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Statement of

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Tax Reform to Encourage Growth, Reduce the Deficit, and Promote Fairness

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Chairman Conrad, Ranking Member Sessions, Members of the Committee: Thank you for inviting me to share my views on tax reform.

The tax code desperately needs reform. It is unfair, inefficient, mind-bogglingly complex, and doesn't come close to raising enough revenue to pay for the government. I'm tempted to say that it couldn't be worse, but sadly that is not true. Some proposals masquerading as reform would increase the deficit, thereby undermining our economy, and are also deeply unfair. Thus, it is not only imperative that we reform the tax system, but that any reform meet the objectives you set out in the hearing title: encourage growth, reduce the deficit, and promote fairness. I'd add one more goal—simplify the tax system so that ordinary Americans can understand it.

Economists often talk about a trade-off between fairness and economic growth, but you have an opportunity to simultaneously advance both objectives with tax reform. For example, the standard prescription of broad base and lower rates can be a win-win for fairness *and* growth. Moreover, extreme inequality is itself anathema to economic growth. The tax system mitigates inequality and tax reform would be a failure if it undermined that important role.

In my testimony today, I will talk about the relationship between tax reform and economic growth, tax revenues, and fairness. Then I will discuss some models for tax reform and how capital gains should be taxed in a reformed system. I will conclude by looking at policy options if the kind of massive base broadening in the Bowles-Simpson plan proves to be infeasible.

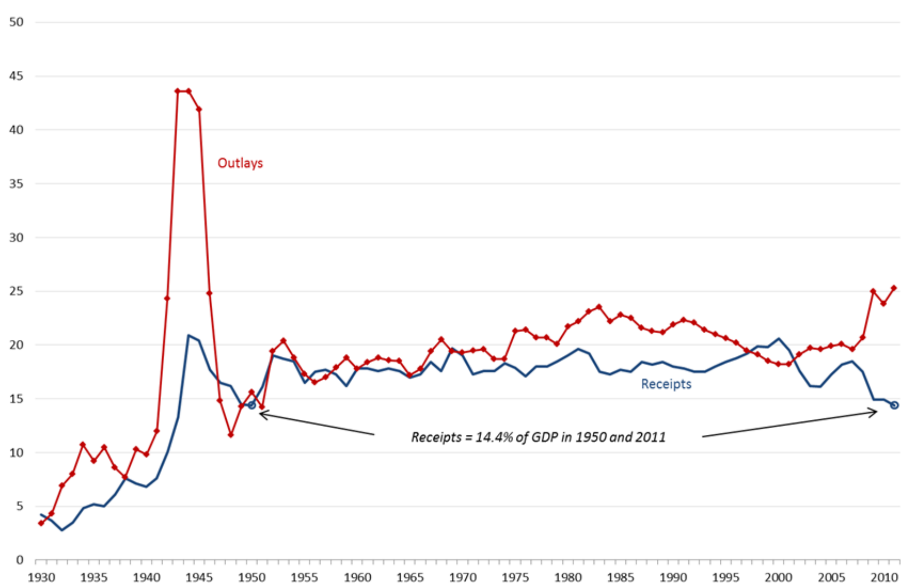
Tax Reform and Economic Growth

A better tax system would be good for the economy. Loopholes, complexity, continuing deficits, and high marginal tax rates all entail an economic cost. Loopholes and preferences sap the economy because individuals and businesses are spurred to make bad economic decisions solely because of the tax rewards they bring. Thus businesses are less productive than they could be. Moreover, the geniuses who invent schemes to exploit loopholes might be doing socially productive work—like figuring out how to produce products that people around the world would like to buy—if they weren't devoted to engineering tax shelters.

The cost of compliance with the individual and corporate income taxes will be roughly $200 billion in FY 2012. Not all of that reduces GDP—more than half of that estimate represents the time individuals spend keeping records, learning about the law, and completing returns—but it all represents an economic cost. If the law were simpler, Americans would have more time to pursue other activities, and companies could invest less in their tax departments and more in innovation.

