S. HRG. 109–982

KICK-OFF FOR TAX REFORM: TACKLING THE TAX CODE

HEARING

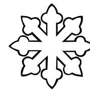
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

AUGUST 3, 2006



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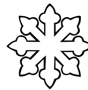

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KICK-OFF FOR TAX REFORM: TACKLING THE TAX CODE

THURSDAY, AUGUST 3, 2006

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:35 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Present: Senators Wyden, Kyl, and Smith.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Thanks, everybody, for your presence, on time and everything. We appreciate it very much.

You can see that the Senator from Oregon is sitting beside me; obviously his interest in tax reform is well known to everybody, so it is perfectly legitimate that he sits there.

But he is sitting in for Senator Baucus because of the sad news that the Baucus family received on the death of Corporal Phillip E. Baucus, who died in action in Iraq over the weekend. Our thoughts and prayers go out to the Baucus family, and we can surely understand his absence from this hearing.

But also, I want you to know that Senator Baucus has been very cooperative in every effort to move along three hearings, this being the second one. The first one was not as pointed as this one is. We will maybe have one in September on other aspects of the tax code, but Senator Baucus has been very cooperative, in a bipartisan way, of moving this along.

There is universal agreement that our tax code is complex. The tax form instrument book is probably the most unwelcome piece of mail many taxpayers get. The complexity means taxpayers cannot be confident that they received all the breaks coming to them or that they have not paid more than what they owe.

Now, add to the complexity of the regular tax system the creeping effects of the Alternative Minimum Tax, and, of course, you have a recipe for disaster. As an example of the program from the AMT side, if we do not extend the hold-harmless or "patch" for the year 2007, 24 million tax filers, mostly families, will be affected by the AMT. Twenty-four million families.

That is a large number of people. But because of the way the AMT is structured, with no indexing, this AMT problem grows exponentially from year to year. The revenue loss for this year's patch was $34 billion, and it grows to $44 billion next year. So,

quite obviously, as far as AMT is concerned, we are facing a train wreck.

Senator Wyden and I resolved, in a dialogue in this committee, to remedy the AMT problem. Senator Baucus introduced legislation to that effect, joined by Senators Kyl, Wyden, the Chairman, and others. So there is no question that we all recognize it is a big problem. It is a problem that the committee should focus on.

Let me say that I have no preconceived notions of which direction we go, whether we are talking about a flat tax, a national retail sales tax, or value-added tax, or a substantial modification of the current system.

Let me also note that I instructed the Finance Committee staff to develop simplification proposals in all income tax areas. The staff are working on those proposals.

On a preliminary note, we did invite Treasury Department officials to today's hearing. Treasury officials told us, at this time, they did not wish to participate in the hearing so that they could have a chance to review tax reform proposals with the new Secretary.

Treasury officials informed the committee that the Treasury would be happy to participate at future meetings. We hope to have hearings this fall on tax reform. We will look forward to Treasury's participation at that time.

In addition, I still expect Treasury and administration officials' responses to the President's Advisory Panel on Federal Tax Reform that is the focus of today's hearings, and that is something that I made clear to the new Secretary at the time I had a private meeting with him, as well as the public meeting.

So today I would like to say that we are kicking off tax reform, but we will be waiting to hear from one of those key coaches, the new Secretary, as he draws the Treasury's playbook. I know that the Secretary is very dedicated to reforming the system, and I look forward to hearing from him and his staff.

Today, we will hear from a couple of former Finance Committee veterans who took the charge from President Bush to take the first step at tackling the problems of the tax system.

Senator Connie Mack of Florida served several years on the committee and came back to public service to chair the President's tax reform panel. Senator John Breaux served on the committee from 1990 through 2004, almost a decade and a half, and served as vice-chairman of the advisory panel.

Joining with us on the first panel is Elizabeth Garrett, who served as Tax Counsel for former committee member David Boren; and we also have Professor James Poterba. I appreciate the tax panel's months of study and analysis.

It seems the panel members were apolitical in their work. Some of their recommendations were bound to be politically unpopular; cutting the home mortgage interest deduction is just one example we often hear about. But it is important to have a comprehensive starting point, and I think they have provided that.

We have a couple of witnesses to provide an evaluation of the Advisory Panel's recommendations. We will hear testimony from David Walker of the Government Accountability Office and Dr. Jane Gravelle of the Congressional Research Service, whom I have

had a chance to visit with privately about this issue of tax reform as well.

So we welcome you. But before we go to your testimony, we will hear now from Senator Wyden.

OPENING STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM OREGON

Senator WYDEN. Mr. Chairman, thank you very much. I particularly thank you for your words about our special friend, Senator Baucus, this morning. I think our hearts are all out to Senator Baucus today. For those of us who know Max well, Max is all about family. Family is everything to Senator Baucus.

So, our thoughts are with him today, our hearts are heavy, and I appreciate your starting this morning's hearing with a prayer for Senator Baucus, because he is very much in our minds this morning.

Mr. Chairman, my thanks to you for scheduling this hearing. I know that you want to aggressively tackle the issue of tax reform. I have learned a great deal from you about how we could work on this in a bipartisan way during the many discussions that we have had about taxes in recent months.

I also want to say that I greatly appreciate the recent comments of Alan Hubbard, the chair of the President's National Economic Council, who has stated that the President also believes that the current tax system is broken.

Mr. Chairman—and I see my friend Senator Smith is here—I want to work with Senators of both parties to make our tax system simpler, fairer, and one where all Americans can accumulate wealth.

Briefly, here is where I think we are on taxes in our country. For millions of Americans, completing their taxes today is unmitigated torture. There have been more than 14,000 changes in tax law since the last reform effort, and it comes to more than three for every working day in the last 2 decades.

So our citizens spend hours and hours tracking down a dizzying array of tax forms, and they still collectively spend more on tax preparation than the annual revenue of Wal-Mart, the largest company in America.

During a recent discussion of tax reform, my staff stacked up next to me just a portion of the tax code, volume on volume, and it dwarfed me at 6 feet, 4 inches. I do not think it has to be this way.

Now, in my proposed tax reform legislation, the Fair Flat Tax Act—I think we have given you one of these forms, Mr. Chairman—this is a one-page 1040 form. It has 30 lines in it. It took me about half an hour to complete it.

I guess that is going to be a bit of a revolution, because they tell me it has been a long time since a member of our powerful committee could fill out their taxes on a 1040 form.

The folks over at *Money* magazine did it in 15 minutes. I bring this up only by way of saying that filling out a 1040 tax form in America does not have to be water torture.

Next, it seems to me our committee needs to tackle the issue of fairness. The current tax system is biased against hardworking

middle-class Americans who get most of their income from wages, not investment.

Right now, the tax rate on a day's wages can be more than 20 percent higher than the rate on investment income. I want everybody in the United States—every person—to be able to accumulate wealth. I deeply believe in markets, and I think that the marginal tax rate is extremely important.

So I am not interested in soaking anybody. I believe this committee can find a way to be fair to both the cop walking the beat who makes most of his money from wages and the investor who is taking risks in the stock market.

The reason I believe tax reform is possible is because we actually have a model. That is the reform of 1986. Democrats and Republicans came together that year to get rid of the loopholes, to hold down the tax rates, make the Code fairer, and let the market, and not government, drive capital to its highest and best use.

I think we can build on the 1986 model. There are obviously new challenges, and you have pointed to one of the biggest, the question of the Alternative Minimum Tax. But with our friends, Senator Mack and Senator Breaux, here, I would like to say there is an awful lot in what the Commission has produced that this committee can build on on a bipartisan basis.

I mentioned my 1-page 1040 form. I have said in discussions with Senator Breaux and Senator Mack that theirs is maybe a few lines longer. For purposes of government work, we are the same. We can do this. I have proposed a tax code with three brackets; Senators Breaux and Mack have proposed four brackets. Again, this is an area where we can come together.

I would also point out, Mr. Chairman—and you and I have talked about this—that I started, for purposes of discussion, my proposal with exactly the same brackets that Ronald Reagan proposed when he started in 1986. But I am very open to a whole variety of alternatives.

For example, it would be fine with me if we came together and eliminated enough loopholes so that maybe the person with the lowest income would pay 10 percent, the person with the middle income would pay 20 percent, and the person at the top would pay 30 percent, and we would have really drained this tax swamp that is replete with so many loopholes. Then we would have a system that was simpler, fairer, and one where everyone can accumulate wealth.

We have a number of panel members whom I have talked to many, many times over the last few months. Jane Gravelle slogged through many numbers and iterations of my proposal; Mr. Walker as well has been helpful on these issues.

I am just very pleased that we have Senators Mack and Breaux, because I think, as they did so often when I had the pleasure of serving with both of them, they showed us the way that we could come up with responsible bipartisan approaches in this area. I look forward to hearing from them and working with them to actually get this done and get it on the President's desk.

The CHAIRMAN. Thank you very much, Senator Wyden.

Senator Baucus has an expression of his views on this subject that I will insert in the record as a statement from him.

[The prepared statement of Senator Baucus appears in the appendix.]

The CHAIRMAN. Senator Smith, since you have had some interest in this, do you want a few seconds or a few minutes to say something?

Senator SMITH. No, Mr. Chairman. I am here to hear the witnesses, so I would go to them.

The CHAIRMAN. Yes. I got an e-mail that we might have a vote at 11. If we do, I would request of the two Senators who are present, that I will run and vote right away while the panel is going on, and you preside, then I will come back and you go vote. Is that all right?

Senator SMITH. Yes.

Senator WYDEN. Yes.

The CHAIRMAN. Then is it all right with Senators Mack and Breaux if we go through the entire panel before we have questions? You can wait?

Senator MACK. Yes.

Senator BREAUX. Yes.

The CHAIRMAN. Thank you very much.

So would you proceed, Senator Mack? And thanks to all the panelists, too. I probably forgot to say that. Thank you very much for taking the time on a very important subject that is starting us down a trail that is not going to be an easy trail, but it is a trail that we must maneuver down and have a destination that we make.

Go ahead.

STATEMENT OF HON. CONNIE MACK III, CHAIRMAN, PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM; AND SENIOR POLICY ADVISOR, KING & SPALDING, LLP, WASHINGTON, DC

Senator MACK. Thank you very much, Mr. Chairman. On behalf of the entire panel—there are only four of us here this morning, but on behalf of the entire panel—let me just thank you and the committee for your interest in tax reform.

Before I provide a brief description of the options, I want to highlight the need for tax reform and to explain the framework under which we operated.

As a member of the Senate Finance Committee for many years, I had spent a lot of time working with the tax code, and I was aware of its deficiencies. However, it is fair to say that in my service on the tax panel, conducting hearings, gathering information, and reading comments, that confirmed just how bad the situation really is.

Instead of the sleek and simple system designed to raise revenues for our national defense, social programs, and other vital public services, we have a system so complex that almost $150 billion is spent each year by U.S. households, businesses, and the Federal Government just to make sure taxes are tallied and paid correctly. In 2003, 60 percent of filers hired a tax preparer. By the way, only 14 percent of Americans actually do it the old-fashioned way with, I was going to say pen and paper, but maybe, appropriately, pencil and paper.

Between 1986 and last November, there were over 15,000 changes to the tax code. Instead of a system that ensures that all pay their fair share, we have a system so confusing that 2 million taxpayers collectively paid over $1 billion more in taxes by simply making a wrong decision about the basic choice of itemizing or taking the standard deduction. And while some people over-pay because of their confusion, the vast majority of people under-pay.

The IRS has estimated that there is a net tax gap of $290 billion per year, which translates into a tax hike of more than $2,000 per year for honest taxpayers. There is no easy answer to reducing the tax gap, but an obvious and productive place to start is by reforming the Code so that it is easier to understand and to enforce.

Instead of a tax system that draws revenue efficiently from the base of the Nation's considerable economy, we have a tax code that distorts basic economic decisions, sets up incentives for unwise and unproductive investments, and induces people to work less, save less, and borrow more. By some estimates, this economic waste may be as high as $1 trillion each year.

In an increasingly global environment, our tax code also plays an important role in the competitiveness of American business. Our corporate tax rates are high, and even if companies can employ strategies to lessen the effect of these rates, they are wasting valuable resources.

Now, let me say a few words about the panel's framework. We operated under a set of rules, some of which the President, through Executive Order, imposed, and others that we adopted for ourselves.

In the former category, our options were to be revenue-neutral, and we used the President's baseline. The Executive Order also instructed us to develop options that were appropriately progressive.

Some panel members felt that the current distribution of Federal income taxes was appropriate or that it should be more progressive, while others felt that the higher-income taxpayers shouldered too large a share of the tax burden.

We quickly realized that we could have consumed all of our time debating this question and still probably not reach a resolution. In the end, we concluded that the appropriate burden of taxation was an issue that elected officials should resolve.

The resolution of the burden question helps to illustrate, though, how we viewed our role. We could have operated through the prism of politics or the prism of economics and tax policy.

We chose the latter, recognizing that the administration and Congress would have to deal with the political issues, and that our options should be based on sound economic and financial principles.

Now, let me say a word about our options. We unanimously settled on two options, which we called the Simplified Income Tax—some refer to that as SIT—and the Growth and Investment Tax, GIT. We did not reach consensus and, thus, did not recommend a national retail sales tax, a value-added tax, or a progressive consumption tax.

The simplified income tax plan dramatically simplifies our tax code, cleans out targeted tax rates that clutter the system, and lowers rates. It does away with gimmicks and hidden traps like the Alternative Minimum Tax.

It preserves and simplifies major features of our current tax code, including benefits for home ownership, charitable giving, and health care, and makes them available to all Americans.

It removes many of the disincentives to saving that exist in our current code, and it makes small business tax calculations much, much easier. It also offers an updated corporate tax structure to make it easier for American corporations to compete in global markets.

The second recommended option, the Growth and Investment Tax Plan, builds on the SIT and adds a major new feature, moving the tax code closer to a system that would not tax families or businesses on their savings or investment.

It would allow businesses to expense or write off their investment immediately, it would lower tax rates, and impose a single low tax rate on dividends, interest, and capital gains.

Both of these plans offer dramatic simplification, reducing the number of lines, as Senator Wyden indicated a moment ago, on the 1040 form, in our case, from 75 to 32, and, I think as important, the number of commonly used forms, schedules, and worksheets, from 52 to 10. We make the tax code fairer by transforming deductions that are only allowed for a few into credits or deductions that are available to all.

These are important accomplishments. But I also believe that the most important thing that we can do is to ensure that the tax code promotes growth and competitiveness.

The principle of freedom—that is, free markets and democratic capitalism—is transforming the world. The growing economies of China and India, along with the rest of the world, are providing us with fierce competition.

Our current tax system distorts capital flows and impacts economic decisions, and our options respond to that challenge by reducing the cost of capital, lowering the corporate rate, moving our international tax system to either a territorial or border-adjusted one.

Expensing is especially important, as it would reduce the effects of the tax rate on new investment from 17 to 6 percent, and it makes us the best place in the world to invest.

In closing, Mr. Chairman, let me just pick up on the theme that I think I heard this morning. The one thing that I remember and cherish about this committee was the ability to work together.

It was not always easy, it was not always fun, but there was a sense that the issues that we were dealing with were so important that we had to find a way to work together. Clearly, you all have continued to carry on that tradition, and I hope that that will continue as we work through tax reform.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Mack.

[The prepared statement of Senator Mack appears in the appendix.]

The CHAIRMAN. Now, Senator Breaux?

STATEMENT OF HON. JOHN BREAUX, VICE-CHAIRMAN, PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM; AND SENIOR COUNSEL, PATTON BOGGS, LLP, WASHINGTON, DC

Senator BREAUX. Thank you very much, Mr. Chairman and members of the Finance Committee, both Senator Wyden and Senator Smith. Thank you for having this hearing, because I thought this report had been lost somewhere. I mean, we sent it. We worked on it. We had 100 witnesses. We had hearings all over the United States. We did this wonderful book. I learned a lot just by reading the book that we produced about the tax code.

After we turned it in, the Secretary wrote on my book: "John, thanks for your great work. Now it is up to us," signed by the Secretary. Then I do not know where it went. I hope someone down there really read it in great detail. But it never came back.

I mean, the purpose of a commission is to produce a product that someone reacts to. We did a lot of work. The Chairman is absolutely correct. We did it not only in a bipartisan fashion, we did it in a nonpartisan fashion, and we spent a lot of time doing it.

I do not think there is an issue of national importance like simplifying the tax code that you could have more agreement by the Republicans and the Democrats that it should be done.

If the President of the United States stood before a joint session of Congress and said, you know, I have asked for this report, here it is, I now challenge Republicans and Democrats to do something for the American people to simplify the Internal Revenue Code so we do not spend $140 billion in complying with it, both sides of the Congress would stand up and give him a standing ovation.

There is an agreement in any forum that you go to back in your States—Rotary Club, Chamber of Commerce, a labor union meeting. If you stand up and say, by golly, I am going to go back to Washington and simplify the tax code because it is too complicated, too complex, and too expensive, you are going to find people saying, yes, you are right. The last time we did it? 1986.

As Connie said, 15,000 amendments have been added to it, some of which I am responsible for. I thought they were great. But that is more than two amendments a day since the last time we did it.

How did we do it the last time? In a bipartisan fashion. A lot of tough work. Some of you all were involved in it. But it was the last time we did it. Certainly, Connie has listed the reasons why it should be done again.

One of the papers asked our group—which contained real tax experts other than myself, certainly—how many of you on that committee do your own tax returns? Only one of us on the panel of experts did their own tax returns, and it certainly was not me. But that was it.

If you have people who are experts, who live their lives teaching this stuff, and they do not even do their own tax returns, something is wrong with it.

Sixty percent of the people have to hire somebody. Seventy-five percent of the people that get the Earned Income Tax Credit, for the poorest among us, have to go out and pay somebody to do their tax return. There is something wrong with a system that does that.

So, anyway, we have some real tight restrictions on what we can do. The President said, look, simplify it. Make sure it is reasonably

progressive. Make sure it promotes economic growth and job creation. Make sure you pay attention to charitable deductions. Make sure you pay attention to mortgage deductions. Make sure you pay attention to health incentives. And, oh, by the way, make it revenue-neutral. Whoa. I mean, that is not easy to do.

But since none of us were running for re-election, we made an effort, and I think we came up with something that did what the President asked us to do. But we made some tough political decisions. Like I said, we are not running, and maybe it is easier to address those things.

We did away with the AMT. Everybody wants to do that. That is easy to say we are going to repeal it. It is $1.5 trillion over 10 years. If you are going to make it revenue-neutral, where is it going to come from?

Priscilla, Connie's wife—and I have said this before—had the greatest comment about the Alternative Minimum Tax. She said, "Why do you all call it that?" He said, "What do you mean?"

She said, "Well, number one, it is not an alternative. You have to pay it. Number two, it is not a minimum tax, it is the maximum tax. So it should not be called the Alternative Minimum Tax. It should be called the Maximum Mandatory Tax." [Laughter.]

But everybody here can agree, let us get rid of it. But how do we pay for it if you are going to make it revenue-neutral? That is the tough part. The easy part is getting rid of it.

So let me just address, briefly, some of the things that we have tried to do in order to take care of, how do you do these fun things, and then how do you pay for the fun things that have to be paid for?

One of the things we did with regard to trying to change it is that we made some changes in charitable deductions. Number one, we felt that it was not being fairly spelled out because everybody does not benefit from them, so we made some changes in the charitable deductions in order to make sure everybody is able to have access to them, not just those who itemize.

Three-fourths of the deductions under the old system went to 12 percent of the taxpayers with incomes of over $100,000. We recommended everybody be available for those deductions after a 1 percent threshold of contributions.

Housing changes. Boy, this was an easy one. You start talking about mortgage deductions, and what are you going to do with it. I was kind of surprised, with the mortgage deductions. They tell us, the experts who testify, that over 70 percent of the taxpayers that filed tax returns in 2002 did not receive any benefit from the mortgage deduction.

I did not know that. I sort of assumed almost everybody got it. But over 70 percent did not get any benefits from the mortgage deduction. Why? Because they are not itemizing or they are not buying a home.

Many countries do not have it: Canada does not have it, the U.K. does not have it, Australia does not have it. Yet, home ownership is very high.

Now, we recommended that the home mortgage deduction be retained, but we tried to make it be shared more evenly. What we did was recommend that the mortgage deduction be replaced with

a home credit available to all homeowners, and that would be equal to 15 percent of the mortgage interest paid by the taxpayer on a loan secured by the taxpayer on their principal residence to construct a home, to acquire it, or to substantially improve it.

But we put a limit on it. We said there should be some type of limit here. We are trying to find some money to pay for these things, so we put a limit on it. We said that the home credit would be based on the average cost of housing within that taxpayer's area, and that would result in current limits being between approximately up to about $412,000 homes.

The interesting thing was that the estimates we got said that between 85 and 90 percent of all the mortgages in 2004 would have been unaffected by what we recommended. That is a huge number that would not be affected by our recommendation.

The last thing I will say is in health care. We all know, and members of this committee know quite, quite well, it is one of the largest expenditures—in fact, it is the largest tax expenditure—the preference for health care.

So we tried to put some limitations on it. We continued the deduction for employer-provided health insurance. It was $141 billion a year, but we tried to make some limitations and caps on it. We capped it to about $11,500 a year for families. It is about the same we had as members of Congress, and Federal employees.

The final thing was, we addressed State and local tax deductions. If you want to hear from New York and California, start saying you are not going to be able to deduct your State and local taxes on your Federal income tax. But again, we were not running for office again, so we could talk about these things without fear.

What we said was, why should someone in Arizona be paying for benefits that someone in California gets because of higher State and local taxes? They may have trash pick-up every day, twice a day, electric lines buried underground, all the services that they are paying high taxes for that the people in Arizona are not benefitting from, or Oregon, or Louisiana, for that matter. But we are subsidizing it because we are paying on the Federal taxes for the high State taxes. I mean, I think that that does not make a lot of sense.

Politically, it is very difficult. But if you are going to do away with AMT, you are going to have to find some revenues to pay for all of this, and these are some of the tough suggestions that we made.

A final note. Congratulations for even having a hearing. This is the first body that really has done that, and I am just delighted that you all have recognized that this is something that needs to be addressed, and I wish you much success.

Thank you.

[The prepared statement of Senator Breaux appears in the appendix.]

Senator WYDEN. Thank you both, Senator Breaux and Senator Mack. I know we are going to have questions in a moment.

Ms. Garrett, welcome.

STATEMENT OF ELIZABETH GARRETT, MEMBER, PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM; AND SYDNEY M. IRMAS PROFESSOR OF PUBLIC INTEREST LAW, LEGAL ETHICS, POLITICAL SCIENCE, AND POLICY, PLANNING, AND DEVELOPMENT, USC GOULD SCHOOL OF LAW, UNIVERSITY OF SOUTHERN CALIFORNIA, LOS ANGELES, CA

Ms. GARRETT. Thank you very much.

I am pleased to have been asked to discuss our recommendations with you today. One of our reform proposals, the Simplified Income Tax, used the current income tax system as a starting point for reform, but worked to significantly simplify its provisions.

I would like to underscore three characteristics of this simplified tax that I believe relevant as you craft legislation.

First, we applied a rigorous burden of proof to tax expenditures, because it is not worth the revenue loss if a tax benefit subsidizes behavior that would occur even without the subsidy.

Instead, policy makers create a windfall for a few at the expense of all taxpayers, the tax code becomes more complex, and ordinary taxpayers perceive the system as skewed in favor of those with political clout.

However, we did not recommend eliminating all tax expenditures, but we did advocate changing the structure of many that we would retain. Namely, the Simplified Income Tax changes most individual-level tax benefits from deductions to credits, and we worked to simplify them.

A more effective individual tax system would restructure most tax expenditures as credits available to all taxpayers, and with refundable features in some cases so that even those without tax liability would benefit.

For example, we recommended adopting a simple refundable Saver's Credit to encourage lower-income Americans, even those who do not pay taxes in a particular year, to save for a better future for their families.

We eliminated the duplicative and overlapping system of standard deduction, personal exemption, child tax credit, head of household filing status, and Earned Income Tax Credit, all of which have different phase-out ranges and eligibility rules. We proposed, instead, two credits designed to work together, a family credit and a refundable work credit.

The combination of eliminating tax expenditures in many cases, in both the business and individual system, and restructuring those that are retained as tax credits, some refundable, will enhance both the fairness and simplicity of the system.

This was one reason for our recommendation to restructure the subsidy for mortgage interests so that it is taken as a credit. Our recommendation ensures that more Americans can enjoy the tax incentive for home ownership, and that the benefit is targeted to lower- and middle-income Americans seeking to buy modest homes, perhaps their first homes.

Second, although we did not expect that our plans would be adopted without change by Congress, some parts are packages that must be enacted together, in our view. One key package is our proposal to encourage savings. It includes a simplified Save at Work

plan, which combines all the current employer-provided retirement plans into one.

Importantly, and crucial to improving the savings rate, these accounts have different default rules than do most current plans. Under the auto-save feature of our proposal, employees would be automatically enrolled in diversified retirement plans.

When they left their job, their savings would be automatically rolled over into a tax-deferred vehicle, unless they chose otherwise. The other two accounts, Save for Retirement and Save for Family, have limitations on withdrawals, so they can be used only for certain life events, such as retirement, education, purchase of a home, and health-related expenses.

We did not support providing tax benefits to accounts that could be used for any purpose. Such a structure does not promote long-term savings and will primarily provide a benefit to savings that would have occurred anyway.

A key component of our savings package is the refundable Saver's Credit I mentioned. This aspect of the package will encourage new savings by people who desperately need to save, but lack the resources to do so.

Finally, we would repeal all of the other tax subsidies for savings currently in the Code. The three simple accounts, plus the Saver's Credit, would replace the plethora of current vehicles, all with different rules, requirements, and eligibility.

One caveat on savings proposals. You must determine, to the extent possible, all the revenue implications of the design of savings vehicles, implications that may well occur outside any 5- or 10-year budget window.

Proposals that reduce the ability of the government to raise the revenue that it needs in the future must be considered with great caution, especially if the revenue bite occurs around the same time that the retirement entitlements will be facing severe fiscal strains.

When tax revenues cannot sustain necessary government programs, the resulting deficit financing has significant deleterious effects on the national savings rate. Thus, a savings proposal that results in higher deficits is counterproductive.

The final noteworthy characteristic of our reform plans is that both have progressive rates. This reinforces the longstanding tradition in this country of progressivity in the tax code as part of its fundamental fairness. Even a pure consumption tax, which was not among our recommendations, can have progressive rates.

As our country is increasingly characterized by growing and profound inequalities of wealth and opportunity, a progressive tax system, as well as government programs designed to increase economic and educational opportunity for all Americans, is one method to redress the inequities.

Progressivity means more than just a progressive rate structure, although that is a necessary component. It also means eliminating or scaling back tax expenditures that disproportionately benefit the well-to-do; using credits—some refundable—rather than deductions for those tax expenditures that remain in the Code for individuals; and minimizing things like the marriage penalty, that play a role in discouraging some women from entering the workforce.

In conclusion, I appreciate the opportunity to testify here today. I ask that my longer comments be made a part of the record.

I look forward to answering any of your questions.

Senator WYDEN. Ms. Garrett, thank you. I know you have done a lot of good work on this over the years, and we appreciate it.

Ms. GARRETT. Thank you.

[The prepared statement of Ms. Garrett appears in the appendix.]

Senator WYDEN. Dr. Poterba, we welcome you.

STATEMENT OF DR. JAMES POTERBA, MEMBER, PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM; AND MITSUI PROFESSOR OF ECONOMICS, DEPARTMENT OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MA

Dr. POTERBA. Mr. Chairman, thank you for inviting me to testify before your committee today. It was an honor to work with the distinguished members of the President's tax panel and our very dedicated staff, many of whom are here today. I am delighted to be able to share some of the results of our analysis with you.

The justification for tax reform often focuses on simplifying the tax code, on improving the fairness of the distribution of tax burdens, and on trying to improve economic growth.

While many will tell you that all three objectives can be achieved simultaneously, in practice there are often tensions between them. One of the reasons the tax code is complicated is to recognize the many disparate circumstances of taxpayers. Simpler tax systems may treat different individuals in similar ways and create what some might point to as unfairness.

One of the difficulties in trying to promote economic growth is that it often involves reducing the tax burden on capital income. That, again, may run into questions of fairness, at least in some people's minds.

I would like to suggest that, as you think about the various options for tax reform, you recognize that the economic growth consequences of changing our tax system can be substantial. Academic studies that have compared tax systems based on consumption with those based on income suggest that in the long run there may be as much as a 5-percent difference between the size of our economy under the two systems. That is a dramatic effect of public policy and one that we should keep in mind as we think about various options for tax reform.

Previous studies probably overstate the actual gains from tax reform, because the current system is not a pure income tax. It includes a number of favorable provisions regarding saving. Moreover, many of the reform options that are likely to be considered are not pure consumption taxes.

Nevertheless, even if existing studies overstate the gains by a factor of two, there would still be very substantial benefits to long-term economic reform of the tax code.

What are the prescriptions one follows to try to encourage maximal economic growth with the tax system? First, one tries to keep tax rates low to avoid distortions in economic activity.

Second, one tries to place similar tax burdens on different activities to avoid creating an uneven playing field across assets or across activities individuals might engage in, thereby distorting their behavior.

Finally, most of the research on tax structure suggests that low tax burdens on capital income can promote long-term economic growth. Capital taxes are, in fact, the most important ones for determining the amount of capital accumulation, which in turn has an important influence on long-term growth.

The tax system today not only places high tax burdens on some types of capital investment, it levies different tax burdens on different types of capital, and thereby distorts both the allocation of capital and the total amount of investment and saving.

Estimates suggest, for example, that current tax rules result in an effective tax burden of about 26 percent on all corporate investments. In the non-corporate sector, the burden is about 17 percent. In owner-occupied housing, it is nearly zero. That, of course, tilts the allocation of capital away from what we would see in a world without taxes, toward more owner-occupied housing and away from corporate investment.

We see the same thing within the corporate sector, where different assets are taxed at different rates and, as a consequence, are favored more or less by the current tax code.

The provisions that the President's tax reform panel focused on in the Growth and Investment Tax—in particular, the combination of expensing for business investment and limitations on interest deductions—are designed to level the playing field across asset categories and to provide strong incentives for economic growth. In fact, of the two proposals the panel offered, the GIT was judged to have the larger long-term impact on economic growth.

Let me say a word about expensing, which is the dessert in this proposal, and a word about the interest deduction limits, which are the spinach.

The expensing provisions are very simple. A firm that made any investment in plant, equipment, or R&D, would basically be able to deduct immediately the costs of that investment. That would have the effect of making the government a partner both on the outlay and the income side of any project, and it would remove the distortions associated with the current tax structure. The result would be essentially a zero effective tax burden on new investment of all types, leveling the playing field and promoting long-term investment.

While providing expensing, the Growth and Investment Tax also places limits on interest deductions. It is extremely important to pair these limitations with expensing. If we adopt expensing without such limits, then a firm that can finance a new project with debt and claim an interest deduction would discover that some projects that did not make sense on economic grounds in a no-tax world would be attractive. Providing both expensing and interest deductions would result in more investment than in a setting without any taxes, and this is inefficient. This would be like returning to the situation before 1986, where some projects—called tax shelters at the time—did not make sense on economic grounds absent taxes, but were attractive in the after-tax environment. That is

why it is important to do these two things together. There are various ways to link interest limitations and expensing. We discuss those in our report.

Finally, the greatest difficulty in tax reform, the one that you confront as policymakers and that we did not have to confront to some degree as analysts, is the transition from the tax system we have today to an alternative that would be widely agreed upon as better.

Making a politically feasible transition requires finding ways to ease the pain in the short run for those who have benefitted from the current tax code, while trying to move toward a system which looks more attractive over the long term.

I am convinced that we can do that by thinking carefully about transition relief, and I welcome today's hearing as a starting point for a broader discussion of tax reform.

Thank you.

Senator WYDEN. Doctor, thank you very much for your input.

[The prepared statement of Dr. Poterba appears in the appendix.]

Senator WYDEN. As you know, there is so much going on, I suspect our Chairman has been derailed for a few minutes on the floor. So what I would like to do is take a short break so that Senator Smith and I can go vote, and Chairman Grassley and I will both be right back.

[Pause.]

The CHAIRMAN. I promised Senator Wyden I would be back in 10 minutes, but there are a lot of press people that are interested in my views on a certain tax bill. [Laughter.] You know you never argue with people who have a barrel full of ink.

Mr. Walker?

STATEMENT OF HON. DAVID WALKER, COMPTROLLER GENERAL, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Mr. WALKER. Mr. Chairman, members of the Senate Finance Committee, thank you for the opportunity to be here this morning. I assume that my entire statement will be included in the record.

The CHAIRMAN. Yes.

Mr. WALKER. Therefore, I will move to summarize.

The CHAIRMAN. Yes, it will.

[The prepared statement of Mr. Walker appears in the appendix.]

Mr. WALKER. I have been asked by your very capable staff to focus my remarks on the individual income tax, but I would note that many of my remarks relate to broad-based tax reform and are, therefore, applicable to any potential reform of the corporate tax system as well.

The President's Advisory Panel on Federal Tax Reform has taken a major step in beginning the debate over much-needed and long-overdue comprehensive tax reform. The panel suggested two alternative proposals for coordinated reform of the individual and corporate income taxes, and thereby served to advance the public debate over how best to simplify these taxes. Their proposals include the desirable combination of a broader tax base and lower tax rates.

The following are key points included in my longer statement. The debate about the fundamental design of the tax system is occurring at a time when our Nation faces large and growing structural deficits.

Under current policy, the gap between revenues and spending will widen over the next several decades. The individual income tax has long been the single-largest source of Federal tax revenue, amounting to $927 billion in 2005.

Concerns regarding the complexity, economic efficiency, and overall equity of the individual income tax have contributed to calls for substantial restructuring of the individual income tax, or for its partial or full replacement with some form of consumption tax.

The individual income tax also causes taxpayers to change their work, savings, investment, and consumption behavior in ways that serve to reduce economic efficiency and taxpayer well-being.

Taxpayer noncompliance with the current individual income tax is another major factor that should motivate reform. From tax year 2001, the IRS estimated that noncompliance with the individual income tax accounted for about 70 percent of the $345 billion gross tax gap. Reducing this gap can improve the Nation's fiscal stability, and each 1 percent reduction in the tax gap would likely yield about $3 billion annually.

In moving forward on tax reform, policymakers may find it useful to compare alternative proposals based upon some standard principles and common dimensions. Among these are: whether a proposed tax system will generate sufficient revenue over time to fund whatever spending path is chosen—because, in the final analysis, we need to have enough revenues to pay our current bills and deliver on our future promises; whether the tax base is as broad as possible so rates can be as low as possible; and whether it further promotes economic growth and individual compliance.

