growth.

Fifth, I strongly support the comments made by Congressman Hinchey. I think the distribution of income is a serious economic issue. It is not only a fairness issue, it is an economic growth issue. I am not supportive of a system where everybody has the same income, or in which we have punitive tax policy that goes too far in equalizing the distribution of income. But I also believe, as Larry Lindsey said earlier, that the world is not linear, and going too far in the other direction, where the distribution of income and wealth becomes too unequal, becomes counterproductive, because purchasing power becomes too heavily concentrated, and that is not helpful for long-term economic growth either.

And clearly -- well, at least in my opinion, the evidence clearly shows that the distribution of income has gotten much more unequal in the last 15 or 20 years, partly as a result of changes in the distribution of tax (although, mostly for before-tax reasons), and I think we have got to be careful not to aggravate this problem with tax changes in the future.

Sixth, I urge the Committee to avoid moving to dynamic scoring. That is an invitation for abuse. But if you do so, you also ought to do the same on the spending side, because when you cut spending programs, there are also dynamic impacts from that on economic growth and on tax revenues. And if we do that, it is going to be a repeat of the 1980s when we essentially assumed our way out of deficits by very optimistic forecasts, and I caution the Committee against that.

What should the Committee focus on, or the Congress and the Administration focus on? In my opinion, the objectives have to be more saving and investment, but also shifting the investment mix, because, in my judgment, this country has become much too short-term-oriented. The focus is much more now on mergers and acquisitions, short-term investment paybacks, cost-cutting investments etc., and has moved away from some of the risk-taking, patient capital, long-term investment that I think do stimulate economic growth. And, in my opinion, some of the tax changes that ought to be considered are those that not only will generate more saving and investment to the extent possible, but also will produce a shift in the mix more toward productivity-oriented long-term investment.

One tax change that I would rule out that doesn't meet this criteria, in my opinion, is a large broad-based income tax cut such as was proposed a year ago. With the economy close to full employment, this would do nothing more than push up interest rates, and widen the deficit in the long-term by feeding on itself through higher interest expense. The national debt is so large now that anything that pushes up interest rates has a big adverse long-term effect on the deficit because higher interest becomes a bigger part of future spending. And it will aggravate the income distribution problem so I think it ought to be excluded from consideration.

I feel strongly that a large across-the-board capital gains tax cut also is misguided at present. It is a windfall on old assets. It will significantly increase the deficit in the long-term. Effective capital gains tax rates are already quite low, given the fact that many pension funds and others don't pay taxes and that capital taxes are not paid as the income is accrued. And most studies that I have done indicate very little impact of broad-based capital gains cuts on savings and investment. I am also opposed to a flat tax because it is too regressive. I share the support for Nunn-Domenici Saving Exempt Income Tax. I think that is far better than a flat tax, primarily because the flat tax would dramatically worsen the income inequality problem that we talked about earlier.

What would I do? I would consider targeted, cost-effective tax cuts that are aimed directly at saving and investment and the investment mix. Those are the only things we can afford. And if they are targeted and impact behavior at the margin, we can affect savings and investment rates with a relatively small budget impact, and in particular we can shift the planning horizon and the decision-making horizon, to stimulate long-term economic growth.

For example, I have been pushing for a long time for a sliding scale capital gains tax structure, in which where we either leave alone or even raise the rate on short-term gains and reduce the rate the longer the asset is held, maybe even making it zero if you hold the asset for five or six years.

If we are really going to shift the investment horizon in this country, we need a big differential on the rates between short-term gains and long-term gains. Cutting it across the board won't do that. Something along those lines, in my opinion, would be more effective.

Going back to an investment tax credit and, in fact, making it an incremental tax credit (i.e., on increases in investment only) so that you don't lose revenues for investment that probably would have been made anyway in my opinion is also a far superior alternative than broad capital gains tax cuts for stimulating investment. Rejiggering the alternative minimal tax for corporations would be another thing to look at.

A change in tax deductibility for interest on mergers and acquisitions, and a number of other targeted tax changes of this type that at the margin might help savings, but more importantly will shift the investment mix and the investment horizon, in my judgment is the best way to stimulate long-term economic growth without widening the deficit in the long term. This would be counterproductive and probably offset whatever gains you get from most other tax cuts.

And finally, let me again share my support for Nunn-Domenici. In my opinion, over time we ought to consider tax reform, partly for simplification, partly for the other reasons mentioned by my colleagues this morning. In my judgment, the USA tax is far and away the best tax reform proposal on the table. In the long run, it is the best way, in my judgment, to increase savings. And secondly, its current expensing of investment provision, is probably in the long run the most, or one of the most, effective ways to stimulate long-term productive investment.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Chimerine appears in the Submissions for the Record.]

Representative Saxton. Thank you very much, and thank all of you for your thought-provoking statements.

There was broad agreement, it seems to me, among our first three witnesses today, and perhaps a different point of view from Dr. Chimerine. Let me try to ask this question, and if you can give us a brief response to it, we would appreciate it.

Many of us in Congress have been under the impression that tax policy we enact from time to time has a very significant impact on economic growth. And the question that all of us have had that Dr. Chimerine just spoke about is: What is it that has caused 2 to 2-1/2 percent growth during this period of expansion that started in the last quarter of 1991? This question is very important for us to contemplate. I am interested in what you think has happened during these years.

I ask this because we had a rather significant tax increase in 1990 and another fairly significant tax increase in 1993. Is it a coincidence that this slower rate of growth has occurred subsequent to those tax increases, or do we read too much into that?

Dr. Lindsey, why don't you start, and we will work our way down the line.

Mr. Lindsey. Let me begin by saying that I do agree with what Larry Chimerine said with regard to one aspect. I don't think that taxes create miracles. I do think that they have an effect. I think we probably agree with that exactly. You can get another 2- or 3/10 or 5/10 of a percent on a growth rate. On the other hand, I think that is probably the right order of magnitude from tax policy change, it adds up. Add a half a point of growth to the growth rate of the economy, and a child born this year will have an additional $300,000 consumption over his lifetime. Now, that is from half a point.

So do I think that tax cuts will go from 2-1/2 to 4? No, I don't think that that is the right order of magnitude. But I do think every tenth counts. There is no magic in this world except for compound interest. And I would urge Congress to again focus -- there is no point in using the fact that you won't go to four as an excuse for saying that we cannot have as efficient a tax system as possible.

Mr. Ture. I always find it delightful to identify areas of agreement with people whose philosophic and analytical approach I know going in is going to differ from mine. So it was very pleasant to hear the first of I don't know how many minutes' worth of Larry's observations -- Larry Chimerine's observations -- yours, too, of course -- about let us not overstate the nature or magnitude of the impacts of public policy changes.

I have alienated a lot of my friends in the conservative community by dressing them down when they talk about inconsequential changes in this, that or the other tax provision as being the absolute sine qua non for turning us on to a great big growth path and solving all of our fiscal and so forth policies.

I think public policy initiatives should not be disregarded. They do exert an influence. The influence is at the margin. The influence may be what we hope it to be. It may be entirely different. And I think that is essentially the point that Larry was trying to make.

We should always be looking for tax changes that go in the right direction; that is, in the sense of reducing the distortionary effects of what we now have in the law. And, boy, we have opportunities galore for doing that. In fact, it is almost impossible to think of a legislative session without being able to identify some kinds of tax changes that would make life better rather than worse. But you should not look for these to produce, say we are going to have one of 4 to 4-1/2 percent, instead of a growth rate of 2 to 2-1/2 percent.

One of the things that economists should do, and they do not do, and they do not do it well enough in their communication with policymakers, is to try to explain to them some rudimentary facts of life, fundamental determinants of how fast the economy is going to grow, how rapidly those factors of production which account for most of the total output of a society, that is human capital, call it labor, whatever you wish. Most of that is going to depend upon what is the rate of growth of capital relative to the rate of growth of labor services.

Without getting into a long dissertation about what determines the rate of growth of the capital labor ratio, let me just assert that when that capital labor ratio begins to slow, its growth begins to slow, you should confidently expect that the rate of growth of total output is going to slow.

We have been on -- as Larry pointed out, we have been on an investment kick since, I guess, late 1983; I do not remember the date, roughly then. And though there has been significant change in the composition of the additions to our stock of capital, human and nonhuman, human being particularly important, you would have to be blind, you would have to close your eyes to what is happening in the economy not to recognize that this has been a phenomenon. Now, how long does that go on?

Well, at some point the opportunity cost of the incremental saving and capital formation, irrespective of the form it takes, is going to be so high that we are going to reduce the rate of additions to the stock of human and nonhuman capital. When that happens, the growth rate is going to slow.

I will lay on the table for you my handy dandy little completely informal forecast. I think we are at the point that before this year is over, we are going to recognize we will have probably peaked, and we are going to rest for a while. That resting may be associated with what the National Bureau of Economic Research will come up with as a recession. I hope not, but it would not surprise me for a moment.

I think you look back at the numbers that we have accumulated on this, what has been going on for two decades now is phenomenal. Bill Gates notwithstanding, we are not going to continue doing this forever and forever. So we are going to slow, and we will survive the slowdown, but it should not be an occasion for saying, let us rush forth and do some great dramatic things to stimulate investment or stimulate this or stimulate that. It should be perceived as an opportunity to look at the fundamental deficiencies in our tax laws and say, let's address them. I can't think of a better opportunity than that.

Representative Saxton. Thank you.

Mr. Rogstad. Let me add to that by making a distinction between levels and rates of change.

First of all, let me note that when I talk about tax policy attributes and the neutrality criterion I think I would differ with Larry Chimerine here. I become much less interested in stimulating certain types of investment as making sure that there is not a bias in the code at the moment against the allocation of saving and investment resources that markets think is correct.

I can go back and look at any particular piece of tax legislation and say, did we worsen in that piece of tax legislation the cost of employing a resource that we think is related to economic growth -- saving, investment, what have you? And so I look back and I think you can make the kind of historical assessment that you are implying here by doing that.

Removing those biases will change the rate of growth, the rate of investment over a period of time because you have just made the activity more attractive. Economic players are going to say, yes, I will now do more of that, since you have lowered its price. How long does that go on? It goes on until they are satisfied with the new level of activity. Notice what exists after those biases have been removed, and economic players have adjusted their behavior. We have a higher level of capital stock; we have a higher level of productivity from which to start and continue a future rate of growth. That rate of growth and rate of saving -- the rate of, not the level now -- could be precisely what it is today, but the economy and citizens and households are at a much better point because they are starting from a higher base. So I think it is terribly important to draw that distinction when we are forecasting at rates of change.

I would reinforce what both Dr. Lindsey and Dr. Chimerine said: The notion that we ought to pooh-pooh 30 or 40 basis points change in our growth rates that would be achieved as a result of good tax policy. In a seven trillion dollar economy this represents very large dollars, the importance of which should not be minimized. We ought to be very careful not to dismiss that at all.

Mr. Chimerine. Mr. Chairman, could I just make a couple of comments, and I will be quick. First, I think all of us now have essentially agreed that we are talking about tenths of a percent. They are important tenths; 3/10 or 4/10s a year in 20 years adds up to a huge amount, and all of us believe that is important. We may differ slightly on how to get there, but I think that by itself it is very important, because as you recall, there were some people that were talking about doubling the growth rate during the debate on tax changes. This creates expectations that cannot be fulfilled and are counterproductive, and I think hurt the debate.

Secondly, given the fact that things are not all that bad, I think the first principle should be to do no harm. Taking big risks and putting in place risky tax changes that we are not certain of, in my opinion, is unwarranted. It might be warranted if we were in 1929 or 1930, but it is not right now.

And third, the tax biases that everyone here has talked about also affect the investment mix. I think Norm mentioned that we have had an investment boom in this country, or certainly rising investment, since the 1980s. However, during the 1980s, most of it was in office buildings and hotels and shopping centers, many of which sat empty for a long time. Investment in equipment in the last three or four years has been far stronger than it was during 1980's. And I think we all agree, or at least I feel, that there were biases in the Tax Code that encouraged some of that overbuilding during the 1980s, and that it was not the, productivity-oriented kind of investment that we would like to encourage. So the biases affect the level of saving, the level of investment and the investment mix, and I think all of them have to be addressed.

Mr. Ture. Mr. Chairman, can I offer a very brief comment going back to something that Larry addressed earlier. He is obviously a pro-target guy. He is a biggest bang for the buck kind of guy. I want to register as clearly as possible that that is as diametrically opposite as can be to the position I take. I want an institutional environment in which there is as little exertion of bias in favor of this, that, or the other kind of capital formation as you can construct. I want it to be freely transacted decisions among free transactors in a free market the outcomes of which determine what kind of capital we get, and in what quantity, and over what period of time.

Let me correct the numbers. It may very well have been what Larry or what somebody else regards as an excessive amount of shopping malls and apartment and so forth construction in the early 1980s, but you take one quick glance at what happened with the mislabeled Tax Reform Act of 1986 and ask anybody in the real estate industry and associated activities was this pro or was this anti-real estate expansion. It was one of the most viciously anti-industry legislative developments. I mentioned to my friend Larry that I have been working in taxes in Washington since 1951. I have never seen the like of the Tax Reform Act of 1986. I really did not believe it could be enacted it was such bad legislation.

Representative Saxton. Thank you.

I would not deny Dr. Lindsey the opportunity for a brief statement here, at the conclusion of which we are going to have to go vote, and then we will hurry back.

Dr. Lindsey.

Mr. Lindsey. I will provide the numbers to the Committee, but I do think it is important to recognize the national saving rate has fallen in the last three years, it has not risen. Even though the budget deficit has come down, by any of the measures the national saving rate, 1993, 1994, 1995, were well below what they were even 10 years ago, which was supposed to be a notoriously low national saving period. And I would be very happy to provide the numbers. They come directly from the Bureau of Economic Analysis, Commerce Department. We have experienced a low national saving rate in the last three years.

Mr. Chimerine. Mr. Chairman, could I quickly respond?

Representative Saxton. You can respond, but I am going to leave. In the true bipartisan spirit --

Representative Hinchey. I would like to hear the response, if you would.

Representative Saxton. Excuse me. We are going to go vote, and while we are gone, you may respond. Senator Bingaman will stay here and ask a few questions.

Mr. Chimerine. The national saving rate is still low. It is lower than all of us would like to see for long-term economic growth. But the big decline in the national saving rate was in the 1980s, when both the personal saving rate dropped sharply, and the deficits were huge. In the last three years the deficit has come down sharply, and the personal saving rate has stabilized, or actually has edged up somewhat.

Mr. Lindsey. I will provide the numbers.

Mr. Chimerine. The numbers I look at show the national saving rate has edged back up.

OPENING STATEMENT OF SENATOR JEFF BINGAMAN, RANKING MINORITY MEMBER

Senator Bingaman. [Presiding.] We would be glad to have you give us the specific numbers, each of you. But the concern I have is that this whole issue of what we ought to do about taxes in this Congress comes up in the context of a bipartisan agreement to get to a balanced budget by 2002. And I see all of the proposals for reducing the amount of revenue coming into the government as creating an obstacle to meeting that goal. Now, that may not be right. There may be ways we can reduce revenue to the government and either offset that revenue from another source or offset that revenue with spending cuts which are not detrimental to our economic strength. I guess I am just not clear as to how much can we reduce revenue and still achieve a balanced budget. Or is there another goal different from stimulating growth?

Mr. Ture. I love your question. And I will tell you why I love your question, because what you are doing is finessing what I regard as the least consequential matters that come up when we talk about budget policy. Those least consequential matters are what are the numbers, and what year do those numbers materialize? I don't think it has anything to do with budget policy. What budget policy should be concerned about, whether you mean it in this respect or not, when you put your finger right on it, is what does that budget encompass in terms of the activities that the government undertakes, to what purpose, at what real cost of resources to society, and so forth? How do we go about making those decisions efficiently if, in fact, we treat the revenue inflow as something entirely different from, which is what we have been doing?

I don't care what your political ideology is, across the entire spectrum, from the far right to the far left, we look at this as, well, what is the appropriate amount of taxes for us to collect in the interest of this, that, or other kind of economic something or other? Wrong. What we should be doing is say, what kind of taxes and in what volume do we need in order to provide effective discipline on decision-making about what the government does and how it does it and in what body.

Senator Bingaman. As I said, I think we are pretty close to a bipartisan agreement as to the amount that is to be spent by the Federal Government over the next five, six, seven years, at least to the year 2000. We don't have a budget agreement yet, and we will obviously have major arguments about how we spend that money. But the total dollar figure that we are expecting to spend is in reasonable agreement, and where we seem to be in major disagreement, as far as I can tell, is how much revenue we can forego. I see Senator Lott's bill, Senate Bill 2, which foregoes a lot of revenue, two or three times as much revenue as the President's proposal foregoes. I don't know how we do that and still get to the balanced budget myself.

Mr. Ture. If I were sitting where you sit, I would raise the question with Senator Lott or anybody else, to what purpose do we introduce those taxes? And I know what the answer is going to be: We need it for economic growth, this, that, and the other thing. And my response would be, no, but you are missing the point. We are talking about budget policy. There are huge numbers of things we can do to remove barriers to economic growth way beyond just cutting taxes in some particular way.

Senator Bingaman. But, for example, this across-the-board capital gains tax cut which has been proposed seems to reflect a major division in the Congress. We are going to have lots of votes on that as to whether we ought to bring the capital gains tax down to 19 percent, I guess.

Larry, I understood your comment to be that you think it is a mistake to do that; you think it should be a targeted capital gains cut, which should be forward-looking, and which should only reward investment in capital in the future and productive investment.

Mr. Chimerine. Senator, let my very quickly address both your points. First, in my own opinion, we ought to minimize any tax cuts as we go forward because they will make it more difficult to balance the budget in 2002. I am not sure why that was the year selected to balance the budget, but now that is the goal.

And secondly, it will aggravate the long-term problem. And I am particularly concerned about the across-the-board capital gains tax cut because, in my opinion, it will be a huge long-term revenue loser, especially in the outer years when the deficits will already be rising sharply unless we reform the entitlements.

And, in my judgment, it will have very little impact on saving and investment and economic growth. It is a poor way to give away revenues, in my opinion, from the standpoint of economic growth.

Mr. Ture. I think that addresses the question of what to do about capital gains tax issues in the wrong context. You don't want to be reprised of years and years of discussions of what is the matter with the current treatment taxation of capital gains.

Senator Bingaman. And I understand Dr. Rogstad's point that we should not have corporate taxes, and perhaps a lot of these double taxations should be eliminated from the system.

Mr. Ture. I treat that as a given, but we live in a world with constraints, and one of the constraints is that you can't just automatically and instantaneously have the better tax bill we all want. Something should be done about capital gains because the existing system is not only anti-save, but also has an extraordinarily deleterious effect on the functioning of the financial markets, the result of which is it gives you valuations -- relative valuations of stocks that bear no relationship to the reality of what the underlying real worth of a corporate entity is.

We really need to reform the tax treatment of capital gains. Question: What are the alternative ways of doing it, the criteria that you think are relevant? I will suggest to you, rollover. We have rollover in the existing law with respect to personal residences. We have rollover in like-for-like property exchanges. The underlying principle for rollover is you keep your investment "in corpus" rather than pulling it out of accumulating stock of capital to finance current consumption, and we are not going to tax the transaction that generated decrease in the stock of capital. The moment you violate that, you will pay the tax. See, that comports with fundamental principle.

Senator Bingaman. How much loss of revenue does that involve? I agree with you in theory that this is a good thing to do. It will stimulate more saving. But given the practical constraints we are operating in, that is trying to get to a balanced budget in five years, how much loss of revenue is involved?

Mr. Ture. Well, if I gave you a number, I would immediately say, don't rely on it, but I would suggest, here is the context in which you ought to ask a technician to generate a number for you.

The rollover proposal would do the following things for you: One, it would certainly increase the volume of transactions in capital assets, but what fraction of them would, in fact, be taxable because we used them to finance current consumption rather than just being rolled over into other investment I could not tell you.

Two, it would certainly instantaneously increase the valuation of all existing capital assets because the potential tax withdrawal will have been reduced by -- you know, the technician tells you how much that is.

And three, because it reduces the effective rate of saving and capital formation. Unless you assume that people have very, very funny preference functions, you ought to assume that there will be an increase in the amount of saving, and an increase in the amount of investment compared to what there otherwise would have been. Order of magnitude of that increase, again, ask the technician to tell you. I cannot.

Senator Bingaman. Doctor Rogstad.

Mr. Rogstad. Let me make a slightly different point. Given a revenue target that you are forced to work in the reality of a budget process, I think that these discussions take you very rapidly into a world of fundamental tax restructuring. Ever since Gramm-Rudman-Hollings, there has always been, in a sense, an offset. Any idea that you or your colleagues come up with needs an offset in terms of revenue. This process puts such constraints on the choices that you even are able to examine that you can't get outside the box.

And I think that one of the things we did in the USA tax is to recognize as a necessary starting point to assume it is going to be revenue-neutral. Are the rates going to be higher because it is revenue-neutral. You bet. But you are counting from a known point of departure here, and I think it allows you to then say, what are the trade-offs? There is the issue in the USA tax system of unlimited deferral of saving. If this has merit, we need to be able to analyze the tradeoffs involved in achieving this objective.

We have been talking here about how do you influence risk-takers, long-term investment and patient capital, stimulate entrepreneurship, et cetera. To me an unlimited deferral of capital gains, indeed abolishing it as capital gains and treating it as ordinary income with a zero basis, is the way to go. When you take it out of the national saving pool, is the right time to tax income.

I work for growth companies. You have talked with them. Lengthen their time/investment horizon and make sure that cost and availability of capital is as low as we can allow it through a balanced tax system and they will respond. It is not the existence of specific incentives in the code that really matter, it is getting the basics correct.

I want to focus on that in particular. I think the issue here is how do you, from a process standpoint in Congress, establish and allow a discussion that allows you to look at some options and, yes, on a larger scale than just marginal increments to the code that we are forced to talk about at the moment, where you can say, how could we achieve this? And I think it is a different issue than current budget policy because you can make tradeoffs that include alternative revenue levels.

Senator Bingaman. Larry.

Mr. Chimerine. I have one quick follow-up. I happen to agree with Norm, and I think Larry does, too, that capital gains, if they are reinvested, should not be taxed; if they are consumed, you should tax them. And that is one of the great features of Nunn-Domenici. But as Barry mentions, the proposal was designed to be revenue-neutral, so you are not widening the deficit by incorporating that provision.

If you were to do that now in the absence of broad-based tax reform, you are going to lose revenues, and, you know, that hurts national savings, and it is not clear you are going to be better off, particularly if I am right that the effect that it is going to have on saving and investment is very, very small.

Unfortunately, you not reforming the Tax Code now. I wish you were, and all of us wish you were. You are having to make these decisions individually on an ongoing basis individually, and I think the revenue loss issue is very important. And at least until some of the spending programs, particularly the health and pension entitlements, are reformed, you cannot afford to give away lots of revenues, and you certainly can't afford to give them away without clear evidence that this is going to stimulate saving, investment and growth.

Senator Bingaman. Mr. Chairman, I have kept everybody busy here while you have been gone. Now it is your turn. Go ahead.

