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Subcommittee on Fiscal Responsibility and Economic Growth
On Creating Opportunity Through a Fairer Tax System

# Fair and Efficient Tax Policy

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Chair Warren, Ranking Member Cassidy, and Members of the Committee, thank you for the opportunity to speak today. My name is Kyle Pomerleau, and I am a resident fellow at the American Enterprise Institute, where I research federal tax policy.

In my testimony, I provide an overview of tax policies lawmakers are currently discussing. I then consider the challenges of two recently proposed policies: a wealth tax and a tax on the book income of corporations. I conclude by discussing alternative revenue sources that I think lawmakers should consider.

**Background**

Two major spending packages are currently under consideration. The first, the "American Jobs Plan," is a $2.7 trillion proposal that includes increased spending on traditional infrastructure, research and development, job training, and long-term care.[i] The second proposal is the "American Family Plan." Although the plan's details are not yet released, news outlets report that it will include spending on childcare, paid family leave, universal pre-K, community college, and an extension of the recently expanded child tax credit.[ii]

Lawmakers are contemplating tax increases on corporations and high-income households to finance this new spending. President Joe Biden has proposed raising the corporate income tax rate to 28 percent, raising the tax burden on the foreign profits of U.S. multinational corporations, and enacting a minimum tax on the book income of corporations. The proposal would also replace the base erosion and anti-abuse tax (BEAT) with a new provision called "SHIELD," which is aimed at preventing profit shifting to low-tax jurisdictions. Finally, it would eliminate several tax provisions for fossil fuel companies.

In addition, the administration plans to increase the top individual income tax rate from 37 percent to 39.6 percent. It will also raise the top capital gains rate from 20 percent to 39.6 percent and make death a realization event for capital gains.[iii]

Other lawmakers have introduced proposals to increase taxes on corporations and high-income households. The Senate Finance Committee Chairman, Senator Wyden (D-OR), has suggested taxing capital gains mark-to-market for high-income households.[iv] Senator Elizabeth Warren (D-MA) has also suggested taxing corporations based on their book income and has a proposal to enact an annual, progressive wealth tax. President Biden, during the campaign, also proposed raising the estate and gift tax.[v]

These proposals would raise trillions in new revenue for the federal government and would be highly progressive. However, a few of these ideas pose considerable challenges.

**Taxing Book Income**

President Biden has proposed enacting a 15 percent minimum tax on the book income, or financial statement income, of U.S. corporations.[vi] Corporations would be required to pay the greater of their ordinary corporate tax liability or 15 percent of their book income. The proposal would only apply to corporations with net income of $2 billion or more. It would allow corporations to reduce their book income with net operating losses and offset their book-tax liability with the foreign tax credit and general business credits such as the research and development credit and green energy credits.[vii]

Senator Elizabeth Warren has also proposed an add-on book tax. Warren's proposal, in contrast, would not be a minimum tax. Corporations would be required to pay a tax equal to 7 percent of their book income each year in addition to the ordinary corporate income tax. The proposal would exempt the first $100 million in net income. It is unclear how Warren's book tax would interact with the ordinary corporate income tax. Nor is it known whether corporations would be able to offset their book-tax liability with any credits.[viii]

*Taxing Booking Income Does Not Necessarily Address Tax Avoidance*

Both proposals are driven by the perception that the large corporations that report low effective tax rates are engaged in aggressive tax avoidance. Recently, the Institute on Taxation and Economic Policy (ITEP) released a report highlighting 55 corporations that reported positive net income but zero or negative federal tax liability in 2020.[ix] Although this result is striking, it is not necessarily evidence of aggressive tax avoidance.

Each year, corporations prepare two measures of income: book income and taxable income. Although both are measures of income, they serve different purposes and are intended for different audiences. Book income follows generally accepted accounting principles (GAAP), as set by the Financial Accounting Standards Board (FASB), and is meant to provide information to investors and creditors about a corporation's performance. In general, book income tries to align the recognition of income with its associated expenses. And while the FASB prescribes standards, corporations have some leeway in how to account for certain expenses and income. [x]

Taxable income is set by the Internal Revenue Code (IRC) and is prepared for the IRS and is meant to determine a corporation's tax liability. In addition, the tax code includes provisions that are meant to accomplish other goals, such as encouraging or discouraging certain behaviors. In contrast with book income, taxable income is calculated based on strict rules with little leeway in how revenue or expenses are realized.

