Testimony of James Poterba, Professor of Economics, Massachusetts Institute of Technology
Senate Finance Committee
August 3, 2006

Chairman Grassley, Ranking Member Baucus, and members of the Finance Committee, thank you for asking me to appear before your Committee today. It is a pleasure to have this opportunity to discuss tax reform with you. It was an honor to work with the distinguished members of the President's Tax Reform Panel, and I am delighted to share some of our findings with you.

This is an opportune moment to consider fundamental tax reform. Our income tax code contains a number of expiring provisions that require ongoing debate and re-authorization. Uncertainty surrounding these provisions, such as the future tax rates on dividends and capital gains, hampers taxpayer planning and discourages long-term investments. Moreover, the looming problem of the Alternative Minimum Tax creates even more uncertainty for many taxpayers. The expanding reach of the AMT has been avoided through the sequential enactment of short-term fixes. As the revenue cost of such temporary solutions rises, however, they will become ever more difficult to sustain. Because the AMT confronts taxpayers with different marginal rates, and different tax rules, than the ordinary income tax, it further complicates long-term taxpayer planning. It would be far better to enact a permanent AMT fix that would not require annual or semi-annual adjustment than to continue with the current strategy of short-term remedies.

The President's tax panel considered three motives for tax reform: simplifying the tax code, making the distribution of tax burdens fairer, and promoting long-term economic growth. While it is tempting to claim that tax reform can achieve all three of these goals simultaneously, in practice these three objectives are often in conflict. The trade-offs are particularly acute when tax reform must be carried out in a revenue-neutral environment. For example, a simple tax code may treat households with different circumstances in the same way, resulting in charges that it is unfair. A tax code that promotes economic growth by avoiding high marginal tax rates may also be viewed as unfair by some observers. Finding a way to balance these competing goals is one of the central political challenges of tax reform.

Tax experts have different views about what constitutes a fair tax system, and they also disagree about the incentive effects of the current tax system. These disagreements lead them to make different prescriptions for the best way to reform our tax system. There is broad agreement, however, that the current system can be improved upon, and that tax reform deserves an important place on the policy agenda.

Tax reformers should pay close attention to how the tax system affects the economy's long-term growth prospects, and in particular to its effects on capital formation. The current tax system places a wedge between the pre-tax return earned on many investments, particularly those in the corporate sector, and the after-tax return earned

by investors. Many economic analyses suggest that reducing this wedge could lead to substantially greater economic growth, and over a horizon of several decades, to significant increases in national income. Some studies suggest that replacing a textbook-style income tax, which places the same tax burden on labor earnings and capital income, with a textbook-style consumption tax, which taxes all consumption at a constant rate, could increase steady-state GDP by as much as five percent. Actual tax reforms, which start from the current hybrid tax structure that allows a number of incentives for saving, and which move to alternatives that may be encumbered with transition relief and other provisions that deviate from a textbook consumption tax, are likely to deliver smaller gains. Yet even if the economic analyses overstate the potential gains by a factor of two, the long-run growth effects from tax reform are likely to be significant and are likely to exceed the economic gains from tax simplification.

Three broad guidelines should be considered in designing a pro-growth tax system. First, keep marginal tax rates as low as possible, thereby avoiding distortions in many aspects of economic behavior. Marginal tax rates on low and moderate income households, which may rise to unintended levels as a result of the combined effect of income taxes, payroll taxes, the phase-out provision in the income tax code, and phase-outs in some transfer programs, must be considered along with marginal tax rates on high income households.

Second, avoid substantial differences in tax burdens across similar activities or sectors. There are many examples of disparate treatment of similar activities in the current tax code. Household Interest income is taxed differently than dividends and capital gains, corporate interest deductions are treated differently than dividend payments, and investments in owner-occupied housing are treated differently than investments in other long-term assets. Each of these disparities distorts the economic decisions of households and firms. The Treasury Department estimates, for example, that the effective tax rate on investments in corporate business is currently 26 percent, while that on investments in non-corporate business is 17 percent and investments in owner-occupied housing are virtually untaxed. Such differences in tax burdens distort the allocation of capital across sectors.

Finally, keep the tax burden on capital income as low as possible, subject to concerns about fairness in distributing tax burdens. The tax burden on saving and investment is a key determinant of long-term economic growth. The current tax code places substantial tax burdens on some types of investments, thereby creating a “tax drag” on long-run economic growth. Shifting the current tax system toward a consumption-based system that exempts capital income from taxation is likely to yield substantial long-term economic benefits.

