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RETHINKING THE TAX CODE

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BEFORE THE

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RETHINKING THE TAX CODE

WEDNESDAY, NOVEMBER 11, 2003

CONGRESS OF THE UNITED STATES,
JOINT ECONONOMIC COMMITTEE,
Washington, DC

The Committee met at 9:30 a.m., in Room 628, Dirksen Senate Office Building, the Honorable Robert F. Bennett, Chairman of the Committee, presiding.

Senators present: Senators Bennett, Sessions, Sununu.

Representatives present: Representatives Paul, Stark.

Staff members present: Melissa Barnson, Gary Blank, Ike Brannon, Daphne Clones-Federing, Sean Davis, Jason Fichtner, Nan Gibson, Colleen Healy, Brian Higginbotham, Brian Jenn, Tim Kane, Rachel Klastorin, Donald Marron, John McInerney, Tom Miller, Wendell Primus, Diane Rogers, Frank Sammartino, Rebecca Wilder, Jeff Wrase.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT, CHAIRMAN

Senator Bennett. The Committee will come to order. Before making my prepared opening remarks, I'd like to say that we're going to be very strict on time during this hearing, because in the wonderful world of Senate scheduling, I have to be on the Senate floor at 10:30 to begin managing the Agriculture Appropriations bill. We had no idea when that would come, but the stars have lined up that it comes exactly at the same time as we have scheduled this hearing. I apologize that that's the way it is.

In May of this year, under the prodding of Senator Specter, the Senate overwhelmingly approved legislation acknowledging the serious problems of our current tax code and called for a Congressional review of ways to overhaul the antiquated system.

It is especially gratifying to me, because tax reform has been a central piece of my agenda in the Senate, and it's been a little frustrating to not see it move much more rapidly than it has. But 70 members of the Senate agreed that the Joint Economic Committee should be the key point for this debate, and today's hearing is a direct response to that vote. It is a part of a series of hearings and studies and related events that the Joint Economic Committee is undertaking to help the Congress find a path to real tax reform.

The present tax system is unduly cumbersome, inefficient, and incomprehensible. Over the years, through revision after revision, the tax code has become a confusing, burdensome web that hampers economic growth, places undue burdens on American busi-

nesses, and needlessly complicates the lives of the American people.

As I reflect upon all of the debates held over the years on tax policy, I realize that there is one word that comes up over and over again, and that word is fairness. Every time we make a change in the tax law, we are told that it is necessary to make things more fair.

But what we have done is tipped the tax code this way and that to encourage one activity, and discourage another. And every time we do this, the tax code gets bigger and more complex.

I find it ironic that in the name of fairness, we have created a system that is unfair to everybody.

Today, during this hearing, I hope we can start with a clean sheet of paper. Let's not talk about tax cuts or mere adjustments to specific parts of the existing system. Let's talk about creating from scratch, a system that is simple, that is fair, and once established, a system that will endure for years to come.

We're not prejudging the issue; we're not coming to the hearing with recommendations already in mind. This is an opportunity to listen and learn and look at the issue from a different perspective.

Whether one is in favor of getting more tax dollars out of the rich, or using the tax code to spur faster economic growth, or implementing a flat tax for all individuals, everyone can agree that the existing code is so badly broken that the principles of simplicity, fairness, and efficiency are not being met.

If we can achieve the goals I have just laid out, then another challenge begins. We must ensure that the new tax system endures.

Businesses cannot make intelligent plans if the tax system constantly changes. That slows economic growth and that slows job creation.

For individuals, the shifting sands of the existing tax code create painful uncertainty. People who want to buy a house, take out a loan, put money aside in a savings account, or make an investment, need and deserve to know that there won't be any surprises coming up after the next election.

Now, that's the predicate for the hearing today. And we have assembled a balanced group of witnesses that will present diverse views about how the government should tax its citizens.

[The prepared statement of Senator Robert F. Bennett appears in the Submissions for the Record on page 35.]

Senator Bennett. And for our first panel, we are pleased to have as a distinguished guest, Senator Arlen Specter of Pennsylvania, who was the primary sponsor of the Sense of the Senate Resolution that brings us here today, and who has for years been a champion of tax reform. We're also pleased to have Representative Jim McDermott of Washington and John Linder of Georgia, and we thank all of you for joining us here today. With that, I recognize the arrival of Mr. Stark, the Ranking Member, and have him give whatever opening statement he might have.

Mr. Stark.

Representative Stark. Mr. Chairman, I'd be glad to withhold on the opening statement and let our colleagues proceed. I'll send them an autographed copy later.

Senator Bennett. I'm sure they will frame it and put it on their walls. Thank you, Mr. Stark. We appreciate it.

Senator Specter, we appreciate your leadership in getting us here, and we look forward to hearing what you have to say to us.

PANEL I

OPENING STATEMENT OF SENATOR ARLEN SPECTER, U.S. SENATOR FROM PENNSYLVANIA

Senator Specter. Thank you, Mr. Chairman and Ranking Member, Congressman Stark. I urge this Committee, this distinguished Joint Economic Committee, to take a forceful, unambiguous stand in support of the flat tax, because if this Committee doesn't get the ball started, nobody will.

These issues have been pending before the Ways and Means Committee in the House and the Finance Committee in the Senate for years, and, understandably, they are preoccupied with many, many subjects as we speak: Prescription drugs, the Energy bill, and a host of other issues on Medicare, and, as you, Mr. Chairman, have already outlined, the serious situation on tax complexity.

And my prepared statement, which I know will be made a part of the record, goes into great detail on the problems. I studied the flat tax back in 1995 when Congressman Dick Armey introduced it in the House in the Fall of 1994. And in the Spring of 1995, I introduced legislation for a flat tax and have reintroduced it every year since, and it is currently pending as Senate Bill 907.

And as you, Chairman Bennett, have noted, I offered the resolution to have this hearing, and you and I have discussed it privately, and somebody has got to take the ball and carry it down-field in an official way. And this Joint Economic Committee has a unique opportunity to really do this very, very important work.

The flat tax would enable taxpayers to file their return on a postal card in 15 minutes, compared with voluminous hours now. This is a carefully worked out program by two distinguished professors from Stanford, Professor Hall and Professor Rabushka, where the flat tax is neutral at 19 percent.

My proposal adds one percent to that to retain modest deductions on home mortgages up to $100,000 and charitable contributions up to $2500, because those two items are so deeply ingrained in the American taxpayer psyche. But I would be glad to see those two eliminated and going back to 19 percent, or see some variation, depending on what this Committee wants, just to move forward on the flat tax principle.

The flat tax does not have any tax on interest, on dividends, on capital gains, or on estates. There is no depreciation. Everything is expensed in the first year.

The flat tax does not benefit the wealthy. As my statement outlines, with a group of income levels, a married couple with two children and $35,000 income will have a savings of $176.

The tax structure is outlined for the upper brackets and it is about the same, or a slight increase, so put to rest the notion that the flat tax is going to benefit the rich at the expense of the poor.

We hear a great deal of talk about having the tax flatter and fairer, but we have not come to the point of really saying we're

going to oppose the flat tax. Mr. Chairman, I see that my yellow light has just started on, and I'm going to do something very unusual in a filibuster-prone body, and yield back about a minute of my time. Thank you.

[The prepared statement of Senator Arlen Specter appears in the Submissions for the Record on page 50.]

Senator Bennett. Thank you very much, Senator Specter, both for your statement and your leadership.

Representative McDermott.

OPENING STATEMENT OF REPRESENTATIVE JIM McDERMOTT, A MEMBER OF CONGRESS FROM WASHINGTON

Mr. McDermott. Thank you, Mr. Chairman. I want to thank you and Representative Stark for having this hearing. I really wish that the Committee were talking about the deficit, because I think we ought to be paying more attention to that and how it affects our economy by increasing interest rates and reducing savings and inflating the value of the U.S. dollar, which has made the American products less competitive overseas.

Next year's deficit may top $500 billion, and there's not an organization in the governmental agency of Washington that knows when we will return to a balanced budget. President Bush inherited a government that took in about 20 percent of GDP in revenue and spent a little less than that. He inherited a budget surplus that could have been used to shore up Social Security and pay off the deficits that piled up during the Reagan-Bush era.

We have quite a different picture today, and mostly due to three rounds of tax cuts in Fiscal Year 2003, revenues dropped to 16.6 of GDP, while our deficit exploded. Revenues now are at the lowest levels since 1959, which was near the end of the Eisenhower Administration.

I want to be sure everyone knows that taxes in America are not high. The U.S. tax revenue as a percentage of GDP, is among the lowest in the developed world. Only two OECD members have lower taxes.

Now, I understand that the hearing is about rethinking the tax code, and the Ways and Means Committee held a host of hearings about this same issue in the mid-1990s under Chairman Archer. At one point during the hearings in 1995, the Chairman said he was convinced that the tax code needed to go a flat tax.

He even said he was going to introduce legislation to do it, but after all the hearings and the rhetoric, he never even introduced the bill.

Today, income taxes, as a share of GDP, are at the lowest level since 1991, but payroll taxes, which takes the heaviest bite from the lower income workers, rose to its biggest share of federal revenue. This is unfortunate because it means our tax system has become more regressive over the past few years. In other words, poor people are bearing more of the tax burden today than in an awful long time.

Now, everybody knows that you can do two things with money: You can save it or you can spend it. Rich people have more to save than poor people, and if all that we do is impose taxes where peo-

ple spend money, then poor people are going to spend a larger share of their paycheck on taxes than rich people are.

A system based on consumption taxes hardly seems fair to me. Legislation has been introduced in the past to convert our tax system to one that relies solely on consumption tax. Representative Linder, who will talk in a minute, has introduced legislation to abolish the IRS and force the Federal Government to rely on a national sales tax.

This proposal would involve an extraordinarily regressive shift of tax burden from the affluent to everybody else and would be a boon for the wealthy elite. His proposal would tax all purchases of goods and services in our economy, including food, healthcare, home rents, and new home purchases.

The Joint Committee on Taxation did an analysis of H.R. 2525, and the study indicated that in order for the bill to be revenue-neutral over ten years, the estimated national sales tax rate would be between 36 and 57 percent. In other words, the price of blood transfusions, prescription drugs, and a pair of sneakers would all increase between 37 and 57 percent.

I don't know how anybody could think that is fair. I don't know how you could sell that proposal to the Baby Boomers, just when they are about to live on a fixed income.

There have been several flat tax proposals floated in the past. As you have heard, Dick Armey was a staunch proponent of the flat tax. Mr. Armey introduced a bill to create a flat tax, consisting of a permanent 17-percent rate.

The Treasury estimated his bill would cost $138 billion each year.

The rate would need to be closer to 21 percent. At this rate taxes would double for the American working poor while they would be cut in half for millionaires. Every time someone talks about a flat tax, my question to them is, what about pensions, health care, home ownership and charitable giving?

The Health Insurance Association of America states that one of the consequences of flat tax bill is likely to be a rapid increase in the number of people without private health insurance. One economist estimated there would be eight million more people without health insurance if a flat tax were enacted.

James Poterba, an economist at MIT, estimated that eliminating the current tax benefits for purchasing homes would result in a 17 percent decline in the value of the U.S. housing market.

Payroll taxes? A flat tax would eliminate the deduction that employers pay for their share, amounting to a massive tax increase on businesses of all size.

Furthermore, it is a bit naive to think that the pressures that we currently have to change the tax code for public policy reasons would go away with the new tax regime. I think it is highly unlikely our tax code would not just become as complex over time as it is today.

I believe we have to stress a few important things—the first fundamentally is the cold question of fairness, as you have indicated. A 20 percent tax to someone making $20,000 is much different than a 20 percent tax to someone making $200,000.

Secondly, a tax system must bring in enough revenue to pay for government expenditures.

Third, our IRS code should try to provide as much efficiency in our economy as possible and, lastly, we should try to reduce the complexity of the code by doing things such as reforming the alternative minimum tax, which is increasingly creeping into the pocketbooks of middle income families.

Thank you, Mr. Chairman.

Senator Bennett. Thank you very much.

Representative Linder.

OPENING STATEMENT OF REPRESENTATIVE JOHN LINDER, A MEMBER OF CONGRESS FROM GEORGIA

Mr. Linder. Thank you Mr. Chairman and Mr. Stark.

I appreciate the opportunity to comment on the fundamental tax reform. I believe that the Congress should judge any such bill following on fundamental tax reform on how it follows eight key principles. It should be fair and it should protect the poor and treat everyone else the same. It should be simple and easy to understand by everyone. It should be voluntary and not coercive or intrusive. It should be transparent. We should all know what the government costs us. It should be neutral at our borders. It should be industry neutral. It should strengthen Social Security and have manageable transition costs. I believe my bill, H.R. 25, meets all those tests.

I will first begin by commenting on the flat tax. The tax you have today, that you come to know and love, is a flat tax on income—ninety years later. As long as we know how people make money, how much they make, we can find the way to get the rest.

My proposal eliminates all income taxes and payroll taxes, replaces them with a national retail sales tax. It is fair, it is understandable, and it totally untaxes the poor.

If you get rid of the income tax, the payroll tax, the gift tax, the estate tax, capital gains tax, the alternative minimum tax, and replace it with a one-time national sales tax of 23 percent, it will be revenue neutral.

We have spent $25 million over the last eight years on economic and market research. The most compelling study was out of Harvard done by Dale Jorgenson, who is head of economics, and he said that 22 percent of what we are currently spending at retail is the embedded cost of the current code.

That is to say, we are losing 22 percent of our purchasing power to the embedded cost of the current code. If we were to get rid of the code, repeal the code, get rid of the IRS, and let competition drive those costs out of the system, and replace it with an embedded 23 percent, it would increase the cost of living by one percent, but everybody would get to keep their whole check, they would be voluntary taxpayers paying taxes when they choose, as much as they choose, by how they choose to spend.

What would happen in our economy? Well, we know that, in the first year we would have a 26 percent increase in exports. In the first year we would have a 76 percent increase in capital spending. We know that from 1945 to 1995 real wages, take home pay, increased in exact correspondence with increases in capital spend-

ing—we spend today anywhere from $250 billion to $500 billion just complying with the current code. Hardly efficient.

We know that, for small businesses to remit $100, collect and remit $100, it costs them $724 to do so. We would have the largest magnet for capital in the history of the world. There are today anywhere from $500 billion—a low estimate—to $2 trillion—in funds stranded overseas because it is cheaper for American businesses to borrow at five percent or six percent than to repatriate at 35 percent—all those dollars would come to our shores and put a new liquidity into our markets and creating new jobs.

We have had problems with government, with companies going offshore recently. They are not going off because they are angry or mean. They are going off because they cannot deal with the tax code. We would have those companies flocking to our shores as well as all the wealth in the world into our capital markets because there would be no tax consequences. We would create huge numbers of new jobs.

There is a recent book out called "Reefer Madness" that says prostitution, pornography, illicit drugs and illegal labor constitute a trillion dollar economy. Those dollars would be taxed at the retail checkout by the Fair Tax.

We believe that we would have no deficits today and indeed have increased revenues. A study done from 1945 to 1995 shows that the consumption economy is a much more steady predictor of activity than the income economy and, indeed, we would have had increased revenues in 10 of the last 11 quarters instead of declines that Mr. McDermott spoke about.

Lastly, to protect the poor, we say that every household should get a check at the beginning of every month that totally rebates the tax consequences of spending up to the poverty line. That would give people spending at or below the poverty level a 22 percent increase in purchasing power that would totally untax them on necessities because that is the definition of poverty level spending. That is spending necessary to meet, to buy, our necessities.

It would save Social Security. Over the next 75 years, we are going to increase the number of people on Social Security by 100 percent. We are going to increase the number of people paying for it by 15 percent. I don't care how much you set aside, that is something that is irretrievably broken and cannot be fixed.

Under our system, the revenues to Social Security and Medicare will double in the next 14 years by doubling the size of the economy.

Lastly, the transition costs are doable. The only transition rule in my bill is that any inventory on hand on December 31, the value of it can be used as a credit against sales in the following year because we think things should only be taxed once, since we have at any given time, a $1.3 to $1.4 trillion in inventory in this country, a fourth of that is about $350 billion. That would be the total transition cost.

I say let's unleash the American people, the economy, turn them all into voluntary taxpayers and we will have a new system that will be endurable.

Thank you, Mr. Chairman.

Senator Bennett. Thank you very much. We appreciate the range of opinions we have got here and the thoughtfulness that has gone into the presentations and recognize that you have other responsibilities. You are welcome to join us here on the dais, if you wish, either one of you, but you are also excused if you feel you have to move on.

Mr. Linder. Thank you very much.

[The prepared statement of Representative John Linder appears in the Submissions for the Record on page 61.]

Mr. McDermott. Thank you.

Senator Bennett. Thank you.

Representative Stark, do you want to do your opening statement now or shall we go on to the next panel?

OPENING STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Representative Stark. Mr. Chairman, I would just summarize it if I may and ask that you include it in the record. I want to thank you for this hearing. It is a topic about which those of us on the tax writing committees have puzzled over a long time and under various philosophies and suggestions for revising the tax code.

I had a guy years ago who wanted to give every American some stock—every American, and I cannot even remember that one, but——

Senator Bennett. Who got to pick the company?

Representative Stark. I do not know what he was going to do. Probably a mutual fund.

But my question now is this. Ken Keyes, who is still around town and used to be staff director of the Joint Committee on Taxation and represents as a staff person, many of the Republicans on the Ways and Means Committee suggested that the time to do tax reform is when we are running a big surplus, because then we have got some money to patch over the inequities or the transition problems that will invariably come up in changing any kind of a commercial tax system that affects commercial intercourse in this country.

So, while it is a topic about which I have great interest, my only suggestion is that this might not be the best time because I think one of the ways to get political support for any kind of tax reform is to get some tax relief.

And at this point, I have to join with most of my Democratic colleagues in saying that our plate is kind of full in terms of tax relief and we may be looking for a little revenue down the line. But, it is a topic that is not going to go away. It is going to be with us and I appreciate the opportunity to hear from my colleagues and we have an excellent panel ahead of us. Thank you very much.

[The prepared statment of Representative Pete Stark appears in the Submissions for the Record on page 48.]

Senator Bennett. Thank you, sir. Your statement will, of course, be included in the Record in its entirety.

We now turn to our second panel. I believe we have been able to attract a wealth of knowledge on the subject of tax reform. We have Dr. Michael Boskin from Stanford University where he is a

professor of economics. He has served as Chairman of the President's Council of Economic Advisors.

Cliff Massa is currently a tax attorney for Patton Boggs, and has served as Chairman on the Committee on Value-Added Taxes at the American Bar Association, and Professor Ed McCaffery joins us from the University of Southern California and is author of a book called "Fair, Not Flat: How to Make the Tax System Better and Simpler."

Finally we welcome Robert McIntyre, the executive director of Citizens for Tax Justice.

So I think we have a mixed but balanced body of opinion here. We look forward to hearing from all four of you.

Before you came in, Congressman Stark, I indicated that, in the genius of Senate scheduling, I have to be on the floor at 10:30 a.m. to manage the Agriculture Appropriations Bill and so, if I can trust you, and I think I can and no one else has shown up, the Vice Chairman does not appear, I will leave the witnesses to your tender mercy at that point and I think the Republic will still stand among those who get concerned about a Republican dealing with a Democrat thusly.

Let's go in the direction that I have indicated. Mr. McCaffery has apparently not shown up yet. So he is on his way, and we will start at this end of the table, then, Dr. Boskin, you go first and then move across.

PANEL II

OPENING STATEMENT OF DR. MICHAEL J. BOSKIN, SENIOR FELLOW, HOOVER INSTITUTION, STANFORD UNIVERSITY

Dr. Boskin. Thank you, Chairman Bennett, Ranking Member Stark—a pleasure to be back before the Joint Economic Committee.

I was asked to make some comments about how we would design a tax system if we could start de novo. What would be the basic principles we would use and what would the tax system look like?

Of course, moving from the current one to that one raises a variety of issues of transition and so on, so I am sure you are aware that the desirable properties of a tax system have been debated since the dawn of political philosophy.

Adam Smith had four canons of taxation: equality, certainty, convenience in payment and economy in collection—that is, equity, efficiency and administrative simplicity, the things that we still debate today. And that was two-and-a-quarter centuries ago.

I have five big tests that I like to apply to tax reform to put taxes and tax reform into the context of the overall economy and society.

The first is, will tax reform improve the economy, and I will spend the bulk of my remaining time on that, but also, second, will it affect the size of government? There are many people who believe a new tax device might just be used to raise revenue and after closing the deficit perhaps grow the government, and that should be a separate debate. So we will talk about tax reform of roughly the same revenue.

Third, will it affect federalism? Fourth, will a new tax structure likely endure and over time, and fifth, will tax reform contribute

to a prosperous stable democracy by making sure we have an abundance of taxpayers relative to people receiving payments from the government. We see as Europe progresses with their demography and very generous social welfare states, that they get into some very awkward politics of budget policy as a majority of the population receives benefits rather than paying taxes.

In designing a tax system there are some key decisions that have to be made. The key decisions that have to be made are four—what is the tax base, should it be income or consumption? Our current system is a hybrid of the two. Should we tax people or transactions?

What should be the tax rate or rates? A flat tax? Progressive rates? And at what level should they be levied? What is the unit of account? Should we use the family? The individual? Or should we tax transactions?

And what time period should we use? Should it be an annual tax? Should we tax individual transactions as they occur daily or should we have a longer horizon view of equity and efficiency?

I will say a few words about each of these. Modern tax theory as it has developed in Academe across America primarily but also importantly, in the U.K., is often called "optimal taxation." It came to the conclusion that the best tax system would be a system with broad bases and low rates and would integrate the personal and corporate tax, and probably tax consumed income rather than taxing savings twice or three times as in separate corporate and personal income taxes.

This occurs for a couple of reasons, but let me just start by emphasizing that economists, starting in ECON 1, teach that the harm done to the economy from taxes goes up with the square of the tax rates, so if you double tax rates—you quadruple the cost of the distortions in the economy to how much people work or save or invest or innovate.

That puts a pretty severe cap on how high tax rates can get before they cause substantial harm.

There are many ways to do this sort of taxation, to tax consumption. You can tax consumption or income in a personal tax or impersonal tax. It could be done at the business level. It could be done at the personal level or some combination of the two. So because consumption and saving are the two uses people have for their income, if we taxed income minus savings, if we had sort of a super IRA where people could deduct all of their savings, you would by this deductible saving method, wind up taxing consumption.

Alternatively, you could do this with a business tax that allowed immediate writeoff of investment. The business tax expensing method, would combine a labor income tax at the personal level and a capital income minus investment tax at the business level—and that would wind up taxing consumption. Finally, as was said earlier this morning, retail sales or direct value-added taxes are alternative methods of getting to the same result of taxing consumption.

Each of these approaches has its strengths and weaknesses. The retail sales tax would probably do the best job of getting at the underground economy. A personal consumed income tax could have

more variations in its features to accommodate personal circumstances. It could have progressive rates if that were desirable.

But the main thing is that the rate or rates be low.

A flat rate has a lot of advantages in simplicity. It eliminates the need to process lots of information and lots of data and can greatly simplify the tax code, for example, deductible interest and taxable interest at the same rate means that the two things would net and you would not have to keep track of it as it would not be taxed at all in the flat tax.

So these are some of the approaches. I would just make a couple of other statements about rate or rates. It is important to take a longer time horizon than just an annual tax. We used to have income averaging in the tax code. It was abolished in 1986.

Over a lifetime, a consumed income tax or consumption tax, would tax lifetime income other than bequests, because over your life you consume your income, and many of us believe that a consumed income tax would do a better job of measuring long run average income than would an annual income tax, because of that fluctuation.

I would also say that the studies that have been done in Academe suggest that the gains from such a tax reform, 7.5 to 15 percent increase in per capita consumption, a decade's worth of per capita consumption—are quite large and would indeed be of an order of magnitude that would be hard to find in any other type of public policy reform.

Thank you.

[The prepared statement of Dr. Michael J. Boskin appears in the Submissions for the Record on page 64.]

Senator Bennett. Thank you very much.

Mr. Massa.

OPENING STATEMENT OF CLIFF MASSA, MANAGER, PATTON BOGGS LLP

Mr. Massa. Thank you, Mr. Chairman. Good morning, Members of the Committee.

In your invitation I was asked to comment on fundamental tax reform, what might replace the current system, as well as how you could hold it, if you could ever do it.

My perspective is as a trained tax lawyer, but really a tax policy lobbyist for most of the last 20 years, and I have spent a lot of time on these subjects, including chairing the VAT committee of the ABA tax section, which came up, believe it or not, with principles that all of the tax lawyers agreed to. They are attached to my statement and I will come back to them.

But it is based on that experience that I would recommend that the individual and corporate income tax systems as we know them, simply be scrapped and be replaced with, and the term I use is a business activities tax, provided that the principles that I am going to cover as quickly as I can, are the ones that implement that system.

If we do not implement a new system with a reasonable set of principles, most of them can morph eventually into the current mess that we have now, and I would simply say, if that is where

we are headed, stay where we are. At least we understand the current mess.

The second question quickly, are there ways to assure that you can hold on to tax reform once you have it?

I know there are proposals for constitutional amendments and super-majorities, and they may have some benefits. My own sense observing the scene for a while is that, if the public and policy makers can actually summon the will to change the system and to change the system using the kinds of principles that I will get to, that probably is the strongest protection that you have for maintaining the reform in the first place, because the pressures for screwing it up come from individuals and businesses, people that I and people like me represent—that is the summary.

The principles I refer to for implementing any kind of new tax—and particularly for a consumption tax—basically are these.

They are slightly restated versions of what the Tax Section Committee approved in January 2000. That position, by the way, was not adopted by the ABA House of Delegates. Frankly I was surprised we got it through the Tax Section and I am satisfied to have had hundreds of tax lawyers, except for one audible "no" in the room, agree to it.

But those principles are these—first, that any tax system that is imposed on consumption should use the most comprehensive definition of economic value-added we could come up with, should apply only one rate of tax to that base, provide no exemptions, exclusions, credits, deductions, anything which is going to favor one group or penalize one group over any other.

Second, all kinds of businesses and organizations need to be in the system. Individuals would be out as remitters and collectors and businesses would simply do what they do now, which is to collect taxes from us in our various roles as consumers or employees, but particularly consumers, and remit—so that all business organizations ought to be in the system, regardless of their corporate versus non-corporate form or anything else.

Third, a topic that is current these days in both the Finance Committee and the Ways and Means Committee, the destination principle—in other words, impose this tax on imports and not impose it on exports. All of the current argument about replacing ETI which replaces FSC, which replaced DISC, is a function of the fact that we have been trying for years to illegally use the income tax to subsidize exports. We know the rules do not permit that, so under a consumption-based tax, we can, in fact, use legal border adjustments.

Fourth, the efforts to offset whatever is perceived or actually is the regressivity of a system of consumption taxes ought to be just dealt with directly. Write the checks to whomever the government decides needs to have those benefits.

There are some complexities that have to be dealt with. Ours is not a simple economy, so a fifth principle is that, in some areas, and financial intermediation is one, it is difficult to find the price, but we have to dig in and come up with some alternative mechanical rules in those services where it is just not clear that this is the price charged.

And finally, keep the bookkeeping and the rules as simple as possible. There are going to be pressures to leave small businesses out and others out because it is too complicated to deal with. I would be very leery of allowing that kind of thing to happen.

Among the options that are available, very quickly, I would see the spectrum of four major proposals as these:

The flat tax could be better than what we have, but it sets right back up the opportunity for people like me and our clients to mess the system right back up. The more people you leave in the system in an attempt to compute income, the worse off you are.

Sales tax, a little better, but it is rife with the ability for revenue to be lost when it is not all collected at the retail level at the last minute. The European style value-added tax, better yet, because you have every business in the economy in the system to varying degrees.

My personal favorite is what is called a Business Activities Tax, which is basically a European style value-added tax computed with a subtraction method, and if time permits, I can get into more details.

But those are my views, based on practice and working with a lot of tax lawyers. If we keep it simple and do it correctly, a new system can be worthwhile. If we do not follow principles like these, let's not even start.

[The prepared statement of Cliff Massa appears in the Submissions for the Record on page 91.]

Senator Bennett. Thank you very much.

Mr. McCaffery.

OPENING STATEMENT OF EDWARD J. McCAFFERY, PROFESSOR OF LAW AND POLITICAL SCIENCE, UNIVERSITY OF SOUTHERN CALIFORNIA LAW SCHOOL

Mr. McCaffery. Thank you very much, Mr. Chairman.

Let me begin with a true conversation I had with my 12-year old daughter before I left for California. I told Cathleen that I was going to Washington to testify.

"Oh, no, Daddy, you didn't do something wrong, did you?" she said.

"No, honey, I am testifying about fundamental tax reform."

"I know, Daddy, that is what I meant."

[Laughter.]

Mr. McCaffery. I have learned since my first days of talking about tax reform to try to keep things short and simple, perhaps especially in a complex field.

Fundamental tax reform, the subject matter of these hearings, is a topic near and dear to my heart. What follows is my attempt to distill decades of critical reflection into ten easy-to-digest truths:

Number one, fundamental tax reform is needed. I hold this truth to be self-evident, that the current tax system is a disgrace.

Two, simplification can only occur with fundamental tax reform. I hold this truth, too, to be self-evident, or at least abundantly clear after too many decades of incrementalism.

Three, fundamental tax reform is possible. Many followers of tax policy draw a despairing lesson from the Tax Reform Act of 1986. At the time this Act, which broadened the income tax base and

lowered its rates, seemed the last best hope for some semblance of sanity in tax on earth.

