

Extension of Saving and Investment Incentives

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Chairman Kyl, Ranking Member Jeffords, and Members of the Subcommittee

Thank you for inviting me to testify today at this hearing on extension of the incentives for savings and investment that are scheduled to expire in the next few years. Major tax incentives enacted in 2001 and 2003 that are scheduled to expire and that the Congress may consider renewing include the special lower tax rates for capital gains and dividend income enacted in 2003, and the increase in the annual deduction amount for qualified section 179 property, the savers credit, and the above the line deduction for qualified post-secondary education expenses, all enacted in 2001. The education deduction and the increase in the section 179 deduction expire at the end of this year, the savers credit expires at the end of 2006, and the lower tax rates for capital gains and dividends expire at end of 2008.

My remarks will focus mainly on the effects of extending lower rates for capital gains and dividends. I will also comment briefly on the savers credit and the education deduction.

Lower Rates for Capital Gains and Dividends

Prior to 2003, dividends of individuals were taxed at the same rate as ordinary income. Long-term capital gains were subject to a maximum tax rate of 20 percent for taxpayers in the 25 percent tax rate bracket and above and of 10 percent for taxpayers in the 15 percent tax rate bracket and below.

Between 2003 and the end of 2007, dividends and capital gains will both be subject to a maximum rate of 15 percent for taxpayers in the 25 percent rate bracket and above and 5 percent for taxpayers in lower brackets. (The lower rate on dividends was effective January 1, 2003; the lower rate on capital gains for sales of assets after May 6, 2003). In 2008, the rates drop to zero for taxpayers in the 15 percent income tax rate bracket and below. The lower rates for dividends and capital gains expire at the end of tax year 2008.

The lower rates for dividends and capital gains have been justified on two grounds: 1) relief of the double taxation of corporate income, so that all income is taxed once, and 2)

promotion of saving and economic growth. I will comment on the extent to which the current provisions promote these goals and discuss their effects on economic efficiency and income distribution.

Does it Tax Corporate Income Once?

Under current law, income from corporate equity is potentially subject to tax at both the corporate and individual level. Because corporations cannot deduct dividends paid to shareholders, dividends can be taxable to both corporations and individuals. In the case of individuals and corporations that are both in the 35 percent bracket, \$100 of pre-tax corporate income is subject to \$35 of corporate tax, leaving \$65 to be distributed to shareholders or retained and reinvested by the corporation. If the \$65 is paid as a dividend to shareholders in the top bracket (35%), the total tax under pre-2003 tax law on the \$100 of income would be \$57.75 -- \$35 of corporate income tax and \$22.75 of individual income tax on the dividend payment. In contrast, interest paid to creditors is deductible from income subject to corporate tax, so that \$100 of corporate net revenues that are paid as interest payments give rise to a maximum individual income tax of \$35 and no corporate-level tax.

Retained earnings also result in two levels of tax to the extent that corporate retentions raise the value of shares and result in taxable capital gains. The second level of tax on corporate retained earnings is lower than the tax on dividends, however, because tax on capital gains is deferred until the gain is realized by sale or exchange and because capital gains held until death escape income tax entirely. In addition, even before the 2003 Act, the tax rate on capital gains was lower than the tax rate on ordinary income.

In general, it is desirable that effective tax rates be equalized across types of investments and forms of saving, so that business investment decisions are driven by economic productivity and not tax considerations and individual portfolio decisions achieve a balance between maximization of yield and minimization of risk that is consistent with investor preferences. The double taxation of corporate income, however, produces a number of biases that distort investment decisions and financing choices:

- It penalizes corporate enterprises compared with non-corporate businesses because the latter face only one level of income tax. This bias discourages businesses from choosing the corporate form of organization and shifts investment and output away from industries characterized by a high reliance on the corporate form of organization.
- It favors debt over equity finance, which could lead some corporations to become over-leveraged and assume too much risk.
- It encourages retained earnings over dividends, which weakens shareholder control over corporate policies and could contribute to problems in corporate governance.