The Tax Reform Panel considered a range of alternatives to the current tax system, and it ultimately recommended two fully articulated reform plans: the Simplified Income Tax (SIT) and the Growth and Investment Tax (GIT). The details of each proposal are summarized in the Executive Summary of the Tax Panel’s report, Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System. The SIT preserves the basic

framework of the current income tax structure. It simplifies the current structure of personal exemptions and deductions, and replaces the bewildering current array of specialized saving accounts with three such accounts: Save at Work, Save for Retirement, and Save for Family. It integrates the personal and corporate income taxes for domestic earnings of U.S. firms, and it reduces the statutory tax rate on capital gains on corporate stock. The GIT combines most of the same features with regard to the tax treatment of taxpayer units and earned income with a flat-rate 15 percent tax on interest, dividends, and capital gains, and it adopts a cash-flow corporate income tax. The business tax structure is similar to that proposed in the Treasury Department's celebrated 1977 Blueprints for Tax Reform, and it represents an important step toward a consumption tax.

Each proposal is simpler than the current tax system, in part because each repeals the corporate and the individual AMT. Each is approximately distribution-neutral, although unresolved conceptual issues about the distribution of a hybrid consumption and income tax like the GIT make comparisons of the SIT and the current system more certain than those involving the GIT and the current system. Each proposal would have a favorable effect on long-term economic growth, although available estimates suggest that these effects would be substantially greater for the GIT than for the SIT because of its focus on reducing the tax burden on new investment.

Because both proposals repeal the AMT, which has a substantial revenue cost, they also include a number of provisions that make up for the revenue that would otherwise have been raised by the AMT. Rather than raising marginal tax rates, and increasing the associated distortions in economic activity, the plans broaden the tax base by limiting deductions and bringing income sources that are not currently taxed into the tax system. The base broadening includes caps on the amount of income that can be excluded from the tax code, as in the case of employer-provided health insurance, limits on the total deduction available to each taxpayer, as with the mortgage interest deduction, and in some cases complete elimination of current deductions, as with the deduction for state and local taxes. Base broadening is never easy, because any reform provision that raises enough revenue to be of consequence is likely to limit a tax benefit that is currently claimed by a substantial group of taxpayers. The SIT and the GIT focus on several of the largest current tax expenditure items. The favorable treatment of owner-occupied housing reduces income tax revenue by about $142 billion at present, while exempting employer-provided health insurance from taxation accounts costs another $126 billion and the deduction for state and local income and property taxes reduces the income tax yield by $56 billion. These are substantial amounts when viewed against the backdrop of aggregate income tax collections, which are currently close to one trillion dollars per year. While it is politically difficult, base-broadening is likely to be an essential feature of any future reform that permanently addresses the AMT problem, or that achieves long-term reduction in marginal income tax rates.

While base-broadening reforms reduce tax-induced distortions and have favorable effects on economic efficiency, the provisions that have the largest estimated effects on long-term growth are the expensing provisions of the Growth and Investment Tax.

Under this proposal, all business investment is eligible for immediate write-off. Expensing makes the government a partner in the cost of any capital project, since the investor receives an immediate write-off for the project's cost. The government is also a partner in the subsequent returns. Provided the same tax rate applies when the project's costs are incurred and when its returns are generated, the presence of this virtual "partner" should not lead to any distortion in investment decisions. Any project that would be undertaken in the complete absence of taxation would still be undertaken when expensing is allowed but corporate earnings are taxed. There is no corporate-level tax distortion in investment incentives, and moreover, the tax treatment of different types of investments is the same.

The present tax system, which incorporates inter-asset differences between depreciation lifetimes and actual depreciation rates, creates substantial disparities in effective tax rates. The Congressional Budget Office recently estimated that the effective tax burden on railroad equipment, for example, is 11.4 percent, while that on agricultural machinery is 20.2 percent and that on computer equipment is 36.9 percent. This pattern implies that the tax system induces a larger reduction in investment in computer equipment than in the other asset categories. Income tax structures that prescribe asset-specific depreciation profiles often lead to differences in tax burdens across assets. Expensing eliminates this source of inter-asset distortions and sets the effective tax rate to zero for all investments.