Less than two decades later, the tax system is as complicated as ever. Perhaps fundamental tax reform, like federal budget surpluses, are doomed not to persist.

But this is the wrong lesson to be learned. The 1986 Act chose one of two routes for tax reform laid out in the classic Treasury study, Blueprints for Tax Reform: Namely, that of perfecting the income tax by broadening its base. Sophisticated foresight would have shown then what hindsight has since proven: this was the wrong means to take to the right end.

Four, fundamental tax reform must center on the tax base. It is easy enough to get blinded by the rates when thinking about tax, but one way or another total taxes in America are going to be pretty close to one-third of our gross domestic product, on average, because this is what government at all levels is spending.

Truly fundamental tax reform, any tax reform that has any chance of effecting permanent gains in equity, simplicity, efficiency, and accountability, must take the question of the tax base or the "what" of taxes at its heart.

Five, the tax base is logically distinct from its rates. The simplest analytic truths can get lost in the fog of tax. Reduced to its essence, any tax consists of the product of a base and a rate structure.

There ought to be, as I shall continue to argue, broad and bipartisan consensus on the base question, yet confusion over the analytics has impaired reasonable compromise. Liberals miss the point that redistribution can be effected under any base by choosing an appropriate rate structure.

Conservatives deserve their part of the blame for the intellectual stalemate, by continuing to link flat rates and consumption taxes. Finally, academics, by lumping all consumption taxes together, have not served the public discourse.

Six, fundamental tax reform must begin with the elimination of all direct taxes on capital, meaning a move to a consistent consumption base. An income tax, under the Haig-Simons definition that Dr. Boskin put up on the board, is supposed to tax all consumption plus all savings.

John Stewart Mill pointed out that this is a double tax on savings; Professor William Andrews, before the Blueprints study, pointed out that the worst problems in the income tax come with its taxation of savings. Consider again the choices confronting policymakers before the 1986 Act.

The path chosen was that of perfecting the income tax.

The other path laid out was to abandon the attempt to have an income tax and to move to a consistent consumption tax. That was the right path to have taken.

But it does not mean giving up the claims for fairness in tax, or the attempt to tax the yield-to-capital in the hands of the socially fortunate.

Seven, all consumption taxes are not created equal. Here is a point where the academy has led policymakers astray.

There are two broad forms of consumption tax. In one model, the tax is imposed up front and never again, a wage tax like Social Security or a prepaid or yield-exempt consumption tax.

The second form of consumption tax imposes its tax on the back end, like a sales tax, a cash-flow, or qualified account model. Under flat rates, the two consumption taxes are equivalent. Under progressive rates, they are not.

Eight, a consistent progressive, postpaid consumption tax is a tax on the yield-to-capital, under just the circumstances in which it is fair and appropriate to tax such yield. Individuals save for two reasons:

One, as Dr. Boskin alluded to, is to smooth out their labor earnings, to take uneven labor market earnings and translate them into a consistent consumption pattern.

The other reason they save is to do better or to do worse.

An income tax double taxes all savings, not differentiating between good and bad savings. A prepaid consumption tax ignores all savings, not differentiating between the savings that enable the lifestyles of the wealthy and all other forms.

A postpaid consumption tax splits the difference by allowing people to smooth and taxing at higher levels only those who enhance their lifestyles through capital.

Finally, the last two points: Actual tax policy, as we read today in the front page of *The Wall Street Journal*, is moving towards a flat prepaid consumption tax.

And, finally, implementation of a consistent progressive, postpaid consumption tax is practical and the case for it is compelling. There are two simple ways to do it:

One, keep the basic income tax system in place, but repeal the limits on savings accounts: The unlimited savings accounts model of the Nunn-Domenici plan.

Two, a three-step plan consisting of a sales tax, a rebate, and a supplemental consumption tax. The two routes lead to the same place.

And, finally, under either means for getting to a consistent postpaid consumption tax and consistent with the principled basis of such a tax, we could and should repeal all capital gains taxes under the income tax, all rules for the basis of investment assets, all rules about maximum contributions to and minimum distributions from savings accounts, the corporate income tax, and the gift and estate tax.

We should do it. It is high time to stop the insanity of tax.

[The prepared statement of Edward J. McCaffery appears in the Submissions for the Record on page 109.]

Senator Bennett. Thank you very much.

Mr. McIntyre, you get the last word.

OPENING STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE

Mr. McIntyre. Thank you, Mr. Chairman. I think I am here for balance. We heard from the semi-right, the center-right, and the far, far, far-right, plus me and Jim McDermott, so there you go.

People have talked today about some of the basic principles of tax reform—fairness, simplicity, economic efficiency—and my testimony touches on those. But I want to emphasize the most important thing that we are not doing with our tax system: raising enough money to pay for the government.

That is the catastrophe we are facing right now. Last year, income taxes fell to their lowest level since before World War II as a share of the economy. Now income taxes are generally how we pay for most of the government, outside of Social Security.

And when they fall to the levels that they have fallen to, and there does not seem to be any relief in sight, we are looking at funding one-third of the non-Social Security part of the government with borrowing. That is what it looks like for the next ten years and beyond.

You cannot sustain that. We cannot do that as a country. Something has to give. We will either see our economy take a big nosedive as we use up investment capital to fund government consumption, or we will have to cut back on basic public services that we need, whether it be defending the country or taking care of the elderly or healthcare, all things that all of us want.

So the situation that we have put ourselves in right now is not sustainable. Any tax reform proposal that says, well, we will be revenue-neutral, or, even worse, say, the Linder Plan for a sales tax that cuts revenues in half, that says we will lose a lot of revenue, I think you should dismiss out of hand.

If we cannot fix our revenue problem, it is not worth doing anything else to the tax code. That ought to be the number one thing.

Now in terms of having a system that raises enough money to fund the government, does it fairly, efficiently, and reasonably simply, we have had that system. Ronald Reagan and Bill Clinton put it together for us.

It began under Reagan, who after a terrible start in his first year when he did everything wrong, realized his errors and spent the rest of his time in office doing penance for them. He came back the year after his 1981 loophole bill with the biggest loophole-closing measure in history at the time, led by Bob Dole and signed by Ronald Reagan.

The next year, he raised taxes again. The next year, he raised taxes again. And the next year he raised taxes again. And in 1986 he gave us the biggest reform of the income tax that we had ever seen, a new tax system that taxed most income at the same rates. Capital gains even were treated the same as other income. It was a huge triumph for truth, justice, and the American way—with one exception: it did not raise enough money to pay for the government.

And so we had tax increases in 1987 and 1989 and 1990, under Bush I, the President's father. Not big ones, but some. And then Bill Clinton came in and finished the job that Reagan started. He pretty much kept the Reagan base, but he raised the rates up enough to pay for the government.

When the economy boomed, particularly for people at the upper end of the income scale in the late 1990s, those rates kicked in with a vengeance or with a goodness, and all of a sudden, we saw the first balanced budgets since the year 1969, the year I turned 21. So I had my adult lifetime without a balanced budget until then. Some of you guys might have seen some earlier, but we are all getting pretty old.

So there is a lesson there. It can be done. That was a bipartisan effort, by the way. You had Dan Rostenkowski and Bob Packwood and Ronald Reagan, so, two-to-one Republican, but bipartisan,

leading the way for something that was terrific. And then you had something a little less bipartisan in 1993. Okay, it was partisan. In any event, it can be done.

That is the direction I think we ought to go in. In contrast, these consumption tax ideas inevitably will lead to a hugely more regressive tax system.

You hear people endorsing the so-called progressive consumption tax. Well, yeah, you can make the rates work out arithmetically to come up with a progressive system. The problem is that the top rate has to be 200 or 300 percent. That is not going to happen. So in practice that is a non-starter for me.

The other proposals, flat tax, Dick Armey style, or national sales tax, which we have heard two different proposals for, all of them would take such high rates that the public would not tolerate them, and in the meantime, they would be hugely unfair, and there would be huge tax evasion because the rates would be so high.

So, my advice is to scrap everything that you have done since 1993, and go home. Thank you.

[The prepared statement of Robert S. McIntyre appears in the Submissions for the Record on page 113.]

Senator Bennett. Thank you all. This has been very provocative, and it is the kind of dialogue that we would hope for.

Let me—if my fellow Committee members would indulge me—let me engage in my round of questioning, and then I will turn the gavel over to Senator Sessions who was the first Senator to arrive, and we are going to stay on the Senate side as I go deal with the Agriculture bill.

Mr. McIntyre, I am very interested in your comments, but let me give you some numbers out of my own personal experience. We are all prisoners of our own personal experiences.

I was involved in starting a business, incorporated on the first of September 1984. And that was what *The New York Times* and some others referred to as the "decade of greed," because the top personal rate was 28 percent and with an S-corporation, that meant that we could have the federal tax rate, effective rate on our earnings in that corporation at 28 percent, so we got to save 72 cents out of every dollar we earned.

Now if you have ever started a business, you know that in a struggling business the worst thing that can happen to you is to earn some money, because the Feds want theirs in cash right now, and you do not have cash. You have got to have that money that you have earned in inventory or receivables or other things to grow the business.

And you either have to sell some stock or you have to borrow some money from the bank in order to pay your taxes. Now, yes, you want to earn some money, but you are doing everything you can to try to make it look on the books as if you are not.

And we did it legally. The folks at Enron chose a different route, but we did it legally to find ways to report no income so that we could save that money. But when the company started to grow, we got to save 72 cents out of every dollar that we earned, and because we were an S-corporation it was not taxed twice. It all ended up on our personal account, so that statistically we were all rich.

Actually, the amount of take-home pay I got stayed exactly the same even though the company's money showed up on my 1040. That made absolutely no difference to my family—all of a sudden it was showing that I was a millionaire, but I did not get to keep any of that money. It all stayed in the company, but for tax reporting purposes, that is the way it was.

Now we grew that company. We started out with four full-time employees. I was number five when I was recruited as the CEO. We grew that company into 4,000 employees, listed on the New York Stock Exchange. At one point it had a market cap of close to three-quarters of a billion dollars.

That is not there now. It got caught in all of the problems of the 1990s, but my point is, as I look back on it, if we had started that company in 1994, instead of 1984, we would have had a top effective rate of 42 percent after the Clinton tax increases of 1993, plus the Medicare item, coming back to us as an S-corporation.

The difference between 28 percent and 42 percent in terms of the survival of that company is very, very great. And I suggest to you that that company, founded in the "decade of greed" with a 28-percent top marginal rate and top effective rate, would not have been able to create the 4,000 jobs that produced the rivers of revenue to the government in the 1990s.

We could afford 42 percent as an effective rate in the 1990s, once we were established. But the great engine of growth in this country has always been the growth of small business. We created jobs while United Airlines, General Motors, and others were downsizing.

Having lived through that experience, I have a hard time believing that long-term economic growth has been benefitted by the two step increases from the 28 percent up to the 42 percent, the first one by Bush I and the second one by Clinton, and that we—I am perfectly agreeable to some of the things Ronald Reagan did in his tax increases because he kept the marginal rates down, and he raised the gas tax. I think we probably ought to do that again. Grover Norquist will have a heart attack to hear me say that, but for our infrastructure of roads, bridges, et cetera, we need more money in the Highway Trust Fund to build those things we need. And user fees to me make sense.

But income taxes impact small business where jobs are being created in a way that too many people who have never gone through the experience of creating a small business do not understand.

So having given my five minutes, would you and some of the others react, and then I will flee, so that I am free from hearing your criticism.

Mr. McIntyre. Well let me just say that I am sure, had you started your business in 1994, that being as smart and hard-working as you are you would have been successful anyway, like so many other businesses were.

Senator Bennett. Flattery will get you nowhere.

Mr. McIntyre. As you know, after the 1993 tax legislation, when many of its opponents predicted that the economy would be destroyed forever by raising tax rates on one percent of the population, our economy went into its longest sustained boom in peacetime in our history, including a business investment boom.

So, I think you could have been part of that wave. Certainly, most other businesses were.

Senator Bennett. My own reaction to that is that the business cycle is alive and well, and President Clinton was very fortunate to have become President when the cycle was going up.

Mr. McIntyre. Well, fine, call it irrelevant, then.

Senator Bennett. And I do not think——

Mr. McIntyre. At least we paid for the government.

Senator Bennett. Well, you know, I have heard that the boom of the 1990s was because Clinton got elected in 1992, and I have heard that the boom of the 1990s was because Newt Gingrich got made Speaker in 1994, and I frankly do not think either one of them had that much to do with it. I think it had far more to do with the American entrepreneurial spirit than it did with who was sitting in either the White House or the Speaker's chair.

Mr. McCaffery.

Mr. McCaffery. Yes, Chairman, I wanted to comment on your story before. I think that another way to sort of simplify and try to see some forest through the weeds and shrubs and microcosms of tax is to think that it is a matter of timing.

I am an advocate of at least moderate progressivity. I do not think you need the absurd and unsustainable rates that my colleague to the left, I suppose, said. But I think it is a question of when is it that we should impose progressive rates on individuals.

The current tax system imposes those rates when they work, when they save, when they give, and when they die.

Those are bad times to do it. There is no reason to tax someone who is building up a business, who is saving, who is working hard. Those are mutually beneficial win/win activities.

We can tax people when they spend. And when they spend, we can impose progressive rates. So if you are working hard and building up a business, if you are carrying an estate to your grave, there is no reason to tax you.

So I think we should systematically eliminate all taxes on the build-up of investment assets and wait until and unless people cash it out in personal consumption.

Senator Bennett. I would love to stay and participate, but I have to go worry about country of origin labeling.

Senator Sessions, I give you the gavel and let you carry this forward.

Senator Sessions. [Presiding.] Thank you, Mr. Chairman. You know, we have all seen those little old ads for "When E.F. Hutton speaks, people listen," well, when Bob Bennett speaks on the economy, people in the Senate listen. He is certainly doing a great job as Chairman of this Committee and I am pleased to fill in. I know you have an unfortunate conflict this morning.

Mr. Stark.

Representative Stark. Well, I think, Mr. Chairman, that perhaps Dr. Boskin and others wanted to respond to the Chairman's comment and I would withhold for a second.

Dr. Boskin. Yes, I would just make the technical important point that as debates occur, including the one over whether 42 percent or 28 percent was a better tax rate, it is important to remember that a large number, a vast majority of businesses, not a vast

majority of GDP generated, but a vast majority of businesses pay taxes on the personal forms as either LLCs or partnerships or sole proprietorships or S-corporations.

So it is important when we get into the rhetoric of taxation and the political debate to understand that when we are talking about taxing the rich we are also talking about taxing small business.

Mr. Massa. And I would add that I think it is more than coincidence that the explosion of concern about tax shelters, the amounts of money that are spent on tax lawyers, financial planners and accountants, has gained attention again in an era when rates have gone up and people are happy to have those rates high.

The amount of money that is spent on and, from my perspective I would say wasted on tax lawyers and accountants and financial planners, even on perfectly legal tax planning, is enormous. And it occurs because the base is income and because the rates are high.

So whatever the revenue generating potential of high rates is, the potential for encouraging more and more people to go find sketchier and sketchier ways to avoid those rates is just, it is there. And the only people who actually end up making quite good livings out of it are people in my business, unfortunately.

Senator Sessions. Any other comments?

[No response.]

Senator Sessions. Well I do remember that "60 Minutes" show in Italy over 20 years ago at least where people were cheating. The tax rates were 60 or 70 percent and they were unhappy with the cheating, so they raised the rates to 90 percent.

Mr. Stark.

Representative Stark. Thank you, Mr. Chairman.

As I say, all of the incidents that my friend, Mr. McIntyre indicated, I guess I participated in those reforms, increases, decreases in rates, and I do not know if the dialogue was any different in those days in over 30 years of changing the tax code, than it is today.

Well-to-do people who paid substantially more in taxes complained the loudest, and basically I do not think I ever heard anybody suggest they ought to pay more for the privilege of living here or enjoying what we enjoy in this country. So I think that greed and selfishness are alive.

I am concerned with how we are going to pay, whether you want to think about paying for six or eight or ten more years in Iraq, whether you want to think of paying for Social Security so that the youngsters here at the table can enjoy the same generous Social Security benefits I now enjoy.

I think all of those things. We do not have the money. I am enjoying low interest rates as all of you are. I do not see how we can continue to con our foreign investors into buying our debt when our income stream is decreasing and we are going to see this problem extend to states.

I am terribly concerned about our unwillingness to deal, to even really discuss under Republican leadership any revenue changes, much less increase. I mean, this abject, almost paranoiac psychotic fear of suggesting that we might increase revenues I find disappointing and, at some point, I guess I could, in a sense of black humor, find it humorous.

But it is going to come home to roost one of these days and it will come home politically. And I think it is inevitable that this country is going to need more revenue. And I do not think the discussion here is how to get more. I think the idea is that we are going to relieve some of these magical entrepreneurs from their unholy tax burden.

I happen to be subject to that and I do not mind it. There are others who do not.

I am curious and, Mr. Massa, one of the things that all of these programs that we heard about earlier from our colleagues and we have heard from Mr. McCaffery and others talk about, I do not suspect any of you have been in business, as the Chairman has, so that you are probably not concerned nor have given a great deal of thought to what the disruption in the normal commercial intercourse, what would happen to our way of doing business?

One of the reasons I oppose the VAT so strenuously is because I have enjoyed the opportunity to go to Italy and France generally every year. I find it much better to study the VAT in April and May than I would in February or January, but I have spent a lot of time in those countries looking at the VAT and looking at the extent to which people cheat, and hide income, and make stupid decisions because of it just as they do in this country because of what our tax code does.

But there would be a tremendous change. I do not know if any of you understand this, but the transfer of title to goods changes by the whole thing.

You are a lawyer, Mr. Massa, you probably understand this far better than I do, but it would completely disrupt how we sell goods and how we store them and who pays taxes.

One of the things, I have been a client from time to time, of Patton Boggs. Other than their extensive lobbying, they have sheltered some of my taxes for me and have done a hell of a job.

But think of this, and I am a slow pay. Think of the lawyers and accountants and everybody else in this country. Let's say the VAT was 30 percent. You would have to pony up 30 percent cash the day you sent me my bill. And you do not know when you would collect from me.

The doctors, Dr. Paul, would have to pay their 30 percent on their doctors bills the day they did the surgery. And then if Medicare did not pay him for a long time—and I just suggest that as the disruption, admittedly we would get used to it and figure out a way to handle it, but I do not ever hear any of these people who talk about how this is all going to fit into a commercial tradition in this country that serves us quite well.

That is what you learn at the Stanford Business School and for those of you who went to other—Bob Jones West, as I call it, but it is a good school. And it teaches people a vocabulary, how to operate business, how to sound sophisticated, how to make presentations on their computers so that they can go into board meetings and tell people how to steal without getting caught.

All of this stuff would change dramatically and I guess my bottom line is, is it worth it?

We have got a code that can be changed. I would, as I told the Chairman earlier, I could see supporting if I had to politically, a

modest federal retail sales tax if it were dedicated to pay, say for health care or education. That may be the only way we will get funding for some of those issues and I could compromise and make a deal.

But I wonder if this idea of completely changing the tax code would, one: get us the money to operate; and, two: whether our commercial system could function?

Mr. Massa. Mr. Stark, on the second, I think the issue of how painful would it be to get from here to there and how disruptive it would be is a real one. It is often in the tax section committee discussions we had referred to as, you know, transition rules and there was another small fortune to be made by those of us who would try to work on the transition rules.

My personal view is that it is worth the hassle and there are going to be a lot of it, because looking at clients with whom I am familiar and just other stories, so much of what their professional tax planners, their corporate tax officers, do is unproductive and so much of the thinking that goes through a CFO or a CEO's mind is, "All right now, this is what I want to do. What is the tax implication? Do I want to go through a corporate inversion? Do I want to locate a plant here or pick some other country?"—is being driven by the income tax.

But yes, it would be very disruptive to begin ripping that out of the system.

My personal hope is that we understand that this is dead weight. It is wasted resources, it is diversion of money into a lot of bright minds, leaving myself aside, a lot of bright minds who could actually be doing something productive for the economy.

But I do not underestimate the difficulty of trying to pull out 90 years worth of thinking in the business community and reorient the commercial system, but I do think it is worth it.

Dr. Boskin. I would just make two comments repeating points I made briefly in my opening statement. The harm done to the economy by the misallocation of resources by altering savings, by sheltering, goes up with the square of the tax rate.

So there is a big difference between adding a consumption tax on top of the existing tax system and replacing the existing hybrid of income and consumption taxation, corporate and personal income tax, with a consumed income tax or some other variant.

I do agree that there is a pretty big range in how disruptive that transition would be with a broad-based VAT being the most disruptive—retail sales taxes, you have federalism issues—my point three, but you still have the fact that most people pay sales taxes in their states.

When people talk about a broad-based sales tax they are talking about extending to services which most states really do not tax, so there are issues there.

But in a consumed income tax, either of the deductible saving method or of the expensing method, we could indeed wind up, in my opinion, much simpler than what we have now.

Senator Sessions. Mr. Paul.

OPENING STATEMENT OF REPRESENTATIVE RON PAUL, A MEMBER OF CONGRESS FROM TEXAS

Representative Paul. Thank you, Mr. Chairman.

I get asked frequently at home about what is happening on tax reform and there was a lot of talk about tax reform, especially after 1994, and my answer has generally been that nothing—we hardly even talk about it.

So I am delighted to have at the hearings today at least know that there are a couple of people still thinking about it—not that it makes me very optimistic that we are going to have it soon.

But certainly in 1994, with the new Congress, there was some enthusiasm for true tax reform and that helped motivate me to get involved in politics once again.

But I respect all the qualifications, the academic credentials that you all have.

The only credential that I have that I am very proud of dealing with taxes is that each year I win the National Taxpayer Union's Award for the Taxpayer's Best Friend.

Which means that I vote for the least amount of taxes and the least amount of spending of anybody in the Congress, and the people in my district sort of like that.

I would take challenge with Mr. McIntyre's statement when he said we do have a revenue problem. But it depends on how you look at it. I think we have a spending problem. You know, two trillion bucks. Not a bad sum of money to run a country. It would be plenty if we were doing the right things and limiting our government to constitutional functions and maybe not pretending we are the policemen of the world and the savior of everybody who wants something in this country—$2 trillion would be way too much.

So we have a revenue problem in that there is much too much taken out of the economy and I would like to see a heck of a lot returned.

But still, even with our discussion, it always frustrates me because to me it comes down to the principles of the technical aspects—should it be consumption tax and what kind of consumption tax? Should it be a flat tax and what kind of a flat tax? And it just goes on and on.

And I really think that misses the entire point. Because if you had a sales tax to cover the revenues and say we go and cover the revenues for the current spending because my argument is not going to win, we are going to continue spending.

So sales tax might not be 20, it might be 28 or 30. The only argument I can give for that that is really practical, is it would cause the most horrendous tax revolt. People just would not pay it.

Like Mr. Stark points out, you know—cough up. And they are not going to cough up on an automobile with 30 percent or so. So there would be a great revolution and then maybe we would get down to serious business. Maybe the people would decide, you know, "I did not know I was paying so much for my government. I would like a little less government and a little more freedom, a little more chance to keep my own revenues."

But the tax, there is another tax that nobody ever talks about that is probably the most important to me, and that is the inflation tax. Last year we spent—the national debt went up approximately

$550 billion, if you count everything that we borrowed. That is a horrendous amount, but nobody sweats it really.

We fuss about it a little bit, but I think this is an outcome of some of our conservative friends who preach that, in the 1980s it was a very, very popular philosophy and that was the philosophy of the supply siders.

Part of that philosophy I really strongly endorse, and that is, get the rates down, because rates, you know, that is how you win NTU awards—get the rates down.

So I am always for lower, lower rates and I think they are very beneficial. But they taught one other thing that I think we as conservatives in the last 20 years have totally accepted—do not sweat the deficits. Deficits do not really matter.

But how do we get away with it? We get away with it because we tax the people through inflation. If we do not have enough revenues, if we do not have these patsies from overseas and there are a lot right now who will loan back just about everything we need, but if we come up short like we are and if we think interest rates should be lower than the market says they should be, we have that money machine and we have the money machine there, that monetizes the debts, buys these securities, and then who pays? Well, nobody pays.

Except for the fact that prices will go up and some people argue that this is a great tax. The politicians love it because nobody sees it. Everybody gets taxed and they figure it is probably very fair. Everybody's prices go up the same—which is the fallacy, which is a myth.

Because the cost of living goes up for middle income and especially low middle income much more so than anybody else. So middle class people get wiped out.

It is very regressive, so taxes on education and medicine and services and energy and food—that goes up. So the real tax hits the middle class and low income people and we go merrily on.

So I do not see the solution with the tinkering. And I am for tinkering in one direction, less taxes, less IRS, less tax on income—and but, if we fail to address the subject of trying to finance this government that is pretending that we can police the world and do all these things around the world about the deficit and, at the same time, add on new welfare programs here at home, I see very little hope for your suggestions.

I would like you to just comment on that and see if I am not saying something worth thinking about in that we should think the bigger picture and that is more important than the tinkering with the tax code. Any comments?

[The prepared statement of Representative Ron Paul appears in Submissions for the Record on page 48.]

Mr. McCaffery. Well, I definitely agree we should look at the big picture. In terms of inflation, all the taxes that we are sort of obsessed with are now pretty well indexed for inflation. That was a Reagan era change.

Before that change, there used to be a tax increase every year and then the government could pretty much cut taxes.

But your comments do make me think. One thing I often teach my students is the very simplest tax system would be a printing press—if the government just printed money to pay its bills.

Now, the problem with that, nobody would fill out forms, there would not be high rates, the problem with that would be that you would have a tax working through the economy falling on individuals through the monetary effect, through the inflation effect.

The reason we buy all the complexity we buy with payroll taxes, personal income taxes, corporate income taxes, gift and estate taxes, is that we believe in some sense of individuated justice. We believe that somehow or another we should make determinations on the basis of individuals' ability to pay.

To me that then gets back to the question of when should we make those decisions? I do not think when people work, I do not think when people save—the first book I wrote showed that I do not think when people get married is an occasion when their taxes should go up. I do not think when people give, I do not think when people die. I think if we are going to buy the complexity of an individuated tax system, we should get it right and we should tax people when they spend.

A comment on other than finding out Mr. Stark is a representative from my home state as I know and I could tell from his comments he has a very safe seat, so that he is not particularly worried about raising taxes, so I am delighted to hear that.

But getting back to a comment in colloquy that Mr. Stark had with Dr. Boskin. I do not think if we have a sales tax or VAT, that should be one-stop shopping because of that rate problem.

So I think we can have a national sales tax as part of a consumed income tax at a moderate rate, maybe 10 percent, that would then take care of the consumption taxes for the masses, we could give them a rebate to give them in effect a zero bracket or a family allowance, then we could have a supplemental consumed income tax for those who make $70,000 or $80,000 along the Nunn-Domenici lines—a proposal very similar to Michael Gretz'.

Senator Sessions. As you think about sales tax, let me add one other thing as long as you brought up California, that the public ought to be concerned about and that is us politicians.

I mentioned earlier how much difficulty any of us would have voting increased taxes, but that is not true on sales taxes. We have increased under the clean up tax for the Superfunds, we have increased that an eighth, a quarter—without anybody looking or knowing about it.

California, when I first moved there, sales tax was about three percent. It is now 8.5. I have never had a letter complaining even though I do not have anything to do with it.

But what I am saying is, it is so easy politically to ratchet that up a quarter here, a half there, and—think about that as whether, I guess as politicians, to pay the bills we would love it—but it is a concern that I have about administering these consumption taxes. Thank you.

Dr. Boskin.

Dr. Boskin. I will just make three points, one with respect to what Mr. McCaffery and Mr. Stark just said. What I was referring to earlier was adding a consumption tax on top of the current sys-

tem so that the size of government got to European levels, that is indeed how Europe financed going to half of GDP going through the government relative to our one-third—and one of the reasons, our economic performance, despite its ups and downs, has been much better than Europe's—is because we have a lighter hand of government. Some would say too light. I personally think it is probably still too heavy.

But in any event, a major part of our success is we did not go the European route, it would have caused much higher unemployment and much slower growth.

Secondly, inflation—Mr. McCaffery is right. We did index the brackets, but we never indexed the definition of income so we still tax nominal interest, not inflation adjusted interest. We still deduct nominal interest. We use historic cost depreciation, we tax nominal capital gains so sometimes even though it is a lower rate and with deferral, sometimes you will pay positive capital gains taxes on real losses.

So it is important to understand that is a big part of the complexity. One advantage of a consumption or a consumed income tax is avoiding all these inflation adjustments.

And let me answer Mr. Paul's question about the deficit in my own views. I think that, unfortunately, there is no simplistic answer to what are the economic effects of deficits. The effect of the economy on the budget is larger, surer and faster than the effect of the budget on the economy.

So if we have a downturn or a recession or slowdown or a stock market collapse, there is a big hit to revenues and, conversely, in a boom, with bracket creep and a variety of other things.

I personally believe that not only the level and structure of taxes and of spending, but the deficit does eventually have some impact on investment, but it is far less than dollar-for-dollar and it varies over the business cycle.

We should indeed not only accept a deficit or a decline in a surplus and run a deficit in a recession or in the early part of an expansion—we might, when we get into a situation as we recently did, where the Fed had used up most of its ammunition, want to supplement monetary policy with a tax cut to try to stimulate the economy.

So I think that was the right thing to do and I am not particularly concerned about the deficit right now. I think it is the right policy.

I think out the other end, five or seven years from now, putatively into a long expansion, we ought to be in a situation where the budget is getting close to balanced.