Representative Saxton. [Presiding.] I thank the Senator. I got in on the tail end of this discussion on -- I guess savings and investment. Let me just frame a question and continue the same line of questioning.

As you probably know, several weeks ago I introduced a bill which would, if enacted the way it was introduced, dramatically expand the IRA system in a number of ways. It would dramatically increase the amount of annual investment that would be permissible and be deductible; it would increase the threshold of family earnings from the current level to $110,000 over six years; and it would make withdrawals from IRA accounts permissible without penalty for a number of additional purposes, including medical care, education, and adoption.

What kind of effect would that have on savings, in your opinion? What kind of an effect would it have on economic growth? And what kind of an effect would it have on Federal revenue?

Mr. Lindsey. On the first two, I think the answer is the numbers would be small. Although, we did describe the small changes could be good. Let me suggest the context in which to think about the revenue that generally is not approached. Because of the way we do budgeting, the Treasury and the Joint Committee score the foregone taxes from the IRA as, "lost this year". In fact, those taxes will be collected when the money is withdrawn. The right way to think about it, I think, from the Government's point of view, is what is the present value of the revenue we are going to collect in the future?

Now, if the saver, the household, puts the money literally in a government bond and withdraws it from the IRA 10 years from now, 20 years from now, three years from now, it doesn't matter. The present value of the revenue the government gets in the future is exactly the same as the value of the revenue lost today. So expanding your IRA from any kind of long-term perspective is revenue-neutral.

And I know that we all want to expand time horizon. Everyone on this panel agrees with expanding time horizon. The shortest time horizon in this society is done on public sector decision-making. And I would urge that change. And if you did take that change, the net position of the government would be unchanged, it would be revenue wash.

Mr. Ture. The other and probably the gutsier part of your question is what will people do if this proposal becomes law? And that is the question of are people responsive to changes in the cost of saving relative to the cost of consumption? That is not a new question. That one has been kicking around for as long as I have been playing with economics, and we won't talk about that. But the answer has to sort of go like so: If a randomly selected individual is confronted with a reduction in how much current consumption he or she must forego in order to have any given additional amount of future income and doesn't respond to that at all, you would say this is a disturbed human being, because, by the same token, it says suppose by virtue of a change this -- the tax law or what have you -- we very substantially increase the cost of using your income for current consumption relative to the cost of buying more income in the future, and you don't do anything. Nobody would believe that. Suppose I say to you, here is a tax provision that is going to double the cost in terms of how much future income you have to give up in order to spend an additional dollar on current consumption, and you respond to me, it is not going to make any difference in terms of my behavior. That is a poor soul. And nobody believes that. Nobody believes that.

Well, of course you are going to be responsive to these changes in relative costs. Whether the response is going to be very big, modest, don't know. But really you don't have to know. All you have to know is whether or not the kind of tax change that you are talking about moves in the right direction, and right direction is defined in two terms. One of them is in terms of principle; does it move toward neutrality, does it move toward reducing the bias against saving and investment? And the answer there is an unmistakable, unqualified yes, it does move in the right direction.

And two, the kind of question that I don't much like, but some people do, which is, is it likely to be dollarwise effective? My answer to that is, you betcha. We did -- I forgot -- Steve, how long ago did we do that study?

Voice. About six to seven years ago.

Mr. Ture. Yeah. I think we tortured the subject, tried to put out an analysis that left very little unanswered in terms of questions about does it or does it not work. And we cited other authorities. We did our own analytics, and the only place we could come out with is, sure it has got to increase saving, and it will increase saving in significant amount. We could have done a much more rigorous analysis than we undertook, but our sponsor did not want it, so we did not do it.

So my conclusion from that was this is potentially one of the most constructive things that can be done in the area of tax policy, and one of the things that makes it most constructive is it is the first major step towards doing what you ultimately want to do, which is what Barry Rogstad proposes with respect to personal saving.

Representative Saxton. Dr. Rogstad, if I could just skip over you for a minute, I will come back to you. Dr. Chimerine wants to say something.

Mr. Chimerine. I could have waited, but since you called me, the truth of the matter is, Mr. Chairman, we really don't know because the issue gets back to the one that Norm mentioned earlier. There is a lot of disagreement within the profession of the sensitivity of savings to the after-tax return on savings.

There are some eminent economists who have done work on it who have concluded that the savings curve is negatively sloped, that people have a targeted level of savings, and if the return on savings rises, they will save less because they can still reach that target by saving less. We don't really know. The best guess is that it is probably not negative sloped, but the degree of sensitivity is low.

But I think Larry Lindsey's point is very important. There is not a lot of risk in what you are proposing because in the long-term, the impact on the deficit will be very small. If it doesn't work, that is if it doesn't stimulate more savings, you really haven't lost a lot. And it may work. I also think it sends the right signal, and as a result, I would not discourage it.

Representative Saxton. Agreement.

Mr. Rogstad. I want to break that pattern. I want to comment on something Larry Chimerine just said. We ought to find out what these behavioral responses are. We ought to do the experiment and just find out. We spend too much time just talking about it.

I think, sir, as I said in my testimony, I applaud your bill. I would ask you, with all due respect, almost a gratuitous question. Why did you stop where you did on those limits? And that was a discussion that we were having with Senator Bingaman when you came in. It is a question of revenue constraints, and we know that, and I think you ought to -- it would be optimal to do it in tax restructuring.

I come back to Larry Lindsey's point that if you have an unlimited IRA, and I agree this is pushing the point a little bit, I say, yes, I think it is in the national interest to have Warren Buffett have an unlimited deferral for all of his income if he saves it. That is in the national interest. People say, you cannot be serious. I am very serious.

Notice what is happening with Mr. Buffett. All we are doing is deferring tax on the saving that he put in his IRA and his tax liabilities are compounding at whatever his rate of return is, which is in excess of 20 percent I believe. In fact, if we did this right, you might solve some major budget problems through Mr. Buffett's deferred tax payments. And I think it is a very serious comment.

Mr. Ture. Beautiful point.

Representative Saxton. Let me ask one final question, and then we will finish up. I believe there is a great deal of concern among the American people about the amount of saving that we are doing as a society, particularly as families and individuals because over the past couple of decades something happened. And what has happened to the savings rate through the late '70s and the '80s?

Mr. Lindsey. That issue is provoked. I went to the *Economic Report of the President*, table B-30, page 335, and in contrast what I did was have the numbers from 1993, 1994, 1995, the last three years, in contrast to 1983, 1984 and 1985, the so-called horrible 1980s. In the 1990s, the personal saving rate averaged 4.3 percent in those three years. In the 1980s it averaged 7.3 percent. When you look at the gross saving rate for the economy as a whole, not just individual, gross saving rate, in the 1990s, in those three years, it averaged 15.1 percent. In the 1980s it averaged 19.1 percent, four points higher.

So I think, in fact, and you can look at the numbers, 1993, 1994 and 1995 are historic lows on both the personal saving rate and the gross saving rate. Even though we brought the public sector debt down, private sector saving fell by more than we reduced the deficit.

Mr. Ture. Let me offer an explanation. It validates Larry's numbers and goes back to what we talked about.

Mr. Lindsey. The President's numbers, not mine.

Mr. Ture. Actually I was going to say the Department of Commerce's numbers.

Suppose that we woke up tomorrow morning and found that the stock of human and nonhuman capital was twice what it is now. What would be the inclination to save an incremental dollar and invest it? Very, very low, because the marginal return on that incremental dollar would be next to zero.

In essence, what I am suggesting is the historical record shows us that very, very rapid rates of additions to the stock of capital, not just the machinery and equipment we use, but what we have up here as well, and the consequence of that is one of the most rudimentary laws of economics, is the marginal value product of capital has come down accordingly, which means that the real cost of buying any additional dollar of future income, the real cost being how much current consumption do you have to forego, has gone up. You have got to say the population is peculiar to say that they ignore that, but they don't care what it costs.

I remember several years ago being in a conference in which sort of the mindset was the Japanese will continue to grow at some -- I forgot what the rate was -- some phenomenal rate forever and ever. They were way ahead of us in the growth rate, and they will continue to get farther and farther ahead of us. My observation to that group of assembled experts was that cannot possibly be. The rate at which the Japanese have been adding to their stock of capital relative to the rate in which they have been increasing their labor supply is such that within a relatively short period of time, they are going to be experiencing a recession.

Representative Saxton. Thank you.

Doctor Lindsey, I understand you have some time constraints here, so we want to thank you for being with us. We appreciate your testimony this morning.

Mr. Lindsey. Thank you, Mr. Chairman.

Mr. Chimerine. Let me just make a quick comment and maybe the last word. First, I think all of us agree that increasing the saving rate would increase long-term economic growth, and I think we all agree on that. Okay?

Secondly, all of us agree that saving rates, whether you take the personal saving rate or the national saving rate, are now considerably lower than they have been during most of the postwar history of the United States. No disagreement. But I think there is some disagreement on how we got to this point, because when you look at the data, the big decline in the personal saving rate and the big decline in the national saving rate took place in the 1980s. It began in the 1983/1984 time period, continued through the rest of the decade into the early 1990s, and in recent years, while it may be zigging up a little bit or zigging down a little bit, it has essentially stabilized.

So it is not accurate to say that the saving rate has fallen out of bed in the 1990s. It fell out of bed in the 1980s. It has been more stable, and I think it has edged up, if you measure it properly, in the last several years. Now the question is, what can we do to increase the saving rate on a long-term basis, and that is the issue that we face.

Representative Saxton. One of the observations that I made pursuant to introducing the IRA expansion bill was the point that you just made: that there appears to be a direct correlation between pulling back of IRA regulations in the middle 1980s and the decline in savings.

Mr. Chimerine. Could be.

Representative Saxton. It just seems to me that we should recognize that -- and I might say that there seems to be some degree of political agreement. The President, in the last two years in his budget submission, has suggested an expansion of the IRA program, although not in specific terms. Senator Bill Roth has suggested the same thing. And of course we are excited about it on the House side, for all of the aforementioned reasons, including the ability to look back just a decade and see what we experienced when we went the wrong way.

Dr. Rogstad.

Mr. Rogstad. In addition, sir, the issue is probably we really miscommunicated to some segment of the population what we did with IRAs with respect to cutting back income eligibility. People who were still eligible ceased to participate because they were under the impression that the game was over.

I think there is another set of issues that influenced the saving rate in the 1980s. Economists point out that households will save principally for three reasons: health care, retirement, and education outlays. There are other issues, but that is the preponderance for the use of savings.

During the 1980s, the rate of growth of third party payments (non-means tested entitlements) available to pay for each of these activities was phenomenal. I was essentially told as a head of a household, you really don't have to worry about the bottom line on education, healthcare, retirement issues. If you don't do it and you are not responsible on your own, somebody will cover it for you. That alternative certainly influenced our individual and collective saving behavior.

Did IRAs work as well as we would have liked in this period? No, but it is not surprising since the marketing device out there at that time was essentially -- you don't really have to save? I would suggest to you that you look differently at what is going to happen to future IRA experience if your legislation becomes law. At the same time that people are being told those third-party payments are not going to be there in abundance any longer, we will find a very different change in behavior and degree of responsiveness to IRAs.

Mr. Ture. May I have one point about what happened in the 1980s? Not only did we decimate IRAs, I did a calculation about what the Tax Reform Act of 1986 did to the tax base. Over the 5-year budget projection period, that piece of legislation added 300 and something or other billion dollars of saving and the returns thereto to what we identified as taxable income. Now, if the saving rate fell in response to that, I would not be surprised.

Representative Saxton. I'd like to make one final point. Before I came to this hearing today, I came from a hearing with the House Committee on Education and the Workforce, and they asked me to come and testify about the IRA bill and also about the President's suggestion that we have a $1500 per year tax credit available for educational purposes at two-year colleges.

As I heard Dr. Rogstad talking about encouraging saving on the one hand and discouraging saving on the other, by saying, if you don't do it, somebody else will, it appears that at least some around here are headed back into that same old trap of saying, "Well, obviously these folks need to go to school; but there are not personal savings available for it, so it is okay, we will take care of it." Those kinds of things, I think, are what we need to be very careful of as we make public policy that has to do with taxes and other issues -- savings in particular.

Thank you very much for being with us today. We have appreciated it. You have been very patient and very articulate. We even found some areas of agreement. Thank you very much.

Mr. Chimerine. Good luck, Mr. Chairman.

Mr. Ture. Thank you.

[Whereupon, at 12:12 p.m., the Committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

It gives me great pleasure to welcome the distinguished panel of witnesses before us today to examine the economic problems posed by the federal income tax system.

The federal income tax system was introduced in 1913 with a top marginal rate of 7 percent and personal exemptions that excluded the vast majority of Americans from the income tax. To many Americans these days, this kind of income tax structure wouldn't sound so bad. However, our current tax system features much higher income tax rates and lower real exemption levels. Furthermore, the current income tax continues the systematic bias against saving common to all income tax systems.

The general problem is that saving is taxed once out of income, and then the return to saving is taxed yet again. This multiple taxation of saving has a variety of forms that can cascade upon one another, a problem that will probably also be discussed this morning. It is true that the current income tax system attempts to soften the extent of this bias by curtailing some of this multiple taxation in a variety of ways, including some limited IRA treatment of some personal saving. Nonetheless, the current tax system remains stacked against personal saving. By undermining personal saving, it also undermines investment and long term economic growth as well as personal responsibility.

The rate structure and multiple taxation of saving and investment of the federal income tax also hinders the entrepreneurship, innovation and creativity which are vital to the flexibility and dynamism of a market economy. The incentive for entrepreneurial discovery leads to unforeseeable breakthroughs and innovations that would not occur in a adverse tax environment. The federal income tax, in a variety of ways, impedes entrepreneurship and innovation in the economy seriously enough to limit long term economic growth.

A neutral tax system would not discriminate against saving on the one hand or consumption on the other. It would not tax saving more heavily that consumption, but would tax them both in an unbiased manner. The additional layers of multiple taxation on saving would be stripped away to establish an unbiased tax treatment of saving and consumption. The larger pool of personal saving would increase the amount of capital available to finance capital formation and economic growth.

Recently, I have introduced legislation to address this imbalance by increasing the deduction ceilings for IRA accounts, raising income caps for deductible IRA contributions, and liberalizing withdrawals for all education and medical expenses, first time home ownership, unemployment, and adoption. This legislation would go a long way towards correcting the current defects in our current tax system. Much more would need to be done in the longer term, but this IRA liberalization would be a good place to start.

This morning we are fortunate to have a distinguished panel of tax experts testifying before the committee. Dr. Lawrence Lindsey was formerly a governor of the Federal Reserve Board, served as a White House advisor, and also a Harvard University professor. Dr. Norman Ture, currently President of the Institute for Research on the Economics of Taxation (IRET), has served as a high official in the Treasury Department, and many years ago on the staffs of the Joint Economic and Ways and Means Committees. Dr. Barry Rogstad is chairman of the American Business Conference. Dr. Lawrence Chimerine is managing director and chief economist of the Economic Strategy Institute.

I

105TH CONGRESS
1ST SESSION

H. R. 891

To amend the Internal Revenue Code of 1986 to increase the maximum amount of contributions to individual retirement accounts and the amounts of adjusted gross income at which the IRA deduction phases out for active participants in pension plans, and to allow penalty-free distributions from individual retirement accounts and 401(k) plans for certain purposes.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 27, 1997

Mr. SAXTON (for himself, Mr. DELAY, Mr. STUMP, Mr. MILLER of Florida, Mr. ARMEY, Mr. CHABOT, and Mr. SMITH of New Jersey) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1986 to increase the maximum amount of contributions to individual retirement accounts and the amounts of adjusted gross income at which the IRA deduction phases out for active participants in pension plans, and to allow penalty-free distributions from individual retirement accounts and 401(k) plans for certain purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. INCREASE IN CONTRIBUTION LIMITS AND AMOUNTS AT WHICH PHASE OUT OF DEDUCTION BEGINS FOR INDIVIDUAL RETIREMENT ACCOUNT CONTRIBUTIONS.

(a) INCREASE IN MAXIMUM AMOUNT OF CONTRIBUTION TO INDIVIDUAL RETIREMENT ACCOUNTS.—

(1) IN GENERAL.—Subparagraph (A) of section 219(b)(1) of the Internal Revenue Code of 1986 (relating to maximum amount of deduction) is amended by striking "$2,000" and inserting "the applicable amount".

(2) APPLICABLE AMOUNT.—Subsection (b) of section 219 of such Code is amended by adding at the end the following new paragraph:

"(5) APPLICABLE AMOUNT.—

"(A) IN GENERAL.—For purposes of paragraph (1), the term 'applicable amount' means—

"(i) for any taxable year beginning in 1997, $2,500,

"(ii) for any taxable year beginning after 1997 and before 2006, the applicable amount determined under this paragraph for the preceding taxable year, increased by $500, and "(iii) for any taxable year beginning after 2005, $7,000.

"(B) INFLATION ADJUSTMENT.—In the case of a taxable year beginning in a calendar year after 2006, the $7,000 amount contained in subparagraph (A)(iii) shall be increased by an amount equal to—

"(i) such dollar amount, multiplied by

"(ii) the cost-of-living adjustment under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting 'calendar year 2005' for 'calendar year 1992' in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $10, such amount shall be rounded to the nearest multiple of $10."

(b) INCREASE OF AMOUNTS AT WHICH PHASE-OUT OF DEDUCTION FOR IRA CONTRIBUTIONS BEGINS.—

(1) IN GENERAL.—Clauses (i) and (ii) of section 219(g)(3)(B) of such Code (relating to limitation on deduction for active participants in certain pension plans) are amended to read as follows:

"(i) in the case of a taxpayer filing a joint return—

"(I) for taxable years beginning in 1997, $50,000,

"(II) for taxable years beginning after 1997 and before 2003, the applicable dollar amount determined under this subclause for the preceding taxable year, increased by $10,000, and

"(III) for taxable years beginning after 2002, $110,000.

"(ii) in the case of any other taxpayer (other than a married individual filing a separate return)—

"(I) for taxable years beginning in 1997, $30,000,

"(II) for taxable years beginning after 1997 and before 2003, the applicable dollar amount determined under this subclause for the preceding taxable year, increased by $5,000, and

"(III) for taxable years beginning after 2002, $60,000, and"

(2) INFLATION ADJUSTMENT.—Paragraph (3) of section 219(g) of such Code is amended by adding at the end the following new subparagraph:

"(C) INFLATION ADJUSTMENT.—In the case of a taxable year beginning in a calendar year after 2003, the $110,000 amount contained in subparagraph (B)(i)(III) and the $60,000 amount contained in subparagraph (B)(ii)(III) shall each be increased by an amount equal to—

"(i) such dollar amount, multiplied by

"(ii) the cost-of-living adjustment under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting 'calendar year 2004' for 'calendar year 1992' in subparagraph (B) thereof.

If any amount as adjusted under the preceding sentence is not a multiple of $100, such amount shall be rounded to the nearest multiple of $100."

(c) CONFORMING AMENDMENTS.—

(1) Paragraph (1) of section 408(a) of such Code is amended by striking "$2,000" and inserting

"the applicable amount (as in effect under section 219(b) for such taxable year)".

(2) Subparagraph (B) of section 408(b)(2) of such Code is amended by striking "$2,000" and inserting "the applicable amount in effect under section 219(b) for the taxable year of such individual".

(3) Subsection (b) of section 408 of such Code is amended in the last sentence by striking '$2,000" and inserting "the applicable amount in effect under section 219(b) for such taxable year".

(4) Subparagraph (A) of section 408(d)(5) of such Code is amended by striking "dollar amount" and inserting "applicable amount".

(5) Subsection (j) of section 408 of such Code is amended by striking "$2,000" and inserting "applicable".

(d) Effective Date.—The amendments made by this section shall apply to taxable years beginning after December 31, 1996.

SEC. 2. PENALTY-FREE DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT PLANS, 401(k) PLANS, ETC.

(a) Distributions Related to First Homes, Education, or Adoption.—

(1) In general.—Paragraph (2) of section 72(t) (relating to exceptions to 10-percent additional

tax on early distributions from qualified retirement plans) is amended by adding at the end the following new subparagraph:

"(E) CERTAIN DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT PLANS, 401(k) PLANS, ETC.—Distributions to an individual from an individual retirement plan, or from amounts attributable to employer contributions made pursuant to elective deferrals described in subparagraph (A) or (C) of section 402(g)(3) or section 501(c)(18)(D)(iii), to the extent such distributions do not exceed the sum of—

"(i) qualified first-time homebuyer distributions (as defined in paragraph (7)) made during the taxable year,

"(ii) qualified education expenses (as defined in paragraph (8)) of the taxpayer for the taxable year, and

"(iii) qualified adoption expenses (as defined in section 23(d), determined without regard to section 23(d)(2)(B)) paid or incurred by the taxpayer during the taxable year."

(2) DEFINITIONS.—Section 72(t) is amended by adding at the end the following new paragraphs:

"(7) QUALIFIED FIRST-TIME HOMEBUYER DISTRIBUTIONS.—For purposes of paragraph (2)(E)(i)—

"(A) IN GENERAL.—The term 'qualified first-time homebuyer distribution' means any payment or distribution received by an individual to the extent such payment or distribution is used by the individual before the close of the 60th day after the day on which such payment or distribution is received to pay qualified acquisition costs with respect to a principal residence of a first-time homebuyer who is such individual, the spouse of such individual, or any child, grandchild, or ancestor of such individual or the individual's spouse.

"(B) QUALIFIED ACQUISITION COSTS.—For purposes of this paragraph, the term 'qualified acquisition costs' means the costs of acquiring, constructing, or reconstructing a residence. Such term includes any usual or reasonable settlement, financing, or other closing costs.

"(C) FIRST-TIME HOMEBUYER; OTHER DEFINITIONS.—For purposes of this paragraph—

"(i) FIRST-TIME HOMEBUYER.—The term 'first-time homebuyer' means any individual if—

"(I) such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which this paragraph applies, and

"(II) subsection (h) or (k) of section 1034 did not suspend the running of any period of time specified in section 1034 with respect to such individual on the day before the date the distribution is applied pursuant to subparagraph (A).

"(ii) PRINCIPAL RESIDENCE.—The term 'principal residence' has the same meaning as when used in section 1034.

"(iii) DATE OF ACQUISITION.—The term 'date of acquisition' means the date—

"(I) on which a binding contract to acquire the principal residence to which subparagraph (A) applies is entered into, or

"(II) on which construction or reconstruction of such a principal residence is commenced.

"(D) SPECIAL RULE WHERE DELAY IN ACQUISITION.—If any distribution from any individual retirement plan fails to meet the requirements of subparagraph (A) solely by reason of a delay or cancellation of the purchase or construction of the residence, the amount of the distribution may be contributed to an individual retirement plan as provided in section 408(d)(3)(A)(i) (determined by substituting '120 days' for '60 days' in such section), except that—

"(i) section 408(d)(3)(B) shall not be applied to such contribution, and

"(ii) such amount shall not be taken into account in determining whether section 408(d)(3)(A)(i) applies to any other amount.