Expensing for new investment is likely to command widespread support in the business community. This is not surprising: replacing the current structure of depreciation allowances with expensing would reduce income tax revenues and would represent a tax cut. Yet to achieve the foregoing claims about eliminating inter-asset distortions and zeroing out the tax burden on new investment, expensing must be combined with another, less popular, reform provision: restricting corporate interest deductions. Enacting expensing without disallowing interest deductions for project-related debt finance would not just reduce current effective tax rates on new investment to zero but would drive effective tax rates <u>negative</u>. If firms can expense the acquisition cost of an asset, and they can also deduct the interest payments on any project-related debt, then some projects that would not be worth undertaking in the absence of any taxes would be undertaken just because of the tax benefits they generate. This would represent a return to the situation that prevailed in the early 1980s, when the combination of accelerated depreciation, safe-harbor leasing, and interested deductibility resulted in negative effective tax rates on many investments. Concern that many projects were being undertaken only for their tax benefits was one of the factors that led to the passage of the Tax Reform Act of 1986. A tax wedge that reduces investment relative to the level that would take place in a world without taxes, just like a tax subsidy that induces over-investment, is a source of economic inefficiency.

The design of limits on corporate interest deductions is one of the most difficult aspects of crafting a cash-flow corporate income tax like that in the GIT. Interest deductions for purely financial activities, such as those associated with banking or insurance businesses, may need to be treated differently than those associated with non-financial

businesses. Because most large firms are engaged in both financial and non-financial activities, deduction limits may need to distinguish different types of borrowing within a given firm. The Tax Panel's report discussed a number of ways to approach this issue. A simple strategy would be to allow interest deductions only up to the amount of a firm's interest income.

The Tax Reform Panel focused most of its attention on the Simplified Income Tax and the Growth and Investment Tax, but it also discussed a third possible reform: enacting a value-added tax (VAT) to replace a substantial fraction of the revenue currently collected by the corporate and personal income tax. One scenario might involve repealing the corporate income tax, and replacing the lost revenue with a VAT. The VAT is a type of consumption tax that is widely used in other nations. One of its most appealing features is its ease of implementation: the experience of other nations shows that the VAT is a consumption tax that is administratively feasible and relatively straightforward to collect. When applied to a broad consumption base, the VAT offers a very efficient means of collecting substantial amounts of revenue. Because the VAT is a consumption tax, it does not distort saving or investment decisions. In practice, however, most VATs do contain other distortions. In most countries with a VAT, a substantial share of consumption is tax-exempt. This both reduces the VAT's revenue potential, and creates distortions between different categories of consumer goods.

Opponents of the VAT worry that once such a tax is enacted, the VAT rate will rise and ultimately lead to an expansion of the government's role in the U.S. economy. Political economy concerns such as this one deserve an important place in tax reform discussions. Existing empirical research, however, does not suggest a robust relationship between a country's enactment of a VAT and the growth of government spending. It is difficult to identify causal links between tax structures more generally and the size or growth rate of government expenditure. Both variables of interest are likely to be co-determined by political and other forces. While the Tax Panel did not endorse the partial-replacement VAT, this option deserves consideration in fundamental tax-reform debates.

My comments thus far have focused on the hypothetical choice among different tax systems, rather than the practical question of how to reform the current system to move in a desirable direction. The transition problem, getting from the current system to an alternative one, is the most difficult part of tax reform. Many voices and interest groups are likely to oppose tax reform because they benefit from some of the provisions of the current tax code, the very provisions that I have described as a source of economic inefficiency and tax drag on economic growth.

There are two ways to address such concerns. One involves focusing on tax reform as a package rather than as a set of component parts. Some taxpayers who lose from a single provision may benefit from other aspects of a reform. The key is to emphasize net changes, rather than gross effects of individual provisions. Even with this strategy, however, a revenue-neutral reform is likely to generate both short-run winners and short-run losers. For the losers, it is essential to emphasize the favorable long-term

growth effects of reform, and the benefits that it will ultimately provide. Because some losses are current and tangible, while potential gains are prospective and uncertain, selling tax reform can be a political challenge.

A second approach, which the Tax Panel discussed, involves phasing in key provisions and providing transition relief that will blunt the short-run effect of various legislative changes. Transition relief can take many forms: gradual changes in marginal tax rates, allowing recovery for future tax benefits that were accrued under the previous system, and even targeted legislative provisions to reduce tax burdens on taxpayers with specific attributes. One important difficulty with allowing transition relief is its cost. The greater the cost of transition relief, the higher the required marginal tax rates in the new tax regime, and the smaller the efficiency gains associated with tax reform. The equity benefits of transition relief must ultimately be balanced against the efficiency cost of such relief and its associated distortions. Recent economic research suggests that the efficiency and growth costs of delivering generous transition relief can be substantial. I therefore urge you to focus your attention not just on the long-term structure of alternative tax systems, but on the least costly way to move from the current system to such alternatives.

Thank you for the opportunity to discuss these issues with your committee.