I would also suggest that we do not in our budgeting separate out capital expenditures from current expenditures. And if we are in a period where we have a big increase in government investment—in the military, let's say for example, when you have a big expansion of things that can be viewed as investment, it may well be desirable to fund that at least partly with debt as many states do and spread the cost of financing over a longer period than just the current year.

Representative Paul. May I make one brief comment? I think you miss my point about the inflation tax, when we create new

money the value of the money goes down. I am talking more not about bracket creep, but the cost of living hitting low middle income and poor people a lot worse than rich people. That was the point I was trying to make. Thank you very much.

Senator Sessions. Thank you.

Senator Sununu.

Senator Sununu. Thank you. Let me state at the outset that the beauty of sitting on a committee with Pete Stark and Ron Paul is that I become the centrist.

[Laughter.]

Senator Sununu. Let me also note that it made it just a little disappointing to find out that, as a member of the Ways and Means Committee, Pete Stark does not do his own taxes—but I am pretty sure if he checks with his lawyers at Patton Boggs, there is nothing that prevents him from writing a bigger check and sending a little more into the federal government.

Dr. Boskin, I think you said, and I am sorry I did not hear your opening testimony and it is a lot of testimony, which is a good thing to have, and I will read it, but you said that the cost, I think the cost of the system increases with the square of the rates.

What about the impact on growth, or are you using those changes interchangeably? In other words, what is the impact on forecasted growth rates or the relationship between growth rates and tax rates?

Dr. Boskin. That is a very good question, Senator. There are two aspects to that. One is in an economy that is not at full employment, higher taxes will be a drag on the economy, prevent it from getting back to full employment on its own rapidly enough and that can be fairly substantial and that is why I personally favored a tax cut in the recent circumstances with interest rates down to one percent, the Fed about out of ammunition.

With respect to long term growth over decades, the basic issue is how is it affecting a broad measure of capital accumulation and investment? Saving and investment in plant and equipment and in human capital and so on.

So the advantage of moving to a consumed income tax or tax on consumption is it gets rid of the double or triple taxation that we have now on saving and investment in the economy.

A progressive rate structure would still affect human investment and slow growth as people invested in themselves and drove themselves into a higher tax bracket—but a flat rate consumption tax or a flat rate consumed income tax would be relatively neutral with respect to savings and investment versus consumption and would not have an effect on growth above and beyond the shifting of the resources from the private sector to the government and then you would have to reflect the differential efficiency with which the private sector did its activity versus the government.

So I would say if we ranked the order, the most pernicious taxes with respect to long term growth are those that affect saving and capital accumulation, and the higher the rates the more the harm, as I said earlier, going up on the square of the rate. While the cost of the distortions go up with the square of the tax rates, you cannot take the growth rate and multiply it by some tax rate squared and

get an answer, it is more subtle and more complicated than that and I will not bore you with the mathematics here.

Senator Sununu. With regard to federalism, you raise that as a concern when we look at proposals for tax reform. What kinds of approaches either strengthen federalism or harm it the least?

Dr. Boskin. I think there is concern on the part of mayors and governors that the federal government launching into a tax vehicle that has primarily been the preserve of state and local governments, like a sales tax, would make it harder for them to collect the revenue they need to collect.

And I think they have historically opposed these types of suggestions and also a value-added tax, which they see as closely related to a retail sales tax.

I think those are the big concerns that mayors and governors have and I think are most likely to affect federalism.

If we could get a broad-based tax that everybody would agree on and each individual state legislature would be happy to piggyback on the federal tax system because they thought it was really good, that might enhance federalism in some way, certainly increase the overall efficiency of the combined state and local and federal tax system.

But I think the primary concern is a new tax device that invades the province that has usually been preserved for state and local governments.

Senator Sununu. Well, that is the historic norm. To what extent do you think that the practicalities of, I think as you just described, leaving consumption taxes to the states and at the federal level focusing on taxing income, either at the corporate or the individual level, to what extent is that maybe no longer the best model?

And when we are talking about the practicalities or the issues of taxing internet commerce right now and the degree to which you have greater and greater volumes of interstate commerce, both at the business and the individual level, and so that may be taxing models based on states that can control and monitor consumption that initiates in their borders and is completed in their borders—it is just becoming tougher and tougher. Do we have the model mixed up?

Dr. Boskin. You are exactly right. A lot of things, such as the mobility of the population, the mobility of economic activity are rendering that old model less and less relevant. You will still get a lot of argument from governors and mayors about federal sales tax for example.

But I do believe that the basic issue is the concern at the state and local level for being able to raise sufficient revenue to pay their bills and they believe that, if the federal government had a sales tax, for example, it would make it harder for them to raise their own because people would see the aggregate.

I think that is a legitimate concern if you see it decreasing.

Senator Sununu. But if the federal government got out of the business of taxing income at the individual and corporate level, would that not create an opportunity for the states to address whatever——

Dr. Boskin. I think that is exactly right. A big difference between replacing the income taxes or greatly reducing them with a consumption tax at the federal level and just adding it as another tax device—I think part of what you hear from governors and mayors is not just the type of tax, but the resistance of the population to an increase of the overall level of taxation, I think you are exactly right about that.

Senator Sununu. Mr. Massa, I guess along those lines, which do you think is more of an abomination? The complexity in the corporate income tax or the individual income tax? In other words, which of these is in most need of reform, either from a policy standpoint or from an economic standpoint?

Mr. Massa. I wish I could separate them that way, Senator. I cannot, since so much of the corporate community is now taxed and the individual community through Subchapter S and so forth, I do not think there is a way to say that. There are different kinds of problems and complexities to be solved.

My personal view is they are both a mess and they both need work. But I cannot rank it that way.

Senator Sununu. From a political perspective, let's stop talking about the theory. How do we get this done? I have only been around for six years, and I think I talked about tax reform in the first, "political" speech that I gave, and I do not feel like we are any further along.

I think that, in some ways, if you look at the tax package that is in the Energy Bill, if you look at the sunset provisions that exist in some of the 2001 tax reform, I think you could argue that we are further away from the goal of simplification.

So from a practical standpoint, I will let each of the four of you at least offer some political advice. What is the best way to move forward? Incrementally? Do you have to have a national dialogue and build consensus? Do you need to put three people in a room and do not let them come out till they agree on a solution? What is, practically speaking, in your opinion, the path forward. We will start with Mr. McIntyre.

Senator Sessions. We are interested in your answers, but if you can keep them as brief as possible, because we could talk a lot about that.

Mr. McIntyre.

Mr. McIntyre. How do we get to a better tax system? I think you probably have to elect some different people than have been running things for the last decade-and-a-half, because none of the current crowd has any interest in real tax reform.

Mr. McCaffery. Well, I will briefly plug my book, "Fair, Not Flat." I think part of the answer is that we need public education. The people have to get involved.

As I often say in my books, tax is too important to leave to the people who understand it. We probably need political entrepreneurialship; we need Presidential leadership. I think history has really shown that we need a John F. Kennedy, the first great tax-cutting President. We need a Ronald Reagan. We need someone who is not going to pander and add complexity to the code by adding token, you know, deck chairs to this Titanic, but we need someone who is really going to take it on as an issue.

So I think public understanding, and strong leadership at the Presidential level.

Mr. Massa. I have given up on being an incrementalist. I do not think it works. The only winners are people in my profession and others.

I think that if it is worth doing, you say we are going to start again, here is the clean sheet of paper, adopt some principles. I have suggested some, and you can come up with your own and adhere to them and just say "new system, old system," but incrementalism, I think, just makes it worse.

Dr. Boskin. I have a slightly different perspective on this. I think there are issues which are timeless like tax reform, that every once in a while percolate up, and if you are ready to take advantage of it when the political process is right, as it was in 1985 and 1986, then you can get something substantial done.

I will remind you, for those of you who were not around back then, what happened in 1986 was not what was originally proposed and originally discussed, and, indeed, the original discussion was for rates of 15, 25, and 35 percent and a very different tax law that was defeated in the House, originally, and then was eventually passed.

And in the end, what happened was Senators Packwood and Bradley hammered out a compromise in private. They had been working on tax reform for a long time, and spent a lot of time. I was privileged to advise both the Ways and Means and Finance Committees at the time.

And that is sort of how we took the general interest in tax reform, pushed by President Reagan and the concern in the population, and transformed it into what I thought was a very good tax reform, far from perfect, but a very good one.

So I think that the answer is all the things people have been saying: Concern of the population, Presidential leadership. But you in the Congress have to have a core of people who have developed a set of principles and ideas about what you want to come to, so that when you actually get to the legislation, you mold it into the right kind of reform. I think that there may well be an opportunity in the not-too-distant future.

It may not be this year, it may be in 2005, but in the meantime, what you might think of is, in part, evaluating individual proposals that come along, by whether they move us in the right direction or not.

Senator Sessions. There is no doubt we can make this system simpler. That is indisputable, I would say, and I would think it is also fair to say that the taxes we impose could be less hurtful to the economy. There is no doubt in my mind that a tax is detrimental to an individual's standard of living.

It reduces the amount of money they have to spend as they choose. It also reduces the amount of money a business has to spend as they choose, so it is detrimental to both, but we do need a certain amount of revenue, and the question is, let's get it in the simplest way possible, with the least possible adverse impact to the economy and jobs and people's ability to save and build for the future.

I do remember when I came here in 1997, about 40 Senators signed legislation to end the tax code as we know it, by 2000, was it? Is that the year? I have often wondered why that did not go anywhere. I really think maybe Mr. Forbes, who ran on that and did not win, maybe somehow that took the steam out of the issue, the momentum there.

And so I would just say that it is a very real issue. I agree with Mr. Paul that I am still hearing that when I am out there. People are telling me it is too complicated, so I know we can fix that.

Tax rates, I believe, should be as low as possible.

Dr. Boskin, you mentioned that and their lack of competitiveness with the United States, and you noted that it is because, your opinion, it is there at 50 percent of GDP going to the government, where we are a third. I asked Mr. Greenspan about that at my first hearing here. I was somewhat nervous to ask him about it, and I asked him about three businessmen who had been interviewed in *USA Today*, and they asked why our economy was better than Europe's, and they said unanimously, "the United States had less taxes, less regulation, and a greater commitment to the free market."

I said, "Do you agree?" And Mr. Greenspan looked up and he said, "I absolutely agree." So I have sort of taking that as marching orders.

Now, Mr. Schroeder of Germany just last week—I am looking at the Associated Press—said, pointing to the acceleration of United States economy, 7.1 percent growth last quarter, pointing to the acceleration of United States economy after tax cuts there, Schroeder hopes to give German growth a boost in 2004 by moving an $18 billion tax cut up. So I think the message is out there that a vibrant, free market is good for the economy, as much as possible.

Let me ask this: I was present at one of those great debates between Congressman Tauzin and Armey over the flat tax and the consumption tax in Mobile, Alabama. It was a fascinating debate, and there was a very packed house. People were very engaged and interested. I would like to ask you this:

Is there a conflict between these two ideas? Can there be a merger? I believe Mr. Tauzin's view was, if you leave any income tax in, and you throw a sales tax on top, the income tax will grow and will just be a way to increase revenue.

But what are your opinions? Do you have any thoughts about that? Would this make the economy healthier, if we could do it in a restrained and effective way? And is there a conflict at all between these two issues?

Mr. McCaffery.

Mr. McCaffery. Well I think we should get—and I think there is a consensus here for the most part, that we should get to a consistent consumption tax. I favor a postpaid consumption tax, which is on the sales tax model with some progressivity, but I think we should only do it—I think Mr. Stark's concern about the ease of raising a sales tax is a legitimate one, so we might move to a single consumed income tax.

But I think, as Mr. Massa said and as Dr. Boskin said, tax reform has to be fundamental, and I think part of this package should be to eliminate all direct taxes on capital, so we are getting

rid of the corporate income tax. I guess Senator Sununu asked about that. I personally think it is about one-fourth the magnitude of the personal income tax.

The problem with the corporate income tax is that nobody knows who pays it. It is a hidden tax. It either falls on workers or it falls on capital, generally, or in some combination. It is not individuated.

Get rid of the corporate income tax, lock, stock, and barrel, get rid of the gift and estate tax. You do not need it under a consistent consumption tax, because you can tax the heirs when they spend.

Get rid of capital gains, get rid of all this other stuff. If you do that, I do not think there is a tension between a moderate national sales tax and a supplemental income tax, putting aside the very important political economy points that Mr. Stark pointed to.

Senator Bennett. Any others comments?

Mr. Massa. I would encourage that there not be two, simply because there is more opportunity for messing up two systems. The written statement emphasizes a bit the desirability, from what I think is an administrative and complex point of view, of simply taking individuals out of the system.

It reduces the amount of returns and makes the IRS job easier. But I think it also substantially reduces the pressure points that members of the Congress face. Turn businesses into the tax collectors and remitters through a sales tax, or a value-added tax or the business activities tax.

I think that one of the eventual fatal flaws of the flat tax—and you have already heard testimony along this line this morning—let's have it a flat tax, except I will raise the rate a little bit, and I want that mortgage deduction and I want that—what was the other one this morning—charitable contributions.

When Senator Long was the Ranking Member in 1986, he told my distinguished partner, Mr. Boggs, do not worry about not having anything to do after the 1986 Act. You all are going to spend 10 or 15 years putting it right back, because we are still taxing people.

That is exactly what has happened. My personal as well as lawyer views are, do not do two systems, and I would personally prefer that individuals simply not be in the system, not be in the system as remitters. We are the only ones that actually pay the taxes. Just do not have 130 or so million returns remitting taxes.

Dr. Boskin. Let me just make a very simple point: As a practical matter, we have both right now, because most states have substantial sales taxes.

Senator Sessions. That is an interesting thought, and I was going to say that it really does require creating two complex systems, and a lot of the complexity that we complain about, really is an attempt to achieve fairness. Some say it is loopholes and benefits for corrupt reasons, and there may be some of that, but sometimes people are clever to get around a tax and beat a tax, and you have to amend the law to make sure that they are not escaping their rightful liability because one person is paying and another one is not in a very similar way.

So perhaps having two systems to defend and protect and complicate, would be unwise.

Mr. Stark.

Representative Stark. Mr. Chairman, without the votes to move ahead on either side of the aisle with any changes, I find this fascinating, but I just come back to my concern. What are we going to do about the deficit? And I do not think we can make any of these changes quickly enough to deal with that.

And I am afraid that is going to be a very tough political strategy for all of us. How do we get some more revenue some time in the next four years, let's say, without you and I having to vote for it?

[Laughter.]

Representative Stark. If we can figure that one out, if our panel of experts here——

Senator Sessions. Seven percent growth, continue that level. It is a dream, anyway, but not likely.

Representative Stark. That is what I think we are going to have to find, and I am not finding it here this morning. Thank you very much.

Senator Sessions. Thank you.

Mr. Paul.

Representative Paul. Briefly, I would say that our problem is that we are trying to make taxes enjoyable and make everybody comfortable about it.

[Laughter.]

Representative Paul. And it is not going to happen.

We are trying to tinker and change a tax code and get the revenues that everybody wants, but unfortunately, I am a pessimist on this. I think that the tax problem that we face is merely a symptom, and unfortunately whether we do go with direct taxation, excessive spending, or we go the inflation route by devaluing the value of the dollar, we always hit the poor and the middle income the worst.

Thank you.

Senator Sessions. Dr. Boskin, you mentioned something that I am not sure of the effect of the economy on the budget. That has become very real to me now that I am on the Budget Committee. We saw, what, an $80 billion turnaround in the estimates of how large the deficit was going to be. And part of that, it strikes me, is when the stock market is down and people sell stock, they don't take a gain.

They are offsetting some, at least, revenue. Small businesses, mid-size businesses, where the entrepreneurs may be making large incomes, can plummet substantially and I am looking at the Joint Economic Committee's numbers that says in the year 2001, the top 50 percent of taxpayers paid 96 percent of the income tax. So we have created, have we not, a very, very economy-driven revenue stream to the government?

And when the economy's growth ceases and drops even a little bit, we will find a larger impact adversely to our income to the government? And when the economy goes up a little bit, we are likely to see a larger increase in revenue to the government? Is that a fair analysis?

Dr. Boskin. That is correct. It is heavily due actually to the progressive rate structure, and it is also due to who gets the income

and where it is accruing if a lot of it is in capital gains and bonuses and stock options and other things tied to stock performance.

Senator Sessions. Well, if a corporate executive gets a $200,000 bonus and pays the maximum tax rate on it, well. But if his corporation is not doing well, he does not get a bonus at all and he pays no tax, or at least none on that money.

Dr. Boskin. You are exactly correct. This is driven home most, unfortunately, in Mr. Stark's and my home state of California and Mr. McCaffery's, where we have a very progressive personal income tax. And of course, California, Northern California, was the epicenter of the technology industry and the bubble in the stock market, where all the stock option income, and capital gains were taxed in full under the California income tax, not at a lower rate. So 9.3 percent more or less came off the top and went straight to Sacramento.

When the bubble burst, revenues collapsed substantially. So it creates a kind of a political economy problem that Mr. Paul mentioned and Mr. Stark mentioned. If the revenue is pouring in and you can't constrain yourself on the spending side, it is hard to constrain yourself, and then you are going to be in a very difficult situation the next time there is a downturn, because you will have these spending programs which have been matched to super-normal revenue. That is what happened in California, and we are struggling to get out of that at the moment.

Senator Sessions. That is a valuable insight, too.

Mr. McCaffery, I would ask, but maybe we will do it by written questions, some questions about the death tax, the estate tax.

We have got some analysis now that indicates that if you do not obtain a complete, stepped-up basis, it has very little revenue cost over ten years. We need to be looking at that. If that could be eliminated, that would be a tremendous savings in terms of paperwork burden and unwise allocation of resources, I think.

Representative Stark. Mr. Chairman.

Senator Sessions. I think I got your attention, Mr. Stark.

Representative Stark. Does that chart say that 50 percent of all Americans earn less than the top one percent? In other words, what I am reading in that chart, it says the top one percent of all Americans earn more than the bottom 50 percent, combined? Is that what that chart says?

Senator Sessions. No, it says that they—because they are paying at the top rate, and don't have the personal exemptions, they don't pay as much tax.

Representative Stark. Just the gray bars, what they earn.

Mr. McIntyre. That is why they call them rich.

[Laughter.]

Dr. Boskin. Let me just repeat what was said earlier, that in these data are a lot of businesses, not just people.

Senator Sessions. Very good. Anything else for the agenda?

[No response.]

Senator Sessions. We stand adjourned. Thank you very much.

[Whereupon, at 11:24 a.m., the hearing was adjourned.]

Submissions for the Record

PREPARED STATEMENT OF ROBERT F. BENNETT, CHAIRMAN

Good morning and welcome to today's hearing on "Rethinking the Tax Code."

In May of this year, the Senate overwhelmingly approved legislation acknowledging the serious problems in our current tax code and called for a congressional review of ways to overhaul the antiquated system. This was especially gratifying to me since tax reform has been a central piece of my agenda in the Senate. Seventy members of the Senate agreed the Joint Economic Committee should be the key point for this debate, and today's hearing is a direct response to that vote. It is part of a series of hearings, studies, and related events the JEC is undertaking to find a path to real tax reform.

The present tax system is unduly cumbersome, inefficient, and incomprehensible. Over the years, through revision after revision, the tax code has become a confusing, burdensome web that hampers economic growth, places undue burdens on American businesses, and needlessly complicates the lives of the American people.

As I reflect on all of the debates held over the years on tax policy, I realize that there is one word that comes up over and over again—and that word is fairness. Every time we make a change in the tax law, we are told that it is necessary to make things more fair.

What we have done is tip the tax code this way and that way to encourage one activity, and discourage another. Every time we do this the code gets bigger and more complex. I find it ironic that in the name of fairness for some we have created a system that is unfair for everybody.

Today, during this hearing, let us get out a clean sheet of paper. Let's not talk about tax cuts or mere adjustments to specific parts of the existing system. Let's talk about creating from scratch a system that is simple, that is fair, and once we have accomplished that, a system that will endure for years to come.

We are not prejudging the issue. We are not coming to the hearing with recommendations already in mind. This is our opportunity to listen, and learn, and look at the issue from a different perspective.

Whether you are in favor of getting more tax dollars out of the rich, whether you believe the tax code should spur faster economic growth, or whether you think we should implement a flat tax for all individuals, we can all agree that the existing code is so badly broken, that the principles of simplicity, fairness, and efficiency are not being met.

If we can achieve the goals I have just laid out, then another challenge begins. We must ensure that the new tax system endures. Businesses cannot make intelligent plans if the tax system constantly changes. That slows economic growth and that slows job creation. For individuals, the shifting sands of the existing tax code create painful uncertainty. People who want to buy a house, take out a loan, put money aside in a savings account or make an investment need—and deserve—to know that there won't be any surprises coming after the next election.

Today we have a balanced group of witnesses that will present diverse views about how our government should tax its citizens.

For our first panel, we are pleased to have as a distinguished guest Senator Arlen Specter of Pennsylvania who cosponsored the Sense of the Senate Resolution that brings us here today and who has for years been a champion of tax reform. We also welcome Representatives Jim McDermott of Washington and John Linder of Georgia and thank them for joining us today.

Our second panel brings a wealth of knowledge on the subject of tax reform. Dr. Michael Boskin is a Stanford University professor of economics, and previously served as chairman of the President's Council of Economic Advisors. Cliff Massa is currently a tax attorney for Patton Boggs, and has served as chairman of the Com-

mittee on Value Added Taxes at the American Bar Association. Professor Ed McCaffery joins us from the University of Southern California, and is the author of "Fair Not Flat: How to Make the Tax System Better and Simpler." And finally we welcome today Robert McIntyre, the executive director of Citizens for Tax Justice.

I look forward to hearing each witness's thoughts on the challenges before us today. And I ask all of you to join me in a bipartisan spirit as we engage in this important task.

JOINT ECONOMIC COMMITTEE
ROBERT F. BENNETT, CHAIRMAN SEPTEMBER 17, 2003

THE TAX REFORM ACT OF 1986: A PRIMER

As perhaps the broadest overhaul of the tax code in recent memory, the *Tax Reform Act of 1986* (TRA86) often stands as a reference point in discussions of future tax reforms. Although this reform looms large in the imagination of many policymakers, tax reform discussions are often hampered by a limited understanding of what changes to the tax code actually took place in 1986. This primer outlines the major changes of TRA86, as well as the current state of the code, in order to promote a better understanding of that often-cited legislation.

Lower individual and corporate tax rates

The *Tax Reform Act of 1986* lowered the top individual tax rate from 50 percent to 28 percent and lowered the top corporate tax rate from 46 percent to 28 percent. Especially for individual tax rates, which stood as high as 91 percent in 1964, this rate reduction represented the culmination of a long-term trend toward lower tax rates. High tax rates impose a drag on the economy by reducing the reward for productive activities such as work, saving, and investment. In the decade following 1986, however, Congress raised individual rates several times, leading to a current top rate of 35 percent.

Increased tax bias against saving and investment

TRA86 temporarily reversed a previous trend toward relieving the double taxation of saving and investment. Prior to 1986, Congress designed certain features of the tax code to encourage personal saving by individuals and investment by businesses. One such provision, the Individual Retirement Account (IRA), allows individuals to save without being penalized by the double taxation that occurs when earnings from investments made with already-taxed wages are again taxed. TRA86 placed new restrictions on the use of these accounts. The Act also repealed a partial exclusion for capital gains, thereby increasing the tax rate on investments that increase in value.

At the corporate level, the investment tax credit was repealed, and the value of tax deductions for the cost of investment was reduced by rules that forced businesses to stretch those depreciation deductions out over a longer period of time. Post-1986 amendments to the code moved again toward more tax-neutral savings treatment through expanded saving incentives like IRAs and reductions in tax rates on capital gains and dividend income.

Tax simplification: one step forward and one step back

The *Tax Reform Act of 1986* struck some gains for simplicity in the tax code, reducing the number of individual tax brackets from fourteen to two (currently, there are five brackets). Both the personal exemption and standard deduction were increased and inflation-indexed, relieving many low-income individuals of the need to itemize or even file taxes at all. Complexities such as income averaging and deductions for consumer interest and sales taxes were eliminated. Unfortunately, these individual-level simplicity improvements were overshadowed by a revision and expansion of the complicated business and individual Alternative Minimum Tax (AMT). Additionally, new rules about inventory, and especially new international taxation rules, grossly complicated business tax compliance. Since 1986, tax code complexity has steadily increased at both the individual and business levels.

The following table highlights certain characteristics of the tax system that were altered by the Tax Reform Act of 1986:

Selected Tax System Characteristics:
Before and After the Tax Reform Act of 1986

	Before TRA86 Enactment (Tax Year 1985)	After TRA86 Enactment (Tax Year 1986)	Current Law
Individuals			
Number of income brackets	14	2	5
Top tax rate	46	28	35
Treatment of saving	60 percent of capital gains excluded from tax	Capital gains exclusion repealed	15 percent capital gains rate
	IRAs for all workers	Income limits on IRAs for workers with pensions	Income limits on IRAs
Percent of tax filers claiming credits	20.7	16.4	29.2
Percent of filers claiming deductions	39.2	39.5	32.9
Corporations			
Top tax rate	50	34	35
Treatment of investment	Accelerated depreciation of investments	Less favorable investment depreciation	TRA86 depreciation system in place
	Investment tax credit	Investment tax credit repealed	No investment tax credit; Temporary bonus depreciation
Percent of filers subject to Alternative Minimum Tax	0.24	0.45	0.26

The **JEC Tax Simplification and Reform** series, to which this report contributes, addresses the growing bipartisan belief that the current tax code is broken and that opportunities exist for wholesale improvements. Future papers will explore topics including the difference between income and consumption taxes and issues in evaluating tax system fairness.

JOINT ECONOMIC COMMITTEE
ROBERT F. BENNETT, CHAIRMAN SEPTEMBER 12, 2003

CONSTANT CHANGE: A HISTORY OF FEDERAL TAXES

The first in a series on tax simplification and reform

The current tax code is the product of an ongoing legislative process influenced both by shifts in the philosophy of taxation and by growth in understanding the economic implications of taxation. The result is an extraordinarily complex code that is frequently at cross-purposes with itself. This report highlights the major trends in the U.S. tax system since the beginning of the income tax, and especially over the last several decades, to illustrate how we arrived at the current tax system. Such an historical perspective on the tax system is crucial for understanding the motivations of features of the current code and evaluating proposals for simplification and reform.

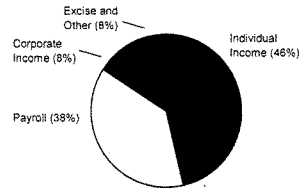
- **The Rise of the Income Tax.** When introduced into law following the ratification of the 16th Amendment in 1913, the income tax directly affected only one percent of the population. With the Great Depression and World War II, however, the number of households paying income taxes shot from four million to 43 million.
- **Mid-Century Experimentation: Tax Cuts to Smooth the Business Cycle.** In the 1960s, policymakers began experimenting with lowering taxes to smooth the traditional economic cycle of boom and recession. The underlying thinking was that increasing consumers' disposable income at precisely the right time could dampen temporary economic declines or speed recovery.
- **The Beginning of Modern Tax Policy: Reagan's 1981 Tax Cut.** The Reagan tax cut of 1981 marked an important new direction in tax policy. That tax legislation put emphasis on lowering marginal rates that discourage work and saving and took special steps – such as the establishment of Individual Retirement Accounts – to reduce the income tax's implicit double taxation of saving and investment. The idea that saving and investment lead to capital formation, a driver of long-run growth, is a basic principle of modern economic thinking.
- **The 1986 Tax Reform Act: A Mixed Bag.** The Tax Reform Act of 1986 (TRA86) was a watershed attempt at wholesale reform marked by both impressive achievements and notable failures. While TRA86 significantly reduced individual and corporate tax rates and deductions, a renewal of double taxation on saving marred those central accomplishments. Moreover, the 1986 reform substantially complicated tax compliance for businesses through complex new inventory and international tax rules and an expanded Alternative Minimum Tax.
- **Tax Policy Since 1986.** The primary achievement of the 1986 tax reform – lowering personal tax rates and reducing the number of brackets – was lost during the 1990s. However, in a positive reversal of a 1986 policy, recent changes have relieved some saving from double taxation by expanding saving opportunities like IRAs. Recent capital gains and dividend tax rate reductions have promoted investment as well. Unfortunately, the *ad hoc* nature of many post-1986 tax changes and the increasing use of the code for social policy have increased tax complexity.

Current tax code complexity reflects a cumulative history of changes motivated by shifting philosophies and priorities. While some of these priorities – such as low rates and a low saving burden – have been rightly pursued and should continue to guide tax policy, constant change without comprehensive reform has made the code ripe for major simplification.

CONSTANT CHANGE: A HISTORY OF FEDERAL TAXES

The current tax code is the product of an ongoing legislative process influenced both by shifts in the philosophy of taxation and by a growing understanding of the economic implications of taxation. The result is an extraordinarily complex code that is frequently at cross-purposes with itself. This report highlights the major trends in the U.S. tax system since the income tax's beginning, and especially over the last several decades, to illustrate how we arrived at the current tax system. Such an historical perspective on the tax system is crucial for understanding motivations for features of the current code and evaluating proposals for simplification and reform.

Where Does Federal Tax Revenue Come From?
(Federal tax receipts, FY 2002)



Source: Office of Management and Budget

While the U.S. relies on estate and payroll taxes in addition to income taxes, the focus of this report will be on corporate and individual income taxes, the main generators of revenue for general government operation and the largest sources of complexity in the tax system. (See the above chart for contributions of each tax to government revenues.)