I might note that this document, which, as you know, Mr. Chairman, was published last September—a copy of which we sent you and all the other members of the Senate Finance Committee—could be helpful in this regard.

Fiscal necessity prompted by our Nation's current imprudent and unsustainable fiscal path will eventually force changes to our spending and tax policies. We must fundamentally rethink existing policies, and everything must be on the table.

Tough choices will have to be made about the appropriate degree of emphasis on cutting back Federal programs versus increasing tax revenue. Tax reform, if it broadens the tax base, could reduce the difficulty of raising a given amount of revenue by reducing the associated economic efficiency cost.

Such a reform also likely would reduce inequities, compliance burdens, and administrative cost. The recent report of the President's Advisory Panel on Federal Tax Reform recommended two different approaches, and I think they need to be seriously considered.

Although each plan provides for significant simplification, neither of them addresses the Nation's large and growing fiscal imbalance. We must address that imbalance. It threatens our future.

One approach for getting the process to comprehensive fiscal reform started could be the establishment of a credible, capable, bi-

partisan commission that is not unreasonably constrained with regard to its scope.

The Commission would examine options for a combination of both entitlement and tax reform, building on the excellent work that has already been done by the tax reform panel, as well as other commissions on Social Security and other issues.

As policymakers consider proposals for reform of the individual income tax or the entire system, I would recommend that they consider this document.

In closing, Mr. Chairman, this past weekend, I personally completed my 2005 Federal tax return, by hand, with pen and calculator, and no software was involved. For the record, as I told Senators Breaux and Mack, I filed timely extensions.

I prepared it by hand and without assistance, but as you know, I am a certified public accountant. I must tell you, I found the process to be incredibly complex, confusing, and extremely frustrating.

To add insult to injury, I, along with millions of other Americans, was unhappy to find out that I had to pay a 10 to 15 percent surtax on my income because of AMT. I would respectfully suggest that if every individual member of Congress was required to do what I did this past weekend, we would have tax reform next year, and we surely need it.

Thank you, Mr. Chairman.

The CHAIRMAN. I do not accept the challenge. [Laughter.] Dr. Gravelle, a couple of months ago you wrote a paper for me that I asked you to, and I have never acknowledged that back to you by letter or by phone, I am sure. So, I thank you very much for doing that. I found it very helpful.

Dr. GRAVELLE. You are welcome.

STATEMENT OF DR. JANE GRAVELLE, SENIOR SPECIALIST IN ECONOMIC POLICY, CONGRESSIONAL RESEARCH SERVICE, WASHINGTON, DC

Dr. GRAVELLE. The President's Advisory Panel presented two proposals, a direct consumption tax, with a top rate of 30 percent, and an income tax, with the top rate of 33 percent, designed to be both revenue- and distributionally-neutral.

Both proposals would eliminate itemized deductions, while allowing credit for mortgage interest, the deductions for charitable contributions and health insurance for all taxpayers.

Both proposals substitute credits for personal exemptions and standard deductions. Both would allow greatly expanded tax-preferred savings plans.

The consumption tax would allow expensing of all investment, while disallowing existing deductions for inventory, basis, and most depreciation and interest. It also includes a tax on passive capital income at the individual level.

The income tax plan would eliminate taxes on dividends and most capital gains from corporate stock, simplify depreciation, and allow expensing for many small business costs, and alter the international tax regime. Those, I think, are the major points that I will talk about.

Let me, first, discuss the issues associated with the consumption tax. The consumption tax has two important advantages. It signifi-

cantly simplifies tax compliance and administration for business, and produces efficiency gains through smaller and more even taxation of the returns to capital investment.

Consumption taxes are also often advanced because of their effects on economic growth. A recent Treasury study estimates these effects.

There are reasons, however, to view the growth benefits with some skepticism. The inter-temporal models that allow significant growth effects require heroic assumptions about the ability of ordinary individuals to perform complex calculations. Let me say, it is an enormous order of magnitude harder than doing your tax return. I think maybe Jim could do it, and maybe me, in this room.

Indeed, the model that produced the largest results does not permit marriage, childlessness, differences in taste, progressive taxes, an open economy, or differential tax rates at the State level, features we know to exist.

I like to say sometimes it requires asexual reproduction, but the people who review my work at CRS always get upset about that word. [Laughter.]

These models are largely not empirically tested. Where empirical evidence exists, the model's responses are larger than suggested by the evidence.

In addition, if one actually believes the theory behind these models, the shift to Roth-style savings plans in the proposal should reduce saving, an effect not considered by Treasury.

Finally, even with the use of these models, the growth effects are small relative to normal growth in the economy, possibly because the tax rate on capital income is only about 14 percent. In other words, the tax reform does not provide a path out of our budget difficulties.

There are also three potentially serious problems with the consumption tax. First, the proposal would lose revenue in the long run, even compared to the lower baseline used in the study which makes the 2001 and 2003 tax cuts permanent, because the estimates rest on an assumption of a major shift from deductible, tax-preferred plans to back-loaded or Roth-style plans.

Second, the consumption tax will be considerably less progressive than the current income tax, in part because of the tax-preferred savings benefits which are obscured in the short run, but more importantly because of the shift from an income to a consumption base. The appearance of distributional neutrality arises because the tax has been distributed in the panel study as if it were an income tax, not a consumption tax.

A third major difficulty with the proposal is transition problems, although they actually are not as difficult as what you would face with, for example, a value-added tax. Taxpayers would lose 100 percent of their deduction for basis on the sale of assets and recovery of inventory costs, as well as much of the depreciation of existing assets.

For a newly acquired building, 95 percent of future depreciation deductions would be lost. Firms would also lose much of their deductions for interest, a problem for firms with long-term, non-callable debt, of which a significant amount exists.

Since there is no tax adjustment for debt repayment, taxes on the sale of assets could easily exceed 100 percent of the equity recovered. Providing full, or even significant, transition relief is prohibitively costly, as inventories alone are close to $2 trillion.

Turning to the income tax reform, there are also some important simplifications, especially for businesses and high-income individuals in this tax plan, although lower-income taxpayers may find their affairs more complicated.

In translating the income tax to a more detailed proposal that deals with small, but important, deductions, however, some of these simplification gains may be lost. For example, we cannot easily restore itemized deductions for extraordinary casualty losses, medical expenses, or employee costs because there are no itemized deductions. This problem would also occur with the consumption tax.

The income tax plan also has some of the revenue sufficiency and distributional issues of the consumption tax, although to a lesser degree. There are also some more limited efficiency gains in a number of areas, although probably little effect on growth. The change to the international tax rules may increase inefficiency, and even exacerbate tax sheltering.

There are also some transition problems which are small compared to the consumption proposal, but, nevertheless, significant for some homeowners. Whether the more limited gains from changes under the income tax plan are worth the cost is unclear. Historically, it has been difficult to make major changes in the tax code because of the disruption in taxpayers' affairs.

Nevertheless, there are some limited aspects of the proposals that do seem to have many advantages and few drawbacks. The proposed floor on charitable contributions has a salutary effect with target efficiency and tax administration and simplification. Encouraging automatic enrollment in employer retirement plans is likely to facilitate savings.

A ceiling on deductions on employers' health insurance plans appears to reserve the benefits of reduced adverse selection in health insurance markets, while reducing both moral hazard effects and differential treatment of taxpayers. It may be that the greatest contribution of the panel study is to identify some possibilities for more limited reforms.

Thank you.

[The prepared statement of Dr. Gravelle appears in the appendix.]

The CHAIRMAN. Well, thanks, all of you, very much. We appreciate your participation. Obviously, those people who have been on the Commission for as long as it served last year, we thank you for your work.

Now, I am going to ask the first question. If I say I am asking questions of the panel, it will be any or all of you who want to answer, but I would appreciate at least two points of view on a question.

The first one comes because the Advisory Panel's recommendations covered so much ground: international, corporate, individual, deductions, et cetera. So the question concerns cherry-picking, that

we might take some reforms but not others. Sometimes that is a Congressional necessity. So, your comments on that.

Are there reforms that can be moved independently or separately from others? For example—and you can take any example you want—the new Family and Work Credits. Second, if there are reforms that can stand on their own, what would be your recommended priorities for the committee in that regard? Just jump in, whoever wants to.

Senator MACK. Well, let me start by saying that there are a number of areas, I think, where you do have the ability to reach and say, I will take this and put it into a plan different than what we had come up with. One of those probably is the real estate decision that we made, to put a cap, establish a credit.

But when you do that—and I am sure you all understand this—it has effects on the issue of distribution. So I think, again, that is something that we attempted to do as we were going through these various choices, again, sort of starting out with the premise that we were going to keep the distribution basically as it is now and let you all decide what changes you want to make in that regard.

But that is an example. You could take that out. You have an option, again, with real estate. You could not have a cap and just change it completely to a credit, but I think you would find out that that is a fairly expensive move.

I will stop at that and let some of the other members hop in.

Senator BREAUX. Let me just say, very briefly, there are some things you can do, but everything you do has an effect on something else. So when you do what Connie says, you have to look at the whole picture. It is difficult.

I think, however, Mr. Chairman, an area of consolidation, I think that is something you could do without having to do everything. We have 15 different ways to encourage savings. Do we need 15 different ways, making it more complicated? We have so many ways to save that are incentives, and yet we have the lowest saving rate of the industrialized nations.

So thinking about trying to consolidate all of these various means that have been enacted over the years and making it simpler is something I think could be done without having to do everything all at once.

Ms. GARRETT. Thank you, Mr. Chairman. In my written testimony, I addressed this issue of cherry-picking, because I think that is a concern. I wrote there of the savings packages that I also talked about here.

Then I also mentioned what Jim did in his testimony, which is, if you want to adopt expensing, it must be accompanied by the elimination of the interest deduction if that expensing is debt-financed. So I think those are packages. That is, as Jim said, the spinach with the dessert. I think most businesses would prefer to have both expensing and the interest deduction.

I think you can look at the individual tax recommendations that we made through the Simplified Income Tax and take lessons from that. I think the move from deductions to credits, some of which are refundable, is something that is worth looking at very seriously.

You might even want to take it further than we did and think about making the charitable deduction a credit as well. I think the package of Family and Work Credits is one that is very attractive.

I did not talk about, in my testimony, some of the changes we made on the business side of the Simplified Income Tax, but thinking about taxing business on the basis of its size as opposed to its form, I think, is something to think about. It should not be the case that, just because you are an LLC versus an S corporation, versus a C corporation, if you are otherwise similar, you should face different tax treatment.

I think integration, which is something Treasury has written about, others have written about, and we talked about, would be something you could think about.

It is true that any change you make has ripple effects, but I do not think any of us thought you were going to take our report and enact it without making some changes.

Dr. POTERBA. Let me make two points. One concerns the imperative of distributional neutrality that we worked with. If one moves away from the constraint that new tax law must have the same distributional burden as the existing tax law, then you get a lot more discretion in thinking about individual parts of the proposals we put forward.

If one works with a distributional neutrality constraint, then you need to find various reform suggestions that might go together in such a way that the burdens and the costs will fall on roughly the same households.

For example, one might think of various kinds of AMT relief and pair that with changes in the State and local tax deduction, because in many cases the same taxpayers who are confronting the AMT today are the ones who are benefitting from the State and local tax deduction.

Similarly, there are some places where the simplification provisions that we discussed may not have very large distributional consequences, and those are elements that one could, I think, view as modular components that could be drawn out of the report.

There are a number of provisions that we suggested in both the Simplified Income Tax and the Growth and Investment Tax that could be taken separately.

The CHAIRMAN. Mr. Walker, go ahead.

Mr. WALKER. Very quickly. On the individual income tax side, I think the concept of broadening the base through limiting and targeting tax preferences, holding rates down as much as possible, clearly has strong merit.

I would note that the revenue neutrality standard that was met here was based on the President's baseline and policy proposals, which is much lower than CBO's. Even CBO's does not come close to dealing with our long-range fiscal imbalance, which we have to keep in mind.

I do think there is clearly a need to consolidate the number of savings vehicles that we have, to move towards automatic savings mechanisms for retirement, and to tighten up on pre-retirement distributions.

For the first time since 1933, which was not a good year for the United States or the world, Americans spent more money than

they made last year. So, obviously, the proliferation of savings incentives has not gotten the job done, but it has clearly increased complexity tremendously.

Dr. GRAVELLE. I guess I mentioned two or three in my testimony, but I think there are a lot of things in here, such as some more possibilities for reforming charitable contributions beyond the floor.

I think simplifying IRAs is a nice idea, but to move everything to Roth is raising revenue in the short run and losing it in the long run, and that is something to be very concerned about.

One of the things that I think there is probably little justification for that raises a little bit of revenue, is graduated rates for corporations. Graduated rates are designed to reflect distributional effects, but the owners of small corporations are richer than the owners of large corporations, on average.

I think it would simplify the tax form if you did an exclusion rather than an alternative rate for capital gains and dividends, if you are going to have relief. Personally, I also do my tax return, just like Dave does, with a calculator at the kitchen table, no Turbo Tax. I really hate running into the phase-outs and all of that stuff.

If the only way you could do it would be to raise the rate, that would certainly make things easier. But I would be happy to go through the proposal and write you a memo and give you a list of other ideas, if you would like.

The CHAIRMAN. Thank you.

[The list appears in the appendix on p. 86.]

Senator MACK. Mr. Chairman?

The CHAIRMAN. Yes?

Senator MACK. I think there was a second part to your question, at least the way I interpreted it.

The CHAIRMAN. There was. A matter of priority if you were going to do these things.

Senator MACK. Right.

The CHAIRMAN. Is that what you are referring to?

Senator MACK. Yes. Yes. I just wanted to make a comment with respect to that. The way I took the question was, what do you think is the most significant thing in the plan that would create higher levels of growth? I think it is expensing. That is an area that we pursued.

We believe that the way we have constructed it, it is like a subtraction-method VAT, similar to the Japanese, which is a border-adjusted program. So again, I think that is an important area that I would encourage you to focus on. I realize it has difficulty in the transitions.

I might say that we do have money in our plan that basically allows for transition. I would say it is not adequate. But I also would say that we did not assume any revenue from a border adjustability perspective, so that is another source of funds for the future.

The CHAIRMAN. All right.

My second question deals with the issue of debt financing for corporations and the possibility of encouragement of businesses getting into bankruptcy. I also have an interest in this area because of efforts to close tax loopholes over a period of time.

Under the present system, it seems to me that there is that encouragement—I think your report says so—and also, dealing with

the international competitiveness of our businesses in a global economy.

So I would like a comment on the point that you are making in regard to debt financing, the encouragement of the tax code for debt financing, at this point.

Dr. POTERBA. Yes, Senator. I think you are exactly right. The current tax system does create incentives for debt financing. Such financing puts firms at a greater risk of financial distress and other concerns.

The two plans have different effects on the incentives for debt versus equity finance. The Growth and Investment Tax, the one that comes with expensing, is based in some ways on the comprehensive business income tax that Treasury worked on in the early 1990s.

That plan delivers neutrality between debt and equity finance, and would try to remove the financing distortions that are built into the current tax code.

The Simplified Income Tax is a more complex animal from the standpoint of business taxation. It provides a dividend relief provision, partial integration for domestic earnings, along with a higher tax burden than the GIT on individual interest, some dividends, and capital gains. It still would allow corporate interest deductibility. It is difficult to exactly determine the net effect of these provisions, and the circumstances would likely vary by firm. This proposal would still create an uneven playing field for debt versus equity.

One of the issues that we did not discuss at length in the panel report, but which the panel viewed as important, is the rise of various kinds of financial engineering opportunities that create hybrid securities, many of which carry the tax advantages of debt, but have risk characteristics which look far more like equity. These innovative products are increasingly blurring the lines in our system between debt and equity finance. The historical distinction between encumbrances on the firm as debt, and residential value claims as equity, is no longer clear.

Ms. GARRETT. Mr. Chairman, if I could just add to that. You also mentioned in your comments the international tax system, which I think is extraordinarily important with respect to our competitiveness, especially as we move increasingly into a global economy.

My own view of our report is, that is one area where we needed to do more work. My observation, as someone who used to work for a Senator, is that was always the case with international tax. We spent a lot of time on individual taxes, business taxes, and then international tax was sort of an afterthought.

So one of the things I would urge this panel to do is to use our report as a starting place, but to understand there is significantly more work that needs to be done. We drew some on the Joint Tax Committee's work and recommended largely a territorial system, which I think needs very serious consideration.

I think you have to be careful not to let rhetoric about outsourcing of U.S. jobs drive the agenda, and to look at that issue in a very sensitive and sophisticated way. Some jobs leave this country then create more jobs in this country, and better jobs in this

country, so I think you have to be very careful not to let rhetoric drive the process.

Then the final thing I would say concerns your need for new revenue—and I share Mr. Walker's very strong concern about the fiscal future of this country. We face serious fiscal problems in the future because of entitlement programs and other programs; I think we have to start considering a value-added tax as an additional source of revenue.

That is what most of our competing nations do for additional sources of revenue. I talk about a VAT in my testimony. But I think that is a very important additional consideration for you as you think about international competitiveness and the need for additional revenue.

The CHAIRMAN. Yes. A follow-up. You said that you are glad we brought up international competitiveness. Maybe I misinterpreted, but I thought part of your recommendation was taking that into consideration, and one of the motivations for your recommendation. Am I wrong?

Ms. GARRETT. No. That is exactly right. That is what drove our suggestions on the international tax system: the need to be more competitive. You need to look both at our tax burdens here in the U.S. and also how we tax the activities of our businesses abroad. That is, I think, what has to be the driving force with respect to the international tax system.

The CHAIRMAN. On the same point, then, the Simplified Income Tax plan would replace our current deferral regime with a territorial one. One of the many issues that will need to be examined in considering international reform is transfer pricing.

The panel report notes that effective transfer pricing enforcement is even more important in a territorial system than the current system, and suggests this issue be addressed by devoting additional resources to examining that. Commissioner Everson identified transfer pricing associated with intangible assets as one of the most significant compliance problems the IRS faces.

With this background, two questions. Why should this committee consider moving to a tax system that intensifies the pressure placed upon transfer pricing enforcement?

Second, given the difficulty that the IRS faces in the current deferral regime, is it realistic to expect enhanced enforcement to adequately address the increased importance of transfer pricing issues with territorial regimes?

Ms. GARRETT. I could give you a couple of quick reactions, and there may be other reactions. I think that, as you think about your recommendations with respect to international tax, you have to take very seriously the challenges of transfer pricing. Those are challenges we face now. As the report points out, those are challenges that do not disappear; rather, they may be exacerbated.

As you think about how those issues will be resolved and how they will affect your recommendations, I think you have to give very serious consideration to the resources that are made available to the Internal Revenue Service.

The IRS has to have the resources to police the system that you put in place. The IRS tends to be the least-liked agency, I think, in the government by taxpayers. It is often easy to gang up on the

IRS. But if one moves to a system where enforcement is important, then resources have to be made available to the IRS to police that system.

The CHAIRMAN. You go ahead. Then we will get Mr. Walker and Dr. Gravelle.

You will have to talk to Senator Wyden now, because I have just got a few minutes to go vote. Go ahead.

Dr. POTERBA. Mr. Chairman, of all the topics that our panel addressed, the issue of international taxation was probably the one where we heard the greatest differences among our witnesses. We heard recommendations both for territorial and for worldwide tax systems defended with great fervor.

The reason there is disagreement is that there is a fundamental trade-off between two different distortions. On the one hand, if you go with a territorial structure, you create incentives for transfer pricing to move income out of the U.S. and to place it in low-tax international jurisdictions that will operate as tax havens.

On the other hand, if one works with a worldwide tax base and uses a deferral system, as we have today, you create distortions in the financial decisions of firms with respect to deferral, keeping income abroad in the operations country, or repatriation. Since bringing earnings home generates a tax, the repatriation decision is a taxable event.

Many argue that the distortions associated with repatriation today are substantial. The panel ultimately decided that those considerations warranted a territorial-type structure. We took some solace from the fact that many of our major international trading partners have also moved over time toward the territorial structure.

I do not think that our recommendation in any way minimizes the concerns about transfer pricing, which the Chairman's question raised, because, in fact, many of those other nations are worrying today about precisely these kinds of transfer pricing issues.

I think the solution, if there is one, is to go very carefully, and with substantial enforcement, in the direction of the territorial system.

Mr. WALKER. With regard to the Chairman's question, Senator Wyden, on transfer pricing, I spent 21 years in the private sector, including with some of the largest professional services organizations in the world.

Transfer pricing is extremely complex. There is no question that the IRS is out-gunned with regard to transfer pricing. They need more human, technological, and financial resources focused on this. It is an issue that exists today that needs to be focused on.

At the same point in time, administrability and enforceability are only two of the elements that need to be considered. You also have to consider economic efficiency, competitiveness, equity, simplicity, a variety of other factors, in order to be able to make a judgment as to, in the aggregate, what is the best way forward.

Dr. GRAVELLE. The panel would tax royalties on a current basis, even associated with active businesses. I think that was directed at reducing tax sheltering in the international economy.

But they chose to move from deferral and repatriation, with its problems for active income, to exemption instead of worldwide tax-

ation. You could have eliminated those repatriation decisions by moving to current taxation of active income.

I think that a territorial tax, inevitably, has to create bigger transfer price problems than current taxation of foreign-source income. And, in addition, current taxation of foreign-source income is economically efficient.

If we make an investment in a low-tax country because it has a low tax rate, we are earning a lower social rate of return than we would if we made that investment in the United States. That is something called capital export neutrality and it is, clearly, the way to move efficiently. So, I do not think efficiency is served by moving to a territorial tax, either.

Senator WYDEN. Well, my apologies to all of you for having to duck out for the vote. It is a crazy day, even by Senate standards. I obviously have missed the earlier discussion.

I think what I would like to do is begin with this topic that I have discussed with Senator Mack and Senator Breaux even recently. When I got on the Senate Finance Committee, I said I was interested in tax reform and basically spent the better part of the year scrubbing the Code from top to bottom, and obviously followed the work that you all did very closely.

The more that I looked at the tax system, the more convinced I was that the basic principles of what brought everybody together in 1986, from Ronald Reagan, to Bill Bradley, Bob Packwood, Dan Rostenkowski, that those principles are still very sound today.

What I have sought to do in my Fair Flat Tax Act is basically look to an updated, modernized version of what was done in 1986. It seems to me what they said in 1986, in a bipartisan way, is, we are going to eliminate a boat-load of tax breaks on both the personal and the corporate side.

We are going to try to get a break to the person in the middle, but we are going to figure out a way to hold down rates for everybody, and we are going to simplify the system. That is essentially the architecture of what was done in 1986.

My question, to start with, for Senators Mack and Breaux, is, do you all share my view that what was done in 1986—not all the details, but the basic 1986 framework—would still be a pretty good model?

Senator Mack?

Senator MACK. I think it probably would. There were things that I disagreed with in the 1986 tax proposal. One of the most significant for me was the notion that we were going to tax capital gains, for example, at ordinary income tax rates.

If I remember correctly, the top rate at that time was 28 percent. But, frankly, when you added in a couple of other features, the rate probably was in the neighborhood of 30, 31.

I think that the 1986 Act also kind of points out a process that works. Both you and the Chairman talked about the importance of bipartisanship. When Secretary Baker testified before the Commission, he made it very clear that without bipartisanship, there would not have been a 1986 Tax Reform Act.

So I think, generally, the notion that was taken in 1986 is a road map, to use an over-used word these days, for how one can get both the process and some of the policy issues to kind of come together.

But as I said, one of the big discussions and debates we had within our Commission was about this issue about taxation of capital. Again, you and I have talked about that.

I am one of those who feels very strongly that the lower the capital rate, the greater the growth. I am sure there are people who strongly disagree with that. So if I were putting together a plan, I would have no tax on capital, dividends on capital gains, and so forth.

But if we are going to end up with a package somewhere, I know that I am going to have to compromise on my principles to some degree if we are going to get a plan. So, I hope that addressed your question.

Senator WYDEN. It does.

Senator Breaux?

Senator BREAUX. I think the short answer is yes, that the framework of 1986 would be something you could work on. Equally important to the framework of the substance, also, is the framework of the methodology they used. It was bipartisan.

I think you certainly have been around long enough to know that you are not going to do just a Republican tax reform simplification bill, or just a Democratic tax reform simplification bill. It is going to have to be both sides together.

If I could make a suggestion, I would think that you also have to have the White House as part of this effort. I would suggest, if you could get the Chairman and the Ranking Members of the Tax Committees to really join together and request the administration, in the next State of the Union address, to call on the Congress to work in a bipartisan fashion to get this done, that that would be the motivation. The administration is supportive of an effort.

Then if you can have the Congress, both Republicans and Democrats, saying, yes, we are willing to do it again, you would hear a huge round of applause from the American people. You know they are working together to simplify something that everybody agrees is too complicated. That is a win-win from a political standpoint, and it would be a win from a substantive standpoint.

Senator WYDEN. I think both of you have given very thoughtful answers. I have had a number of those conversations with the administration as well. This is something where you can bring people together. You look, for example, at the Social Security debate we have had.

I can tell you, I think we all know, those of us who serve in public life, you are not going to see any rallies outside a Congressperson's office with people carrying signs saying, "I love the tax code." They did on Social Security. So this is an area, in my view, where people can come together.

I want to ask one more question of the Senators, then I am going to get all the rest of the panel members into the act.

For you, Senator Mack and Senator Breaux, the discussion about this is always, this is impossible. Tax reform? It cannot be done. These special interest groups are too powerful. The differences are too stark. It just cannot happen.

But I was struck, when I looked at what you all did, at how much common ground there already is in areas like simplicity. Looking at the brackets, I mentioned you all have four brackets, I

have three brackets. I am open on these kinds of things. I think Chairman Grassley would say, when you work in the Senate Finance Committee, you have to be open on this.

But is it not fair to say that it is popular wisdom that this cannot be done, that there is no common ground? It is just not accurate when you look at what is actually out there on issues of simplicity, the number of brackets, a variety of areas where there is common ground.

I think, Senator Mack, you are right on the question of capital and wages. This is obviously going to be one where you have to figure out an approach that brings both sides together.

But I would like to get both of you on the record on the proposition of whether you think there is a fair amount of common ground here for Democrats and Republicans on this committee to go to work.

Senator MACK. The answer is, absolutely, there is. First of all, let me just go back to 1986. They said exactly the same thing when we went through the 1984, 1985, 1986 period on tax reform. Exactly the same thing. So I think that the 1986 Act makes the case that, in fact, this can be done.

But I am going to venture, maybe, into another area. I think that people are also saying that because, frankly, there have been very few areas in which Democrats and Republicans have chosen to work together over these past years.

As you know, and most members know, there is great talk about the level of discourse that takes place in the Senate, in the House, the confrontations that take place, the personal relationships that have deteriorated.

So part of what people are saying is, the attitude of the Congress, House and Senate, is not likely to produce a bipartisan effort. So, I think there is great skepticism on their part.

Clearly, there are huge issues. If you go to address, for example, the mortgage interest deduction and our proposal with respect to that, it is interesting that so many people around the country assumed, when they heard what we had proposed, assumed that we had proposed doing away with any mortgage interest deduction. So that is a huge issue.

You are going to have enormous pressure from all of the groups that we dealt with back in 1986 to retain that. Again, this is a personal opinion of mine. It does not necessarily reflect the panel.

My feeling is, if you really are going to address the issues of simplification, and fairness, and growth, you have to modify the way we treat mortgage interest deduction.

It is indefensible. As John indicated earlier, there are countries—England, Australia, Canada—that have no mortgage interest deduction and have about the same ownership rates as we do, one country greater than we do.

Second, it is an enormous distortion. The present code is an enormous distortion with respect to people making decisions about where they are going to invest.

Nobody should be surprised at the huge second and third vacation home market that has developed around our country. So, I think it is imperative. You are going to run into enormous forces

to keep that from happening, but I do believe it can be done. Absolutely.

Senator BREAUX. I think it is clear from history that it can be done, and Connie mentioned the fact that we did it in 1986. How did we do it? Well, we joined hands and both sides were going to take political hits.

It is obviously very clear that you cannot touch the tax code without punching some special interest in the face. Then they go out and hire somebody like me to help them. That is what we are all facing. But we all know that.

That is why it has to be done together, in a bipartisan fashion. I cannot over-emphasize my strong feeling that you have to get the administration on board to make the request for Congress to do it in a bipartisan fashion. Every couple of decades, it is time to do it, and this is the time.

Senator WYDEN. Let me start at this end so I can get the rest of you into this discussion. I would like your sense of how low tax rates have to go to get people to say, all right, I will start giving up some of these individual breaks that I have been interested in in the past.

Let us just get a kind of general sense, on the basis of what you have done, how low you think the rates have to get so that people would be open to giving up various breaks. To the extent that you can do it in a way that keeps some sense of fairness in terms of the rates, that would very helpful.

Dr. Gravelle, why don't you start? Let me, again, express my thanks for all the help you have given to me, slogging through vast amounts of paper and charts to help me put together my proposal.

Dr. GRAVELLE. You are welcome. I do think that, for the vast majority of taxpayers who never see tax rates, they either take the tax off a table or they do Turbo Tax. So I think you could probably trade off between rates and base broadening for a lot of people without a great deal of trouble. So I do not see that as a really big barrier.

But as for a number, we began some years back and we had tax rates at 50 percent. During World War II, we had tax rates of 90 percent. I mean, our rates are really very low today by historical standards, and also by worldwide standards, the tax burden, at least, that we bear.

So I would think you would be able to raise the rates, or you would be able to trade off either way, broadening the base or changing the rates if you needed to do that to deal with the AMT, phase-outs, or those kinds of problems that are facing us.

Senator WYDEN. Any sense of a number? I know Senator Bradley, Senator Packwood, and probably John Mack—and Connie remembers those discussions—ended up, I think, somewhere between 14 and 28 percent.

I suggested that I had started with the brackets Ronald Reagan proposed, but we wanted to end up at 10, 20, and 30; 10 for the most modest income, 20 in the middle, 30 at the top. I would certainly be interested in looking at that.

I think part of all of this is to get a sense of how low the rates have to get for people to say, all right, I can swallow giving up those breaks. Do you want to take any other crack at it?

Dr. GRAVELLE. No.

Senator WYDEN. All right.

Dr. GRAVELLE. I really have no idea.

Senator WYDEN. All right.

Mr. Walker?

Mr. WALKER. I think it is important to put this in context, Senator. Number one, 70 percent-plus of Americans pay more in payroll taxes than income taxes when you recognize the reality that, even though the employer pays half of the payroll tax, the individual bears the economic cost and burden. It is part of their compensation.

So, 70 percent of the people are paying more money in payroll taxes than income taxes to start off with, and most Americans care about, what is the net spendable bendable? How much do they take home to be able to spend on food, housing, or whatever?

Secondly, do not under-estimate the degree of frustration and the degree of relief that Americans would find if you could really streamline and simplify this. Yes, you would be able to reduce the rate somewhat and maintain revenue neutrality, and I think they would love it.

Okay, now, how low do you go? I think part of the problem with that is, we are not raising enough revenue to pay our current bills and deliver on our current promises now.

One of the biggest problems we have right now is, we have this false theory that every tax cut is going to stimulate economic growth and they are going to pay for themselves. That is just flat false. So we need to recognize reality here.

Let me tell you, there is one word that is needed, and you, and Senator Grassley, and a few others are trying to provide it. It is called leadership. We have a huge leadership deficit in this country.

I totally agree with Senator Breaux that you have to get the President of the United States, and you have to get bipartisan leadership on both the Senate Finance Committee and the House Ways and Means Committee.

Anything is possible if you get committed leadership. If you focus on the people rather than the special interests, there is a huge win-win here. But it is going to take leadership.

Senator WYDEN. Dr. Poterba?

Senator MACK. I wonder if I could just interrupt for a second. Mr. Chairman, I am going to have to go. I have a flight to make. So, I apologize for having to leave before you all were through asking questions.

The CHAIRMAN. Well, we thank you for your 2 years of work on this. Thank you very much. Of course, you will be busier next year if things go as I have them planned, whether the President has it planned that way or not.

Dr. POTERBA. Senator, if I were to give you a number, it would be 30 percent. If you get below 30, I think people may sense that they are in a different tax world than the one they have lived in in the past.

It is extremely difficult to get enough base broadening to cut rates that much precisely because of the concentration of income tax revenues among the higher-income part of the population.

A lot of revenue is being collected in the current high-rate brackets. As you try to find ways to move the tax rates on those brackets down significantly, you really have to do base broadening of a kind that will touch on many popular deductions and exclusions from the income tax base.

It may be easier to do larger tax reforms than smaller ones. Singling out any particular provision and saying we are going to lower rates and finance the rate cut on the back of a particular change, whether it is State and local deductibility, or the mortgage interest, or employer-provided health insurance, assures a battle with a particular special interest group.

Making several base-broadening changes at once offers the potential to get a larger total reduction in rates, which may look more attractive for the rank-and-file taxpayer, and makes it more complicated to determine exactly where the plan leaves any given taxpayer.

Commissioner Rossotti, a member of our panel, worked very hard to tell people that you have to look at the full picture and recognize that the benefits of tax reform are often mixed in with the costs. It is critical not to focus just on the components of reform that lead to higher taxes.

Senator WYDEN. Very helpful.

Ms. Garrett?

Ms. GARRETT. Yes. I think it is very difficult to focus only on rates or to give you a number. I think it may be a little bit dangerous to do so, with all due respect.

One reason is, as you have heard, it ignores a tremendous tax burden, the payroll tax burden. So if you are just focusing on income tax rates, you lose track of that. My concern is the same as yours, that is, our tax rate on labor. There, payroll taxes are an issue you really have to look at.

One thing we found, and this is what Jim alluded to, is that we would eliminate these "sacred cows" or scale them back and think, "Wow, so tomorrow when we get the revenue estimate, rates are going to be really low, because, look, we went after health care, we went after mortgage interest deduction, we went after State and local taxes."

Then we would get the revenue estimates back, and the rate had not moved very much. So one of the things you learn is, even when you go after the sacred cows, you just do not get the bang on the rate that you would like.

Then the final thing I would say is, I think fairness is more complicated than just the rate. It is sort of a "sound bite" part of the fairness debate, and it is important. I do not want to say it is not important. But I think there is a lot more to fairness that people understand, and they are things like, who is benefitting from the expenditures? What do we do with respect to the millions of Americans who do not pay tax and, thus, to the extent that there are incentives in the Code for savings, et cetera, do not benefit from that? Refundable credits are a way to deal with that.