Perhaps the biggest failure of the tax system is that it hasn't come close to paying for the costs of government for the past dozen years. To be sure, I'm not advocating that the budget be balanced every year. It makes sense to run deficits during recessions to help spur the economy, but the budget should be close to balance over the business cycle. Currently, revenues are at their lowest level since the Truman Administration. (See figure 1.) OMB and CBO project a slight improvement as the economy recovers, but then the red ink comes back with a vengeance.

Figure 1. Historical Receipts and Spending, as Percent of GDP, 1930-2011



Source: OMB, Budget of the United States, 2012 (historical tables)

As the members of this committee know well, ballooning public debt could do tremendous harm to the economy. The fact that tiny Greece's debt crisis roiled the world economy is especially disconcerting. If the US were foolish enough to follow in Greece's path, our collapse would be cataclysmic. We are the richest country in history—and intricately connected with all the other major nations. If we failed, we would bring down the rest of the world economy with us. I never want to find out how that plays out.

Finally there is the issue of marginal tax rates. One of the singular accomplishments of the Tax Reform Act of 1986 was the dramatic reduction in marginal tax rates. The tax rate on the wealthiest individuals fell from 50 percent to 28 percent and the corporate tax rate was cut from 46 percent to 34 percent. This was done without sacrificing revenues or progressivity because a host of tax breaks and loopholes were eliminated. As you know, that was also the approach taken by the president's fiscal commission, on which Chairman Conrad and Senator Crapo served, and the Bipartisan Policy Center's Debt Reduction Task Force, on which I served.

Lower tax rates are not the economic panacea that supply siders make them out to be—and can be downright counterproductive if they produce budget deficits—but in a fiscally responsible setting, they produce tangible economic benefits. The tax rate is a good barometer of the incentive to avoid taxes. At a 50 percent tax rate, every dollar of income hidden from the tax authorities saves 50 cents in tax. At a 25 percent tax rate, tax avoidance is half as profitable. Thus tax shelter schemes become more and more profitable as tax rates rise and diminish in value as rates fall. We will never have a perfect tax system, but the cost of our tax system's imperfections diminishes at lower rates.

However, if low tax rates are accompanied by larger deficits, any short-term economic gains may prove illusory. Even if lower tax rates boost the economy in the short run, the much higher tax rates required to pay back the resulting debt with interest in the future will entail a far bigger economic cost than setting rates at the level required to tame deficits and keeping them there. Studies by the nonpartisan staffs of the JCT, CBO, and Treasury (all under Republican appointees) concluded that deficit-financed tax cuts ultimately sap the economy if they lead to higher tax rates in the future.

Policymakers must figure out what government needs to do and, after the economy has recovered from the recession, pay for it. That will probably require higher tax rates or significant tax reform.

Tax Reform and Revenues

As you well know, the question of whether tax reform should raise revenues is highly contentious. Some point to the precedent of the Tax Reform Act of 1986, which was designed to be revenue-neutral, as a rationale for holding the line on tax revenues now. I believe that revenue-neutral tax reform now would have no chance of passage. In 1986, although the whole package did not increase revenues, a large corporate tax increase financed large cuts in individual taxes. This was feasible because the corporate tax code was riddled with costly tax preferences and investment subsidies. Corporate CEOs and shareholders were more than happy to trade corporate tax increases for substantial cuts in their own tax rates. But I think a substantial corporate tax increase would be infeasible and undesirable at a time when our corporate tax rates are the highest in the world.

And revenue-neutral reform of the individual income tax would necessarily mean that some, and probably many, individuals would pay higher taxes. The losers would strongly oppose the reform, probably dooming it to failure.

Moreover, as the Chairman has articulated well, we need more revenues. The retirement of the baby boomers and soaring healthcare costs mean that there will be enormous pressures on spending. Unless you are prepared to renege on the promises we have made to seniors, eviscerate the social safety net, and weaken our national defense, we will need more revenues (as well as spending cuts, especially in entitlements). House Budget Committee Chairman Ryan has done a great service to the nation by putting forward a plan that would eventually balance the budget with spending cuts alone. The plan shows just how draconian those cuts would have to be, and the public response to that plan suggests that a spending-only solution is utterly infeasible.

Some argue that limiting federal revenues is the only way to restrain government spending. That was certainly the operating principle of the previous Administration.