It is important to note that the existence of *two* levels of tax does not necessarily mean that the overall tax burden on corporate source income is too high. Many corporations pay low effective tax rates on their income, either because of the use of legislated tax incentives or through international income shifting and other sophisticated tax avoidance techniques (McIntyre 2003, Desai 2002, Sullivan 2004). And a significant portion of corporate-source income pays no income tax at the shareholder level or tax at reduced rates even when paid out in the form of dividends or share repurchases or accrued as capital gains by shareholders. This includes income accrued in employer-funded pensions, individual retirement accounts, 401k plans, life insurance policies, and other tax-deferred vehicles and income accruing to tax-exempt organizations. For example, Gale (2002) reports that just under half of dividends paid out of the corporate sector were subject to taxation at the individual level in 2000 and a similar share in prior years going back to 1982.

Proposals to eliminate the double taxation of corporate income by integrating individual and corporate income taxes have been advanced a number of times since the 1970s. These include the income tax reform option in *Blueprints for Basic Tax Reform*, published at the end of the Ford Administration (Bradford and U.S. Treasury Tax Policy Staff, 1984) the first version of the Reagan Treasury's tax reform proposal in 1984 (U.S. Treasury, 1984), and a Treasury Department Report in the administration of the first President Bush (U.S. Treasury, 1992). In 2003, the current Administration proposed a version of corporate integration in which dividends from previously taxed corporate income would be exempt to individual shareholders.

The current partial exemption of dividends and capital gains, however, differs from previous proposals in two important ways:

- Tax relief on dividends and capital gains is provided, without regard to whether any tax was actually paid at the corporate level. In contrast, the prior proposals, including the current Administration's original 2003 proposal, sought to provide credits or exemptions only to offset corporate taxes actually paid.
- It increases the Federal budget deficit and provides disproportionate tax relief to high-income taxpayers. In contrast, the Ford and Reagan integration proposals were included as part of overall tax reform proposals that were revenue neutral and roughly maintained the existing distribution of the tax burden, while the Treasury report in the first Bush Administration included an option (the Comprehensive Business Income Tax, or CBIT) that actually raised revenue by eliminating interest deductibility at the corporate-level. (U.S. Treasury, 1992).

These differences are important because, instead of moving towards a system in which all capital income is taxed once, the current provisions create new distinctions among taxation of different forms of income. Taxable shareholders of fully taxable corporations continue to pay two levels of tax on dividend income, but shareholders of corporations

that pay zero or low effective tax rates at the corporate level receive an additional benefit because their distributions are lightly taxed as well.

The partial exemption of capital gains and dividends raises the benefits of corporate shelters and increases incentives for corporate tax avoidance behavior because fewer of the benefits of shelters are recaptured upon payment of dividends or realization of capital gains. It also increases the incentive for individual tax shelters that work through techniques that convert ordinary income to capital gains. In addition, while the capital gains cut offsets in part the double taxation of corporate income, a substantial share of capital gains comes from sales of assets not subject to corporate-level tax, including real estate, land, and non-corporate businesses.¹

The provisions do reduce the *net* bias towards corporate debt finance by lowering the combined tax rate at the corporate and individual levels on corporate equity income. But they do not provide equal treatment of corporate debt and equity finance, as would earlier proposals for corporate tax integration. Instead, they move towards a tax structure that taxes returns from debt at the individual level only and returns from equity mostly at the corporate level. This provides incentives for portfolio reshuffling among individuals. It encourages individuals in high tax brackets to hold more corporate equity, and tax-exempt investors (including 401k plans and pension funds) to hold more debt than they otherwise would under both pre-2003 law and a neutral corporate integration system.²

Finally, on balance, the 2003 changes do appear to have increased dividend payouts by corporations with large taxable institutional owners or independent directors with large shareholdings (Chetty and Saez, 2004). Whether or not the same increase in dividend payouts will persist if the tax cut becomes permanent will become evident over time.

¹ IRS Statistics of Income reports that for tax year 1999 capital gains less losses on corporate stock and mutual funds other than tax-exempt funds and capital gains distributions accounted for 57 percent of all capital gains less losses. The corporate share of gains was higher than usual in 1999; in some prior years the share has been less than 50 percent. Burman (1999) reports that capital gains on corporate stock and mutual funds accounted for 47 percent of realized capital gains in 1993.