Having said that, I think we ought not to focus on rate very much. It does not mean rate is inconsequential. For example, I think the national retail sales tax is an absolute non-starter in terms of policy. One reason is, to be revenue-neutral, even under

the President's baseline, the rate for a national retail sales tax would have to be extraordinarily high and unsustainable. We estimate it at 34 percent. That is probably a low estimate.

So I do not want to say that rates are entirely irrelevant. I think that with national retail sales tax, which has a number of problems, the rate is one of the biggest ones.

Senator WYDEN. Senator Breaux?

Senator BREAUX. I have no idea on the rate. I think we are all in the same ballpark. Ours was, what, 33 percent, I guess, on one of the plans. It is all interconnected.

If you lower the rates, you are going to have to get rid of some of the things that people think are really important. You are going to have to bite the bullet. That is why it has to be done in a bipartisan fashion. But that is the ballpark area, 15 to 30.

Senator WYDEN. All right. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

I am going to have just 5 minutes of questions, and if other members do not show up, we are going to adjourn. I could keep you here for the next 2 hours with all of the questions that need to be asked, and you are probably fortunate that more members did not come. We had those votes and everything.

Presumably, we may have the same group of people back here January of next year as we start with a new Congress down this road in a more comprehensive way than we had planned for this year.

My first question would be in regard to the capping of tax-free benefits of health insurance, and particularly the point that the committee made, that this is a cause of the increase in health care costs. I would appreciate any of your views on the health tax proposal of the panel, and also the impact of tax benefits on health care costs.

Senator BREAUX. Well, very briefly, we continue to allow for a deduction in our recommendation for the purchase of health insurance, but we thought that a limitation would be the appropriate way to be fair to everyone.

The tax preference for health care is our largest tax expenditure. It is huge. It is $141 billion, 12 percent of all the Federal income tax revenues in the year 2006. It is huge. Yet, we still have 40 million people-plus who do not have health insurance in this country.

So what we recommended is that we continue to allow, of course, the employers to be able to deduct the costs of their employee compensation, and employees continue to be allowed to not count it as taxable income.

We said, simply, that we are going to put a cap on it, and the amount of that exclusion would be limited. What we did was picked the number of $11,500 for families and $5,000 for single individuals. That was the national average when we did the report.

If you want a plan that costs more than that, you are certainly entitled to do it, but the government is not going to pay for it. We picked something that is an average for all Federal employees and members of Congress. It is true that an unlimited deduction encourages people to buy more than they actually need.

You lose a connection between the cost if you know it is going to be deductible and it is not going to end up costing that much.

So we are trying to say, look, this stuff costs. If you want to have no deductibles, no co-payments, that is fine, but that is not necessarily the best policy for individuals.

This recommendation would connect people better to the costs of their health care, and I think it still allows for a very generous deduction.

Ms. GARRETT. Just briefly, Mr. Chairman, I think that this recommendation illustrates two important ways that we approach the individual tax system. One is, we did cap the exclusion.

The idea there was, we want to encourage people to have health coverage and to have reasonable health coverage, but to the extent that someone wants a high-end plan, that is not something that government should subsidize because those subsidies come at a cost of higher tax rates. So that was something we tried to do with the home mortgage subsidy, and we tried to do it here as well.

Second, we always tried to expand the coverage, so that here we tried to expand the incentive beyond those who received their health benefits through their employers to all Americans who purchase health plans.

A couple of things I would highlight for you to think about. First, we increased the cap by inflation, I believe. I think you should think about whether to increase it by inflation or the cost of health care, which can be a different rate. To be honest, I think revenue concerns led us to pick inflation; it was a lower indexation. But I think you need to think about that carefully.

The second thing I would say is, I think this is a very important change and a beneficial change, and one I would support even if you did not need to raise revenue. I think it is the right policy decision. But it will not be a panacea for the health care problems in the country, so it should be viewed as only part of the solution.

Dr. POTERBA. Mr. Chairman, I think that offering a quantitative estimate of U.S. health care cost growth that can be pinned specifically on the current tax treatment of employer-provided health insurances is very, very difficult. There are many links in the chain between the tax code and the amount of insurance households purchase, and then between that insurance coverage and the services that doctors choose to provide, and that consumers choose to purchase.

But I think the underlying analysis that Senator Breaux has outlined is unimpeachable. The distortion we create with the current system encourages over-consumption of health insurance, it insulates the consumer from the price of health care purchased from the provider, and it surely leads to greater outlays on health care than we would have in a world which created a level playing field, and health insurance and health outlays were treated in a more symmetric way with other household purchases.

The CHAIRMAN. Mr. Walker?

Mr. WALKER. Mr. Chairman, first, I agree fully that you should not do anything to limit the deduction to the employer for health care. Doing so would be totally counterproductive, because that would provide an incentive for employers not to provide health care to their employees, and they would just pay it in the form of cash and let the employee be on their own.

There are various proposals that have come out throughout the year saying, gee, it is easier to limit the employer deduction than take on the individual exclusion, but it would be totally wrong and counterproductive.

Second, I think the Commission was too easy. I think we have to limit the individual income tax exclusion to a much greater extent than is being proposed. Health care costs are out of control. If there is one thing that could bankrupt America, it is health care. We need to improve the transparency and accountability mechanisms with regard to the true cost of health care.

The fastest-growing cost for the Federal Government and State governments, the fastest-growing cost for employers in the private sector, the number-one competitiveness challenge, is health care. So, we need to do much more than this. We need to have much more comprehensive health care reform.

I think the question is not if you limit this. The question is, how much and as a part of what reform? As part of comprehensive tax reform? As part of comprehensive health care reform? Because we need to do both. It is absolutely essential.

Frankly, I would have limited it more. One of the reasons wages are not going up as much, one of the reasons that pensions are declining, is because compensation costs in the form of health care are crowding out other forms of compensation.

One of the reasons that is happening is because of the special tax preferences accorded to health care, which might have made sense in the 1940s right after World War II, but do not make sense today.

Dr. GRAVELLE. Well, as I indicated in my testimony, I think there is kind of a mixed bag with respect to the health proposals in terms of efficiency. I am sort of inclined to like the notion of some kind of limit on employer health care.

I think having employer plans is crucial to preserve, because I think it is the one thing in the private health market that deals with the severe problem of adverse selection that naturally occurs for people with bad health histories not being able to get health insurance. Whether you can do a dollar cap, technically, I am not sure. That is something for tax administrators.

The other thing you could have done is make the tax deduction contingent on plan features. So, say you only get the deduction if you have a certain co-payment or a certain deductible. I mean, that would be another way to do the same sort of thing.

I also think you cannot ever deal with the exclusion. I think that is impossible to allocate the benefits to individual employees in terms of doing it as an exclusion.

The deduction for individuals—my theory would say that that is going to increase health costs because more people are going to have insurance coverage.

I am not sure how much of an effect that proposal is going to have though, because I think there is some empirical evidence that low-income people are unlikely to respond by buying health insurance anyway.

A lot of them do not have tax liability and really would not get any benefit from a deduction anyway, so I think that would have

some effect. Whether it would be a major effect, I kind of suspect not.

The CHAIRMAN. All right. I am going to thank you, for my part. Senator Wyden has some more questions, and he will finish the hearing, because I have a 12:30 meeting I have to get to. Thank you all very much for participating.

Senator Wyden?

Senator WYDEN. Mr. Chairman, thank you. As you leave, again, let me just thank you for all of your willingness to discuss this issue and to just say how much I will look forward to working with you on a bipartisan basis on this.

The CHAIRMAN. You bet. Thank you.

Senator WYDEN. Just a couple of other questions I am going to ask. I am sure when Chairman Grassley said that Senator Wyden had some additional questions, you all looked at your watches and said, my God, we are going to be here until breakfast time tomorrow.

I just have a few additional matters I want to get into, and I will let you all get off to your business.

Mr. Walker, one of the things that has been striking to me about this health care issue is that it has been possible to put a valuation on the value of the benefits that the workers get.

It appears that it is upwards of $150 billion a year, essentially, the break that the worker gets on their health care. But I have not been able to locate anywhere exactly what the value is to business of being able to deduct the cost of health care.

As far as I can tell, the costs to the business that are deductible get clumped into business expenses generally, so we have been calling all of those who have expertise in this area to try to see if we can get a sense of what the number is as it relates to the business write-off for health care. I am curious if you have any information on that.

Mr. WALKER. I assume you mean the value of the deduction for the employer. Is that what you mean?

Senator WYDEN. Correct. Yes.

Mr. WALKER. I do not have it off the top of my head, but I will go back and ask my staff. They probably do have it, and I will be happy to provide it for the record.

Senator WYDEN. Senator Breaux?

Senator BREAUX. If you take a look at page 79 of our report, Mr. Chairman, we address that. These are not my figures; we got them from tax experts within Treasury, obviously

The first paragraph on that page says, "Taken together, the tax preferences for health care represent the largest tax expenditure and will have an out-sized impact on health care spending in America. The United States has the highest per capita health care spending in the world, $1.5 trillion, or $5,400 per person in the year 2002. The tax benefit associated with health care will cost approximately $141 billion, or 12 percent of all Federal income tax revenues this year. The largest component of this cost is an employee exclusion for the employer-provided health insurance and medical care, which is a tax expenditure of $126 billion."

So this is telling us that the costs for the employees, non-taxable benefits, is $126 billion. I do not know if that is correct to extrapo-

late that from $141 billion leaves $15 billion. It may be, but we could get more information, maybe, from Treasury on that.

Mr. WALKER. If I can, Senator. We will provide it for the record. There are several preferences you have to look at.

Senator WYDEN. Right.

Mr. WALKER. That is the value of the deduction to the employer, which is what you ask, which I do not recall off the top of my head. There is the individual income tax exclusion, for the fact that individuals never pay income tax on the value of employer-provided and paid health care, no matter how much money they make, how wealthy they are, and how generous their plan is.

Number three, they never pay payroll taxes on it either, since there is an exclusion from the taxable wage base as well. If you add up all three of those, you are probably over $200 billion in the current year. So, I will provide something for the record.

Senator WYDEN. That would be very helpful, Mr. Walker.

[The information appears in the appendix on p. 222.]

Senator WYDEN. I think in the combination of your answer and Senator Breaux's, I just missed that figure. My sense was that the difference between $141 billion and $126 billion did involve the employer component, but I also sensed, as I tried to look at it—what Mr. Walker is talking about—there are some other aspects of this, and it gets us up over $200 billion. So, we are going to want to work with you all on it.

The second question that I wanted to ask you about involves some exceptionally important work that Senator Baucus has been involved with, and that is the tax gap question. Chairman Grassley has been very interested in this as well.

What the two of them have pointed out is that the current tax system fails to collect at least $350 billion a year of taxes that are owed, but not collected. Obviously, the under-collection of taxes from some taxpayers means that they are not paying their fair share, and everybody else has to pay higher taxes to make up for those who are not paying their fair share.

So, closing the tax gap could also raise an additional $1 trillion or more that you could essentially look at on this question that I was talking about, in terms of lowering rates.

Why do we not just go down the row, and I would like to start with Dr. Gravelle on this one, how you would look at this issue that Senator Baucus and Senator Grassley have really led us on, which is closing the tax gap and how it fits in to the debate about tax reform.

Dr. GRAVELLE. Well, that is probably in Mr. Walker's expertise more than mine. I think the places where we have the missing taxable income are the places where we do not get our hands on it before it goes to people, so the more withholding that you can do of any kind of income probably would help with the tax gap.

Other than that, I think it is small businesses that are a major part of that. There is also the underground economy, and I guess you are probably never going to collect much on drugs and prostitution, and things like that.

I do not know whether the tax gap includes these international tax shelters. If it does, though, I think we need some bigger guns

in court on the part of the IRS to go after these international tax scams.

Senator WYDEN. That is a very valid point. We all saw the report that was done by the Investigations Committee; again, a bipartisan report talking about the enormous sums of money that are wasted with these offshore tax shelters. You can be assured, I am going to follow up on that. I know colleagues on both sides of the aisle will.

Mr. Walker?

Mr. WALKER. Senator, I, within the last several months, had the opportunity to testify before this Committee about the tax gap. The latest estimate, as I recall, is about $345 billion, but that is as of several years ago, of which about 70 percent relates to individual income taxes.

There are several issues. One, we have recommended additional reporting, in addition, additional withholding; both would help to reduce that tax gap. Furthermore, we reinforced at that time that simplification was essential to make real progress in this area. I think there are millions of Americans who really do not know whether they have done it right or not.

We have also done work with regard to tax preparers and found problems with regard to tax preparers. Obviously, a vast majority of Americans, as we have heard today, go to tax preparers because they cannot begin to try to do it themselves.

So I think simplification would help with regard to the tax gap, but it is not a magic bullet. We still have to take other steps to make sure that people are disclosing income, to look at issues like, what is the basis for capital gains.

Right now, when you sell stock or some other capital asset, you get a reporting to the government on the gross proceeds, but you do not have any idea what the basis is, and obviously, you pay income tax on the difference. So, there are opportunities to make more progress here.

Senator WYDEN. Dr. Poterba?

Dr. POTERBA. Senator, I think that it is very important to do whatever we can to collect what the current statutes stipulate and to try to improve enforcement.

Estimates I have seen suggest that additional dollars spent on enforcement probably yield more than a dollar in revenue return, so we may not be devoting enough resources in that direction. I know, of course, there are considerations about individual freedom and intrusion of rights that must be considered in deciding on the optimal level of enforcement.

There are two things to suggest here. One, expansion of third-party reporting is likely to be very important as a way of trying to expand the information base that the IRS has available as it tries to identify the parts of the economy where current compliance is relatively low.

Second, it is essential to preserve taxpayer confidence in the system. Voluntary compliance is our norm. Our system critically relies upon individuals choosing to comply for virtually everything other than simple W–2 reporting.

Senator WYDEN. Ms. Garrett?

Ms. GARRETT. Let me just emphasize that I think there are more than just revenue concerns here at stake, there are fairness concerns. Those people whose income is mainly from their labor, from employment, their taxes are withheld. There is not a tax gap there. The tax gap occurs other places.

To the extent that ordinary Americans who are paying their taxes think that others are getting away with something, that undermines the legitimacy of the system.

The last thing I would say is, I think it is very important to go after the tax gap, for both revenue and fairness concerns. But I think we also have to be careful and not think that is going to solve all the problems. It is a little bit like "waste, fraud and abuse."

We hope we can get rid of the deficit by eliminating "waste, fraud and abuse," but we know we really cannot do that. You cannot solve the structural and other problems facing this country solely by closing the tax gap.

Senator WYDEN. I spent a lot of years sitting next to Senator Breaux, where we heard people say that the magical solution for everything is just getting that "waste, fraud and abuse."

Senator BREAUX. We heard one person suggest to me about closing the tax gap, that we ought to just have the person tell the IRS how much they made, then let the IRS tell them how much they owe, and it would be real simple. But we did not accept that suggestion.

I think the complexity of the Code contributes to the gap. I mean, very rarely could you ever get two tax preparers who come up with the same decision on what is owed for the same taxpayer.

Because of the complex nature of the Code, they can look at it different ways, approach it different ways, and come up with different conclusions for the same taxpayer. No wonder we have a gap, because of the complexity.

The simpler it gets, the easier it is to understand, the more difficult it is to cheat. It is so complicated, it makes cheating easy. Therefore, the simplification really would help address this problem.

Senator WYDEN. I think you all are spot-on on this simplification issue. It has been stunning this year, the number of reports, journalists and others who would essentially send a tax form to a variety of preparers, and they would all come back with wildly different kinds of responses. So, your point is on target.

My last question. I think I would like to engage Dr. Poterba and Dr. Gravelle on the question and maybe some of the rest of you would like to participate in this, too. But the differences, I think, were clear between Dr. Poterba and Dr. Gravelle on the question of consumption taxes and their impact on economic growth.

I ask this again because Senator Baucus has really done some very important work in terms of looking at the tax code and what it is going to take to make us competitive in these tough global markets.

I am certainly interested in any ideas you all have about various proposals and what they do for economic growth. So, why do we not start with Dr. Gravelle and Dr. Poterba on this one, but I would invite the rest of you to participate. This will be about it, for the purposes of the morning.

Dr. Gravelle?

Dr. GRAVELLE. Well, I think the simple evidence that we have seen through history is, people are not very responsive in their savings or their labor supply to marginal tax rates. They certainly are not responsive on the order of magnitude, I believe, that comes out of these inter-temporal models.

In the short run, in the inter-temporal models that the Treasury used, one of them was the asexual model. That is the one that had the biggest effects. That depicts everybody as one single, infinitely lived, identical individual that looks through to their descendants, their grandchildren, and their great-grandchildren and has an infinite time horizon.

The other, I think, is probably a little more pragmatic. It is called a life cycle model. But in both of those models, in the short run, the response of the labor supply to the interest rate is what is driving the short-run response.

I would like to quote Charlie Ballard, who has a general equilibrium model, who commented when the Joint Tax Committee studied this. He said, "Anybody who believes they can project the effects of a tax change based on the response of workers to the interest rate, is shooting in the dark."

There is absolutely no evidence of this. I do not know about you, but I do not go home and reconsider my labor supply over my lifetime based on what the interest rate is, and I doubt very many other people do.

It is something that falls naturally out of the micro-models that we do to look at individual behavior. But I think there is a big move now in the economics profession—at least I hope there is—to think about sort of bounded rationality models, models where people cannot make these complex calculations with perfect information.

The default argument is exactly in that framework. You cannot, on the one hand, believe that people are super-rational, and at the same time believe that whether they sign a paper or not is going to determine a major part of the savings in their 401(k) plan. So, I think we have to look at the simple evidence.

The simple evidence says, for many years, none of these things changes very much. I think we have to expect limited growth responses from these tax changes, and I think we need to step away, as an economics profession, from mathematically tractable and fun models to do and solve and assign graduate students problem sets with, into something that more realistically depicts how people behave.

That is why I am very, very skeptical that we would get very much. Plus, the tax rate right now, on average, is only 14 percent. So, it is not like we have a 90-percent tax rate on capital income right now.

Senator WYDEN. Dr. Poterba?

Dr. POTERBA. Senator, I think Jane and I agree on many things and disagree on some. The place where we agree is that the analytical framework for trying to pin down precisely the economic growth effects of even quite fundamental tax reforms is, if not wanting, at least imprecise. Many of the models that are currently used allow for a wide range of possible estimates, and their results

are quite likely to depend on some assumptions that we make, many of which are, frankly, difficult to test, and some of which may be difficult to square with the realities of behavior that we see. One should not put tremendous faith in any specific number on growth effects.

The place where Jane and I differ is, I am more convinced that taxes affect behavior than she is. I think we can look at the historical record and find a number of times when tax reforms, major changes in tax rates, have produced quite stark changes in behavior. The dividend pay-out response of U.S. corporations after the 2003 reduction in dividend tax rates would be the most recent case in point.

Another example is the sharp increase in female labor supply, especially in high-income households, after the 1986 Tax Act reduced the tax rates on secondary earners in high-income households. The sharp changes in capital gains realizations around major changes in tax rates, say, in 1986, is yet another. Taxpayers clearly are thinking about rate structures as they make their decisions.

The open question is how this evidence links up with the basic issue of how much economic growth we could expect from tax reform. Some behavioral responses may not translate into the kinds of long-term investment that would promote economic growth.

My instinct is that by lowering rates and by trying to keep the U.S. tax burden on capital competitive with the tax burden found in our major international competitors, we can ensure that our capital base in this country is preserved. This in turn is a groundspring for long-run productivity growth.

Therefore, I am more optimistic than Jane is that, by putting in place a tax system which is favorable towards investment, we will manage to achieve higher rates of long-term economic growth. If you try to pin me down to a precise number on it, though, I will come back and be on Jane's side and say it is very hard to give you a specific estimate.

Senator WYDEN. Mr. Walker, Ms. Garrett, Senator Breaux, anything on economic growth and consumption tax?

Senator BREAUX. I agree with both Dr. Poterba and Dr. Gravelle.

Senator WYDEN. There you are. Which is why the Breaux touch is always so magical. [Laughter.]

Dr. GRAVELLE. Senator, I disagree with his interpretation of those studies that he referenced, as far as his interpretation of their meaning.

Senator WYDEN. Well, you all have been very, very helpful. Chairman Grassley, I think, has given us a sense of what is ahead. Today's kick-off for tax reform is, in my view, a sense of what is ahead over the next 6 months.

The next 6 months are absolutely key if we are to have what Senator Breaux told us about a couple of hours ago, which is, by next year, the President saying he would like to see the Senate Finance Committee go after this issue on a bipartisan basis.

I thought and I felt going into the hearing, and I have not heard anything else, that there are key consensus principles for bipartisan tax reform and they are in front of us if we can kind of hold off the politics and be willing to work together.

Simplifying the tax system is certainly something that has broad support, giving all persons the opportunity to accumulate wealth, giving markets the chance to drive the economy, not government, and being sensitive to issues of the deficit. A lot of those principles were not very different than what they did in 1986.

So, the fact that we have been able to bring leaders like yourselves together is exactly what I had been hoping that we could do. With Chairman Grassley and Senator Baucus leading us, I think over the next 6 months we can put this in place and then go to work.

So, we will have some additional questions for you. I think both Democratic Senators and Republican Senators would like to pose some questions in writing. But you all have given us a very good launch this morning. You will probably be getting lots of calls from me, and others, in the days ahead. We thank you very much for coming.

With that, the Senate Finance Committee is adjourned.

[Whereupon, at 12:45 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Tax Reform Hearing
Senate Finance Committee
Statement of Senator Max Baucus
August 3, 2006

Mr. Chairman, I am glad that you called this hearing today. And I am pleased that the Committee has named as witnesses today four members of the panel that advised the President on tax reform proposals. I expect that we will learn much from the discussion today.

But apparently, we will not learn one thing about what the administration thinks. Now, that was of course the original idea behind the tax panel: The panel was to make recommendations. The Treasury was to submit those recommendations, or their own, to the President. And then the President was to move forward with a plan.

But a funny thing happened on the way to the White House. It reminds me of the Harry Potter books. Harry Potter's evil nemesis, Lord Voldemort, is so bad that no one says his name. Characters call him simply "He Who Must Not Be Named."

Well, ever since the panel submitted its recommendations, back in October of last year, the administration has been treating tax reform like Lord Voldemort. Tax reform has become "the Issue that Must Not Be Named."

Tax reform not only went from the front-burner to the back-burner. It got knocked off the stove. It got kicked out of the kitchen.

Today, we could have heard from the Treasury Department. Treasury supplied much of the background expertise to the panel during its deliberations. It is my understanding, Mr. Chairman, that we invited the Treasury to testify. But Treasury declined. Treasury said that it simply was not ready. Staff needed to confer with the new Secretary.

Does this sound familiar? It should. We heard the same excuses last month, when we tried to nail down Treasury on the $350 billion tax gap: "Not ready. Need to meet the new guy."

Fortunately, Mr. Chairman, we were able to find a Treasury position. We went to the internet. And we found a paper published in May extolling the virtues of a consumption tax.

Did Treasury deliver their paper to Congress? No. It was delivered to the American Enterprise Institute. So the Treasury leaves us wondering: What has AEI got that the Senate Finance Committee doesn't? Apparently one thing that AEI gets that Congress doesn't, is Treasury's views.

Mr. Chairman, I look forward to the testimony of our panelists today, former Senators Connie Mack and John Breaux, along with Professors Beth Garrett and James Poterba. You should be commended for your service on this panel. It took a great deal of time from your already busy schedules and the country is grateful for your commitment.

I am also pleased that David Walker of the GAO is here today to give us some overview, along with Jane Gravelle of CRS.

I wish them all the courage of Harry Potter in dealing with this "Issue that Will Not Be Named."

University of Southern California
Gould School of Law

Statement on Tax Reform
Senate Finance Committee, U.S. Senate

Elizabeth Garrett *

August 3, 2006

The President's Advisory Panel on Tax Reform, a bipartisan advisory committee on which I served, issued a report in November 2005, providing two proposals for fundamental tax reform: the Simplified Income Tax and the Growth and Investment Tax. Both met the President's mandate that our proposals simplify the tax system, promote economic growth and competitiveness, and achieve fairness through progressivity and other features. I am pleased to have been asked to discuss our recommendations with you today, particularly in a hearing with my colleagues Senators Breaux and Mack and Professor Poterba. In my statement, I would like to underscore four characteristics of both of these proposals that I believe relevant as you craft your own tax reform legislation, and then mention briefly two other tax reform proposals that the Panel did not unanimously endorse.

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A Rigorous Burden of Proof for Tax Expenditures

First, the Advisory Panel was very skeptical about the many tax expenditures in the current tax system and contained in the tax reform proposals put forward by those on both sides of the aisle. As you know, our tax system is not solely devoted to raising the revenue necessary to run government programs, but it also contains hundreds of provisions designed to encourage particular kinds of behavior. Government has a choice when it designs policies to provide incentives to citizens: It can establish a direct subsidy program funded either through annual appropriations or an entitlement program, or it can provide tax subsidies. As the Panel said in its April 13, 2005, statement: "Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers can create complexity and instability, impose large compliance costs and can lead to an inefficient use of resources. A rational [tax] system would favor a broad [tax] base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies the higher taxes paid by all taxpayers."

I urge you to apply a more rigorous burden of proof to proposed and existing tax expenditures – which are often substitutes for discretionary spending programs that would be scrutinized during the annual appropriations process. Tax incentives are justified only when they actually change behavior in the way we intend it to change. It is not worth the revenue loss if a tax expenditure subsidizes behavior that would occur even without the tax benefit. Instead, policymakers create a windfall for a few at the expense of all taxpayers; the tax code becomes more complex; and ordinary taxpayers perceive the system as skewed in favor of those with political clout. Given the long-term fiscal challenges that face this country, Congress can only responsibly maintain lower individual and corporate rates if it also substantially broadens the base, eliminates or scales back many tax expenditures (including those that represent significant revenue loss to the Treasury and are thus valued most by recipients), and imposes a burden of proof on all those advocating new tax subsidies.

Tax Credits are Preferable to Tax Deductions

Second, the Panel did not recommend eliminating all tax expenditures, but we did advocate changing the structure of many of the tax benefits that are retained. We modified most tax benefits aimed at individuals from deductions to credits, and we worked to simplify them. I believe this is one of the Panel's most significant recommendations with respect to individuals, and one that could substantially improve the tax system in ways that would immediately affect the lives of many taxpayers. A deduction can be taken only by taxpayers who have tax liability, and most can be enjoyed only by those who itemize. For example, over 70 percent of tax filers did not receive any benefit from the home mortgage deduction in 2002.

A more effective tax system would restructure most tax expenditures as credits available to all taxpayers and with refundable features in some cases so that even those without tax liability can benefit. As you know, the Panel recommended changing the home mortgage interest deduction to a credit that all taxpayers with tax liability could enjoy, not just those who itemize. We also recommended adopting a simple refundable savers' credit to encourage lower-income Americans, even those who do not pay taxes in a particular year, to save for a better future for their families. Both our reform plans eliminated the duplicative and overlapping system of standard deduction, personal exemption, child tax credit, head of household filing status, earned income tax credit, and refundable child tax credit – all of which have different phase-out ranges and eligibility rules. We proposed instead two credits designed to work together, a Family Credit and a refundable Work Credit.

Using credits is a fairer, more progressive way to provide tax subsidies to Americans. Deductions provide benefits in an "upside-down" manner that offends fairness principles. Deductions are worth more to taxpayers in the higher brackets, but credits are worth the same to all taxpayers and can be made refundable. This was one reason for our recommendation to restructure the subsidy for mortgage interest so that it is taken as a credit, not a deduction, and so that the amount of principal eligible for the deduction is capped below the current limit and applied only to one home. Our recommendation ensures that more Americans can enjoy the tax incentive for home ownership and that the benefit is targeted to lower- and middle-income Americans

seeking to buy modest homes – perhaps their first homes – rather than disproportionately aimed at higher-income Americans and encouraging the purchase of larger homes.

I strongly urge this committee to adopt our approach with respect to tax credits in the individual tax system. The combination of eliminating tax expenditures in many cases and restructuring those that are retained as tax credits, some refundable, will enhance both the fairness and simplicity of the system. The structure is also a more effective way to incentivize the behavior of all taxpayers and, in the case of refundable credits, all tax filers.

The Importance of Integrated Packages

Third, although we did not expect that either of our plans would be adopted without change by Congress, some parts of our proposals are "packages" that must be enacted together in our view. If lawmakers cherry-pick some provisions from these packages without also enacting others, they will not be following our recommendations and, more importantly, they will not be improving the tax code. For example, proposals to replace depreciation with expensing to recover the costs of investment in business assets must be accompanied by a repeal of the deduction for interest. As our Report notes: "Allowing both expensing of new investments *and* an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity."

One key package is our proposal to encourage savings. It includes a simplified "Save at Work" plan which combines all the current employer-provided retirement plans into one. Importantly, and crucial to improving the savings rate, the "Save at Work" accounts have different default rules than do most current plans. For example, under the Auto-Save feature of our proposal, employees would be automatically enrolled in diversified retirement plans and would have to act in order to opt-out. When they left their jobs, their savings would be automatically rolled over into a tax-deferred vehicle unless they chose otherwise. This retains freedom of choice while also increasing the number of people who will save for their retirement. The other two accounts – "Save for Retirement" and "Save for Family" – have limitations on withdrawals so that they can be

used only for certain life events such as retirement, education, purchase of a home, and health-related expenses. We did not support providing tax benefits to accounts that could be used for any purpose; such a structure does not promote long-term savings and will primarily provide a benefit to savings that would have occurred anyway.

A key component of our savings package is a refundable Saver's Credit that would provide low-income Americans a strong incentive to save by matching contributions to savings accounts. This aspect of the package will encourage new savings by people who desperately need to save but lack the resources to do so; recent studies indicate that a refundable saver's credit could significantly change behavior.

Finally, we would repeal all the other tax subsidies for savings currently in the Code, including benefits targeted toward particular uses like education or health and the substantial tax benefit for the inside build-up in life insurance and deferred executive compensation. Thus, our proposal substantially simplifies the tax system for individuals, which may itself encourage some new saving. The three simple accounts we propose would replace the plethora of current vehicles, all with different rules, requirements and eligibility.

As you consider a savings package, I caution you to keep two concerns in mind. First, as with any tax subsidy, you must aim to encourage new savings and not merely provide a windfall for those who would have saved without the tax benefit. You also need to study seriously the full range of consequences of any reform. For example, perhaps the most successful incentive in the tax code to encourage savings is the tax-preferred employer-provided retirement plan, which we strengthen with Auto-Save features. You must be careful not to make any changes in individual savings plans that might discourage businesses from offering such plans to their workers. Some analysts have cautioned that wider availability of very generous individual savings plans might lead some business owners and managers to abandon their employer-provided plans, thereby reducing pension coverage for middle-income workers. On the other hand, our Panel unanimously believed that phase-outs and other methods to constrain eligibility for savings incentives increased complexity to unacceptable levels.

Second, you must determine, to the extent possible, all the revenue implications of the design of savings vehicles – implications that may occur well outside any five- or ten-year budget window. The Simplified Income Tax used the "Roth IRA" back-loaded format, which masks the ultimate revenue loss, particularly when combined with

incentives to encourage taxpayers to convert traditional IRAs. Our report discusses the potential magnitude of these losses in Chapter 4 (page 48). Proposals that reduce the ability of government to raise the revenue that it needs in the future must be considered with great caution, especially if the revenue bite occurs around the same time that the retirement entitlements, such as Social Security and Medicare, will be facing severe fiscal strains. When tax revenues cannot sustain necessary government programs, the resulting deficit financing has significant deleterious effects on the national savings rate; thus, a savings proposal that results in higher deficits is counter-productive.

Progressivity is a Necessary Element of Tax Reform

The final noteworthy characteristic of our reform plans is that both have progressive rates. This reinforces the long-standing tradition in this country of progressivity in the tax code as part of its fundamental fairness, and it responded to the direction of the President to bring forward proposals that were fair and appropriately progressive. Even a pure consumption tax – which was not among the Panel's recommendations – can have progressive rates. Some lawmakers and policy makers have advocated a Flat Tax – which interestingly has two rates, not one – but a single-rate proposal was not supported by the Panel, notwithstanding testimony from its leading advocates. Interestingly, one of the fathers of the Flat Tax, Professor Hall, testified that given growing inequality of wealth in the country, he would now be inclined to include two rates, plus a zero bracket, in the Hall-Rabushka Flat Tax.

For the record, I have included with this testimony my statement upon the release of the Panel's report that discusses the urgent need for a renewed commitment to increased progressivity in today's current economic and social climate. As our country is increasingly characterized by growing and profound inequalities of wealth and opportunity, a progressive tax system – as well as government programs designed to increase economic and educational opportunity for all Americans – can help to redress the inequities. Progressivity means more than just a progressive rate structure; it also means:

- eliminating or scaling back tax expenditures that disproportionately benefit the well-to-do;

- using credits, some refundable, rather than deductions, for those tax expenditures that satisfy the "burden of proof" and remain in the tax code; and
- minimizing the "marriage penalty" that plays a role in discouraging some women from entering the workforce.

The Roads Not Taken in the Panel's Report

I want to conclude by mentioning two proposals that the Panel did not endorse. One, the national retail sales tax, should not continue to have the prominence on the political agenda that it currently enjoys. The other, a credit-invoice Value Added Tax, should remain under consideration, particularly as you begin to grapple with the fiscal challenges facing the entitlement programs and seek a source of revenue more stable than the payroll tax.

In our hearings, former Assistant Secretary of Treasury Mark Weinberger told us that we could play a positive role in the national debate by ruling some things off the table, as well as by putting forward recommendations for reform. Our report, in Chapter 9, should decisively rule out a national retail sales tax as a serious contender for reform. The so-called "FairTax" plan is not a realistic proposal for the country, it would not provide adequate revenue at reasonable rates; it would harm many of the very people who support it; and it meets none of the goals of a healthy tax system.

In contrast, a Value Added Tax, along the lines of the VATs used by the vast majority of our major international competitors, should remain on the table but as part of the reform of Social Security and Medicare. Replacing the payroll tax with a VAT would provide a more stable source of revenue for these important programs. It would appropriately expand the base of those paying for the programs past today's workers to all citizens. Because it would replace the payroll tax, it would not worsen the progressivity of the overall tax system, and the Family and Work credits could be expanded to further reduce regressivity.

Our report, together with other work done by the Treasury Department and scholars, provides a blueprint for a broad-based VAT with very few exemptions, avoiding many of the problems in the European system. It need not be "invisible" but instead could be clearly stated in every purchase of goods and services. Although this issue is

not before you now, I encourage you to refer to the Panel's report when you do consider this possible source of revenue, and I urge you to consider it seriously as a replacement for the payroll tax.