Although this argument—sometimes called "starve the beast"—appears plausible, it is hard to imagine that spending could have been higher as the Bush tax cuts slashed revenues. Government grew much faster from 2001-2009 than during the Clinton Administration. While some of that was war-related, nondefense discretionary spending also sped up and the largest expansion in Medicare since its inception was enacted.

It appears that instead of constraining spending, deficit financing was contagious. If deficits don't matter when considering tax cuts, why should they be considered when evaluating a new drug benefit or a "bridge to nowhere?"

The late William Niskanen posited a public choice critique of "starve the beast" when he was president of the libertarian Cato Institute. If deficits finance 20 percent of government spending, then citizens perceive government services as being available at a discount. Services that are popular at 20 percent off the listed price would garner less support at full price.

Niskanen found strong statistical support for the hypothesis that higher revenues constrain spending in a time series regression of revenues against the change in spending between 1981 and 2005. Another Cato researcher, Michael New, tested Niskanen's model in different time periods and using a more restrictive definition of spending (non-defense discretionary spending) and found the earlier results to be robust.

Niskanen and New might actually have understated the effect of deficits on spending. The message during the last decade seems to have been not that spending and tax cuts were available at a discount, but that they were free. Spending for wars, Medicare expansion, and "no child left behind" happened at the same time that taxes were falling. Citizens could be forgiven for forgetting that there is any connection between spending and taxes.

My guess is that if President Bush had announced a new war surtax to pay for Iraq or an increase in the Medicare payroll tax rate to pay for the prescription drug benefit, both initiatives would have been less popular. Given that the prescription drug benefit only passed Congress by one vote after an extraordinary amount of arm-twisting, it seems unlikely that it would have passed at all if accompanied by a tax increase.

Starve the beast doesn't work. Disillusioned conservative Bruce Bartlett called it "the most pernicious fiscal doctrine in history."

I also think that revenue-increasing tax reform would be more popular than a revenue-neutral package because Americans have embraced the notion of shared sacrifice when they supported the underlying objective. For example, in the past, we have supported tax increases to finance wars. As Joint Chiefs of Staff Chairman Admiral Michael Mullen has said, "The most significant threat to our national security is our debt." A tax reform that raised revenues, reduced the debt, and simplified the tax system in a fair way could be sold to the American public, especially if it had bipartisan support among policymakers. The Bowles-Simpson and Bipartisan Policy Center plans are both good examples of such plans.

Tax Reform and Fairness

Fairness is an essential element of a good tax system. There are two elements of fairness—one is to treat people in similar positions the same way. Broadening the base and eliminating unwarranted subsidies (and penalties) helps to advance that goal.

The other is to require a larger proportional contribution from those who are better off than those with more modest means. This objective, sometimes called progressivity, is more subjective. However, surveys suggest that the public supports more progressivity—at least at the top of the income scale. Pew commissioned a survey in December 2011 (table 1) that found that 57 percent of respondents felt that the wealthy do not pay their fair share of taxes. By comparison, 28 percent thought complexity was the most vexing defect of the federal tax system and only 11 percent ranked their own tax burden as the top concern. This suggests that the public would favor a more progressive tax system—and would be unhappy if tax reform undermined progressivity.

Table 1. Pew Survey of Views about Federal Taxes
Shares in Percent

Federal tax system is …	**Mar 2003**	**Dec 2011**
Very/Moderately fair	51	43
Not too/at all fair	48	55
What bothers you most …		
Amount you pay	14	11
Complexity of system	32	28
Feel wealthy people don't pay fair share	51	57
Tax system …		
So much is wrong, Congress should completely change	52	59
Works pretty well, Congress should make minor changes	44	34