² A corporate integration system that taxes debt and equity the same way can be accomplished either by allowing corporations to deduct qualified dividend payments or by requiring shareholders to gross up dividend income for corporate taxes paid and allowing them to claim a credit for the corporate tax (the credit imputation method). The latter method is equivalent to treating the corporate tax as a withholding tax on dividends. Under both methods, corporate tax associated with distributed corporate income is eliminated and shareholders pay tax on dividends at their individual marginal tax rate. OECD countries that have provided relief of double taxation use either the dividend deduction or credit imputation method. Alternatively, the single level of tax could be shifted to the corporate level by eliminating taxation of dividends and capital gains on corporate shares, eliminating tax on corporate interest payments, and eliminating deductibility of interest by corporations. (U.S. Treasury Department, 1992)

Under an imputation system, it is also possible to provide relief for the double taxation of retained earnings by allowing corporations to declare stock dividends instead of paying out cash to shareholders. Shareholders would have to report the stock dividends and associated tax as income, but would receive a credit for the corporate-level tax paid and raise their basis for computing any subsequent capital gains tax upon sale of the stock by the amount of income reported.

Will it Increase Savings and Economic Growth?

Reducing the tax rate on income from capital may stimulate more saving and thereby increase investment and economic growth. This could happen because raising the after-tax return on saving increases the amount of future consumption that an individual can obtain by sacrificing an additional dollar of consumption today. But tax cuts that raise the rate on saving also make it possible for people to accumulate more wealth for retirement or other future purposes without saving as much. When taxes on income from capital are reduced, *without offsetting increases in other taxes or cuts in government benefits*, economic theory does not predict whether private saving will increase, decrease, or remain the same. And studies of the relationship between after-tax returns and saving by economists have produced no clear conclusion that higher after-tax returns increase saving.³

Moreover, the higher deficits that will result from extending the cut in capital gains taxes and dividend taxes will reduce national saving on balance, unless private saving rises enough to offset the cut in public saving. The higher deficits will raise interest rates unless foreign savers are willing to finance the additional U.S. borrowing without demanding higher yields. Most likely, the additional deficits will result in both higher interest rates and increases in our already large dependence on foreign sources of funding for the needs of both the public sector and an expanding private economy.

A number of economists have simulated models in which replacing an income tax with a consumption tax that removes the tax on the return to capital will improve economic efficiency and raise GDP in the long run (See discussion in Gale and Orszag, 2004). But the conclusion that growth will increase is based on the implicit assumption in the models that implementing a new consumption tax will impose a lump-sum tax on current wealth. This lump sum tax, unlike taxes on wages and new saving, has no adverse economic effects because it cannot be avoided; the wealth has already been accrued. Without the wealth effects, however, some of the same models that show economic gains from replacing an income tax with an *equal revenue* consumption tax show a much smaller benefit from reducing the tax rate on income from capital. (Altig *et. al*, 2001). And the current proposal to reduce tax rates selectively on capital gains and dividends provides large windfall benefits to existing wealth holders by reducing income taxes on the return to wealth that has been accumulated in the past.

Who Benefits from the Tax Cut?

The distribution of taxable capital gains and dividends is highly skewed towards upper-income tax returns. Simulations with the Urban-Brookings Tax Policy Center (TPC) micro-simulation model show that 48 percent of qualifying dividends and 69 percent of capital gains accrue to taxpayers with annual cash income over \$200,000 and 22 percent of dividends and 59 percent of capital gains are received by taxpayers with cash income

³ These studies are reviewed in Congressional Budget Office (1997). According to CBO, “existing empirical studies provide a bewildering range of estimates. Some find that saving responds markedly to changes in after-tax rates or return; others find no response.”

over \$1 million. (Table 1). Taxpayers with income over \$1 million represent 0.3 percent of all tax returns with 11.5 percent of pre-tax income. Taxpayers in the top 1 percent of the income distribution receive 9 percent of pre-tax income, but receive 33 percent of qualifying dividends and 72 percent of capital gains. (Table 2).