Conclusion

In conclusion, I thank you for allowing us to discuss the Panel's report with you today as you embark on your work on tax reform. I hope that your proposal will incorporate the progressive elements of our proposals, and that you will keep in mind the need for our tax system to raise enough revenue to adequately fund necessary government services. Fundamental and structural tax reform is necessary, but at the same time, cries to constantly reduce taxes are problematic because they leave us – and future generations – unable to meet our obligations as a country. Oliver Wendell Holmes called taxes the "price we pay for civilization." The key is to pay for civilization fully, fairly, and simply.

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Statement Concerning the Release of the
Final Report of the President's Panel on Tax Reform

Elizabeth Garrett*

November 1, 2005

I am pleased to join in the recommendations released today in Washington, D.C. by the President's Panel on Tax Reform. I am honored to have had the opportunity to work closely with the other panel members to assess the current tax system, analyze several proposals for sweeping reform, and recommend two comprehensive tax systems. Working as a group of people with different perspectives and from different backgrounds, we were able to reach consensus agreement on plans that we all support. Both proposals that we recommend represent fundamental reform of the income tax system and deserve serious consideration by policy makers in the executive and legislative branches.

I want to emphasize two constraints facing our Panel that will not affect lawmakers when they begin their work on sweeping reform of the tax system. The first constraint – to retain the status quo distribution of tax burdens – was one that the Panel imposed on itself to eliminate one area of potential irresolvable conflict, and the other – revenue neutrality – was part of the President's mandate so that we focused our attention on the best structure for the tax system without determining how much money it

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should raise. Although I believe legislators should use this Panel's report as a roadmap for reform, they should use the structure we have provided to increase the progressivity of the tax system and to raise sufficient revenue to responsibly meet the country's short- and long-term obligations.

First, as described in Chapter Four of the Report, the Panel decided to craft options so that they had the same distribution of tax burdens as the current system. The current system is somewhat progressive, so retaining the status quo is consistent with the President's mandate to retain progressivity as an element of our tax system. Although this decision made sense because it took a contentious issue off our agenda – i.e., how progressive our tax system should be – and allowed us to reach a consensus, responsible tax policy should include significantly greater progressivity than the status quo or the options we now recommend.

The current distribution of tax burden is not acceptable in light of the substantial inequality of income in the United States. Economists have been telling us for several years that income and wage inequality is higher now than it was in the 1970s; yet we have not paid much attention to these dry economic reports. We can no longer afford to ignore inequality of wealth in the United States. The tragedy in New Orleans and the Gulf Coast concretely demonstrated the effects of poverty and limited economic opportunities on the lives of our fellow citizens. Hurricane Katrina provided a dramatic example of the extent and effects of poverty; those who live daily in economic distress know the reality of poverty that does not receive the full attention of the public, the press or elected officials.

For the last several years, tax policy makers have seemed oblivious to growing income inequality; instead, recent tax laws have moved in precisely the opposite direction and made our income tax system less progressive. Thus, to use the current distribution of tax burdens is to accept a distribution that is unacceptably skewed toward upper-income Americans and insufficiently attentive to a fair allocation of the tax burden. However, the options put forward by this Panel provide a good starting point for comprehensive reform that would enhance fairness through a more progressive rate structure than those we propose. Fundamental aspects of our reform proposals are already fairer than the current tax system: we have replaced many deductions with credits; we have eliminated or scaled back a significant number of tax expenditures that disproportionately benefit the well-to-do; we have simplified refundable credits for lower-

income Americans; we have worked to minimize the marriage penalty. Our proposals provide a structure that is fairer to all Americans, and they can easily accommodate more progressive tax rates that acknowledge the need to take care of the less fortunate in our country.

Second, the President's Executive Order removed from consideration the question of the amount of revenue the income tax should raise because it required our proposals to be revenue-neutral. This was a reasonable constraint on this Panel as it allowed us to focus only on the structure of the income tax. As policy makers take these proposals and craft legislation, however, they should use the structures we recommend to raise more revenue than the United States is currently collecting. This Panel has noted on several occasions that the main function of a tax system is to raise revenues for necessary government programs. Currently, we are paying for too many government programs through deficit financing, passing the financial burden to our children and grandchildren. Responsible fiscal policy requires the government to raise additional revenue to fund entitlement programs that are increasingly fiscally precarious.

In other cases, the unwillingness to make the politically difficult decision to raise taxes has meant that we have failed to adequately fund initiatives and programs that are most efficiently handled by the federal government. An effective fiscal policy must determine the level of necessary public expenditure on public goods and infrastructure. For too long, policy makers have identified the spending side of the fiscal equation with dispensable "waste, fraud and abuse," rather than acknowledging the arenas where government is the best provider of vital goods and services and working to design and fund those government programs so they operate well. The events surrounding Hurricane Katrina are a dramatic example of the folly of failing to adequately fund expenditures that should be made by government – funding for infrastructure like levees and highways; money to develop and implement adequate disaster management plans; revenues to ensure safety and security for all our citizens. The tax reform proposals contained in this Report provide a foundation to craft a responsible tax system that will provide a stable source of revenue to adequately fund programs now and in the future. Because they are presented as revenue neutral proposals, however, they do not directly deal with the need to raise additional revenues. More money is not the only answer to providing government services to our citizens, but it is a necessary part of well-functioning society.

Katrina and its aftermath are a wake-up call for the United States. The disaster shows the wisdom of what we have been told for several years – that we can no longer ignore the fact that in the midst of the great riches of this country, too many of our citizens live in poverty and find their opportunities limited or nonexistent because of economic conditions into which they were born. For the sake of agreement on innovative and comprehensive structural reform options, this Panel did not address the need for greater progressivity in the tax code, nor did we consider the right level of revenue that our tax system must raise so we can responsibly fund necessary government programs. Those who make the tax laws in the legislative and executive branches cannot ignore the issues we took off the table. They have a responsibility to enact both a more progressive tax system and one that raises sufficient revenues to meet our obligations now and in the future.

U.S. SENATE COMMITTEE ON

Finance

SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN

http://finance.senate.gov

Statement of Senator Chuck Grassley
Senate Finance Committee Hearing:
Kick-off for Tax Reform: Tackling the Tax Code
Thursday, Aug. 3, 2006

There's almost universal agreement that our tax code is too complex. The tax form instruction book is probably the most unwelcome piece of mail many taxpayers get. The complexity means taxpayers can't be confident that they've received all the breaks coming to them, or that they haven't paid more than they owe. Add to the complexity of the regular tax system the creeping effects of the alternative minimum tax ("AMT"), and you have a recipe for disaster. As an example of the problems from the AMT side, if we do not extend the hold-harmless or "patch" for 2007, 24 million tax filers, mostly families, will be affected by the AMT. Twenty-four million families. Think about it. And, because of the way the AMT is structured, with no indexing, this AMT problem grows exponentially from year-to-year. The revenue loss for this year's patch was $34 billion and it grows to $44 billion next year. We are facing an AMT train wreck.

Senator Wyden and I resolved in a dialogue in this committee to remedy the AMT problem. Senator Baucus introduced legislation to that effect, joined by Senators Kyl, Wyden, myself, and others. So, there's no question that we have a big problem. It is a problem that the committee should focus on. Let me say that I have no pre-conceived notion of which direction we should go, whether we're talking about a flat tax, national retail sales tax, value-added tax ("VAT") or substantial modification of the current system. Let me also note that I instructed the Finance Committee tax staff to develop simplification proposals in all income tax areas. The staff are working on those proposals.

On a preliminary note, we did invite Treasury Department officials to today's hearing. Treasury officials told us that, at this time, they did not wish to participate in the hearing so that they could have a chance to review tax reform proposals with Secretary Paulson. Treasury officials informed my staff that Treasury would be happy to participate in future hearings on this topic. We hope to have hearings this Fall on tax reform. We will look forward to Treasury's participation at that time. In addition, I still expect Treasury and the Administration's official response to the President's Advisory Panel on Federal Tax Reform that is the focus of today's hearing. In other words, we're kicking off tax reform, but we'll be waiting to hear from one of the key coaches, Secretary Paulson, as he draws up the Treasury's playbook. I know the Secretary is very dedicated to reforming the system and look forward to hearing from him and his staff.

Today, we'll hear from a couple of former Finance Committee veterans who took the charge from President Bush to take the first step at tackling the problems of the tax system. Senator Connie Mack, from Florida, served for several years on the Committee, and came back to public service to Chair the President's tax reform panel. Senator John Breaux served on the committee from 1990

through 2004, almost a decade and a half, and served as the Vice-Chairman of the advisory panel. They are with us today as are panel members, Elizabeth Garrett, who served as tax counsel for former Finance Committee member David Boren, and Professor James Poterba.

I appreciate the tax panel's months of study and analysis. It seems the panel members were apolitical in their work, and that's good. Some of their recommendations were bound to be politically unpopular. Cutting the home mortgage interest deduction is an example. But it's important to have a comprehensive starting point that will get everyone talking and thinking. We have a couple of witnesses to provide an evaluation of the advisory panel's recommendations. We'll hear testimony from David Walker, Comptroller General of the Government Accountability Office ("GAO") and Dr. Jane Gravelle of the Congressional Research Service ("CRS").

Statement of Jane G. Gravelle
Senior Specialist in Economic Policy
Congressional Research Service
Before
The Committee on Finance
United States Senate
August 3, 2006
on
Tax Reform Proposals

Mr. Chairman and Members of the Committee, I am Jane G. Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss tax reform proposals. Although I analyze options and approaches, please note that the Congressional Research Service takes no position on legislative options.

In November 2005, the President's Advisory Panel on Tax Reform presented two potential reform proposals: a simplified income tax (SIT) and a consumption tax proposal (the growth and investment tax, or GIT). Allow me to summarize the main points made about the panel's tax reform proposals in a recent CRS report and in this testimony.

- The plan does not deal with many details that are likely to be important in a legislative proposal, including many minor provisions of current law that may be difficult to eliminate. The resolution of these issues will have important implications for the proposals' effects on revenues, distribution, and simplification.

- The proposals are stated to be both revenue and distributionally neutral. Because the panel uses a baseline assuming the 2001 and 2003 tax cuts are permanent, both would lose revenue compared to the Congressional Budget Office (CBO) official baseline, which has the tax cuts expire as provided by current law. An additional long run revenue loss is expected because of tax-deferred savings plans. These plans also cause the income tax proposal to be slightly less progressive than current law. The consumption tax proposal is likely to be significantly less progressive than current law.

- The plans would simplify tax filing for higher income individuals and the self employed; lower income taxpayers could, in some cases, have more complicated tax returns. Much simplification for ordinary individuals rests on the assumption that many minor provisions, not actually discussed in the panel's report, will be eliminated, which may be unlikely in the case of provisions such as casualty losses and catastrophic medical expenses. Tax compliance by businesses would be simplified, especially with the GIT.

- Both plans would likely increase efficiency in the allocation of capital, by narrowing differentials in tax rates across forms of investment, reducing distortions that favor debt finance over equity finance, and reducing distortions affecting pay-out decisions and realization responses. Most of these effects would be quite small for SIT. The SIT may magnify distortions in the allocation of capital around the world.

- The effects on overall economic growth would be negligible for SIT because of the limited change in marginal tax rates. Although there would be a substantial reduction in effective tax rates on new investment under GIT, the growth effects for this plan are uncertain and may be quite modest. Projections made in a recent Treasury study show substantial variation in results depending on the model used, but the largest results are based on complex economic models whose assumptions are probably not realistic and whose main results are not based on empirical evidence. In addition, the parameters chosen for the models lead to responses that are large relative to the empirical evidence that is available.

- If one accepts the theory behind the complex models, the shift to back-loaded IRAs and other savings accounts, which is particularly significant in the GIT, would reduce saving, a feature not accounted for in the Treasury's study.

- Even where effects on output are greatest, they are small relative to normal growth and are not large enough to materially affect the budget outlook.

- The effects on economic efficiency other than in the allocation of capital are mixed: a floor under charitable deductions along with expansion to non-itemizers would contribute to efficiency, but the effects on health markets are unclear.

- Transition problems present difficulties; the main issue with the SIT would probably be in the loss of deductions for homeowners with large houses and mortgages. These transition problems in the SIT are minor, however, in comparison with the significant problems in the GIT arising from the loss of depreciation deductions, interest deductions, and deductions for the recovery of inventory. The cost of providing full transition relief is prohibitive. Inventories alone amount to close to $2 trillion.

- While the consumption tax proposed would likely increase economic efficiency and provide considerable simplification for business, transition and distributional issues may present significant barriers to adoption. These problems suggest a focus on the income tax proposal. Gains in efficiency and simplicity are smaller for this proposal, however, and problems (albeit more limited) remain with transition. Certain aspects of the plan, however, appear to contribute to efficiency and simplification without creating serious problems, including a charitable deduction floor, encouraging automatic enrollment in savings plans, and capping employer health insurance deductions. Addressing the alternative minimum tax remains an important tax issue if many more families are not to be subject to that tax over time.

The advisory panel's report discussed and found some merit in considering partial replacement of the income tax with a value added tax (VAT), but did not propose such a tax. Finally, the report discussed but rejected a retail sales tax as a replacement for the income tax, and also rejected full replacement of the income tax with a VAT. Note, however, that

there are several congressional proposals that include value added taxes and retail sales taxes as well as flat tax proposals, as well as a proposal for a 1986 style income tax reform.[1]

The remainder of my testimony discusses the panel's tax proposals in more detail. The analysis draws heavily from CRS Report RL33545, *The Advisory Panel's Tax Reform Proposals*, by Jane G. Gravelle, which contains more technical background.

Description of the Proposed Tax Changes

The income tax proposal, or SIT, is an income tax reform proposal that broadens the base and lowers the rates. The consumption tax, or GIT, is imposed as a direct tax which includes a cash flow tax on businesses and a progressive tax on individual wage income. A consumption tax of this type is often referred to by the generic term "flat tax" when rates are flat, and as an "x-tax" when the tax on wages is progressive. The GIT is not a pure consumption tax plan because it also includes a 15% tax on financial income (interest, dividends, and capital gains); rather it is a consumption tax, with a wage credit and an add-on tax on passive capital income at the individual level.

The tax reform plans have not been presented in legislative language, and therefore details of the plans are not always clear. Many tax issues, such as the treatment of casualty losses or alimony, or capital gains on owner-occupied housing, are not directly addressed, but would presumably be addressed once specific legislative changes are contemplated. For example, the proposal appears to disallow casualty loss deductions, even though these deductions were recently expanded for victims in the aftermath of Hurricane Katrina. Current law also allows alimony to be deductible by the payer and taxable by the recipient, and presumably many divorce settlements take into account this tax treatment. Many other small tax provisions are not explicitly addressed in the proposal.

The proposals generally have similar provisions that relate largely to the current individual income tax. Perhaps the most significant individual income tax deductions eliminated are itemized deductions, including the deduction for state and local taxes, although the mortgage interest deduction is replaced by a 15% capped credit and charitable deductions in excess of one percent of income are allowed to all filers. A new deduction for health insurance is added and the deduction for employer health insurance plans is capped.

The current rate structure is flattened, moving from the current rate structure of 10%, 15%, 25%, 28%, 33% and 35% to four rates (15%, 25%, 30%, and 33%) in the SIT and three rates (15%, 25%, and 30%) in the GIT. The alternative minimum tax is also eliminated and personal exemptions and standard deductions are converted to credits, with the maximum earned income credit (EIC) increased.

The proposal simplifies and indexes the exclusion for Social Security benefits, and significantly expands existing preferred savings accounts such as individual retirement

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[1] See CRS Report RL33443, *Flat Tax Proposals and Fundamental Tax Reform*, by James M. Bickley for a discussion of these plans and see CRS Report RL32603, *The Flat Tax, Value-Added Tax and National Retail Sales Tax: An Overview of the Issues*, by Gregg A. Esenwein and Jane G. Gravelle for a discussion of these different approaches to a consumption tax. Transition problems are actually more severe for these forms of consumption tax.

accounts. This latter provision allows two savings accounts, each with a limit of $10,000. No income restrictions would apply. The "Save for Retirement" account would replace existing individual retirement accounts with a current limit of $5,000. The "Save for Family" account would replace education and health savings accounts; funds could be used for education, health, and first time home purchase. The proposals would also simplify employer savings plans and remove barriers to and encourage automatic enrollment and growth of contributions. All individual savings plans would be converted to Roth-type plans (not deductible up front) and, in the case of the GIT, 401(k) and similar plans would be converted to Roth-type plans as well.

Several provisions listed above would also have consequences for the taxation of investments in assets. For owner-occupied housing the changes in mortgage interest and property taxes would affect the return on that investment. Tax burdens on capital income would also be affected by the preferred savings accounts. In addition, taxes on dividends would be eliminated and taxes on capital gains on corporate stock reduced to much smaller levels under the SIT. A separate financial income tax (on interest, dividends, and capital gains) would be applied under the GIT, although most taxpayers would be able to shield this income in tax preferred savings accounts.

The plans would make major revisions in the taxation of business income, including the elimination of most corporate preferences. Corporate tax rates would be reduced to 31.5% in the SIT and 30% in the GIT and the corporate AMT would be repealed. The SIT (the income tax proposal) would allow a significant amount of expensing of investment in equipment as well as cash accounting for small businesses, and cash accounting for medium sized businesses (small businesses would be required to have a separate business bank account), provide a new, simplified, depreciation system, and eliminate the taxation of income from active business abroad (while taxing foreign source earnings from intangibles on a current basis).

Under the GIT all investments and purchases would be expensed (deducted when paid); old depreciation deductions are phased out, interest would not be deductible by business and interest income would not be taxable; and deductions and payment of taxes on interest on existing debt would be phased out. Taxes paid would be rebated at the border (similar to the treatment of a value added tax).

As in the case of the individual structural provisions the treatment of some items is not entirely clear. For example, while the research and experimentation credit would presumably be repealed, the expensing of intangible investment in R&D would presumably continue in the SIT as well as in the GIT .

Currently, the reform proposals are being considered further by the Treasury Department, which has recently released a dynamic analysis that discussed the two tax reform proposals as well as a third proposal, a progressive consumption tax (PCT) that modifies the GIT by eliminating the 15% financial income tax, and raising the top rate to 35%.[2]

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[2] Robert Carroll, John Diamond, Craig Johnson, and James Makie III, *A Summary of the Dynamic Analysis of the Tax Reform Options Prepared for the President's Advisory Panel on Federal Tax* (continued...)

Revenue Neutrality

One of the objectives of the proposal was revenue neutrality. How revenue neutrality is measured depends on the baseline used, and the panel to used the Administration baseline which included the permanent extension of the 2001-2003 tax cuts. This baseline differs from the baseline used by the Congressional Budget Office (CBO) which simply relies on the current tax law, and thus assumes that temporary provisions, including the 2001-2003 tax cuts, will expire. Thus, revenues raised under the Administration baseline are smaller than those raised under the CBO baseline.

As a result, the revenues raised by the tax reform proposal are associated with a substantial deficit—and one even more substantial given that there is a currently a surplus in the Social Security account that will eventually disappear and become a deficit. Over the period 2007-2016, in addition to the projected deficit of $0.8 billion, the cost of making temporary tax provisions (except the AMT) permanent, including debt service, is about $2.3 trillion. And these projections do not include the possibility that discretionary spending will rise to keep pace with national income, which would increase the deficit by $1.6 trillion.[3]

Because the panel used the Administration baseline, any comparisons made in this testimony are with current law incorporating the 2001-2003 tax reductions. Nevertheless, some additional source of revenue must eventually be identified, which means that tax rates might need to be increased or tax preferences reduced, and how that revenue is made up would affect the analysis. Also there are some smaller provisions that would be difficult to dispense with, as discussed below, and if they were restored, an additional revenue shortfall would occur.

There is an additional reason that the proposals may not be truly revenue neutral even within the context of the baseline used. The adoption of Roth-type savings accounts reduces current losses from deductions in traditional accounts, but loses revenue in the future. Such a loss could be significant. For example, some rough estimates suggest that a similar proposal by the Administration that gained a small amount of revenue in the budget horizon could eventually cost around $50 billion at current income levels, an amount equal to about 4% of current income tax revenues.[4]

Simplification

Both proposals contain many elements that would simplify tax compliance. The elimination of itemized deductions would simplify tax filing. The proposal would, however, add complexity to current non-itemizing returns, which account for 70% of all returns, by allowing the charitable deduction, health insurance deduction, and mortgage credit. Some non-itemizers do not give in amounts that exceed the threshold for charitable deductions (1%

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[2] (...continued)
Reform, U.S. Department of the Treasury, Office of Tax Analysis, May 25, 2006, prepared for the American Enterprise Institute Conference on Tax Reform and Dynamic Analysis, May, 2006.

[3] Based on data in CRS Report RS22045, *Baseline Budget Projections Under Alternative Assumptions*, by Gregg Esenwein and Marc Labonte.

[4] See CRS Report RL32228, *Proposed Savings Accounts: Economic and Budgetary Effects*, by Jane G. Gravelle and Maxim Shvedov.

of income), and either rent their homes (about a third of the population rents) or have paid off their mortgages. But for those who have either a mortgage payment or significant charitable deductions, or who purchase health insurance, tax filing will be more complicated. Charitable deductions, in particular, require record keeping, although floors may eliminate the need of those with small contributions relative to income to do so. All taxpayers should experience simplification from the collapsing of deductions, exemptions, and credits into a single family credit, and, for higher income taxpayers, from eliminating phaseouts and the AMT. Higher income taxpayers who save will also benefit from the simplified savings accounts.

The proposal, on its surface, also eliminates some itemized deductions that are difficult to dispense with, such as the casualty loss deduction, the deduction for extraordinary medical costs, and the deduction for miscellaneous items such as employee and investment costs. Because the panel remained silent on these other itemized deductions, there is no way to know how they would be treated. These exemptions, all over a floor (except for casualty losses for hurricane victims in 2005), are designed to allow offsets for unusually large costs relative to income. It is difficult to imagine not allowing some deduction for these extraordinary costs, but allowing the deductions for all taxpayers would significantly add to the complexity of the tax form. Under current law, two factors limit the claiming of these deductions to truly large costs: the floor, and the fact the deduction is itemized (so that low income individuals must have a significant dollar loss). Since itemized deductions are no longer feasible, as there is no longer a standard deduction, restoring these deductions would be complicated and undo much of the apparent simplification with respect to itemized deductions.

There are also "above the line" deductions, such as those for alimony and for moving expenses, as well as some credits that might be thought desirable (the child care credit) whose retention might prove important. Given the extension of tax benefits to non-itemizers, and the possibility of reintroducing some additional deductions, it is not clear whether simplification for individual tax filers on the whole is increased or decreased.

Allowing cash accounting and expensing for small businesses under the income tax proposal would also significantly simplify their tax compliance, although much of this benefit would be lost if state income taxes do not make similar adjustments. The provision requiring small business bank accounts to be handled separately from personal accounts could complicate the affairs of those with occasional small amounts of self-employment income unless a de-minimus rule were adopted, however. (An example would be a professional who receives a small consulting fee, but whose major source of income is employment, or a skilled workman who occasionally moonlights). Complications would also occur for business owners who use assets for both business and personal use (e.g. homes and cars). Although there is some simplification of the depreciation system for larger businesses, most of the current complexities would remain, as would most of the challenges in allocating international income for multinationals which cannot be eliminated. The elimination of the production activities deduction is an important simplification, however.

On the whole, the income tax proposal appears to simplify the tax system for higher income taxpayers and the self-employed, while possibly complicating it for lower and middle income wage earners. The consumption tax proposal should achieve more simplification for business because all acquisitions would be expensed. In this system, there is no need to keep depreciation accounts or inventories, or deal with the foreign tax credit.

Fairness and Equity

Issues of tax equity may concern vertical equity (how effective tax rates rise as incomes rise) and horizontal equity (how different taxpayers with similar circumstances are treated). The discussion below suggests that the income tax replacement would have relatively small effects on either vertical or horizontal equity, and indeed may increase differentials across family types. It is more difficult to characterize the growth plan, which is essentially a consumption tax, but there is a case to be made that such a tax would be much less progressive than the current income tax system. In any case, the distributional method used in the panel's study for their progressive consumption tax is inconsistent with the one they suggest is appropriate for another, economically equivalent, consumption tax—the VAT.

Vertical Equity

An objective of the panel was to maintain the current progressivity of the tax system and the panel's report shows both the SIT and the GIT to be distributionally neutral, at least across broad income classes. (There is no detail about the extremely high income individuals at the top who constitute only a tiny fraction of taxpayers but a large fraction of income.) Note that this distributional comparison is with respect to the assumption that the 2001and 2003 tax cuts, which favored higher income individuals, are in place. Even so, there are questions about the distributional neutrality of the plans.

The commission's distributionally neutral system is likely, in part, a temporary artifact of the shift into back loaded savings accounts (which can raise revenue from owners of assets in the short run but lower it dramatically in the long run). The magnitude of this effect is difficult to determine, but analysis of the President's budget proposals of this nature, which had less generous contribution limits and negligible revenue effects in the budget window, suggested the long run revenue loss could easily be $50 billion or more at current income levels, an amount equal to 4% of FY2005 corporate and individual income taxes.[5] This saving would accrue to individuals in the higher income levels, as savings of any sort tends to be concentrated there.

Distributional issues are far more problematic in the case of the consumption tax proposal. Although distributional tables are presented that also show distributional neutrality, that conclusion is not clear. As in the case with the income tax proposal, some of the effect reflects the effects of savings accounts and this effect is even more important in the GIT because all defined contribution plans (such as 401(k)s) will be converted into backloaded plans. Moreover, because dividends and capital gains are taxed under this proposal, the long run sheltering of income by high income individuals may be even more important. The effects will likely be larger than the effects in the SIT, which are already significant.

A second, and more important, problem with evaluating vertical equity under the GIT is how to distribute the tax that is collected. One might propose to allocate the tax according to consumption, along with a credit for wage tax reductions due to graduated rates. Indeed, in discussing the VAT, which is also a consumption tax, the study indicates that tax would be allocated according to consumption and would be regressive, not progressive, requiring

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[5] Ibid.

additional fixed rate credits and, even in that case, resulting in lower shares of tax paid by the highest income individuals. However, for the GIT, which is simply a VAT imposed in a different form with a wage credit, a different distributional methodology was used. The business cash flow tax is allocated according to income, and thus the tax is modeled as if it were an income tax.

A consumption tax is a tax on wage income and a lump sum tax on old capital that is effectively collected over time as the assets are consumed. For very high income individuals who indefinitely pass on assets in estates, that consumption may never occur. If one distributed the tax on the basis of consumption, the tax would decline as income rises despite the rate structure. The tax was, however, distributed as if it were an income tax and thus the cash flow tax at the firm level (which is really a lump sum tax on old capital that may or may not be translated into an effective tax on consumption) is treated as if it is a tax on income and falls on high income individuals.

To illustrate the importance of these approaches, consider a recent study that compared the distributional effects of an "x" tax with a 15% and 30% rate and a demogrant (rebate to lower income individuals to offset the tax) under both approaches.[6] This plan is similar in many respects to the panel's proposal. If distributed according to consumption, the middle quintile has an effective tax rate of 23.3%, the top quintile a tax rate of 12.1% and the top 1% a tax rate of 6.1%. If distributed according to income, the tax rate is 11.4% for the middle quintile, 22.5% for the top quintile, and 22.0% for the top 1%.

Distributing a consumption-based tax in the short run is tricky, and there is no perfect answer because the cash flow tax is a tax that causes asset values (or their purchasing power) to fall, but does not burden new investment which can be purchased at a discount. However, in the long run the consumption tax base tends to be similar to a wage tax base, except that it also favors higher income people, even in the long run, because they are less likely to consume all of their lifetime wage income. Thus it is highly unlikely that the GIT is distributionally neutral; it makes the tax system less progressive by largely exempting capital income from tax.

Horizontal Equity

Horizontal equity refers to the equal treatment of equals. There are three basic issues of horizontal equity that could be considered: equal treatment of different family sizes, equity in the treatment of different age cohorts, and equity in the treatment of taxpayers who vary in their preferences for tax favored activities.

A recent study used an equivalency index (similar to the poverty levels that vary across family size) to compare tax burdens on families of different sizes.[7] This analysis suggested that in the lower income levels, families with children tend to be heavily favored compared to singles and childless couples with similar abilities to pay, while the reverse is the case at the higher income levels. The tax reform plans appear largely to preserve these features of

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[6] See Leonard Burman, Jane Gravelle, and Jeff Rohaly, *Towards a More Consistent Distributional Analysis*, forthcoming in the Proceedings of the National Tax Association, 2005 Conference.

[7] See Jane Gravelle and Jennifer Gravelle, "Horizontal Equity and Family Tax Treatment: The Orphan Child of Tax Policy," forthcoming, *National Tax Journal*, Sept., 2006.

the tax system. The benefits for families with children at lower income levels arise from the earned income tax credit and child credits, which are maintained. At higher income levels families with children are penalized because the adjustments for family size are not large enough; this problem may be magnified by the converting of personal exemptions into credits, but reduced by the repeal of the alternative minimum tax and phase-outs of deductions. On the whole there appears to be no major change in this aspect of the tax system.

Consumption taxes, such as the GIT, inevitably shift the burden of the tax towards the current older generation and away from young and future generations. Essentially, those with assets who expect to consume out of these assets are subject to a substantially higher tax. This shifting across the generations is relieved to some extent by the transition rules that allow some recovery of depreciation, but this offset is quite limited. That shift means that older people pay a higher lifetime tax than younger or unborn generations.

The elimination of preferences for investment types, the most frequent type of tax preference in the income tax, is generally not viewed as important to horizontal equity in the long run, since capital and pre-tax returns shift to equate returns after tax. The tax revisions continue to favor home ownership, although, as seen below, to a lesser degree. The proposals eliminate the preferences for taxpayers in states with higher taxes, and appear to reduce the benefits for those covered by employer provided health care while allowing benefits for those not covered by employer plans. Charitable contributions effects are mixed as the benefit is provided to non-itemizers, but also subject to a floor. On the whole, the proposals appear to improve horizontal equity as measured on this basis.

Efficient Allocation of Capital and The Taxation of Capital Income

In the broadest terms, a tax reform can alter economic behavior by changing the tax rates on labor and capital income. One of the most important ways in which the tax reform proposals would affect the nature of the tax system is through changes in the taxes on capital income. Indeed, the indications from a recent dynamic analysis of the tax reform proposals[8] suggest there is little or no change in either average or marginal tax rates on labor income from the proposals. It is largely in the treatment of capital income that the proposals have a potential effect.

Change in the treatment of capital income can improve economic efficiency if they lead to a better allocation of capital to different uses. In general, more even taxation of different types of assets is more efficient. If investors tend to equate returns after tax on different investments, then more neutral taxation will more clearly equate the pre-tax, or social, return, leading to a higher level of output and well-being. A lower aggregate tax rate on capital income can also reduce distortions and lead to a more optimal savings behavior.

CRS Report RL33545, *The Advisory Panel's Tax Reform Proposals*, contains an extensive discussion and estimates of effective tax rates on new investments to indicate the

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[8] Robert Carroll, John Diamond, Craig Johnson, and James Mackie III, *A Summary of the Dynamic Analysis of the Tax Reform Options Prepared for the President's Advisory Panel on Federal Tax Reform*, U.S. Department of the Treasury, Office of Tax Analysis, May 25, 2006, prepared for the American Enterprise Institute Conference on Tax Reform and Dynamic Analysis, May, 2006.

narrowing of differentials of various types, which will be briefly summarized in this section. The discussion below indicates that the SIT is likely to slightly narrow differentials across assets, but the GIT will have a substantial effect.

Distortions Across Assets

Distortions across different types of assets within a firm will be slightly reduced by the SIT, and eliminated by the GIT. Under current law, at the corporate level, tax rates of fixed assets (excluding oil and gas production investment other than equipment, which is taxed at around 6%) vary from 15% for certain long lived equipment eligible for the production activities deduction to 40% for certain structures; the SIT will reduce the range to 13% to 37% inclusive of oil production. The GIT will set all rates to zero. On average, under current law, equipment is taxed at 25%, structures at 30%, and inventories at 37%. SIT would change the rates to 27%, 31%, and 35%, while the GIT would lower them to zero.

Distortions in Financial Decisions

The tax rates discussed in this and the following subsection take into account not only the tax on corporate profits, but also individual level taxes and the benefits of deducting interest by corporations. Under current law, not taking into account tax preferred savings in IRAs and pension plans, corporate debt is taxed at 9% and equity at 37%; under SIT the rates would be 16% and 33%, while under the GIT they would be 15% and 12%. Currently about half of assets are in tax exempt forms, and if those benefits are taken fully into account, the tax rate is -11% for debt and 33% for equity; under SIT the rates are -3% and 31%; under GIT 8% and 6%. It is possible that the SIT could magnify effects, however, if more assets are in tax exempt form. With 100% of assets not subject to individual level tax, the rates would be -23% and 30%. For the GIT they would be zero. The proposals also reduce the distortions between dividends and capital gains and the capital gains lock in effects.

Distortions Across Sectors

The plans also reduce the distortions between corporate business, noncorporate businesses, and owner-occupied housing, especially under the GIT. Under current law, ignoring tax exempt forms, the overall effective tax rate on returns to corporate investment is 32%, for noncorporate business 20% (18% for firms who are eligible for equipment expensing at the margin), and for housing -3%. Under SIT, tax rates are 30% on corporations, 18% on small noncorporate business (who dominate the noncorporate sector), 22% on large noncorporate business, 20% on medium non-corporate business, and 3% on housing. The GIT imposes a tax of 14% on corporations, 6% on noncorporate business, and 0% on housing.

With 50% of assets held in tax exempt forms, the overall effective tax rate for corporations is 25%, for noncorporate business 18% (16% for firms who are eligible for equipment expensing at the margin), and for housing -13%. Under SIT, tax rates are 25% on corporations, 14% on small noncorporate business, 18% on large noncorporate business, 16% on medium non-corporate business, and -1% on housing. The GIT imposes a tax of 7% on corporations, 3% on noncorporate business, and -8% on housing. With 100% tax exempt forms, under SIT, tax rates are 20% on corporations, 10% on small noncorporate business, 14% on large noncorporate business, 12% on medium non-corporate business, and -6% on

housing. The GIT imposes a tax of 0% on corporations and unincorporated businesses and -17% on housing.

In general, therefore, the differentials across assets are narrowed, but that effect is much smaller under the SIT than under the GIT.