"(8) QUALIFIED EDUCATION EXPENSES.—For purposes of paragraph (2)(E)(ii)—

"(A) IN GENERAL.—The term 'qualified higher education expenses' means tuition, fees, books, supplies, and equipment required for the education of—

"(i) the taxpayer,

"(ii) the taxpayer's spouse, or

"(iii) any child (as defined in section 151(c)(3)), grandchild, or ancestor of the taxpayer or the taxpayer's spouse,

whether or not such education takes place at an eligible educational institution (as defined in section 135(c)(3)).

"(B) COORDINATION WITH SAVINGS BOND PROVISIONS.—The amount of qualified education expenses for any taxable year shall be reduced by any amount excludable from gross income under section 135."

(3) CONFORMING AMENDMENT.—Subparagraph (B) of section 72(t)(2) is amended by striking "or (D)" and inserting ", (D), or (E)".

(b) PENALTY-FREE DISTRIBUTIONS FOR CERTAIN UNEMPLOYED INDIVIDUALS NOT LIMITED TO HEALTH INSURANCE COSTS AND ALLOWED FROM 401(k) PLANS, ETC.—Subparagraph (D) of section 72(t)(2) is amended—

(1) in clause (i), by inserting ", or from amounts attributable to employer contributions made pursuant to elective deferrals described in subparagraph (A) or (C) of section 402(g)(3) or section 501(c)(18)(D)(iii)," after "individual retirement plan",

(2) in clause (i), by inserting "and" at the end of subclause (I), by striking ", and" at the end of subclause (II) and inserting a period, and by striking subclause (III), and

(3) by striking "FOR HEALTH INSURANCE PREMIUMS" in the heading.

(c) UNLIMITED PENALTY-FREE DISTRIBUTIONS FOR MEDICAL CARE AND EXPANDED DEFINITION OF DEPENDENTS FOR PURPOSES OF SUCH DISTRIBUTIONS.—Subparagraph (B) of section 72(t)(2) is amended by striking "medical care" and all that follows and inserting "medical care, determined—

"(i) without regard to whether the employee itemizes deductions for such taxable year, and

"(ii) in the case of a distribution from an individual retirement plan, or from amounts attributable to employer contributions made pursuant to elective deferrals described in subparagraph (A) or (C) of section 402(g)(3) or section 501(c)(18)(D)(iii)—

"(I) without regard to whether or not such expenses exceed 7.5 percent of adjusted gross income, and

"(II) by treating an individual's dependents as including all children and grandchildren of the individual (or of such individual's spouse), and all ancestors of the individual (or of such individual's spouse)."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to payments and distributions in taxable years beginning after December 31, 1996.

JEC FACT SHEET

JEC Chairman Jim Saxton's
Investment Revitalization Act

The Investment Revitalization Act (IRA), H.R. 891, seeks to re-establish the individual retirement account as a simple, flexible, and cost effective vehicle for personal savings. The bill achieves its goal by removing much of the tax bias against personal saving. The IRA bill would **increase the deductible contribution limits, increase eligibility for participation in IRAs, and increase the number of penalty-free withdrawals from IRAs.**

The current income tax system is biased against personal saving and investment. When income is consumed, it is taxed once. However, saving is taxed twice. The first tax is out of income, and then the return to saving is taxed a second time. This multiple taxation of saving relative to consumption increases the incentive to consume, while penalizing personal saving and investment.

Personal saving is an important component of the capital base necessary to finance investments in the technology, skills, and tools for higher long-term economic growth. This IRA bill would increase personal saving while empowering American families to become financially stronger. As families become economically more independent, they greatly reduce their potential dependence on inefficient government programs.

Outline

H.R. 891: Investment Revitalization Act

Section One

The bill would increase the annual deductible contribution ceiling for IRA's, currently set at $2,000. **By increasing the deduction ceiling by $500 a year for 10 years, the ceiling would be eventually raised to $7,000.** This would provide an attractive incentive for increased personal saving by middle class taxpayers. Because the amount of consumption in the economy is so large (about two thirds of output), even a relatively modest shift from consumption to saving would significantly increase the amount of personal saving.

Section Two

The IRA bill would also raise the income caps imposed to qualify for the deduction. Under the 1986 tax law, taxpayers with joint incomes over $50,000 cannot qualify for the IRA deduction. The IRA bill **raises the $50,000 by $10,000 a year for six years to a level of $110,000, and indexes it thereafter.** (Single filers would increase from $30,000 to $60,000 in six years also.) The increased eligibility caps would broaden the availability of the expanded IRA deductions to over 90 percent of taxpayers.

Section Three

The IRA bill also **greatly liberalizes penalty free withdrawals to include expenses for all education, medical care, adoption, unemployment, and first time home ownership.** By liberalizing withdrawals, people can save without worrying as much about not having access to their money without paying penalties. This removes the current disincentive from saving out of fear that the invested money would not be available in the case of a personal or family emergency.

Revenue Maximizing Taxation is Not Optimal

Lawrence B. Lindsey[1]

Thank you, Mr. Chairman. I am grateful for this opportunity to provide this Committee with some of my thoughts regarding tax policy. I believe that Congress is taking a very appropriate look at our tax system with the intent of rebuilding it from the ground up. Ultimately, one would hope that the final product of this work will be a tax system which is less of a burden on the U.S. economy and its taxpayers and therefore more conducive to economic growth. In that regard, it is important to lay an appropriate groundwork for a proper analysis of the issues involved.

My objective today is to focus on one very important and widely misunderstood aspect of the analysis of taxation: the existing confusion between "revenue maximization" and "optimal taxation". I believe that this confusion is leading tax and budget policy makers to legislate tax systems with rates which are excessive from the point of view of economic growth.

Oddly enough, I believe that many of those who were most important in pointing out two decades ago that the U.S. suffered from excessively high tax rates have contributed to the confusion between revenue maximization and optimality. Consider Figure 1. It depicts the Laffer Curve, named for economist

[1] The views expressed are the author's and do not necessarily reflect those of the American Enterprise Institute or any other employer past or present.

Arthur Laffer. Laffer elegantly depicted an economic reality that economists since Adam Smith have recognized: that higher tax rates might not necessarily produce higher revenue. He noted that at tax rates of either zero or 100 percent government tax collections would be non-existent. He reasoned, correctly, that at some point between these two figures, revenue would be maximized. Although Laffer certainly never claimed that the revenue maximizing rate was the best one, or the optimal one, the construction of the figure naturally leads one to think that there is something good about being at the top.

I believe Laffer's actual point was that being on the right side of that revenue maximizing point was truly foolish. Not only were taxpayers worse off on that right hand slope, so was the government. The point had real policy relevance, since with tax rates of up to 70 percent, the top portion of the U.S. tax system was clearly in that prohibitive range.

Some analysts who supported lower rates actively led to the confusion about the high point of the Laffer Curve being optimal. For example, Jude Wanniski argued regarding the revenue maximizing point, "It is the point at which the electorate desires to be taxed. It is the task of the statesman to determine the location of (the maximum) and follow its variations as closely as possible."[2]

On this issue, Wanniski was completely wrong. Far from being desirable, the revenue maximizing rate is actually one which any statesman would want to avoid like the plague. As I shall show, only those individuals who care only

[2] Jude Wanniski, "Taxes, Revenues, and the 'Laffer Curve'," The Public Interest, Winter 1978, pp.4-6.

about the well being of the Treasury and do not care anything about the well being of the taxpayer would choose the revenue maximizing point.

Please bear with me as I revert to Professor mode to suggest a different way of looking at this issue, and introduce the concept of the excess burden of taxation. Consider Figure 2. The figure depicts what I term the "Demand for Taxable Income". Like any demand curve in economics, it is downward sloping. That is, as the price of taxable income falls, people demand more of it. In this case, the price of taxable income is the tax rate. It is how much the taxpayer must pay the government in order to earn another dollar of taxable income. Note that at a tax rate of 100 percent, the taxpayer chooses to earn zero taxable income. At a zero tax rate we would depict the amount of taxable income that a taxpayer would choose in the absence of any taxation.

The Demand for Taxable Income is a useful analytic tool since it helps to graphically depict two important considerations regarding tax policy. The first is revenue. The government sets a tax rate and the demand for taxable income shows what the tax base will be at that rate.[3] The amount of revenue the government collects is therefore easily shown as a rectangle – the tax rate times the tax base.

The second concept depicted by the Demand for Taxable Income is the Excess Burden of taxation. The Excess Burden is a very important concept. First, it is different from tax revenue. After all, paying taxes is a burden to the

[3] This assumes that all taxable income is taxed at a single rate. Mathematically, it can be shown that a progressive rate structure would produce a lower revenue maximizing rate.

taxpayer. But, from society's point of view it is not a net loss in economic well being. The taxpayer's loss is the government's gain.

Excess burden is the loss in the taxpayer's well being above and beyond the taxes he pays. There is no offsetting gain to the government from this loss in well being. The excess burden of the tax is indicated by the triangle to the right of the revenue rectangle. In order to understand why this is the case, we must think about what the Demand for Taxable Income means.

Like any demand curve, the Demand for Taxable Income shows how much the demander (the taxpayer) values receiving another unit of the good, in this case another dollar of taxable income. Note that this value is always less than one dollar. For example, when the tax rate is 20 percent, the taxpayer gives up all those dollars of taxable income which he values at less than 20 cents on the dollar.

Why would a taxpayer value a dollar of taxable income at less than a dollar? It is because he must give up something to get that dollar of taxable income. For example, he may have to work more, giving up leisure. Or, he may have to give up a dollar of untaxed enjoyment such as a perk or fringe benefit. So, the demand curve tells us the NET value to the taxpayer of getting another dollar of income; literally this is the dollar minus how much he valued what he had to give up to get that dollar.

So, a taxpayer who values his time spent going fishing instead of working at 80 cents has a net value of getting another dollar of taxable income of 20 cents. If his tax rate on that dollar is more than 20 percent, the cost of giving up his time – 80 cents value in fishing plus more than 20 cents in taxes – is more than the value of earning the extra dollar, and he chooses not to earn it. If his tax rate on that dollar is less than 20 cents, on net he comes out ahead, and chooses to earn. The demand curve tells us exactly the "break even point" between earning and not earning.

So, from the taxpayer's point of view, the net value to him of giving up dollars of taxable income is given by the triangle, the area under the demand curve, on dollars of taxable income not earned because of taxes. This is less than the amount the economy shrinks as a result of the tax. Generally, the economic output forgone is dollar for dollar with the process of giving up taxable income. That is because untaxed activities which also don't show up as economic activity, such as going fishing, are substituted for taxed activities.

Thus, excess burden is over and above the cost of paying taxes, but is less than the reduction in economic activity from taxes. It is the net loss in economic well being to the taxpayer from the tax.

Now, consider Figure 3 to show what happens when a tax rate is increased from rate T1 to rate T2. First, the government collects taxes at a higher rate on the new level of taxable income earned. That is depicted in the box labeled "A". Second, the government gives up some revenue which it would have collected at the old rate of T1 because the level of taxable income falls. That is depicted in the figure by the box labeled "B". So, the net increase in revenue from raising this tax is A minus B, the revenue gained from raising the rate minus the tax rate minus the income lost from shrinking the tax base.

As drawn, this tax increase is a revenue gainer, placing it on the left hand slope of the Laffer curve. But, does this mean that raising the rate was a good idea? That depends on how much worse off the taxpayer is. Obviously the taxpayer is worse off by rectangle "A", because that is revenue he is now paying the government. But, because the government is ahead by that box, it is not a net loss in well being for society as a whole, only for the taxpayer. Therefore it is not counted as an Excess Burden of the tax.

The increase in the excess burden of this tax is given by how much bigger the triangle to the right of the revenue box grew. That is graphically depicted in Figure 3 by rectangle "B" plus little triangle "C". To sum up, the government gained rectangle A and lost rectangle B. The taxpayer lost rectangles A and B and little triangle C. Whether or not it was a good idea or not to raise taxes depends on how much you value the government's need for revenue and how much you value the taxpayer's well being.

The concept that I would strongly urge the Congress to begin considering is what is technically called "The Marginal Excess Burden per Extra Dollar of Revenue". In terms of the figure it is a comparison of areas B and C with area A minus area B. As shown in the figure, the marginal excess burden is larger than the extra revenue collected. This means that the net loss in social welfare was more than dollar for dollar with the gain in revenue. Stated differently, the taxpayer lost more than $2 for every $1 the government collected.

So much for the theory. Let me bring this down to a very practical application. I refer you to an editorial in the Washington Post on February 20,

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1990. [4] In the second paragraph, the Post goes through an analysis very similar to the one which I have just performed. A key difference is that the discussion is about CUTTING tax rates not RAISING them. So, we have to consider the question in reverse: what is the GAIN in taxpayer well being -- or the reduction in EXCESS BURDEN per dollar of revenue lost by the Treasury.

The editorial notes, "The Treasury would lose from the lower rate but gain from the higher volume." In this case, the Post is talking about area A as a loss to the Treasury and area B as a gain to the Treasury from an expansion in taxable income. The editorial goes on to talk about the Joint Committee on Taxation's estimates of the burden of the tax, citing $100 billion as the amount that taxpayers would be better off over 5 years. This is the JCT's estimate of areas B and C. It then gives an estimate of the net revenue foregone of $11 billion. This is the JCT's estimate of area A minus area B.

The marginal excess burden per dollar of revenue collected in the tax change talked about in the Post is roughly $9 per dollar of revenue. In the case discussed, the JCT estimated that taxpayers would be made better off for every $1 that the Treasury would sacrifice in revenue. Would this have been a good idea?

Now the Post argued that it would not be a good idea. They argued that because these taxpayers who would have seen their burdens reduced were largely well to do, that the government was smart to keep the rates high. In the Post's reasoning, it was sensible to make these taxpayers $9 worse off in order

[4] "Rich and Poor", The Washington Post, February 20, 1990.

for the Treasury to collect an additional dollar in revenue. The Post is entitled to its opinion, after all this is a political judgment.

I would respectfully disagree with the Post's conclusion. If the Congress genuinely is interested in improving economic well being and fostering economic growth, taxes which make society $9 worse off to collect an extra $1 of revenue are luxuries we simply cannot afford. But again, that is a political judgment. The more important issue is the analytic point. If Congress is going to consider how to build a better tax system, it must begin to consider this tradeoff explicitly.

Note that this is going to be radically different than looking at the Laffer Curve or searching for the revenue maximizing rate. If you thought that the revenue maximizing rate was where you should head, then you would have to agree with the Post. After all, the Treasury did gain from keeping the rate higher. The revenue maximizing rate argument does not factor in the costs to society of collecting the revenue.

It is a mathematical point, but at the very top of the Laffer Curve the marginal excess burden per extra dollar of revenue is infinite. Literally, by picking the revenue maximizing rate, Congress is saying that it is willing to impose ANY cost on the taxpayer in order to collect more revenue. Frankly, I don't think that is economically defensible, nor do I really believe that any of you would care to defend such a position in your districts.

So, my request today is for you to change your analytic approach, and begin to consider how much of a burden you are imposing at the margin for maintaining today's rather high tax rate structure. If you make such calculations the basis for your analysis, you will by definition, be doing the best job you can at maximizing economic welfare. Any tax you will be imposing will carry an excess burden. But, isn't it smart policy to make that burden as small as possible?

Thank you, Mr. Chairman.

Figure 1

The Laffer Curve

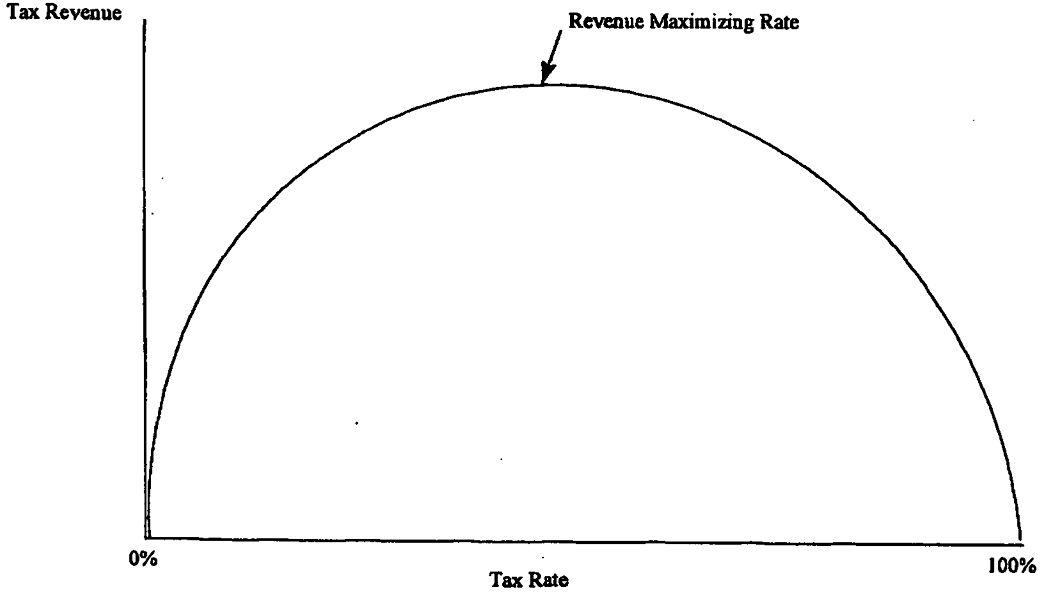


Figure 2

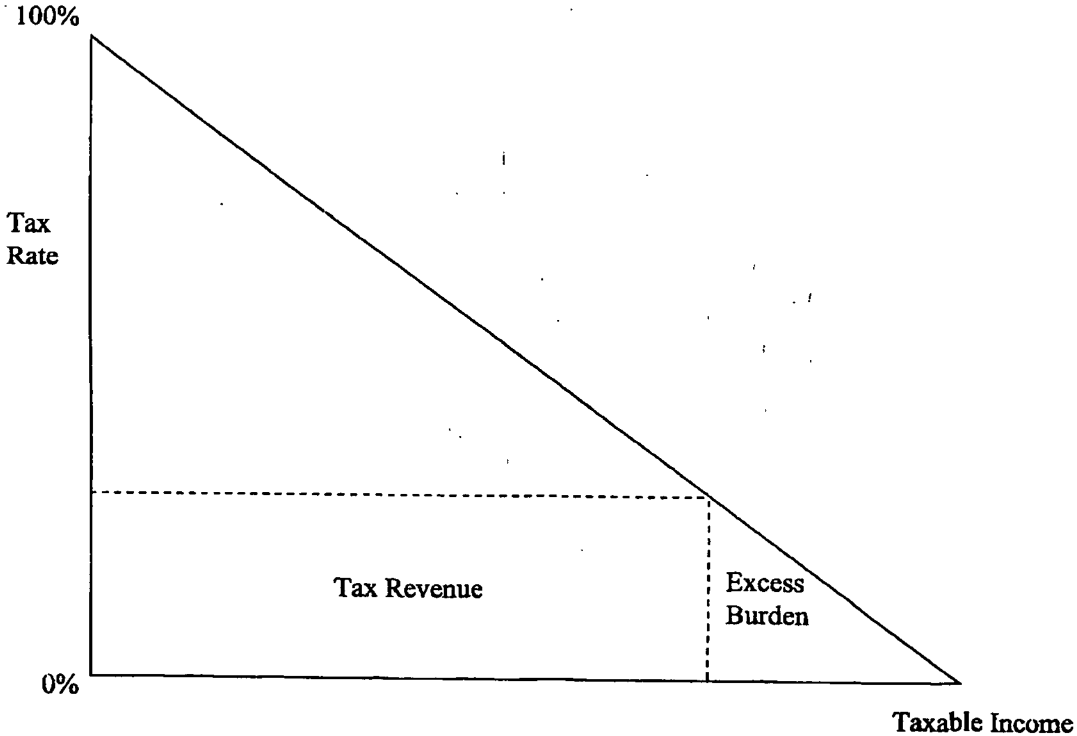
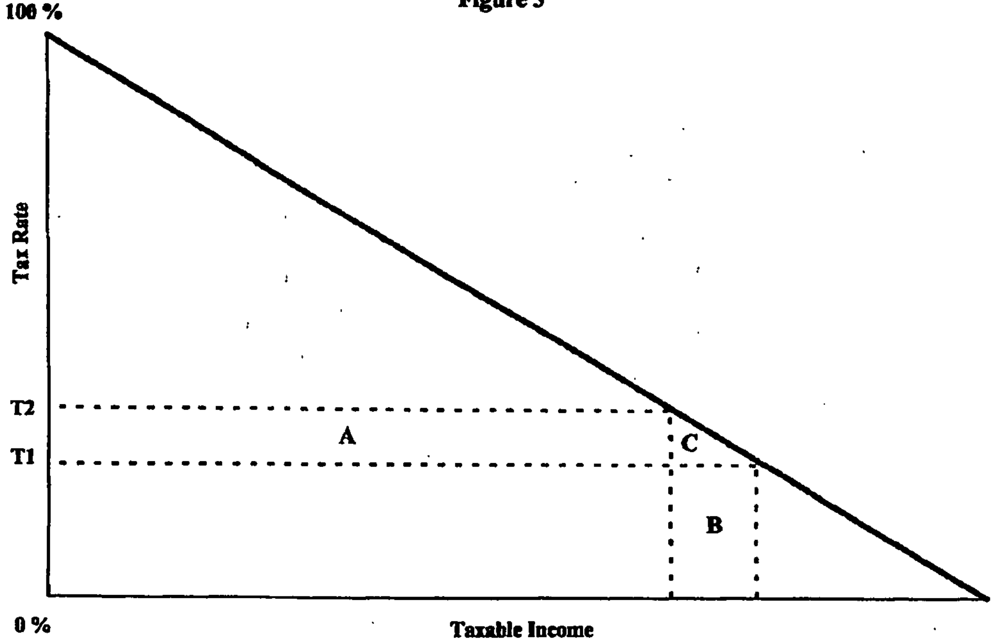


Figure 3



IRET *Institute for Research on the Economics of Taxation.*

FEDERAL TAX POLICY AND THE U.S. ECONOMY: POLICY OPTIONS FOR IMPROVING BOTH

Statement Presented by Norman B. Ture, President
Institute for Research on the Economics of Taxation (IRET)
to the Joint Economic Committee
March 13, 1997

Mr. Chairman, members of the Joint Economic Committee, I am Norman B. Ture, president of the Institute for Research on the Economics of Taxation (IRET). IRET is a tax-exempt public policy research organizations focusing its research efforts on analyzing the effects of tax, budget, and other public economic policies on the effectiveness with which the free market system operates.

High on our research agenda for 1997 and beyond is restructuring of the federal tax system.

WHY TAX RESTRUCTURING?

The simple answer to this core question is that the existing tax system, evaluated against appropriate principles and criteria, is widely deemed to be unacceptable. There is a rapidly broadening consensus that the existing system has erected major obstacles to economic progress, although the how and why of these adverse tax effects on growth are not widely understood. There is a well-nigh universal consensus that the existing tax system is unfair, but it is not clear what people really mean when they make this charge. A standard complaint about the system is that it is terribly complicated and that it imposes extraordinarily high costs of compliance, administration, and enforcement. For a substantial number of taxpayers who receive significant amounts of their incomes in the form of returns on their saving and investment or who have complex compensation arrangements with their employers this is certainly true, but for the preponderant number of individual income taxpayers, compliance burdens are relatively slight.