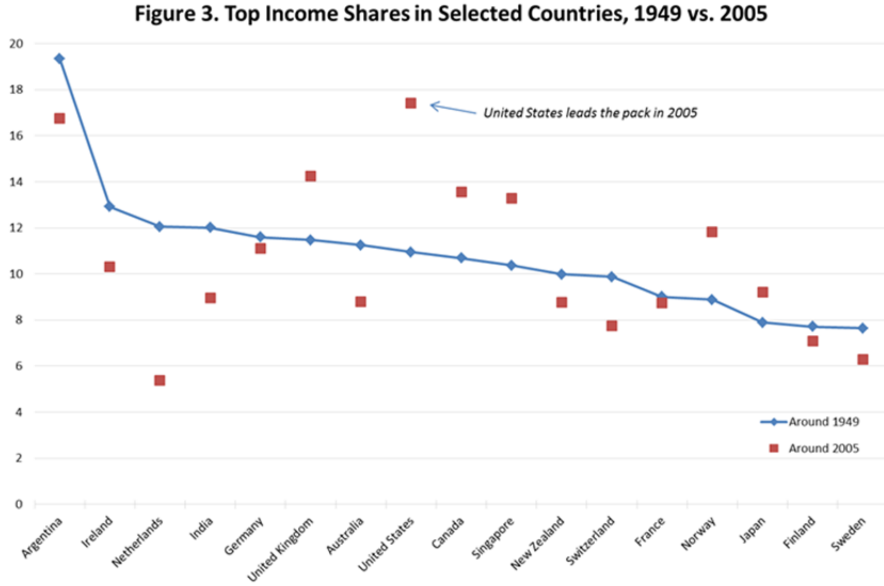
Source: Pew Research Center, "Tax System Seen as Unfair, in Need of Overhaul," December 20, 2011.

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

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

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

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

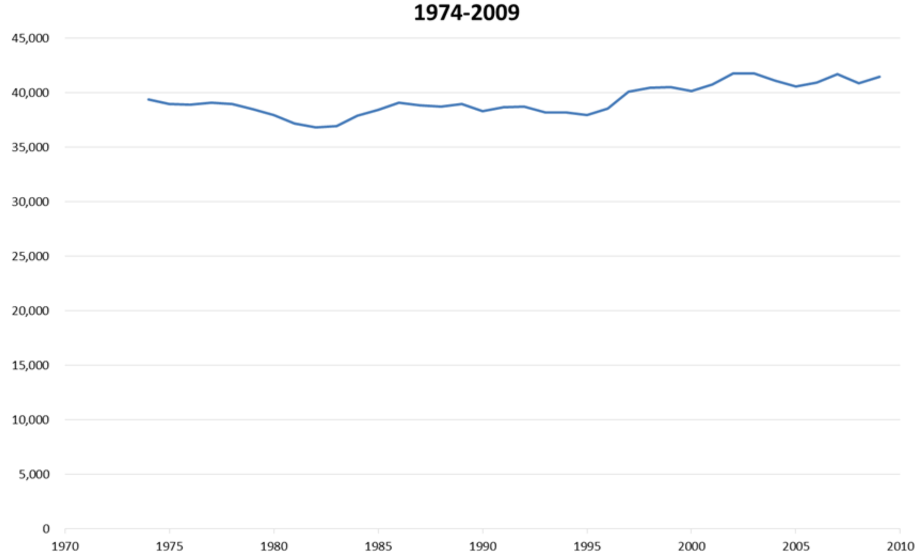


Tony Atkinson, Thomas Piketty, and Emmanuel Saez, "Top Incomes in the Long Run of History", Journal of Economic Literature, 49(1), 2011, 3-71.

Rising inequality might not be a pressing concern if families at all income levels were gaining ground, but that is patently not the case. The middle class in the United States has experienced almost no income growth for the past 30 years. Incomes by a variety of measures have grown barely faster than inflation. For example, figure 4 shows that median earnings for full-time, full-year workers grew by only 0.15% per year from 1974 to 2009 after adjusting for inflation. Some point out that total compensation has grown faster because most workers still get health insurance at work and the cost of health insurance has far outstripped inflation. But I doubt that workers perceive more economic gain when it's explained that almost all of their pay increases have gone to pay for increasingly expensive health insurance.

If economic mobility in the U.S. were high, inequality would be less troubling since everyone would have a similar chance at success, but that is also inconsistent with the evidence. Children of rich parents are much more likely to grow up rich than children of lower-income people. Upper-income children have access to better schools, live in safer communities, and when they grow up, have better connections to help them succeed.