Economy Wide Tax Rates

Overall, without tax exempt forms the total tax rate is 18% for current law, 17% for SIT and 7% for GIT. With 50% tax exempt financing, the rates are 11% for current law, 13% for SIT and 1% for GIT. With 100% tax exempt financing the rates are 9% for the SIT and -6% for the GIT. Thus, overall, the SIT has little effect on marginal tax rates on capital income, while the GIT tends to lower the rate.

International Allocation of Capital

The panel proposes a significant change in the tax treatment of foreign source income in its income tax proposal, and proposes to treat taxes in its consumption tax proposal (GIT) in the same manner as a VAT.

Under current income tax law, income of foreign subsidiaries of U.S. parents is not taxed until repatriated as dividends, a treatment referred to as deferral. Income of foreign branches of U.S. companies is taxed currently as is certain passive income (Subpart F income) of subsidiaries that is easily subject to abuse. When income is taxed, firms can take a credit against foreign taxes paid up to the amount of the U.S. tax due and these credits are aggregated across countries, so that unused credits for taxes in high tax countries can be used to offset U.S. tax due in low tax countries. This offsetting of credits across countries is referred to as cross-crediting. Certain passive income is segregated into a separate foreign tax credit "basket."

The international tax regime has several problems relating to economic efficiency and tax compliance. First, because of deferral and cross-crediting, too much of U.S. investment flows to low tax countries (where its pre-tax return is too low) and too little to the United States and high tax countries. Deferral does not produce as large a disincentive as outright exemption, but once income is earned abroad there is an incentive to reinvest abroad to avoid the repatriation tax. Second, the potential to reallocate profits from high to low tax jurisdictions complicates tax administration and compliance. Profits may be reallocated by setting prices for inter-company transactions and by assigning patent rights to operations in low tax countries. In addition, since companies control their tax liability through repatriation decisions, they engage in complex planning to minimize their taxes, and, indeed, very little tax is paid on foreign source income.

One reform approach would be to tax all income currently, which would eliminate the repatriation issue. Also, if it were administratively feasible (although there are claims that it is not), foreign tax credits could be separated into country baskets, a treatment that would eliminate incentives for investment in low tax countries (although it would increase the disincentive to invest in high tax countries). But even with cross-crediting, a case can be made that this change would lead to greater economic efficiency through eliminating much of the incentive to invest in low tax countries. Moreover, there would be less incentive to transfer income across different countries. U.S. individual investors could avoid some of this

current tax by investing in foreign parents and there would also be incentives for U.S. parents to transform into foreign parent corporations (corporate inversion). The evidence suggests that these effects would probably be small, and corporate inversions could be discouraged with legislation. Revenue raised from this approach could be used to reduce the corporate income tax rate and top income tax rates, if the distributional effects are to be held constant.

An argument is sometimes made that this type of change would lead to an unfair disadvantage to companies that must compete in low tax countries with firms from other countries who do not tax their subsidiaries' income. It could lead to a smaller presence abroad of U.S. firms, but, nevertheless, the investment that takes place in the United States would earn a higher return and benefit the U.S. economy. That is, from the point of view of U.S. society as a whole this is not so much an "unfair competition" but rather a system that diverts resources to their best uses.

The panel did not choose current taxation of foreign source income, but rather a complete exemption of active income, and current taxation of passive income including royalties. This latter provision would eliminate the ability of companies to shift income abroad through the use of royalties. This option suggests the panel wanted to focus more on the international abuses and reduction of planning costs, as this treatment eliminates the repatriation decision and reduces the opportunity to shift income through royalties. The panel argues their plan on the basis of conforming to what most other countries do and also invokes the "level-playing-field" argument discussed above. They also suggest that the tax shelter problem is more severe than the real allocation of capital. But the plan can be criticized as not only increasing real asset allocation distortions but also giving up the opportunity to reduce transfer pricing and expense allocation methods of shifting profits to low tax jurisdictions.[9]

For the consumption tax plan, since the tax is no longer a corporate income tax, all of these mechanics would be abandoned. Two approaches that are generally equivalent for a uniform tax (and this tax is relatively uniform) are an origin basis tax (where output is taxed where produced) and a destination basis tax (where output is taxed where consumed). In the destination approach, as used in the VAT, taxes would be rebated on exports and imposed on imports. The panel recommends a destination basis because it eliminates the incentive to shift taxable sales into low tax countries.

Effects on Savings, Labor Supply, Growth, and Output

If tax rates on capital and labor income affect labor and savings and if they are altered, output and, in the near and intermediate term, growth rates in the economy can change.[10]

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[9] For a recent study which compares these systems, with a discussion of these profit shifting issues, see Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross Border Income," presented at the James A. Baker III Institute for Public Policy Conference, "Is It Time for Fundamental Tax Reform?: The Known, Unknown, and Unknowable," Houston, TX, April 27-28, 2006.

[10] In most growth models changes in savings rates and labor supply cannot affect the long run growth rate which is determined by population growth and exogenous technological change. There are models of endogenous growth, but the factors that drive those growth rates are unlikely to be

(continued...)

Despite the presumption that lower tax rates will increase supply, such an outcome is neither theoretically nor empirically certain. For both of these effects, there are offsetting income and substitution effects. A rise in after tax wage income can cause work effort to decrease because the individual wishes to consume more of everything, including leisure, offsetting the incentive to shift consumption from leisure to other goods, with the outcome uncertain. Similarly, a rise in the after tax rate of return can allow individuals to achieve a target amount with smaller savings, offsetting the effects of the incentive to save more to achieve a higher target. Simple empirical evidence suggests that effects are small because labor supply and savings responses are relatively small.[11]

Economists at the Treasury Department recently prepared a dynamic analysis of the tax reform plans, and that analysis will be used to discuss the potential growth effects.[12] The Treasury study, in addition to examining the two reform plans, also examined a personal consumption tax (PCT) that was similar to the panel's consumption tax (GIT), but excluded the 15% tax on financial income (interest, dividends, and capital gains) and had a slightly higher top tax rate (35% rather than 30%).

The Treasury used three different models to analyze the effects. One model is a standard neoclassical growth model with fixed labor supply and an elasticity of savings with respect to the rate of return equal to 0.4. The other two models used in the Treasury study were the standard intertemporal models, the Ramsey model which depicts the economy as a single infinitely lived person, and the overlapping generations model (OLG) which traces cohorts of individuals over time. These intertemporal models were developed to bring the microeconomic foundations of decisions regarding savings and labor supply into macroeconomic models. While more satisfying theoretically to many economists, these models have not been tested empirically and are highly stylized in many ways.

Table 1 summarizes the effects on output of the various reform plans using the three models in the first 10 years, in year 20, and in the long run steady state. As the numbers in this table indicate, two results are clear. First, the income tax reform has very small effects on growth in any of the model simulations, because it has little effect on tax rates. None of the proposals had a significant effect on marginal and average wage tax rates, and only the consumption tax proposals had an effect on tax rates on investment.[13] Second, for those

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[10] (...continued)
affected by the tax changes in the reform plan.

[11] For a review of the empirical evidence see CRS Report RL31949, *Issues in Dynamic Revenue Estimating*, by Jane G. Gravelle.

[12] Robert Carroll, John Diamond, Craig Johnson, and James Mackie III, *A Summary of the Dynamic Analysis of the Tax Reform Options Prepared for the President's Advisory Panel on Federal Tax Reform*, op. cit.

[13] The Treasury study reports the marginal and average income tax rates on labor income at 24% and 13% respectively. Under the income tax plan, these rates are estimated at 24% and 12.8%, while in the consumption tax plan they are 23.5% and 13.3% respectively. The marginal and average rates go up slightly in their personal consumption tax plan (PCT), to 26.4% and 14.7%. For capital income, the Treasury study estimates a current marginal tax rate of 13.9%. For the income tax reform, the rate falls slightly to 12.8% but for the consumption plan (GIT), the reduction is much larger, to 1.1%. Their personal consumption tax rate is -3.7%. The tax rates used in their analysis (continued...)

proposals that had a noticeable effect on the capital income tax rate, the results vary significantly depending on the model used. In the first 10 years, on average output increases by 1.9% for the Ramsey model, 1.5% for the OLG model, and 0.1% for the Solow model. In the long run, output is larger respectively by 4.8%, 2.2%, and 1.4%.

Table 1: Percentage Change in National Income, Treasury Study

Plan	Solow Model	OLG Model	Ramsey Model
Simplified Income Tax (SIT)			
Budget Window	0.0%	0.4%	0.0%
Year 20	0.1%	0.8%	0.2%
Long Run	0.2%	0.9%	0.3%
Consumption Tax Plan (GIT)			
Budget Window	0.1%	1.5%	1.9%
Year 20	0.4%	2.1%	3.7%
Long Run	1.4%	2.2%	4.8%
Personal Consumption Tax (PCT)			
Budget Window	0.2%	0.7%	2.3%
Year 20	0.6%	2.6%	4.5%
Long Run	1.9%	2.8%	6.0%

Source: Treasury Department, Office of Tax Analysis.

Explaining the causes of these different results and evaluating the reasonableness of the models is quite complicated, and the technical discussion is contained in an appendix to CRS Report RL33545, *The Advisory Panel's Tax Reform Proposals*. The major conclusions suggested in that appendix are as follows:

[13] (...continued)
are similar to the ones calculated in this study in Table 5.

- Straightforward empirical evidence indicates that savings could rise or fall and even in the model with the most modest results (the Solow model) it is not clear that the effects would, indeed, be positive, as some time series elasticities are negative.

- The use of Roth-type IRAs and, in some cases, 401(k)s from traditional IRAs would, according to the theory embedded in intertemporal models, be less likely to induce savings as individuals would no longer need to save the up-front tax reduction to pay future taxes. This effect could be particularly pronounced in the GIT where defined contribution pension plans will be converted to Roth style plans, as substituting a Roth for a deductible plan should *reduce* savings. These effects are not accounted for.

- Intertemporal models, while theoretically appealing in many ways, involve some fairly heroic assumptions about the abilities of individuals to make complex decisions and have not been empirically tested. Much of the savings response reflects intertemporal substitution of labor in response to interest rates changes, where virtually no evidence of a response is available. Alternative "rules of thumb" savings behavior may be more consistent with individual savings behavior and tend to imply a zero or negative elasticity. This view of behavior suggests that automatic enrollment in employer retirement plans, facilitated by the proposals, might increase savings, for which there is some direct evidence.

- The Ramsey model also suffers from some serious limitations, as it requires some strict assumptions to achieve an internal solution (i.e. where there is general ownership of capital across many people, as observed in the economy), including homogeneous preferences, asexual reproduction, and a common tax rate, thereby making it impossible to apply the model to a progressive tax rate structure, an open economy, or to incorporate differential state tax rates.

- Even within the context of the intertemporal models, many of the implicit elasticities are inconsistent with the empirical evidence, including the labor supply elasticities and particularly the intertemporal labor substitution elasticity, which empirical work suggests is less than 0.2 but which is set at around 0.75 in the Ramsey model and around 0.5 in the OLG model. Standard labor supply elasticities also tend to be higher than most empirical estimates, especially in the Ramsey model. Part of the reason for these high elasticities is the somewhat arbitrary choice of hours available for additional work.

- Even where the higher growth effects are expected, these effects are quite modest compared to the normal growth of the economy. For example, the largest growth is projected for the GIT by the Ramsey model. In that simulation, over the 20-year period, output rises by 3.7%, for an average annual growth rate of less than 2/10 of a percent. Normal growth is usually 2 to 3% and growth per worker typically 1% or more. Growth induced by even a significant tax change of this nature is not likely to materially affect the fiscal outlook—that is, we cannot grow our way out of the deficit by changing the shape of the tax system.

Other Tax Incentives

The tax reform proposal eliminates a series of tax preferences, some of which are discussed in the document and some of which are simply presumed to be eliminated based on general statements. An analysis of this myriad of tax incentives is beyond the scope of this discussion, although it is possible to argue that many of them tend to distort the allocation of resources and many are simply accidents of history.[14] Some provisions, however, are substitutes for what might be desirable spending programs that are channeled through the tax system, and repealing them without providing an alternative spending program may be questioned.

An example is the low income housing credit, for which a case may be made that use of the tax system is inefficient, but where the goal (helping low income people obtain decent housing) may be laudable. Another example is the education tax credit and deduction which was aimed at making higher education more affordable for the middle class and was phased out at higher incomes. The tuition credits and deductions were criticized because a direct system for delivering aid was already in place, and using the tax system simply made the system more complicated. One can also debate the desirability of expanding aid to middle class, given the extensive subsidies that already exist, but that is a debate about education, not tax, policy. It is the case, however, that the proposal retained the subsidies for saving for higher education through the "Save for Family" accounts, subsidies that are likely to be more concentrated to higher income families who can afford to save for a long period of time.

As noted above, many of the provisions in current law affect the allocation of capital investment and the major ones are incorporated in the analysis of capital income taxes. There are certain consumption items that are favored in a significant way by the current tax law, and these will be discussed briefly in this section. Perhaps the most significant, in terms of lost dollars of revenue, is the current benefits for health care, and specifically for health insurance. Also discussed is the subsidy for charitable giving and the effect on state and local governments (due to the deductibility of state and local taxes and the exclusion of interest on tax exempt bonds). The panel's proposal would make changes in all of these areas. While a full analysis of these issues is beyond the scope of this analysis, some brief discussion is provided.

Health Care

Some of the largest subsidies in the tax code accrue to health care, with forgone revenues of $90.4 billion in FY2006 for the exclusion of health insurance benefits from employees' income. There is also a $3.8 billion loss for exclusion of health insurance for the self-employed. Some part of spending for cafeteria plans, where employees choose benefits, is associated with health care; these plans result in a revenue loss of $27.9 billion. In addition to these benefits for private health insurance, $7.5 billion is lost in itemized deductions for major health costs (those over 7.5% of income). There are also some losses

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[14] For a brief discussion of each of the over 100 tax expenditures see U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compilation of Background materials on Individual Provisions*, Prepared by the Congressional Research Service, S. Prt. 108-54, Dec., 2004.

due to exclusion of employee benefits and Medicare benefits, the latter being relatively costly.

There are reasons for government intervention into the health care market, which is subject to adverse selection (differential premiums for people with poor health histories) and moral hazard (encouraging too much spending on health care due to insurance). In addition, our society does not wish to deny critical medical care to people due to lack of ability to pay.

The revisions in the panel's plan may reduce some of the problems but possibly aggravate others. The exclusion of insurance for employer plans (and the self-employed) can be criticized on the grounds that it adds to moral hazard (by encouraging coverage of ordinary medical expenses) and is unfair because it does not benefit employees of firms without plans. At the same time, employer plans, by pooling individuals in the workplace, can address adverse selection. The proposal to limit employer contribution deductions (it is not practical to tax this implicit income to employees) might reduce moral hazard without interfering with the benefits of offsetting adverse selection, and thus may be considered an efficient reform. Allowing a deduction for health insurance premiums to those not covered by employer plans has both desirable effects—it would be more equitable and would improve coverage—and undesirable effects—it would increase moral hazard and could undermine the employer system with its improvement of adverse selection. In addition to including health-related fringe benefits, the plan would eliminate the extraordinary medical expense deduction, a provision that allowed relief for families with significant medical costs, and which might be difficult to dispense with.

Charitable Contributions

The panel's proposals would restrict the current deduction for charitable contributions to amounts over a floor equal to 1% of income, and would also extend the benefits to all taxpayers, not just itemizers. The proposal would also permit individuals to sell assets and donate the cash to charity without paying a capital gains tax if the cash is donated within a short time frame, a provision that would eliminate the tax benefits of donating property directly.

Charitable contributions are subject to a market failure in that, assuming individuals benefit from the goods financed by charitable contributions, individuals can "free-ride" on others' contribution. Because of this "free-ride," people count on others to fund charities and do not give enough in the aggregate. Thus there is a justification for a subsidy. The tax benefit is potentially subject to abuse as people attempt to gain private benefits, overstate their deductions, and exaggerate values of property donated. Even for taxpayers who are intending to be honest, valuation of property is often difficult. This problem would be reduced to some extent by the provision allowing the property to be sold and then donated.

The 1% floor would contribute to target efficiency, which focuses on how much charitable contributions are increased for each dollar of revenue loss. Target efficiency is often referred to as "bang for the buck." The floor would also achieve administrative simplicity, by disallowing small deductions. Among itemizers, it would reduce the overall incentives for giving (for those with contributions under the threshold). According to calculations using the public use statistics of income file, about 63% of itemizing

contributors gave over 1% of income.[15] These contributors accounted for 95% of giving, with 18% under the floor and 77% above the floor. These numbers suggest for itemizers that the floor will create a more target efficient system without doing much to reduce giving, since 78% of the revenue gain from the floor is associated with the loss deductions by those already over the threshold who will retain an incentive to give at the margin.

The extension of the deduction to non-itemizers may offset the reduction in coverage and also will be more efficient than a deduction without a floor. Thus, overall this change is likely to lead to a more effective incentive for charitable giving.

State and Local Tax Deductions; Tax Exempt Bonds

The proposal eliminates the existing deductions for state and local taxes, which include income, property, and, as a temporary alternative to income tax deductions, sales tax deductions. The property tax deduction can be considered as part of the general beneficial treatment to owner-occupied housing, as well. But, in general, the argument against deducting state and local taxes is that these taxes pay for state and local goods and services that are not taxed to the recipients; hence the deduction encourages more expenditure on these goods. Of course, there is no close relationship between taxes and services as there is for private spending or even fees (such as those for national parks), so this argument is not entirely straightforward. The deduction also encourages the use of deductible taxes (income and property, and, temporarily, general sales taxes); some consider this effect to be an inappropriate interference in choice, but others may support the encouragement to use more progressive taxes, especially the income tax. Another argument for allowing a deduction is that these taxes are not voluntary and reduce ability to pay, although the deduction can also be criticized as favoring taxpayers in high tax states. Whether the deduction for state and local taxes is desirable, or undesirable, therefore, is difficult to determine.

Another major subsidy in the tax system is the exemption of interest on state and local bonds. On theoretical grounds, this benefit is questionable because there seems no particular reason to favor spending on investment goods (which generally are the purposes of these bonds) and some of the subsidies go to investments which are not really public goods either through localities financing (for example) sports stadiums and convention centers, or through the use of private activity bonds which are permitted to benefit private investors with restrictions on the purposes and amounts. Although there is no explicit elimination of the subsidy, the expansion of tax favored savings accounts in both plans will diminish the tax benefit.

Transition Issues

In any major tax revision, transition issues become difficult. In the case of the income tax plan (SIT), these transition issues are likely to be most problematic for moderately high and higher income homeowners who have purchased homes with values high relative to income, and will lose part of the value of their mortgage deductions and their deduction for property taxes.

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[15] These estimates were provided by Maxim Shvedov of CRS based on the Statistics of Income public use file.

The transition problems are much more severe for the consumption tax proposal and, indeed, may be severe enough to make adoption of such a proposal impossible. In shifting from an income to a consumption base, businesses would normally lose all of their recovery of costs of existing assets, including depreciation deductions, basis in the sales of assets, and costs of goods sold when selling items in (or produced from) inventory or intermediate purchases.

A consumption tax is, as noted above, equivalent to a wage tax and a lump sum tax on capital income. Under a consumption tax without transition rules, the value of assets falls because the full value of the asset will be taxed upon sale. Also, because the consumption tax does include financial assets in its base but does not require a price accommodation (as might be the case for a VAT or a retail sales tax), that lump sum tax on old assets falls on the equity share of capital. It should also be reflected in stock market share values, where, absent adjustment costs, the imposition of a 30% consumption tax should be expected, given that about one third of assets is debt financed, resulting in a theoretically predicted fall in asset value of 45% (20%/(2/3)).[16] Taxpayers with heavily debt financed assets not only would not be able to deduct interest costs, as well as depreciation or costs of goods sold, but also can suffer a significant burden if they wish to sell their business or major asset, with the tax due on sale exceeding their cash proceeds.[17] Examples of taxpayers who might be adversely affected are individuals with substantial inventory going out of business (and unable to deduct the cost of their goods sold) or individuals who own and wish to sell a single piece of property, such as a building.

These effects are adjustment costs, and can be reduced by transition rules, but transition rules for recovery of depreciation or inventory costs would be extremely expensive. This lump sum effect would be offset in part if depreciation deductions and recovery of old inventory costs were still allowed, but without adjustment costs, assets would still lose about half of their value because the present value of depreciation deductions is less than the current value of the property.[18]

The panel's transition rules are quite limited. There would be a four-year phaseout of depreciation deductions and interest deductions—80% in the first year, 60% in the second, 40% in the third, and 20% in the fourth. (Interest would be taxed in the same proportions.) No other transitions are allowed, and sale of an asset would terminate depreciation transitional rules and new financial contracts would terminate interest deduction allowances.

Based on this transition rule, a taxpayer with a new nonresidential building purchased before the tax was imposed would lose approximately 95% of scheduled deductions on buildings, about 65% of deductions for equipment (for a typical seven year asset), and all of the deductions for existing inventory (either goods for sale or goods in process). The loss would be smaller in present value for the buildings and, to some extent, for equipment, and smaller for older assets. But inventories would bear virtually the full loss, and the loss is

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[16] These effects are smaller in the short run, if there are adjustment costs.

[17] See CRS Report RL32603, *The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues,* by Gregg A. Esenwein and Jane G. Gravelle for a further discussion.

[18] See Leonard Burman, Jane Gravelle, and Jeff Rohaly, *Towards a More Consistent Distributional Analysis*, forthcoming in the Proceedings of the National Tax Association, 2005 Conference.

substantial. "Current inventories" for the fourth quarter of 2004 were $1.7 trillion, so that providing any sort of partial relief would be extremely costly, as most inventories are turned over very quickly.

Taxpayers with outstanding debt would also lose a significant fraction of interest deductions unless they can refinance. Not all bonds can be called. According to bondmarket.com, out of $207.7 billion of corporate bonds with maturities of over a year, over half, or $121.7 billion, are not callable.[19] The average maturity of bonds is approximately seven years.[20] For a seven-year bond paying a coupon, taxpayers would lose 71% of interest deductions. The loss would be greater for longer maturities: 80% for a 10-year bond, 90% for 20-year bond, and 93% for a 30-year bond.

Presumably all depreciation would be lost when an asset is sold and presumably the basis of the asset would not be recovered (all proceeds taxed). Thus all depreciation would be lost for these assets.

These transition problems impose a very significant barrier to the possibility of adopting a consumption tax.

Conclusion

Of the two proposals presented by the panel, the income tax revision may well be more practical to implement. The consumption tax has gains in efficiency (through the allocation of capital), possibly some gains in growth (although the analysis in this testimony and the CRS report suggests these effects may be modest), and some significant gains in simplicity, especially for business, that exceed those of the income tax proposal. However, the analysis presented in the last section suggests that the progressive consumption tax proposed by the panel would be very difficult to implement. Moreover, the consumption tax is likely, when appropriate distributional analysis is considered, to significantly reduce the progressivity of the federal tax system.

These observations suggest further consideration of the income tax proposal (SIT). There are some important simplifications in the SIT, especially for businesses and high income individuals, although lower income taxpayers may find their affairs more complicated. In translating the income tax plan to a more detailed proposal that deals with small, but important, deductions, however, some of these simplification gains may be lost. The SIT faces revenue sufficiency problems that will require some taxes to be increased in the future, and is probably not entirely distributionally neutral, but shifts some of the burden somewhat away from high income taxpayers. There are efficiency gains in a number of areas, although probably little effect on growth, and the change to the international tax rules may increase inefficiency and even exacerbate tax sheltering. There are also some transition problems, but they are small compared to the consumption proposal.

Whether the gains from the changes under the SIT are worth the costs is unclear. Historically, it has been difficult to make major changes to the tax code because of the

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[19] See[http://www.bondmarkets.com/story.asp?id=2234].

[20] See[http://www.bondmarkets.com/story.asp?id=2235].

disruption in taxpayers' affairs. Nevertheless, there are some limited aspects of the proposals that do seem to have many advantages and few drawbacks. The proposal for a floor on charitable deductions has a salutary effect on both target efficiency and tax administration and simplification. Removing barriers to automatic enrollment in employer retirement plans is, as well, a proposal that is likely to facilitate savings. A ceiling on deductions by employers in health insurance plans appears to preserve the benefits of reduced adverse selection in health insurance markets while reducing both moral hazard effects and differential treatment of taxpayers. It may be that the greatest contribution of the panel study is to identify some possibilities for more limited reforms.

Memorandum August 14, 2006

TO: Senate Finance Committee

FROM: Jane G. Gravelle
Senior Specialist in Economic Policy
Government and Finance Division

SUBJECT: Followup Questions from the Tax Reform Hearing

This memorandum provides answers to followup questions from the Committee relating to the August 3 hearing on tax reform. After the responses to these questions, there is also a discussion about possible selected tax reform ideas from the President's Advisory Panel tax proposals, as promised during the hearing.

From Senator Grassley:

Dr. Gravelle, in your testimony you state that the income tax proposal presented by the President's Advisory Panel appears to simplify the tax system for higher income taxpayers and the self-employed, while possibly complicating it for lower and middle income wage earners. One reason stated for this is that certain tax benefits, previously allowed only if a taxpayer itemizes deductions, are now extended to non-itemizers. However, all taxpayers must currently be aware of the rules on itemized deductions in order to properly determine whether to claim the standard deduction or itemize. As a result, wouldn't the simplified income tax plan presented by the Panel have an overall decrease in burden and complexity for all taxpayers?

Answer:

Most taxpayers probably know that their circumstances are such that they do not have to deal with itemized deductions because of past filing experience. In fact, they receive a form in the mail based on forms filed in the past. Without a significant mortgage or other unusual circumstances, most lower and middle income individuals do not have enough itemized deductions to exceed the standard deduction. Home ownership usually triggers itemized deductions; in fact, of the returns with itemized deductions, 87% had a deduction for real property taxes and 82% had a deduction for mortgage interest. About half of non-itemizers are renters.

Also, in 2003, 38% of individual tax returns were filed on the Form 1040A or the Form 1040EZ which do not even have a place to report itemized deductions. The 1040EZ accounted for 16% of returns. Overall, 66% of taxpayers do not itemize deductions.

These simpler forms and non-itemizers are likely to be concentrated in the lower income groups. Although we have no data for types of forms, in the bottom 70% of returns (for adjusted gross income less than $50,000) the share not itemizing is 83%; in the bottom half (for adjusted gross income less than $30,000) the share not itemizing is 90%. Note also that at the rough midpoint income of $30,000, the standard deduction is 17% of income for singles and 33% of income for joint returns. At $50,000, roughly the 70th percentile, the share is 10% and 20% respectively.

Thus, while there are some taxpayers in each year who must investigate to determine whether the itemized deductions are better than the standard deduction, it is likely that most taxpayers already know this information because they do not own a home and, especially for lower income individuals, because they are aware of the large size of the standard deduction relative to income.

From Senator Snowe:

Question 1 - Low-Income Housing Tax Credit

Lead in: The final report of the President's Advisory Panel on Federal Tax Reform suggests that the 1986 Tax Reform Act broadened the tax base by eliminating "more tax preferences than had been enacted in all tax legislation between 1913 and 1985," for example, the long-term capital gains exclusion, the investment tax credit, and the two-earner deduction.

Yet, the Tax Reform Act also created new tax incentives such as the Low Income Housing Credit program, which has since become the nation's largest and most successful production program of rental housing affordable to low- and moderate-income Americans, producing over 1.9 million units since its inception. Because of the public-private partnership created by the program, the Housing Credit is far more successful than any direct spending housing program.

Question: Does the panel feel there is still room within the Tax Code for such incentive programs while still achieving the goal of a more fair, simpler, and pro-growth tax system?

Answer:

While there is some debate about the merits of the low income housing credit, it is an example of a general problem with eliminating a large array of tax provisions that, it can be argued, serve a desirable purpose. The credit is, essentially, a housing program run through the tax system. It would be possible to institute the low income housing credit as a direct spending program, but that would probably involve no savings in compliance for business or administrative costs for the government, and indeed might be more costly to administer in that fashion. The only other option would be to abandon the notion of having a program that subsidizes private construction at all.

Another example of such a program is the tuition tax credit, although it might be possible to administer this program through the Education Department. One could also argue that the earned income credit is not part of the tax system, but is a welfare program, although this was a provision that was preserved in the tax reform plan. Indeed, several new or retained provisions in the reform proposal relate to incentives (charitable contributions, mortgage credits, health insurance) and not to the appropriate measure of income. Thus, the advisory panel itself continued to see a role for tax incentives. From an efficiency standpoint, which ones are chosen to retain or reject should depend on their individual merits and whether such a program, if retained, could be administered more efficiently as a tax provision rather than a spending program. In sum, there appears to be no public policy reason for a general exclusion of all tax incentives from the tax code.

Each provision restored, of course, would require other adjustments in the plan, if it is not to alter the consequences for revenue and distributionally neutrality.

From Senator Baucus:

Question 1:

Treasury recently released a report analyzing the panel's recommendations using dynamic analysis and you issued a critical report of that analysis. Can you summarize your main criticisms of the Treasury analysis?

Answer:

I had three criticisms of the Treasury's dynamic analysis: the use of intertemporal models, the choice of elasticities (responses to changes in wage rates and rates of return) within all of the models, and the inconsistency in not incorporating the effects of switching to Roth IRAs into the analysis. The Treasury used a model that had simple savings elasticities (the Solow model), but also used two intertemporal models (Ramsey and the overlapping generations life cycle model, or OLG) that involve much more complex responses. They found negligible effects for the income tax plan, but major effects for the consumption tax plan due to the reduction in tax on new capital investment.

These intertemporal models assume that people have the skills and information to respond to changes in taxes in an extremely complex fashion, taking into account everyone else's responses, over very long periods of time. One of the models—the Ramsey model which produced the largest effects—treats these decisions as if they were made by a single infinitely lived individual, and to allow this model to represent the aggregated effects of individual behavior requires assumptions that are inconsistent with observation, including asexual reproduction (no marriage and no childlessness), perfect information, identical tastes in preferences for consuming and working over time, no progressive tax rates, no differential state income tax rates, and no open economy, Even in the remaining intertemporal model, the life cycle model, people respond to taxes by altering consumption and labor supply over periods of 55 years. The major forces that affect the responses, the substitution across long periods of time and the response of labor supply to the interest rate (which is almost completely responsible for short term effects), are not empirically tested.

A model of savings behavior that recognizes the cognitive and informational limits on ordinary individuals' behavior would use a model with a simple elasticity, as in the Solow

model, or consider rules of thumb such as those proposed by financial advisors. These rules usually involve either a fixed savings rate or a target savings for retirement, rules that would lead to no response or a reduction in saving rates when interest rates change. This view (referred to as a "bounded rationality" model) is the type of view that is consistent with the proposal for automatic sign up for thrift savings plans; indeed, it is difficult to argue on the one hand that whether an employee is automatically signed up for a retirement savings plan makes a great deal of difference in saving behavior and, on the other hand, that people make optimal choices for saving and working over a 55 year planning horizon.

In addition, even where some empirical evidence is available, the elasticities in the models are larger than those justified by empirical evidence. In the Solow model, the estimate used appears to reflect a savings elasticity estimate by Michael Boskin, of 0.4, whereas the empirical evidence has generally found lower estimates, more typically close to zero and often negative. The central tendency of these directly estimated responses is essentially zero, implying no effect. Large elasticities also characterize the labor supply responses in the intertemporal models, particularly in the Ramsey model, where these responses are, in some cases, three to four times larger than central case empirical estimates.

Finally, if the intertemporal models are to be relied on, the theory underlying them also suggests that a shift to Roth style IRAs and 401(k) plans would reduce saving, perhaps significantly. These effects were not taken into account.

Question 2:

On a related topic, the Treasury Department has issued a few reports using dynamic analysis recently, including one on tax reform and one on the President's tax cuts. Regarding the tax cuts, is it true that even if these tax cuts are made deficit-neutral with offsetting spending cuts, the amount of extra revenue generated is small? Is it true the amount of the extra revenue generated is nowhere near the amount that would be required to have the tax cuts pay for themselves? Is it true that to achieve even this small amount of extra revenue, there would need to be spending cuts that would be very large, perhaps exceeding $150 billion per year? Is it true that technical problems with the model and methodology used by Treasury cause the estimate of the additional revenues generated by the tax cuts to be overstated?

Answer:

The Treasury study of the effects of the permanent tax cut relied only on the OLG intertemporal model. This change is significant because the intertemporal models tend to yield larger behavioral responses to changes in the tax on capital income than the reduced form growth models, especially in the short run. Moreover, the Solow model used in the initial tax reform analysis assumed no labor supply response, and would have shown virtually no effect of the tax cut.

The Treasury also included a sensitivity analysis to higher and lower elasticities, with a high, low, and base case. In the earlier study, the "static" substitution effect for labor (which determines the within period labor supply response to changes in marginal tax rates on labor income) was around 0.5 in the Ramsey model, 0.3 in the OLG model, and zero in the Solow model. In the new study, this elasticity is set at around 0.3 in the base case, around 0.2 in the low case, and around 0.5 in the high case. The income elasticities (where tax cuts reduce labor supply) are all high. The intertemporal substitution elasticity for labor, which measures how labor is shifted over time in response to wage changes over time (and

that also governs the labor response to interest rates) was originally around 0.75 in the Ramsey model, around 0.49 in the OLG model, and zero in the Solow model. Under the current analysis, the estimates appear to be around 0.4 for the base case, around 0.2 for the low case and around 0.75 for the high case. The effective response in the original Solow model was much smaller. The low case is reasonably consistent with the evidence, while the middle case is somewhat high and the high case significantly higher. These effects of different elasticities are significant.

Since the Treasury was studying a tax cut, rather than a revenue neutral change, some assumption must be made as to how the revenue loss would be made up; otherwise one cannot solve an intertemporal model. Two assumptions were made: a cut in government spending after 10 years and an across the board increase in marginal and average tax rates after 10 years. The study also divided the effects into dividend and capital gains cuts, which had a relatively small but positive effect, the reductions of the top rates (which had the largest positive effects with spending cuts, reflecting the labor supply substitution effect) and the remaining extensions, which tended to be negative (with spending cuts) because of income effects. The simulation with tax increases actually found a larger short run increase in output (2011-2016) but a negative effect in the long run. Why does suspending a tax cut in the future lead to larger short run growth? Again, it reflects the intertemporal shifting of labor in response to increases in future tax rates on wages and capital income, an important characteristic of intertemporal models.