Almost entirely overlooked by critics of the existing system is that it miserably fails to perform the core function of taxation for a free society -- to inform the body politic about what they must pay for government's activities and services. Our prevailing fiscal system obscures rather than informs us in this regard. Financing some government outlays by borrowing conceals and understates what we have to pay for government programs; little wonder that we don't more successfully resist growth in programs. The taxes we rely on, moreover, are of such a character and are imposed in such a way that we are little aware of paying them, let alone in what amount. I am confident that no one in this room knows what amount of the federal corporate income tax he or she paid in 1996. How much federal

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gasoline excise did you pay last year or for that matter the last time you filled your tank? I suspect that a fair number of the people present had 1996 incomes high enough to have topped out on their FICA bills and given a few moments, could figure out how much their payroll tax amounted to last year, but I doubt that many of us remember our income tax liability or could reconstruct the amount before the close of business today. In short, we pay a huge amount of taxes every year and because of the nature of those taxes, we are not acutely aware of how much we pay.

To recap briefly, we have a tax system that interferes with our economic progress, that we believe to be unfair, that we are convinced is complicated and costly to live with, and fails to perform the key function of a free society's tax system. It would seem obvious that we should be about the business of replacing it. Examination of the deficiencies in the existing system should persuade us that we need to focus on fundamentals and shun the long-standing nickel-and-dime "reform" approach that, each time it is undertaken, has made our tax system worse, not better.

Permit a brief digression in this respect concerning the current agenda of tax "reforms" proposed by the Administration. Ostensibly, the long list -- more than 50 -- of proposed corporate tax changes are aimed at closing prevailing corporate tax "subsidies," but analysis reveals that each of the proposed changes is in fact a grab for additional federal revenues and each will increase the cost of saving and investment, hence would intensify the anti-growth impetus of the existing tax structure. I offer the Committee a prepublication copy of a paper produced by my colleague, senior economist Dr. Michael Schuyler, that provides a rigorous examination of several of the most counterproductive of the Administration's anti-saving, anti-investment tax proposals.

One might hope that if these $80 billion of anti-growth tax increases are to be pushed as part of the Administration's five-year budget policy, there would also be included therein some major tax initiatives that would address the fundamental deficiencies in the existing tax system. Instead, we are offered a new round of "targeted" tax cuts. The Administration's tax policy people appear to have lost sight of the well-nigh universal consensus that the long-standing pick and choose tax favors and tax penalties approach to tax legislation is largely responsible for the dissatisfaction that so strongly urges scrubbing the existing system and starting from square one to produce a tax environment that would conform with basic principles and criteria of an acceptable tax system. The Administration's tax policy proposals should be summarily rejected; Congressional tax policy initiatives should be based on a careful identification of those principles and criteria, to which I now turn.

GUIDING TAX PRINCIPLES

Effective Performance of the Core Function of Taxation

Achieving an acceptable tax system requires relying on clearly specified tax principles, instead of on ad hoc suggestions reflecting the particular interests of one or another group of taxpayers. However appealing may be the notion of reducing the taxes to be paid by families with children of a given age or less, there is no principle of taxation that validates any such targeted tax change. Enacting this sort of tax change creates new barriers to basic tax restructuring and inevitably leads to modifications and additional complexity. The Congress should turn its back on this proposal as well as on the various proposals for tax subsidies of higher level educational outlays by families in specified economic circumstances. The Congress needs to make a statement opposing targeted tax revisions and in favor of tax initiatives that address the basic deficiencies in our existing tax structure.

To this end, the Congress should seek to make the tax system a more effective device for pricing government. As indicated earlier, the core function of an acceptable tax system in a free society is that it effectively informs the public about what must be paid for the services and activities of government. The first principle to be observed, therefore, is that the tax should be imposed only on real people, since determining that any of the total tax revenue to be collected should be collected from corporations or other organizations inevitably conceals that tax burden from the individuals who ultimately bear it. A corollary to this basic rule is that corporations or other organizations would not act as payers of the tax liabilities of their owners, for even though the burden of the tax would rest on the owners, their perception of that burden would be diminished by its discharge by some other entity.

A collateral rule to be observed is that the tax should not be confined to the so-called affluent; the largest possible proportion of the population should be called upon to pay some tax; only the truly destitute should be excluded from taxpaying responsibility. Finally, the tax should be so designed that each of us is acutely conscious of paying it. Abiding by this stricture precludes relying to any significant extent on sales and excise taxes, as well as on taxes paid by others on our account.

Equity

For most people, the instinctive response to the question "what is a fair tax?" is one in which all people are treated the same. This is, of course, a woefully unsatisfactory response because it tells us nothing about what "the same" is for people whose circumstances differ, nor does it even help us to understand what differences in circumstances should be relevant variables in determining our tax liabilities. In tax policy formulation, such questions are seldom confronted. The bottom line question almost invariably is what will such or so a tax initiative do to the distribution of tax liabilities by income level, hence what will it do to the distribution of after-tax income? The fact that we have no adequate data or methods of analysis with which to answer these questions has not deterred policy makers from initiating legislative changes that often are vigorously anti-growth, hence act to accentuate economic inequality, all in the interests of tax fairness.

In my judgment, this approach affords no useful guide to providing for fairness in taxation. The underlying premise is that inequality among our citizens in the distribution of income, wealth, or any other significant economic magnitude is per se unfair. I can't think of any analytical basis on which to rest such a judgment. Validating this approach to tax fairness requires two things, one -- persuasive evidence that poor people are poor because rich people have taken their -- the poor's -- substance, and two -- persuasive evidence that redistributive fiscal policies succeed in leveling out income and wealth. The first of these propositions is challenged by the facts of life in a free society. With very few exceptions, the income a person receives and the wealth he or she accumulates closely matches what that person has contributed to the economy's total output and income. Rich people are rich because they are more productive than people who are less rich, not because they've deprived the poor of the income or wealth they've earned. Policy makers should give themselves the luxury of contemplating the possibility that it is highly unfair to tax away a larger portion of the income of the productive rich in order to transfer income to the less productive, less rich.

What the most basic economics tells us is that if we wish to increase the income and wealth of those who have little, we must find some way of combining their productive efforts with a greater amount of more productive capital, be it machinery, equipment, and other nonhuman capital or of the more or less productive human capital that the individual begins to accumulate at the time of birth.

A far more satisfactory approach to the principle of tax fairness should be derived from the basic prescripts for a free market economy. First among these is that taxes should to the least possible extent violate each person's property rights. It must be recognized that this proposition is very much a contradiction in terms, since every tax is an exaction rather than a free, voluntary exchange of property rights among willing transactors. Nonetheless, recognition of this basic flaw should constrain tax imposition. At the least, it should militate against increasing the rate of government confiscation of property rights on the basis of how productively these rights are used.

Second, an operational equity principle should be based on recognition of the constitutional principle that all of us stand equally before the law. Differences in our productivity should not be inputs in determining a more or less favored position in our standing with respect to any issue of the acquisition, use, or disposition of property. With respect to taxation, this principle argues that each of us should bear the same percentage tax obligation, rather than increasing obligations as our contributions to society's total output increases.

Minimize Costs of Compliance, Administration, and Enforcement

Complaints about the complexity and the resulting compliance burdens of the income and payroll taxes probably exceed in frequency and magnitude those about the unfairness of the income tax. Estimates of compliance costs in terms of dollars of the time and paper work dedicated to compliance run into the hundreds of billions of dollars. The point at issue, however, is not how much we and the Internal Revenue Service must spend to comply with, administer, and enforce the law. It is, rather, whether the results we get provide a sufficiently accurate measure of our taxable income and tax liability to warrant incurring those costs. Few, if any of us, would confidently answer in the affirmative.

The common assumption is that these compliance and administrative costs are generated by oppressive rule-making by IRS officials. In fact, they are the fall-out from legislative enactments, for which the IRS has the responsibility to translate into rules of compliance. If the statutory provisions are vague in substance, one must expect that the regulations produced by the IRS to implement them will leave many taxpayers floundering in attempting to determine whether they are in compliance.

The fundamental source of the difficulty is that the statutes are written without the benefit of close and clear definitions of what is to be taxed and how that is to be measured. Nowhere does the Internal Revenue Code define income or offer any conceptual guides to what is to be treated as taxable income and what is to be allowed as deductions or other offsets thereto. Instead, the approach is to provide an ever-expanding, ever-changing list of revenue items and expenses that are taken into account on the basis of other attributes of the taxpayer.

The consequence of this approach is that many people whose income is principally compensation for labor services confront little complexity, except with respect to tax accounting for those compensation elements that are retirement saving. Roughly two-thirds of individual income tax returns rely on the standard deduction and obtain virtually all the information needed to complete the return from the W-2 the employer provides. The major compliance burden for these taxpayers arises from their assuring themselves that the standard deduction rather than itemized deductions will minimize their taxes.

In the case of business taxpayers and those receiving some substantial fraction of their incomes as returns on their saving and investment, complexity results from the enormous variety of transactions and activities that generate income. Lacking any basic definitional rules, the policy approach has been to tailor the law to the greatest degree possible to every possible variation in situation, taxpayer attribute, type of transaction, etc. The result is a jumble of statutory provisions and regulations that defy business, saver, and investor capability to determine whether they are in compliance with the law.

Minimizing compliance, administration, and enforcement costs, all of which are dead weight, should be a major goal of tax restructuring. Achieving that goal, in turn, requires defining the base of the appropriate tax to replace the existing revenue measures.

Neutrality

Much of the impetus for basic tax restructuring during the last several years has reflected the conviction that the existing system, with its emphasis on income and payroll taxes, has imposed major roadblocks to economic growth. Much of the policy discussion has focused on eliminating the income tax and replacing it with one or another consumption tax. Underlying this position is the observation that the national saving rate -- the fraction of our total output and income reserved from consumption and used to add to our stock of capital -- is too low to provide an acceptable rate of increase in productivity, employment, and real income. The inadequacy of national saving, moreover, is attributed in very large part and with much justification to the biases against saving and investment that are inherent in income taxation.[1]

More fundamentally, the problem is not the reliance on income and payroll taxation, but the fact that these taxes distort the relationships among prices and costs that would otherwise result from the operations of an efficient market system. The consequence is that individuals are misinformed about the opportunity costs for saving -- reserving part of their current incomes from consumption uses in order to acquire sources of additional future income. Similarly, both the income and payroll taxes tell people that producing additional income by the use of their labor services -- more accurately, their human capital -- requires them to incur a greater cost in terms of foregone "leisure" uses of their time, energy, and resources. Minimizing this tax non-neutrality -- distortion of relative prices -- should be a major target of tax restructuring, but it doesn't call for scrapping the income tax. Instead, it calls for clearly defining the concept of income to be embodied in the tax.

The most compelling reason for this position is that all taxes, no matter their name, are paid out of income. We may choose to design taxes so that liability for their payment is triggered by some particular kind of behavior, e.g., buying a tankful of gasoline, but the tax payment comes out of income, no matter the occasion for the payment.

For reasons discussed earlier, it is essential to define income correctly for tax purposes. Income consists of the claims generated by production activity, by the use of production inputs to produce valued products and services. Clearly, the aggregate amount of income claims generated by production activity and the market value of the total output of products and services must always be the same.

For income tax purposes, the correct concept of income is readily derived from this basic proposition. One obtains income only as a reward for providing production inputs. The amount of that reward is the plain common sense concept: all of one's revenues less all of the costs one necessarily incurs to produce those revenues. Where the revenues come from, what kinds of costs must be incurred to obtain them, attributes of the revenue or cost generator are irrelevant considerations for purposes of defining income.

Moreover, this concept of income dictates that revenues and costs are taken into account when they are incurred, not spread over time in a mistaken effort to match the timing of the one against the other. Thus, in measuring the amount of income generated in a business enterprise on behalf of its owners, the amount the business spends for machinery, raw materials, additions to inventory, labor services, research and development, etc., should

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[1] An exposition of the anti-saving, anti-investment, as well as of the anti-effort bias of income taxation is presented in Norman B. Ture, "THE ECONOMIC EFFECTS OF TAX CHANGES: A NEOCLASSICAL ANALYSIS," in 96th Congress, 2nd Session, Joint Committee Print, Special Study on Economic Change, Volume 4, Joint Economic Committee, December 17, 1980, pages 322-328.

be deducted in full when the outlays are made. By the same token, the revenues received by the business should be taken into account at the time of receipt irrespective of when they may be deemed to have been "earned." The reader may recognize that so far as timing is concerned, the proposed concept of income conforms with the so-called "cash flow" tax, and rejects the generally accepted accounting principles approach that underlies so much of the complexity in the existing income tax.

Clearly, a major cost of obtaining revenues is forgoing the use of current income for current consumption purposes, instead using that income to purchase income-producing assets. This saving, therefore, should be deductible as of the time it is undertaken, irrespective of the form it takes. By the same token, consistent with the basic income concept, all returns produced by this saving should be included in revenues for tax purposes. No capital gains provisions would remain in the tax law; the full proceeds from the sale or other disposition of assets would be included in revenues. Insofar as these revenues are reinvested, i.e., saved, they would be deducted from revenues in arriving at taxable income. In short, the proposed restructured tax would provide for automatic roll-over of investments.

The proposed concept of income excludes neither the revenues nor the costs associated with financing a business or household activities. Thus, proceeds from borrowing or from the sale of an ownership interest in a business should be included in revenues at the time of their receipt, while service of any such debt and payment of dividends should be treated as deductible expenses at the time the payments are made. The form of the debt service and/or dividends should have no bearing on the tax treatment.

As indicated and stressed earlier in this discussion, businesses and other organizations would not be tax paying entities under this restructured tax. Insofar as they generated income, as defined above, these organizations would assign the income to individual owners. As under present law, many businesses, guided by the preferences of their individual owners, would choose to retain some of the net income, as defined above, that they generate. By definition, such earnings retentions are saving that would be used by the business to increase its revenue-generating capacity or to stem a decline in revenues In either event, the tax consequences would be exactly the same as if the individual owners had received the net revenues from the business and had chosen to reinvest the same amount as the retained earnings.

Only revenues and costs generated in the United states would be taken into account in determining the amount of income generated by U.S. businesses. This territoriality treatment is called for by the effort to implement the neutrality standard far more fully than under present law.[2] Moreover, because no tax is to be imposed on the business per se, attempting to impose the tax on individual owners of companies producing income in foreign

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[2] For a detailed, technical examination of the territoriality issues, see Norman B. Ture, "Taxing Foreign-Source Income," in U.S. TAXATION OF AMERICAN BUSINESS ABROAD, American Enterprise Institute for Public Policy Research, Washington, D.C., 1975

jurisdictions would produce the very sort of complexity the restructured tax seeks to eliminate.

No so-called "border adjustments" -- rebating the tax on exports and imposing it on imports -- would be provided under this restructured income tax. For one thing, such adjustments make no sense in a tax that is imposed only on individuals. More fundamentally, in a tax on income as defined herein, the source or destination of products and services has no relevance for measuring the amount of income the individual produces and receives.

During the tax restructuring discussions of the past few years, much was made of the question of allowable tax deductions, concentrating mostly on the charitable contribution, mortgage interest deductions, and other itemized deductions. The mantra was to maximize the size of the tax base. Far more appropriate, of course, is to define the tax base correctly, irrespective of the deductions, credits, etc., doing so might call for. A basic tax principle leads to quite a different set of answers about such deductions. The principle is that one should not pay tax on income over which one does not retain control. Everyone is familiar with the proposition that one shouldn't pay taxes on taxes. Neither should you include in your taxable income amounts such as alimony, child support payments, or damages that a court of law has ruled you must pay to someone else. If you choose to give some of your income to some one else, you should exclude that amount from your income and the recipient should include it in his or her income.

This principle dictates that charitable contributions must be deductible. When you make such a contribution, you give up control of the donated income and assign it to someone else. The recipient of the contribution should take it into its income, but except under extraordinary circumstances is likely to spend these revenues on deductible research, wages, and other costs, including the donations and gifts it makes to its beneficiaries. Many of the beneficiaries, of course, would be too poor to owe tax.

CONCLUSIONS

Whether the desirability of a completely restructured federal tax system is as urgent as many of us believe is a matter for the Congress to resolve. There is, in my judgment, a very high price to be paid in either rejecting the difficult chore of constructing a new tax system or in fudging the job with nickel and dime revisions. That price may be delineated in terms of a fiscal system that every day further relaxes the constraints on government's preemption of our production resources and that every day intensifies the distortions of the market's price signals, resulting in less and less efficient use of our production capabilities. One of the major, least understood consequences thereof is the erosion of our property rights and the effectiveness with which we use them.

The price is too high to regard with equanimity. What brings people like me to bear witness to the Committee is the hope that we can persuade you to act on the basis of principles that you deem to be appropriate for a free society.

<table>
<tr><th colspan="2">INCOME OF BUSINESSES UNDER AN INFLOW-OUTFLOW TAX (distributions to shareholders and creditors taxed on individual tax returns)</th></tr>
<tr><th>Income flows</th><th>Deductions from income</th></tr>
<tr><td colspan="2">INCOME AND COSTS OF PRODUCTION</td></tr>
<tr><td>REVENUES FROM OPERATIONS:

<u>Sales and Fees</u>: sales of products, services, or property to individuals or other businesses; fees for financial, legal, personal services; insurance premiums; rents, royalties received

RETURNS ON PORTFOLIO INVESTMENTS:

<u>Interest and dividends received</u></td><td>COSTS OF PRODUCTION:

<u>Labor Costs</u>: wages, pension contributions, fringe benefits, workers' compensation

<u>Purchases</u>: goods, services, and property bought from individuals and businesses (expensing of plant and equipment, structures, inventory, materials, energy, supplies, R&D, accounting services, cleaning services, etc.), rents, royalties paid

<u>Interest, Insurance Benefits paid</u>

<u>Taxes</u>: payroll taxes, state and local income and property taxes, sales and excise taxes</td></tr>
<tr><td colspan="2">OPERATING and PORTFOLIO INCOME: The above items, net (left column less right column) constitute operating and portfolio income. Premiums received and benefits paid by insurance businesses are a mixture of fees and capital flows. Pure capital transactions are shown below.</td></tr>
<tr><td colspan="2">PORTFOLIO SALES AND CAPITAL ACCOUNT TRANSACTIONS:</td></tr>
<tr><td>BORROWING and PROCEEDS OF STOCK ISSUE; DEPOSITS BY CUSTOMERS (financial institutions, brokerages, etc.)

PROCEEDS FROM ASSET SALES OR OTHER DISPOSITIONS OF ASSETS:

<u>Sales of assets</u>: sales of stock in other companies, bonds, mortgages, foreclosed assets;

<u>Drawdowns</u>: drawdowns of bank deposits, maturing bonds, returns of principal, etc.</td><td>REPAYMENT of BORROWING and REDEMPTION of STOCK; WITHDRAWALS OF DEPOSITS BY CUSTOMERS (financial institutions, brokerages, etc.)

DISPOSTION OF NET REVENUES:

<u>Portfolio Investment</u> (including bank deposits)

<u>Dividends Paid to Shareholders</u></td></tr>
<tr><td colspan="2">NET REVENUES: Net revenues consist of net operating income plus asset sales and net capital account transactions (equity, debt and deposit inflows less outflows). DISPOSITION OF NET REVENUES: Businesses may use the revenues for two purposes. PORTFOLIO INVESTMENT: They may retain and save the revenue via portfolio investment. DIVIDENDS: Alternatively, they may pay dividends, which become shareholders' taxable income. These options exhaust business revenue. There is nothing to tax.</td></tr>
<tr><td colspan="2">TAXABLE INCOME AT BUSINESS LEVEL: ZERO. There is no tax at the business level under an integrated inflow-outflow tax. All taxes are paid by individuals. There is no need for the business to file an income tax return. It merely generates W-2 forms for workers, and 1099 forms to report interest and dividends to recipients and to show savers their net saving (net deposits or share purchases).</td></tr>
</table>

Addendum, testimony of Dr. Norman B. Ture, President, IRET

IRET Institute for Research on the Economics of Taxation.

March 20, 1997

TAX INCREASES BY ANY OTHER NAME

IRET Economic Policy Bulletin No. 70

by Michael Schuyler

- The approximately 50 tax increases that the Administration seeks in its budget this year have received much less attention that the tax cuts the Administration is promising. The Administration describes the revenue raisers, which it estimates would collect $76 billion over 5 years, as ending various corporate tax breaks and other unwarranted tax subsidies while extending several taxes that are slated to expire.

- In fact, the tax hikes the Administration wants have the common feature that they would increase marginal tax rates, especially on funds that are saved and invested. The higher tax rates would discourage capital formation, which would weaken the economy, and further distort business decision making, which would also lower the economy's efficiency.

- Most of the Administration's proposed tax increases are very technical and would be collected at the business level. That combination would largely shield them from view, despite their magnitude.

- This paper evaluates in detail a sample of a dozen of the Administration's proposals. The sample includes changes that would raise effective marginal tax rates on capital gains, add tax traps for companies attempting to change their structures, increase multiple federal taxation of the same income when one company owns shares in another, make it harder for firms with losses to reflect those losses against income and taxes from prior years, poison a section of the municipal bond market, intensify a double-tax hazard for U.S. firms that export, and extend an (appropriately named) unemployment tax surcharge that discourages employment.

- The tax system is already too distortionary and complicated and too much of it is hidden from the public. The Administration's proposals would worsen these problems. They are directly contrary to principled tax reform.

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Institute for Research on the Economics of Taxation.

March 20, 1997

TAX INCREASES BY ANY OTHER NAME

IRET Economic Policy Bulletin No. 70

Along with the much publicized tax reductions in its budget plan, the Administration is including a long list of proposed tax increases. Although the President did not mention the tax increases even once in his State of the Union speech, they are not puny--$76 billion through 2002. Some would extend expiring or expired tax provisions; many, the Administration declares, would close supposed corporate tax loopholes or correct other abuses. Most are directed at investment income and generally would be collected at the business level. By and large, these proposals were made by the Administration last year but rejected by Congress then.[1]

One Clinton Administration source is quoted as claiming the tax increases targeted at supposed loopholes would actually "help the economy."[2] According to the source, the proposals, if enacted, would "reallocate resources from tax-avoidance activities to business activity."[3]

In economic analysis, higher taxes on investment income weaken investment by undercutting investment incentives; people are not as eager to invest when higher taxes reduce their after-tax returns. The Administration claims its recommended tax hikes are different. Supposedly, the revenue raisers would ferret out what a senior Administration official describes as "corporate [tax] loopholes and unwarranted [tax] subsidies."[4] In the budget documents it has submitted, the Administration says of its proposals, "The budget eliminates or shrinks a wide range of tax loopholes and preferences that are no longer warranted... Restricting them would help balance the budget, increase the equity and efficiency of the tax system, and keep corporations focused on productivity and profits..."[5]

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[1] See Michael Schuyler, "False Charges of Corporate Welfare Fuel Administration Tax Hike Proposals," **IRET** Policy Bulletin No. 66, June 1996 and Michael Schuyler, "The Clinton Economic Plan: Contingent Promises and Hidden Burdens," **IRET** Policy Bulletin No. 69, October 1996.