The benefits of extending the tax cut on capital gains and dividends would also accrue mostly to upper-income taxpayers. The TPC estimates that, in 2010, taxpayers with cash income of \$200,000 or over in 2005 dollars would receive 72 percent of benefits from the extension of the tax cut and taxpayers with income of \$1,000,000 or over would receive 46 percent of the benefit. The increase in after-tax income would be 1.6 percent for taxpayers with income over \$1,000,000, 0.7 percent for taxpayers with income between \$500,000 and \$1,000,000, 0.5 percent for taxpayers with income between \$200,000 and \$500,000 and 0.2 percent or less on average in all income groups with income below \$200,000. (Table 3). When taxpayers are ranked by percentile of the income distribution, taxpayers in the top 1 percent receive 58 percent of the tax benefit and taxpayers in the top 0.1 percent receive 39 percent of the tax benefit. (Table 4). While taxpayers on average receive a tax cut of \$209, taxpayers in the top 1 percent receive an average tax cut of over \$12,000 and taxpayers in the top 0.1 percent receive an average tax cut of over \$80,000.

Can the Provisions be Improved?

Cutting taxes on capital income of individuals disproportionately benefits high-income individuals not only because high-income individuals hold a large share of total wealth, but also because much of the wealth of most Americans is already held in the form of assets, such as homes and pensions, that do not generate taxable income from capital. Cuts in taxes on capital gains and dividends do not directly benefit the vast majority of Americans who either have not accumulated much savings or hold most of their wealth in the form of homes, pensions, and tax-deferred savings plans.

Nonetheless, the distortions resulting from the double taxation of corporate income remain a major flaw in the U.S. income tax system. Proposals to reduce or eliminate double taxation of corporate income, if designed properly, could be an important part of a broader tax reform that eliminated and reduced some tax preferences, simplified the structure of remaining preferences, and adjusted rates to maintain revenue and keep the tax system from becoming less progressive. The President has endorsed the goals of revenue neutrality and maintaining a progressive system in his instructions to the Tax Reform Commission that is planning to produce options by the end of September.

With the retirement of the baby boomers and the accompanying fiscal pressures on the Federal retirement program coming soon, it is also important to think how we can use the tax system to help Americans save for retirement. To do so, it is important to re-design savings incentives to make them more effective in increasing net saving of average Americans. The saver's credit is one type of incentive that, with some modifications, has the potential to promote more saving by low and middle-income taxpayers who are

currently not saving enough for their future retirement needs. I now turn to a brief discussion of the saver's credit.

The Saver's Credit

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) included a new tax credit for qualified retirement savings contributions of taxpayers with income below certain thresholds. A 50 percent tax credit is available for single filers with adjusted gross income (agi) below \$15,000. The available credit rate is reduced to 20 percent for single filers with agi between \$15,000 and \$16,500 and a 10 percent credit for single filers with agi between \$16,500 and \$25,000. The agi thresholds are 1.5 times the individual threshold amounts for head of household filers and twice the individual threshold amounts of joint filers, so that joint filers receive some credit for agi up to \$50,000. The credit is reduced dollar for dollar for any distribution from the account during the taxable year, including up to the due date for filing the return for that year, and for the two preceding taxable years or for any distribution received by a spouse if the couple files a joint return. The credit is not refundable, so it is limited to the income tax liability the taxpayer would otherwise have.

By providing a larger subsidy rate for lower income taxpayers, the credit differs from other savings incentives in the Federal income tax. Because they reduce or defer income subject to tax, IRAs and 401k plans are relatively more valuable to taxpayers in higher tax brackets. Research results are ambiguous as to whether these traditional incentives raise net private saving or merely cause people to shift assets to tax-preferred accounts.⁴ But some research results do suggest that deposits to tax-preferred accounts by low-income individuals (without other sources of wealth) are more likely to come at the expense of current consumption instead of other saving or borrowing as compared with deposits of high-income individuals.