The 16th Amendment and the Rise of the Income Tax

Before the ratification of the 16th Amendment in 1913 gave the federal government the power to levy an income tax, the U.S. government raised revenue primarily through tariffs and excise taxes on items such as liquor and tobacco. Following ratification, Congress created an income tax featuring a seven percent top rate, with only the richest one percent of individuals paying this tax. Although Congress sharply raised tax rates during World War I and again during the Great Depression, the proportion of people facing the income tax remained quite small. However, the demands of World War II prompted Congress to extend the reach of the income tax to the masses. Between 1939 and 1945, the number of households subject to the income tax shot up from four million to 43 million.

Mid-Century Experimentation: Tax Cuts to Smooth the Business Cycle

Although it was necessary to raise taxes to pay for the war, increasing taxes during the Depression was an economically disastrous strategy that reflected poor knowledge of the effects of taxes on the economy. Benefiting

The Payroll Tax's Great Depression Origins

Congress enacted the *Social Security Act of 1935* during the middle of the Great Depression and two years later created a distinct *payroll tax* system to fund it. Payroll taxes currently provide financing for Social Security – Old Age, Survivors, and Disability Insurance (OASDI) – and part of Medicare. The tax was introduced at a rate of one percent on all payrolls (wages and salaries), payable by both employers and employees, for a total rate of two percent.

The current payroll tax is 15.3 percent of wages, on paper split evenly between employer and employee. Economists of all stripes agree, however, that the employee bears the employer portion of the tax in the form of lower wages. The first 12.4 percent of the payroll tax is levied on payroll income up to a cap, which was $87,000 in 2003. Due to this cap, the payroll tax would be considered regressive (i.e. a tax under which lower-income individuals face a higher average tax rate than higher-income individuals) if it stood alone. That regressivity is offset, however, by Social Security benefits that replace a much higher fraction of earnings for low-earners than for high-earners. The Social Security system taken as a whole, including its payroll tax financing mechanism, is actually quite progressive.

from an improved understanding of economic theory, policymakers after 1950 began to view tax cuts as a way to boost personal disposable income and consumer spending, thereby smoothing the business cycle. Accordingly, the 1960s saw a modest drop in the top tax rate to 70 percent from over 90 percent, as well as experimentation with investment tax credits that reduced tax liability for companies using earnings to make investments. Despite several tax cuts during the 1970s and relatively stable real incomes, inflation pushed millions of workers into higher tax brackets and reduced the value of exemptions and deductions.

The Beginning of Modern Tax Policy: Reagan's 1981 Tax Cut

With the passage of the *Economic Recovery Tax Act of 1981*, two major themes emerged that would dominate federal tax policy in the following decades: reducing *marginal tax rates* that discourage work and investment, and reducing the *bias against saving* inherent in any income tax. The Act reduced the top individual tax rate from 70 percent to 50 percent and indexed all brackets for inflation. This legislation also reformed business depreciation rules to encourage investment by allowing firms to deduct more quickly the cost of investment from their tax liability.

Marginal Tax Rates Emphasized

The idea that a person's *marginal* tax rate has important effects on economic decision-making was not prominently embodied in tax legislation before 1981. Previous policymakers had recognized that lowering *average* tax burdens could have positive effects on the economy by providing individuals with more disposable income to spend. This 1960s-era thinking had given less attention to the importance of the marginal tax rate (see box). The marginal rate – which determines how much of each additional dollar of earnings a person keeps – is the rate that matters for a worker making a decision about whether to work extra hours, or a business deciding whether to invest in another machine. Before 1981, the highest federal rate was 70 percent – meaning that a person in the top income bracket was allowed to keep only 30 cents of every additional dollar earned after paying federal income taxes. By emphasizing marginal tax rate reduction, the 1981 tax cut encouraged more work and savings, ushering in a decade of sustained economic growth.

Marginal versus Average Tax Rates

A person's *marginal* tax rate is the tax rate that person would pay on an additional dollar of income earned or received beyond his current income. In an income tax system where tax rates increase with income, the marginal rate is the rate corresponding to a person's top income tax bracket. For example, if the first $10,000 of income is taxed at 10 percent and the second $10,000 is taxed at 20 percent, a person who earned $15,000 would be in the 20 percent bracket facing a 20 percent tax rate on an additional (marginal) dollar of income.

An *average* tax rate, in contrast, is the overall rate at which a person is taxed on all his income, as opposed to the tax rate on just an additional dollar of income. In the tax system example above, a person earning $15,000 would pay $1,000 in taxes on his first $10,000 of income and another $1,000 in taxes on the remaining $5,000 of income. The average tax rate is calculated by dividing his total tax payment of $2,000 by his total income of $15,000. This individual would thus face an *average* tax rate of 13.3 percent (2,000/15,000=13.3 percent) but a *marginal* tax rate of 20 percent.

Average and marginal tax rates serve different functions in evaluating tax policy. While average rates are used to determine how different groups are impacted by a tax, marginal rates are important for determining how much taxes affect individuals' work and saving decisions.

Saving and Investment Encouraged

Saving and investment, which lead to a higher level of capital in the economy, are important drivers of long-run economic growth. The 1981 tax cut promoted saving and investment by reducing the burden that a standard income tax imposes on saving. By collecting a tax both when a dollar is initially earned and again on

the investment income generated if it is saved, an income tax system penalizes saving through double taxation.

In recognition of the income tax system's bias against saving, the 1981 Act included provisions that relieved a portion of the double burden on saving and investment. One such provision, the Individual Retirement Account (IRA), allows individuals to save while avoiding double taxation. Earnings invested in a traditional IRA are taxed only once – upon withdrawal from the account. Other tax code changes allowed businesses to accelerate depreciation of their investments and provided tax credits for new investments – encouraging capital formation and thereby economic growth. Investment tax credits, accelerated depreciation, and IRAs all introduced elements of a consumption tax system into the traditional income tax.

The Tax Reform Act of 1986: A Mixed Bag

The *Tax Reform Act of 1986* (TRA86) was a watershed attempt at wholesale reform, albeit a reform marked both by impressive achievements and by notable failures. The 1986 Act represented a compromise between those who wanted a broader tax base with a broader definition of income and those who wanted to reduce high marginal tax rates and their depressing effect on economic growth. The reform made important gains for economic efficiency by dramatically lowering tax rates – including a reduction in the top individual rate from 50 to 28 percent – and reducing the number of tax brackets. As discussed below, those achievements were marred by the introduction of new complexities into the tax code and a renewal of the income tax's bias against saving and investment.

Marginal Tax Rates and Progressivity

Progressivity refers to the extent that higher-income individuals pay a higher tax rate than do lower-income individuals. A tax system's progressivity depends on a number of factors, including the rate structure, the forms of income subject to taxation, and the availability of deductions and credits.

The *Tax Reform Act of 1986* represented the culmination of a trend toward lower marginal tax rates that began hesitantly in the 1960s and was reaffirmed in 1981. In the 22 years between 1964 and 1986, the top individual tax rate fell from 91 percent to 28 percent. Yet, tax system progressivity actually increased over this period of falling rates for two reasons: 1) higher-income individuals chose to take more of their compensation as taxable salaries rather than as non-taxed fringe benefits, and 2) tax base broadening resulting from elimination of many deductions.

Some Progress on Simplification

The 1986 reform made some progress on simplifying the tax code, but it also added considerable new complexity. The Act made some advances in simplicity for individuals, reducing the number of individual tax brackets from 14 to two (15 and 28 percent). Both the personal exemption and standard deduction were increased as well as indexed to inflation, relieving many lower-income individuals of the need to itemize or even file taxes at all. Additionally, complexities such as income averaging and deductions for consumer interest and sales taxes were eliminated.

Unfortunately, several features of the 1986 Act actually added significant new complexity to the tax code, offsetting many of the positive accomplishments. New rules governing IRAs complicated retirement planning for many individuals. At both the individual and business level, the Alternative Minimum Tax (AMT) – which requires many filers to calculate a second tax liability (and pay the greater of the two) – was revised and expanded. For businesses, new rules about inventory grossly complicated tax compliance. New international tax rules changing the timing of tax payments for certain types of foreign income also greatly added to tax complexity for businesses.

Temporary Reversal on Saving

Whereas the Reagan tax cuts of 1981 made important inroads in alleviating the tax system's double taxation of savings, the Tax Reform Act of 1986 negated this accomplishment by reducing saving and investment incentives. At the individual level, the 1986 reform placed new restrictions on the use of IRAs and also repealed the partial exclusion for capital gains, thereby increasing the tax rate on investments that increase in value. At the corporate level, the investment tax credit was repealed and less favorable depreciation rules were re-imposed, making new investment a less attractive proposition. While these changes reinstated much of the tax code's bias against saving and investment, this reversal would prove to be an aberration rather than a trend. Future amendments to the tax code would again move toward tax-neutral savings treatment, and nearly all major tax reform proposals would advocate adoption of a saving-friendly consumption tax base.

Since 1986: Fluctuating Rates and Steadily Increasing Complexity

The prime achievement of the 1986 tax reform – lowering tax rates and reducing the number of brackets – was lost during the 1990s through a series of increases in both tax rates and the number of tax brackets. With tax hikes enacted under President George H. W. Bush in 1990 and President Bill Clinton in 1993, the top tax rate climbed from 28 percent to 39.6 percent while the number of tax brackets proliferated from two to six. Tax cuts in 2001 and 2003 brought the top marginal rate down slightly again and eliminated one bracket. Two other trends during the 1990s – an increasing use of the tax code to achieve social policy objectives and an increase in tax preferences for saving – both contributed to increasing complexity in the tax code, as described below.

Social Policy in the Tax Code

During the late 1980s and especially the 1990s, legislators made increasing use of the tax code to encourage or reward certain behaviors unrelated to the tax system's primary purpose of raising revenue in the most efficient, fair, and simple way. Certainly, social policy goals have long been pursued through the tax code. The corporate income tax, for example, contains an alternative fuel production credit, while both the individual and corporate sides contain incentives for the restoration of historic buildings. Yet, the growth in the 1990s of narrowly targeted tax provisions, especially on the personal side of the tax code, was remarkable. The Earned Income Tax Credit (EITC), available to workers who pay no federal individual income tax, expanded significantly between 1991 and 1996. The Tax Relief Act of 1997 established a child credit, two different education tax credits, and IRAs specifically for educational saving. Legislation in 2001 expanded the child credit and offered it even to those paying no federal income tax.

Many of the social objectives pursued through the tax system are surely worthy goals. Nonetheless, one must be aware that the use of credits, deductions, and exemptions instead of direct spending programs has undeniably complicated the code and made tax filing a more daunting task for the average tax filer.

Encouraging Saving and Investment ... Again

The 1990s also saw a resumption of the battle against the double taxation of savings, albeit in a narrow, targeted way symptomatic of the trend toward using the tax code to encourage specific approved behaviors. Medical Savings Accounts were established to encourage saving for medical expenses, although in reality few people were eligible to participate. Saving

In 2003, Congress took another important step toward relieving the double taxation of saving by reducing the individual tax rate on dividend income to 15 percent.

for educational expenses was encouraged through an Education IRA and the Section 529 Qualified Tuition Program. Roth IRAs were also introduced, providing a similar tax benefit as traditional IRAs but changing the timing of the tax payment from the time of distribution to the time the money is earned.

Although the 1986 reform taxed capital gains at the same rate as other income, the cause of eliminating saving disincentives in the tax code realized a minor victory when the capital gains tax rate was held constant in 1990 and in 1993 even as ordinary income tax rates increased. Between 1997 and 2003, Congress reduced the capital gains rate to its current level of 15 percent. The tax on capital gains is often the second or even third layer of taxation imposed on saved income. Accordingly, this tax is an important disincentive to saving and potential drag on efficient capital movement and economic growth. In 2003, Congress took another critical step toward reducing the double taxation of investment in corporate stock by reducing the tax rate on dividend income at 15 percent.

While all of these provisions represent important progress toward reducing the burden on saving, they simultaneously complicate tax and financial planning. The number of savings plans to choose from, the restrictive rules governing those plans, and the different tax rates for various income sources all add complexity and offer ripe targets for simplification agendas.

Where Do We Go From Here?

The history of the income tax reveals several clear patterns in tax legislation over the last two decades. The Reagan tax cut of 1981 promoted two trends – lowering marginal tax rates and reducing the double taxation of saving – that have remained important tax policy considerations since that time. The Tax Reform Act of 1986, although affirming the importance of lower tax rates, temporarily reversed the effort to alleviate the tax burden on saving. Since 1986, the tax treatment of saving has improved, but complexity and tax rates have generally increased along with the targeted use of the tax code as an instrument of social policy.

Congress now faces important questions about the future of tax policy. How should future tax reforms further relieve the double taxation of saving? Can complexity in the tax code be relieved through incremental simplification efforts within the existing structure, or is fundamental reform necessary? If fundamental reform is the route chosen, what can be done to prevent the unraveling of reform as occurred in the aftermath of 1986? Future reports in this JEC series will explore these questions and consider how Congress can approach tax code changes from a consistent framework that incorporates the lessons of recent history.

Further Reading

Treasury Department's Fact Sheet on the History of the U.S. Tax System
(Part of the Treasury Department's series of fact sheets on tax policy and history.)
http://www.treasury.gov/education/fact-sheets/taxes/ustax.html

The Decline (and Fall?) of the Income Tax
(A 1997 book by Michael J. Graetz on the history and politics of income taxation in the U.S.)

This report is the first in the **JEC Tax Simplification and Reform** series. This series addresses the growing bipartisan belief that the current tax code is broken and that opportunities exist for wholesale improvements. Future papers will explore topics including the difference between income and consumption taxes and issues in evaluating tax system fairness.

Committee Publications

JEC publications released this month:

- "Constant Change: A History of Federal Taxes," September 12, 2003. First in a series of reports on tax simplification and reform.

- "Recent Economic Developments: The Economy Builds Momentum," September 10, 2003. Reviews key economic data from the past month and indications for future economic growth.

- "Understanding Today's Deficits," September 3, 2003. Update of previous JEC report using new budget estimates made by the Congressional Budget Office.

Other recent JEC publications include:

- "10 Facts about Today's Economy"
- "New Possibilities for Financing Roads"
- "Prescription Drugs Are Only One Reason Why Medicare Needs Reform"
- "Health Insurance Spending Growth – How Does Medicare Compare?"
- "Medicare Beneficiaries' Links to Drug Coverage"

Recent JEC hearings include:

- "The Employment Situation," September 9, 2003.
- "Technology, Innovation, and the Costs of Health Care," July 9, 2003.
- "Transforming Iraq's Economy," June 11, 2003.

Copies of the above publications can be found on-line at the committee's website at jec.senate.gov. Publications issued by the vice-chair and ranking member can be accessed via the same website.

JOINT ECONOMIC COMMITTEE

ROBERT F. BENNETT, CHAIRMAN OCTOBER 14, 2003

A PORTRAIT OF THE PERSONAL INCOME TAX BURDEN IN 2001

The Internal Revenue Service (IRS) has released its most recent data on the distribution of income and personal income tax payments. The IRS data show that a small group of earners accounts for most federal income tax revenue and highlight how dependent tax revenues are on the incomes of the highest earners. Incomes of the top 1% of earners declined significantly in the recession year of 2001 (the data arrive with a two-year lag), leading to lower tax collections.

Half of Taxpayers Paid Nearly All Personal Income Taxes

The top 50% of taxpayers, by income, accounted for 96% of all personal income taxes paid in 2001; the bottom 50% of taxpayers accounted for the remaining 4%. These percentages have remained essentially constant for the last five years. Personal income taxes are used to finance general government operations, as opposed to the payroll tax, which is borne more broadly and is primarily used to finance social insurance programs such as Medicare and Social Security.

Taxpayers Grouped by Income*	Percentage of All Income Earned		Percentage of All Income Taxes Paid	
	2000	2001	2000	2001
Top 1%	20.8	17.5	37.4	33.9
Top 5%	35.3	32.0	56.5	53.3
Top 10%	46.0	43.1	67.3	64.9
Top 25%	67.2	65.2	84.0	82.9
Top 50%	87.0	86.2	96.1	96.0
Bottom 50%	13.0	13.8	3.9	4.0

*Income measured as Adjusted Gross Income (AGI).

The Recession's Impact on High-Income Individuals Dampened Tax Receipts

Due to the weak economy and declining stock market, the incomes of the top 1% of earners declined by 18% in 2001 – as did their tax payments. This decline in income for the highest earners resulted in a $66 billion reduction in federal income tax receipts. Because such a large percentage of tax revenue is collected from a very small portion of the population, federal revenues are highly sensitive to changes in the income of the top earners.

The Highest Earners Continue to Bear Most of the Cost of General Government

Those with highest incomes pay for the bulk of government's general operations (that is, operations other than Social Security and Medicare) through their income tax payments. The top 5% of taxpayers paid more than half of all personal income taxes in 2001, while earning less than a third of taxable income. On the other hand, the bottom 50% of taxpayers paid 4% of personal income taxes while earning 13.8% of taxable income. The personal income tax system remains highly progressive.

Source: Internal Revenue Service (http://www.irs.ustreas.gov/pub/irs-soi/01in01ts.xls)

Committee Publications

JEC reports issued in the past month:

- "A Portrait of the Personal Income Tax Burden in 2001," October 14, 2003. Explains how federal tax revenues are dependent on a small group of high income earners and other issues about new tax distribution data from the IRS.

- "A Tale of Two Employment Surveys," October 14, 2003. Update of previous report that explains how two employment surveys from the same monthly report paint a surprisingly different picture – one survey shows job losses, while the other shows job gains.

- "The Tax Reform Act of 1986: A Primer," September 17, 2003. Outlines the major changes of the Tax Reform Act of 1986, as well as the current state of the tax code, in order to promote a better understanding of that often-cited tax reform.

- "Constant Change: A History of Federal Taxes," September 12, 2003. Highlights major trends in the U.S. tax system since the beginning of the income tax to show how we arrived at the current system (first in a series of reports on tax simplification and reform).

Other JEC reports include:

- "Recent Economic Developments: The Economy Builds Momentum"
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- "Prescription Drugs Are Only One Reason Why Medicare Needs Reform"
- "New Possibilities for Financing Roads"

Recent JEC hearings and events include:

- "Reshaping the Future of America's Health," October 1, 2003.
- "The Employment Situation," September 9, 2003.
- "Technology, Innovation, and the Costs of Health Care," July 9, 2003.
- "Transforming Iraq's Economy," June 11, 2003.

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PREPARED STATEMENT OF REPRESENTATIVE PETE STARK,
RANKING MINORITY MEMBER

Thank you, Chairman Bennett for holding this hearing on "Rethinking the Tax Code." While we're at it, we should be rethinking President Bush's tax cuts. Three rounds of tax cuts since 2000 have contributed significantly to empty treasury coffers and ballooning federal budget deficits for the foreseeable future.

President Bush would have us believe that taxes are an unnecessary burden—unless, of course, they're supporting the commitments he's made in Iraq. But taxes are a necessary means to meeting important responsibilities, such as providing affordable health care and prescription drugs, educating our children, or protecting the homeland.

Unfortunately, federal income tax revenues are no longer sufficient to meet the basic obligations of the federal government, even as non-Social Security spending has been falling. By the year 2000, federal spending on all programs except Social Security had fallen to just 15 percent of the nation's GDP, down from an average of 16.8 percent for the previous four decades. Meanwhile, federal revenues (excluding Social Security) have fallen to about 12 percent of GDP, their lowest levels since 1942—before Medicare, Medicaid, aid to education, and a host of other popular programs were created.

In addition to bankrupting the federal government, the recent tax cuts have also shifted the distribution of taxes. The combination of income tax cuts that disproportionately benefit higher-income families, elimination of the estate tax, and unchanged payroll taxes, means that lower- and middle-income families are shouldering more of the tax burden.

The President's tax cuts have also made the tax system much more complex. Many provisions slowly phase-in or abruptly phase-out, and all provisions sunset by the end of the decade, increasing the costs, of tax planning and compliance. And since Congress failed to fix the alternative minimum tax (AMT) problem, an increasing number of taxpayers will be forced to calculate their taxes twice.

We hear the cries for reform in order to simplify the tax code, but most proposals for "fundamental tax reform" involve replacing the current income tax with a broad-based consumption tax. As our witness Robert McIntyre has observed, "Virtually any flat-rate tax plan that adds up must, by simple arithmetic, produce huge tax cuts for those with the highest incomes and therefore big tax increases on almost everyone else."

While a consumption tax might address complexity issues with the Internal Revenue code, replacing the income tax with a consumption tax raises serious questions about fairness. None of the progressive consumption taxes proposed so far would keep taxes the same for the highest income families. However, proposed higher sales taxes would be damaging to low- and moderate-income families because they spend a larger percentage of their income on necessary consumer goods. Their ability to "choose" how much of their income they spend is a dubious notion. Low-income families would be the biggest losers unless the earned income tax credit remained in place.

Most consumption tax proposals would eliminate long-standing provisions in the tax code that give favorable treatment to housing, employer-sponsored health insurance, state and local taxes, and charitable giving. Eliminating these subsidies could be detrimental. If employers could no longer deduct the cost of health insurance, for example, workers would face higher costs for insurance and the ranks of the uninsured would grow even larger. Retaining these subsidies would mean higher tax rates on other consumption.

These are just some of the hard questions that need to be addressed before Congress leaps into a radical overhaul of the tax code in the name of reform.

Thank you Mr. Chairman and I look forward to the testimony of our witnesses.

PREPARED STATEMENT OF REPRESENTATIVE RON PAUL,
A MEMBER OF CONGRESS FROM TEXAS

I would like to thank Chairman Bennett for holding this much-needed hearing, and also thank our panelists for devoting their time and energy to study our tax system and educate members of this committee. The statements and articles submitted certainly are provocative, too provocative, I fear, for Congress and the administration. I say this because we've been debating tax reform, or at least pretending to debate it, for years.

In fact, some very powerful members of Congress have advocated real changes in our tax laws in recent years, all to no avail. We've heard about the flat tax, the national sales tax, capital gains taxes, alternative minimum taxes, etc., but we've

made zero progress toward coherent tax reform. The two most recent overhauls of the tax code, in 1986 and 1997, produced only more complexity and frustration. Tax simplification and basic fairness seem almost completely out of reach as a political and legislative matter.

As members of Congress we've all heard how frustrated the American people are with the tax code and the IRS. They hate the complexity of the tax laws, the hate the time it takes them to fill out the forms, they hate living in fear of an audit, and they hate paying so much. They bombard our congressional offices with complaints about taxes and the IRS, but nothing ever changes.

We also hear from our nation's businesses about the tremendous compliance costs associated with the tax code. Countless man-hours and millions of dollars are consumed every year by companies large and small around the country, all trying to comply with the rules concerning withholding for employees, corporate income tax, and accounting issues.

So while I'm eager to hear from our panelists today, I hope that we can start from the premise that the current approach is not working. If we as legislators don't make some fairly radical changes, this committee surely will find itself holding another tax reform hearing ten years from now.

We should remember that no rational discussion of tax reform or tax policy can ignore the other side of the equation: government spending. We cannot talk about tax reform without talking about a federal government that will spend roughly $2.3 trillion in 2004. We need to ask ourselves why the federal government increases spending by 3 or 5 or 7 percent each and every year. We need to recognize that the federal government's voracious appetite for tax dollars is the real problem; taxes are just a symptom. Unless and until Congress changes the spending culture in Washington, tax reform will remain a political shell game. With the federal government hell-bent on collecting and spending $2.3 trillion, the only "reform" available is tinkering with the code to shift the tax burden around from one group to another.

HEARING OF THE JOINT ECONOMIC COMMITTEE
"RETHINKING THE TAX CODE"
NOVEMBER 5, 2003
TESTIMONY FOR SENATOR ARLEN SPECTER

Chairman Bennett and distinguished members of the Committee, I appreciate the opportunity to testify before the Joint Economic Committee today about the importance of a simple and fair tax code. In May of this year, the Senate overwhelmingly agreed to an amendment that I offered to the Jobs and Growth Tax Reconciliation bill of 2003, that this Committee should look into ways to overhaul our antiquated tax code.

The date of April 15 stabs fear, anxiety, and unease into the hearts of millions of Americans. Every year during "tax season," millions of Americans spend their evenings poring over page after page of IRS instructions, going through their records looking for information and struggling to find and fill out all the appropriate forms on their federal tax returns. Americans are intimidated by the sheer number of different tax forms and their instructions, many of which they may be unsure whether they need to file. Given the approximately 325 possible forms, not to mention the instructions that accompany, simply trying to determine which form to file can in itself be a daunting and overwhelming task. According to the Tax Foundation, American taxpayers, including businesses, spend more than 5.8 billion hours and $194 billion each year in complying with tax laws. That works out to more than $2,400 per U.S. household. Much of this time is spent burrowing through IRS laws and regulations which fill 17,000 pages and have grown from 744,000 words in 1955 to over 6.9 million words in 2000. By contrast, the Pledge of Allegiance has only 31 words, the Gettysburg Address has 267 words, the Declaration of Independence has about 1,300 words, and the Bible has only about 1,773,000 words.

The majority of taxpayers still face filing tax forms that are far too complicated and take far too long to complete. According to the estimated preparation time listed on the forms by the IRS, the 2002 Form 1040 is estimated to take 13 hours and 10 minutes to complete. Moreover this does not include the

estimated time to complete the accompanying schedules, such as Schedule A, for itemized deductions, which carries an estimated preparation time of 5 hours, 37 minutes, or Schedule D, for reporting capital gains and losses, shows an estimated preparation time of 7 hours, 35 minutes. Moreover, this complexity is getting worse each year. Just from 1998 to 2002 the estimated time to prepare Form 1040 jumped 96 minutes.

It is no wonder that well over half of all taxpayers, 56 percent according to a recent survey now hire an outside professional to prepare their tax returns for them. However, the fact that only 29 percent of individuals itemize their deductions shows that a significant percentage of our taxpaying population believes that the tax system is too complex for them to deal with. We all understand that paying taxes will never be something we enjoy, but neither should it be cruel and unusual punishment. Further, the pace of change to the Internal Revenue Code is brisk – Congress made about 9,500 tax code changes in the past twelve years. And we are far from being finished. Year after year, we continue to ask the same question -- isn't there a better way?

My flat tax legislation would make filing a tax return a manageable chore, not a seemingly endless nightmare, for most taxpayers. My flat tax legislation will fundamentally revise the present tax code, with its myriad rates, deductions, and instructions. This legislation would institute a simple, flat 20 percent tax rate for all individuals and businesses. This proposal is not cast in stone, but is intended to move the debate forward by focusing attention on three key principles which are critical to an effective and equitable taxation system: simplicity, fairness and economic growth.

My flat tax plan would eliminate the kinds of frustrations I have outlined above for millions of taxpayers. This flat tax would enable us to scrap the great majority of the IRS rules, regulations and instructions and delete most of the 6.9 million words in the Internal Revenue Code. Instead of billions of

hours of non-productive time spent in compliance with, or avoidance of, the tax code, taxpayers would spend only the small amount of time necessary to fill out a postcard-sized form. Both business and individual taxpayers would thus find valuable hours freed up to engage in productive business activity, or for more time with their families, instead of poring over tax tables, schedules and regulations.

My flat tax proposal is dramatic, but so are its advantages: a taxation system that is simple, fair and designed to maximize prosperity for all Americans. A summary of the key advantages are:

- SIMPLICITY: A 10-line postcard filing would replace the myriad forms and attachments currently required, thus saving Americans up to 5.8 billion hours they currently spend every year in tax compliance.

- CUTS GOVERNMENT: The flat tax would eliminate the lion's share of IRS rules, regulations and requirements, which have grown from 744,000 words in 1955 to 6.9 million words and 17,000 pages currently. It would also allow us to slash the mammoth IRS bureaucracy of 117,000 employees.

- PROMOTES ECONOMIC GROWTH: Economists estimate a growth of over $2 trillion in national wealth over seven years, representing an increase of approximately $7,500 in personal wealth for every man, woman and child in America. This growth would also lead to the creation of 6 million new jobs.

- INCREASES EFFICIENCY: Investment decisions would be made on the basis of productivity rather than simply for tax avoidance, thus leading to even greater economic expansion.

- REDUCES INTEREST RATES: Economic forecasts indicate that interest rates would fall substantially, by as much as two points, as the flat tax removes many of the current disincentives to savings.

- LOWERS COMPLIANCE COSTS: Americans would be able to save up to $194 billion they currently spend every year in tax compliance.

- DECREASES FRAUD: As tax loopholes are eliminated and the tax code is simplified, there will be far less opportunity for tax avoidance and fraud, which now amounts to over $120 billion in uncollected revenue annually.

- REDUCES IRS COSTS: Simplification of the tax code will allow us to save significantly on the $7 billion annual budget currently allocated to the Internal Revenue Service.

The most dramatic way to show what the flat tax is to consider that the income tax form for the flat

tax is printed on a postcard -- it will allow all taxpayers to file their April 15 tax returns on a simple 10-line postcard. This postcard will take 15 minutes to fill out.

At my town hall meetings across Pennsylvania, the public support for fundamental tax reform is overwhelming. I would point out that in those speeches that I never leave home without two key documents: (1) my copy of the Constitution; and (2) a copy of my 10-line flat tax postcard. I soon realized that I needed more than just one copy of my flat tax postcard -- many people wanted their own postcard so that they could see what life in a flat tax world would be like, where tax returns only take 15 minutes to fill out and individual taxpayers are no longer burdened with double taxation on their dividends, interest, capital gains and estates.