[2] Clay Chandler, "Corporate Tax Plan Readied," *The Washington Post*, January 31, 1997, p. A8.

[3] Chandler, "Corporate Tax Plan Readied," *op. cit.*

[4] Chandler, "Corporate Tax Plan Readied," *op. cit.*

[5] U.S. Office of Management and Budget, *Budget Of The United States Government, Fiscal Year 1998* (Washington, DC: Government Printing Office, 1997), p. 115.

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Passing off higher taxes as a fight against corporate welfare has obvious political appeal, but the Administration's assertions omit an essential step. In order to determine whether a provision in existing law is a subsidy, it must be compared to a neutral tax -- one that does not favor or penalize the taxed activity relative to other activities. Such comparisons reveal strong biases in the existing income tax system against saving and investment. Some provisions in current law ease--but generally do not eliminate--those biases. Such provisions are often mistakenly labeled as tax subsidies even though they continue to penalize saving and investment relative to neutral tax treatment. Unfortunately, the Administration does not use tax neutrality as its benchmark.

Many of the provisions would add additional layers of tax on targeted forms of income. Almost all of the recommendations would increase effective marginal income tax rates, especially on income associated with saving and investing. Most of the provisions would raise the service price of capital (the pre-tax return required on the marginal unit of capital to justify its purchase), meaning that more worthwhile investment projects would be rejected for tax reasons. The Administration's proposals are complex, which would make the tax system more complicated and push up taxpayers' compliance costs. The tax hikes would also be hidden, causing people to underestimate how much they are paying in taxes for government services.

A Representative Sample of the Administration's Proposed Tax Hikes

In its budget submission to Congress, the Administration seeks approximately 50 tax increases or extensions of taxes that are scheduled to expire. Because of the number of proposals and their complexity, it would not be practical to examine all of them here. A representative sample, consisting of a dozen of the Administration's revenue raisers, is analyzed below.

<u>Require sellers of capital assets to use an average-cost method in computing their capital gains</u>
Notwithstanding Administration rhetoric about corporate taxes, the primary target of this proposal is the individual taxpayer. Under current law, when an investor sells part of his or her holding of a particular security, shares of which were acquired at different times and at differing prices, the investor must specify which shares have been sold and identify their cost or other basis. The investor may rely on various ways to do so. One way is to specify a specific block of shares as the ones sold and use the actual cost of those shares in computing the capital gain (capital gain = sale price - cost). Another way is to assume the first shares bought were the first ones sold and use their cost. Yet another way (permitted with mutual fund shares) is to assume the shares sold were a blend of all the shares owned before the sale and use the average cost of all the pre-sale shares. (If 500 shares were owned before the sale and 100 are sold, the cost of each of the 100 shares is assumed to be the average per-share cost of the 500 shares.) The Administration's proposal would disallow all but the last method, known as the average cost method. Inconsistently, the Administration's proposal would not allow taxpayers to do any averaging in determining holding periods but would require them to use the first-in, first-out method for that purpose. Heads the government wins; tails the taxpayer loses.

To defend its proposal, the Administration says, "[S]pecific identification is artificial and complex."[6] This argues that the Administration's proposal should be accepted in order to simplify the tax code; it does not imply, even if the claim were true, that other identification methods are loopholes. Unfortunately, the Administration's promised simplicity is illusionary. The cost averaging may itself be artificial and complex, often more so than other identification methods, involving as it does a consideration of all shares owned and an artificial blending of their various purchase prices. The complexity is increased because the Administration would force taxpayers to use a different identification method (first-in, first-out) in determining holding periods. The Administration also complains that current law "permits taxpayers to engage in [tax] planning so that the amount of gain or loss they recognize for tax purposes is unrelated to their actual economic gain or loss."[7]. The Administration is correct that current law does allow taxpayers more options than the Administration would. But the mere presence of options does not constitute a loophole unless some of the options are unwarranted, a case the Administration has not succeeded in making. It is hardly a tax subsidy to allow investors to choose among several reasonable basis determination methods.

By restricting investors' options in identifying the cost basis of the shares they sold, this change would effectively raise the marginal rate of tax on investors' realized capital gains tax liabilities. Suppose, for example, that a person had bought 100 shares of a stock for $8 each in 1980, another 100 shares for $25 each in 1990, and another 100 shares for $60 each in 1996. (The price of this hypothetical stock increases at roughly the same rate as the Dow Jones stock-market index.) Suppose, further, that the person decides to sell 50 of those shares for $70 each in 1997. If the person uses the specific identification method and identifies the shares as ones that were bought in 1996, the cost basis on each of those shares is $60 and the capital gain on each is $10. If the law were changed along the lines of the Administration's basis averaging proposal, however, the per share cost basis would become $31 (purchases of $800, $2,500, and $6,000 averaged over 300 shares) and the capital gain on each share sold would jump to $39. In this case, the Administration's proposal would increase the capital gains tax by 290%. If the person pays capital gains tax at a 28% rate, his or her tax bill would shoot up from $140 (28% of 50 shares x $10 capital gain per share) to $546 (28% of 50 shares x $39 capital gain per share). Notice that although the statutory tax rate remains 28%, the change in the tax base produces, in effect, a dramatic rise in the person's marginal tax rate.[8]

The capital gains tax is one of the levies that worsens the tax system's bias against saving and investment. Consider some of the tax penalties. The income tax begins with a fundamental

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[6] *Treasury Explanations, op. cit.*, p. L-15.

[7] *Treasury Explanations, op. cit.*, p. L-15.

[8] To be sure, if the person subsequently sells the remaining 250 shares, the capital gain reported on them for tax purposes would be correspondingly lower. The effect of the Administration's proposal in that case would be to front-load the capital gains tax. Because time has value, forcing taxpayers to pay taxes sooner is equivalent to a higher marginal tax rate.

bias against saving and investment. If a person directs some of his or her earnings into saving, the person must pay income tax on both the earnings and the returns on the saving. If the person uses the earnings for current consumption, however, the person pays income tax only on the earnings. By taxing the saving stream twice but earnings used for consumption only once, the income tax places a tax penalty on saving and investment. If individuals invest via corporate equity, the income tax penalty increases because the same income is subjected to two levels of income taxation. The returns on the saving are taxed once at the corporate level by the corporate income tax. Then, if the already-taxed earnings are paid out to shareholders as dividends, they are taxed again at the personal level by the individual income tax. On the other hand, if the after-tax earnings are retained by the company and reinvested, they will increase the company's expected future earnings, which will increase the company's stock price. When the retained earnings generate income in the future, that income will itself be subject to tax. Individual shareholders can realize the retained earnings by selling their shares, but at that point they must pay capital gains tax, effectively paying tax on the retained earnings again. In summary, rather than taxing the income stream once, the current tax system applies layer after layer of income tax. One of those excess layers of income tax is the capital gains tax. In order to move towards tax neutrality, the capital gains tax should be reduced or, better, eliminated.

By increasing the marginal capital gains tax rate, the Administration's proposal would push up the tax-inclusive service price of capital. (Additional units of capital would need to earn higher pre-tax returns to justify their purchase.) The higher service price of capital would block some investment projects from being undertaken. With less capital, the economy would be less productive than otherwise. Capital owners would bear some of the loss, but much of it would be passed to workers.[9] Workers are paid based on how much value they add to output, and when productivity is higher, they add more value. Conversely, when productivity is lower, they add less value and command lower wages. The Clinton Administration's proposal would add new tax barriers to advancing employment, output, and real wages.

In addition to the economic damage it would cause, a stiffer capital gains tax would not even be very effective as a revenue raiser. The higher marginal tax when assets are sold would cause investors to sell assets less frequently (the lock-in effect), depress asset prices (reducing the stock of unrealized gains), and weaken the economy (reducing tax revenues from other sources). These feedback effects would whittle away at the potential revenue gain. Some studies suggest a heavier capital gains tax may be a revenue loser.

<u>Prohibit issuers of corporate bonds with maturities exceeding 40 years from deducting their interest payments</u> When businesses issue debt, they can normally recognize interest payments on the debt as business expenses and deduct those costs in computing taxable income. The

[9] The benefits to workers of higher productivity are extremely significant. Many studies of production functions have found that when capital accumulation raises productivity, about one-third of the gain goes to capital owners and about two-thirds goes to labor.

Clinton Administration wants to deny the deduction of interest paid on corporate securities with maturities of over 40 years. This would most affect 100-year bonds, which were once common, then fell into disfavor when inflation was higher and more volatile, but are now being issued by a few companies. The Administration's position is that when the maturity of a debt instrument extends past a certain point, the debt instrument becomes like equity. The Administration notes that dividends on equity are not deductible and asserts that the same disallowance should apply to supposedly equity-like debt; doing otherwise, it hints, is a tax loophole. "The line between debt and equity is uncertain, and it has proven difficult to formulate general rules to classify an instrument as debt or equity for all purposes....Taxpayers have exploited this lack of guidance by, among other things, claiming interest deductions for instruments that have substantial equity features..."[10] This is one of a number of proposals that, according to the Administration, "clarifies the treatment of new financial instruments that aim to exploit the different tax treatment of equity and debt, by denying or deferring interest deductions on certain instruments that have substantial equity features."[11]

The Administration's proposal, however, completely ignores the legal and economic distinctions between debt and equity. Those distinctions do not depend on the maturity of the instrument. If the debt-vs-equity character of a financial instrument depended on its maturity, for instance, commercial paper and 3-month Treasury bills would be virtually pure debt, but 30-year corporate and Treasury bonds would be regarded almost as stocks. In fact, there is no such relationship. A basic distinction between debt and equity is that debt holders have greater certainty than equity owners regarding future payments because the payment schedule on debt securities is generally specified in advance. Further, debt holders enjoy legal priority over equity owners in receiving payments: debt holders can push a company into bankruptcy if they are not paid; equity owners cannot. On the other hand, if a company prospers, equity owners have greater potential to share in the gains. These distinctions are unrelated to a debt's maturity; they are the same whether a debt's term is 3 months or 100 years. Even the Administration seems uncomfortable with its argument, for it admits that the bonds whose interest costs would become nondeductible are not really equity: "The proposal is not intended to affect the tax characterization of instruments described in this proposal as debt or equity under current law."[12]

In assessing the Administration's proposal, it should also be understood that the deduction for interest costs is not a tax loophole. Clearly, if the interest were not deductible, the before-tax interest that a borrowing company would be willing to pay per dollar of borrowing would be less than under present law. The consequence would be that lenders would be willing to invest less in the company or would require other, greater rewards for doing so. The cost to the company

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[10] *Treasury Explanations, op. cit.*, p. L-13.

[11] *U.S. Budget FY98, op. cit.*, p. 115.

[12] *Treasury Explanations, op. cit.*, p. L-13.

of attracting the saving it requires to finance its capital additions would be raised by the Administration's proposed arbitrary change in the tax treatment of long-term debt.

Beyond this, however, the Treasury proposal would result in double taxation. If debt service payments could not be deducted, they would be included in the tax bases of both the businesses paying the interest and the lenders receiving the interest. Thus, two different parties would be paying income tax on the same income.

On the payments it affected, this change would generate an enormous rise in marginal tax rates. As an illustrative example to show how the loss of the interest-expense deduction would adversely affect the service price of capital, suppose a company intends to finance a marginal dollar of investment with a 100-year bond issued at 10% interest. Assume that the company's marginal tax rate is 35%. Suppose, also, that under current law the company's service price of capital is 15%: the marginal dollar of investment must generate a gross return of 15% to provide the company with an adequate reward on its managerial efforts after subtracting interest, taxes, and other expenses and adjusting for inflation. If the interest payments become nondeductible as proposed by the Administration, the change would suddenly increase the company's tax bill. As a result, a 15% gross return, which previously sufficed, would no longer provide the company with an adequate after-tax return. To counterbalance the higher tax, the company's service price of capital would have to rise to 20.38%, a jump of 35.9% (5.38 percentage points).[13] This sharp rise in the service price of capital would squeeze out many desirable investments.

How does this selective tax penalty on a particular form of debt being proposed by the Administration improve the allocation of anything? If companies planning to issue 100-year bonds to finance their investment projects did not have other financial options, many would cancel the investments because of the extraordinary increase in the tax-inclusive costs of the investments. The loss of valuable investment projects would lead to a weaker economy, characterized by lower productivity, less output, and lower incomes for capital owners and labor. In many cases, companies could avoid the new tax by financing their investments with bonds whose maturities did not exceed 40 years or by issuing stock. If they all do this, the tax will raise no revenue at all. Still, when companies find they must rearrange the financing of their investments because of a new tax, some may have second thoughts about making the investment, causing a decline in the total quantity of investment.

This proposal may also be of concern because of the precedent it would set for limiting the tax deduction on interest payments. Given the tendency in Washington to argue that a restriction

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[13] With interest deductible, the after-tax cost of the debt financing was 6.5%: 10% interest payment minus 3.5% tax reduction due to reduced income. With interest non-deductible, the after-tax cost of the debt financing would rise to 10%. To make up for the higher tax, the company would need an extra 5.38% of gross return. (The increase in the gross return exceeds 3.5% because it is itself subject to tax. Given the company's tax rate, it is 3.5% on an after-tax basis.)

on taxpayers in one case ought to be extended to taxpayers in other cases, one must wonder whether this or a subsequent Administration would later assert that if interest on 100-year bonds is nondeductible, interest on, say, 30-year bonds should also be nondeductible. After all, since the Administration is being entirely arbitrary when it claims that debt becomes like equity after 40 years, it could later try to move that arbitrary line.

Accelerate assessment of capital gains tax when asset owners largely eliminate risk through hedges Under current law, the owner of an asset is generally not charged capital gains tax on the asset until gain or loss on the asset is realized, that is, until the asset is sold, exchanged, or otherwise disposed of. The Administration would change this by assessing the tax earlier if the asset has risen in value and if the taxpayer (or sometimes a relative of the taxpayer) "substantially eliminates [further] risk of loss and opportunity for gain by entering into one or more positions with respect to the same or substantially identical property." [Ibid., p. L-16.] The Administration calls the elimination of risk a "constructive" sale and says that a "constructive" sale should be treated as a regular sale, provided the asset's value has risen. If a "constructive" sale produces a capital loss, though, the Administration would not view it as the equivalent of a regular sale.

Most press stories and Administration comments have described this proposal in terms of a procedure known as "selling short against the box", but the proposal is potentially much broader; it applies to using hedges that eliminate most of the risk from price fluctuations in an asset, not to a particular procedure for doing so.

Because the important economic functions of hedges are often misunderstood, it is useful to begin by describing them. Generally, a tradeoff exists between the riskiness of an asset and the asset's expected return. For instance, a 3-month Treasury bill has low risk and a low return while a growth stock is much riskier but has a far higher expected return. The willingness to shoulder risk in order to seek higher expected returns varies from investor to investor. Furthermore, it often varies for an individual investor over time as the investor's specific circumstances change. Hedges provide a means for investors to adjust the riskiness vs. expected returns on their assets better to meet their preferences. Suppose one investor would like to reduce risk on an asset and is willing to sacrifice some potential return to do so. Suppose another investor attaches more priority to the possible return and is willing to bear added risk. Then both parties can better satisfy their wants by entering into a transaction: the first party shifts some of the asset's risk to the second in return for the second being able to claim more of the asset's future returns. Under this arrangement, the total returns on the asset remain taxable to one or another of the two parties. The earnings may be shifted from one taxpayer to the other, but they do not escape tax, as can be seen if both parties to the transaction are included in the analysis.

Often hedges are criticized because only the party taking on risk is considered. In that incomplete analysis, hedges are then disparaged as being akin to gambling. As just explained, however, the typical hedge has two parties -- one reduces risk and the other accepts risk -- and the hedge serves the very valuable economic function of allowing investors to come closer to their risk-return preferences. In the past, it has sometimes been suggested that the government ought to use taxes or regulations to restrain the party taking on risk to obtain a higher expected return. Ironically, the Administration's proposal attacks the other side, in seeking to toughen the tax treatment of the party anxious to reduce risk.

Another motivation for hedging is that two parties may have different expectations about an asset's future returns. One may be fearful the asset's price has a good chance of falling; the other may think its price is likely to rise. Because of their divergent expectations, a hedge makes good sense for both of them (with the two parties on opposite sides, of course.)

These two motivations do not depend on tax considerations. Even if taxes did not exist, people would sometimes want to hedge because doing so allows them to tailor their investments to their risk-return preferences and their expectations about the future. Further, if new tax rules penalized hedges, investment would suffer because potential investors would confront heavier tax-inclusive costs when they tried to adjust the mixture of risk and expected return they carried. Those higher costs would make people more reluctant to invest in the first place.

The Administration totally ignores these reasons for hedging and pretends that hedges are necessarily wasteful and undesirable. "If you didn't save a dime [that is, collect any taxes sooner], I think this [Administration proposal] is something you should do," said Treasury Secretary Rubin at a Congressional hearing. "When you allow these kinds of distortionary mechanisms to exist, they absorb a lot of capital that would otherwise be put to productive use."[14] In reality, as explained above, hedges, which Secretary Rubin dismisses as "distortionary mechanisms", are extremely important and valuable to investors for nontax reasons. Making them into tax targets would make investment less desirable, and that would reduce the amount of investment.

There is a third reason for using hedges that is tax related. If a person wants to sells an asset and does so in the current year, that is treated as a taxable realization that year. If a person uses a hedge in the current year to lock in the asset's current price but does not sell the asset until the next year, that is generally treated as a taxable realization in the next year. Thus, a person who wants to sell an asset at its current price can use a hedge so that the taxable realization occurs in the next tax year. This motivation is often a factor in the type of hedge known as selling short against the box. In selling short against the box, an investor arranges to sell borrowed shares while owning identical shares. For example, an individual who owns 100 shares of XYZ Company might borrow 100 shares of XYZ Company and sell the borrowed shares. Because the person now has opposing positions in the owned and borrowed shares, the person will neither gain nor lose from subsequent changes in the price of XYZ stock. Under current law, a taxable realization is not deemed to occur until the positions are closed (perhaps by using the owned

[14] Reported in *Daily Tax Report*, February 13, 1997, p. G-3.

shares to replace the borrowed shares), and the closing of positions might not happen until the next tax year. But delaying receipt of the proceeds from a sale is not costless. The money received next year instead of this year is of less value to the seller, and his tax liability should be lower -- or postponed until next year -- to reflect this.

Whether or not a short-against-the-box position is taken solely for tax reasons, though, the effect of the Administration's proposal on an investor selling short against the box should be considered. If the procedure produces a gain, the taxable realization would be deemed to occur immediately under the Administration's proposal. Further, if circumstances are such that present law treats the gain as occurring next year, that would speed up the investor's tax liability by a year. Because time has value, that, in effect, raises the tax rate on the gain from the investment. At a 10% discount rate, for instance, the change would effectively boost the marginal tax rate on capital gains by 10%. The higher capital gains tax would reduce the incentive to invest; that would tend to lower the quantity of investment; and the tax-induced drop in investment would hurt the economy. Thus, even in those instances where selling short against the box is tax motivated, the Administration's recommended change in the law would have negative economic consequences that should be weighed against the efficiency gains the Administration promises. Note, too, that the tax on the capital gain is a form of double taxation to begin with.

Although the Administration insists that current law, which does not regard substantial risk reduction through hedging as equalling asset disposition, is transparently wrong, the details of the Administration's proposal indicate either that the Administration is not really sure or that the Administration is simply casting about for ways to hike taxes. If the Administration is sincere in its stated belief that eliminating risk from subsequent changes in an asset's price is a "constructive sale", the proposed rule should apply whether a "constructive sale" produces a capital gain or a capital loss. The Administration, however, would only apply its new rule when doing so would produce a capital gain. When a taxpayer has an asset that has declined in value and uses a hedge to protect against further price movements, the Administration would not recognize a realization. Again, heads the Treasury wins; tails the taxpayer loses. Like the Administration's basis-averaging proposal, this one would place further restrictions on taxpayers' choices in figuring capital gains in a way that would accelerate the investors' tax liabilities.

Another concern is tax complexity. The Administration says a hedge that "substantially eliminates [further] risk of loss and opportunity for gain" on an appreciated position should be treated as a taxable realization. How much risk reduction would trigger the tax -- and how much leeway would the IRS have in interpreting the amount of risk reduction? While it may be clear enough when selling short against the box, there are many other risk-reduction techniques and situations for which it is very unclear. The Administration's proposal, if enacted, virtually guarantees legal uncertainty and costly disputes between taxpayers and the IRS. Taxpayers trying to reduce risk will have to be wary of falling into tax traps that accelerate their tax liabilities. Good tax policy should strive to reduce tax uncertainty and administrative costs, not increase them.

If the Administration's propo·al is adopted in any form, the situations to which it applies should be clearly and explicitly spelled out in the law. For example, if it applies only to selling short against the box, there would be much less uncertainty and potential for confusion than under the Administration's current proposal.

Shorten the carryback period on net operating losses (NOLs) Under current law, businesses owe taxes if they earn profits but do not receive government checks if they suffer losses. They can, however, carry current-year losses back up to 3 years to reduce taxes they paid in previous years and carry losses forward up to 15 years to reduce taxes they will owe in future years. Carrybacks and carryforwards of net operating losses (NOLs) are not tax loopholes but means of letting businesses offset losses to a limited extent against profits when calculating their taxes. A better netting of losses and gains over the life of a business would occur, of course, if the carryback period were not so short.

The Administration, however, wants to shorten the carryback period to just 1 year and claims it is merely trying to simplify the tax code. In the Administration's words, "[B]ecause of the increased complexity and administrative burden associated with carry-backs, the period of carry-back should be shortened."[15] Perhaps to give the appearance of being evenhanded, the Administration would lengthen the carryforward period to 20 years. The Administration, which expresses such concern about the complexity of the carryback period, posits that the carryforward period can be lengthened "without substantially increasing either complexity or administrative burdens."[16]

Carrybacks are more helpful to companies with losses than carryforwards because carrybacks reduce taxes immediately while carryforwards only reduce future tax payments.[17] Because future dollars are worth less than current dollars, the delay associated with carryforwards reduces to less than its original amount the present value of an NOL that cannot be claimed until some future year. For example, if a $1 NOL in the current year can be claimed as a carryback to a year in which income was realized, tax on $1 of income in the prior year can be recovered without delay. That means the value of the NOL does not have to be discounted. On the other hand, if the NOL must be carried forward, say, 15 years and the discount rate is, say, 10 percent, the discounted value of the $1 NOL plummets to 24 cents.

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[15] *Treasury Explanations, op. cit.*, p. L-18 to L-19.

[16] *Treasury Explanations, op. cit.*, p. L-19.

[17] With carrybacks, companies can net their current losses against income from prior years. This de facto income averaging reduces the companies' taxable incomes for the prior years and lets them obtain refunds on some of the taxes they paid in those prior years. With carryforwards, companies must wait until future years when they have positive taxable incomes and then net their losses against their future incomes. This netting reduces the companies' future taxes below what they would be otherwise — provided the companies have positive incomes in the future so they can use the carryforwards.