A recent research study from a carefully designed controlled experiment with H&R Block clients in St Louis found that higher match rates on contributions to IRAs induces more low-income taxpayers to deposit their tax refunds in IRAs and induces participants to deposit more on average than those with a lower match rate or no match (Dullo *et. al* 2005). The same study found the existing savers' credit to be less effective than the matching program in the experiment. Three possible reasons for the greater effectiveness of the matching program are that: 1) taxpayers in the matching program were informed by a tax preparer of the availability of the subsidy and counseled on how to use it, 2) the match was designed as an 100 percent add-on to the net amount contributed instead of a 50 percent offset to the gross contribution, so it may have appeared larger even though it was not, and 3) the subsidy was not limited to tax liability.

Several modifications to the savers' tax credit could make it more effective, although it would add to the budgetary cost. The credit could be made refundable, so that low-income taxpayers without tax liability could benefit from it (Gale, Iwry and Orszag, 2005). To ease concerns about ineligible people filing returns just to claim the credit,

⁴ For opposing perspectives, see Engen, Gale, and Scholz (1996) and Hubbard and Skinner (1996).

availability could be limited to individuals with a minimum amount of reported earnings. The maximum credit amount could be phased out gradually as income increases over a threshold, instead of having the credit rate drop precipitously when income passes a certain point. That would avoid the higher marginal tax rate on earnings that some taxpayers may face because they would lose a big amount of credit if they earn an additional dollar above a threshold amount.

Recent research suggests that individuals may be very responsive to the way incentives are delivered as well as the actual financial benefit. For example, there is evidence that the take-up rate on 401k plans is much higher when employers automatically deposit money in the plan, with an option for the employee to opt out, than when the employee is simply offered an opportunity to contribute (Choi *et. al* 2004). This does not mean that the tax incentives are ineffective, but merely that they are more effective when they work in coordination with institutional arrangements that make it easier for employees to contribute to savings plans.

Deduction for Expenses of Post-Secondary Education

EGTRRA also created an “above the line” deduction for post-secondary education tuition and fees. The maximum deduction was \$3,000 in 2002 and 2003 for taxpayers with modified adjusted gross income (magi) less than \$50,000 for single and \$100,000 for joint returns. (Modified adjusted gross income is agi less the tuition and fees deduction for purposes of the deduction and agi plus excluded foreign earned income for purposes of the Hope and Lifetime Learning credits.) Smaller deductions were available for single filers with magi less than \$65,000 and for joint filers with magi less than \$130,000. In 2004 and 2005, the deduction increased to a maximum of \$4,000 for single taxpayers with magi less than \$65,000 (\$130,000 for joint returns). Single taxpayers with magi between \$65,000 and \$80,000 (\$130,000 and \$160,000 for joint returns) can deduct up to \$2,000 in tuition and fees. The deduction for tuition and fees is scheduled to expire after tax year 2005.

The deduction adds to the Hope and lifetime learning credits that are permanent features of the tax law. The Hope credit is available for the first 2 years of post-secondary education only and can be claimed for any student in a family. It is equal to 100 percent of the first \$1,000 of qualified expenses (tuition and fees) and 50 percent of the next \$1,000, for a maximum credit of \$1,500. The lifetime learning credit (LLC) is available for undergraduate, graduate, and professional students and for people upgrading skills or changing careers. It equals 20 percent of expenses up to \$10,000 per household, a maximum credit of \$2,000. Only one LLC may be claimed per return.

A student cannot take advantage of both the Hope credit and the LLC in the same year. Both credits phase out for taxpayers with magi of \$42,000 if single or \$85,000 if married at a rate of 20 cents on the dollar for single returns and 10 cents on the dollar for joint returns. Taxpayers cannot claim a credit for any expenses paid for with certain tax-free funds, including scholarships, Pell grants, employer-provided educational assistance, Coverdell Education Savings Accounts, or Section 529 plans.

Deciding which credit or deduction to use for higher education is a complicated calculation for taxpayers. In cases where there is only one student in the tax unit, the HOPE credit is most advantageous for the first 2 years of higher education at institutions with tuition below \$7,500 and the LLC may be more advantageous if tuition is above \$7,500. However, if there is more than one student in the household, the choice between these credits becomes more complicated because the Hope credit is available per student and the LLC is available per return. The deduction benefits primarily taxpayers in the 25 percent rate bracket or higher because for these taxpayers the matching rate is higher than with the LLC, but this also depends on the level of expenses. If expenses are \$3,000 or less, the deduction is more beneficial than the LLC for any taxpayer in the 25 percent bracket or above. If expenses are higher, however, the choice depends on the trade-off between the higher match rate and higher income limits of the deduction and the higher amount of match-able expenses for the LLC.