This is a win-win situation for America because it lowers the tax burden on the taxpayers in the lower brackets. For example in the 2002 tax year, the standard deduction is $4,700 for a single taxpayer, $6,900 for a head of household and $7,850 for a married couple filing jointly, while the personal exemption for individuals and dependents is $3,000. Thus, under the current tax code, a family of four which does not itemize deductions would pay taxes on all income over $19,850--that is personal exemptions of $12,000 and a standard deduction of $7,850. By contrast, under my flat tax bill, that same family would receive a personal exemption of $27,500, and would pay tax on only income over that amount.

The tax loopholes enable write-offs to save some $393 billion a year. What is eliminated under the flat tax are the loopholes, the deductions in this complicated code which can be deciphered, interpreted, and found really only by the $500-an-hour lawyers. That money is lost to the taxpayers. $120 billion would be saved by the elimination of fraud because of the simplicity of the Tax Code, the taxpayer being able to find out exactly what they owe.

This bill is modeled after legislation organized and written by two very distinguished professors of law

from Stanford University, Professor Hall and Professor Rabushka. Their model was first introduced in the Congress in the fall of 1994 by Majority Leader Richard Armey. I introduced the flat tax bill--the first one in the Senate--on March 2, 1995, Senate bill 488. On October 27, 1995, I introduced a Sense of the Senate Resolution calling on my colleagues to expedite Congressional adoption of a flat tax. The Resolution, which was introduced as an amendment to pending legislation, was not adopted. I reintroduced this legislation in the 105th Congress with slight modifications to reflect inflation-adjusted increases in the personal allowances and dependent allowances. I re-reintroduced the bill in this Congress on April 15, 1999--income tax day--in a bill denominated as S. 822. I then introduced my flat tax legislation as an amendment to S.1429, the Tax Reconciliation bill, the amendment was not adopted. Most recently, on May 14, 2003, I offered an amendment to the Tax Reconciliation legislation urging the Senate to hold hearings and consider legislation providing for a flat tax – this amendment passed by a vote of 70 to 30 on May 15, 2003.

Over the years and prior to my legislative efforts on behalf of flat tax reform, I have devoted considerable time and attention to analyzing our nation's tax code and the policies which underlie it. I began the study of the complexities of the tax code over 40 years ago as a law student at Yale University. I included some tax law as part of my practice in my early years as an attorney in Philadelphia. In the spring of 1962, I published a law review article in the Villanova Law Review, "Pension and Profit Sharing Plans: Coverage and Operation for Closely Held Corporations and Professional Associations," 7 Villanova L. Rev. 335, which in part focused on the inequity in making tax-exempt retirement benefits available to some kinds of businesses but not others. It was apparent then, as it is now, that the very complexities of the Internal Revenue Code could be used to give unfair advantage to some. Einstein himself is quoted as saying "the hardest thing in the world to understand is the income tax."

The Hall-Rabushka model envisioned a flat tax with no deductions whatever. After considerable reflection, I decided to include in the legislation limited deductions for home mortgage interest for up to $100,000 in borrowing and charitable contributions up to $2,500. While these modifications undercut the pure principle of the flat tax by continuing the use of tax policy to promote home buying and charitable contributions, I believe that those two deductions are so deeply ingrained in the financial planning of American families that they should be retained as a matter of fairness and public policy -- and also political practicality. With those two deductions maintained, passage of a modified flat tax will be difficult, but without them, probably impossible.

In my judgment, an indispensable prerequisite to enactment of a modified flat tax is revenue neutrality. Professor Hall advised that the revenue neutrality of the Hall-Rabushka proposal, which uses a 19% rate, is based on a well-documented model founded on reliable governmental statistics. My legislation raises that rate from 19% to 20% to accommodate retaining limited home mortgage interest and charitable deductions.

This proposal taxes business revenues fully at their source, so that there is no personal taxation on interest, dividends, capital gains, gifts or estates. Restructured in this way, the tax code can become a powerful incentive for savings and investment -- which translates into economic growth and expansion, more and better jobs, and raising the standard of living for all Americans.

The key advantages of this flat tax plan are threefold: First, it will dramatically simplify the payment of taxes. Second, it will remove much of the IRS regulatory morass now imposed on individual and corporate taxpayers, and allow those taxpayers to devote more of their energies to productive pursuits. Third, since it is a plan which rewards savings and investment, the flat tax will spur economic growth in all sectors of the economy as more money flows into investments and savings accounts.

Professors Hall and Rabushka have projected that within seven years of enactment, this type of a flat tax would produce a 6 percent increase in output from increased total work in the U.S. economy and increased capital formation. The economic growth would mean a $7,500 increase in the personal income of all Americans. No one likes to pay taxes. But Americans will be much more willing to pay their taxes under a system that they believe is fair, a system that they can understand, and a system that they recognize promotes rather than prevents growth and prosperity. My flat tax legislation will afford Americans such a tax system. Thank you.

2003 Individual Tax Return

Form 1 **2003**	**Individual Wage Tax**	
Your first name and initial (if joint return, also give spouse's name and initial)		Your social security number
Home address (number and street including apartment number or rural route) number		Spouse's social security
City, town, or post office, state, and ZIP code		

1. Wages, salary, pension and retirement benefits
1_____
2. Personal allowance (enter only one)
   -- $17,500 for married filing jointly
   -- $10,000 for single
   -- $15,000 for single head of household
2_____
3. Number of dependents, not including spouse, multiplied by $5,000 3_____
4. Mortgage interest on debt up to $100,000 for owner-occupied home 4_____
5. Cash or equivalent charitable contributions (up to $2,500) 5_____
6. Total allowances and deductions (lines 2, 3, 4 and 5) 6_____
7. Taxable compensation (line 1 less line 6, if positive; otherwise zero) 7_____
8. Tax (20% of line 7)
8_____
9. Tax withheld by employer 9
_____
10. Tax or refund due (difference between lines 8 and 9) 10_____

A variety of specific cases illustrate the fairness and simplicity of this flat tax:

CASE #1 -- Married couple with two children, rents home, yearly income $35,000:

Under Current Law:

Income	$35,000
Four personal exemptions	$12,000
Standard deduction	$ 7,850
Taxable income	$15,150
Tax due under current rates	$ 1,676
Marginal rate	11.1%
Effective tax rate	4.8%

Under Flat Tax:

Personal allowance	$17,500	
Two dependents	$10,000	
Taxable income	$7,500	
Tax due under flat tax	$1,500	******Savings of* $176*****
Effective tax rate	4.3%	

CASE #2 -- Single individual, rents home, yearly income $50,000.

Under Current Law:

Income	$50,000
One personal exemption	$ 3,000
Standard deduction	$ 4,700
Taxable income	$42,300
Tax due under current rates	$ 7,774
Marginal rate	18.4%
Effective rate	15.5%

Under Flat Tax:

Personal allowance	$10,000	
Taxable income	$40,000	
Tax due under flat tax	$8,000	******Increase of* $226 *****
Effective rate	16.0%	

CASE #3 -- Married couple with no children, $150,000 mortgage at 9%, yearly income $75,000:

Under Current Law:

Income	$75,000
Two personal exemptions	$ 6,000
Home mortgage deduction	$13,500
State & local taxes	$ 3,000
Charitable deduction	$ 1,500
Taxable income	$51,000
Tax due under current rates	$ 7,573
Marginal rate	14.8%
Effective tax rate	10.1%

Under Flat Tax:

Personal allowance	$17,500	
Home mortgage deduction	$9,000	
Charitable deduction	$ 1,500	
Taxable income	$47,000	
Tax due under flat tax	$9,400	******Increase of $1,827******
Effective tax rate	12.5%	

CASE #4 -- Married couple with three children, $250,000 mortgage at 9%, yearly income $125,000:

Under Current Law:

Income	$125,000
Five personal exemptions	$15,000
Home mortgage deduction	$22,500
State & local taxes	$5,000
Retirement fund deductions	$6,000
Charitable deductions	$ 2,500
Taxable income	$74,000
Tax due under current rates	$13,783
Marginal rate	18.6%
Effective tax rate	11.0%

Under Flat Tax:

Personal allowance $17,500
Three dependents $15,000
Home mortgage deduction $9,000
Charitable deduction $2,500
Taxable income $81,000

Tax due under flat tax ..... $16,200 ***Increase of $2,417***
Effective tax rate 13%

ANNUAL TAXES UNDER 20% FLAT TAX FOR MARRIED COUPLE WITH TWO CHILDREN FILING JOINTLY

Income	Home Mortgage*	Deductible Mtg Interest	Charitable Contribution*	Personal (w/ children)	Taxable Allowance	Marginal Tax Rate	Taxes Owed Income
<27,500					0	0%	None
30,000	60,000	5,400	600	27,500	0	0%	None
40,000	80,000	7,200	800	27,500	4,500	2.3%	900
50,000	100,000	9,000	1,000	27,500	12,500	5.0%	2,500
60,000	120,000	9,000	1,200	27,500	22,300	7.4%	4,460
70,000	140,000	9,000	1,400	27,500	32,100	9.2%	6,420
80,000	160,000	9,000	1,600	27,500	41,900	10.5%	8,380
90,000	180,000	9,000	1,800	27,500	51,700	11.5%	10,340
100,000	200,000	9,000	2,000	27,500	61,500	12.3%	12,300
125,000	250,000	9,000	2,500	27,500	86,000	13.8%	17,200
150,000	300,000	9,000	2,500	27,500	111,000	14.8%	22,200
200,000	400,000	9,000	2,500	27,500	161,000	16.1%	32,200
250,000	500,000	9,000	2,500	27,500	211,000	16.8%	42,200
500,000	1,000,000	9,000	2,500	27,500	461,000	18.4%	92,200
1,000,000	2,000,000	9,000	2,500	27,500	961,000	19.2%	192,200

* Assumes home mortgage of twice annual income at a rate of 9% and charitable contributions up to 2% of annual income

PREPARED STATEMENT OF CONGRESSMAN JOHN LINDER,
A MEMBER OF CONGRESS FROM GEORGIA

Mr. Chairman, thank you very much for giving me a chance to testify before the Joint Economic Committee this morning on the need for fundamental tax reform generally, and H.R. 25, the FairTax, my fundamental tax reform proposal specifically. I appreciate having the chance to share with the Committee my thoughts on this pressing issue.

In debating any fundamental tax reform proposal, I believe that the Congress should judge any such bill by the following key principles:

1. Fair: It must protect the poor and treat everyone else the same. No exemptions—no exclusions—no advantages.
2. Simple: It must be easy to understand for all Americans—no matter one's education, occupation, or station in life.
3. Voluntary: It must not be coercive or intrusive.
4. Transparent: We should all know what the government costs. There must be no "hidden" taxes.
5. Border-Neutral: Our exports must be unburdened by any tax component in the price system, while imports carry the same tax burden at retail as our domestic competition.
6. Industry-Neutral: It must be neutral between businesses and industries.
7. Strengthens Social Security: Fundamental reform must address the long-term solvency of Social Security.
8. Manageable Transition Costs: It must not be costly or difficult to implement.

My FairTax proposal, which eliminates all income and payroll taxes and replaces them with a national retail sales tax, meets these criteria. The FairTax is a compelling proposal that would benefit the U.S. economy, businesses across the nation, and all American taxpayers.

The FairTax plan is fair. It contains a monthly rebate of the sales tax for every household, which would totally rebate the tax consequences of spending up to the poverty line. This rebate mechanism ensures that every household can buy necessities taxfree, and it totally untaxes the poor. All Americans receive equal, fair treatment. If Bill and Melinda Gates want to move to a farm and grow their own groceries and live off the rebate, what do we care? We'll borrow his money and create jobs.

The FairTax plan is simple. It totally eliminates the more than 10,000 pages of complexities in the current income tax code once and for all, replaces them with a simple uniform sales tax.

The FairTax plan is a voluntary tax system. Every citizen becomes a voluntary taxpayer, paying as much as they choose, when they choose, by how they choose to spend.

The FairTax plan creates transparency within the tax code. It eliminates the hidden tax component from the prices of goods. According to a Harvard study, the current tax component in our price system averages 22 percent, meaning that the least well off among us lose 22 percent of their purchasing power.

Any system that burdens business with any payroll tax, income tax, or compliance costs embeds that cost in our price system. By abolishing the IRS and abolishing the income paradigm in favor of a consumption paradigm we let the market drive the tax component out of the price system.

Moreover, knowing how much we pay in federal taxes on every purchase we make would make all Americans more aware of the cost of government. The next time someone wants to raise taxes, they will not be able to be sell such a bad idea with the old argument that it only applies to the "wealthiest amongst us." The rationale for any future tax increase must necessarily be so compelling that my mother would be willing to pay it.

The FairTax plan is border-neutral. Under a national sales tax, imported goods and domestically produced goods would receive the same U.S. tax treatment at the checkout counter. Moreover, our exports would go abroad unburdened by any tax component in the price system.

The FairTax plan is industry-neutral. There is not a good reason that our neighbor who builds a bookstore, hires our kids, votes in our elections and supports our community should be placed at a seven percent disadvantage against Amazon.com. Governors have a keen interest in this due to the loss of hundreds millions of dollars in revenue to Internet and catalogue sales. A national retail sales tax would collect these revenues, and in doing so help the states.

Nor is there a good reason why I, as a dentist, didn't have to collect a sales tax in Georgia while my neighbor, the retailer, did. The first principle of government tax policy ought to be neutrality.

The FairTax plan would also strengthen Social Security's longterm future. The arguments about partial private investments saving Social Security seem to miss an important point—we will increase the number of retirees in the next 30 years by 100 percent and increase the number of workers supporting them by 15 percent. That system will only survive by dramatically reducing benefits, increasing taxes, or increasing the number paying into it, or some combination of both.

Under the FairTax, Social Security benefits would be paid out of the general sales tax revenues. The sales tax would be collected from roughly 285 million Americans and 51 million visitors to our shores. Revenues to Social Security and Medicare would double, as we expect the size of the economy to double, in 13 to 14 years under the proposal.

The FairTax plan has manageable transition costs. The only transition rule we envision is to allow retailers to use inventory on hand on December 31 as a credit against collecting taxes on sales in the new year, on the principle that things should be taxed only once and goods produced before the transition would already have the current tax embedded in them.

According to the U.S. Census Bureau, at any given time, U.S. businesses have about $1.1 trillion in inventory on hand at any given time. Not collecting taxes on that inventory would cost the treasury about $300 billion. Compare that to any estimates of transition costs just trying to bring some private investment into Social Security alone. According to the Social Security Administration, the 75-year unfunded liability in Social Security is nearly $5 trillion. Remember this proposal fixes Social Security in 13 to 14 years.

Beyond the above arguments, what will the new paradigm do in our present economy? Passing the FairTax does several things that will directly affect the U.S. economy:

1. We currently spend anywhere between $250-500 billion a year on compliance with the tax code. Most of that is spent by corporate America and high-income investors. The savings that accompany a simpler tax system will go to bottom lines and investment for job creation.

2. Corporate America spends additional billions calculating the tax implications of business decisions. The savings generated by the FairTax will go to the bottom line.

3. Eliminating the income tax will bring long-term interest rates down to municipal bond rates, ultimately reducing interest rates by 30 percent. That is good for corporate profits and the market.

4. What do you think will happen to the stock market if all the world's investors could invest in our markets with no tax consequences?

5. Having no complicated depreciation schedules, no Alternative Minimum Tax, no credits and deductions to confuse investors,, and no tax or compliance costs forces a whole new look at corporate accounting. Only three numbers have meaning: earnings, expenses and dividends.

This will make it much easier for shareholders and investors to evaluate and monitor all publicly-owned companies.

6. Deficits spook the market. Instead of declining Federal revenues because an income-based tax system depends on ever growing incomes, the Federal government would collect higher revenues under the FairTax, as revenues would track consumption. A study from 1945 to 1995 shows that the consumption economy is a far more predictable revenue base than the income economy, which has much higher amplitudes of volatility.

7. The FairTax would bring a 26 percent increase in exports in the first year as well as a 76 percent increase in capital investment. Capital investment increases lead to increases in productivity and then increases in real wages.

How does the FairTax compare to other fundamental tax reform ideas? The FairTax is decidedly simpler and fairer than flat tax proposals.

The U.S. instituted a flat tax in 1913. Since then, it has been amended over and over, resulting in the very plan you are working to correct today. In 1986, we eliminated many itemized deductions and drastically lowered tax rates to only two levels. We have amended the code over 6,000 times since then.

I know that you recognize the need for a more fundamental change—we have walked the flat tax path before, to no avail, and it simply does not make sense to implement the same mistake again.

Some other sales tax proposals leave in place the payroll tax—the largest hidden tax component in the prices of our goods and services. The FairTax would completely eliminate these hidden taxes, allowing competition to bring prices down an average of 20-30 percent and increasing the transparency of the tax system.

The FairTax has the following other benefits:

• Because of the tax component incorporated into prices under the current income tax code, we are already paying the equivalent of the FairTax!

• The FairTax eliminates payroll taxes, which are the most regressive of existing taxes.

• The FairTax is a tax on accumulated wealth. However, the holders of accumulated wealth are already paying it. It's just hidden.

In closing, thank you for the opportunity to testify. I'll be more than happy to answer any questions the Committee members may have about H.R. 25, the FairTax.

Principles of Tax Reform

Testimony
Joint Economic Committee
U.S. Congress
Washington, D.C.
November 5, 2003
by

Michael J. Boskin
T.M. Friedman Professor of Economics
and Hoover Institution Senior Fellow,
Stanford University

Chairman Bennett and other distinguished members of the Committee, it is a pleasure to renew my long-standing association with the Joint Economic Committee. I have worked with the Committee for a quarter century on issues ranging from policies to promote long-term economic growth to the short-run economic outlook to improving the nation's economic statistics. I have greatly appreciated the Joint Economic Committee's focus on broader issues that frame specific legislation, and it is in that spirit that I testify today on the principles that should guide fundamental tax reform. In doing so, I will endeavor to summarize the latest academic thinking on this vital issue and apply it both to some general reform ideas (e.g. replacing the corporate and personal income taxes with some form of an integrated consumption tax) and to some specific reform ideas (e.g. expansion and reform of tax-deferred saving).

I. Introduction

Views of what constitutes the "best" tax system date almost from the dawn of political philosophy. The suggested ways to balance concerns with efficiency, equity and administrative simplicity and reliability have evolved considerably since Adam Smith enunciated his famous Four Canons of Taxation in *The Wealth of Nations* in 1776 (*see insert*). Before turning to that subject, let me emphasize the likely large payoff to a better tax system. Simply put, there is a tremendous opportunity to improve the federal system of corporate and personal income taxation in a manner that will both significantly improve economic

ADAM SMITH'S FOUR CANONS OF TAXATION

1. **Equality**: (Ability-to-pay) "...ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue (income) which they respectively enjoy under the protection of the state."

2. **Certainty:** "The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person."

3. **Convenience in payment**: "Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it."

4. **Economy in collection**: "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state."

performance and substantially reduce the compliance and administrative burden on America's families and firms. Estimates of the annual compliance burden range into the many billions of dollars, including over a billion hours devoted to that task. The cost in distortions of economic decisions such as how much and in what form households save, businesses invest and people work is enormous. The tax system is clearly too complex. Remarkably, the system of voluntary compliance yields a very high percentage of income tax liabilities actually due, especially when viewed relative to other countries. That speaks well of Americans' basic values. But there is episodic concern, for example in Treasury, that the system of voluntary compliance will be decreasingly effective over time and the nation will be driven to transactions taxes unless a simpler tax system replaces the current complex income tax system.

Before discussing alternative reforms and how they relate to various standards, a simple parable will distill much economic knowledge on the subject

of the economic cost of taxation. Suppose the government takes a dollar away from taxpayers to finance spending. To collect that dollar, the government has to distort the allocation of resources. The tax will affect private decisions. Our income tax doubly or triply taxes some type of saving and thus distorts the incentive to consume versus save or, alternatively, to consume in the present versus the future, e.g. at retirement. Both income and payroll taxes distort the incentive to work, etc.

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

Generally, the overall total burden that these tax distortions impose on the economy goes up with the *square* of marginal tax rates. Thus, doubling the tax rate quadruples the inefficiency or waste or harm done by the tax distortion. The marginal cost goes up proportionally with tax rates. *Thus, high marginal tax rates are very bad for the economy.* The cost to the economy of each additional general tax dollar is about $1.30 or $1.40. This immediately tells us that a key to the quality of the tax system – how badly it distorts the economy, hinders growth, misallocates resources – is the level of *effective* marginal tax rates. *The lower the effective marginal tax rates, the smaller the distortion of private decisions.*

Now the tax dollar (which costs the economy $1.30 or more) is put into a bucket. Some of it leaks out in overhead, waste, and so on. In a well-managed program, the government may spend $.80 or $.90 of that dollar on achieving its goals. Inefficient programs would be much lower, $.30 or $.40 on the dollar. Thus, another key to an efficient tax system is efficient spending that keeps the revenue needed to the minimum necessary spending.

It is important to note that the effective tax rates on private activity can be quite different from statutory rates because they interact with the tax base and can cascade across several taxes. For example, state and local income taxes and payroll taxes add to the distortions caused by the federal income tax. Clearly, the broader the tax base, the lower the rates to raise any given amount of revenue. Hence, broad bases and low rates are hallmarks of a good tax system.

II. Five Big-Picture Tests for Tax Reform

I have five big-picture standards or tests that I apply to tax reform proposals.

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

By far the most important aspect of economic performance is the rate of economic growth because that growth determines future living standards. The most important way the tax system affects economic growth is through the rate of saving, investment, entrepreneurship and human capital investment.

2. Will tax reform affect the size of government?

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

has happened in many European countries and is a major detriment to their economic performance.

3. Will a new tax structure affect federalism?

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

4. Will a new tax structure likely endure?

We have had 15 major tax reforms or fundamental tax reforms in the last quarter-century, more than one every Congress. We should be concerned that we might move to a better tax system only to undo it shortly thereafter. In 1986, the trade-off was lower rates for a broader base. That was slightly undone in 1990, and dramatically so in 1993, whereas in the past three years, rates have been reduced. A more stable tax system would reduce uncertainty and, in its own way, be less complex.

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

Are we likely to see a change in the ratio of taxpayers to people receiving income from government? We now have a much higher ratio of people who are net income recipients to people who are taxpayers than in any previous time in our history, reflecting not only transfers but the EITC and other features of the income tax itself. Fortunately, that number is still well under 50 percent. But as we move through time, as the retired population grows, the baby boom generation approaches retirement and then retires, the fraction of the population in any given year who are receiving more than they are paying will grow. We must deal with this both on the tax side (underground economy, chary of too many off the income tax rolls) and, especially, on the transfer payment side (the

EITC, entitlements programs) and do so soon, or we will get into a spiral of higher benefits, higher tax rates, a weaker economy, and ever-greater political conflict between taxpayers and transfer recipients. Just examine the plight of some large cities in the 1970s, or many European countries today.

III. Evaluating Tax Systems

With these big-picture issues in mind, we can ask in designing a tax system, what are the major decisions that need to be made? There are four interrelated decisions: the choices of tax base, tax rate(s), the unit of account and the time period of account (*see insert*). We outlined above why it is important to keep the rate(s) as low as possible to minimize the distortions to the economy. What about the tax base?

KEY DECISIONS FOR DESIGN OF TAX SYSTEM

1. Tax base(s): income, consumption, hybrid; people or transactions
2. Tax rate(s): flat, progressive, levels
3. Unit(s) of account: family, individual, transactions
4. Time period of account: transaction, annual, longer-horizon

A. The Tax Base

Most fundamental reforms are designed to redress the severe distortion of saving and capital formation caused by the current system of income taxation. Most other countries rely much more heavily on taxes on consumption – so-called indirect consumption taxes such as sales taxes and value-added taxes and income tax systems that exempt large amounts of saving from the tax base – thereby leaving most households' tax base as income minus all saving (i.e., only that part of income that is consumed). Most of their corporate taxes have various features that allow more rapid write-off of investment than does the U.S.

corporate tax; some have features by which they integrate the corporate and personal tax; others, such as Japan, have corporations that have much higher leverage and therefore finance a much larger fraction of investment through tax-advantaged debt.

The U.S. corporate and personal income taxes (and other taxes at both the federal and state level) tax some types of saving once, others twice, some three times, and in some instances even four times. To set concepts, *it is generally understood that a pure income tax would tax saving twice: first when it is earned as part of income and again when it earns a return in the form of interest or dividends.* An alternative way to think about this is that present consumption is taxed once while future consumption is taxed twice because the bulk of saving is done for the purpose of future consumption, for example, during retirement.

Now consider the separate corporate and personal income tax and a family putting their saving in corporate equities. The family first pays taxes on their own income, their consumption plus saving. That is tax one. They save some of that after-tax income in the form of corporate equities. But the corporation pays corporate taxes (on behalf of the family as a shareholder). That is a second tax. Then the family pays taxes again when it receives dividends or capital gains (in this case one has to net out inflation, deferral, the possibly lower tax rate, incomplete loss offset, and so on to determine the true effective tax rate). That is a third tax on the saving. If the family is fortunate enough to accumulate over its lifetime enough to leave a taxable estate, the saving may be taxed a fourth time.

Of course, there are numerous exceptions to this rule. For example, employer-provided pensions (401k) plans, IRAs, and so on are forms of tax deferral (not tax forgiveness) that eliminate one layer of the taxation of saving. But going through the entire complexity of the tax code, despite the recent

reforms which are a step in the right direction, still produces the overall conclusion that *saving and capital formation are taxed especially heavily in the United States*, relative to other uses of income and relative to our competitors.

There are numerous ways to simplify the tax system and remove the distortion between the present and the future, between consumption and saving of households, and among types of investments. That is, there are numerous ways to tax consumption in the economy. We can generally divide these into two approaches – direct and indirect. So-called indirect taxes include a national retail sales tax, various types of value-added taxes, and excise taxes. So-called direct taxes would tax households and firms on the part of income that was consumed. Those taxes are sometimes called consumed income taxes. It is important to examine the combination of the business-level tax and the personal-level tax to determine what the final tax base will be.

Economists use a concept called the circular flow of income and product to describe the economy. Business firms use capital and labor, to which they pay wages and interest or other forms of capital income, to produce products, which they sell to obtain revenues out of which the payments to labor and capital are made. One can look at the total value of the production of the firms or the total income received by households as two equivalent sides of the nation's accounts. Thus, households can be taxed at the personal level by taxing their total income, or various components of it such as wages, interest, dividends, and so on. Alternatively, households can be taxed by taxing firms on the capital and labor they employ, or on their output. The taxes thus collected would reduce the flow of payments back to households. In this sense, a tax at the business level should be thought of as a withholding tax on households. To repeat the old saying, corporations do not pay taxes, people do. Taxes collected at the business level are paid by shareholders, owners of capital in general, workers, or consumers.

Thus, a tax on output sold by firms is equivalent to an equal-rate tax on the wage income and capital income paid by the firm from the sales of the output. Alternatively, households could be taxed when they use the income they receive from the firms to purchase goods and services or to save, the two broad uses that are made of income. Alternatively, because saving equals investment (ignoring the complexities of the international economy for the moment), income can also be taxed by taxing consumption plus investment in the economy.

Turning from taxing output or income to taxing consumption, the government can do so in a variety of ways (*see insert*). The most obvious is taxing the purchase of goods through a retail sales tax or excise taxes. A second option is to tax income of households but allow them to deduct net saving, leaving a tax base of consumed income. An alternative is to tax wage income at the personal level but to tax capital income at the business level (a withholding tax on the capital income of the shareholders); to make the tax a consumption tax, we would allow immediate expensing (i.e., a business tax deduction for investment in the year made).

ALTERNATIVE WAYS TO TAX INCOME AND CONSUMPTION

(1) Income = Consumption + Saving
or Income – Saving = Consumption
(deductible saving method)

(2) Income = Consumption + Investment
or, Labor Income + Capital Income = Consumption + Investment
Labor Income + (Capital Income – Investment) = Consumption
(business tax expensing method)

(3) Excise, sales taxes

defined in two dimensions: among investments (atemporal neutrality) and between investment and consumption (intertemporal neutrality). Think of

intertemporal neutrality as a level playing field goalpost-to-goalpost and atemporal neutrality as level from sideline to sideline. Even a perfect income tax would only achieve atemporal neutrality, not the more important intertemporal neutrality. A pure consumption tax, however levied, would guarantee neutrality both with respect to investment versus consumption *and* among types of investment. The attempt to achieve neutrality among types of investment in an income tax is almost guaranteed to fail as problems such as inflation accounting, measuring true economic depreciation, and so on present huge hurdles to properly measuring real economic income. The most complex parts not only of the U.S. income tax but of any income tax concern capital income and international transactions.

The U.S. tax system favors investment in owner-occupied housing. To oversimplify, by not explicitly taxing the imputed income to owner-occupied housing (the rent an owner occupier could earn or implicitly pays to himself/herself), saving in the form of housing equity is tax-advantaged in a manner similar to IRAs and 401(k)s. Fundamental tax reform replacing the personal and corporate income tax with a consumed income tax would not only create a level playing field between consumption and saving, but also among all types of saving. So long as housing is afforded this type of tax treatment, an income tax is guaranteed to seriously misallocate resources.