In any given year, corporations may have differences in book and taxable income that have little to do with tax avoidance. For example, corporations that benefit from accelerated depreciation may receive large upfront deductions for new investments. In the first year, this will result in lower taxable income than book income. In the following year, the corporation would no longer have any deductions but would continue to deduct the asset for book purposes. This could result in taxable income that is higher than book income.

Taxing book income may result in corporations adjusting book income to avoid taxes. Empirical evidence suggests that taxing book income could reduce the informational quality of book income for investors and creditors. Between 1987 and 1989, the federal government used book income to calculate the corporate alternative minimum tax. As a result, firms shifted sales outside the window during which book income impacted tax liability.

*Taxing Book Income Could Undermine Congress's Policy Goals*

Taxing book income would outsource a portion of the tax code to an unelected nonprofit organization.[xi] As mentioned previously, financial accounting income is regulated by the FASB. Any changes that the FASB makes to accounting standards would have a direct impact on the book tax base and federal tax revenue. These decisions would be made without Congress's fiscal or other goals in mind. Creating a link between the FASB decisions and federal revenue will create an incentive for Congress to lobby the board to make or refrain from making changes.

It is unclear why Congress would desire to link tax collections to book income as it would undermine many of Congress' own policy goals. For example, Congress wanted to limit executive pay by limiting the deduction for compensation. Some limit has been in place since the 1990s. However, companies would be able to fully deduct executive compensation against their book income. A pure book income tax would also disallow credits such as green energy credits.

The Biden administration has already scaled back its book tax for this reason. As mentioned above, Biden's proposal for a minimum tax on book income allows corporations to offset book-tax liability by using general business credits. This maintains the incentive effects of the credits but weakens the book tax and means it will raise little revenue.

***Taxing Book Income Would Distort Investment Incentives***

Taxing book income would also impact investment incentives in the United States. The impact on investment incentives will depend on whether the tax is a minimum tax or an add-on tax that corporations are required to pay each year.

If a corporation were subject to an add-on book tax each year, as they would be under Sen. Warren's proposal, it would raise the tax burden on new investment. A significant difference between book income and taxable income is the treatment of capital expenditures or investments. In calculating taxable income, corporations can expense or fully deduct the cost of short-lived assets. Expensing eliminates the tax on marginal investments. In contrast, book income would require businesses to deduct all investments over their useful lives, which would increase the effective tax burden on new investment.

The impact on investment incentives of Biden's proposal for a minimum tax, on the other hand, would depend on how businesses interact with the tax. Corporations would not be perpetually subject to either the book or the ordinary income tax. They would move between the two systems and may make an initial investment under one tax and face taxes on the returns on that investment under the other tax. Since the tax rates on these taxes are different, the minimum tax may either reduce or increase the tax burden on new investment (Table 1).[xii]

**Table 1. Marginal Effective Tax Rate by Asset, Ordinary Corporate Tax, and Book Tax, 2021**

| | Ordinary Corporate Tax (Current Law and 28% Statutory Rate) | 15% Book Tax | Three Years Ordinary Corporate Tax, Switch to Book Tax for Five Years, Back to Ordinary Tax. | Five Years on Book Tax, Back to Ordinary Tax |
|---|---|---|---|---|
| **Overall** | **3.53%** | **8.75%** | **-2.15%** | **13.59%** |
| Machinery | -10.57% | 9.47% | -22.80% | 14.07% |
| Intellectual Property | -29.06% | -1.99% | -42.22% | 0.46% |
| Structures | 6.37% | 9.47% | 3.45% | 12.66% |
| Land | 20.38% | 9.47% | 18.98% | 18.64% |
| Inventory | 25.20% | 12.41% | 21.06% | 20.04% |
| **Standard Deviation** | **18.23%** | **3.91%** | **22.74%** | **7.64%** |

*Source:* Kyle Pomerleau, "Joe Biden's Alternative Minimum Book Tax," *Tax Notes Federal*, October 5, 2020, pp. 109-116.