Even in the context of an intertemporal model with relatively large behavioral responses, the effects are not very large. The fact that revenues must be made up by spending cuts clearly acknowledges that the tax cuts do not pay for themselves. But what is the magnitude? For the base case reported above with spending cuts, output increases by 0.5% in the short run and 0.7% in the long run. The short run effects included an increase of 0.1% due to dividend and capital gains tax reductions, an increase of 0.6% from the top four lower marginal tax rates, and a 0.2% decrease from other provisions (such as the child credit). In the long run, the dividend and capital gains provisions increased output by 0.4%, the marginal tax rates increased it by 0.7% and the other provisions reduced it by 0.4%. If the low case, which one can argue has elasticities more consistent with the empirical evidence, the short run effect is about a fifth as large, 0.1% in the short run and long run.

According to CBO projections, individual income taxes would be 8.4% of GDP in FY 2009 and 9.8% in FY2012, suggesting that the tax cuts are about 1.4% of GDP. In the tax reform study, Treasury indicated the marginal tax rate on labor income was 24% and the marginal rate on capital income 14%. Using an overall rate of 20%, the offsetting revenue gain from induced economic effects would be 0.1% of output, or 7% of revenue loss in the next five years. It would be about 10% in the steady state. It would be less than 2% in the low case.

In either case, the difference amounts to about $170 billion at 2006 income levels; it would be higher in the 2011 and later periods.

Question 3:

Your testimony states that the panel's recommendations could actually increase complexity for lower income taxpayers, while simplifying it for higher income taxpayers. Can you explain?

Answer:

The vast majority of lower income taxpayers who do not currently itemize (while 2/3 of taxpayers overall do not itemize, 90% of those in the bottom half of the income distribution do not). They will now deal with three new generally available tax items, two of which were formerly itemized deductions: the mortgage credit, the charitable deduction, and the health insurance deduction. All taxpayers not currently itemizing will have to confront these line items, even those who formerly used the 1040EZ (filed by about 16% of taxpayers), and many are likely to report deductions. Also, the proposal would require the tax on the inside buildup of life insurance policies and annuities.

About two thirds of families live in owner occupied homes, suggesting that up to half of current non-itemizers may be eligible for a mortgage credit. (Note that some of these homes may have mortgages that are paid off and may be more likely to fall in the non-itemizer status). The reporting of the mortgage credit is slightly complicated by the ceiling, which presumably will require taxpayers to look up a ceiling for their county since there will not be a common ceiling. This ceiling will be more binding than the present cap and will also require taxpayers to know their mortgage amounts. Probably most of those who did not already itemize will not be subject to the ceiling, but the calculation will still need to be done because of the regional variation.

In 1986, the last year in which a charitable deduction for non-itemizers was allowed, 45% of non-itemizers deducted charitable contributions, so that this deduction is common (while many other deductions and credits that are eliminated may be used by relatively few taxpayers). Some of these contributors may not make contributions above the 1% floor, but they may still have to do the calculation in some cases. Reporting charitable contributions is complicated because it requires data from the taxpayer's own records rather than from a standard information form and because there may be numerous contributions that have to be added up. For donations in kind, the taxpayer must also obtain an itemized receipt list.

The usage of the health insurance deduction is difficult to know in advance, but it also requires information not reported on information returns. Life insurance is a broadly held asset. Although the inside build-up tax benefit is popularly associated with whole life insurance and annuities, level premium term life insurance also has inside buildup (as higher premiums when young generate interest earnings to pay premiums when old). To obtain the joint benefits of tax free inside build-up with insurance, taxpayers would have to rearrange their insurance to combine an increasing payment term policy with an individual retirement account.

In addition to these issues, there would be a problem if other former itemized deductions, such as those for extraordinary medical expenses, casualty losses, or miscellaneous deductions (including employee expenses) were to be restored. It is difficult to imagine completely disallowing these deductions for extraordinary costs. Without dismantling the entire framework of the individual reform which completely eliminates itemized and standard deductions, these items would have to be added as additional line items.

Many tax payers have other simplifications from the revision that outweigh these effects, but it is clear that some taxpayers will find filing taxes on the single 1040 Simple to be more complex than their current practices. And there are a number of adjustments that

have been eliminated that it might be deemed necessary to restore, such as the deduction for alimony payments.

Selected Tax Reforms From the Panel's Recommendations

Discussed below are several more limited reforms that might be considered as part of a less extensive tax revision, following the discussion in the hearing. They are discussed by topic. These provisions are ones that, analysis suggests, are likely to improve economic efficiency or tax administration and compliance without creating significant transitional or equity problems.

Charitable Contributions

The proposal to allow a 1% floor under charitable deductions is likely to increase target efficiency (induce more charitable giving per dollar of revenue lost). It also has the advantage of eliminating deductions for very small contributions that are difficult to police.

Another proposal related to charitable contributions that the committee might wish to consider is to allow individuals to sell appreciated assets and not pay tax on the gain if the proceeds are donated within a given time period (60 days in the proposals). This option might help reduce the problems with uncertain valuations of assets. There are a number of other provisions that might be adopted to deal with the problem of valuing gifts of appreciated property that are not commonly traded and priced assets (such as stocks). One alternative is to require the charity to sell the assets and allow the individual contributor to deduct only the net proceeds; another is to require baseball arbitration (where the court can only choose one of the party's prices).

Housing

The proposal would substitute a mortgage credit for the current itemized deduction and constrain the amount deducted to be a fixed percentage of area median housing prices. This proposal would reduce the tax preference for owner occupied housing investments which produces an efficiency loss, but it would be more complicated because of the variable ceiling and extension to non-itemizers. Simply imposing a lower cap itself might lead to more efficiency with limited transitional and administrative problems if it were uniform and perhaps gradually falling over time. If not indexed to prices, the real value would fall faster.

The proposal would also eliminate the deduction of mortgage interest for second homes and for home equity loans, provisions that would also restrict the benefits without causing transitional problems for most taxpayers, particularly if these deductions were phased out.

Finally, the plan would increase the length of time from two years to five years to hold a house before qualifying for capital gains exclusion, a change that might reduce some of the tax sheltering operations and would, in ordinary times, have not many consequences for ordinary sellers of homes, since most houses do not appreciate a great deal over this short period of time and since capital gains rates are low. The gain from this provision might be used to index the dollar ceilings, which have not changed since 1997, expand benefits for surviving spouses, or to make other changes to simplify and reduce tax barriers to selling a home that has been held for a long time, and reduce the need for extensive record-keeping. A modification of this proposal might involve a phased in exemption that begins at two years

and rises to a peak at five. CRS Report RL32978, *The Capital Gains Exclusion for Owner-Occupied Homes*, by Jane G. Gravelle and Pamela J. Jackson discusses the tax sheltering issues and some potential reform options.

Health Insurance

The health insurance proposals have two parts: caps on employer deductions and a deduction for the purchase of health insurance for those not covered by employer plans. The latter provision has both benefits and drawbacks, as discussed in my testimony. The former, however, seems likely to contain the growth in health insurance costs by discouraging plans with excessive coverage, without undermining the pooling and administrative advantages of insurance in general. An alternative to a dollar cap would be to make the deduction contingent on desirable plan features.

Note that the cap would not affect non-taxable entities, including governments and non-profits, but these plans are not likely to be the high cost ones. An alternative would be to tax excess benefits to employees, but this approach would be extremely difficult to do fairly, since employees vary substantial in the benefits they receive from health insurance coverage.

Savings Plans

New evidence has indicated that automatic enrollment in thrift saving plans increases participation, and the proposal recommended several proposals to encourage "Autosave" plans that would automatically enroll employees in plans with a diversified portfolio and increase percentages as income increases. Employees would have to take action to opt out. These proposals include removing legal barriers, less stringent discrimination testing, and adoption of Autosave by the federal government. The provisions to remove legal barriers have just been adopted by the Pension Protection Act, but additional steps might be taken to encourage autosave plans. One possibility is to make tax benefits contingent on automatic sign-up features (while still allowing an opt out provision).

Alternative Minimum Tax (AMT)

The proposal would eliminate the individual and corporate alternative minimum taxes. The AMT, because it was not indexed for inflation and because rates were not adjusted to reflect the rates in the 2001 tax cut, is increasingly covering ordinary families, particularly those with children, not the audience it was intended for. In fact, the original objective for the AMT was largely tax preferences for capital gains, which are not excluded from the base. The AMT also complicates tax compliance and administration. The AMT could also be scaled back by expanding and indexing exemptions and could be revised in other ways. The major problem is funding the cost, which is significant.

Flat Corporate Tax Rate

Graduated tax rates for corporations appear to serve no equity objective, as owners of small corporations are likely as wealthy as, or perhaps even more wealthy than, owners of large corporations. Thus the normal rationale for graduated rates does not apply. Moreover, smaller firms can elect to be taxed as partnerships, thus avoiding the corporate tax. Graduated rates are more likely to simply provide another sheltering mechanism for

higher income individuals, a mechanism that is much more attractive with current lower tax rates on dividends and capital gains.

International Taxation

There are two major revisions of international tax rules in the income tax plan: the provision currently taxing all royalties, and the provision exempting (rather than deferring) tax on active income. While exempting tax on active income has costs in economic efficiency, it would be possible to enact the first alone, which should significantly reduce the tax shelters that are based on turning profits to royalties through patent assignments. These royalties are deductible abroad and, under current rules, those associated with active income are not taxed currently.

Production Activity Deduction

The plans would eliminate the production activity deduction, which probably adds to economic inefficiency (by distorting the allocation of capital in favor of certain activities), but which, more importantly, complicates administration and compliance. The revenue gained could be used to reduce corporate tax rates or eliminate or phase out the corporate alternative minimum tax.

Eliminating State and Local Tax Deductions

The pros and cons of this provision make its benefits uncertain. However, it would be possible to put a percentage of income floor under this provision, which would raise revenue which could be used for other purposes (such as reducing the scope of the AMT). This restriction would also reduce the scope of the AMT automatically since state and local tax deductions are included in the base for the AMT. Retaining a deduction with a floor would provide relief for taxpayers in high tax states.

Opening Statement of Senator Connie Mack
Senate Finance Committee
August 3, 2006

Before I provide a brief description of the options, I want to highlight the need for tax reform and to explain the framework under which we operated.

As a member of the Senate Finance Committee for many years, I had spent a lot of time working with the tax code, and I was aware of its deficiencies. However, it was my service on the tax panel—conducting hearings, gathering information, and reading comments—that really confirmed just how bad the situation really is.

Instead of a sleek and simple system designed to raise revenue for our national defense, social programs, and other vital public services, we have a system so complex that almost $150 billion is spent each year by U.S. households, businesses, and the federal government, just to make sure taxes are tallied and paid correctly. In 2003, 60 percent of filers hired a tax preparer. Between 1986 and last November, there had been over 15,000 changes to the tax code.

Instead of a system that ensures that all pay their fair share, we have a system so confusing that two million taxpayers collectively paid over $1 billion more in taxes by making a wrong decision about the basic choice of itemizing or taking the standard deduction. And while some people overpay because of their confusion, the vast majority of people underpay. The IRS has estimated that there is a net tax gap of $290 billion per year, which translates into a tax hike of more than $2,000 per year for honest taxpayers. There is no easy answer to reducing the tax gap, but an obvious and productive place to start is by reforming the code so that it is easier to understand and enforce.

Instead of a tax system that draws revenue efficiently from the base of the nation's considerable economy, we have a tax code that distorts basic economic decisions, sets up incentives for unwise or unproductive investments, and induces people to work less, save less, and borrow more. By some estimates, this economic waste may be as much as $1 trillion dollars each year. In an increasingly global environment, our tax code also plays an important role in the competitiveness of American business. Our corporate tax rates are high, and even if companies can employ strategies to lessen the effect of those high rates, they are wasting valuable resources.

Now let me say a few words about the Panel's framework. We operated under a set of rules—some of which the President imposed and others that we adopted for ourselves. In the former category, our options were to be revenue neutral—and we used the Administration's baseline.

The Executive Order also instructed us to develop options that were "appropriately progressive." Some Panel members felt that the current distribution of federal income taxes was appropriate or that it should be more progressive, while others felt that higher-income taxpayers shouldered too large a share of the tax burden. We quickly realized that we could consume all of our time debating this question, and still probably not reach a resolution. In the end, we concluded that the appropriate burden of taxation was an issue that elected officials should resolve.

The resolution of the burden question helps to illustrate how we viewed our role. We could have operated through the prism of politics or the prism of economics and tax policy. We chose the latter, recognizing that the Administration and Congress would have to deal with the political issues, and that our options should be based on sound economic and financial principles.

Now let me say a word about our options. We unanimously settled on two options, which we called the Simplified Income Tax Plan (SIT) and the Growth and Investment Tax Plan (GIT). We did not reach consensus, and thus did not recommend, a national retail sales tax, a value added tax, or a progressive consumption tax.

The Simplified Income Tax Plan dramatically simplifies our tax code, cleans out targeted tax breaks that have cluttered the system, and lowers rates. It does away with gimmicks and hidden traps like the Alternative Minimum Tax. It preserves and simplifies major features of our current tax code, including benefits for home ownership, charitable giving, and health care, and makes them available to all Americans. It removes many of the disincentives to saving that exist in our current code, and it makes small business tax calculations much easier. It also offers an updated corporate tax structure to make it easier for American corporations to compete in global markets.

The second recommended option, the Growth and Investment Tax Plan, builds on the SIT and adds a major new feature: moving the tax code closer to a system that would not tax families or businesses on their savings or investments. It would allow businesses to expense or write-off their investments immediately. It would lower tax rates, and impose a single, low tax rate on dividends, interest, and capital gains.

Both of these plans offer dramatic simplification—reducing the number of lines on the Form 1040 from 75 to 32, and the number of commonly used forms from 52 to 10—and make the tax code fairer—transforming deductions that are only allowed for a few into credits or deductions that are available to all. And these are important accomplishments. But I also believe that the most important thing that we can do is to ensue that the tax code promotes growth and competitiveness. The principle of freedom—free markets and democratic capitalism—is transforming the world. The growing economies of China and India, along with the rest of the world, are providing us with fierce competition. Our current tax system distorts capital flows and impacts economic decisions. And our

options respond to that challenge by reducing the cost of capital, lowering the corporate rate, moving our international tax system to either a territorial or a border-adjusted one. Expensing is especially important, as it would reduce the effective tax rate on new investment from 17 percent to 6 percent, and make us the best place in the world to invest.

I have been asked numerous times since we submitted our report to point out the Panel's most significant accomplishment. I am extremely proud of our substantive work and our recommended options, but in answering that question, I often pick up the Panel report, and turn directly to the signature page, where I point to the signatures of all nine Panel members. We had our disagreements, and each of us did not get everything we wanted, but we worked together and we issued a unanimous report; Republicans and Democrats—working together.

I do not need to tell members of this committee about the importance of bipartisanship. One of the great things about this committee is its long history of bipartisanship in order to achieve significant accomplishments. We all know that in 1986, which is the last time that major tax reform occurred, it took a bipartisan effort. I applaud this committee for holding this hearing and focusing on tax reform, and I hope that you will carry forward the spirit of bipartisanship in order to accomplish a major victory for the American people.

Thank you.

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 negative. 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.

Responses to Questions for James Poterba
Hearing of August 3, 2006

Questions From Senator Grassley

1. Dr. Poterba, you mentioned in your testimony that the Tax Reform Panel's Simplified Income Tax Plan "integrates the personal and corporate income taxes for domestic earnings of U.S. firms." A similar proposal was made by Treasury in 1992, called the Comprehensive Business Income Tax.

The idea is to tax corporate earnings only once. In combination with the proposed territorial regime, the single level of tax would be at the corporate level on the corporation's U.S. earnings. But with respect to a U.S. multinational's foreign earnings, that single level of tax would be at the shareholder level. Of course, those earnings would have been subject to tax in the foreign jurisdiction, so foreign earnings of U.S. multinationals would still be subject to a different form of double taxation.

I have three questions on this subject:

(a) How is this integration system different from Treasury's 1992 proposal?

(b) One key goal of tax reform is to reduce tax-induced distortions. What distortions does this method of integration address?

(c) Does the distinction between U.S. and foreign earnings create any distortions? For example, how might a U.S. multinational's cost of equity capital be affected by its mix of domestic and foreign earnings?

Answer: The Simplified Income Tax (SIT) exempts shareholders from taxation on their dividend income when the dividends are attributable to domestic earnings of U.S. corporations. It implements a form of integration by exempting U.S. source corporate capital income from taxation at the investor level. It preserves an investor-level tax on dividends paid out of foreign operations, so it is still possible that U.S. firms will face distortions between the tax burdens on domestic and foreign source income. The distortion depends on the foreign tax rates applicable to the income of the U.S. multinational. The Comprehensive Business Income Tax (CBIT) proposed by the Treasury Department in 1992 achieves integration by eliminating corporate-level taxation of capital income. It treats debt and equity similarly at the corporate level. One could implement either a territorial or a worldwide CBIT structure. The SIT approach reduces the differential tax burden between debt and equity financing, but it leaves in place some distortions between projects that generate earnings in different countries. The SIT does not achieve "capital export neutrality" because the incentive for a U.S.-based firm to undertake a project in another nation will depend on the tax system in that country. Under the SIT proposal, a U.S.-based multinational firm's cost of capital would depend on the precise configuration of its operations in the United States and abroad, and on the corporate tax rate in the nations in which it earns income.

2. Dr. Poterba, it is estimated that the federal government will give up over 40 billion dollars in fiscal 2008 due to forgone taxes on the interest on tax-exempt bonds. A substantial portion of this revenue lost is attributable to so-called private activity bonds. It is also estimated that hundreds of millions of dollars will be lost in revenue for tax credit bonds.

The panel's Growth and Investment plan recommends that interest received by corporations on all bonds should be tax-free. The Simplified Income Tax plan would tax municipal bonds when the interest is earned by corporations. Either of these proposals will obviously have an impact on the current tax-exempt bond market. First, I'd like your thoughts on how the panel reached these conclusions on interest.

Second, I know that the panel was not able to get into the weeds of every single tax issue, and I'd like you to comment on whether the panel engaged in a thorough examination of the tax-exempt and tax credit bond area in terms of determining whether there are areas that should be expanded or narrowed in the context of reform.

Answer: The Tax Reform Panel considered how best to address the tax treatment of interest paid by entities that currently pay tax-exempt interest, although it did not specifically examine the issues concerned with private-activity bonds or tax credit bonds. The changes in tax rates at both the corporate and the individual level under the SIT and the GIT would affect the equilibrium yields on tax-exempt bonds and the set of investors who would hold these bonds. The SIT proposal to tax corporations on their tax-exempt interest was motivated by a desire to reign in tax arbitrage strategies at the corporate level. The panel was generally inclined to eliminate as many tax expenditures as possible, and to broaden the tax base in an effort to reduce marginal rates across the board. This conceptual underpinning for the panel's work led to recommendations that would substantially curtail many tax expenditures that are part of the current tax code. The panel members recognized that there are potential justifications for most tax expenditures. They nevertheless suspected that many current tax expenditures had been enacted without adequate demonstration that their benefits, net of the costs imposed in the form of a narrow tax base and correspondingly higher tax rates, were positive.

3. Dr. Poterba, the panel report states that "allowing both expensing of new investments *and* an interest deduction would result in a net tax subsidy to new investment." It goes on to say that "this would result in economic distortions and adversely impact economic activity." If we are considering a hybrid income and consumption tax plan, how would you counsel the Committee with respect to a plan that seeks to combine an interest deduction with expensing?

Answer: The combination of an interest deduction and expensing can lead firms to undertake investments that would not be attractive in a world without any taxes. One of the key benchmarks guiding the efficiency analysis of the tax system is whether it distorts decisions relative to what they would be in a "no-tax" world. The current system, which places a substantial tax burden on investments in the corporate sector, leads to less investment and to a smaller capital stock than one would observe in a world without taxes. This represents an important distortion. If interest deductions were retained and firms were allowed to expense their investments, firms would discover that some projects

that would not make sense in a no-tax world would generate a positive rate of return net of tax. The interest deductions associated with debt finance would represent an additional tax benefit to investors undertaking a project, even though expensing in the absence of interest deductions is enough to set the firm's effective tax rate to zero. Thus a system that combined expensing with interest deductions would result in relatively more investment in tangible assets such as plant and equipment, and relatively less in R&D and other intangible assets that are difficult to finance with debt, than a system that applied a zero effective tax rate to all assets.

4. In her testimony, Dr. Gravelle points out the difficulties in dealing with transition problems under both proposals and states that the transition problems may be so severe in the consumption tax proposal as to make the adoption of such a proposal impossible. Putting aside revenue neutrality for the moment, how do you recommend treating transitional items such as credit carryforwards and the loss of depreciation deductions, interest deductions, and deductions for the recovery of inventory?

Answer: Dr. Gravelle and I agree that the transitional arrangements associated with a consumption tax reform are extremely important for determining the long-run economic benefits of such a tax change. If all of the existing assets with depreciable basis are fully protected in a reform, and if all of the existing claims for tax-deductible debt finance are preserved, the tax rate in the new consumption tax regime will be substantially higher than in the regime that provides only partial transitional relief. Balancing the concern for gains in long-term economic efficiency with the concerns of fairness in making sure that those who have made particular types of past investments or financing decisions are not unduly disadvantaged by tax reform is a delicate political challenge. The panel wrestled with this problem, but did not offer very precise suggestions. Rather, we suggested that it would be possible to offer partial transition relief to some of the existing claimants on tax benefits. Our revenue-neutrality analysis included an allowance for transition relief, but we did not offer specific recommendations for transition allowances. One important goal is to make the transition period brief. Instead of allowing those who own long-lived assets to continue to claim depreciation allowances for a long period into the future, it would be better to have a short period during which some fraction of the present discounted value of such allowances could be claimed.

5. This question is for the tax reform panel members, and it relates to the taxation of foreign earned income.

In general, U.S. citizens are taxed on their worldwide income. To avoid double taxation, the U.S. system employs a credit system that allows taxpayers a foreign tax credit to offset U.S. tax liability on foreign income.

Another way to avoid double taxation would be to exclude foreign income from U.S. taxation altogether. This is the type of double tax relief provided by territorial tax systems. Under current law, the foreign earned income exclusion allows U.S. citizens to, in effect, elect territorial treatment with respect to a limited amount of foreign earned income.

In the Simplified Income Tax Plan, the tax reform panel recommended that we "update our international tax regime" by adopting a territorial system for corporations.

The most common reason given by supporters of a territorial system is that such a system is common to many industrialized countries and it would therefore enhance the competitiveness of U.S. businesses.

Based on those same arguments, there have been recent proposals to enact a territorial regime for individuals by removing all restrictions on the foreign earned income exclusion. Yet, in its recommendations, the tax reform panel appears to retain worldwide taxation of U.S. citizens.

Can you please explain (1) whether the panel considered a territorial system for individuals; and (2) if so, why it was not included in the panel's recommendations?

Answer: The panel did not explicitly discuss the tax treatment of individuals working abroad. The concern that arises in thinking about an unlimited exclusion for foreign earned income is that it would facilitate tax evasion. An individual who works for a large multinational with business activities in many nations might agree to reduce his compensation while he was working in the United States, in return for an unwritten promise of higher compensation when working abroad. Such an arrangement would permit the taxpayer to avoid being taxed on the compensation that was moved across jurisdictions and time periods. The panel adopted different approaches to taxing corporate and individual income in part because of concerns that it may be easier for individuals to change their residence than for firms to do so.

Questions From Senator Hatch

1. Dr. Poterba, you testified that tax reform that is designed to maximize economic growth could result in significant growth, and even exceed the economic growth from tax simplification. Can you give us an idea of how large a difference a growth-optimized system might make, say in the 10th year, compared with no tax reform?

Answer: Estimates of how much more economic growth the U.S. would experience if the tax system was more efficient, in particular if the tax burden on new investment was reduced, are subject to significant uncertainty. These estimates are based on long-run economic models and they embody many assumptions about the way saving and labor supply will respond to changes in marginal tax rates. The Tax Reform Panel reviewed evidence from a number of different models, suggesting that the size of the U.S. economy could be as much as 5 percent larger if the U.S. tax system followed consumption tax principles than if it followed the current income tax – consumption tax hybrid.

2. I have noticed that the capital gains and dividend tax revenue is on pace this year to exceed what was received in 2002, the year before the tax cut on this income. I am not saying that this tax cut has paid for itself, but it does seem to me that the "cost" of this tax cut is much less than other tax cuts, and that the reduction has set us up for more growth in the long-run than if we had never cut the tax. Am I correct in this?

Answer: Taxpayer responses to the tax reductions that were enacted in the early part of this decade have reduced the revenue cost of these tax provisions. There is a large body of empirical work suggesting that the amount of taxable income reported on tax returns, particularly high income tax returns, is a function of the marginal tax rates facing households. The most widely cited estimates, based on a 2002 study by my MIT colleague Jonathan Gruber and Berkeley economist Emmanuel Saez, indicate that a 10 percent increase in the amount of income that households keep net of taxes when they receive a dollar before taxes, for example the effect of cutting marginal rates from 50 percent to 45 percent, would raise reported taxable income by about 4 percent. The evidence for an expanding tax base as rates fall is even stronger for capital gains realizations, and the recent evidence on dividend payout also suggests substantial responsiveness of payout behavior to marginal tax rates. The short-term revenue cost of the 2002 tax reductions for dividends and capital gains therefore appears to be much smaller than any simple "static analysis" might have suggested. The recent increases in dividend payout following the tax cut and increases in capital gain realizations may have generated revenue in the last few years in part at the expense of revenue in future years, when these dividends might otherwise have been paid and capital gains might otherwise have been realized.

3. How sensitive is savings and investment to the tax on the returns to investment?
   (a) Have we seen a marked increase in investment from the reduction in capital gains and dividend taxes?
   (b) Do you think that expensing would be an effective use of tax expenditures if our goal is to increase investment and productivity?
   (c) Can we reform our tax system so as to further reduce or eliminate the tax on saving while maintaining the current distribution of tax burdens?

Answer: Economic theory creates a clear presumption that when tax changes increase the after-tax return to new investments, firms and their investors will respond by raising the investment rate. With regard to saving the conceptual case is less clear: higher after-tax returns could raise, or in some cases lower, net saving. Most models that make realistic assumptions about household lifetimes, wage profiles, and willingness to trade off consumption at different dates suggest that higher after-tax returns will raise household saving. Detecting either investment effects or saving effects of tax changes in time-series data on the U.S. economy is difficult because there are so many other factors that affect each of these variables. I have not seen any compelling evidence suggesting that investment rose in response to the dividend and capital gains tax rate reductions earlier this decade. The temporary nature of the tax cuts in each case, however, is likely to have blunted their impact on investment. Tax cuts like these affect investment by raising the after-tax return that investors expect on long-term investments that generate future capital gains and dividends. When investors are not certain whether the reduced tax rates will still be in force when their investments bear fruit, the impact of the tax cuts is likely to be reduced. Expensing, in contrast, is likely to provide a substantial stimulus to new investment, since in that case the tax savings associated with the new project accrue immediately and are not dependent on future tax rates. Note that if one starts from the benchmark of a consumption tax system, expensing is not a tax expenditure – this point

and other similar ones have been made by the Treasury Department in their recent work on the analysis of tax expenditures under a consumption tax. The tax system can be reformed to provide stronger incentives for saving and investment while not dramatically altering the distribution of tax burdens. The distributional analyses prepared in conjunction with the tax panel's two reform options demonstrate this.

4. The Panel's report recognized that only people, not corporations, bear the burden of taxation. You acknowledged reports from economists at both the Treasury Department and CBO that indicate that corporate tax is initially borne by owners of capital and, over time, some of the burden is then shifted to workers and consumers. It appears that the panel did not evaluate the merits of integrating corporate income tax and individual income tax. Because the tax is ultimately borne by individuals, does it make sense to integrate the individual and corporate tax structures? What do you see as the biggest impediments to such a system?

Answer: Integrating the corporate and personal income taxes is an important goal for tax reform and, while the tax panel's proposals stopped short of a full integration proposal, integration is consistent with the panel's effect to move the tax system toward a consumption base. One of the greatest impediments to integration is the potential appearance that investors who invest in companies are not taxed on their income. Convincing the public that taxes on corporations have many effects, including reductions in the rate of return earned by investors holding corporate stock but also potentially including higher prices and lower wages, is an important step in developing political support for corporate tax reform.

5. I would like to ask all the members of the panel what their priorities would be for tax reform if we were to undertake this task in the next 2 years.

Answer: My tax reform priorities would be (i) reforming the Alternative Minimum Tax, either by eliminating it entirely or by raising and indexing the exemption level to remove the prospect of tens of millions of taxpayers shifting from the individual income tax to the AMT; (ii) simplifying the structure of tax-deferred saving arrangements such as IRAs and 401(k)s by combining the raft of current provisions into a smaller and broader-gauge set of saving vehicles that effectively offer consumption-tax treatment to the saving of most U.S. households; (iii) making further progress to reduce the double-taxation of corporate capital income by preserving the reduced tax rate on corporate dividend income and taking other steps to reduce effective marginal tax rates on new investment.

Question From Senator Snowe

Low-Income Housing Tax Credit

The final report of the President's Advisory Panel on Federal Tax Reform suggests that the 1986 Tax Reform Act broadened the tax base by eliminating "more tax preferences

than had been enacted in all tax legislation between 1913 and 1985," for example, the long-term capital gains exclusion, the investment tax credit, and the two-earner deduction.

Yet, the Tax Reform Act also created new tax incentives such as the Low Income Housing Credit program, which has since become the nation's largest and most successful production program of rental housing affordable to low- and moderate-income Americans, producing over 1.9 million units since its inception. Because of the public-private partnership created by the program, the Housing Credit is far more successful than any direct spending housing program.

Does the panel feel there is still room within the Tax Code for such incentive programs while still achieving the goal of a more fair, simpler, and pro-growth tax system?

Answer: There are many provisions in the income tax code that are designed to encourage particular kinds of activity. The Low-Income Housing Tax Credit is one example. The Advisory Panel called for the elimination of virtually all of these provisions, including the LIHTC. In general the Panel argued that such specialized provisions need to be held to a very high standard of proof before they are included in the tax code. The current income tax base is much narrower than it would be if most "tax expenditures" were eliminated, and it consequently requires higher rates to collect a given level of revenue. The tax base has been eroded by many provisions that were originally introduced and created with good intentions such as the promotion of housing construction for low-income families. In some cases the efficacy of these provisions in achieving their goals is open to question. In others there has been little effort to evaluate the provisions' effects. The tax panel did not specifically consider the efficacy of the LIHTC in achieving its goals, and in debating fundamental tax reform Congress would want to consider the case for a variety of tax expenditures. While there is a case for virtually every targeted incentive program, the benefits are rarely compared with the costs that correspondingly higher tax rates impose on economic activity. There is also very little analysis of whether the best way to achieve a given policy objective is by modifying the income tax code to provide a tax credit or tax subsidy, or by providing a direct federal subsidy to the activity in question. The panel urges the Congress to preserve a strong presumption against including credits and deductions in the tax system.

Questions From Senator Baucus

1. You served on the group that devised the modified consumption tax proposal, an idea that the National Retail Federation deemed, "one of the largest tax increases on American consumers in recent memory, and devastating for our nation's economy." In a letter to the President, they argued that disallowing the deduction for imports results in a 30 percent additional tax, passed onto consumers. While your group felt that floating exchange rates would compensate, the retailers argue

that most of these imports come from countries without floating exchange rates. Do you have a response?

Answer: The mechanics of the tax panel's modified consumption tax proposal are very similar to those used to implement value added taxes in many countries around the world. The general claim that "the exchange rate" would adjust to offset the effects of a shift from income to consumption taxation does not necessarily apply on a product-by-product, country-by-country basis. Rather, it applies at the economy-wide level. It may also not apply at the moment when the tax reform is enacted; it may take some time for the new market equilibrium to emerge. Thus while it is possible that fixed exchange rates associated with some countries would render their products less competitive in the short run, those exchange rates might be re-set over time as competitive pressures dictate. A country cannot indefinitely sustain a fixed exchange rate at a level that is not consistent with market equilibrium. In the short run, if a country with a fixed exchange rate experiences an increase in the retail price of goods it produces as a result of the new tax system, other nations with flexible exchange rates might discover an increase in demand for their goods and a corresponding expansion in their market shares. The characterization of the tax plan as a massive tax increase is inappropriate: there are offsetting tax increases and decreases in the proposal that render the package approximately revenue neutral.

2. Dr. Gravelle has testified about the extensive transition costs necessary to make your consumption tax work, resulting in a one-time, lump-sum tax on capital. This means that a taxpayer with existing inventory would lose all the deductions for purchasing the goods for resale or purchasing materials for processing. With inventories valued in the billions, any transition relief could be extremely costly and hamper the growth effects you hope for. How did the panel propose to handle such transition relief – through higher taxes or cuts in spending?

Answer: The panel's proposal allowed a budget for some transition relief but did not specify the specific aspects of such relief that might be granted – we concluded that the specifics of issues like the inventory valuation problem you raise were best left for Congressional action. Any serious consideration of fundamental tax reform will result in substantial lobbying efforts directed at Congress and aimed at highlighting types of economic activity that might suffer transitional losses. The panel did not attempt to prioritize which transitional effects should receive remediation nor did it specify appropriate amounts. The panel approached its work in the context of a given government spending path; we never explored the possibility of reducing government spending to pay for tax reform.

3. Do you agree that any long-term or significant transition relief may hamper the expected growth effects of your consumption tax plan?

Answer: There is a tradeoff between the generosity of transition relief and the long-term pro-growth effects of tax reform. This operates through a very simple channel: because providing transition relief means collecting less revenue in the near-term, preserving

revenue neutrality over a given budget window requires higher tax rates at some point. One option is to raise tax rates during the time period that coincides with transition relief, and to reduce them after the transition period ends. That leads to higher distortions in the short run but preserves the steady-state efficiency gains of tax reform, since the long-run tax rates are unaffected by the transition relief. The other option is to raise tax rates forever. This would entail a smaller tax rate increase during the transition period than the first option, but would reduce the long-run efficiency gains associated with tax reform. Recent research by David Altig, Alan Auerbach, Laurence Kotlikoff, Kent Smetters, and Jan Walliser suggests that transitional arrangements can have an important effect on the long-run economic growth effects of tax reform. In some cases it appears that providing generous transition relief to existing asset holders can largely undo the favorable economic growth effects of some reforms.

Senator Charles E. Schumer
Opening Statement

Senate Finance Committee
Hearing on President Bush's Tax Reform Panel
August 3, 2006

Thank you, Mr. Chairman. I want to take a few moments to talk about one issue that is very important to New York, but also a number of other states that are represented on this Committee – the deduction for state and local income taxes.