Given that the Administration nowhere contends that the current carryback period is a tax subsidy, it is surely deceptive to include it among alleged subsidies and loopholes. Moreover, an internal contradiction emphasizes the implausibility of the Administration's stated rationale for changing current law. The Administration claims that current law's short carryback period is unacceptably complicated, but it also claims that a five-year lengthening of the already long carryforward period would not increase complexity in the slightest.

This proposal is a tax rate hike in disguise. Anyone planning a capital outlay must take account of possible losses as well as gains. If the Administration makes the tax consequences of losses more onerous (i.e., increases the asymmetry in tax treatment between gains and losses), that is the same as reducing the weighted mean of the likely net return. Hence, this change in the tax code would increase the service price of capital, causing fewer investment projects to be undertaken. Especially disadvantaged would be the risky investments that often add great vigor to an economy: start-up businesses and investments based on innovative technologies.

The Administration's proposal would encourage tax-driven mergers. Suppose a shorter carryback period prevents a company from claiming NOLs it otherwise could use. That would create a tax incentive to merge with a profitable company because a merger would allow the NOLs to be put to use immediately. (The NOLs could offset the profitable company's current income.)

This proposal to shorten the carryback period while lengthening the carryforward period is anything but evenhanded. It is punitive. The Administration's proposal would effectively increase the tax rates of many businesses suffering losses. It is a revenue grab that would enrich the government at the expense of businesses experiencing losses.

<u>Scale back the dividends received deduction (DRD)</u> Under current law when a corporation receives a dividend from another corporation, it may exclude part of the dividend from its taxable income. The exclusion is 100% if the recipient owns at least 80% of the stock of the dividend payor, drops to 80% if the recipient owns between 20% and 80% of the dividend payor's stock, and falls to 70% if the recipient's ownership stake is less than 20%. The Administration recommends that the 70% deduction be cut to 50%. In addition, the Administration would prevent companies from claiming a DRD unless they met a more restrictive holding-period requirement than that specified under current law. Furthermore, the Administration wants to scrap the DRD altogether on limited-term preferred stock.

If there were no deduction for inter-corporate dividends, the cumulative tax at the corporate level would rise far above its statutory rate of 35% because a succession of companies would each be paying tax on the same income. For instance, suppose Company A earns $100 and, after paying $35 of corporate tax, remits the remaining $65 to Company B. If there were no inter-corporate deduction, Company B would have to pay $22.75 on the dividend, leaving it with only

$42.25 of the original $100. The cumulative corporate-level tax would be 57.75%.[18] To prevent the cumulative corporate tax from exceeding the 35% statutory rate, the dividend received deduction needs to be 100%. Thus, in most cases the current-law DRD is already too small to be adequate. The Administration's proposals would worsen the multiple taxation at the corporate level.

Its effort to cut the 70% exclusion to 50% would do so in the very category (ownership stake less than 20%) where the DRD is already most deficient. Consider the previous example of Company A earning $100 and paying the $65 that remains after tax to Company B. With the present 70% DRD, Company B's corporate tax is $6.825 (35% tax on 30% of $65), leaving B with $58.175 of the original $100 and making the cumulative corporate income tax 41.825%. Under the Administration's plan, B's tax would rise to $11.375 (35% tax on 50% of $65), leaving B with only $53.625 and pushing the cumulative corporate income tax to 46.375%. That is a 4.55 percentage point increase in the marginal tax rate at the corporate level on the investment return.

In arguing for its request, the Administration seeks to make the DRD conditional on whether corporations are "alter egos" of each other. "The 70-percent dividends-received deduction is too generous for corporations that cannot be considered an alter ego of the distributing corporation because they do not have a sufficient ownership interest..."[19] The Administration seems to be saying that dividends between companies should always be taxed unless they are financial flows within what is, in effect, the same company. On its own terms, this rationale is deficient because it does not explain why current law's 70% DRD is suddenly "too generous" while 50% is just right. Actually, if the Administration's argument were accepted, it could be used to argue that the DRD ought to be abolished unless one company is wholly owned and controlled by another. (Perhaps the Administration's request this year is an interim step toward that end.)

More important, the Administration's rationale completely fails to address the extraordinarily high total corporate tax that results when one corporation pays dividends to another. Incredibly, the Administration actually portrays the DRD's partial relief from multiple taxation at the corporate level as creating "tax arbitrage opportunities that undermine the separate corporate income tax."[20] The Administration's assumption is that it is tax arbitrage if, when one company

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[18] That is not the end of the income taxation. If Company B passes the $42.25 to its individual shareholders as dividends, they must pay individual income tax on it. If Company B retains the $42.25, it will increase the value of B's shares and this gain will be taxed as a capital gain at the individual level when individual owners sell their shares. For an individual in, say, the 28% tax bracket, the individual level tax is $11.83, leaving only $30.42 of the original $100. That is a cumulative corporate-individual income tax rate of 69.58%. By contrast, if Company A were owned by individual shareholders and it paid a $65 dividend directly to them, the shareholders would pay $18.20 in tax, leaving $46.80 of the original $100. The combined tax would be "only" 53.2%.

[19] *Treasury Explanations, op. cit.*, p. L-14.

[20] *Treasury Explanations, op. cit.*, p. L-14.

pays a dividend to another, both do not pay corporate income tax on the same income; in other words, anything less than multiple taxation is tax arbitrage, according to the Administration. Multiple taxation of the same income, however, is not good tax policy. Again, to prevent the cumulative corporate tax from exceeding its statutory rate of 35%, the DRD needs to be raised to 100%, not lowered. The Administration also fails to consider that companies ought to be viewed as mere custodians of the income of their ultimate owners, the shareholders. There ought not be any tax on dividends or retained earnings at the business level, only at the shareholder level. And this is true regardless of the number of companies through which the income must pass before it reaches the shareholders.

Moreover, the Administration's proposal would have the effect of increasing the tax penalty on a company that buys part, not all, of another company. Is there a tax principle against partial as opposed to complete ownership? If there is, the Administration certainly has not explained it. Accepted economic theory provides no basis for imposing tax restrictions of this sort on the portfolio decisions of businesses. The government should not be telling businesses how to structure themselves.

The Administration's argument for stiffening the holding period requirement is, "No deduction for a distribution on stock should be allowed when the owner of stock does not bear the risk of loss otherwise inherent in the ownership of an equity interest..."[21] The Administration goes on to say that when its suggested holding-period requirement is not met, stock becomes "the equivalent of a bond", implying that dividends are the equivalent of bond interest. One flaw in this argument is that it is irrelevant. The key problem is that when one corporation pays a dividend to another, the same income will be taxed twice at the corporate level unless there is a 100% DRD. Regardless of whether the inter-corporate transfer is classified as dividend or interest, the income should not be taxed twice (in addition to the third tax at the shareholder level). A second problem is that neither economics nor finance supports the notion that equity transmutes into debt if an arbitrarily specified holding period is not met.

Even on its own terms the Administration's argument is inconsistent in a heads-the-taxpayer-loses, tails-the-government-wins manner. If the Administration honestly believes that dividends become interest unless its proposed holding-period requirement is met, the company paying the dividend should be able to treat it as stock. If both the payor and the payee treat the dividend like debt, the payor would deduct it and the payee would include it in income. Thus, it would be taxed once at the corporate level. Rather than being consistent, however, the Administration would exact a double tax by forcing the payor to treat the dividend like equity and the payee to treat it like interest, thereby denying deductions to both.[22]

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[21] *Treasury Explanations*, *op. cit.*, p. L-14.

[22] In its long-term bond proposal, the Clinton Administration is trying to raise taxes by claiming debt is like equity. Here it is trying to raise taxes by claiming equity is like debt. The Administration seems to be arguing whichever way would raise taxes in any given case.

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The Administration's proposals would harm saving and investment by adding to the tax penalties on the corporate form of business organization. Indeed, even if the DRD were raised to 100%, corporate earnings would still be double taxed, once at the corporate level by the corporate income tax and a second time when realized at the individual level by the individual income tax. Scaling back the DRD would worsen the multiple taxation. The heavier tax would also intensify an unwarranted tax signal to corporations either not to own shares in each other or to increase their holdings towards complete ownership.

Treat certain preferred stock as "boot", which would cause more corporate reorganizations to trigger immediate taxes on shareholders In corporate reorganizations, the receipt of stock generally does not require shareholders to recognize gain (or loss). For example, if a corporation wants to spin off a subsidiary and issue stock in the new company to shareholders in the parent company, that is not a taxable event, and the shareholders who receive the new shares do not have to pay tax on them until they sell them. On the other hand, if the shareholders receive "boot" (property other than stock, in this case), they generally are subject to immediate taxation.

The Administration seeks to recategorize certain preferred stock as "boot" (non-stock property) in this one section of the tax code. The change would force those who receive certain preferred stock in a corporate reorganization to pay taxes as a direct result of the reorganization. In rationalizing its recommendation, the Administration insists that preferred stock is not really stock because preferred stock "has an enhanced likelihood of recovery of principal or of maintaining a dividend or both..."[23]

The Administration's attempt to deny in this one section of the tax code that preferred stock is stock is wholly without merit. Preferred stock is generally recognized as a category of stock. It has features that distinguish it from common stock, but those features have a very long history and do not suddenly cause preferred stock to cease to be stock. Further, if the Administration were sincere in the belief that preferred stock is not stock, it would extend its reclassification to preferred stock dividends. Businesses cannot deduct preferred stock dividends, but if the government reclassified preferred stock as debt throughout the tax code (the Administration states, "[M]any preferred stocks are functionally equivalent to debt securities."[24]), businesses could deduct their preferred stock dividends. Of course, the Administration proposes nothing of the sort; the reclassification it wants favors the tax collector. In this case, it would call equity debt.[25]

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[23] *Treasury Explanations, op. cit.*, p. L-19.

[24] *Treasury Explanations, op. cit.*, p. L-19.

[25] If the Administration's argument were accepted and followed to its logical conclusion, it would suggest that all outstanding preferred stock should be rated in terms of likelihood of recovery of principal and maintenance of dividends, and treated partially as stock and partially as debt based on the rating, with the debt share treated as debt throughout the tax code (implying deductibility of a portion of preferred stock dividends).

The Administration would not be closing a tax loophole here but taking advantage of taxpayers. For the taxpayers it affected, this proposal would sharply increase the marginal tax rate on their investments. The Administration's proposal would also hurt the economy. Because the tax would be triggered by certain corporate reorganizations, it would tend to lock in existing business arrangements, making change more difficult and existing organizational structures more rigid. Spinoffs and other corporate reorganizations are important to the economy because they help businesses operate more efficiently, and that leads to a more vibrant and competitive economy. If the government succeeds in throwing another hurdle in the path of corporate reorganizations, it will prevent some of them from being undertaken. The result will be a less flexible, less innovative, and less competitive U.S. economy.

<u>Treat conversions from C corporations to S corporations as taxable events</u> Under tax code section 1374, a C corporation can convert into an S corporation without triggering taxes. (If the S corporation sells within 10 years assets that it held at the time of the conversion, though, it must pay tax on the assets' built-in gain.) The Administration wants to treat the conversion as a total liquidation of the C corporation if the C corporation's value exceeds $5 million. That would make the conversion a taxable event at both the corporate and shareholder levels. At the corporate level, capital gains tax would be due on all appreciated assets within the corporation. At the shareholder level, capital gains tax would be due on any appreciated value in the shares of the company.

When businesses are organized as sole proprietorships or partnerships, business earnings are imputed directly to the individual owners and taxed at the individual level. S corporations, which resemble partnerships in having a relatively small number of owners, receive similar tax treatment: incomes from S corporations are imputed directly to shareholders. Thus, the earnings of S corporations are taxed at the individual-holder level but not at both the corporate and individual levels. When businesses are organized as C corporations, however, the government applies a tax penalty: earnings from the business are taxed at the corporate level and again at the individual level. The Administration refers to this difference in tax treatment of business income when it says, "C corporations are generally subject to a two-tier tax [i.e., two income taxes on the same income]. A corporation can avoid this economically unjustified two-tier tax by electing to be treated as an S corporation..."[26] Substituting a single level of tax for two levels of tax, though, is hardly a tax break. Instead, it is a move towards more principled, less onerous taxation. From the perspective of good tax principles, income from a business should not be subject to two separate income taxes on the same income. The single-level tax on sole proprietorship earnings, partnership earnings, and S corporation earnings could serve as a model for how C corporation earnings ought to be treated.[27]

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[26] *Treasury Explanations, op. cit.*, L-19.

[27] Once upon a time, it would have been computationally difficult to take the income of a large corporation and figure out how much to attribute to each shareholder. That computational challenge may help explain, historically,
(continued...)

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The Administration's only defense of its proposal is that "The tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the treatment of its conversion to a partnership."[28] Under current law, a conversion from a C corporation to a partnership is treated as a complete liquidation of the C corporation. Instead of being a good model, though, this is a very bad model. First, it is artificial to regard a going business as being completely liquidated merely because it converts from one form of organization to another. Second, capital gains taxes come due if the conversion is treated as a liquidation, and capital gains taxes are excessive. Third, capital gains taxes are doubly inappropriate in this case. When assets held by a business appreciate in value, that tends to be reflected in higher share prices. Thus, taxing asset appreciation at the business level and share appreciation at the shareholder level subjects the same appreciation to <u>two</u> capital gains taxes. Rather than patterning the tax treatment of conversions to S corporations on the tax treatment of conversions to partnerships, conversions to partnerships ought to be treated like conversions to S corporations.

Again, in supposedly leveling the playing field, the Administration moves to extend double taxation to the correctly-taxed case, instead of reducing it in the double-taxed case. Thus, the Administration's idea does not address a tax loophole but seeks to protect egregious overtaxation by demanding a tax ransom from those who try to escape.

<u>Impose a corporate-level capital gains tax on certain business spinoffs</u> Suppose that one company would like to acquire the assets of a second company but that some parts of the second company would not be a good fit in the post-acquisition organization. Using a legal arrangement known as a Morris Trust, the second company can spin off to its shareholders the unwanted assets prior to the acquisition without triggering capital gains tax. The Administration seeks to impose a test that in many cases would not be met after the acquisition, making the spinoff subject to a corporate-level capital gains tax. According to the test, the spinoff would become taxable if the historic shareholders of the distributing company did not retain at least 50% control of the distributing company and the spinoff in the 2 years preceding and the 2 years following the spinoff. The rub is that with the acquisition the interest of the historic shareholders of the distributing company would often fall below 50%.

Under the Administration's proposal, one capital gains tax would be assessed at the corporate level on the spinoff. In addition to this, as the Administration notes, current law already assesses a capital gains tax on the spinoff at the individual level when individual shareholders sell their stock.

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[27](...continued)
why there is a separate income tax on C corporations rather than imputing the income directly to owners, as is done with sole proprietorships, partnerships, and S corporations. Today, however, the computational constraint no longer exits. Modern computers can perform the required calculations easily.

[28] *Treasury Explanations, op. cit.*, L-19.

To defend this proposal, the Treasury states, "A corporation is generally required to recognize gain on the distribution of property (including stock of a subsidiary) if such property has been sold for its fair market value."[29] The Treasury then says such a capital gains tax should come due in the case of Morris-trust arrangements, "Corporate nonrecognition under [tax code] section 355 should not apply to distributions that are effectively dispositions of a business."[30]

In its argument the Treasury does not inquire whether it is desirable to tax distributions. The tax would be appropriate if income could be invested and earn a return without being subject to any income tax except for this one tax. Not having the tax would then be a genuine loophole. On the other hand, if investments are taxed at other points -- which they are -- this tax contributes to multiple taxation and penalizes saving and investment. The tax code would be more efficient, simpler, and fairer without this tax. The Treasury also does not ask whether spinning off a subsidiary by issuing stock to shareholders should be regarded as "property ... sold for its fair market value." It is a stretch to call a spinoff a sale at fair market value just because shareholders who had previously owned a subsidiary through their stock in the distributing company now have separate shares for the spun-off subsidiary and the rest of the company.

The proposed limitation on the use of the Morris trust arrangement would impose a new capital gains tax on investments that are already subject to multiple income taxes. It would, accordingly, increase the tax cost of changing corporations' organizational structures to no identifiable constructive purpose. Faced with the increased marginal rate of tax on capital that is reallocated via a new corporate structure, some companies would decide to go it alone although joining with other companies would be more efficient. With some acquisitions that did proceed, companies would decide to retain units that they thought could become more productive if spun off because retaining the unwanted units would avoid the new tax.

<u>Deny non-financial corporations deductions for a portion of their interest expenses based on their holdings of municipal bonds</u> Under current law, interest costs on debts incurred to finance the purchase of tax-exempt securities generally cannot be deducted. Financial institutions face a tougher restriction. They are required to apply an interest allocation rule, according to which it is arbitrarily assumed that they used a portion of their debts to finance the purchase of any tax-exempt municipal securities they own. For those institutions, "debt generally is treated as financing all of the taxpayer's assets proportionately."[31] The Administration wants to extend this allocation rule to non-financial corporations (except insurance companies). The percentage of a company's debt charges allocated to tax-exempt munis by the proposal, and rendered

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[29] *Treasury Explanations, op. cit.*, p. L-20.

[30] *Treasury Explanations, op. cit.*, p. L-20.

[31] *Treasury Explanations, op. cit.*, p. L-15.

nondeductible, would equal the percentage "of their [the company's] total assets that is comprised of tax-exempt investments."[32]

Notice that current law already bars taxpayers from deducting interest on debt used to finance muni purchases. Thus, the effect of the proposed rule would be to disallow deduction of interest charges on debt that did not finance munis. This slants tax calculations in a way that favors the government at the expense of taxpayers and can be expected to damage the market for municipal obligations. For example, if a company is paying interest on bonds that it issued several years ago to finance a new factory and if it now buys some munis, the Administration's proposal would render nondeductible a portion of the debt service costs on the bonds that helped finance the investment in the factory. The Administration brushes such problems aside by assuming that "borrowing for one purpose frees money for other purposes."[33] In this case, the Administration would regard the previous debt taken on to finance the factory as equivalent to borrowing now to buy the munis, notwithstanding the facts.

At a more fundamental level, the Treasury is incorrect in its position that interest charges should be nondeductible when taxpayers borrow money from others and use the borrowed funds to buy tax-exempt securities. The Treasury worries that allowing the deduction would provide taxpayers with "double Federal tax benefits" (tax-exempt interest income and tax deductible interest costs), enabling them to shrink the tax base at will.[34] What the Treasury overlooks is that for every borrower who pays interest there is a lender who receives interest. That is relevant because interest payments are included in lenders' incomes. For example, if someone borrows from a lender to buy a muni and subsequently pays the lender $100 of interest, that $100 is added to the lender's income. Thus, allowing someone who buys munis with borrowed funds to deduct his or her interest payments would not shrink the tax base relative to its size if the borrowing had not occurred: the interest cost subtracted from the borrower's income ($100 in the example) is offset by the interest income added to the lender's income ($100 in the example). If interest payments were not deductible, on the other hand, the tax base would increase when people borrowed because the same interest payments would be included in the taxable incomes of both borrowers and lenders. (The increase would be $100 in the example.)

The Administration's proposal is a poison pill that would exact a stiff penalty on non-financial corporations holding municipal securities. Non-financial corporations would respond by selling many of the munis they now hold and thinking long and hard about buying new ones. That would constrict the demand for munis, making it more expensive for state and local governments to finance their debts. Indirectly, then, the Administration's proposal is an attack on the ability of state and local governments to borrow. Given the nation's federal system of

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[32] *Treasury Explanations*, *op. cit.*, p. L-15.

[33] *Treasury Explanations*, *op. cit.*, p. L-15.

[34] *Treasury Explanations*, *op. cit.*, p. L-15.

government and the importance of tax-exempt munis to state and local governments, that raises serious financial and political issues which the Administration fails to address in its proposal. If the Administration objects to the tax-exempt status of municipal bond interest, it should attack munis directly and take the accompanying political heat. Assuming munis are intended to be tax-exempt, the current rules are already too restrictive. They should be eased, not tightened.[35]

Repeal a rule allowing half of export earnings to be treated as income from foreign sources The United States allows its taxpayers to claim U.S. tax credits for the income taxes they pay to foreign governments. The United States permits these foreign tax credits (FTCs) because, unlike many other nations, it taxes its business and individual taxpayers on their worldwide incomes. Paying two nations' income taxes on the same income would obviously put U.S. companies trying to do business abroad at a grave competitive disadvantage compared to foreign rivals paying only one income tax. The purpose of FTCs is to avoid this double taxation.

In seeking added revenues over time, however, the U.S. government has increasingly tightened the allocation rules, which has cut the income taxpayers can classify as foreign source and reduced the maximum amount of foreign taxes on which they can claim credits. When a U.S. company pays income taxes to a foreign government, the credit that the company can claim against the U.S. income tax cannot exceed the lower of: (a) the company's actual foreign tax payments or (b) the U.S. tax that would be due on the income. For example, if a company has $100 of foreign source income and pays $33 of foreign income taxes, it could claim $33 of FTCs, assuming the U.S. tax on the $100 is $35. But if the United States modifies its allocation rules so that foreign source income for tax purposes falls to $80, the maximum credit would drop to $28, assuming the U.S. tax on $80 would be $28. The firm would then have $5 of excess FTCs it could not claim ($33 foreign taxes - $28 maximum credit) and its U.S. tax liability would rise by $5. The U.S. allocation rules and other restrictions often prevent U.S. taxpayers from fully crediting their foreign tax payments against their U.S. tax liabilities.

Under a rule that has been in effect almost as long as the income tax has been in existence, U.S. multinational companies can allocate their income from export sales on a 50-50 basis between production and sales, with the sales classified as generating foreign source income if they occur abroad. The Administration proposes to eliminate this export sales source rule and replace it with an "activity based" allocation procedure that would tend to give more weight to the location of production. If companies were forced to use the activity based rule, many would show drops in how much of their income they could categorize as foreign source, reducing their ability to claim U.S. tax credits for the income taxes they pay to foreign governments. The

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[35] The tax exemption that municipal securities provide is often regarded as a tax loophole. It is not. Ordinarily, the income tax overtaxes saving relative to consumption. Suppose, though, a taxpayer has income and is choosing between using the money for consumption or to buy tax-exempt munis. The choice is tax-neutral because in either case the income will be taxed just once: neither the benefits from consumption nor the returns on the muni are subject to further income tax.

Administration estimates this would increase exporting companies' tax bills by about $7.5 billion over 5 years.