The current tax system, as noted, is a hybrid with respect to the tax base. Some saving is taxed once, some twice, some three or four times. The last two decades of academic research have strongly reaffirmed the view that tax neutrality toward saving and investment should be a very high priority. To greatly oversimplify, even modest tax rates on saving produce tax wedges and distortions that are enormous when compounded over the relevant time span. While a 30% tax rate might reduce the return to saving from, say, 10% to 7% and that might seem modest in comparing this year to next year, over the decades of saving to finance retirement, removing the 30% tax wedge compounds into a

much larger 130% increase in the cumulative future value of the saving over 30 years. Since the corporate income tax and the personal income tax drive this tax wedge between the returns to an investment in the economy and the net of tax returns received by the savers supplying the capital, one of the primary conclusions of modern public finance economists is strong support for an integrated corporate and personal tax on consumption (on which more below). The current corporate and personal income taxes, through depreciation and interest deductions in the corporate tax and tax-deferred saving in the personal tax move part-way toward this ideal. The immense complexity of measuring and deducting true economic depreciation, real interest, reasons for saving, etc. create a tax system with widely different effective tax rates on alternative types of saving and investment.

It is sometimes argued that taxing consumption is unfair; income, the argument goes, is a better measure of ability to pay. Thomas Hobbes first made the case for taxing what is taken out of the economy (roughly measured by consumption) rather than contributed to it (approximated by income). Such philosophical arguments aside, modern economics recognizes that households smooth their consumption when income fluctuates and that most households have a longer time horizon and consume out of permanent or expected average income. Thus, consumption in any year may well be a better proxy for permanent income than is income in that year. Over a lifetime, a consumption tax will tax lifetime income (ignoring bequests), but do so in a manner that does not distort saving decisions.

Although there are several different approaches to consumption taxation, with very different attributes, it is important to stress their conceptual equivalence. Consumption equals income minus saving; a tax with an unlimited net saving deduction is a consumed income tax whether levied at flat or progressive rates. Consumption taxes can be levied directly as a retail sales tax on the purchases of goods *and* services. But consumption is also equal to

income less investment and therefore labor income plus capital income less investment. Hence, a tax such as the so-called flat tax of my Hoover colleagues Bob Hall and Alvin Rabushka, which taxes wages at the personal level and capital income less expensed investment at the business level, also winds up with consumption as the tax base.

I noted above the importance of low tax rates: the broader the base, the lower the rate or rates. Thus, a national retail sales tax on all consumption goods, including services, replacing the current corporate and personal income tax, would reduce the drag on saving, investment, entrepreneurship, and economic growth. It could be implemented in a manner that is far less intrusive and burdensome on taxpayers. It would, however, be a proportional tax on consumption. If greater progressivity is desired, a refundable tax credit, or exempting commodities consumed disproportionately by the poor, would be the two possible approaches. The latter is inefficient in the sense of exempting, for example, food for rich and poor alike. The former would require some cumbersome administrative apparatus and, as we have seen with the earned-income tax credit, open up opportunities for abuse. I believe each of these problems is surmountable. Also, although it would not completely eliminate the underground economy, this approach probably would get at more of the underground economy than any other.

The approach of allowing an unlimited saving deduction (a super IRA, the recent Treasury proposals would accomplish this for most households) in a system similar to the current income tax system is a progressive-rate consumed income tax. Indeed, one of the most interesting developments of the past two decades in tax policy, capital markets, personal finance and the economy has been the remarkable expansion of tax-deferred saving. Tax-deferred saving vehicles include individual retirement accounts (IRAs), private pensions including 401(k)s, certain life insurance products, and federal and state and local pensions. The Federal Reserve data indicate the assets in these vehicles have increased

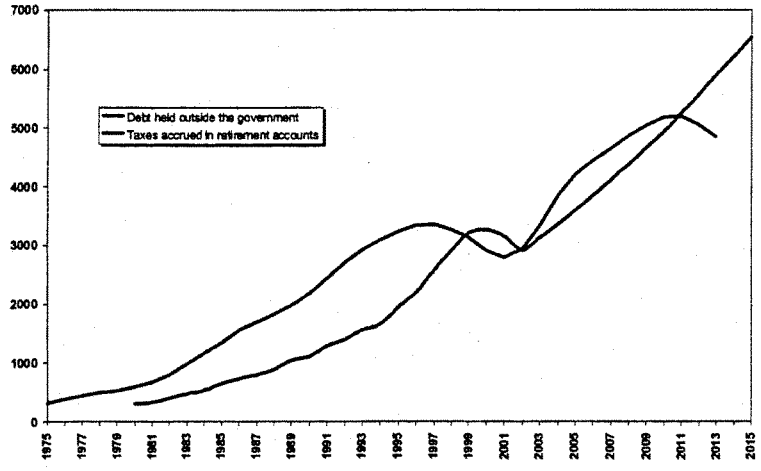
roughly tenfold in nominal dollars since 1981, when universal IRAs were introduced and 401(k)s launched, three times as fast as nominal GDP. They currently total well over $11 trillion. Very rough estimates suggest $400 billion per year is contributed and a similar amount withdrawn each year. The balances grow (or as in 2001 and 2002, shrink) with market returns (net of fees) on the various investments in the accounts, plus contributions less withdrawals.

Because the withdrawals from these balances will be taxed as ordinary income, the federal government has accrued what might be called a deferred-tax asset (DTA) on a hypothetical balance sheet. Just as the national debt requires future taxes to pay interest, the balances in tax-deferred accounts will yield future taxes. At current marginal tax rates (weighted by balances) of 28.7%, the DTA would exceed about $3 trillion, about the size of the national debt held outside the government (the publicly held debt less holdings by the FED, *see chart*). If future lower pre-retirement tax rates more than offset real bracket creep and the rate fell to 21%, the DTA would still equal three-fourths of "outside" debt. The tax-deferred asset has accrued because the deductions on the contributions have already been taken and show up as historical revenue losses (future contributions will do so in the future), whereas the taxes on the withdrawals have yet to be paid. The government is a 20-30% minority partner in that balance on your last quarterly report and you have a deferred-tax liability.

To repeat, much traditional saving has historically been taxed twice – first when the saving was part of taxed income, again when returns such as interest and dividends were earned and nominal capital gains realized. The corporate, estate, and state and local income taxes raise effective tax rates still higher, although lower capital gains rates and deductible interest on debt work in the opposite direction (the recent reductions in dividend taxation and marginal rates reduce, at least temporarily, the net tax on saving). Tax-deferred saving vehicles, in contrast, allow contributions out of before-tax dollars, allow returns to buildup inside without current tax, and tax withdrawals later in life as ordinary

income. Roth IRAs accomplish "single taxation" the other way around: you put in after-tax dollars but pay no tax on withdrawals. Over time, contribution limits have been raised, and new vehicles added for college tuition and health costs. Treasury has innovative proposals to expand, simplify and consolidate these programs, discussed briefly below.

Accrued Deferred Taxes in Retirement Accounts vs.
National Debt Held Outside the Government



Sources: debt data for 1975 – 2002 are from OMB; for 2003 – 2013, CBO, August 2003; deferred tax data are from author's calculations

Understanding the reach, efficacy and implications of these deferred-tax saving vehicles is important in its own right and as part of a broader set of economic issues such as assessing household and government balance sheets, fiscal history and future saving. Do the contributions represent largely new saving, or do they merely divert saving (old or new) from taxable to tax-deferred status? Do they really reduce the marginal tax rate on new saving, or do the contribution limits make the saving inframarginal? Are the early revenue losses made up later, or do they lose revenue permanently? Economists have been

deeply divided on these issues. I am in the more optimistic camp and believe they have been a powerful net wealth accumulator thus far.

The importance of answers to such questions becomes apparent with projections of the future evolution of the system of deferred-tax accounts. For example, if – and it's a big if -- historical contribution retirement/withdrawal/return patterns continue, contributions and withdrawals will run in the tens of trillions of dollars (inflation-adjusted, undiscounted), and the balances grow more rapidly than income in coming decades. The growth of the withdrawals will add a growing elderly constituency for lower income taxes – at least on their withdrawals – to the predicted generational tension in the future political economy of budget policy.

The deferred-tax asset on the hypothetical federal government balance sheet grows with the balances in these accounts (*see chart*). From 1981-92, the growth in this already-accrued deferred tax asset was equal to 40-50% of the growth in the national debt; since then, a multiple of the more slowly growing debt. Forty years from now, it will be much larger. Thus, current "scoring" procedures are quite misleading in evaluating the revenue effects of expanding tax deferred saving and will bias policy evaluations against this potentially attractive reform.

In early 2003, Treasury proposed a major overhaul of tax-deferred saving, with a view to simplifying and expanding such saving. The saving proposal would create "back-loaded" retirement saving accounts (RSAs) into which contributions would not be deductible, but from which withdrawals would not be taxed. The proposed annual contribution limits of $7500 per person are much larger than traditional IRA limits, and there would be no income limits on eligibility. Employer sponsored retirement saving vehicles such as 401(k)s would be simplified into new ERSAs. New lifetime savings accounts (LSAs) would be established with a $7500 per person annual contribution ceiling from which

withdrawals could be made without penalty, greatly increasing flexibility. Traditional IRAs could be converted to RSAs; state college tuition plans, Coverdell education saving plans and Archer medical saving accounts could be converted to LSAs; 401(k)s, 403(b)s, and 457s could be converted to ERSAs. Future contributions would be limited or banned unless conversions were made to ERSAs and RSAs.

If enacted, these reforms would move the personal income tax much closer to a consumed income basis (relative to the current hybrid of a pure income and pure consumption tax), although the treatment of debt and the tax treatment of "old" saving cloud that issue. If enacted, anything approaching these reforms would affect the incentive to save in tax-deferred vehicles in several ways and therefore would likely also affect the budgetary effects of these vehicles. For example, the higher contribution limits and the abolition of the income eligibility restrictions could increase saving in these vehicles relative to the current ones. The new lifetime saving accounts might generate a sizeable flow of saving from those desiring greater flexibility, although some may come at the expense of longer-term deferred tax saving for retirement. The ERSAs, by virtue of simplicity, might encourage some small businesses not now offering 401(k)s to do so. A concern has also been expressed that some firms might not make them broadly available. Finally, it should be noted that the nondeductible contributions, nontaxable withdrawals nature of LSAs and RSAs, compared to the current tax-deductible contributions and taxable withdrawals treatment, would shift the timing of tax collections toward the present. There is also a concern that some of the saving historically induced by the prospect of the immediate tax deduction might not occur with the new system. In combination with permanent dividend relief, this expansion of "consumption tax" single taxation of saving would move the current tax system much closer to an ideal integrated business and personal consumed income tax.

A progressive consumed income tax has many admirable features and offers some flexibility in exemptions and deductions, but it would be desirable to broaden the base and lower the rates from the current system. If a so-called flat tax is not feasible, a broad-based consumed income tax with rates of, say, 10%, 20% and 30% at the personal level and 30% at the business level should eventually be feasible and would be a significant improvement over current law. A serious transition complexity issue is the need to track all preexisting assets.

The possibility of taxing capital that was previously accumulated but already taxed a second time when it is used to finance consumption, however, is a particularly important issue, especially for the elderly who, on balance, consume out of their assets. Also, because a huge part of the complexity of the tax system is in the treatment of capital income, I believe the alternative of taxing labor income at the personal level while taxing capital income minus investment (business cash flow) at the business level would be administratively simpler. My former CEA colleague, Princeton's David Bradford, has designed such a tax.

This approach to the tax base, with a flat rate, is the so-called flat tax. Although common usage calls it a flat-rate income tax, the flat tax taxes labor income at the personal level and capital income minus investment at the business level at the same proportional rate. Some of the simplicity is a result of the single rate, as various transactions just net out, such as a business deducting interest paid and a household paying taxes on interest received, because these would be at the same rate. Some progressivity is introduced into the flat tax with high personal exemptions that remove many households from the income tax rolls. Whereas the tax rate is constant, the ratio of taxes to income rises with income until it gradually approaches the flat rate, i.e., the flat rate tax is progressive, but obviously less so than current law (see below). For example, if the exemption level for a family of four were set at $25,000, a family earning $25,000 would have an average tax rate of zero; one earning $50,000 would have an average tax rate of 10 percent if the flat rate is 20 percent (20 percent on

the $50,000 minus the $25,000 exemption); a family earning $100,000 would have an average tax rate of 15 percent (20 percent on $100,000 minus $25,000); at extremely high earnings, the average tax rate gets very close to the marginal rate of 20 percent.

The value-added tax (VAT), which is in widespread use in other countries, (although, as mentioned above, it is often used as the way to finance much larger government spending), also usually taxes income minus investment, i.e., allows immediate deduction of full capital expenditures rather than gradual depreciation over a number of years. It does so for each good and service by taxing value added at each stage of production. Adding up across stages of production and across all goods and services leaves the tax base as aggregate income minus investment, or aggregate consumption in the economy. As a technical matter, among types of VATs, a subtraction method VAT with destination-principle border tax adjustments on balance would be better than the other types of VATs.

Each of these alternatives has its pluses and minuses. I can only begin to mention a few here, using the criteria above. If it could completely replace the corporate and personal income tax, a national retail sales tax probably in the end would be the simplest to administer and do the best job at getting at the underground economy. It might also tie taxes and spending more closely, or at least continuously. Some argue it would encroach on the states' revenue source. With no income tax, there would be no deductibility of state and local income taxes and no tax-exempt bonds (the same would be true in a pure flat tax with no deductions, although lower interest rates would partly offset this effect). A broad-based indirect consumption tax would be rebatable at the border under WTO rules and avoid the thorny international tax issues with which the House and Senate are now grappling. To the extent refundable credits and/or exemptions were necessary, tax rates would have to be higher and the advantages of a low-rate broad-based consumption tax would be diminished.

The same is true of a value-added tax, which, although it has a self-policing feature, is somewhat more complex than the retail sales tax but still relatively simple compared with income taxes. A VAT, however, unlike a retail sales, tax, *may* loosen the tie between taxes and spending from the standpoint of the taxpayer consciously "feeling the pain" of taxation. In either case, a large distinction should be drawn between using a VAT to replace income taxes fully, or simply adding a new tax vehicle which could be used to expand the scope of government and reduce the rigor of the cost benefit tests that should be applied to spending decisions.

The flat-rate tax would be a major improvement over the existing income tax system on efficiency grounds, but again, to the extent that exemptions, deductions and such were left in place or crept back in over time, some of its advantages would be eroded. Of course, while progressive, it is less progressive than current law and also than the likely integrated corporate and personal consumed income tax with progressive rates. And, as with a broad-based sales tax or VAT, I would be concerned that small increases in the rate would raise lots of revenue and that, over time, we would evolve back toward a higher-rate system *unless spending was strictly controlled.*

B. Deductions, Credits

Every deduction in the income tax has its supporters – including the direct beneficiaries – and an apparent rationale. A deduction or credit alters the price of the activity in question to one minus the marginal tax rate or one minus the credit rate, respectively. In some cases the response may be sufficient to render a deduction or credit efficient in promoting the desirable behavior relative to the lost revenue. But the general interest in lower rates and a healthier economy overwhelms almost, perhaps all such arguments.

The two I would be most concerned about are the mortgage interest deduction and the charitable deduction. The United States does favor

investment in housing relative to corporate plant and equipment compared to most other countries. The equity in their home is the largest asset for a majority of American families, and home values reflect the value of the mortgage interest deduction. Perhaps a gradual transition could mitigate this effect. I believe charities strengthen a pluralistic democracy, and the charitable deduction may well be an efficient way to finance charities. We are all better off having thousands of charities doing their good deeds than to have them replaced by government agencies. Note that these deductions also vanish with a retail sales tax or VAT. Some of the same federalism issues arise if there is no deduction for state and local taxes and local government bonds lose their tax-free advantage. Finally, to strengthen or make more obvious the tie between taxation and government spending, some have suggested abolishing withholding, but this would add additional administrative and compliance costs.

C. Tax Rates

I noted above that the harm done by taxes distorting economic decisions goes up with the square of the rates. Thus, from the standpoint of economic efficiency, the lowest possible tax rates are desirable. But what about equity, fairness? Doesn't equity demand steeply progressive tax rates? The original academic answer to this question dates back about a century and assumed high, indeed prohibitive tax rates did not affect economic behavior. But it is obvious that, at some point, tax rates not only distort economic decisions but can reduce the tax base considerably, in the extreme enough to decrease revenue. (At current rates, the tax base changes about -0.3 times the percentage change in rates; while this is not supply-side nirvana, the supply –side response is large enough to merit consideration in tax policy.)

Thus, taxpayer responses to tax rates constrain the top marginal tax rate to be quite modest. Most academic studies, using plausible empirical estimates of labor supply and other responses, would cap the top rate at around one-third for <u>all</u> taxes at current spending levels. This insight from so-called optimal tax

theory provides an explicit method for combining and trading off the several desirable features of tax systems, e.g. efficiency and equity.

Back in the Eisenhower Administration, six out of every seven dollars of the much-smaller federal budget were spent on purchases of goods and services. Today, about half are on transfer payments. Thus, equity concerns no longer extensively focus on how to "fairly" apportion tax burdens, but also on how to efficiently finance transfer payments that preserve work incentives. Explicit transfers such as temporary assistance to needy families (TANF) are supplemented by large and rapidly growing transfers in the income tax, such as the EITC and other refundable credits, by in-kind programs such as Medicaid, and by social insurance programs, especially Social Security and Medicare. Shifting around the tax burden among the upper half of the income distribution won't affect the after-tax and transfer distribution of income nearly as much as the size and structure of these transfers payments. Modern optimal tax theory strongly supports such negative taxes, but again at a modest level, generally totaling roughly one-third of average income.

It should be noted that the current tax system is extremely progressive (*see chart*). The top half of the income distribution pays over 95% of income taxes; the top 1% pays over 37%. The bottom half of the income distribution pays almost no income taxes (see inserts).

Summary of Federal Individual Income Tax Data, 2000

	Number of Returns	AGI	Income Taxes Paid	Group's share of Total AGI	Group's Share of Income Taxes	Income Split Point	Average Tax Rate
	0	($000,000)	$(000,000)				
All Taxpayers	128,227	6,423,977	980,521	100.00%	100.00%	-	15.30%
Top 1%	1,282	1,336,773	366,929	20.80%	37.40%	above $313,469	27.40%
Top 5%	6,411	2,267,403	553,670	35.30%	56.50%	above $128,336	24.40%
Top 10%	12,822	2,955,386	660,150	46.00%	67.30%	above $92,114	22.30%
Top 25%	32,057	4,313,786	823,706	67.20%	84.00%	above $55,225	19.10%
Top 50%	64,114	5,589,755	942,179	87.00%	96.10%	above $27,682	16.90%
Bottom 50%	64,114	834,222	38,342	13.00%	3.90%	below $27,682	4.60%

Source: taxfoundation.org

Total Income Tax Share
(percentage of federal income tax collections paid by each group)

	Total	Top 1%	Top 5%	Top 10%	Top 25%	Top 50%
1980	100.00%	19.05%	36.84%	49.28%	73.02%	92.95%
1981	100.00%	17.58%	35.06%	47.96%	72.29%	92.55%
1982	100.00%	19.03%	36.13%	48.59%	72.50%	92.65%
1983	100.00%	20.32%	37.26%	49.71%	73.10%	92.83%
1984	100.00%	21.12%	37.98%	50.56%	73.49%	92.65%
1985	100.00%	21.81%	38.78%	51.46%	74.06%	92.83%
1986	100.00%	25.75%	42.57%	54.69%	76.02%	93.54%
1987	100.00%	24.81%	43.26%	55.61%	76.92%	93.93%
1988	100.00%	27.58%	45.62%	57.28%	77.84%	94.28%
1989	100.00%	25.24%	43.94%	55.78%	77.22%	94.17%
1990	100.00%	25.13%	43.64%	55.36%	77.02%	94.19%
1991	100.00%	24.82%	43.38%	55.82%	77.29%	94.52%
1992	100.00%	27.54%	45.88%	58.01%	78.48%	94.94%
1993	100.00%	29.01%	47.36%	59.24%	79.27%	95.19%
1994	100.00%	28.86%	47.52%	59.45%	79.55%	95.23%
1995	100.00%	30.26%	48.91%	60.75%	80.36%	95.39%
1996	100.00%	32.31%	50.97%	62.51%	81.32%	95.68%
1997	100.00%	33.17%	51.87%	63.20%	81.67%	95.72%
1998	100.00%	34.75%	53.84%	65.04%	82.69%	95.79%
1999	100.00%	36.18%	55.45%	66.45%	83.54%	96.00%
2000	100.00%	37.42%	56.47%	67.33%	84.01%	96.09%

Source: taxfoundation.org

A few observations on equity or progressivity are worth noting. First, while Social Security payroll taxes are a proportional tax on wages (up to the cap for OASDI, on all wages for HI), and including payroll taxes would render the overall tax system less progressive, payroll tax revenues are dedicated to financing current and future Social Security benefits. Social Security benefits are quite progressive; hence, so is the Social Security system. In any event, in analyzing the allocation of tax burdens to finance general spending or non-Social Security transfer payments, earmarked payroll tax revenues are not directly part of the story.

Second, moving to an integrated personal and corporate consumption tax might require slightly higher rates than if saving were (doubly or triply) taxed. Since in the U.S., the saving rate is low (partly because of the tax system), this effect would be small. Further, most reform proposals would further broaden the tax base by eliminating many deductions and other credits, thereby enabling rate reduction.

Third, annual distributions of tax burdens and of income can be quite misleading. There is a lot of income mobility over time. Also, there is a natural life-cycle earnings profile that leads to concentration of annual income and saving (wealth) by age. Thus, even if everyone had the same lifetime income, a snapshot at any point in time would reveal a quite unequal annual income distribution, as workers in their 40s and early 50s would be "rich", retirees "poor", younger workers "middle-income", even though they were all identical. To be sure, there are many other factors affecting income inequality.

Fourth, there are two other dimensions of equity besides current or lifetime income or consumption: horizontal equity and intergenerational equity. Horizontal equity refers to the equal treatment of similarly situated individuals. While this itself has several dimensions, one very important dimension is equal treatment of taxpayers with similar average, but very different annual, incomes. Consider twin sisters, one a high school principal, one a real estate broker, who

each average $60,000 a year. One (the principal) makes $60,000 every year; her sister makes $30,000 and $90,000 in alternate years. Thus, an annual tax with progressive rates with no income-averaging provisions (as those that were removed in the 1986 tax reform) would tax the fluctuating income more heavily.

Finally, while it is beyond the scope of the testimony, the incidence of taxes across generations is closely tied to public debt and intergenerational transfers such as Social Security. Public debt implies future tax payments to finance interest (and/or repay principal). Pay-as-you-go financed Social Security benefits transfers resources from current younger taxpayers to current retirees. Both public debt and intergenerational transfers affect saving and capital accumulation as do taxes on saving such as the personal and corporate income taxes. Thus, the choice of tax base is closely related to public debt and Social Security policy.

D. The Unit and Time Period of Account

The U.S. tax system relies on a modified family basis as the unit of account. Most families file "married, filing jointly". There are numerous social, economic and legal (community property states) reasons for the family as the basis of account. Some tax systems, for example in Scandinavia, rely more on the individual filing separately and allocating capital income between spouses. The U.S. Social Security system collects taxes on an individual basis, but pays benefits on a modified family basis. I support the family as the basis for the personal tax, but with progressive rates two additional problems emerge. First, family income fluctuates considerably in response to temporary movements in and out of the labor force, for example, due to childbirth and rearing. This creates the horizontal equity problem mentioned above. Further, taxing based on pooled family income places very high marginal tax rates on the first dollar earned by second earners in families, where labor supply may be much more

responsive to tax rates than primary earners. Perhaps the best way to balance all these concerns is to make sure the tax rates are low.

In discussing horizontal equity, I introduced income averaging over time. A Nobel laureate economist, William Vickery, was so concerned about the efficiency and equity of an annual income tax that he proposed cumulative lifetime averaging of income for tax purposes. While a theoretical possibility, the fact that income averaging over a four-year period was eliminated as too complex in the 1986 tax reform calibrates how impractical it would be to average over very long periods. As I pointed out two decades ago, there is a clear relationship, interconnection, among the time period and the rates, base and unit of account. To take this most important relationship for our purposes here, most households (perhaps three-quarters) consume out of a longer-term average or permanent income. If income is temporarily high or low, they don't adjust their consumption proportionally. Thus, an annual tax on consumption provides some indirect averaging. Indeed, for most households, consumption would better measure permanent income than would current income. Finally, lifetime income is consumed over the lifetime (other than bequests), so an annual consumption tax approximates a lifetime income tax (again, other than bequests).

E. Automatic Stabilizers

There is one feature of the choices of tax base and rates that used to be heavily emphasized as a feature of the tax system: automatic stabilizers. These are tax (or spending) features that tend to stabilize private spending and hence the economy when income fluctuates. In a boom, people are driven into higher tax brackets; the opposite in a bust. Hence, after-tax disposable income is stabilized by progressive rates. While modern macroeconomists would consider the automatic stabilizers less effective than in old-fashioned Keynesian theory, which had consumption a function of short-run disposable income, nonetheless these properties are worth considering as well as traditional efficiency and equity concerns in the design of fundamental tax reform. Two additional points on the

automatic stabilizers are important. First, as the recent boom/bust cycle demonstrated forcefully at the state as well as federal level, the political budgeting process can be very volatile over the cycle. In my own state of California, which was the epicenter of the Internet boom and which has a very progressive income tax that taxes capital gains as ordinary income, the extra revenue from income growth, bracket creep, stock options and capital gains was not only immediately spent, but built into the spending base as if the economy would grow rapidly, and the stock market bubble continue, forever. With the bursting of the bubble, revenue collapsed. With hindsight, perhaps a more stable revenue source might prevent such wild swings. Indeed, certainty of revenue was one of Adam Smith's Four Canons of Taxation.

Second, however, this raises an interesting dilemma. In some sense the government should have broader concerns than just its own revenue. It might look to cushioning the fluctuations in private after-tax incomes, not just its revenue. To play this "insurance" role to households and firms, the government must accept these fluctuations in its revenue.

IV. Conclusion

The theory and empirical studies developed in recent decades by academic public finance experts, often called optimal tax theory, strongly endorses an (explicitly or implicitly) integrated business and personal tax which taxes broad consumption at low rates and includes transfers (negative taxes). As discussed above, there are several approaches to implementing such a system. What is likely to be gained by moving to one of these tax systems? Will it be worth the substantial political capital and transition costs to various families, firms, industries, and economic disruption that accompany any major tax change? The answer, in my opinion, is that the gains are *potentially* quite large. In this year's Presidential address to the American Economic Association, Nobel Laureate Robert Lucas of the University of Chicago reviews the literature and estimates long-run gains in consumption of 7.5-15% from replacing the current

corporate and personal income taxes with a broad-based, direct or indirect tax on consumption or consumed income. This occurs because the increased saving and capital formation increase wages and future income. These are large potential gains, on the order of a decade's worth of per capita consumption growth. It is hard to find another policy reform with that large a potential payoff. In this regard, the recent rate reductions and dividend and estate tax relief are steps in the right direction. If a fundamental overhaul of the tax code is not possible in the near future, further piecemeal reforms consistent with the desirable fundamental tax reform, such as expansion of tax-deferred saving, should be undertaken, with due regard to the long-run fiscal outlook.

Statement of

Cliff Massa III

Submitted to

The Joint Economic Committee

United States Congress

November 5, 2003

Summary

Chairman Bennett's invitation asked for my views on fundamental tax reform and simplification as well as my thoughts about the long-term endurance of any tax reform that can be enacted. In summary form, these are my views:

1. The individual and corporate federal income tax system should be replaced with a "business activities tax" that is constructed by applying rigorously the six principles discussed later in this statement. Among the benefits of such a replacement would be the following:

   - remove individuals from the tax collection and remittance processes altogether (except for those who are sole proprietors of their own businesses), thereby reducing drastically both the sources of political pressures for tinkering and the number of taxpayers needing to file returns while enhancing the ability of the IRS to audit properly;

   - eliminate the endless refinements that are enacted to shut down creative tax planning that is related to characterizing income (ordinary vs. capital gain) and to realizing income (artificial losses now vs. income later) along with the enormous complexities of depreciation/amortization/capitalization;

   - put in place a simpler and more stable tax base (the value of goods and services consumed rather than income – however it is measured);

   - provide our country with a ***legal*** way to remove a federal tax burden from exports while imposing it on imports; and

   - at least offer to states an opportunity to use a model that could provide benefits to their revenue systems as well.

2. If government and taxpayers can summon the political will to replace the current income tax with a clean and simple consumption-based system (recognizing that "simple" is a relative term in an economy such as ours), that may be the best safeguard against eroding reform. Statutory super majorities and Constitutional amendments may be useful, but the ability to point to the increase in the single tax rate on everyone else resulting from efforts by a few to gain favored treatment could be a far more effective deterrent to erosion than elaborate rules.

Background

As a tax lawyer by training and a tax policy lobbyist for most of my career, I have studied various alternatives to the income tax for about 20 years. My views have evolved over time as I have worked with clients to understand different approaches and have worked with former Members and staffs in the development of both concepts and specific legislative drafts.

A few years ago, I was the vice chair and then the chair of the Committee on Value Added Taxes of the Tax Section of the American Bar Association. That period of service coincided with the development and adoption by the Committee of a comprehensive set of principles that should be applied if the federal government ever enacts a consumption-based tax. The Committee was comprised of law school professors, corporate tax vice presidents, policy attorneys like me and tax practitioners from large and small law firms around the country. Getting agreement on these principles from people who have studied VATs around the world, sales taxes in this country and other formulations was not automatic, but it probably was not as difficult as some of us feared when we began the project because there was a great deal of knowledge around our meeting table.