As we have heard here this morning, while the President's tax panel recommended changing a number of current deductions into credits, such as the mortgage interest deduction, they have targeted one major deduction for complete repeal, and that is the deduction for state and local taxes.

Cynics who have looked at the panel's work may say that the move is politically motivated, arguing that state and local deductibility mostly affects big, high-tax, so-called "blue states" like California, New York, and Illinois. They believe in the theory that any tax panel set up by Republicans would want to stick it to Democrats.

Yet a closer look at the data shows that this theory is simply a myth. Repealing this deduction will be as difficult for families in "red states" as it is for families in "blue states." I doubt that many of my colleagues know about this.

When it comes to tax reform, members of this Committee are all going to be concerned with how proposals affect their constituents, not with national averages, simplistic suppositions, or ideological arguments. And when you look at the state-by-state data for the state and local deduction, there are a lot of surprises.

I urge my colleagues to look at this chart, which shows the percentage of taxpayers in each state represented on the Finance Committee that took advantage of this deduction in 2003. In 2003, ten members of this committee had 30 percent or more of the taxpayers in their states take the deduction for state and local taxes. If you round up the numbers for Kentucky, at 29.6 percent, and Vermont, at 29.7 percent, you have a clear majority. Ranking Member Baucus's state of Montana is close, at 29.4 percent.

In Senator Breaux's testimony, be brought up the state of Arizona as an example – he asked, why should taxpayers in Arizona subsidize services in the states of New York and California? But nearly 37 percent of

taxpayers in Arizona use this deduction! So Senator Kyl – who sits on this committee and admittedly may have different ideas about tax reform than I do – he would have to decide to eliminate a benefit that more than one-third of his constituents benefit from! That's not going to be an easy choice.

In all, 22 states and the District of Columbia saw more than one-third of their taxpayers deduct state and local taxes in 2003. Fully 40 states saw more than one-fourth of their taxpayers take the deduction. So this isn't a tax break that just benefits rich people in blue states.

Eliminating this deduction is going to be nearly impossible politically. Consider that *more than 40 percent* of taxpayers in Colorado, Oregon, and Minnesota – three states fairly evenly split across party lines, with one senator from each major party – take the deduction under current law.

Even Virginia, Utah, and Georgia – three states that went heavily for George Bush in 2004, and each with two Republican senators – have about the same percentage of taxpayers taking than the deduction as California does, and all three rank higher than New York. More than one-third of families also take the deduction in Arizona, North Carolina, and Nevada – all red states.

And in the Washington, DC metro area of Maryland, Virginia, and the District of Columbia – home to most of the pundits that will critique the Tax Panel's proposals, as well as the reporters covering this hearing today – 43 percent of taxpayers took the deduction in 2003.

These numbers show that members of both parties, from every part of the country, will want to maintain the deduction for state and local taxes. One of my highest priorities as a member of this Committee will be to defend it.

I have no specific questions, but if any of the panel members would like to comment on these statistics, or the political difficulty of eliminating a deduction that nearly one-third of our constituents benefits from, I would be happy to listen.

Thank you, Mr. Chairman.

Usage of State and Local Tax Deduction In Finance Committee States

State	Percentage of Taxpayers Taking Deduction (2003)
Iowa	30.0
Utah	39.4
Mississippi	21.7
Maine	30.0
Arizona	36.8
Wyoming	17.8
Pennsylvania	30.6
Tennessee	20.3
Oregon	40.8
Kentucky	29.6
Idaho	33.8
Montana	29.4
West Virginia	16.9
North Dakota	16.9
Vermont	29.7
New Mexico	25.7
Massachusetts	39.8
Arkansas	22.7
Oregon	40.8
New York	37.6

Statement of Senator Gordon H. Smith
U.S. Senate Committee on Finance Hearing
"Kick-Off for Tax Reform: Tackling the Tax Code"
August 3, 2006

Thank you Chairman Grassley and Senator Baucus for holding this very important hearing and beginning the dialogue on how best to reform our tax code.

I also would like to commend the President for his leadership on this issue. In January 2005, the President appointed a bipartisan panel to study the tax code and to propose reform options. The panel issued its report last fall and provided us with a blueprint to begin this debate. I look forward to discussing the panel's findings with a number of its members today, including my former colleagues, Senators Mack and Breaux.

Our tax code is extremely complex and the great majority of Americans don't understand how all of the rules work. As a result, Americans spend an extraordinary amount of money each year to figure out the maze of the tax rules. These extra fees are the equivalent of a tax for owners of small businesses and families that need professional help to comply with our tax rules.

Over half of all taxpayers used a paid tax return preparer to assist them with their individual tax returns. This is true for all income levels. Although those earning more than $100,000 were the most likely to use a paid preparer, 53 percent of taxpayers with income of less than $20,000 used a paid preparer in 2002.

This trend also occurs in my home state of Oregon, where over 50 percent of individual taxpayers used a paid tax return preparer in 2004. For Oregonians with incomes of less than $50,000, about 49 percent used a paid tax return preparer.

The bottom line is we need to simplify our tax rules. If we our going to require our citizens to pay significant sums of their hard earned money to the government, it is only fair that they understand how the tax rules work. However, I think it's safe to say that even the most sophisticated tax attorney doesn't understand all of our tax rules.

As a part of this process, I hope we can address one of my tax reform priorities – depreciation. The current depreciation system is overly complex and dated due to the development of new technologies and industries. Last year I introduced the Tax Depreciation, Modernization and Simplification Act, which would modernize and simplify the depreciation rules. One key provision of the bill would provide Treasury with the authority to modify or create class lives for capital assets. I look forward to working with members of this committee to enact this important legislation.

It has been twenty years since the last time Congress enacted comprehensive tax reform. The time has come to address this important issue again.

Thank you.

United States Government Accountability Office

GAO

Testimony
Before the Committee on Finance,
U.S. Senate

For Release on Delivery
Expected at 10:30 a.m. EDT
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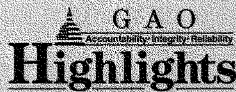
INDIVIDUAL INCOME TAX POLICY

Streamlining, Simplification, and Additional Reforms Are Desirable

Statement of David M. Walker
Comptroller General of the United States

GAO-06-1028T



Highlights

Highlights of GAO-06-1028T, a testimony before the Committee on Finance, U.S. Senate

Why GAO Did This Study

The federal government currently relies heavily on the individual income tax and payroll taxes for about 80 percent of its total annual revenue. Long-range projections show that without some form of policy change, the gap between revenues and spending will increasingly widen. The debate about the future tax system is partly about whether the goals for the nation's tax system can be best achieved by reforming the current income tax so that it has a broader base and flatter rate schedule, or switching to some form of consumption tax.

This testimony reviews the revenue contribution of the current individual income tax as well as its complexity, economic efficiency, equity, and taxpayer compliance issues; discusses some common dimensions to compare tax proposals; and draws some conclusions for tax reform.

This statement is based on previously published GAO work and reviews of relevant literature.

www.gao.gov/cgi-bin/getrpt?GAO-06-1028T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact James White at (202) 512-9110 or whitej@gao.gov.

August 3, 2006

INDIVIDUAL INCOME TAX POLICY

Streamlining, Simplification, and Additional Reforms are Desirable

What GAO Found

The United States faces a large and growing structural budget deficit as current projected revenues are not sufficient to fund projected spending. The individual income tax has long been the largest source of federal revenue—amounting to $927 billion (7.5 percent of Gross Domestic Product (GDP)) in 2005. (Total revenues that year amounted to 17.5 percent of GDP.) Income tax policy, including existing tax expenditures, such as the exclusion of employer-provided health insurance from individual income, and enforcement approaches, need to be key elements of a multipronged approach that reexamines federal policies and approaches to address our nation's large and growing long-term fiscal imbalance.

Concerns regarding the complexity, efficiency, and equity of the individual income tax have contributed to calls for a substantial restructuring of the individual income tax or its full or partial replacement with some form of consumption tax. The widely recognized complexity of the tax results in (1) significant compliance costs, frustration, and anxiety for taxpayers; (2) decreased voluntary compliance; (3) increased difficulties for the Internal Revenue Service (IRS) in administering the tax laws; and (4) reduced confidence in the fairness of the tax. The tax also causes taxpayers to change their work, savings, investment, and consumption behavior in ways that reduce economic efficiency and, thereby, taxpayers' well-being.

Taxpayer noncompliance with the current individual income tax is another factor that could motivate reform. For tax year 2001, IRS estimated that noncompliance with the individual income tax accounted for about 70 percent of the $345 billion gross tax gap, which is the difference between the taxes that should have been paid voluntarily and on time and what was actually paid. Reducing this gap can improve the nation's fiscal stability, as each 1 percent reduction in the tax gap would likely yield about $3 billion annually. Reducing the tax gap within the current income tax structure will require exploring new and innovative administrative and legislative approaches.

In moving forward on tax reform, policymakers may find it useful to compare alternative proposals along some common dimensions. These include, in part, whether proposed tax systems over time will generate enough revenue to fund expected expenditures, whether the base is as broad as possible so rates can be as low as possible, whether the system meets our future needs, and whether it has attributes that promote compliance. Our publication, *Understanding the Tax Reform Debate* (GAO-05-1009SP), provides background, criteria, and questions that policymakers may find useful.

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to contribute to your consideration of fundamental tax reform by discussing the individual income tax. Although the focus of my statement is the individual income tax, it clearly makes sense to consider a broader reform encompassing both the individual and corporate income taxes and much of my message is applicable to broad reforms.[1]

As the Committee is well aware, two fundamental objectives of a tax system are (1) to raise revenue sufficient to fund projected spending and (2) to do so in a manner that is fair, relatively easy to administer, and minimizes negative effects on the economy. Unfortunately, over time, the accumulated changes to our individual tax system have not been consistent with these objectives and, not surprisingly, there is a growing debate about the fundamental design of the current tax system.

The debate about the future tax system is partly about whether the goals for the nation's tax system can be best achieved by reforming the current income tax so that it has a broader base and a flatter rate schedule, or switching in whole or in part to some form of a consumption tax. The President's Advisory Panel on Federal Tax Reform has taken a major step in beginning this debate.[2] The Panel suggested two alternative proposals for coordinated reform of the individual and corporate income taxes and thereby advanced the public debate over how best to simplify these taxes and their proposals include the desirable combination of broader tax bases and lower tax rates.

My statement reviews the revenue contribution of the current individual income tax as well as its complexity, economic efficiency, equity, and taxpayer compliance issues. It also draws some conclusions regarding the need for tax reform. My statement today makes the following points:

- The debate about the fundamental design of the tax system is occurring at a time when the nation also faces a large and growing structural budget

[1] I addressed a number of issues relating to the corporate income tax in a statement before this committee several weeks ago. See GAO, *Tax Compliance: Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting*, GAO-06-851T (Washington, D.C.: June 13, 2006).

[2] President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, (Washington, D.C.: November 2005).

deficit, as under current policy, the gap between revenues and spending will widen over the next few decades. The individual income tax has long been the single largest source of federal tax revenue—amounting to $927 billion in 2005. Individual income tax policy, including existing tax expenditures and enforcement approaches, needs to be an element of a multipronged approach that reexamines existing federal policies and approaches to address the nation's large long-term fiscal imbalance.

- Concerns regarding the complexity, economic efficiency, and overall equity of the individual income tax have contributed to calls for a substantial restructuring of the individual tax or its full or partial replacement with some form of consumption tax. The widely recognized complexity of the tax results in (1) significant compliance costs, frustration and anxiety for taxpayers; (2) decreased voluntary compliance; (3) increased difficulties for the Internal Revenue Service (IRS) in administering the tax laws; and (4) reduced confidence in the fairness of the tax. As discussed in our publication, *Understanding the Tax Reform Debate*[3] the individual income tax also causes taxpayers to change their work, savings, investment, and consumption behavior in ways that reduce economic efficiency and taxpayers' well-being.
- Taxpayer noncompliance with the current individual income tax is another factor that could motivate reform. For tax year 2001, IRS estimated that noncompliance with the individual income tax accounted for about 70 percent of the $345 billion gross tax gap, which is the difference between the taxes that should have been paid voluntarily and on time and what was actually paid. Reducing this gap can improve the nation's fiscal stability, as each 1 percent reduction in the tax gap would likely yield about $3 billion annually. Given its persistence and size, reducing the tax gap within the current income tax structure will require exploring new and innovative administrative and legislative approaches.
- In moving forward on tax reform, policymakers may find it useful to compare alternative proposals along some common dimensions. Among these are whether a proposed tax system will generate sufficient revenue over time to fund whatever spending path is chosen, whether the base is as broad as possible so rates can be as low as possible, and whether it has attributes that promote compliance. Our publication, *Understanding the*

[3]GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions,* GAO-05-1009SP (Washington, D.C.: September 2005).

Tax Reform Debate, provides background, criteria, and questions that policymakers should find useful.[4]

My statement today is drawn from previous GAO reports and testimonies, which were done in accordance with generally accepted government auditing standards, as well as reviews of relevant literature.

Background

The base of the individual income tax covers income paid to individuals, such as wages, interest, dividends, realized net capital gains, various forms of business income, and income from pensions, annuities, trusts and estates. This tax base is reduced by personal exemptions for taxpayers and their spouses and children, as well as by numerous preferences—statutorily defined as tax expenditures—such as the deduction for mortgage interest, the earned income tax credit, and the exclusion of the value of employer-provided health insurance from individuals' taxable income and taxable wage base. The statutory rates of tax on net taxable income range from 10 percent to 35 percent. Lower rates (5 percent and 15 percent, depending on taxable income) apply to long-term capital gains and dividend income.

Individuals may also pay tax under the alternative minimum tax (AMT). The base of this tax equals regular taxable income, plus the value of various tax items, including personal exemptions and certain itemized deductions that are added back into the base. This AMT income base is then reduced by a substantial exemption and then taxed at a rate of 26 percent or 28 percent, depending on the taxpayer's income level. Taxpayers compare their AMT tax liabilities to their regular tax liabilities and pay the greater of the two.

Although the income tax applies to all who have taxable income, nearly all workers pay social insurance taxes to fund retirement, disability and retiree health programs. According to Congressional Budget Office estimates, in 2000 over 40 percent of households paid more in just their portion of social insurance taxes than they paid in income taxes. Further, when both their contribution and their employers' is counted, over 70 percent of households paid more in social insurance taxes than they did in income taxes. The consensus among economists is that the employees ultimately bear the entire social insurance tax burden. In 2005 workers

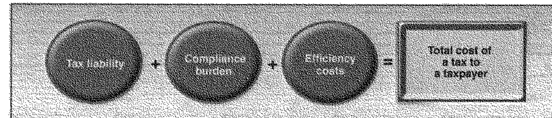
[4]GAO-05-1009SP.

paid a total of $794 billion in social insurance taxes to fund federal social insurance, retirement, disability, and retiree health programs. This amount was in addition to their income tax liabilities. From the taxpayers' view, these taxes may not appear significantly different than income taxes. They reduce the workers' take-home pay each pay period and, although the taxes are set aside in a separate account to fund specific benefits, the portion of these taxes not immediately needed for current beneficiaries goes to fund current government expenses just like income taxes.

Three long-standing criteria—equity; economic efficiency; and a combination of simplicity, transparency, and administrability—are typically used to evaluate tax policy. These criteria are often in conflict with each other and, as a result, there are usually trade-offs to consider and people are likely to disagree about the relative importance of the criteria.

To the extent that a tax is not simple and efficient, it imposes costs on taxpayers beyond the payments they make to the U.S. Treasury. As shown in figure 1, the total cost of any tax from a taxpayer's point of view is the sum of the tax liability, the cost of complying with the tax system, and the economic efficiency costs that the tax imposes. In deciding on the size of government, we balance the total cost of taxes with the benefits provided by government programs.

Figure 1: Components of the Total Cost of a Tax to Taxpayers



Source: GAO.

The United States Faces a Large and Growing Structural Budget Deficit

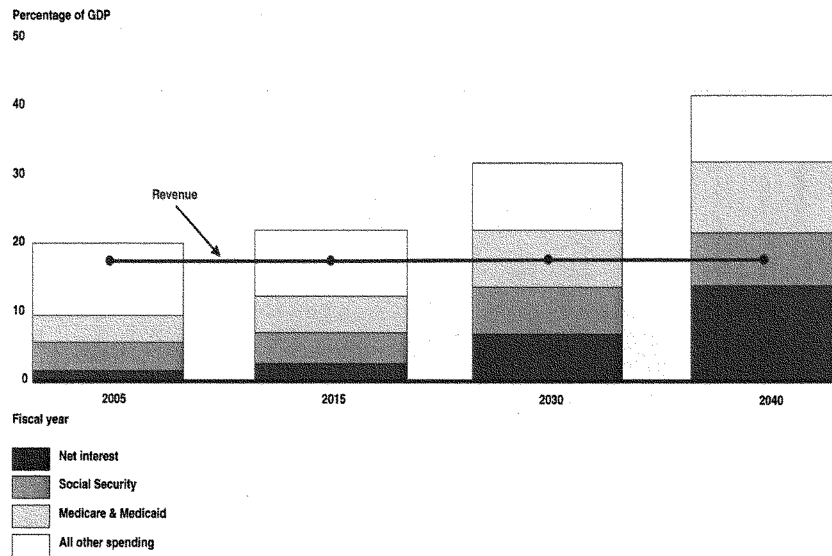
Over the long term, the United States faces a large and growing structural budget deficit primarily caused by known demographic trends and rising health care costs, and this deficit is exacerbated over time by growing interest on the ever larger federal debt. Continuing on this imprudent and unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Addressing the nation's long-term fiscal imbalances constitutes a major transformational challenge that may take a generation or more to resolve.

Fiscal necessity may prompt a fundamental review of major program and policy areas. Many current federal programs and policies—including tax policies—were designed decades ago to respond to trends and challenges that existed then but may no longer suit our 21st century needs. Clearly, the individual income, social insurance, and corporate income taxes, which have been the federal government's three largest sources of revenue, will need to be considered in any plan for addressing the nation's long-term fiscal imbalance.

Revenues from the Current Tax System Are Not Sufficient to Fund Projected Spending

Over the next few decades, as the baby boom generation retires, federal spending on retirement and health programs, such as Social Security, Medicare, and Medicaid, will grow dramatically and bind the nation's fiscal future. Absent policy changes on the spending and/or revenue sides of the budget, a growing imbalance between federal spending and tax revenues will mean escalating and ultimately unsustainable federal deficits and debt. In simple terms, the gap between projected spending and expected revenues grows larger every year. For example, as figure 2 indicates, if discretionary spending grows at the same rate as the economy, all expiring tax provisions are extended, and then federal revenues are held as a constant share of the economy, revenues could be adequate to cover little more than interest on the federal debt by 2040.

Figure 2: Composition of Federal Spending as a Share of GDP, Assuming Discretionary Spending Grows with GDP after 2006 and That Expiring Tax Provisions Are Extended



Source: GAO's May 2006 analysis.

Note: The revenue projection in this figure includes certain tax provisions that expired at the end of 2005, such as the increased alternative minimum tax exemption amount.

We cannot grow our way out of this long-term fiscal challenge because the imbalance between spending and revenue is so large. We will need to make tough choices using a multipronged approach: (1) revise budget processes and financial reporting requirements; (2) restructure entitlement programs; (3) reexamine the base of discretionary spending and other spending; and (4) review and revise tax policy, including tax expenditures and tax enforcement programs. Individual income tax policy, tax

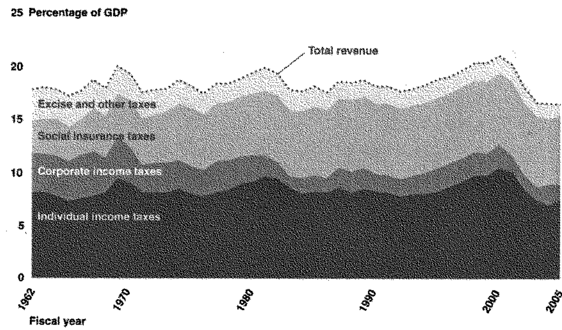
expenditures, and enforcement need to be key elements of the overall tax review.

One promising—and perhaps necessary—approach to tackling both the tax and entitlements part of our long-term fiscal challenge is a credible, capable, and bipartisan Tax and Entitlements Reform Commission. Such an approach would help ensure that any decisions made on taxes and spending are well coordinated and will produce a sustainable fiscal system that meets agreed-upon objectives.

The Individual Income Tax Is the Largest Single Source of Federal Revenues

The individual income tax has long been the single largest source of federal tax revenue. In 2005, individual taxpayers paid $927 billion in income taxes. Figure 3 shows the relative importance of federal taxes. Since 1962, the individual income tax has ranged between a low of 7 percent (in 2004) and a high of 10.3 percent (in 2000) of gross domestic product (GDP). Over the same period, social insurance taxes have grown considerably in importance—from 3 percent of GDP in 1962 to 6.5 percent of GDP (or $794 billion) in 2005. Revenue from the individual income tax has historically accounted for between 40 percent and 50 percent of total federal tax revenue. In contrast, in the early 1960s, social insurance taxes accounted for less than 20 percent of the total; however, they have grown to represent 37.1 percent of revenue in 2005.

Figure 3: Federal Revenues as a Percentage of GDP, 1962 to 2005



Source: GAO represenation of Office of Management and Budget (OMB) data.

Individual Income Tax Complexity, Compliance, and Efficiency Costs and Equity Concerns Contribute to Calls for Reform

Concerns about the complexity, efficiency, and equity of the individual income tax have motivated calls for a substantial restructuring of the tax or its replacement with some form of consumption tax. The widely recognized complexity of the tax results in (1) significant compliance costs, frustration, and anxiety for taxpayers; (2) decreased voluntary compliance; (3) increased difficulties for IRS in administering the tax laws; and (4) reduced confidence in the fairness of the tax. The individual income tax also causes taxpayers to change their work, savings, investment, and consumption behavior in ways that reduce their well-being.[5] These reductions in well-being, known to economists as efficiency costs, are likely to be large—perhaps on the order of 2 percent of GDP or more. The success of our tax system hinges very much on the public's perception of its fairness and transparency. There are differences of opinion about the overall fairness of the individual income tax and concerns have been expressed about the equity of many specific features of the tax.

Important Sources of Complexity Are Income Documentation Requirements and Tax Expenditure Rules

If they are to take advantage of the many tax benefits in the tax code, virtually all taxpayers must familiarize themselves with, or pay someone to advise them on, the sometimes complex rules for determining whether they qualify (and, if so, to what extent). Moreover, in cases where multiple tax expenditures have similar purposes, taxpayers may have to devote considerable time to learn and plan in order to make optimal use of these tax benefits. For example, the IRS publication *Tax Benefits for Education*[6] outlines 12 tax expenditures, including 4 different tax expenditures for educational saving. The use of one of these tax expenditures can affect whether (or how) a taxpayer is allowed to use the other tax expenditures. Adding to the taxpayer's challenge to select the best educational tax benefit, the use of one of these tax expenditures may affect a student's

[5] GAO-05-1009SP.

[6] Department of the Treasury, IRS, Publication 970, *Tax Benefits for Education*, 2004.

eligibility for other forms of federal assistance for higher education, such as Pell grants and subsidized loans.[7]

The tax benefits, or tax expenditures, available under the income tax are usually justified on the grounds that they promote certain social or economic goals. They grant special tax relief (through deductions, credits, exemptions, etc.) that encourages certain types of behavior by taxpayers or aids taxpayers in certain circumstances. Tax expenditures can promote a wide range of goals, like encouraging economic development in disadvantaged areas, financing postsecondary education, or stimulating research and development. For example, a wide range of tax provisions are intended to help individuals save for their retirement. These include traditional and Roth Individual Retirement Accounts (IRA) and various plans administered by employers or available to self-employed individuals. Again, individuals face complex choices to select the best options as well as complex rules to stay in compliance once they select a retirement savings option. From a public policy perspective, all of this complexity and the burden it imposes on taxpayers would most likely be worthwhile if the tax incentives are successful in achieving their intended purposes. However, in many cases this is questionable or unknown. Although research results vary, many studies suggest that IRAs result in little actual increase in retirement saving. One concern is that individuals can take a lump sum withdrawal and, depending on how the sum is used, the individual may not have a sufficient stream of income over his/her remaining lifetime.

Tax Expenditures Have Been Growing

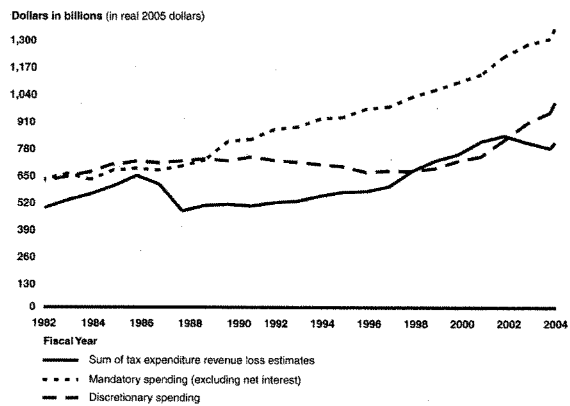
The sum of the revenue loss estimates associated with tax expenditures was more than $775 billion in 2005 and the vast majority of this loss was for tax expenditures provided to individuals, rather than to corporations.[8]

[7]Three of the tax incentives for saving—Coverdell Education Savings Accounts, Qualified Tuition Programs, and U.S. education savings bonds—differ across more than a dozen dimensions. Similarly, three other tax expenditures, all of which help students meet current costs—the Hope credit, Lifetime Learning credit, and the tuition deduction—differ in terms of eligibility criteria, benefit levels, and income-related phase-outs. For a fuller discussion, including estimates of the number of taxpayers who made suboptimal choices in selecting among three tax provisions, see GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences*, GAO-05-684 (Washington, D.C.: July 29, 2005).

[8]Summing the individual tax expenditure estimates is useful for gauging the general magnitude of the federal revenue involved, but it does not take into account possible interactions between individual provisions.

As the data in figure 4 indicate, revenue losses due to tax expenditures exceeded discretionary spending for half of the last decade.

Figure 4: Trends in Spending and Tax Expenditure Revenue Losses, 1982-2005

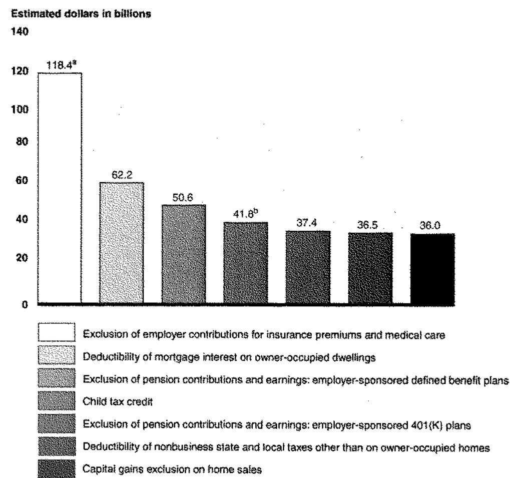


Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1976-2007.

Note: Summing the individual tax expenditure estimates is useful for gauging the general magnitude of the federal revenue involved, but it does not take into account possible interactions between individual provisions.

Much of the revenue loss due to individual income tax expenditures is attributable to a small number of large tax expenditures. The seven tax expenditures shown in figure 5—each with an annual revenue loss estimated at $36 billion or more—accounted for about half of the sum of revenue losses for all tax expenditures for fiscal year 2005. With revenue losses estimated at $4.9 billion, the earned income tax credit (EITC) does not appear on this list. The EITC has both revenue losses and outlays when a taxpayer's refund exceeds their tax liability. If $34.6 billion in associated outlays were included, this refundable credit would rank among the largest tax expenditures.

Figure 5: Revenue Loss Estimates for the Seven Largest Reported Tax Expenditures for Individuals, Fiscal Year 2005



Source: OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2007*.

[a]If the payroll tax exclusion were also counted here, the total tax expenditure for employer contributions for health insurance premiums would be about 50 percent higher or $177.6 billion.

[b]This is the revenue loss and does not include associated outlays of $14.6 billion.

Although Difficult to Measure, Compliance Burden Is Likely a Significant Cost to Taxpayers

The costs of complying with the individual income tax are large but unclear. IRS's most recent estimates suggest that these costs are roughly on the order of ½ to 1 percent of GDP. These costs include the time and money spent complying with the computational, reporting, planning, and recordkeeping requirements of the tax system. Estimates of compliance costs are uncertain because taxpayers generally do not keep relevant records documenting their time and money spent complying with the tax system and many important elements of the costs are difficult to measure

because, among other things, federal tax requirements often overlap with recordkeeping and reporting that taxpayers do for other purposes.

The available compliance cost estimates do not represent the potential cost savings to be gained by replacing the current federal individual income tax. Any replacement tax system will impose significant compliance costs of its own. Moreover, given that many state and local government income taxes depend upon the same compliance activities as the federal income tax does, taxpayers would still bear the costs of those activities unless those other governments replaced their own taxes to conform to the new federal system. In addition, if some of the subsidies, such as the earned income tax credit and child tax credit, which are provided by the current federal tax system, are replaced by spending programs under a reformed system, tax compliance costs may be reduced, but only as a result of their being shifted to those new programs. Similarly, if a replacement tax system no longer requires individuals to compute and document their incomes, individuals will still need to document their incomes for borrowing and other purposes, and government statistical agencies will incur expenses to replace the data that they currently obtain from income tax returns.

Taxes Generally Reduce Economic Efficiency

Taxes impose efficiency costs by altering taxpayers' behavior, inducing them to shift resources from higher valued uses to lower valued uses in an effort to reduce tax liability. This change in behavior can cause a reduction in taxpayers' well-being that, for example, may include lost production (or income) and consumption opportunities. One important behavioral change attributable to the income tax arises from the fact that investment in housing is given more favorable treatment than investment in business activities. Economists generally agree that this differential tax treatment reduces the amount of money available to businesses for investment in productivity-enhancing technology. This in turn results in employees receiving lower wages because increases in wages are generally tied to increases in productivity. The tax exclusion for the exclusion of employer-provided health insurance from individuals' taxable income, discussed in text box 1, is another example of an income tax provision that clearly reduces economic efficiency. The exclusion encourages more extensive insurance coverage, but introduces a well-known problem with health insurance. Because much of the cost of medical treatment is paid for by the insurer, patients and doctors are generally unaware of, or disconnected from, the total costs of health care and have little incentive to economize on health care spending.

Efficiency costs, along with the tax liability paid to the government and the costs of complying with tax laws, are part of the total cost of taxes to taxpayers. However, this does not mean that taxes are not worth paying. One reason people bear taxes is they desire the benefits of government programs and services. (The government does deliver some services effectively and often provides services that otherwise would not be available.) Taxpayers implicitly or explicitly balance the costs of taxes with the benefits of government.

Nevertheless, minimizing efficiency costs is one criterion for a good tax. Economists agree that taxes with broad bases and low rates generally cause lower efficiency costs than do taxes with narrow bases and high rates. The goal of tax policy is to design a tax system that produces revenue needed to pay current bills and deliver on future promises while at the same time balancing economic efficiency with other objectives, such as equity, simplicity, transparency, and administrability. Moreover, as noted earlier, the failure to provide sufficient tax revenues to finance the level of spending we choose as a nation gives rise to deficits and debt. Large, sustained deficits could ultimately have a negative impact on economic growth, productivity, and potentially our national security. Large structural deficits also raise serious stewardship and intergenerational equity issues.

Text Box 1: Tax Expenditure for Employer-Provided Medical Insurance Premiums and Medical Care

The current U.S. tax system excludes employer-provided health insurance from individuals' taxable income even though such insurance is a form of income (noncash compensation). The Department of the Treasury estimates that the tax exclusion for employer-provided health insurance resulted in $118.4 billion in lost revenue during 2005, not including forgone social insurance taxes and state taxes. Including forgone federal social insurance taxes, an estimated $177.6 billion in revenue was forgone due to this exclusion.

The tax exclusion increases the proportion of the population covered by health insurance. In 2004, nearly 46 million Americans were without health insurance. The tax exclusion encourages employers to offer and employees to participate in health insurance plans, increasing the proportion of workers covered. Because individuals may be better able to anticipate their health care needs than insurers, health care plans may attract customers with higher risk of poor health, resulting in higher premiums. By encouraging the pooling of high-and low-risk individuals, the tax exclusion may help to reduce premiums below those that individuals would face if they purchased insurance on their own.

However, some question whether the tax subsidy for health insurance is the best way to increase health insurance coverage. For example, the tax exclusion provides the most assistance to taxpayers who have high marginal tax rates (those with high incomes)—the exclusion saves those taxpayers more in taxes owed than it saves those with lower marginal tax rates.

The tax exclusion for health insurance also contributes to higher health care costs. The exclusion, by lowering premiums, encourages more extensive insurance coverage, which compounds another well-known problem with health insurance. Because much of the cost of medical treatment is paid for by a third party (the insurer), patients and doctors are generally unaware of, or disconnected from, the total costs of health care and have little incentive to economize on health care spending.

Unlike the tax exclusion for employer-provided health insurance, an ideal health care payment system would foster the delivery of care that is both effective and efficient, resulting in better value for the dollars spent on health care.

Efficiency Costs Resulting from the Individual Income Tax Are Likely to Be Large but Can Only Be Estimated with Considerable Uncertainty

Estimating the efficiency costs of the federal tax system is an enormous, complicated, and uncertain task, given the complexity of existing tax rules, the breadth and diversity of the U.S. economy and population, and the limited empirical evidence available on how individuals and businesses change their behavior in response to tax rules. In practice, researchers have not been able to obtain and analyze all of the detailed data they need

to produce efficiency cost estimates that are free from a large degree of uncertainty.

The two studies that have made the most comprehensive estimates of the efficiency costs arising from the individual income tax in the past two decades suggest that those costs are considerable. The first study, which examined the combined efficiency costs of the individual income and payroll taxes, estimated those costs to have been on the order of 2 to 5 percent of GDP in 1994.[9] Estimates from the second study indicate that the efficiency cost of the individual income tax was on the order of 2 percent of GDP in 1997.[10] Efficiency cost estimates such as these are often quite sensitive to the assumed magnitude of key behavioral responses and those assumptions are often based on empirical research that continues to evolve over time or, in other cases, has yet to be undertaken. For example, the consensus of recent research is that individuals are less responsive to changes in taxes than the first study assumed them to be.

The extent to which efficiency gains could be realized by switching to an alternative tax system depends critically on the detailed characteristics of the alternative. All of the alternative tax system proposals that have received serious consideration in recent decades would have imposed significant efficiency costs. Moreover, in assessing the potential efficiency gains from any tax reform proposal it is also important to consider compensating changes that may be made on the spending side of the federal budget. For example, if any tax expenditures in the current federal income taxes are replaced by grants, spending programs, regulations, or other forms of nontax subsidies, those subsidies can result in efficiency costs similar in magnitude to those associated with the tax expenditures they replaced.