The Tax Policy Center simulated the distributional effects of the deduction under the assumption that taxpayers choose the incentive most favorable to them. Compared with the other incentives, the deduction is relatively more favorable to higher-income taxpayers. Taxpayers with annual cash income between \$100,000 and \$200,000 receive 51 percent of the benefits of the deduction and receive the largest increase in after-tax income of any income group. (Table 5) Less than 20 percent of the benefits go to taxpayers with income less than \$50,000. The other tax incentives are also relatively more favorable to upper middle-income than to lower-income taxpayers, but less so than the deduction. In contrast, the distribution of the Pell Grants, which depend on measures of family ability to pay, is highly progressive.

The distributional effects of the deduction should not be surprising because the deduction, when added on top of the other incentives, benefits only taxpayers in the 25 percent bracket or above or with incomes above the thresholds for the Hope or lifetime learning credits. In 2002, more than 60 percent of taxpayers had marginal rates below 25 percent. (IRS Statistics of Income).

The main goal of the tax incentives is to increase enrollment in higher education. A number of studies have found that reducing college costs increases college attendance (Dynarski 2002). There is little direct evidence on the effect of tax incentives on enrollment, but a simulation study by Long (2004) suggests there is no overall impact on enrollment because of the inability of low-income families to access the credits. It is questionable, therefore, whether a deduction focused on upper-middle income families will have any significant effect on enrollment. Consideration should be given to simplifying the tax incentives for higher education and focusing them more effectively on families with financial need who are most likely to respond to incentives.

Conclusions

A number of tax incentives for savings and investment enacted in 2001 and 2003 are scheduled to expire in the next few years. These incentives are being considered at a

time when the United States is experiencing large budget deficits and faces the prospect of growing fiscal problems once the baby boom generation begins to retire. At the same time, the private saving rate is very low and many Americans are confronting the prospect of reaching retirement age with inadequate saving. In this context, it is important that tax benefits be paid for and that they be designed to be effective in encouraging additional saving and investment in productive assets and human capital.

The special rates on capital gains and dividends address in part the problem of double taxation of corporate equity income. But they fail to achieve the goal of corporate integration of taxing all capital income equally because they provide benefits to shareholders regardless of whether tax is paid at the corporate level. Unless the lower tax rates on capital gains and dividends were offset by lower spending or increases in other taxes, extending them is likely to reduce instead of to increase national saving and economic growth. The lower rates on capital gains and dividend income provide disproportionate benefits to taxpayers in the highest income groups, who receive most dividend and capital gain income.

Elimination of the double taxation of corporate income remains a worthy goal of tax reform, but should be considered only in the context of a broader reform that is revenue neutral or revenue increasing and distributes the overall tax burden fairly among income groups. Double tax relief should be designed to make the tax treatment of different forms of income received by shareholders and lenders more equivalent and to ensure that shareholder relief for taxes at the corporate level is provided only if the taxes are actually paid.

The Saver's Credit is an alternative approach that provides an incentive for new saving and, in contrast with other saving incentives in the tax law, provides a larger matching grant to low-income than to high-income taxpayers. Recent research suggests that matching grants can increase contributions to retirement accounts by low and middle-income Americans. This is a promising approach to help low and middle-income Americans save more and reduce their future dependence on government retirement programs. Congress should consider ways of modifying the Saver's credit to make it accessible to more people and increase its effectiveness.

The deduction for education is one component of a very complex set of tax incentives for spending on higher education. With the other incentives in place, the additional benefits of the deduction go mostly to upper middle-income taxpayers and probably have little effect on college enrollment. Congress should consider combining and simplifying the current complex set of tax incentives for education and targeting their benefits more to students from families that are more likely to need assistance to finance higher education.

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