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



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

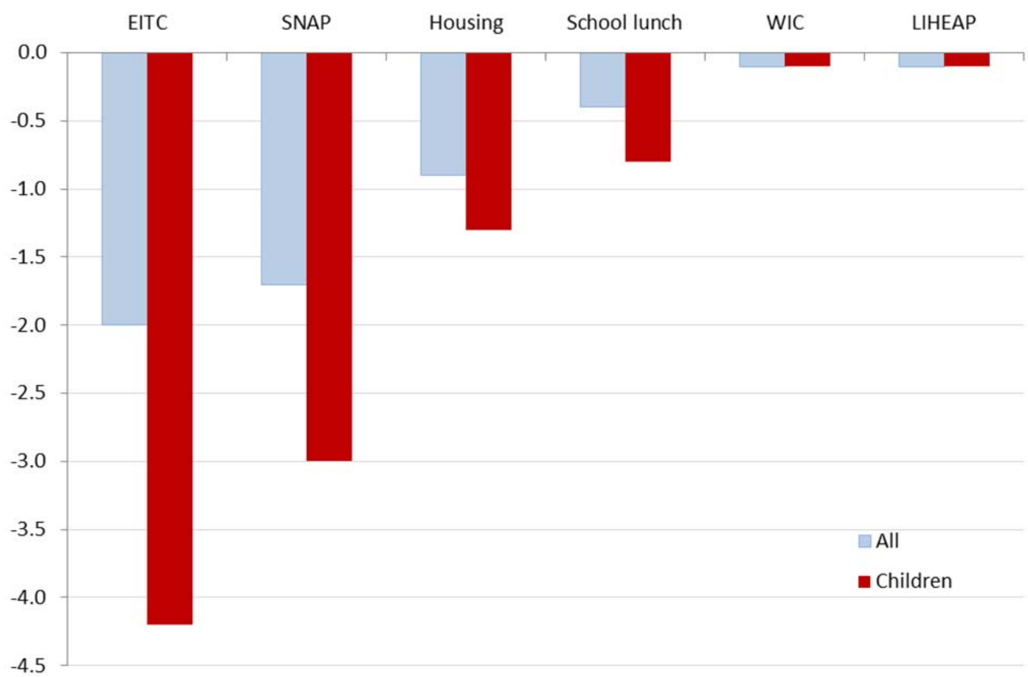
While I view rising economic inequality as undesirable in its own right, I'd argue that even those who do not care about inequality *per se* should be concerned about this trend. If the bottom 80 percent of the population feels like they're not getting their fair share, that could lead to a populist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

What's more, development economists have long observed that very unequal economies grow slower than economies with less skewed income distributions. There has been debate about whether economic inequality causes slower growth. It is possible that the causality goes in the opposite direction because richer countries can afford better public education and other services that boost economic opportunity for those with low incomes. But a study by economist William Easterly concludes that inequality causes slower growth because poor families cannot afford to invest in their own or their children's human capital, which makes for a less productive work-force.

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

There is one more aspect of fairness: the income tax is now a critical component of the safety net. The Census Bureau recently developed a new alternative measure of poverty that accounts for the effect of tax and transfer programs on poverty levels. (Astonishingly, under the standard measure of poverty, anti-poverty programs can't reduce poverty because they are not counted in families' incomes.) The single most effective program at reducing poverty in 2010 was the Earned Income Tax Credit (EITC). It reduced overall poverty rates by 2 percentage point and the child poverty rate by 4.2 percentage points. (See Figure 5.) Overall, this single program cut child poverty by more than 20 percent. It encourages work and helps a significant fraction of working families and children escape poverty.

Figure 5. Effect of Selected Government Programs on Poverty Rates in 2010



Source: Kathleen Short, "The Research Supplemental Poverty Measure: 2010," US Census, Current Population Reports, P60-241, November 2011.

While the EITC and other tax provisions helping low-income working families such as the child tax credit could certainly be simplified, a fair reform would preserve the tax-based safety net that so many low-income families and children rely upon.

Models for Tax Reform

I will not go into detail in this testimony about how to reform the tax system. There are many good models. The Wyden-Coats Bipartisan Tax Fairness and Simplification Act of 2011 would significantly simplify the tax code by eliminating the unfair and pointlessly complex alternative minimum tax, eliminating a number of loopholes and preferences, and consolidating and simplifying some of the remaining tax subsidies. Senator Wyden has been a steadfast advocate of tax reform and I applaud his efforts with Senator Coats to move tax reform onto the agenda.