**Taxing Wealth**

Several lawmakers have proposed an annual tax on the wealth of very high-net-worth households. During the presidential campaign, Senator Elizabeth Warren proposed a progressive wealth tax that would levy a 2 percent per year tax on net wealth between $50 million and $1 billion and 6 percent per year on net wealth of $1 billion and more. Similarly, Senator Bernie Sanders proposed levying an annual tax on net wealth from 1 percent to as high as 8 percent.

***Taxing Wealth Would Place A High Burden on Saving***

Supporters of a wealth tax typically argue that the tax places only a low-rate tax on wealth. Sen. Warren famously argued that her 2 percent annual wealth tax is a "2 cent" tax. This is highly misleading. A wealth tax taxes a stock of wealth each year. As a result, even at what seems to be a low tax rate, a wealth tax places a significant burden on saving.

The burden a wealth tax places on saving can be measured by the tax wedge it places between pre-tax and after-tax returns. Take, for example, an asset with a pre-tax rate of return of 3 percent. A wealth tax of just 0.2 percent would reduce the return on that asset to 2.8 percent, resulting in an effective tax rate of 7 percent. A more substantial tax rate of 2 percent would reduce the return to 1 percent, for an effective tax rate of 67 percent. A 3 percent wealth tax would result in an effective tax rate of 100 percent.

Reducing the after-tax return on saving could lead to a reduction in national saving. The impact lower savings would have on the economy depends on how open the U.S. economy is to foreign investment. In a closed economy, a reduction in national saving would reduce the amount of saving available to finance productive capital. This would result in a smaller capital stock, lower labor productivity, and, ultimately, lower wages for workers. In contrast, if the economy is very open to foreign investment, the reduction in national saving would result in an inflow of capital from abroad. This increase in lending would lead to an increase in the trade deficit, an increase in foreign ownership of U.S. assets, and ultimately a reduction in national income.

The U.S. economy is open, but it is implausible that the US economy is perfectly open. As a result, we would see a combination of both effects. The wealth tax would likely have a negative impact on the domestic capital stock, wages, and economic output. In addition, it would result in an inflow of foreign capital, an increase in the trade deficit, and a reduction in national income.

Two groups have estimated the wealth tax's impact on the economy and found it would have a negative impact. The Penn Wharton Budget Model found that Sen. Warren's wealth tax proposal would reduce gross domestic product (GDP) by 1.2 percent by 2050.[xiii] The Tax Foundation found that a wealth tax like Warren's campaign proposal would reduce GDP by 0.8 percent in the long run, but because they assume the economy is very open to foreign capital, the wealth tax would reduce national income by 1.5 percent.[xiv]

### *A Wealth Tax's Revenue Potential Is Uncertain*

Proponents of a progressive wealth tax argue that it could raise a large amount of revenue progressively. It would indeed be a very progressive source of revenue, but the amount of revenue a wealth tax will raise remains uncertain. Revenue estimates of wealth tax proposals vary significantly. At the low end, Larry Summers and Natasha Sarin estimate that a wealth tax could raise as little as $366 billion over a decade. In contrast, Lily Batchelder and David Kamin estimate that a wealth tax could raise as much as $5.3 trillion over the same period.[xv] The large range of estimates reflects the wide variation in several assumptions.

The amount of revenue a highly progressive wealth tax will raise depends on how much wealth is held by the wealthiest households. Unlike with income, no administrative data on wealth exists.[xvi] As a result, researchers must develop methods to estimate the share of wealth held by high-income households. These methods produce a range of estimates of the share of wealth by the top 0.1 percent. For example, using estate tax returns, researchers estimated that the top share of wealth was 10 percent in 2014. In contrast, research that capitalized income reported on tax returns found that the share could be as high as 20 percent.

The amount of revenue that the federal government will raise also depends on how taxpayers respond to the wealth tax. In the presence of the wealth tax, taxpayers would have an incentive to reduce their reported wealth. Researchers use elasticities of taxable wealth with respect to the wealth tax rate to estimate this effect. Studies of taxpayer response to the wealth tax have a wide range of elasticities, and some estimates are unrealistically small and imply levels of avoidance that are far lower than the avoidance response we expect from the income tax.