The surprise for me was that our Committee's work was adopted by the Tax Section at a plenary session in January 2000 with only one audible "no" vote among the few hundred voting members. While the ABA House of Delegates did not adopt the policy as a formal position for the whole organization, the adoption by the Tax Section of the principles and the accompanying explanatory report are akin to a "man bites dog" story because it was a statement by tax attorneys in private practice, in companies and in the academic community whose livelihoods are, to varying degrees, significantly enhanced when tax rules are complicated and perpetually changing. They understand the issues and they spoke accordingly.

Attached to this statement is the formal resolution of the Tax Section and the accompanying report. It is attached solely for your information because I am not representing the Tax Section here today. In fact, the views I express to the Committee are my own and cannot be attributed to anyone else. Also, please note that neither my Committee nor the Tax Section endorsed replacing all or part of any existing federal tax with a consumption-based tax, although I do.

My policy perspective

My support for replacing the income tax is based partially on economics and partially on a desire for efficiency. I will summarize these views here just to provide context for the recommendations regarding a new system.

The economic case for replacing the income tax is, for me, obvious and strong. The federal government needs a general revenue tax to meet its general revenue needs (leaving aside at this point the Social Security taxes, gasoline taxes, *etc.*). The strongest possible economy should be the most reliable generator of a predictable stream of tax revenues, so a tax system should seek to extract such revenues without imposing any more drag on the private sector than is the inevitable result of removing resources from the private sector for use in the public sector.

The income tax does not meet that objective. It is a substantial burden on the very economy from which it is expected to produce revenues. I am not entering here the debate

about whether the total tax burden is too high or not or whether double taxation of corporate income is too high and so on. Instead, my point is that the income tax diverts tens and probably hundreds of billions of dollars annually from productive investments in our economy and into the incomes of tax lawyers, accountants, financial planners and other professionals who engage in tax administration and compliance as well as in perfectly legal tax planning that is based on all the carrots and sticks that have been put into the Internal Revenue Code over a long period of time to induce individuals and companies to do certain things and not to do others. These professionals earn quite good livings doing nothing more than helping clients manage their taxes. They are some of the hardest working people with some of the best business and financial minds in the country; if they were not, they could not succeed in this work. But is this a good public policy result?

Now, add to this planning, administration and compliance work the extensive efforts of all kinds of organizations and their representatives here in Washington who devote countless hours to attempting to change the Code or not to change the Code or both on different issues at the same time, and who do so year in and year out. Whether representing businesses or unions or exempt organizations or public groups or any other entities, the amounts of money paid for the services of these people and the brainpower that is not being devoted to other issues are both substantial.

On top of what it does to the private sector, consider how much time you and your colleagues and your staffs and the professionals in the Treasury and IRS spend in refining the Code and trying to shut down the latest shelter schemes while also using the revenue system as an economic and social policy tool. Though it might be less interesting to serve on the Finance Committee and on the Ways and Means Committee, would a rational tax system improve the ability of Congress and the Administration to make decisions about how to *spend the money* that such a system produces? My personal view is "yes, if" and the "if" is important.

If we could replace the income tax with a simple and more stable consumption tax that is based on principles described below, then the change would be worth the considerable hassle of overcoming the significant obstacles between here and there – both political and substantive, such as transition rules and related spending issues and others, I'm sure. However, if the result is to replace the mess we already know with another mess that we don't yet know, then the effort is not worth beginning.

Principles to apply

Revising somewhat the principles developed by the Tax Section committee, I believe that a federal revenue system based on the value of goods and services consumed in this country should replace the federal income tax – *but only if it is enacted with a firm commitment to these principles:*

1. A tax system that is imposed on consumption should use the most comprehensive definition of "value-added" as its base, should apply only one rate of tax to that broad base and should provide no exemptions, exclusions, deductions, credits, multiple rates or other rules that grant favored treatment to or impose punitive treatment on particular sectors of the economy or on specific goods or services.

2. All businesses and organizations engaging in sales of goods or services as a business activity should be taxable without regard to their particular legal structures or profit motives.

3. The "destination principle" should be used, consistent with our international trade agreements, to prevent both double taxation and undertaxation in international activities.

4. Any efforts to offset perceived "regressivity" of a consumption tax should be created and administered outside the consumption tax system itself to assure that principles 1 and 2 above are not undermined as well as to assure that large amounts of revenues aren't lost by providing such tax savings to tens of millions of unintended beneficiary households.

5. In those sectors for which explicitly stated prices for services are not available (financial intermediation is a prime example), alternative mechanical rules should be applied to assure that all value-added created by these sectors in their business activities is included in the overall tax base.

6. Recordkeeping and reporting rules for businesses should be as simple as possible. Arguments about administrative convenience may suggest that small business exemptions or similar devices are desirable, but these should be weighed against the likelihood of tax avoidance opportunities, competitive distortions and other possible problems.

Options available

Four principal models have been developed and put into legislative drafts over the last 20 years, and my own work has led me through all of them. My personal "spectrum" of choices from least useful to the most useful is summarized below along with a few comments on why I place each one in its position from least to most useful.

1. **Flat tax**

Compared to retaining the income tax, enactment of a pure flat tax would be a better option, but not by much. For this purpose, a flat tax would be a split tax base system (i) with businesses taxable on the sum of receipts from sales of goods and services minus costs of goods and services purchased from other businesses minus compensation paid to employees and (ii) with individuals taxable on compensation received from the businesses for which they work. The same single rate would be applied to both businesses and individuals. In this form, a flat tax would have a lot to offer in terms of simplicity and avoiding the distortions of behavior caused by multiple tax rates and lots of deductions, credits, exemptions, exclusions, *etc.*

But flat tax proposals do not come in this form. Rather, they tend to have at least a personal exemption or household exemption that removes a substantial amount of the otherwise taxable base, thereby pushing up the rate needed to generate the needed revenues. They also come with proposals to allow some additional deductions for mortgage interest and/or charitable contributions and/or other items. By having individuals in the tax system, by attempting to offset perceived effects on households through the tax law and by providing special rules intended to favor particular activities over others, the typical flat tax proposals set the stage for recreating the system we now have. Also, even if it were "pure," it would not permit a "border adjustable" feature for exports and imports.

So, while starting off better than the current system, the flat tax would put back into play the pressures that have brought us to the state of current law.

2. Sales tax

Next would be a national sales tax. This would be a better option than the flat tax. For this purpose, the sales tax would impose a single rate on each retail sale of goods and services – meaning a sale to a person who consumes the good or service rather than using it in a business activity. It would be applicable to the retail sale of imported goods and services, and it would not be applicable to the export of goods and services to purchasers in other countries.

The sales tax has much to offer. By removing individuals from the collection and remittance process, the administration of the system will rely on a relatively small number of businesses. This also reduces the pressures that could be brought to bear under a flat tax for special provisions for particular groups of individuals. Furthermore, it can be applied with the border adjustment feature as noted.

But the sales tax also poses the greatest risk to the government that revenues will not be collected while imposing the greatest difficulties on untold numbers of businesses every day. The revenue risk arises from the fact that the tax only applies at the last possible point – namely, the sale to the ultimate consumer. When fraud occurs, the government loses the tax attributable to the full retail value of the final good or service because there has been no intermediate collection. This will place a premium on administration and enforcement by the IRS with respect to retail sellers – probably the smaller businesses and those with more cash sales than credit card sales. But the principal problem may well be faced by the honest business which must question each customer about whether the good or service being sold is going to be used by the purchaser in a business (in which case the sale is excluded from the seller's tax base) or is for personal consumption (in which case the sale is taxable). While this will not be a problem for many companies which sell only to other businesses, it will be an enormous problem for those which sell to both businesses and consumers all day every day. The resentment that is likely to set in cannot be overestimated.

Also, the sales tax is subject to the pressure to apply multiple tax rates, as is the case in the states today, and/or to exempt certain items altogether. When the sale of food, for example, is taxable at a lower rate than clothing, the rate on clothing and all other goods and services must rise. An equally troubling problem is the fact that such distinctions will set off sustained efforts to have particular goods or services placed into ever-growing lists of what is subject to the lower rate (or exempt altogether). For example, how much fruit juice must a beverage contain to be treated as nontaxable food vs. a taxable beverage? When does an elective medical procedure move from being a reduced rate medical service to a standard rate "vanity" procedure?

While a sales tax would offer benefits compared to both the flat tax and current law, the risks are high that the system would be troubled by fraud and increasing complexity within a short time.

3. European-style VAT

Next in the line of improvements would be the European-style VAT that is used in most other industrialized countries. This would offer considerable improvements over both current law and a flat tax while lessening considerably the revenue loss from fraud under the sales tax

and avoiding altogether the customer-by-customer inquiries that the sales tax makes inevitable. For this purpose, the VAT would be imposed on every business on every sale of goods and services by that business. The VAT rate would be applied to the price and be paid by the customer at the time of the purchase. At the end of the tax reporting period, the business adds up the VAT amounts on all of its sales and then adds up the VAT it has paid on all of its purchases. The aggregate amount of VAT paid is credited against the aggregate amount of VAT on its sales, and the business remits the net VAT to the government.

The merits of the VAT are many. Like the sales tax, it removes individuals from the system. But unlike the sales tax, the VAT minimizes the risk of revenue loss from fraud by imposing the tax on each stage in the production and distribution of goods and services rather than waiting until the last possible moment – the retail sale – to generate revenue. Even if retail sales are the subject of evasion, the earlier stages are likely to have generated a significant portion of the tax that would otherwise be lost under a sales tax. The VAT also eliminates the need for the business to quiz the customer about whether the purchased good or service will be used in a business or be consumed. Since the business is taxable on its own value-adding activities, the nature of the customer is irrelevant. If the customer is a business purchaser, it will in turn credit the VAT paid against the VAT it collects from its own customers. If the customer is the ultimate consumer, no credit will be available to it. Also, the VAT is subject to border adjustments, meaning it can be applied using the destination principle that imposes it on imports and does not impose it on exports.

But the VAT also carries one significant weakness that is identical to the sales tax – namely the ability to using differing rates and exemptions to provide preferential and punitive treatment, with all of the complexities that such variations produce. In fact, the history of the VAT in other countries demonstrates this weakness clearly. I know of no countries that have imposed a single rate on the broadest possible tax base. The tendency to turn a VAT into a very complicated system with perpetual arguments and lobbying to affect definitions of particular categories of goods and services is evident around the world.

So, while offering substantial benefits over current law, the flat tax and the sales tax, the VAT still comes up short.

4. Business activities tax

The final option is the one that I believe is the best – the business activities tax. For this purpose, the business activities tax looks very much like the familiar VAT but it is computed somewhat differently. Rather than applying the tax rate to each sale to each customer and then "crediting" aggregate purchase VATs against aggregate sales VATs, this system simply requires the business to add up sales revenues, subtract the costs of its purchases, apply the tax rate to the difference and remit the tax to the government. This "subtraction method" tax applies to the same tax base as the VAT and the sales tax; only the computation is different.

But that computation is a significant substantive difference. While presenting all of the merits of the VAT such as multi-stage taxation, no need to quiz each customer about the use of the purchased item, being border adjustable and so on, it does not present the VAT's great weakness – namely, the ability to impose varying rates of tax (including the zero rate) on particular goods and services. While multiple rates are possible under the VAT because each sale is subject to the applicable VAT rate which is then recorded, the business activities tax cannot be administered in that way. Only aggregate sales data are required, so attempting to

break down that data into sales of widgets at one rate and wadgets at another rate and wudgets at yet another rate just doesn't work.

While the computation of tax using the subtraction method is not an iron-clad guarantee of success, the business activities tax does provide the best combination of features from the principles that need to be used. If we find the will to make a change, we should seek to make the change that offers the best results and the best prospects for remaining in place. I believe that the business activities tax offers both.

One additional observation needs to be made. There are a host of conceptual and technical issues that would need consideration when developing any one of these four basic alternatives, so I do not intend to suggest that the factors I have mentioned are the only important ones. For example, the "visibility" or "invisibility" of a tax inspires passionate debate, but a sales tax or a VAT or a business activities tax can be required to show up on every invoice or sales receipt or it can be invisible to the customer by imposing a lower rate on a higher grossed-up price. Once basic decisions are made on questions like this, statutory drafting can produce a wide range of details to flesh out the few factors I have covered here.

Conclusion

For decades, we have debated the question of ***how much we tax ourselves*** in this country. Important as that is, we need now to give serious attention to ***the way in which we tax ourselves.***

Just consider the primary stories in the tax press in recent memory -- tax shelters, corporate inversions, replacing the ETI provisions to avoid European Union trade sanctions, tax credits to subsidize various alternative energy sources. Controversies over these and many other issues have arisen from the evolution of the income tax from a small revenue source 90 years ago to a major tool for changing government policy priorities that is also expected to generate huge amounts of general revenues. These controversial issues are natural results of clinging to the income tax for both the revenue and policy purposes. As long as we insist on sticking with it, such problems will only continue to divert brainpower and private sector dollars into activities that don't do all that much for the economy as a whole.

Surely it is time to consider scrapping the income tax and putting something clean, efficient and simple (relatively speaking) in its place. Tax shelters won't be a problem when "income" is not the tax base. Corporate vs. non-corporate forms of business would no longer be important. Elaborate depreciation rules and other timing devices become irrelevant when the only question is "when did you buy it?". Domestic vs. foreign operations would not be treated differently because only the destination of the goods and services you sell would be important. Squabbles with trading partners over our illegal export subsidies won't be a problem under a business activities tax.

All of this being said, I have no illusions about what would be required. In an economy as large and complex as ours, no consumption tax is going to be "simple" in the absolute sense. Financial services, international transportation, governments and "exempt entities" selling goods and services – these are some of the matters that would require detailed rules under a consumption tax. But a good one – particularly the business activities tax with the recommended principles in action – would be *simpler* and much less of a drag on the economy.

Attachment

Attachment

Note: The following resolution and the accompanying explanatory statement are attached to this statement solely as reference documents with respect to the views of the Tax Section of the American Bar Association. The resolution was not adopted by the ABA House of Delegates as a formal policy statement of that organization.

Cliff Massa III

June 1, 1999

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION
REPORT TO THE HOUSE OF DELEGATES

RESOLVED that the American Bar Association recommends that a new tax that is applied to a personal consumption base should generate revenues efficiently, avoid distorting private sector activities and not be used to implement other policy objectives; that a tax that is constructed on the following principles can achieve these results; that principles 1 and 2 are the fundamental rules; and that subsequent principles address particular situations and activities that require variations from or elaboration on the two basic principles.

FURTHER RESOLVED that the American Bar Association affirms that this policy statement is a resource for providing guidance to federal policy makers who may consider a new tax imposed on consumption; that it is not a recommendation that a new consumption-based tax be considered either as an additional tax or as a replacement for an existing tax system; and that it is not intended to provide principles applicable to the income tax.

FURTHER RESOLVED that the American Bar Association adopts the following principles for the purposes stated above:

1. A tax system that is imposed on personal consumption, whether all at once (such as under a retail sales tax) or in increments (such as under the VAT, flat tax and business activities tax proposals), should use the most comprehensive definition of "value-added" as its base and should apply only one rate of tax to that broad base. No exemptions, exclusions, deductions, credits, multiple rates or other rules should either grant favored treatment to or impose punitive treatment on particular sectors of the economy or on specific goods or services.

2. Under a consumption-based tax, all persons and entities engaging in sales of goods or services for consideration in a business activity should be taxable without regard to their particular legal structures or profit motives.

3. As long as the national consumption taxes imposed by our major trading partners continue to apply the destination principle, a U.S. consumption-based tax system should apply this principle under rules which are consistent with our international

trade agreements to prevent both double taxation and undertaxation in international or other interjurisdictional contexts.

4. If the political process seeks to create any offsets to perceived "regressivity" of a consumption tax, such offsets should be created and administered outside the consumption tax system itself to assure that principles 1 and 2 above are not undermined.

5. Explicitly stated prices which would normally be used in computing tax liability under a consumption tax often are not available with respect to the sales of goods and services by financial intermediaries, gaming businesses, government entities and income tax exempt organizations. In such situations, alternative mechanical rules should be developed and applied to assure that all value-added created by these sectors in their business activities is included in the overall tax base.

6. If a consumption-based tax increases federal tax collection and remittance obligations of businesses, its recordkeeping and reporting rules should be as simple as possible. Administrative convenience may suggest that dollar sales thresholds or other mechanisms be used to exclude the smallest businesses from the tax net. The extent to which these mechanisms are used should be weighed against the risks of avoidance planning opportunities, competitive distortions and other possible problems.

7. The following principles should apply to collateral issues which are not directly related to the operation of a new federal consumption tax itself.

   a. Both a transition period and potential transition rules should be constructed with great care at the same time the tax is being developed.

   b. Any federal personal consumption tax should be constructed so that state and local governments can either adopt a new system or revise their existing systems to "piggyback" on the new federal tax.

   c. The United States should honor its treaty obligations and should require treaty partners to do the same. All countries should avoid double taxation, prevent discrimination, minimize tax avoidance and prevent evasion of continuing tax obligations while assisting each other in enforcing their consumption taxes.

June 1, 1999

DISCUSSION

The Purpose and Structure of this Policy Statement

The policy statement has been adopted to provide substantive guidelines which the Section of Taxation of the American Bar Association can use when it is asked to comment on the development of any new federal tax that is to be applied to a consumption base. The statement does not represent and may not be used to suggest that the Section of Taxation takes a position regarding either the desirability of enacting such a tax or the use of such a tax as either an additional tax or a replacement tax.

The principles in the policy statement – particularly principles 1 and 2 – are well supported by scholarly studies, but here they are based on simple common sense that is reinforced by decades of experience with foreign value-added taxes ("VATs") and domestic sales tax systems which have not applied such principles. The first two principles are the fundamentals which should guide the development of a consumption-based tax. Subsequent principles elaborate on issues that require particular attention.

The policy statement might be characterized as proposing an ideal tax rather than providing realistic guidance to policy makers who will be subject to a range of political pressures to deviate from the ideal. However, it is the responsibility of the Section of Taxation to make recommendations for achieving the best possible tax system. It is the policy makers – not the Section – who will make the political decisions after considering the substantive advice that is given to them.

Even in this context, the policy statement expands on the strong "ideal" recommendations presented in the first two principles by elaborating on them in principles 3 and 4 and by proposing more flexible rules for certain situations in principles 5 and 6 and, finally, by calling attention in principle 7 to issues which require attention even if they are not directly linked to the substance of a new tax itself. All together, these principles are a comprehensive set of guidelines which take into account that achieving the ideal tax for the economy as a whole will require some administrative flexibility and careful attention to the handling of collateral issues.

With this overall purpose and structure in mind, the following discusses the preamble and each of the seven principles in the policy statement.

The Overall Concept

The mutual interest of both taxpayers and government can be well served by a tax system which produces the desired revenues from the maximum level of voluntary self assessment with the least amount of government administrative cost, of private sector compliance costs and of disruption of the economy which actually produces the resources from which taxes are paid. Enthusiastic support for any tax may be an unrealistic objective, but adequate public support is essential if a tax is to produce these optimal results.

Public support for a new tax can weaken as the tax expands to fill countless pages of statutes, regulations and rulings which even government administrators and private sector specialists have difficulty understanding in their entirety. A complicated tax also is more

susceptible to suspicions that it provides special benefits to those capable of paying for tax avoidance advice or to whole groups/economic sectors with significant political clout or, generally, to lots of people other than "me." Put bluntly, the concern is that the complications must be hiding something for someone; otherwise a simpler set of rules would apply to everyone.

A federal proposal for a tax based on consumption will provide an opportunity to develop a system which serves only the essential but relatively simple purpose of generating a desired amount of revenue. There are many examples of foreign VATs and of domestic state and local sales taxes, but these generally are poor models to follow. With few exceptions, these systems are very complex as a result of attempts to achieve purposes which are not related to raising revenues. Such complexities create substantial amounts of work for government administrators and for tax professionals in the private sector while creating numerous problems for consumers, businesses and other organizations.

The policy statement constitutes a strong recommendation that enactment of any new tax applied to a consumption base be taken as the opportunity to confirm a simple and clear philosophy for federal taxation – namely that a general tax should be drafted to achieve its revenue-raising purpose with minimal impact on the private sector. A tax which does not seek to alter economic behavior can provide a more stable and predictable tax base for the government's revenue needs because it does not distort economic decisions within the private sector which generates those revenues.

Principle 1

The taxes covered by this policy statement are often described as "consumption taxes" because the tax base is the aggregate amount of personal consumption in the economy. Labels such as "sales tax," "VAT" and "flat tax" can be useful as shorthand descriptions of the mechanics of a particular tax, but the tax bases are essentially the same. Each tax is applied to the total amount of economic value embodied in the goods and services that are consumed in the country.

For example, "retail sales tax" generally describes a system which imposes a tax on the sale of goods and services to the retail customer who uses them for personal consumption rather than for resale or for another business activity. The final retail sales price equals the total amount of value that has been added to the goods and services being consumed. "VAT" is the acronym often used to describe a tax on consumption that is collected from each business in the economy based on the increments of value they have added to goods and services (computed as the excess of their sales over their purchases to avoid multiple taxation of the same value-added); in the aggregate, these increments equal the final retail sales price. "Flat tax" is the label for a system which also imposes a tax on value that is added in increments, but the tax is divided between businesses and their employees. Flat tax proposals begin with a VAT-like computation by a company and then deduct the wages/salaries component of such value-added; the wages/salaries component is taxable to the employees, while the profit, interest and benefits components of value-added are taxable to the company.

A system which applies one tax rate to the broadest possible tax base is highly desirable because it virtually eliminates the possibility that some sectors will be given a tax-induced preference over others. Absent such preferences, there is no tax-induced reason to change behavior, to spend resources in an attempt to get into a preferred category or to alter an

economic activity which otherwise makes sense on its own. One of the lessons learned from studying foreign VATs is that it is impractical to seek to limit preferences to just one or two special rules or reduced rates. Once accepted, the use of such preferences expands, and the resulting complex system no longer serves its revenue function with minimal cost and disruption. Common sense confirms the conclusion that principle 1 is a fundamental rule. Research and conversations with those who administer and comply with most foreign VATs reinforce the principle. Studies by both the Government Accounting Office and the Internal Revenue Service further reinforce the view that multiple rates and exemptions would increase dramatically the costs of a consumption-based tax.

Principle 2

Applying one tax rate to a comprehensive tax base is essential, but a tax on consumption also should be applied uniformly to all individuals and entities which engage in selling goods in a business activity. The federal income tax distinguishes among different entities -- C corporation, S corporation, partnership, limited liability company, sole proprietorship -- and the rules for applying the income tax to profits vary from entity to entity. There is no need for such distinctions under a consumption tax; if an entity sells goods or services, the presumption is that it is subject to the tax.

While this rule will avoid many of the complexities created within the income tax, there must be a comprehensive definition of what constitutes the business activity which will subject any entity to the system. An individual or entity generally comes within a consumption tax regime if it engages in regular sales of goods or services (without regard to a profit motive). Clarifying exclusions may be useful (*e.g.*, non-recurring sales by consumers such as resale of the personal residence, yard sales, estate sales and other situations where used items are being disposed of by consumers), but even these should be subject to scrutiny. (For example, routine yard sales may actually be a functioning flea market business.)

The parenthetical reference above to a profit motive is important. Many entities which do not have a profit motive nonetheless regularly engage in value-adding activities and sales (particularly sales of services). Examples include (i) the membership organizations which provide a wide range of goods and services for members who pay dues or direct charges or both, (ii) colleges which provide educational services/rooms/meals to students who pay tuition/room/board and (iii) cooperatives which sell goods and services to their own members -- just to name three. Some of these and other entities may be wholly or partially "charitable" and actually give away their goods and services, in which cases special rules may be needed. But the presumption should be that an entity which provides goods and services is subject to the system unless its activities are clearly excluded.

Government sales of goods and services generally should be included in a consumption tax base when there is a charge for acquiring them. This rule should be applied in a way which excludes essential government services such as the courts, police, fire departments and numerous other functions. But it should also be applied to include many utility services (water, electricity, *etc.*) and other goods and services which are sold, particularly if they compete with substitutable services provided by the private sector. Government purchases also should be subject to tax.

Many foreign VATs do not tax certain goods or services while requiring their providers to pay VAT on their own purchases that relate to these untaxed goods or services. This

"exemption" treatment may actually increase prices and tax revenues over what would otherwise occur if the goods or services themselves were taxed. One example is financial intermediation services rendered to taxable businesses.

Principle 3

The federal government can utilize one of two principles when determining the jurisdictional scope of a consumption-based tax. These are referred to as the "origin principle" and the "destination principle."

In general, the origin principle allows the taxing jurisdiction to apply its tax to value-added produced within its own borders, regardless of whether the goods or services are consumed domestically. Goods and services produced overseas and imported into this country would not be subject to the U.S. tax. In other words, the country of origin (not necessarily the country of consumption) is the jurisdiction that is allowed to tax the value-added. The flat tax as proposed is an origin principle tax.

The destination principle allows the taxing jurisdiction to apply its tax to the consumption of goods and services within its borders without regard to their country of origin. In this situation, the foreign goods that are imported into this country are taxed at import at the same rate of tax as goods produced and sold here. Stated another way, the destination principle is used to impose a tax on all domestic consumption, which enables the government to determine the level of tax paid on its citizens' consumption.[1]

Either principle can produce a rational international system of consumption taxation. But use of the destination principle is the only one that allows each country to tax at its own rate all consumption occurring within it, and only that consumption. The substantive case for applying the destination principle to any such tax is strongly reinforced by the fact that more than 100 other nations – including all of the major trading nations[2] -- already utilize federal/national consumption taxes based on the destination principle. While economic theory holds that in the long run trade, in a world of flexible exchange rates and relative wages, will be unaffected by the choice between the destination principle and the origin principle, it is clear that short-run and sectoral effects, as well as effects on wages and exchange rates, would be quite different under the two systems. For all these reasons, any federal consumption tax should be based on the destination principle.[3]

But the use of the destination principle would still require agreements among the U.S. and countries with similar taxes to assure that certain international transactions are not double taxed or undertaxed. Transportation services are one such activity. Telecommunications services are another. Development of a clear statutory guideline in these and other areas should be used to develop both U.S. regulations and reciprocal agreements with other countries.

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1 By applying a "zero" percent tax rate to exports, the destination principle under the familiar VAT does not violate principle 1 above regarding a single rate of tax. Instead, this is just the mechanism for removing all exported goods and services from the tax base.

2 As of February 1999, Australia's government has proposed but not yet enacted a VAT.

3 The "border adjustments" of some U.S. consumption tax alternatives may be questioned under our World Trade Organization obligations.

Principle 4

Both foreign VATs and domestic sales taxes routinely violate principle 1 by providing lower rates or zero rates for a wide range of goods and services. In general, these preferential rules are provided to sellers of an array of goods and services that are often described as "necessities;" some combination of food, medical care, housing and clothing are usually found here. The generally stated purpose for such preferences is the desire to reduce the impact of the VAT or sales tax on lower income consumers who generally spend a larger share of their available incomes than higher income individuals while also devoting a higher proportion of that spending to the "necessities" which are taxed at a lower or zero rate.

When first described, the purpose for these "regressivity" offsets can be widely appealing. But this broad mechanism is at best a wasteful and inefficient means for achieving its desired end. At worst, it creates significantly more problems than it solves.

Consider the simple mathematics of removing up to 40% of the tax base when all of the categories of necessities are subject to a zero rate of tax. One effect is to increase the rate applicable to all other sectors by two-thirds in order to generate the same amount of revenue from the smaller base. Another effect is the substantial amount of foregone revenue from the middle and upper income households which are not the intended recipients of the benefits. Economic data confirm the common sense conclusion that the farther up the household income scale you go, the more money the households tend to spend on their food, medical care, housing, clothing, *etc.* Taking both effects into account, it is likely that these attempts to reduce the burden of a VAT or sales tax on lower income households in fact raises the tax attributable to all other goods and services they purchase (thereby offsetting much of the intended benefit) while foregoing several times as much revenue from households that are not among the intended beneficiaries.

Additional problems are likely to arise if multiple tax rates, exclusions and other preferential rules are used. First will be the difficulties with interpreting what is and is not covered by the preferential rules. Foreign VATs are subject to extensive interpretive guidelines and litigation for this reason. Simple questions such as "what is medical care" and "what is food" will give rise to substantial complexities for both tax administrators and businesses. Then, with such rules firmly in place, businesses will try to expand them to cover more goods and services, and both lobbying and litigation will increase considerably.

For these reasons, principle 4 states the high desirability of addressing all regressivity concerns outside of the consumption tax system itself. By leaving the tax system free of such preferences and resulting distortions in behavior, it is likely that a more stable and predictable revenue base can fund other mechanisms to achieve the desired result, such as providing support directly to the intended beneficiaries. While social spending in response to a new tax may present its own complexities, such programs are more effectively administered through systems dedicated to their objectives than through a tax system dedicated to the objective of revenue collection.

These are practical reasons for avoiding preferential rules, but the same result is supported generally by economic commentators as well. In the 1950s when European VATs were being introduced, noted economist John Kenneth Galbraith in his book ***The Affluent Society*** said the following:

"The relation of the sales tax to the problem of social balance is admirably direct. The community is affluent in privately produced goods. It is poor in public services. The obvious solution is to tax the former to provide the latter - by making private goods more expensive, public goods are made more abundant. Motion pictures, electronic entertainment and cigarettes are made more costly so that schools can be more handsomely supported. We pay more for soap, detergents and vacuum cleaners in order that we may have cleaner cities and less occasion to use them. We have more expensive cars and gasoline so that we may have more agreeable highways and streets on which to drive them. Food being relatively cheap, we tax it in order to have better medical service and better health in which to enjoy it."