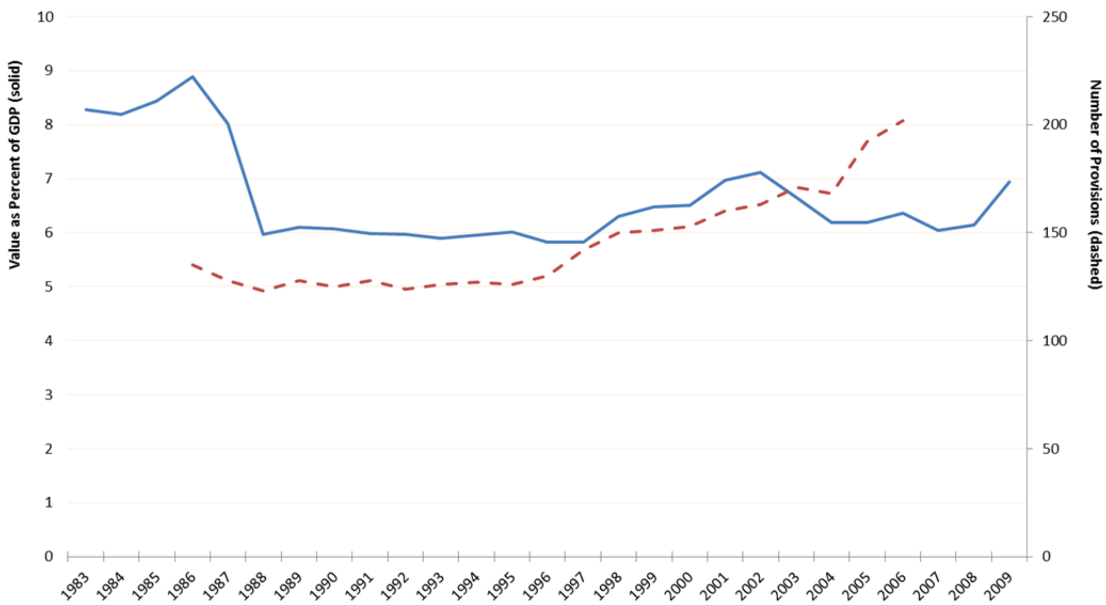
For reasons I outlined above, I think that tax reform should contribute to deficit reduction. The proposals of the Bowles-Simpson commission and the Bipartisan Policy Center (BPC) task force both would have closed a portion of the deficit through higher revenues. The two plans had a number of features in common. They both would massively broaden the tax base while slashing individual and corporate income tax rates, and both were designed to be at least as progressive as current law. As in the Tax Reform Act of 1986, both plans would eliminate the differential in tax rates between capital gains and ordinary income. Since capital gains are disproportionately held by those with very high incomes, the increase in tax rate on capital gains offsets the effect of reducing ordinary income tax rates for the wealthy. Like Wyden-Coats, both plans would eliminate the alternative minimum tax.

The BPC plan would simplify the tax system so much that about half of households would no longer need to file a tax return. By turning the popular deductions for charitable contributions and mortgage interest into flat credits, the IRS could pay the tax credit directly to the charity or financial institution at the time a payment is made, eliminating the obligation to claim the credit on a tax return. Withholding by employers and financial institutions would exactly match tax liability for many households.

BPC's plan, unlike Bowles-Simpson, would rely on a new 6.5 percent value-added tax (VAT) as a supplemental source of revenue. Bowles-Simpson gains all of its revenue from base broadening, which is more extensive than in the BPC plan.

The other common feature of the two bipartisan plans is that, arguably, their "tax increases" are accomplished entirely via spending cuts. As you know, a large and growing number of spending programs are run through the tax code in the form of tax expenditures. Somewhere between $800 billion and $1.2 trillion of spending (depending on whether you take a broad or narrow view of what qualifies as a tax expenditure) is accomplished via deductions, exclusions, credits, or other tax preferences. The number of tax expenditures increased by 60 percent between 1996 and 2006 (from 126 to 202). (See Figure 6.) Eliminating or scaling back inefficient tax expenditures is a way to reduce the size and scope of government, just as cutting direct spending would do. Both plans would eliminate almost all of these stealth spending programs.