A wealth tax would also reduce the accumulation of wealth and reduce the amount a wealth tax would raise in the long run. One of the stated goals of the wealth tax is to reduce the amount of wealth held by the wealthiest individuals in the United States. For example, economists Gabriel Zucman and Emmanuel Saez estimated that Warren's wealth tax proposal would have eroded the share of total wealth held by the *Forbes* 400 by more than half if the tax had been in place since 1982. Taxing away this wealth would raise revenue in the near term, by would erode its own base.

A reduction in wealth would also have a negative impact on other sources of federal revenue. A large source of individual income tax receipts comes from capital income: capital gains, dividends, interest income, and business income. This income represents the returns to wealth. If the total amount of wealth falls due to evasion, avoidance, or reduced saving, total capital income reported to the IRS would also fall.

The wealth tax risks not raising any revenue at all. This is because the wealth tax, if enacted, is likely to face a constitutional challenge. The U.S. Constitution requires that all "direct taxes" be apportioned by the states by population. The 16$^{th}$ amendment exempts the income tax. If courts determine that the wealth tax is a direct tax, it would either need to be apportioned by state population, which would be undesirable, or would be struck down altogether.[xvii] Other taxes would not face this risk.

**Lawmakers Should Focus on Broader-Based Taxes**

Given the downsides of taxing wealth and book income, lawmakers should consider other sources of revenue that would be simpler to administer and more economically efficient. Below, I discuss three options: a gas tax or vehicle miles traveled (VMT) tax, a carbon tax, and a value-added tax (VAT).

***Gas Taxes and VMT Taxes***

A portion of President Biden's spending proposals include an expansion of infrastructure. Currently, the federal government finances most of its infrastructure spending through the Highway Trust Fund (HTF). The HTF provides funding for highways and other capital projects primarily through grants to state and local governments.[xviii] The HTF receives most of its revenue from the 18.4 cents per gallon tax on gasoline and 24.4 cents per gallon tax on diesel fuel.

The taxes and spending associated with the HTF are based on the "benefit principle" of taxation. This principle states that the fiscal costs of a government service should be borne primarily by those who benefit. Since the consumption of gasoline roughly corresponds with the use of roads, it is seen as a fair way to finance road construction and repair. This is not only fair, but it is more efficient. Financing roads with taxes and fees that correspond with driving effectively sets a price on road use. This helps address many of the costs, or externalities, associated with driving such as congestion, noise, and pollution.

According to the Congressional Budget Office, raising the gas and diesel tax by 15 cents per gallon and adjusting it for inflation going forward would raise $291 billion over the next ten years. Raising the taxes by 35 cents would raise $627 billion over the same period.[xix] This amount of revenue would cover the current HTF shortfall and raise additional revenue that could be used to finance new infrastructure spending.

That said, the gas tax is not perfect. Motor vehicles are becoming more fuel efficient and can now use less gasoline per mile driven. Motorists can drive as much or more but pay less in tax. In addition, the gas tax does not address road congestion. The cost a driver places on others in an urban area is much higher than in a rural area. As a result, a fixed federal gas tax will underprice driving in the city and overprice driving elsewhere.[xx]

To address these shortcomings, lawmakers could also consider a VMT tax in combination with a gas tax. A VMT tax would charge drivers based on the miles they travel. As a result, the tax would be less sensitive to increases in fuel efficiency of vehicles. In addition, the VMT tax could vary by location and time of day to address congestion in densely populated areas.[xxi]

### *A Carbon Tax*

The Biden administration has also expressed interest in addressing climate change in their spending package. A policy that would simultaneously address this issue and raise additional federal revenue would be a carbon tax. A carbon tax is an excise tax levied on the production of greenhouse gas emissions. Most proposals would set the tax at some rate per metric ton, such as $50 per metric ton, and would collect the tax directly from businesses who emit carbon dioxide and other greenhouse gasses.

If considered, a carbon tax should also include a border adjustment that would apply to the embedded carbon emissions from imports and exempt exports from the tax.[xxii] This would eliminate the incentive for US producers to shift emissions out of the United States and would put a price on goods produced in countries such as China and India that end up being consumed in the United States.