The Administration offers two rationales for its proposal. First, it says, "The existing 50/50 rule provides a benefit for U.S. exporters that also operate in high-tax countries. Thus, U.S. multinational exporters have a competitive advantage over U.S. exporters that conduct all their business activities in the United States."[36] This argument is complicated and roundabout. The Administration is aware that U.S. companies with operations in other countries often pay more income taxes to foreign governments than the companies can claim as credits against their U.S. taxes. The Administration then claims that when these companies export, the export sales rule allows the companies to allocate too much of the resulting income to foreign sources, which inflates their apparent foreign source incomes. The extra income categorized as foreign source, says the Administration, lifts the ceiling on the quantity of foreign tax credits the companies can claim and enables them to credit against their U.S. taxes more of the foreign taxes assessed on their foreign operations. The Administration is asserting, in other words, that under the export source rule companies with foreign operations gain a tax advantage when they export: they can sometimes claim FTCs stemming from their foreign operations that would otherwise be excess. The Administration insists that it is motivated by a concern that exporters without foreign operations are relatively disadvantaged because they do not gain this alleged benefit when they export.

What the Administration does not point out, however, is that the main reason many companies are concerned about paying more foreign income taxes than they can claim in FTCs is that the U.S. allocation rules are already subject to so many restrictions. For instance, foreign source income is divided into categories by country and type of income, with a separate limitation on each type of income in each country. U.S. companies operating abroad often find that the maze of limitations understates their foreign source incomes, arbitrarily denying them U.S. tax credits for some of the foreign income taxes they pay. This handicaps the companies by compelling them to pay two nation's income taxes on the same income. Given that severe U.S. limitations are the main reason why U.S. taxpayers often have FTCs they cannot claim, it is ironic that the Administration would cite the problem of excess FTCs in arguing for yet another limitation. Under the guise of treating all exporters equally, the proposal would throw a greater double-tax roadblock in the path of many U.S. firms trying to maintain a presence in international markets. The proposal would be especially harmful to U.S. exports because; whereas the Administration takes as its benchmark exporters who only manufacture in the United States, America's most significant exporters usually find that to be successful in foreign markets they need to carry on some of their production in those markets.

A second Administration rationale is that the United States now has tax treaties with many countries that are intended to reduce double-tax problems. Supposedly, those treaties have made

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[36] *Treasury Explanations, op. cit.*, p. L-24.

the sales source rule unnecessary. Unfortunately, there are many other countries with which the U.S. does not have tax treaties. With all those other countries, the rule still serves a purpose. Moreover, unless one assumes that tax treaties fully solve international-tax problems, the rule may still be useful even with some countries with whom the U.S. does have tax treaties.

Another perverse consequence of the Administration's proposal is that if it were enacted, it would give some companies now producing in the United States and exporting their American-made products to foreign affiliates a tax motive to move production offshore: in some cases, under an activity based rule, the move would allow the companies to classify more of their income as foreign source, permitting them to claim FTCs on more of the foreign taxes they pay. Another drawback to the Administration's proposed rule is that it would be much more complicated and potentially contentious than the relatively simple and well-established 50-50 allocation rule.

<u>Shorten the carryback period on foreign tax credits (FTCs)</u> When taxpayers have foreign tax credits (FTCs) they cannot claim against current income, they are permitted to carry the credits back up to 2 years and forward up to 5 years. (The procedure is similar to that already discussed with NOLs, but the carryback and carryforward periods are shorter with FTCs.)

Supposedly out of solicitude for the "complexity and administrative burdens" that taxpayers suffer when the have FTCs they cannot claim against current income, the Administration proposes to reduce the carryback period to only 1 year and lengthen the carryforward period to 7 years.[37]

As discussed with the Administration's similar proposal regarding NOLs, a shorter carryback period would not simplify the tax code. Nor is the present carryback period a tax loophole. It allows a more complete view of a taxpayer's overall situation than that provided by arbitrarily dividing the taxpayer's continuing activities into one-year intervals and looking only at the current interval. The effect of the proposal would be to compromise further the ability of U.S. individuals and businesses with foreign source income on which they have paid foreign taxes to recognize those payments in a timely manner for U.S. tax purposes. When a taxpayer is able to carry back an FTC, the credit can be used immediately, producing a current tax saving. In contrast, if FTCs must be carried forward, their present value declines because future tax savings have a lower discounted value than current tax savings due to the value of time.

Hence, by delaying when credits can be claimed, this new limitation, if it becomes law, would effectively raise the marginal tax rate on the results of foreign operations, discouraging such operations. Besides being unfair to U.S. taxpayers, this worsening of the double tax problem already faced by U.S. taxpayers with foreign source incomes would diminish the ability of U.S. companies to compete in foreign markets.

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[37] *Treasury Explanations, op. cit.*, p. L-23.

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<u>Extend the Federal Unemployment Tax Act (FUTA) surcharge and require monthly deposits</u> The federal government requires employers to pay a tax on the first $7,000 of each employee's wages and salaries. The ostensible purpose of the tax is to help fund the federal-state unemployment compensation system. The net federal tax rate is 0.8% (after a credit), which is divided between a permanent tax of 0.6% and a "temporary" tax surcharge of 0.2%. (States impose additional unemployment taxes on payroll.) The "temporary" surcharge was enacted in 1976 and has been extended ever since. Under current law, the "temporary" 0.2% surtax will lapse at the end of 1998. Generally, employers must pay the 0.8% unemployment tax quarterly. The Administration proposes to extend the 0.2% "temporary" surtax through 2007. The Administration also wants to require employers to pay the unemployment tax monthly if their FUTA tax liability in the previous year was $1,100 or more. The Administration estimates these two changes would bring the U.S. Treasury a 5-year revenue gain of $6 billion.

The Administration argues, "Extending the surtax will support the continued solvency of the Federal unemployment trust funds and maintain the ability of the unemployment system to adjust to any economic downturns."[38] "Accelerating collections," says the Clinton Treasury, "may reduce losses...caused by employer delinquency and provide a regular inflow of money to State funds to offset the regular payment of benefits."[39]

In its analysis, the Administration fails to acknowledge that there are several good economic reasons to let the "temporary" surtax finally die. By increasing the after-tax cost of hiring workers, the surtax discourages employers from hiring as many workers as otherwise or paying them as much. Because the FUTA tax applies to the first $7,000 of payroll, the anti-employment effect is especially great for the lowest paid workers. Moreover, by increasing businesses costs, the tax makes it more difficult for businesses to succeed. In short, the tax is a drag on employment and production. Letting the surtax expire would strengthen the economy.

The Administration gives the impression that letting the surtax lapse would threaten the solvency of the federal unemployment system. Actually, unemployment taxes have generated billions of dollars more than the program's outlays. The government diverts the surplus collected by the unemployment tax to help pay the government's other bills. (The unemployment trust funds receive, in return, Treasury IOUs.) Thus, the notion that the unemployment tax goes solely to support the unemployment-compensation system is false, and the Administration's warning that unemployment benefits might be threatened if the surtax is not extended is without substance. Indeed, to prevent the amount in one account (the Federal Unemployment Account) from exceeding its statutory maximum, the Administration wants to change the law to double that account's statutory limit. From the point of view of keeping the federal unemployment funds solvent, not only could the 0.2% "temporary" surtax be eliminated but the remaining federal tax

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[38] *Treasury Explanations, op. cit.*, p. L-29.

[39] *Treasury Explanations, op. cit.*, p. L-29.

of 0.6% could be lowered. The Administration would have been more forthright if it said it wanted to extend the unemployment surtax to help pay for general government operations.

The Administration's request to triple the frequency with which taxes must be paid would greatly increase employers' administrative costs. Because of the interconnections between federal and state management of the unemployment system, it would also raise administrative costs for the states. Despite the much higher administrative costs on employers and state governments, the U.S. Treasury's only gain would be a slight acceleration in tax payments. Although the Clinton Administration says the higher paperwork costs are not worrisome because they would only affect "larger firms", good tax policy calls for simplifying the tax system whenever possible, not cavalierly increasing its complexity for a small acceleration in revenues.[40]

Conclusion

In the last several years, scholars and elected officials have become more acutely aware of the many severe deficiencies in the current income tax system. The issues are not primarily dollars and cents. The current system is much too complex and confusing. It produces large distortions in the relative prices of different products and activities, causing people to make inefficient production and consumption decisions for tax reasons. It is arbitrary and capricious and, therefore, unfair. Moreover, many taxes are hidden in production costs, which conflicts with the important role taxes should play in making people aware of what they are paying for government services.

The Clinton Administration's proposed tax hikes do not address any of these flaws. On the contrary, the Administration's recommendations would worsen many of the problems. The long list of new rules and restrictions the Administration would impose on taxpayers would add to the tax system's complexity. That would boost taxpayers' already very high paperwork and recordkeeping costs. The changes would intensify tax distortions, particularly tax biases against saving and investment. That means more tax roadblocks impeding the productive activities that generate economic growth. Because the proposals would intensify the overtaxation of selected taxpayers and activities, they are unfair. And virtually all of the tax increase would be concealed, which is flouts the goal of having readily visible taxes.

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[40] The discussion in the text assumes the federal unemployment system will remain in place and examines only whether the surtax is needed. A bolder initiative would be to get the government out of the unemployment insurance business. That would mean eliminating the unemployment tax and allowing people who want unemployment insurance obtain it through the private sector. The government has compiled a deplorable record of inefficiencies and perverse incentives in the many insurance programs it runs, with the hundreds of billions of dollars lost in the federal deposit insurance debacle being only the most extreme example. If it makes sense to provide a particular type of insurance, the private sector can do so more efficiently than the government and structure the program so as to provide much better incentives to policyholders to act responsibly.

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Measured against sound tax principles, the tax hikes in the Clinton Administration's budget would be steps in the wrong direction. Moreover, to the extent they advance in Congress, they will impede efforts to fundamentally reform the tax system by shifting attention from core tax principles to the minutia of collecting more taxes. Members of Congress should ask themselves whether they want to waste this year and maybe next year working on Administration-suggested changes that would leave the tax code worse off and make it harder to achieve improvements.

Michael Schuyler
Senior Economist

PREPARED STATEMENT OF BARRY K. ROGSTAD

"THE ECONOMIC PROBLEMS OF THE INCOME TAX SYSTEM"

I am Barry Rogstad, president of the American Business Conference (ABC). ABC is a nonpartisan coalition of chief executives of fast-growing, mid-size companies. Before coming to ABC, I served as chief economist and managing partner for International Consulting at Coopers & Lybrand, a leading accounting and consulting firm.

I applaud the purpose of this hearing today. Our tax system has a major impact on the behavior of all households and businesses. It is essential that we understand that impact as we examine near-term improvements and more fundamental reform of our tax regime. I believe that we are only at the beginning of a significant national discussion of our income tax system.

My remarks today come from the perspective of having been involved in the issue of fundamental tax reform over the past eight years. Specifically I have been working over that period with Senator Pete Domenici and former Senator Sam Nunn on the development and full exposition of the Unlimited Savings Allowance (USA) tax proposal. This experience has caused me to focus on the main economic problems resulting from the current tax system.

Any effort to improve our tax system must start, as you have noted, with a statement o f the principles of fundamental tax reform. They provide discipline for all of us whether we are designing replacement tax proposals or near-term changes. They serve to define the order of magnitude of the key issues and tell us about the right direction. They are particularly useful as we think about proposed interim and marginal changes in tax policy by insuring consistency with the broader objectives.

What are the attributes of a good tax system?

1. A tax system must raise revenue sufficient to finance the amount of government citizens demand. To do this properly requires that the tax system be visible to the taxpayer and thereby serve the function of pricing out government services. It is desirable to have as many citizens be taxpayers as possible. A situation wherein we have all citizens voting on the size of government and a significantly smaller number paying for that government is not desirable in our democracy.

2. The ideal tax system would seek to raise revenues in a manner that did not change the set of relative prices in our economy. In practice this is impossible to achieve. This "neutrality" objective seeks to minimize the amount of distortion that a tax system imposes on the behavior of business and households. All taxes change the price of economic activities. The challenge is to maintain as far as possible, the same relative prices post-tax that existed before taxes were levied. This assures that the imposition of a tax will bring about the lowest possible disruption to our market based economy.

The most important violation of the neutrality criterion in our current income tax system is the double taxation of the savings versus consumption uses of income. I will return to this point later in my testimony.

3. A good tax system is one that should be simple to administer and uniformly understood by all taxpayers. Our current system fails this test and unfortunately scores lower and lower with the passage of time.

The real complexity in the tax code falls most heavily on business and on upper-income Americans. And, at least insofar as that complexity applies to wealthier Americans, there is a common perception among taxpayers of more modest means that that complexity favors the rich and near-rich by allowing them to lower their tax bill. Not everyone seems to be playing by the same rules. If that perception festers, it will undermine the willingness of citizens to participate in what is still a voluntary system of revenue collection.

I would like to reference a few areas of business tax complexity. The major technical issue in our income tax system arises from the correct tax treatment of income from capital. Our current approach relies on accrual accounting (depreciation) to measure the costs associated with producing capital income. I estimate that if these timing issues were removed from our tax system (for example, by expensing all capital outlays) 70% of the complexity inherent in our corporate income tax would be removed.

The taxation of foreign source income to American corporations is another significant source of complexity and inefficiency. Most experts agree that the compliance and economic costs of the current set of rules far exceed the revenues derived. American businesses that are succeeding in the global market place understand the importance of using the full array of operating techniques and strategies to correctly position themselves to gain permanent market share around the world. What concerns them most about our current foreign source income rules is that their decisions can be more influenced by tax considerations than the fundamental economic and business realities they must focus on in order to be successful.

In this area we could achieve significant simplification by moving toward a territorial system where the US tax system taxed all income generated from business activity conducted in the United States and all other nations were encouraged to adopt the same rules.

4. Fairness and equity are the attributes most difficult for our society to agree on. We all seem to share the view that the current system is not fair, but for many different reasons. As an economist, I am very concerned about the efficiency of our market economy. I hold the view that from an efficiency (and neutrality) standpoint, all income should be taxed alike and at the same rate. Increasing marginal rates of taxation at higher income levels, exacerbates the double taxation on saving and investment and discourages additional work effort by our citizens. The degree of progressivity in our income tax rate structure is largely a political determination, involving significant tradeoffs across these attributes.

Furthermore, the sense of fairness with which the code is viewed is as much a question of uniform understanding of the tax base as it is the result of a particular rate structure on that base. If, for example, we all understand what comprises taxable income and that allowable deductions were limited and available to all citizens, I suspect we would have a very different perception of the fairness of the code. We would perceive each other as playing by the same rules which is far different from our current image of the income tax system.

I will now return to the core problem inherent in our current tax system: the double taxation of saving and investment.

Under current rules, consumption outlays are made with after-tax income but we do not tax the services and pleasure they provide. On the other hand, that portion of our income that we save, which has already been subjected to tax, is taxed again when we tax the returns on that saving. In a speech on the Senate floor, former Senator Sam Nunn illustrated the difference:

If you take $200 and buy a television set, you are not again taxed for whatever enjoyment or enlightenment you may receive by watching it. If, however, you take that $200 and put it in a college savings account, all the interest you earn is subject to tax. The act of consumption...is taxed once, as income. The act of saving... is taxed twice. The original $200 has already been taxed as income. The returns to that $200, in this case, interest, is taxed again. Saving $200 for tomorrow is more expensive than consuming it today.

Furthermore if the saving is invested in corporate equities, the returns on that saving are subject to multiple levels of taxation: (1) the corporate income tax, (2) the personal income tax, and (3) capital gains tax.

The income tax thus discourages saving in favor of consumption. We know therefore that because of this distortion we, as individuals, households, business and as a nation save less than we otherwise would.

Saving is the tool with which people control their own economic fate and achieve a higher standard of living. Saving is the activity that permits investments in new technology, plant and equipment as well as the development of skills in our citizens through education and training. It is the key to sustained economic growth. We do not, therefore, want a tax system that is biased against saving.

We can make short term changes that help to remove this double tax on saving. Indeed our current treatment of individual retirement accounts, pension plans, and other tax deferred saving vehicles is a recognition of this inherent problem and the need to provide relief. In my opinion, the most important near term step that could be taken in tax policy would be to expand the IRA provisions. I commend the Chairman for his recently introduced legislation, "The Investment Revitalization Act of 1997," which expands the amount of income that taxpayers may contribute annually to their IRA and broadens the income eligibility levels as well.

Many of the goals we seek can be achieved through an unlimited and universal IRA. Advocating a deferral of tax on all saving raises issues of fairness and understandability. Saving benefits everyone regardless of who is doing the saving. It finances the capital that raises worker productivity and therefore workers' wages and living standards. Everyone has a large stake, in fact, in the national stock of savings whether or not they personally own any of that saving at the present time.

Removing the double taxation of saving is an objective of all the major fundamental tax restructuring proposals. The USA tax, the flat tax, and the sales tax proposals all emphasize the key attributes of taxing all income once and only once. This important commonality has not been sufficiently emphasized.

Effectively removing the double taxation on saving under our current income tax system requires significant changes in the tax treatment of corporate as well as personal income. How to successfully "integrate" these two components of the income tax system has been a long-standing issue of federal tax policy. A tax system that levies a tax on corporate income when produced and another tax when that same income is distributed to creditors and shareholders fails to meet the neutrality criteria.

In our economy, income is created at the business level when goods or services are produced and sold. That income then flows to people: employers, investors, and owners. We know that the correct income tax base is comprised of the net returns to labor and capital services (net in the sense of payments for the services provided by owners of labor and capital minus all costs associated with producing these services).

There are three mechanisms by which these incomes can be taxed:

1. All taxes could be levied at the source of these income flows, specifically at the business (or government) entity where they originate. Under this approach all taxes would be collected at the business level and payments of wages, interest, dividends, etc. to households and individuals would be net of tax.

2. On the other hand, all taxes could be levied and collected at the household level when payments for labor and capital services are received by individuals. This approach would eliminate the corporate income tax and recognize the reality that businesses do not pay taxes, but rather they are fully borne by the providers of labor and capital services.

It is important to note that such an approach becomes attainable when we have correctly taxed all personal income and permitted an unlimited deferral for the savings uses of that income. Under such a framework, there would be no purpose served by keeping earnings in the corporation which has been a long standing rationale for the corporate income tax.

3. It is also possible to maintain a two-tier tax system under which taxes are levied and collected at both the business and the household level. However, this approach faces the daunting, if not impossible, task of avoiding some double taxation on significant elements of our national income stream.

In setting up such a framework, it quickly becomes evident that the business level tax becomes a pre-collection point for taxes that can be more efficiently collected at the household level. Attempting to maintain a business level tax provides very little net economic benefit, results in no greater revenues than either of the other options and is the source of significant additional complexity.

It is useful to ask the question, if we were starting from scratch and designing a tax system based on our key attributes for an optimal tax system would we have established a corporate income tax? I think not.

Avoiding the double taxation of saving involves other elements of the code as well. Of most significance are the areas of estate taxes, the alternative minimum tax, and capital gains. All three are, in effect, additional "excise taxes" on saving and therefore result in further violation of the neutrality criteria. I will comment on capital gains to illustrate this point.

The case for a significant capital gains differential rests on the fact that reducing capital gains tax would obviously have the effect of mitigating the double tax on saving. As noted earlier the returns to saving invested in corporate equities is subject to multiple levels of taxation. The capital gains tax applied to the increase in the nominal value of the asset is a major part of the problem. The inappropriateness of taxing the inflation component of any gain is clear and should be a high priority for any near term tax policy improvements. In addition, the objective of unlocking and reallocating investment across assets could be achieved by capital gains treatment that "deferred" any tax until the savings were withdrawn from the national saving pool. Such a rollover provision, consistent with the broadening of IRAs, would greatly improve the tax treatment of saving under our current tax regime.

Finally, I would like to impart a sense of urgency to your proceedings. Increasingly Americans are becoming convinced that there is a saving problem, both on the family and national levels. They are realizing that the economic security of our citizenry, in part, depends on solving that saving problem. They are becoming more aware that the current tax system inhibits national saving and investment, as well as their own capacity to assemble a nest egg. As this happens we will see the right kind of advocacy for change.

This increased public awareness is happening while we are also discussing the "privatization" of social security and the curtailing of the growth in non-means tested entitlements. The message coming from these discussions to our citizens is one of increased personal responsibility which translates directly to saving behavior. In this environment, making our tax system more saver friendly will become a top Congressional priority.

There is no single silver bullet answer to the issues this panel raises today. But there is an opportunity to make significant strides in improving the tax regime of our nation. I look forward to working with you and your colleagues in the Congress to achieve this goal.

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

PREPARED STATEMENT OF DR. LAWRENCE CHIMERINE

My name is Lawrence Chimerine. I am Managing Director and Chief Economist of the Economic Strategy Institute, and Senior Advisor to the WEFA Group. I appreciate the opportunity to testify before the Joint Economic Committee on key issues relating to U.S. tax policy.

In sum, my views are as follows:

- Although economic growth has slowed in the U.S. on a trend basis, this in great part reflects demographic factors and measurement errors. The economy is not doing so poorly that huge tax cuts or other drastic changes are necessary.
- The tax cuts enacted in the early 1980s did not produce the incentive supply-side effects that were predicted, and has actually been counterproductive for long-term economic growth. Furthermore, they did not even come close to paying for themselves.
- Large tax cuts would even be more harmful now than they were in the 1980s, and thus are highly unwise. This is especially true in view of the poor long term budget outlook, and our already huge and rising trade deficit and foreign debt.
- The evidence overwhelmingly suggests that the disparity in income and wealth has grown in recent years, partly as a direct result of shifts in the distribution of the tax burden.
- In view of the poor deficit outlook, any tax cuts that are enacted in the next several years should be targeted rather than broad based, should limit the revenue loss on a long term basis, should focus both on the amount and mix of investment, and should not widen income disparity even further.
- An across-the-board capital gains tax cut would not meet these criteria and, thus, should be rejected. Instead, consideration should be given to adopting a sliding-scale capitals gains tax structure, or only reducing the rate on long-term, productive investment.
- At some time in the future, major tax reform that would shift the reform system away from income toward consumption, but would simplify the tax code and be fair and progressive, should be considered. In my judgment, the best current reform proposal is the USA Tax originally introduced by Senator Domenici and former Senator Nunn.

INTRODUCTION

There is currently a wide range of opinion regarding appropriate tax policy in the United States. Some are advocating large, supply-side oriented tax cuts, much like those in the 1980s, as a way of increasing what is alleged to be an anemic economic growth rate, and because, in their view, the tax cuts of the 1980s were beneficial for the economy. Others take the opposite view, that given the extremely poor long term deficit outlook, any tax cuts are now ill-advised. Many are in between, suggesting that some targeted tax cuts, particularly those that affect either the level or mix of investment, would help the economy, as long as they are cost effective. In this testimony, I will lay out my views on these key issues, including what I believe to be the appropriate guidelines for any tax changes in the years ahead.

WHAT REALLY HAPPENED IN THE 1980s

Most advocates of large tax cuts, such as those proposed by Republican presidential candidate Bob Dole in 1996, base their support not only on the alleged success of the Reagan tax cuts, but also on their belief that such cuts would work even better this time. A careful reading of the evidence, however, leads to the opposite conclusion.

In the early 80s supply-side economics promised that cuts in marginal tax rates would increase economic incentives so dramatically that savings, investment, and work effort would rise sharply, leading to a spurt in economic growth. The evidence indicates that this did not occur, and that the long 1980s expansion did not result directly from the incentive-creating policies that have been labeled supply-side economics.