Figure 6. Number and Value of Tax Expenditures, 1983-2009



Source: For tax expenditures as percent of GDP, GAO analysis of OMB, Analytical Perspectives, Budget of the United States Government, Fiscal Years 1985-2011; for count of provisions, Joint Committee on Taxation (annual tax expenditure compilations back to 1985), and author's calculations.

Taxing Capital Gains and Dividends as Ordinary Income

A lynchpin of the Tax Reform Act of 1986 and the two recent bipartisan tax reform proposals is that they cut ordinary income tax rates and tax capital gains and dividends the same as other income. This is a very controversial proposal as some view a preferential capital gains tax rate as an essential element of a pro-growth tax plan. My research suggests that this argument is wrong. Lower capital gains tax rates provide enormous opportunities for inefficient tax avoidance and are as likely to harm the economy as help it. What's more, taxing capital gains in full allows for substantial cuts in ordinary income tax rates while maintaining progressivity.

Long-term capital gains (those on assets held at least one year) and qualifying dividends are taxed at a top rate of 15 percent. By comparison, the top tax rate on other income is 35 percent. If Congress does nothing, the rates on gains will increase to 20 percent in 2013 and the top rate on dividends will return to 39.6 percent. The Affordable Care Act included a surcharge on investment income of 3.8 percent, which would raise the effective rates to 24 and 44 percent.

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

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

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

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

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

One other area of concern is the effect of the tax on entrepreneurial activity. In fact, the income tax treats investments of "sweat equity" very favorably. Entrepreneurs do not have to pay tax on the value of their labor until it produces income. Effectively, investments in one's own business are expensed in the sense that tax is avoided altogether on the value of the uncompensated labor invested. Like an IRA or 401(k), this makes entrepreneurial capital tax free. To the extent that entrepreneurial capital ultimately produces returns in the form of capital gains, entrepreneurs effectively pay a negative tax rate on their own labor input

The Simplest Tax Shelter

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

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

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

because the contributed labor is expensed while the ultimate return is only partially taxed. And capital gains that are considered "small business" might even be taxed at a zero rate.

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

Treating carried interest like other wage and salary income is one approach to diminishing this inequity. The "Buffett Rule," which stipulates that millionaires pay an average tax rate of at least 30 percent, is another, but that amounts to creating a new AMT—albeit a better targeted one than the existing provision. A better and more consistent approach would be to tax all capital gains the same as other income.

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

The argument against providing capital gains tax breaks is that removing them could improve both efficiency and equity. Lower capital gains tax rates fuels inefficient tax shelters that entail a significant economic cost. Second, it is unfair and inefficient to favor people like hedge fund managers and investors who earn a substantial portion of their income from capital gains rather than other more highly taxed forms of income. Third, the vast majority of capital gains are realized by people with very high incomes. Thus, tax breaks on capital gains undermine the progressivity of the tax system. (See Table 2.)

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

Taxing gains and dividends as ordinary income would also significantly simplify the tax code. The alternate rate schedule for capital gains and dividends is needlessly complex. And tax lawyers say that half of the tax code is devoted to defining and monitoring the boundary between tax-favored capital gains and other fully taxed forms of income.

Table 2. Distribution of Net Long-Term Capital Gains and Qualified Dividends, 2010

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

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

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

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

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

What if Major Revenue from Base-Broadening Proves Infeasible?

As discussed above, the major bipartisan tax reform plans call for wholesale elimination of tax expenditures to finance major rate reduction. This would clearly be highly desirable, but it may not be feasible. The biggest tax expenditures include very popular items such as tax-free health insurance, 401(k) plans and pensions; the mortgage interest deduction; the deduction for charitable contributions; and the deduction for state and local taxes. If scaling them back proves elusive, it may be difficult or impossible to raise revenue without either raising income tax rates or adopting a new revenue source as a supplement to the income tax.