Research from various economists and analysts has found that a carbon tax would reduce greenhouse gas emissions. For example, one economist found that even a $15 per metric ton carbon tax could reduce greenhouse gas emissions by 14 percent. Other researchers found that carbon taxes in European countries have reduced emissions by 15 percent.[xxiii]

While reducing greenhouse gas emissions, a carbon tax also would raise revenue for the federal government. The amount of revenue will depend on the rate. However, the Tax Policy Center estimated that a $50 per metric ton carbon tax would raise $2.1 trillion between 2020 and 2029.[xxiv]

### *A Value-Added Tax*

Even before the pandemic and President Biden's spending proposals, the federal government faced a fiscal imbalance. A tax favored by economists that could finance new spending and address the fiscal imbalance is the value-added tax, or VAT.

A VAT is a broad-based tax on goods and services. A VAT is like a sales tax, but it is collected in stages along the production process. Take, for example, the process of making bread under a 10 percent VAT. When a farmer sells wheat to the baker for $40, he charges the baker $44 ($40 for the wheat plus $4 for the VAT that the farmer remits to the government). The baker then sells the bread to the consumer for $110 ($100 for the bread plus $10 in VAT). However, the baker gets a credit for the $4 VAT it already paid on the wheat, for a net VAT burden on the baker of $6. The total tax ends up being $10 ($4 paid by the farmer and $6 paid by the baker) on the $100 loaf of bread.[xxv]

VATs are common globally. Every country in the Organization for Economic Co-operation and Development (OECD) except the United States raises revenue through a VAT. In fact, more than 160 countries have a VAT. Among OECD countries, the average VAT rate is 19.3 percent and ranges from 5 percent to as high as 27 percent.[xxvi]

A VAT would raise a significant amount of revenue for the federal government, but the revenue will depend on how broad the tax base is. According to research by William Gale, a broad-based VAT that covered most domestic consumption could raise $842.4 billion each year or $10 trillion over the next decade.[xxvii]

A VAT would be more economically efficient than the income tax or a wealth tax. A VAT is a tax on consumption. As a result, it does not distort saving or investment decisions like the income tax does. In addition, the VAT is border-adjusted, which means it avoids distorting business' location decisions—businesses cannot avoid the tax by shifting certain assets or income out of the United States.

Enacting a VAT would be equivalent to applying a one-time tax on wealth. Households finance part of their consumption with existing wealth.[xxviii] When the VAT is enacted, the price level would rise by the amount of the tax. This would immediately reduce the value of all existing wealth and the federal government would collect revenue as individual spend down their wealth. Since this would be a one-time tax on existing wealth, it would not distort saving and investment decisions like an annual wealth tax.

### *Addressing Regressivity*

Lawmakers have expressed concerns that taxes such as the gas tax, a VMT tax, a carbon tax, or a VAT would be regressive. Indeed, these taxes would place a larger burden on lower and moderate-income households as a share of income than high-income households. The Tax Policy Center estimates that in the first year after implementation, a carbon tax would reduce the after-tax income of households in the bottom 20 percent by 2.1 percent. At the same time, the top 20 percent of households would see a reduction in after-tax income of 1.4 percent.[xxix]

Lawmakers should consider the distribution of the entire fiscal system, not just one tax in isolation. The regressivity of these taxes could be offset with transfers or other tax reductions for low-income households.[xxx] For example, many advocates of the carbon tax have suggested using some of the carbon tax revenue to reduce taxes or send rebates to low-income households. This would make a carbon tax proposal, on net, highly progressive.[xxxi] In addition, without these taxes, lawmakers would need to make even larger future reductions in programs such as Medicare and Social Security, which would be far more regressive than these taxes.[xxxii]

## Conclusion

President Biden and other lawmakers have proposed a host of tax increases on corporations and high-income households to finance spending. Two revenue-raising proposals have gained prominence over the last couple of years: a wealth tax and taxing the book income of corporations. These taxes come with notable downsides.

Lawmakers should consider broader-based taxes to finance new government spending and address the federal government's fiscal imbalance. Raising the gas tax or enacting a VMT tax would be a reasonable way to pay for infrastructure. A carbon tax would help address climate change while raising revenue. A VAT could raise additional revenue with a limited negative impact on the economy.

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