John Kenneth Galbraith, THE AFFLUENT SOCIETY (Boston, Houghton Mifflin Co., Fourth Edition, 1984), p. 238. (See same wording in first edition: Cambridge, MA, The Riverside Press, 1958, pp. 315-316).

The best modern brief statement of this policy comes from the Fiscal Affairs Department of the International Monetary Fund which advises foreign governments which are considering this question:

"Fiscal policy - taxation and spending - is a government's most direct tool for redistributing income, in both the short and the long run. However, the effect of redistributive tax policies, especially in the face of globalization, has been small. Policymakers should focus on developing a broadly based, efficient, and easily administered tax system with moderate marginal rates. Although the primary goal of the tax system should be to promote efficiency, policymakers also need to consider how to distribute the burden of taxation so the system is seen as fair and just.

"The expenditure side of the budget offers better opportunities than the tax side for redistributing income. The link between income redistribution and social spending - especially spending on health and education, through which governments can influence the formation and distribution of human capital - is particularly strong, and public investment in the human capital of the poor can be an efficient way to reduce income inequality over the long run."

Excerpt from "Should Equity Be a Goal of Economic Policy?" by staff of IMF's Fiscal Affairs Department, 35 Finance & Development #3 September 1998, pp 2-5, quotation from p. 4.

A broad-based, low, flat rate tax will not distort production and consumption choices. Applied uniformly, it can be a stable revenue source from which the political process can then determine how to design and implement any direct benefit programs for those considered adversely affected by the tax system as a whole.

Principle 5

A tax system which applies to a consumption base uses the prices charged for goods and services in its computation. These sales prices less purchases from other taxable businesses represent the value-added that has been created by companies through each point of the production and distribution of goods and services. For the vast majority of sales transactions, there is an explicit price used in computing the tax base. But there are situations in which there are no explicit prices charged for goods and services or the taxable value-added cannot be calculated in the manner described above. In these situations, a consumption tax will need to apply alternative mechanical rules to assure that the seller's tax base is computed appropriately.

One such situation is common in the financial services sector. While many financial services are provided for an explicit fee (*e.g.*, brokerage commissions, financial planning services, safety deposit boxes, printing of checks along with many others), the fees for "financial intermediation services" generally are not separately stated by the company and separately remitted by the client. Instead, the service provider is paid from the flows of funds which it handles in its role as an intermediary. One example is a simple bank loan in which the bank's role is to pool the funds of its depositors and to loan such funds to individuals and businesses. The intermediary does all of the work for depositors and borrowers who otherwise would be required to find each other and to engage in all the work needed to undertake direct loans. The bank's fee for this service is not separately stated; instead, the bank is compensated by retaining a portion of the interest paid by the borrower before paying the depositor an amount of interest as a return on the deposit. An insurance company which pools the risks of many insureds, manages the premiums and pays claims is also a financial intermediary which is compensated from the flows of funds which it handles among policyholders. In these situations, the tax system will need an alternative set of mechanical rules which allows the value-added created by the intermediaries to be included in their tax bases without reference to an explicit price because that generally will not exist.

Other situations also will require flexibility. Government entities which sell goods and services may not do so for an explicit price, or the explicit price may not reflect the actual amount being paid by the purchasers. Casinos mix bets and cash paid to winners, so the general definition of the taxable value of a sale does not work. Barter transactions may involve a cash price which does not fully state the price paid, even though goods and services are being sold. These and other situations in which goods and services are being sold but without a stated price (or where the price may be described in other ways such as "dues" to membership organizations) should be included in the system using a workable set of alternative rules which seek to meet the expectations of principles 1 and 2 that all sales of goods and services are in the tax base and subject to the same rate of tax.

Principle 6

While any federal tax system necessarily imposes some administrative and compliance costs, a consumption-based tax which is structured using these recommended principles can be relatively simple and inexpensive for both government and taxpayers. The key word is "relatively" because an economy as large and complex as the U.S. economy probably cannot be subject to a tax which is "simple" in the absolute sense. Principle 5 recognizes that one large sector of the economy – financial intermediation services – will require alternative rules which may be more complicated than the rules applied to businesses generally. Nonetheless, any of these taxes can be much simpler than the more familiar income tax because most of the more complicated accounting rules (such as depreciation and inventory capitalization) and classifications (such as ordinary income vs. capital gain) are not needed.

All of the consumption-based taxes place substantial reliance on businesses to be the collectors and remitters of taxes. The sales tax and value-added tax formats do this exclusively, and the flat tax format does so substantially (particularly if businesses are required to withhold the flat tax on individuals' wages and salaries). So the role of businesses in the tax collection process is likely to be increased to some degree. The administrative efficiency of relying on fewer entities to remit taxes should not result in any unnecessary burdens on those businesses.

For example, the government's need for a steady revenue flow should be weighed against the private sector's need for a reasonable reporting period.

There is a case to be made that very small businesses should be excluded from a consumption tax to reduce further the numbers of taxpayers and to avoid imposing the compliance costs of a new tax on such businesses. But this case should be weighed against possibilities that sales thresholds or compliance cost deductions or other mechanisms create strong incentives to "break up" businesses (particularly personal services businesses) into entities with sales close to or even below the threshold. Further, the case may vary depending upon the form of tax chosen and upon whether other taxes are replaced by the new tax.

Principle 7

The three components of principle 7 are, in a sense, corollary issues rather than issues which must be addressed in the drafting of a consumption tax itself. However, they are sufficiently important to the process of implementing any new tax that they should be considered carefully and perhaps at the same time as the drafting of a new tax is being considered.

a. Transition

Whether or not a consumption tax is used as a complete or partial replacement for an existing tax or as an additional tax, a series of "transition" issues will arise. Depending on the situation, one or more of the following categories will require consideration. For businesses, these can include (i) the impact of post-effective date sales of goods or services which are wholly or partially produced prior to the effective date because the value-added base will include amounts created before the tax takes effect; (ii) the impact of unrecovered costs of capital goods and inventories; and (iii) the effects of possible financial accounting rules governing the new tax and the continuing or replaced taxes. For individuals, these can include post-effective date taxation of consumption of pre-effective date income which has been subject to an income tax.

Historically, transition rules generally are not addressed until after "big picture" legislative goals have been decided. However, given the magnitude of a possible consumption tax and potential changes in other taxes, transition issues should be identified early and considered carefully and objectively. Also, policy makers should seek as much objective analysis as possible regarding the effects of a new consumption tax and possible changes in a current federal tax before drafting any transition rules. There is a tendency to base transition rules in the income tax on the rather narrow consideration of how changes in a particular provision will affect specific taxpayers. The impact of a new consumption tax is likely to be so pervasive that it will not be realistic to simply assume that particular effects will arise.

b. State and Local Taxes

The form of a federal tax may affect the administrative and compliance costs of operating such a tax alongside state and local taxes. States will be affected by federal legislation that implements a consumption tax, particularly if it replaces all or part of the federal income tax which they use as the base for their own tax structures. Implementation of a significant national sales tax can impact a state sales tax, both with respect to the rate and the base of the tax. Therefore, the federal government should develop any new consumption tax with an awareness that the entire legislative package will affect the states.

c. Treaties

If the U.S. income tax were wholly or partially replaced with a consumption based system, this would have a substantial impact on tax treaties which address income tax issues. If there were little or no residence taxation of interest and dividends (and little or no withholding taxes on such items paid to foreigners), the reciprocity of U.S. bilateral income tax treaties would be altered fundamentally. Treaty partners may balk at continuing to provide relief from their withholding taxes when the U.S. would not even tax the income in question. The viability of treaty protection related to income taxes for U.S. taxpayers with foreign source income needs careful consideration.

TEN FACTS ABOUT FUNDAMENTAL TAX REFORM

[By Edward J. McCaffery, University of Southern California, California Institute of Technology]

The older I get, the less time I seem to have to read, or to pay attention to anything at great length. I presume, or hope, that this is because I am busy, not on account of any biological decline. In any event, I have learned since my first days of talking about tax reform to try to keep things short and simple, especially in such a complex field.

Fundamental tax reform, the subject matter of these hearings, is a topic near and dear to my heart. What follows is my attempt to distill decades of critical reflection into ten easy to digest truths.

1. *Fundamental tax reform is needed.* I hold this truth to be self-evident: The current tax system is a disgrace. It is too complicated, too inefficient, too unfair. Its unpopularity, itself a problem, is fully warranted. Among the many deficiencies of the status quo, its very complexity and the lack of transparency in its principles holds tax hostage to the whims of politicians and the fads of academics.

2. *Simplification can only occur with fundamental tax reform.* I hold this truth too to be self-evident, or at least abundantly clear after too many decades of incrementalism. The current tax system is flawed at its root. Federal tax policy is an incoherent and inconsistent blend of conflicting policy elements, effected through a confusing mixture of income, payroll, corporate income, and gift and estate taxes. It is hard to see any forest through its weeds and shrubs and micro-organisms. If we are to obtain simplification—and any hope for political accountability and economic stability in tax can only come with simplification—we must revisit first principles, and create a consistently principled tax system.

3. *Fundamental tax reform is possible.* It is easy to lose hope for a better future and thus to cling to a hopeless present.

In particular, many followers of tax policy draw a despairing lesson from the epochal Tax Reform Act of 1986. At the time, this act, which broadened the income tax base and lowered its rates, seemed the last best hope for some semblance of sanity in tax on earth (Birnbaum and Murray 1987). Less than two decades later, the tax system is as complicated as ever. (McCaffery 1999). Perhaps fundamental tax reform, like federal budget surpluses, is doomed not to persist.

But this is the wrong lesson to be learned. The 1986 act chose one of two routes for tax reform laid out in the classic Treasury study, Blueprints for Tax Reform (Bradford et. al., 1984)—namely that of "perfecting" the income tax by broadening its base and lowering its rate structure.

Sophisticated foresight would have shown then what hindsight has since proven: This was the wrong means to have taken, not a wrong end to pursue.

4. *Fundamental tax reform must center on the tax base.* It is easy enough to get blinded by the topic of tax rates when thinking about tax. But one way or another, total taxes in America are going to be fairly close to one-third of GDP, on average, because this is what government spending (at all levels) is. Truly fundamental tax reform—any tax reform that has any chance of effecting permanent gains in equity, simplicity, efficiency and accountability—must take on the question of the tax base, or the "what" of taxes. And here we must come to see that the current system is an incoherent mishmash of conflicting bases.

5. *The tax base is logically distinct from its rates.* The simplest analytic truths can get lost in the fog of tax.

Reduced to its essence, any tax consists of the product of a base (what is being taxed) times a rate structure (how much it is being taxed). There ought to be, as I shall continue to argue below, broad and bipartisan consensus on the base question. Yet confusion over the analytics has impaired reasonable compromise.

Liberals miss the point that redistribution can be effected under any base by choosing an appropriate rate structure.

Conservatives deserve their part of the blame for the intellectual stalemate, by continuing to link flat rates and a consumption base.

Finally, academics, by lumping all consumption taxes together, have not served the public discourse.

If we set aside disputes over the appropriate rate structure, and focus instead on the base question under at least moderately progressive rates, as we have had for nearly a century now, we can at last begin to see fundamental tax reform in a new and better light.

6. *Fundamental tax reform must begin with the elimination of all direct taxes on capital, meaning a move to a consistent consumption base.* Now we start getting to the heart of the matter.

An income tax, under the so-called Haig-Simons definition of income, is supposed to tax all consumption plus all savings, the two all-encompassing and mutually

exclusives uses of "income" (McCaffery 2002). John Stuart Mill pointed out in the mid 19th Century that this leads an income tax to be a "double tax" on savings; Professor William Andrews of Harvard Law School observed in 1974 that the worst problems with the so-called income tax come in its commitment to taxing savings (Mill, 1848; Andrews, 1974).

Consider again the choices confronting policymakers at the time of the Tax Reform Act of 1986. The path chosen, as noted above, was that of "perfecting" the income tax. It failed, both because it did not really perfect the income tax (McCaffery 2003), and because no one really wanted it to do so, in any event.

The other path laid out in Blueprints was to abandon the attempt to have an income tax altogether and move instead to a consistent consumption tax. This is the right path to take. It means eliminating all attempts to tax savings directly under the income tax—having unlimited savings accounts, no capital gains taxes, no tax-law concept of "basis." It also means eliminating the adjutants or "backstops" to the income tax's porous and flawed commitment to taxing capital, namely the corporate income and gift and estate taxes (McCaffery, 2003). But it does not mean giving up the claims for fairness in tax, or the attempt to tax the yield to capital in the hands of the socially fortunate.

7. *All consumption taxes are not created equal.* Now here is a point where the academy has led policy-makers astray.

There are two broad forms of consumption taxes.

In one model, the tax is imposed up-front, and never again: a wage tax, like social security, or so-called pre-paid or yield-exempt consumption tax. "Roth" IRA's work on this model (pay tax now, never again).

The second form of consumption tax imposes its single tax on the back-end: this is a sales tax, a postpaid, cash-flow or "qualified account model" consumption tax. Traditional IRAs work this way (no tax now, only later).

Under flat or constant tax rates, the two principal forms of a consumption tax are equal. Both taxes are single taxes on individual flows of wealth.

But this equivalence does not hold under non-constant or progressive rates.

8. A consistent, progressive, postpaid consumption tax is a tax on the yield to capital, under just the circumstances in which it is fair and appropriate to tax such yield.

The simple analytic truths lead to a different understanding of the traditional choices of tax policy, as I have been attempting to explain in my academic work (McCaffery, 2003). Better understanding points the way out of the current morass of tax policy politics, and towards a grand compromise.

Consider where the debate stands.

For some time now, conservatives have been clamoring for a flat consumption tax. Flat consumption taxes of all sorts are indeed broadly equivalent—none effectively tax the normal yield to capital under any conditions. And so the choice among a Hall-Rabushka style flat wage tax, a national sales tax, or a value-added tax (VAT) is largely one of administrative convenience (Slemrod & Bakija, 2000).[1]

Liberals for their part are opposed to any such tax, both because of its flat rate, and because of the thought that a consumption tax ignores the yield to capital altogether, and that such yield is the domain of the socially fortunate. So liberals insist on maintaining, even strengthening, a progressive income tax, with its corollaries, the gift and estate and corporate income taxes.

But once we assume that we are going to have at least some progression in the rate structure, the traditional understanding of consumption taxes is no longer accurate. The two forms of consumption taxes, prepaid and postpaid, differ under progressive rates. Now there are three—not two—alternatives. The differences come in when the tax falls, and how this impacts choices of work, savings, education, and so on.

One, an income tax falls on all labor market earnings and savings, at the time they come into a household. Savers are hurt by the "double taxation" of savings, whatever the intended or actual use of the savings. Individuals, like the highly educated, who see their earnings come in relatively short concentrated bunches, are hurt by the timing of the imposition of progressive rates.

Two, a prepaid consumption tax falls on labor market earnings alone, again at the time they come into a household. Once more, people whose earnings profiles are uneven throughout their lifetimes are hurt by the timing of the imposition of the

[1] There is important work showing that the supra-normal rate of return to capital may be captured under a postpaid, but not a prepaid, consumption tax. (Bankman and Griffith, 1992, Warren, 1996). In my more general argument, this fact serves as one of the reasons to prefer, on normative grounds, a postpaid to a prepaid consumption tax. (McCaffrey 2003).

progressive rate structure. But—and here is the rub for most liberals and even moderates—those who live off the yield to capital are never taxed.

Three, a post-paid consumption tax does not come due at the time of initial inflows, but rather at the time of outflows, when money is spent in consumption. This means that a progressive postpaid consumption tax stands between an income tax, which double taxes all savings, and a prepaid consumption tax, which ignores all savings. A consistently progressive postpaid consumption tax treats savings differently depending on its use.

We can think of two broad uses of savings. One is to smooth out consumption profiles, within lifetimes or across individuals—to translate uneven labor market earnings into smooth consumption flows. We do this by borrowing in our youth and saving for retirement in midlife. A second use of savings is to shift consumption profiles, up or down. An upward shift occurs when the fruits of our own or another's savings allow us to live a "better" lifestyle than we could on the basis of our own labor market earnings, alone, smoothed out over time. A downward shift occurs when beneficence or bad fortune means that we will live at a lower lifestyle than we otherwise could, again on the basis of our smoothed out labor market earnings profile alone.

Once again, whereas an ideal income tax double taxes all savings, whatever their use, and a prepaid consumption tax ignores all savings, again whatever the use, a consistent progressive postpaid consumption tax splits the difference, in a principled way, and by design. It allows taxpayers to lower their taxes by smoothing, but it does fall on the yield to capital when such yield is used to enhance lifestyles. This reflects simple, commonsensical attitudes about life, income, and savings. It can lead to a dramatically simpler tax system that is at the same time far fairer.

Consider for example the role of a separate freestanding gift and estate tax system within this construct. The current system aims to "backstop" the income tax, which tax is (in ideal theory) supposed to burden savings, by levying a hefty tax on those decedents who die with large estates. This tax is obviously desired as a matter of fairness. But its very existence encourages the rich to consume more, and die broke, whether the spending is on themselves or their heirs. In contrast, a consistent progressive postpaid consumption tax never taxes savings directly. Saved assets have a zero basis. These can be passed on to heirs on life or at death, without the moment of transfer triggering tax. On the other hand, spending by the heirs will generate tax, and under the progressive rate structure. A consistent progressive postpaid consumption tax does not need, in principle, a separate gift and estate tax, because the very design of the tax entails an accessions or inheritance tax.

A similar argument can be made against a separate corporate income tax. The problems with this tax begin with its uncertain incidence: since corporations are not real people, they do not really pay taxes. A corporate tax falls on workers and consumers, on capital generally, or on some combination thereof. But to the extent it does falls on capital, it does not do so in any individuated way. Savers bear the burden of the corporate income tax whether they are rich or poor, saving for lifetime needs or emergencies or to support a high-end lifestyle. Once again, under a consistent, progressive, postpaid consumption tax—which falls on the yield to capital as a source of personal consumption—such a tax is not needed.

9. *Actual tax policy is headed towards a flat prepaid consumption tax.* In fact, when we observe the status quo, we see a slow but steady movement towards a flat or flattened prepaid consumption tax. Second taxes on capital have long been fairly easily avoided (McCaffery 2000). Recent legal changes, such as the lowering of the capital gains rate and the exclusion of corporate dividends from income, and more recent proposals, such as those for more expansive Roth-style savings accounts, continue and confirm the trend. These changes are moving and will move the United States ever farther towards a wage tax, in which the yield to capital is never taxed. This is the wrong place to go, in the name of fairness. But whereas most liberals today, laboring under the traditional understanding of tax, feel that they can only counter the trend by insisting on retaining the status quo, a better understanding of tax shows that a consistent progressive postpaid consumption tax is an attractive option, for just the reasons liberals oppose consumption taxes—because such a tax does, whereas a prepaid consumption tax does not, reach the yield to capital.

10. *Implementation of a consistent, progressive, postpaid consumption tax is practical, and the case for it is compelling.* Academics tend to be idealists who get nothing done. These traits are reflected in the endless discussions over transitions from an ideal income to a consumption tax. But we do not have, and have never had, an ideal income tax. The current tax is so far on the path towards a consumption one that transition concerns should not deter the movement towards principled consistency.

There are two broad ways to implement a consistent, progressive, postpaid consumption tax.

One is to keep the basic income tax system in place, but repeal the limits on savings accounts: adopting unlimited IRA or savings account treatment, as in the Nunn-Domenici USA tax plan. These savings accounts must be on the postpaid model.

Two is to take advantage of the analytic equivalence of sales taxes and postpaid consumption ones, and replace the income tax with a three-part plan, consisting of:

- A national sales or value-added tax at a modest, sustainable rate, say 10 to 15 percent;
- A system of rebates to effect a "zero bracket" under the national sales tax, say $500 per person, which would offset $5,000 of taxable consumption (at a 10 percent rate);
- A supplemental "consumed income tax" for the wealthiest Americans, modeled along the lines of the existing income tax with unlimited deductions for savings. This tax could apply to households consuming say $80,000 a year or more, and would back out the national sales tax rate.

The net result of this three-step plan would be to have a zero bracket of $20,000 for a family of four; followed by a 10 or 15 percent bracket extending to $80,000 of consumption; followed by 20 or 30 percent brackets, and so on, but effected by a consumed income tax with rates starting in again at 10 or 15 percent (to add to the national sales tax).

The choice of which mechanism to choose comes down to administrative and political concerns, including the wisdom of having two taxes rather than one. But the simple analytic fact of the matter is that the two broad choices lead to the same place: a consistent, progressive, postpaid consumption tax (McCaffery 2002).

Under either means for getting to a consistent postpaid consumption tax, and consistent with the principled basis of such a tax, we could and should repeal:

- All capital gains taxes under the income tax;
- All rules for "basis" of investment assets;
- All rules about maximum contributions to and minimum distributions from the savings accounts;
- The corporate income tax; and the
- Gift and estate tax.

Taxes would, at last, rest on a simple and consistent principle: tax people when they spend, not when they work or save. Simplicity, transparency, and efficiency would be enhanced; fairness would not be abandoned. Such a tax system would apply to the yield to capital, when but only when it is appropriate to do so. The rich would not be let off the social hook; their tax would come due when, as, and if they spent wealth on themselves. Progressivity could be maintained, even strengthened.

Here, at last, would be something fundamental, to get us off the treadmill of incrementally increasing complexity.

We should do it. It is high time to stop the insanity of tax today.

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PREPARED STATEMENT OF ROBERT S. MCINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE

Thank you for the opportunity to appear before the Committee today to discuss fundamental tax reform. This is an issue near and dear to my heart. Since 1976, I have devoted my career to promoting fairer taxes and to keeping the public informed about the meaning of various tax change proposals. That is also the mission of my group, Citizens for Tax Justice.

In my view, our nation's current tax policies are a disaster: morally, fiscally and economically. In my brief testimony today, I want to discuss what I think should be the principles of fundamental tax reform, illustrate how they have been applied in real life, and touch on what I see as false paths to reform.

I. PRINCIPLES OF FUNDAMENTAL TAX REFORM

Tax reform experts have traditionally pointed to three basic goals for a good tax system: fairness, simplicity and economic efficiency. l would add one more essential ingredient: revenue sufficiency. All four are interrelated.

Principle 1: Revenue sufficiency. The fundamental goal of any tax system is to raise the money needed to pay for public services. Our current tax system is failing miserably in this regard.

In the just-completed fiscal year, combined federal personal and corporate income taxes fell to only 8.3 percent of the economy, their lowest level since before World War II and a third lower than in fiscal 2000—with no relief in sight.

• Personal income taxes have fallen to their lowest level as a share of the economy in more than 50 years.

• Corporate taxes have plummeted even more than personal taxes. In fact, at only 1.2 percent of the economy over the past two fiscal years, corporate income taxes are at their lowest level since the 1930s, except for one year during Ronald Reagan's first term. The most recent OECD data show that U.S. corporate taxes as a share of the economy are now virtually the lowest in the industrialized world.

Some of the recent tax shortfall and the resulting huge budget deficits reflect the weak economy, but most of it is self-inflicted. President Bush's personal income tax cuts enacted in 2001 and 2003, for example, are expected to total $197 billion next year. The decline in corporate taxes mainly stems in about equal parts from President Bush's big corporate tax cuts enacted in 2002 and 2003 and the huge amount of offshore tax sheltering that corporations now engage in with congressional tolerance. Counting tax breaks that have been on the books for longer, corporate taxes are now almost 60 percent below the 3 percent of GDP they averaged from 1950 through 2000. To put that in perspective, if corporate taxes had equaled that 3 percent of GDP average last year, then revenues would have been $180 billion higher than they actually were.

For the foreseeable future under current policies, a third of the regular government will be financed with borrowed money. Obviously this can't be sustained for very long, either fiscally or economically. Such excessive borrowing endangers essential government programs and robs investment capital from our economy that we will need to sustain growth.

So a central goal of fundamental tax reform must be to address our huge revenue shortfall. Correspondingly, any "reform" proposal that purports to be "revenue-neutral"—let alone revenue-losing!—should be dismissed out of hand.

Principle 2: Fairness. Tax fairness is not only morally right, it's also essential to maintaining public support for the tax system. Traditionally, fairness has been dividend into two important elements: horizontal equity and vertical equity.

First of all, taxpayers with similar incomes should pay similar taxes, no matter how they happen to earn their money. It's not fair to tax wage-earners more heavily than investors, and it's not fair to tax investors in, say, fake synthetic coal, more heavily than investors in non-tax-sheltered activities.

Second, taxes ought to be based on people's ability to pay them. Those who have benefitted most from our society should pay the highest share of their income in taxes to support our country. Those who are struggling should pay the lowest rates.

Unfortunately, our current tax system violates both of these principles of fairness. An array of loopholes favors some taxpayers and some kinds of income over others.

And the progressivity of our tax system has declined markedly over the last quarter century.

According to Congressional Budget Office data, the effective tax rate on the best-off one percent of Americans dropped by 16 percent from 1977 to 2000, despite rapidly rising incomes at the top end that normally would have produced higher effective tax rates. Since 2000, according to calculations by the Institute on Taxation and Economic Policy, President Bush's tax cuts have lowered the effective tax rate on the wealthiest by another 17 percent. In combination, that's a 30 percent drop.

This sharp decline in progressivity has a lot to do with our government's revenue shortfall, by the way. If the effective tax rate on the top one percent were as high today as it was in 1977, the government would collect more than $200 billion in additional revenue in 2004.

Principle 3: Simplicity. In a complicated world full of would-be tax avoiders and their highly paid advisors, no tax system can be completely simple. But a tax system that is generally understandable and that is devoted to raising revenue fairly would be much simpler than the one we have today. Unfortunately, the past decade or so has seen rapid growth in tax complexity, largely because lawmakers have chosen to use the tax code as a vehicle for numerous programs unrelated to fair tax collection. Some of these "tax expenditures" have noble goals; others would never be seriously considered if they were proposed as part of the regular budget process. But all these programs make tax filing and tax enforcement far more difficult than they need to be.

Principle 4: Economic efficiency. Most of us would be reluctant to endorse central planning as an ideal economic system. Instead, we'd probably insist that letting market forces drive consumer and business decisions is usually the best way to maximize our economic well-being. Virtually the entire economics profession agrees. But our tax code is increasingly becoming an ad hoc tool of central planning, as we lard the code with more and more "incentives" to shift economic activity into areas that have gained congressional favor. In contrast, an even-handed, level-playing-field tax code without favoritism for some business activities over others would improve the allocation of capital and enhance economic growth.

II. TAX REFORM PRINCIPLES IN ACTION:

A fair, revenue-sufficient tax code is certainly difficult to achieve, but history shows us that it's not impossible. In fact, we came rather close to having such a tax code for a brief period a decade ago, due to the efforts of President Reagan, President Clinton, and to a lesser degree, the first President Bush.

After a dismal start with his loophole-laden, budget-busting 1981 tax act, President Reagan dramatically shifted gears. For the rest of his time in office, he devoted his tax policy primarily to closing unwarranted loopholes and boosting revenues. Reagan's tax reform drive began with the loophole-closing 1982 tax bill and reached its fulfilment in the 1986 Tax Reform Act.

To be sure, Reagan's post-1981 tax changes did not come close to bringing revenues in line with spending, nor did they fully restore the progressivity that the 1981 act had sharply eroded. But the tax code Reagan bequeathed to his successors was as close as our country may have ever come to a horizontally equitable, simple and economically efficient tax system. Its major flaw was that its upper-income tax rates were much too low.

Reagan's successors, the first President Bush and President Clinton, retained most of the Reagan reforms, at least initially, while addressing the continuing revenue problem. Bush I increased the top income tax rate in 1990, although he unfortunately resurrected the Reagan-repealed capital gains tax loophole at the same time. President Clinton further increased the tax rates on the highest earners in his 1993 legislation. When incomes boomed at the top of the income scale in the second half of the nineties, those higher tax rates helped give us our first balanced budgets since 1969.

I suggest that would-be tax reformers take the Reagan tax code of 1986, supplemented by the Clinton tax rate hikes of 1993, as an excellent paradigm for future fundamental tax reform. (Most of what's happened to the tax code since 1993, on the other hand, I suggest you spurn.)

III. FALSE PATHS TO REFORM:

On the other side of the tax reform issue are those who totally repudiate the Reagan-Clinton legacy. Specifically, they would scrap the progressive income tax in favor of a flat-rate consumption tax. One version of this approach calls for a high-rate national sales tax. Another is the flat-rate wage tax promoted by former presi-

dent candidate and publisher Steve Forbes along with former House Majority Leader Dick Armey.

These and similar proposals are designed to drastically reduce taxes on the wealthiest people, both by lowering their tax rate and by exempting a large share of their income from tax. The plans would also increase taxes dramatically on middle- and low-income Americans, especially if they came even close to raising enough money to pay for the government.

Proponents of consumption taxes often argue that their plans would discourage consumer spending, promote savings and thereby increase long-term economic growth. But unbiased experts who have examined these claims generally find little if any economic improvement from switching to a regressive tax system. Indeed, since these consumption tax proposals would require tax rates that are implausibly high to avoid even bigger deficits, their net effect would probably be to reduce total national savings.

IV. CONCLUSION: CURRENT PROSPECTS FOR REFORM

I wish I could reasonably hope that the current management in the White House and Congress will rush to repeal the Bush tax cuts, crack down on offshore corporate tax sheltering, reinstate the estate tax and otherwise take us back to the days when a fair, progressive tax system paid the government bills and even started to reduce the national debt. But despite my pessimism that you'll listen to my advice, I do recommend that you take all these steps.