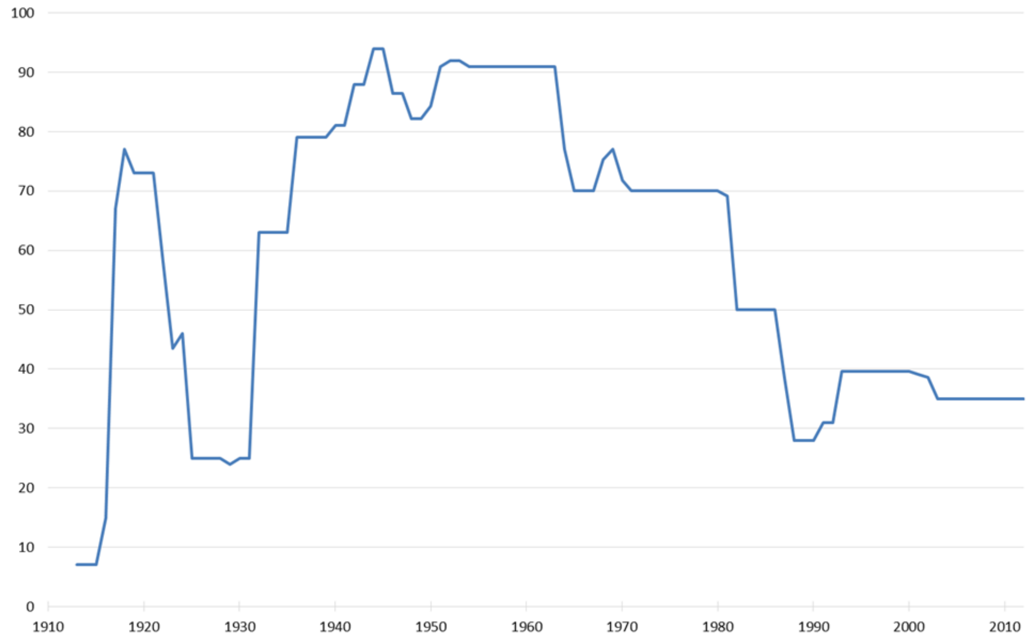
As noted, the BPC proposed to introduce a small VAT in the U.S. The advantage of a VAT is that it does not tax saving and is thus thought to be more conducive to economic growth than the income tax. The tax has never gained traction in the U.S. because conservatives are concerned that it would fuel more growth in government and liberals worry that it is regressive. To address the first concern, I have suggested that a VAT be earmarked to pay for government's health care costs. I believe this would actually help to constrain spending since, for the first time, consumers would see a connection between their health benefits and their tax bill. If health care costs continue to grow faster than the economy, the VAT rate will rise, which taxpayers would dislike. This could build support for sensible measures to constrain government health care spending.

The regressivity of a VAT may be offset by refundable tax credits designed to match the typical VAT levied on a family at the poverty line. This is similar to, although much smaller than, the "prebate" proposed as part of the national retail sales tax (or "FairTax").

Most economists' favorite new revenue source would be a carbon tax. By putting a price on carbon emissions, the tax would provide consumers and businesses an incentive to economize on the burning of fossil fuels and boost carbon saving innovations. This is a far better approach than providing subsidies to particular technologies. The government isn't smart enough to know which technologies should be subsidized. The advantage of the carbon tax is that private profit-maximizing enterprises could decide for themselves which technologies can best replace fossil fuels. The disadvantage of a carbon tax is that it seems even less politically viable than a VAT.

If substantial base broadening and new revenue sources are ruled out, the only remaining option to raise revenues is to raise marginal tax rates. This would not be my first choice, but it would certainly be better than allowing the debt to continue to grow unchecked. Top tax rates are very low by historical standards. Although higher than they were in the immediate aftermath of the Tax Reform Act of 1986, top tax rates are now (and were during the Clinton Administration) lower than at any time between 1932 and 1986. (See Figure 7.) While it is possible that the economic costs of taxation have grown over time—for example, because the technology of tax avoidance has improved—it is unlikely that returning tax rates to their levels in 2000 would be very harmful. Despite predictions that the economy would collapse in 1993 when tax rates increased, economic growth was quite robust until 2000. And notwithstanding forecasts that the Bush tax cuts would turbocharge the economy, growth was anemic throughout the last decade (even before the Great Recession). This certainly does not prove that economic growth is independent of tax rates, but it does suggest that, at least at current tax levels, other factors are more important.

Figure 7. Highest Individual Income Tax Bracket, in percent, 1913-2012



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

This concludes my testimony. I would be happy to answer any questions.