In the first place, the labor force did grow fairly rapidly during much of the 1980s, even faster than population growth. Yet the increase in the participation rate (the percentage of the population actually working or looking for work) was no greater in the 1980s than in previous decades. Participation rates for adult men remained flat, but the rates for women continued to rise sharply, extending a long-term trend deeply rooted in social factors and economic pressures. In fact, female participation continued to rise in the 1980s in part because job cuts, a loss of high-paying jobs, wage freezes and give-backs, and other factors created a real-earnings squeeze for many families during the decade. Thus, many women, and probably some teenagers, joined the labor force for reasons other than supply-side incentives that, through a lower tax rate, increase the after-tax return from working. Rather, it was stagnant real incomes that forced many families to seek a second income source, in order to maintain the living standards to which they had grown accustomed.

What these trends actually imply is a downward-sloping supply curve for labor -- lower tax rates may reduce labor supply by enabling families to earn the same after-tax income with less work. More important, there is not conclusive evidence from the experience of earlier years that reduced tax rates boost labor supply. Thus, the so-called incentive effects for labor were not a significant factor in the expansion of the 1980s.

Perhaps the supply-siders' most notable prediction was that a sharp reduction in marginal tax rates would substantially boost household savings. Yet exactly the opposite occurred. U.S. personal saving rates during the 1980s were far below not only those in virtually every other major industrialized country, but far below the U.S. average for the 1945-80 period. This trend is even more remarkable considering several other developments. For instance, the extraordinarily high real interest rates of the 1980s should have stimulated more savings by increasing the after-tax return on such savings. The introduction of IRAs, Keoughs, 401Ks, and other savings vehicles, the phasing out of the deductibility of consumer interest, and other tax changes should have had the same effect. Yet the personal saving rate plummeted. This not only suggests that savings is not positively affected by the after-tax returns on such savings, but that the reverse may be the case -- just as it may be for workforce participation. Many people may base their savings behavior on achieving a targeted level of savings at some time in the distant future. If so, a higher after-tax return would actually reduce the amount of new savings necessary to reach the target. Again, the evidence is mixed. Neither the data nor the experience of the 1980s support the supply-side view that the savings supply is strongly positively sloped and that the supply-side incentives actually work. The soundest conclusion seems to be that the tax system has little or no effect on savings patterns and that savings for most families are more of a residual rather than determined by a direct decision. In effect, the weakness in real incomes, coupled with the desire of many families to maintain and improve their living standards, actually caused a decline in personal savings in the 1980s, despite the new incentives.

If investment in the long term is largely determined by the amount of savings, then the savings drop-off must have curbed the growth of business investment during the 1980s. Therefore, supply-side incentives not only failed to deliver on their promise of a big increase in personal savings, but by creating enormous budget deficits, supply-side policies also caused the sharp decline in the supply of national savings that made a big increase in investment impossible. Indeed, the 1980s was not a period of strong investment, despite the long expansion. In fact, the decline in national savings and the relatively high real interest rates caused by supply-side policies apparently deterred net investment.

Supply-siders also predicted that their incentives would revive productivity growth. Yet, as is now well documented, productivity growth continued to lag in the 1980s. The latest data show that productivity rose from the 1979 peak to the 1989 peak by only 1 percent a year. During the Reagan expansion, it rose by only 1.5 percent a year, a very slow performance for an up cycle.

Supply-side theory also promised that lower marginal tax rates, by stimulating savings, investment and productivity, would improve America's competitive position in world markets and ultimately enhance national economic security. Unfortunately, the 1980s witnessed the largest trade deficits in U.S. history and losses of market share in virtually every manufacturing industry. The supply-siders remained undaunted. True, they acknowledge, they did not anticipate these deficits, but they turned the tables and actually portrayed the trade gap as a sign of supply-side success. The deficit allegedly reflected the strength of demand in the U.S. economy plus the higher returns on investment in America made possible by lower tax rates and other supply-side incentives. This is a complete misreading of U.S. trade performance and competitiveness in the 1980s.

The erosion of U.S. trade reflected a deterioration in U.S. competitiveness, not American success. U.S. productivity and technology advantages were so large during the early postwar years that the United States could maintain dominance in world markets and generate large ongoing trade surpluses despite funding much of the free world's defense, keeping its markets open, and tolerating cultural and trade barriers erected by other nations. These basic advantages narrowed dramatically during the 1970s and 1980s, primarily because of rapid productivity growth among traditional foreign competitors and the emergence of many highly productive new competitors. These developments reflected:

- The speedier transfer of U.S.-developed technology to the rest of the world;
- A more rapid rate of innovation in many other countries than in earlier years;
- A strong foreign emphasis on product quality and design;

- High saving and investment rates abroad;
- The replacement of World War II-ravaged infrastructures with modern equipment (and the increased use of such equipment in the newly industrializing countries);
- The increased mechanization of foreign agriculture;
- The lower base from which many foreign countries started;
- An emphasis on policies that fostered rapid growth, both domestically and in exports, in order to generate the higher profits necessary to fund additional investment and research and development.

During the same time, productivity growth in the United States was slowing compared to the earlier postwar years. In fact average productivity levels in many tradable-goods industries in the United States actually fell behind those in Japan and some other countries (although not on an overall economy basis, because U.S. productivity levels remained higher in various other industries). As a result, relatively high U.S. wage and capital costs could no longer be offset by productivity differences and became an enormous competitive disadvantage.

The combination of these developments ended U.S. dominance in world markets for most manufactured and agricultural goods and spurred massive trade deficits and rapidly growing foreign debt. These trends were aggravated by the enormous U.S. budget deficits, the overvalued dollar and slow growth overseas in the early 1980s, and the Third World debt crisis.

The decline in fundamental competitiveness (i.e., in relative productivity) and its likely effect on economic growth were unrecognized for several reasons. First, the ratio of manufacturing output to GNP (in real terms) remained relatively stable, suggesting that the United States did not de-industrialize. Yet the apparent stability of manufacturing output as a share of GNP during the 1980s should be viewed in the context of the rapid rebound in the demand for manufactured goods (relative to total demand) in the United States, reflecting the large turnaround in consumer durables and the procurement-dominated military buildup. In effect, the surge in demand for goods in the early 1980s was so strong that it prevented the manufacturing output/GNP ratio from declining despite the loss of U.S. global market shares and the related influx of imports and slowdown in exports. Without the change in relative competitiveness, the manufacturing output/GNP ratio would have risen sharply during the 1980s. This also explains why manufacturing output grew more rapidly in America than in the rest of the world during the initial stages of the recovery--the U.S. market, in which American producers had a relatively large (but declining) share, simply grew much more rapidly than markets overseas. Second, while the faster economic growth in the United States during the 1980s relative to some other industrialized countries increased the trade imbalance in some years, it does not account for the sharp rise in import penetration rates and the decline in U.S. exports in real terms after 1980. These shifts combined to cause the sharp decline in the U.S. share of worldwide production in most industries referred to earlier, and of overall world trade, during much of the decade. Further, the U.S. trade imbalance continued to rise even as U.S. demand and overall economic growth slowed in 1985 and 1986.

Third, the onset of massive trade deficits coincided with large budget deficits, indicating to many that the budget imbalance, by pushing up interest rates and the dollar exchange rate, caused most of our trade problem. Yet, as most clearly shown by the large increase in the U.S. trade deficit with Japan and the steady decline in the U.S. dollar relative to the yen and other industrialized-country currencies, our trade problems were developing well before the 1980s. The full extent of deteriorating competitiveness at that time was temporarily masked by the surge in exports to Latin America (financed by unsustainable U.S. bank lending, much of this, in turn, tied to exports), rising exports to OPEC countries, and the relatively weak dollar. Large U.S. budget deficits clearly made the trade deficits worse in the early 1980s, both by pushing up the U.S. dollar and by directly stimulating import demand. Yet foreign competitive pressures would have mounted even in the absence of unbalanced U.S. fiscal policies. The bottom line is that the prediction that U.S. competitiveness would improve as a result of supply-side economics was flat wrong.

Perhaps the strongest indictment of supply-side economics is the questionable strength of the 1980s recovery itself. Despite the seven-year expansion in the middle of the decade, average economic growth during the decade as a whole actually lagged behind growth in each of the three preceding decades, including the stagflation years of the 1970s. Moreover, as will be discussed further below, the long expansion to a great extent simply represented a catch-up following back-to-back recessions in 1980 and 1982. Consequently, the expansion benefited from an extremely low starting point and was followed by very weak growth in the late 1980s.

In sum, there was no supply-side miracle in the 1980s. Other explanations are required for the long but relatively modest economic expansion over those years. Moreover, contrary to the supply-siders' expectations, the budget picture has been a disaster. Reaganomics brought massive deficits, not healthy surpluses, Nor can the deficits be blamed on excessive spending by Congress. Nondefense discretionary expenditures were reduced by approximately 2 percent of GDP in the 1980s and were about $100 billion less in 1990 than they would have been had they retained their 1980 share of GDP. Further, total spending did not significantly exceed the administration's budget requests during the 1980s. What changed was simply the mix between defense and nondefense programs--the former swelling, the latter shrinking. Supply-siders now offer the excuse that the large deficits were caused by the absence of significant spending cuts, but the real causes were the excessively optimistic economic growth and tax revenue forecasts, plus the huge increase in interest expense as the deficits began to feed on themselves.

Finally, in one or more efforts to defend their poor history, supply-siders now argue that tax revenue as a share of GDP remained constant during the 1980s, so the deficits cannot be blamed on the tax cuts. They neglect to mention the huge social security tax increases enacted early in the decade to ensure future trust-fund solvency. Income tax revenues as a share of GDP were considerably lower at the end of the decade than in 1980, exactly as most conventional economists had predicted when the tax cuts were enacted.

The bottom line is that the supply-side tax cuts of the 1980s were not a success. They have proven to be harmful for the economy and have put a huge and unconscionable burden on future generations.

ARE LARGE TAX CUTS APPROPRIATE NOW?

A new round of tax cuts now is likely to be even more damaging than were the cuts of the 1980s, as reflected in the following considerations:

- The economy is much closer to full utilization now than it was in 1981. Both financial markets and the Federal Reserve believe the economy is essentially at full employment and, in fact, is on the threshold of overheating. Thus, huge tax cuts--without clearly defined matching spending cuts--would trigger higher interest rates, which, in turn, would offset most or all of the direct short-term stimulative impact of the tax cuts.

- Discretionary, non-defense spending has already been cut sharply. Unfortunately, those cuts were swallowed up by increases in interest payments and public health programs, so that overall spending has continued to grow. Additional cuts in education, export promotion, technology, research, and other such investment programs, even if politically possible, would prove counterproductive by reducing potential long-term economic growth.
- The long-term deficit outlook is far worse than it was in 1981. Virtually all credible projections show that the deficit will start rising again this year. Even worse, it will begin to accelerate at a dramatic rate in about 10-15 years, in response to huge increases in spending on the health and pension entitlements as the baby boomers begin to retire. Extremely large spending cuts will be needed to reduce those deficits even without any new revenue losses.
- The national debt is now five times higher than it was in 1981. Because the debt is already so large, policies that cause higher interest rates would produce a much larger absolute and relative increase in interest expense than occurred in the 1980s, creating an even steeper upward spiral. Also, because so much of our debt is now held by foreigners, much of that interest would leave the country, reducing U.S. incomes.
- Income disparity in the United States has increased significantly over the past 15 years. Large tax cuts would make the problem even worse because it would produce larger absolute and relative increases in after-tax income for individuals sand families in the upper income levels. Also, the higher interest rates that are likely would generate a significant increase in income for generally well-to-do bond holders, at the expense of other income groups.
- We already are experiencing an investment-led recovery. This largely reflects a number of economic forces, including the high level of economic activity, strong growth in corporate profits, relatively low interest rates and, most important, the sharp decline in the budget deficit in recent years. Pushing the deficit up could well reverse the upward trend in business investment.
- The trade and current account deficits are still huge, and are rising again. These deficits have held down economic growth by shifting the mix of economic activity away from relatively high-wage, high-value-added industries toward industries with lower average productivity. New, large tax cuts, and the added budget deficits

they would likely produce, would make our international accounts even more unbalanced by reducing national savings and investment and creating upward pressure on the dollar exchange rate. In the process, U.S. competitiveness would deteriorate

The bottom line is that large, across-the-board, consumption-oriented tax cuts are now ill-advised and potentially very dangerous to the long-term health of the economy. At most, they would provide a small boost to the economy in the very short term, but the larger deficits and higher interest rates they would cause would actually reduce long-term economic growth. A better approach would be target tax cuts that stimulate job creating long-term investment (see below).

Nor would a large across-the-board capital gains tax cut, such as the 50% tax exclusion of capital gains, coupled with indexation of capital gains for inflation in the future, now being proposed, be helpful for long term growth. Supporters argue that such a cut would stimulate substantial investment and new enterprise, promote additional economic growth and create millions of new jobs. Furthermore, the combination of increased economic activity and the unlocking of existing assets will purportedly produce higher, rather than lower, tax revenue.

The evidence strongly suggests that none of this will be achieved, and that instead, an across-the-board capital gains rate cut would encourage more speculation in the markets and more tax shelters designed to shift ordinary income to capital gains.

Further, sizable tax revenues will be lost in the long run, mostly benefiting the same high-income, wealthy individuals whose share of the economic pie has already increased markedly in recent years.

The goals of stimulating productive investment and the creation of new enterprises are important, especially since the U.S. still under invests relative to virtually all of our major foreign competitors. Also, despite the recent cyclical bounce, productivity growth still lags behind earlier decades. However, because most capital gains result from the purchase and sale of existing assets--primarily stocks, bonds and real estate--a straight capital-gains tax would provide a huge windfall on assets currently being held without stimulating a new investment. At the same time, contrary to the assertion of those pushing for the indexation provision, current capital-gains tax rates are often quite low, even though gains resulting solely from inflation are now taxed. This is because capital gains are accrued tax-free until they are sold, dramatically reducing the effective rate. Compare this with interest on savings accounts and most other types of income that are taxed on an annual basis as earned income. Moreover, much of the capital gains now earned by pension funds are not taxed at all. Thus, effective capital gains tax rates are very low already, and are not an impediment to saving and investment.

IS THE ECONOMY REALLY ANEMIC?

Many advocates of large tax changes, as mentioned earlier, are basing their case on the claim that the economy is under performing, as witnessed by the economic growth rate in recent years of approximately 2 1/2% as compared with 4% or more in the first three decades after World War II. However, the economy is doing far better than this comparison would suggest.

- Much of the slower rate of economic growth experienced in recent years is actually a continuation of a trend that began in the mid-1970s--in fact, as indicated earlier, the 1980s was the slowest growth decade since World War II, even with the big Reagan tax cuts. Thus, singling out the 1990s is misleading.
- Much of the slowdown in the trend rate of growth over the last 20 years reflects demographic factors, including the sizable slowdown in population growth, a slower rate of increase in labor participation rates for some groups, and a flattening in average educational payment. These factors by themselves count for at least 2/3 of the decline in economic growth from over 4% during 1945-1973 to about 2.5% since that time. These changes have led to slower growth not only because of the direct effect of slower population and labor force, but because they have contributed to the slowdown in productivity growth.
- The immediate post World War II period was also helped by huge pent-up demands which were created during the war, especially for housing, consumer durables, and business equipment, and by the fact that the United States dominated the world economy during that period, and had huge advantages in productivity, technology, and product quality. These conditions have obviously faded.
- Thus, even under the best of conditions, there is no way that the economy in recent years could have come close to matching the growth rate in the golden years after World War II. Furthermore, there is growing evidence that recent growth rates have been understated as a result of the overstatement of the price indexes. In particular, anecdotal evidence, and the huge increases in corporate profits and the stock market, suggest that productivity growth in

recent years has been much stronger than indicated by government official statistics.

In sum, while there are some problems, the U.S. economy is not doing as poorly as many supporters of large tax cuts suggest. While it certainly is possible that it could be doing better, drastic changes of the type that some tax cut advocates are proposing cannot be justified on the grounds that the economy is doing so badly that drastic actions are the only sensible approach.

WHAT SHOULD WE DO?

There are other considerations that also should be taken into account in the debate on tax cuts, in addition to the fact that the economy is far from anemic, as some people have described it. These include the following:

- First, as mentioned earlier, despite the progress in recent years, the long term budget outlook remains disturbing. Regardless of whether we balance the budget in the year 2002, it is clear that deficits will build very sharply starting in less that 15 years as a result of the upward pressure on the health and pension programs that will be caused by increases in the number of retiring baby boomers. In fact, without major reform to these programs, annual deficits will be so large that they will make the deficit of the 1980s look small, both in absolute and in relative terms. In my opinion, it would be foolish to enact tax cuts that would widen longer term deficits over and above what they are already projected to be--this would be counterproductive in two ways. First, higher deficits would push up interest rates and hurt our international competitiveness, offsetting the impact of any supply-side effects. Second, they would probably force more cuts in various spending programs, most likely the very same programs which have already been cut sharply, and which are important for long term economic growth. These include infrastructure, education, research and development, trade promotion, and other essentially investment programs, as distinct from consumption-oriented government programs.
- The evidence overwhelmingly suggests that the disparity in both income and wealth has grown sharply in recent decades. While most of other growing disparity has occurred at the pre-tax level, shifts in the distribution of the tax burden in the last 15 years have exacerbated the problem. In fact, some estimates indicate that about 20% of the widening inequality in after-tax incomes reflects the

direct impact of shifts in the tax burden, while the other 80% has taken place in before-tax incomes. In my opinion, any tax changes that would widen the distribution of income even further would be unwise. This would not only be unfair, but would probably be counterproductive for economic growth because purchasing power would be even more concentrated.

- As indicated earlier, experience in recent decades clearly suggests that many economists dramatically overstate the impact of tax changes on consumer and business decisions. In particular, not only did the predicted impacts of the 1980s tax cuts not occur, but the doom and gloom forecasts made several years ago after the increase in the top marginal income tax rate in the Clinton economic program have obviously been proven wrong. Quite the opposite, in view of the fact that this has been the strongest investment-led expansion in many decades, that the stock market is setting record highs regularly, that the personal saving rate is now moving higher, and that new business start-ups are growing rapidly, it is difficult to make the case that either high capital gains or marginal income tax rates are stifling investment and innovation. Yet this is exactly what was predicted by supply-siders and their supporter just 3 1/2 years ago.
- We should not be lulled into using dynamic revenue scoring in the budget process, for a number of reasons. First, revenue feedback from tax cuts comes primarily from standard income effects -- very little comes from so-called supply-side effects. However, adding substantial additional revenue from these mythical supply-side effects to those from the demand side will result in huge revenue overstatements. Second, spending cuts, by reducing taxable income, also have revenue effects -- this seems to have been overlooked by proponents of dynamic scoring. Thus, dynamic scoring as it is now being proposed would create a huge upward bias to the federal deficit, and would amount to "assuming our way out of the deficit" much like what occurred in the 1980s.

With these in mind, I propose the following guidelines for any tax cuts in the next several years:

- No tax cut should be enacted that will significantly increase long term deficits, based on static revenue estimates.
- No tax cuts should be enacted that will make the tax system even less progressive than it currently is.

- Tax cuts should focus on increasing long term savings and investment, with investment being broadly defined to include research and development, infrastructure and human capital.
- Tax cuts should also be designed to shift the investment mix, which is also important for long term growth. In particular, stimulating more investment is not all that helpful if most of it goes toward mergers, acquisitions, stock market speculation and non-productive fixed investments. And, even though investment designed to cut costs and improve efficiency can be desirable in the short run, investments with a more long-term view, and that helps create new jobs, are better for the economy in the long term.
- Tax cuts should thus be targeted rather than broadbased, and should be at the margin, where possible, rather than across-the-board. One example of a tax change that would fit these criteria is a sliding scale capital gains tax structure in which the tax rate would be increased from the current rate on short-term gains, with the rate declining as the holding period is increased (to near zero after perhaps seven years). The resulting large difference in the tax rates between short-term and long-term gains, and between long-term capital gains and ordinary income, would provide major incentives for both new business formation and for investments in growth companies and new technologies. A change in the tax rate from 28 percent to 14 percent is not large enough to encourage such a shift because it does not come anywhere close to compensating for the high risk in most long-term investments. The impact on the deficit would be minimized with a sliding-scale structure because it avoids revenue losses on investments already made, and also because higher revenues from short-term gains still taken even at the higher rate would offset some of the revenue lost on longer term investments. Finally, a sliding-scale capital-gains structure would help unlock some of the investment already in place, thereby contributing to economic efficiency. Investors would no longer be able to benefit from the lower rate unless they liquidate existing holdings and reinvest those funds.

Given the urgency of reaching a budget compromise as soon as possible, a restructuring of capital-gains taxation may not be possible at the present time. However, it is possible to move in the right direction by enacting a large reduction in the capital-gains tax rate only on new, long-term investment, or only on new investment in small businesses. Other tax changes to consider include the elimination of the alternative minimum tax on corporations, which in my view has depressed investment. This can perhaps be paid for by phasing out the interest deduction on mergers and acquisitions, which would provide an additional incentive for real fixed investment.

Even though this is not the focus of this hearing, I urge the committee to begin looking at broad tax reform sometime in the future. The tax reform debate in recent years has centered largely on finding good, or best, taxes - and while opinions vary widely, almost everyone agrees that a good tax should be fair, as simple as possible and effective in raising revenues to pay the bills. Most would also argue that a good tax system should promote individual savings and investment and should not put our exports at a disadvantage in global markets.

No tax system has yet been offered that meets all of these goals. Our present federal system - a mix of individual and corporate income taxes, plus a payroll (Social Security) tax - is supposed to be fair because it is progressive. But because the corporate income tax may be passed on to consumers in a nonprogressive manner, and because the ever rising payroll tax makes no pretense of progressivity, our current system is less progressive than many believe.

There are, thus, many reasons to consider significant modifications is to the existing tax system. All of us who wrestle with Form 1040 will certify that it is certainly not simple. And, unfortunately, it appears that our current system may have already reached the outer limits of its effectiveness.

There is a new proposal that would correct some of the problems with the existing structure but at the same time would avoid the extreme regressivity implicit in the flat tax. It is called the "unlimited savings allowance" tax - which produces the acronym USA Tax - recently introduced by former Senator Sam Nunn and Senator Pete Domenici. It is a consumption tax, meaning that it applies only to income that is spent, not saved. Since it can accommodate a progressive rate structure and in addition provides for exemptions for low-income earners and a credit for the payroll tax, it can claim good marks for progressivity. In addition, the USA Tax would eliminate the efforts of high-income earners to protect their income through nonproductive business arrangements; all they would have to do is save it. And although taxpayers would need more than a postcard, as in a pure flat tax, it is far simpler than the present system - more than 75 percent of the 700 sections of the present income tax code would be dropped.

Those who are concerned about international trade will be pleased that the USA Tax is border adjustable. In other words, export sales are exempt from the tax, but importers have to pay. Our trading partners, through their value-added taxes, have benefited from this for many years.

Those concerned with stimulating long-term growth should also be pleased that the tax gives a free ride to savings while it taxes borrowing. Hopefully this will encourage more Americans to save and invest more of their income.

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