Perceptions of Inequities in the Tax System Can Undermine Its Success

The success of our tax system hinges very much on the public's perception of its fairness and transparency. The myriad of tax deductions, credits, special rates, and so forth cause taxpayers to doubt the fairness of the tax

[9]Martin Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," *The Review of Economics and Statistics* (1999).

[10]Dale Jorgenson and Kun-Young Yun, *Investment Volume 3: Lifting the Burden: Tax Reform, the Cost of Capital, and U.S. Economic Growth* (Cambridge, Ma.: MIT Press), 2001.

system because they do not know whether those with the same ability to pay actually pay the same amount of tax. Fairness is ultimately a matter of personal judgment about issues such as how progressive tax rates should be and what constitutes ability to pay.

Public confidence in the nation's tax laws and tax administration is critical because we rely heavily on a system of voluntary compliance. If taxpayers do not believe that the tax system is credible, easy to understand, and treats everyone fairly, then voluntary compliance is likely to decline. The latest available IRS estimates indicate that about 84 percent of total taxes due for tax year 2001 were paid voluntarily and on time. Complexity and the lack of transparency it can create exacerbate doubts about the current tax system's fairness.

There are differences of opinion about the fairness of the individual income tax. Likewise, concerns have been expressed about the equity of many specific features of the tax, such as:

- marriage penalties (and bonuses) built into the tax under which the combined tax liabilities of two individuals differ, depending on whether or not those individuals are married;
- the inconsistent treatment between taxable wages and salaries and other components of total employee compensation, such as employer-provided health benefits that are not taxed;
- the fact that many low-income individuals face high effective marginal tax rates over certain income ranges as the benefits of tax preferences, such as the earned income tax credit, phase out;
- the provision of certain tax benefits in the form of deductions, which are more valuable to taxpayers in higher income brackets, rather than as tax credits;
- the requirement that a taxpayer must own a home in order to receive the significant advantage of tax-preferred borrowing; and
- the greater ease with which self-employed individuals can underreport income, compared to employees whose incomes are subject to withholding and third-party reporting.

Judging the equity of the individual income tax can depend substantially on the frame of reference used. For example, for many, a progressive tax code is considered to be more equitable. When looked at in isolation, the individual income tax system is somewhat progressive. If the frame of reference is expanded, however, and payroll taxes are also taken into

account, total progressivity drops.[11] As mentioned earlier, more than 70 percent of taxpayers are estimated to pay more in payroll taxes than individual income taxes when the combined employee and employer shares are considered.[12] These frames of reference, of course, look only at the payment of taxes. An even wider frame of reference would take into account the benefits taxpayers receive, which could alter yet again judgments about the equity of the tax system. In fact, it could be argued that the full effect of federal government policies on different groups of individuals can only be determined by examining the effects of all federal taxes, spending programs, and regulations.

Ensuring Individual Taxpayer Compliance with the Tax Laws Is Challenging

The extent of individual taxpayer noncompliance with the current tax laws is another factor that could motivate calls for reform. Ensuring compliance with our nation's tax laws is a challenging process for both taxpayers and IRS. The difficulty in ensuring compliance is underscored by the tax gap—the difference between the taxes that should be paid voluntarily and on time and what is actually paid—that arises every year when taxpayers fail to comply fully with the tax laws. Most recently, IRS estimated the gross tax gap for tax year 2001 to be $345 billion, including individual income, corporate income, employment, estate, and excise taxes. IRS estimated it would eventually recover about $55 billion of the

[11]Although it makes sense to consider the significant additional burden of social insurance taxes when evaluating individual tax burdens, there is some disagreement regarding the proper way to analyze the two taxes jointly. Many economists consider the portion of payroll taxes that fund Old-Age and Survivors Insurance benefits to be materially different from other federal taxes because individuals receive future benefits that are directly related to the amount of tax they pay. In their view some account should be made of the redistributive nature of the social security benefits formula. (See, for example, Richard V. Burkhauser and John A. Turner, "Is the Social Security Payroll Tax a Tax?," *13 Public Finance Quarterly*, (1985) and Andrew Mitrusi and James Poterba, "The Distribution of Payroll and Income Tax Burdens, 1979-99," *National Tax Journal*, Vol. 53 no. 3 Part 2 (September 2000) pp. 765-794.) Other observers assert that future benefits are an entitlement based on participation in the workforce, not on the payment of tax, and that all social insurance taxes should be treated the same as individual income taxes when analyzing the distribution of tax burdens. (See Patricia E. Dilley, "Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization," *Boston College Law Review*, 975 (2000) and Deborah A. Geier, "Integrating the Federal Tax Burden on Labor Income," *Tax Notes*, January 27, 2003), pp. 563-583.)

[12]The Tax Policy Center, using its tax simulation model, has estimated that 96 percent of taxpayers pay more in payroll taxes than individual income taxes when both the employee and employer shares of taxes are considered. Economists widely agree that the employee bears the full amount of the payroll tax.

gross tax gap through late payments and enforcement actions, resulting in a net tax gap of $290 billion.[13]

About 70 percent of the gross tax gap for tax year 2001, or an estimated $244 billion, was attributed to the individual income tax. As shown in table 1, individual taxpayers that underreported their income, underpaid their taxes, or failed to file an individual tax return altogether or on time (nonfiling) accounted for $197 billion, $23 billion, and $25 billion of the tax gap, respectively.

Table 1: Individual Income Tax Portion of the Tax Year 2001 Gross Tax Gap Estimate

Type of noncompliance	Tax gap (dollars in billions)
Underreporting	$197
Business income	109
Nonfarm proprietor income	68
Partnership, S-Corp, estate and trust	22
Rents & royalties	13
Farm income	6
Nonbusiness income	56
Capital gains	11
Wages, salaries, tips	10
Pensions and annuities	4
Interest and dividend income	3
Other	28
Credits	17
Deductions, exemptions, adjustments	15
Underpayment	23
Nonfiling	25
Total	**$244**

Source: IRS.

Note: Figures may not sum to totals because of rounding.

Improving compliance and reducing the tax gap would help improve the nation's fiscal stability. Even modest progress would yield significant revenue; each 1 percent reduction would likely yield nearly $3 billion

[13]Unless otherwise noted, references to the tax gap refer to the gross tax gap.

annually. However, the tax gap has been a persistent problem in spite of a myriad of congressional and IRS efforts to reduce it, as the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades. As such, we need to consider not only options that have been previously proposed but also explore new and innovative approaches to improving compliance including fundamental reform of the tax system as well as providing IRS with additional enforcement tools and ensuring that significant resources are devoted to enforcement.

Fundamentally reforming our tax system has the potential to improve compliance, especially if a new system has few tax preferences or complex tax code provisions and if taxable transactions are transparent to tax administrators. One factor that some believe contributes to the difficulty of achieving compliance is the complexity of our tax system. The complexity of, and frequent revisions to, the tax system make it more difficult and costly for taxpayers who want to comply to do so and for IRS to explain and enforce tax laws. Complexity also creates a fertile ground for those intentionally seeking to evade taxes, and often trips others into unintentional noncompliance. Likewise, the complexity of the tax system challenges IRS in its ability to administer our tax laws.

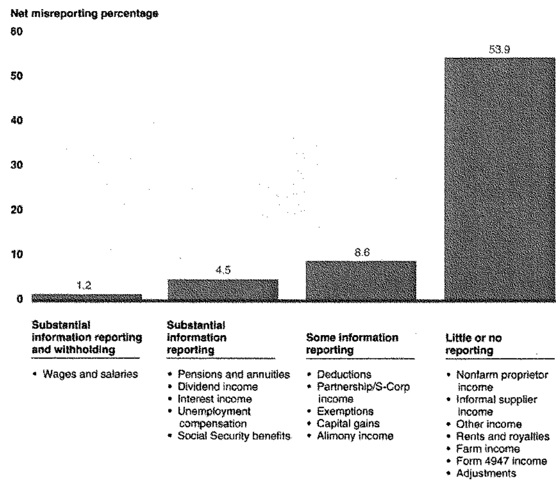
Whether under our current income tax system or a reformed one, enforcement tools, particularly information reporting[14] and tax withholding,[15] are key to high levels of compliance. The extent to which individual taxpayers accurately report the income they earn has been shown to be related to the extent to which the income is reported to them and IRS by third parties or taxes on the income are withheld, as shown in figure 6. Taxpayers tend to report income subject to tax withholding or information reporting with high levels of compliance because the income is transparent to the taxpayers as well as to IRS. For example, employers report most wages, salaries, and tip compensation to employees and IRS through Form W-2. Also, banks and other financial institutions provide information returns (Forms 1099) to account holders and IRS showing the taxpayers' annual income from some types of investments. Findings from IRS's recent study of individual tax compliance indicate that nearly

[14]Information reporting involves the filing of information returns with IRS and taxpayers that contain information on certain transactions, such as wage and salary information employers report to employees and IRS through Form W-2.

[15]An example of tax withholding is when employers withhold taxes on the wages that employees earn and remit them to IRS.

99 percent of these types of income are accurately reported on individual tax returns. For types of income for which there is little or no information reporting, individual taxpayers tend to misreport over half of their income.

Figure 6: Individual Net Income Misreporting Categorized by the Extent of Income Subject to Withholding and Information Reporting



Source: IRS.

Ensuring that significant resources are devoted to enforcement also has the potential to minimize the tax gap for our current income tax system as well as for reformed systems Congress may adopt. For the current system, devoting more resources has the potential to reduce the tax gap by billions of dollars in that IRS would be able to expand its enforcement efforts to reach a greater number of potentially noncompliant taxpayers. Importantly, expanded enforcement efforts could reduce the tax gap more than through direct tax revenue collection, as widespread agreement

exists that IRS enforcement programs have an indirect effect through increases in voluntary tax compliance.[16] However, determining the appropriate level of enforcement resources to provide IRS requires taking into account many factors, such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities.

Generally, when holding IRS accountable for the use of resources, it is also desirable to focus on the outcomes achieved rather than on how IRS allocates the resources it receives. Results are really what counts. If IRS, or any other agency, can figure out how to more cost effectively achieve a result, then reallocation of resources to other problem areas could be an appropriate strategy, within the restrictions applying to appropriation accounts, for making the best use of limited resources. In sum, regardless of the tax system, Congress needs to assure itself that the revenue agency has sufficient resources and reasonable flexibility to achieve desired outcomes and hold the agency accountable for those outcomes.

Comparing Proposals on Common Dimensions

In moving forward on tax reform, policymakers may find it useful to compare proposals on common dimensions. These comparisons can be helpful whether reform is of the individual income tax, the current tax system more broadly, or in considering new systems altogether.

First, is the tax base as broad as possible? Broad-based tax systems with minimal exceptions have many advantages. Fewer exceptions generally means less complexity, less compliance cost, less economic efficiency loss, and by increasing transparency may improve equity or perceptions of equity. In terms of the individual income tax, this suggests that eliminating or consolidating the myriad of tax expenditures must be considered. We need to be sure that the benefits achieved from having these special provisions are worth the associated revenue losses just as we must ensure that outlay programs—which may be attempting to achieve the same purposes as tax expenditures—achieve outcomes commensurate with their costs. To the extent tax expenditures are retained, consideration should be given to whether they are better targeted to meet an identified

[16]Two types of indirect effect are (1) the increase in voluntary compliance in the larger population resulting from examinations or other enforcement and nonenforcement actions on targeted taxpayers, and (2) the increase in voluntary compliance of the targeted taxpayer in subsequent years.

need. Many tax expenditures are broadly available and, in fact, provide greater "assistance" to those that most would consider least in need. This is broadly true of any tax expenditure that is worth more to higher income taxpayers than to lower income taxpayers, like the exclusion for the value of employer-provided health insurance and the mortgage interest deduction.

Broad based tax systems can yield the same revenue as more narrowly based systems at lower tax rates. The combination of less direct intervention in the marketplace from special tax preferences, and the lower rates possible from broad based systems, can have substantial benefits for economic efficiency. For instance, some economists estimate that the economic efficiency costs of tax increases rise proportionately faster than the tax rates. In other words, a 50 percent tax increase could more than double the economic efficiency costs of a tax system.

Does the proposed system raise sufficient revenue over time to fund our expected expenditures? As I mentioned earlier, we will fall woefully short of achieving this end if current spending and/or revenue trends are not altered. The economic efficiency costs of our current tax system likely will become an even more important issue as we grapple with the nation's long-term fiscal challenges. Although we clearly must restructure major entitlement programs and the basis of other federal spending, it is unlikely that our long-term fiscal challenge will be resolved solely by cutting spending. If we must raise revenues, doing so from a broad base and a lower rate will help minimize economic efficiency costs.

In this regard, the President's Advisory Panel on Tax Reform has taken a useful step forward for tax reform, helping, for example, to focus the debate on specific proposals. Those proposals incorporate broader bases, with lower rates. However, the Panel acted within the guidance it was given, and one result is that the proposed reforms, if implemented as proposed, appear to provide much less than the necessary revenue to fund expected government spending. Although we have not evaluated the revenue effects of these proposals, other respected analysts have and they point to future revenue yields that would worsen the already difficult fiscal challenges the nation faces.

Does the proposal look to future needs? Like many spending programs, the current tax system was developed in a profoundly different time. We live now in a much more global economy, with highly mobile capital, and investment options available to ordinary citizens that were not even imagined decades ago. We have growing concentrations of income and

wealth. More firms operate multi-nationally and willingly move operations and capital around the world as they see best for their firms.

Do the revenues for the proposed system hold up in the future? As an adjunct to looking forward when making reforms, the revenue consequences of all major tax changes should be estimated well into the future. Such long-term projections undoubtedly will be subject to uncertainty, but at the very least we should have the best estimates possible of whether the revenue trend is likely to shift up or down over the long-term.

Does the proposed system have attributes associated with high compliance rates? Because any tax system can be subject to tax gaps, the administrability of reformed systems should be considered as part of the debate for change. In general, a reformed system is most likely to have a small tax gap if the system has few tax preferences or complex provisions and taxable transactions are transparent. Transparency in the context of tax administration is best achieved when third parties report information both to the taxpayer and the tax administrator.

What transition issues exist and have they been dealt with in an equitable fashion that minimizes additional complexity and any adverse effects on the benefits to be gained from the new tax system? Under the current individual income tax system, citizens have made fundamental life choices based at least in part on the incentives in the tax system. For many, the favorable tax treatment of owner-occupied housing has led to choices to invest disproportionately in housing. Others have made long-term investments in tax-favored college savings plans. Thus, changes to the tax system can materially affect citizens' futures. Still others make their livings advising taxpayers, helping them understand tax provisions and complete their tax returns, and helping them devise investment and other financial plans taking into account current tax rules.

Our publication, *Understanding the Tax Reform Debate: Background, Criteria, and Questions,*[17] may be useful in guiding policymakers as they consider tax reform proposals. It was designed to aid policymakers in thinking about how to develop tax policy for the 21st century. While not designed to break new conceptual ground, this report brings together a number of topics that tax experts have identified as those that should be

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considered when evaluating tax policy. It attempts to provide information about these topics in a clear, concise, and easily understandable manner for a non-technical audience.

Concluding Observations

The problems that I have reviewed today relating to the compliance costs, efficiency costs, equity and tax gap associated with the current individual income tax system—many of which arise from the complex accumulation of tax preferences in that system—would seem to make an overwhelming case for a comprehensive review and reform of our tax policy. Further, we live a world that is profoundly different than when the individual income tax and many of its provisions were adopted. Despite numerous and repeated calls for such reform, progress has been slow. One reason why reform is difficult to accomplish is that the provisions of the tax code that generate compliance costs, efficiency costs, the tax gap and inequities also benefit many taxpayers and the individuals and companies that advise taxpayers and help them with their tax filing obligations. Reform is also difficult because, even when there is agreement on the amount of revenue to raise, there are differing opinions on the appropriate balance among the often conflicting objectives of equity, efficiency, and administrability. This, in turn, leads to widely divergent views on even the basic direction of reform.

Fiscal necessity, prompted by the nation's unsustainable fiscal path, will eventually force changes to our spending and tax policies. We must fundamentally rethink policies and everything must be on the table. Tough choices will have to be made about the appropriate degree of emphasis on cutting back federal programs versus increasing tax revenue.

Tax reform, if it broadens the tax base, could reduce the costs of raising a given amount of revenue by reducing the associated efficiency costs. Such a reform also likely would reduce inequities, compliance burden, and administrative costs. The recent report of the President's Advisory Panel on Federal Tax Reform recommended two different tax reform plans. Although each plan provides for significant simplification, neither of them addresses the growing imbalance between federal spending and revenues that I highlighted earlier. One approach for getting the process of comprehensive fiscal reform started would be through the establishment of a credible, capable, and bipartisan commission, to examine options for a combination of entitlement and tax reform.

As policymakers consider proposals to reform the current individual income tax, or the entire tax system, they may find it useful to compare

the proposals on common dimensions. Our publication, *Understanding the Tax Reform Debate*, may be useful when making these comparisons.

Mr. Chairman and Members of the Committee, this concludes my statement. I would be pleased to answer any questions you may have at this time.

Contact and Acknowledgments

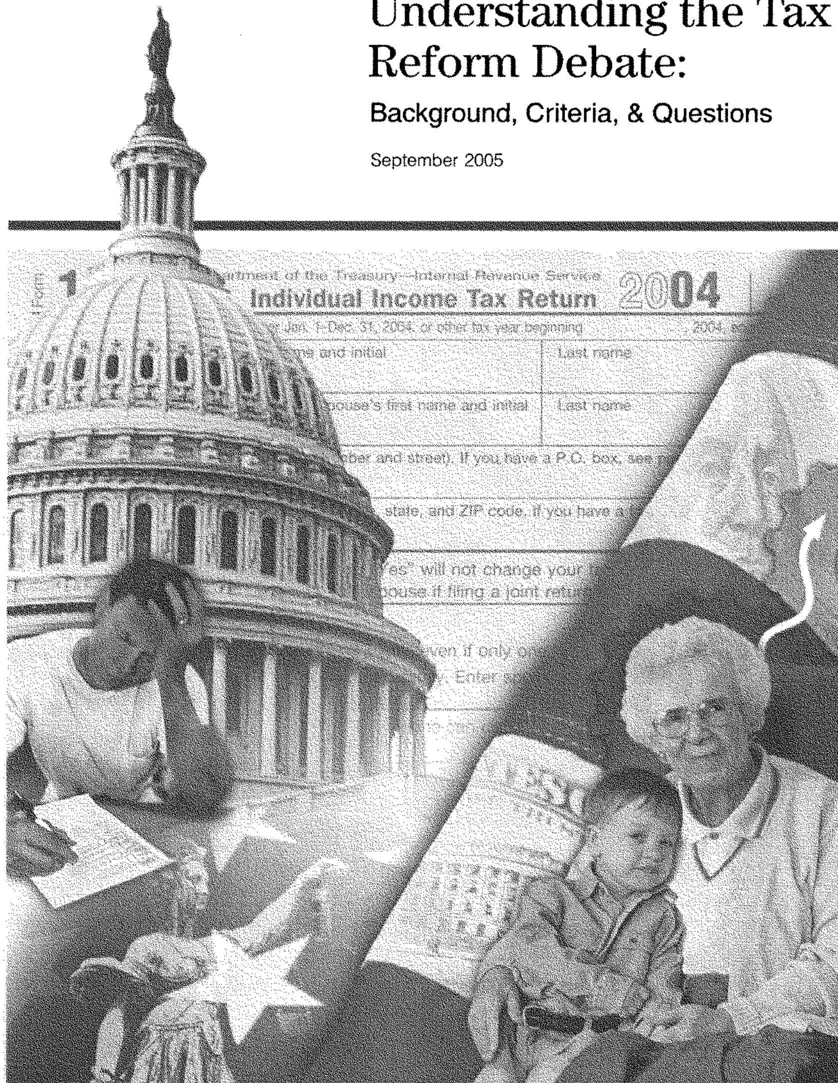
For further information on this testimony please contact James White on (202) 512-9110 or whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this testimony. Individuals making key contributions to this testimony include Michael Brostek, Director; Kevin Daly and Jim Wozny, Assistant Directors; Jeff Arkin; Elizabeth Fan; Tom Gilbert; Don Marples; and Jeff Procak.

United States Government Accountability Office

Understanding the Tax Reform Debate:

Background, Criteria, & Questions

September 2005



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Preface

Taxes are necessary because they fund the services provided by government. In 2005, Americans will pay about $2.1 trillion in combined federal taxes, including income, payroll, and excise taxes, or about 16.8 percent of gross domestic product.

Beyond funding government, the federal tax system has profound effects on the economy as a whole and on individual taxpayers, both for today and tomorrow. Taxes change people's behavior and influence the economy by altering incentives to work, consume, save, and invest. This, in turn, affects economic growth and future income—and thus future government revenues. At the same time, the current tax system generates fierce controversy over fairness—who should pay and how much they should pay. In addition, the current tax system is widely viewed as overly complex, thereby reducing the ability of individuals to understand and comply with the tax laws. Furthermore, the tax system is costly to administer with most of the costs of administration, such as record keeping, understanding the laws, and preparing returns, borne by taxpayers.

Concerns about the economic effectiveness, fairness, and growing complexity of the current tax system raise questions about its credibility. These concerns have led to a growing debate about the fundamental design of the federal tax system. The debate includes the type of base—income or consumption—and the rate structure—flatter or more progressive. Additionally, some question to what extent and how the tax system should be used to influence economic behavior and social policy.

Some see tax rates as too high—discouraging work, savings, and investment and consequently slowing economic growth. At the same time, the myriad of tax deductions, credits, special rates, and so forth cause taxpayers to doubt the fairness of the tax system because they do not know whether those with the same ability to pay actually pay the same amount of tax. In addition, tax expenditures, also called tax preferences, just like spending programs, can lead to higher tax rates over time. Complexity and the lack of transparency that it can create exacerbate doubts about the current tax system's fairness. Public confidence in the nation's tax laws and tax administration is critical because we rely heavily on a system of voluntary compliance. If taxpayers do not believe that the tax system is credible, is easy to understand, and treats everyone fairly, then voluntary compliance is likely to decline.

The debate about the fundamental design of the tax system is occurring at a time when the nation also faces large current deficits and a significant and structural long-term fiscal imbalance. Long-term budget simulations by GAO, the Congressional Budget Office, the Office of Management and Budget, and nongovernment analysts show that absent policy changes, the federal budget is on an unsustainable path. Known demographic trends and rising health care costs will cause ultimately

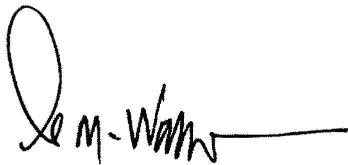
unsustainable deficits and debt that will threaten our national security as well as the standard of living for the American people in the future.

While additional economic growth is critical and can help to ease the burden, the projected fiscal gap is so great that it is unrealistic to expect that growth alone will solve the problem. Ultimately, the nation will have to decide what it wants from the federal government, that is, what level of spending do we want on programs, tax preferences, and other government services and how we will pay for that spending. Clearly, tough choices will be required. Addressing the projected fiscal gap will prompt policymakers to examine the advisability, which includes both the effectiveness and affordability, of a broad range of existing programs and policies throughout the entire federal budget—spanning discretionary spending, mandatory spending, entitlement programs, tax expenditures tax rates, and tax system design. This examination will likely result in actions affecting both tax revenues and tax expenditures.

The background, criteria, and questions presented in this report are designed to aid policymakers and the public in thinking about how to develop tax policy for the 21st century. This report, while not intended to break new conceptual ground, brings together a number of topics that tax experts have identified as those that should be considered when evaluating tax policy. This report attempts to provide information about these topics in a clear, concise, and easily understandable manner for a nontechnical audience. In developing this report, we relied on government studies, academic articles, and the advice of tax experts to provide us with information on the issues surrounding the tax reform debate. For a short bibliography of related publications, see appendix II. For easy reference, key terms are defined in the glossary located in appendix III—these glossary terms appear in **bold** type the first time they are used in the text.

This publication was prepared under the direction of James R. White, Director, Strategic Issues (Tax Policy and Administration Issues), who may be reached at (202) 512-9110 or WhiteJ@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Kevin Daly,

Tom Gilbert, Don Marples, Donna Miller, Ed Nannenhorn, and Amy Rosewarne made key contributions. This report will be available at no charge on the GAO Web site at http://www.gao.gov.

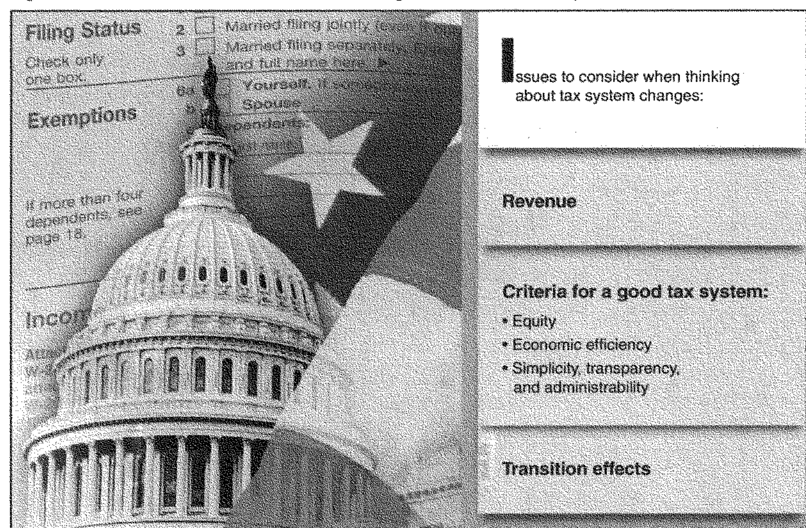


David M. Walker
Comptroller General
of the United States

Introduction

This report provides background information, criteria, and key questions for assessing the pros and cons of tax reform proposals, both proposals for a major overhaul of the current federal tax system and incremental changes to the system. Figure 1 outlines the key issues that we address. First, we discuss how the size and role of the federal government drive the government's revenue needs. Second, we describe a set of widely accepted criteria for assessing alternative tax proposals. These criteria include the equity, or fairness, of the tax system; the economic efficiency, or neutrality, of the system; and the simplicity, transparency, and administrability of the system. The weight one places on each of these criteria is a value judgment and will vary among individuals. As we note, there are trade-offs to consider among these criteria, and we discuss how these criteria can sometimes be in conflict with each other. Finally, we turn to a consideration of the issues involved in transitioning from the current tax system to an alternative tax system.

Figure 1: Issues to Consider When Assessing Alternative Tax Proposals



Sources: GAO (text); PhotoDisc, IRS (images).

The primary purpose of the tax system is to collect the revenue needed to fund the operations of the federal government, including its promises and commitments. Tax revenues may not fully match government spending each year, but over time, the federal government needs to be able to raise sufficient revenue to cover its current and expected financial obligations. Decisions about spending and the role of government have a direct impact on the government's ultimate revenue needs.

Whether the resources to fund government spending are provided through taxes or borrowing has consequences for the economy and the federal budget. Borrowing (which has often led to budget **deficits**) may be appropriate for federal investiment such as building roads and scientic research, and during times of recession, war, and other temporary challenges. However, federal borrowing also absorbs scarce savings that would otherwise be available for growth-enhancing private investment. In addition, large amounts of borrowing may increase the share of interest payments in the federal budget overtime, placing additional pressure on future budgets.

One's view about the equity of a tax system is based on subjective judgments about the fairness of the distribution of **tax burdens**. The actual burden of a tax—the reduction in economic well-being caused by the tax—is not always borne by the people who pay the tax to the government because tax burdens can be shifted to other parties. For example, the burden of a tax on business can sometimes be shifted to consumers by increasing prices or to workers by decreasing wages. Public debates regarding the equity of the tax system reflect a range of opinions about who should pay taxes and how much of the tax burden should be shouldered by different types of taxpayers.

Taxes impose **efficiency costs** by altering taxpayers' behavior, inducing them to shift resources from higher valued uses to lower valued uses in an effort to reduce **tax liability**. This change in behavior can cause a reduction in taxpayers' well-being that, for example, may include lost production (or income) and consumption opportunities. Efficiency costs, along with the tax liability paid to the government and the costs of complying with tax laws, are part of the total cost of taxes to taxpayers. One of the goals of tax policy, but not the only goal, is to minimize compliance and efficiency costs. The extent to which efficiency costs can be reduced by reforming the tax system depends on the design features of the new tax system, such as the nature and number of any **tax preferences**.

Simplicity, transparency, and administrability are related but different characteristics of a tax system. Simplicity is a gauge of the time and other resources taxpayers spend to comply with the tax laws. This includes the time and resources spent on record keeping, learning about tax obligations, and preparing tax returns. The transparency of a tax system refers to taxpayers' ability to understand how their liabilities are calculated, the logic behind the tax laws, what their own tax burden and that of others is, and the likelihood of facing penalties for noncompliance. Administrability refers to the costs, ultimately borne by taxpayers, of collecting and processing tax

payments as well as to the costs of enforcing the tax laws. While simplicity, transparency, and administrability are related concepts, they are not the same thing. A very simple tax rule may not be transparent if the rationale for the rule is not clear. Similarly, not all simple taxes are easy to administer.

Designing tax policy requires making trade-offs among these criteria. For example, a proposal to improve the efficiency and simplicity of the tax code may involve eliminating **exemptions** or **deductions** originally introduced to improve the equity of the system. Moreover, some criteria include subjective elements. One individual's perception of the equity of a tax proposal can differ from another's. However, being subjective or objective does not make a criterion superior.

In addition to determining the type of tax system, policymakers also determine the amount of revenue to be raised, which involves balancing the costs of taxes against the benefits of government services. Despite the fact that no tax system is perfectly fair, efficient, simple, transparent, and without administrative costs, in general people are willing to pay taxes and bear the other costs of the tax system because they desire the benefits of government and understand that sufficient tax resources are necessary for a sound fiscal policy in the long term.

Finally, because moving to an alternative tax system creates winners and losers, transition rules may be included in tax reform proposals to mitigate some of the **windfall gains** and **windfall losses** that are likely to occur. However, debate exists as to whether transition rules, which are usually proposed on equity grounds, are appropriate because they may also reduce the efficiency of the tax system and temporarily make the tax system more complex.

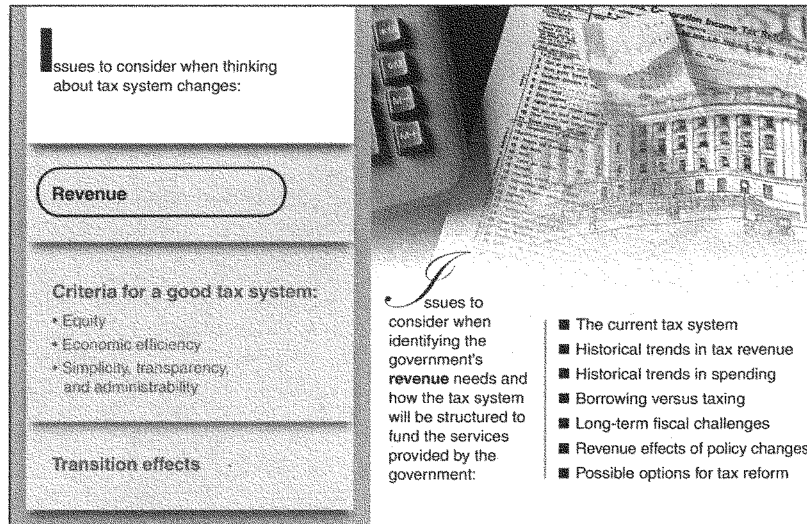
Tax reform proposals can range from small changes to the tax code to more comprehensive changes. The issues and questions we discuss in this report are designed to apply to both incremental changes to the tax system, such as changing **tax expenditures** to encourage savings, and to more comprehensive tax reform proposals, such as switching from a predominantly income-based tax to a **consumption tax base**.

In addition to discussing the criteria used to evaluate changes to the tax system, this report provides information about economic and budgetary trends, the current tax system, and definitions of important tax concepts. For each section of the report, we provide a set of key questions designed to help identify the important features of the proposals This is information that we believe would be useful for evaluating the proposals and identifying limitations of the data and analysis.

Revenue—Taxes Exist to Fund Government

Taxes exist to fund the services provided and the promises made by the government. Since tax revenue may not match spending in each year, the resources needed to fund government can be also be raised by borrowing (deficit financing). Both taxes and borrowing affect economic performance. Taxes can affect the economy because they alter decision making by people and businesses. Federal borrowing absorbs savings otherwise available for private investment and postpones the need to tax or reduce spending. (See fig. 2.)

Figure 2: Revenue Overview



Sources: GAO (text); PhotoDisc (images).

The Current Tax System

The federal tax system in the United States primarily consists of five types of taxes: (1) **personal income taxes**; (2) **social insurance taxes** (employee and employer contributions for Social Security, **Medicare**, and unemployment compensation); (3) **corporate income taxes**; (4) **estate and gift taxes**; and (5) **excise taxes** based on the value of goods and services sold and other taxes. The tax bases, rates, and collection points of the major federal taxes are summarized in table 1.

Table 1: Features of the Current Tax System

Type of tax	Tax base	Tax rates	Collection points
Personal income taxes (PIT)	**Regular PIT** Personal income, including income from wages, interest and dividends, capital gains, and small business income. Numerous tax expenditures exist that reduce the size of the tax base.	**Regular PIT** Graduated rate structure: Statutory marginal rates of 10%, 15%, 25%, 28%, 33%, and 35%. Deductions and other tax expenditures, such as refundable tax credits like the Earned Income Tax Credit, create a group of taxpayers who have no tax liability or a negative tax liability.	**Regular PIT** Employers withhold payments, but individuals file tax returns wherein they are also required to disclose nonwage income and remit appropriate taxes. Small business owners self-report income and remit taxes to the government.
	Personal alternative minimum tax (AMT) Taxable income exceeding certain threshold amounts based on filing status.	**Personal AMT** 26% or 28% depending on taxable income subject to the AMT. Individuals are eligible for a credit for a portion of the AMT paid in a prior year.	**Personal AMT** Individuals compare their regular PIT liability to their AMT liability and pay the greater of the two (less taxes previously withheld or paid during the year).
Corporate income taxes (CIT)	**Regular CIT** Corporate profits (total revenues less total expenses). Numerous tax expenditures exist that reduce the size of the tax base.	**Regular CIT** Statutory marginal rates range from 15% to 35%.	**Regular CIT** Corporations file tax returns and remit payment to the government.
	Corporate AMT Broader definition of the tax base (corporate income) than regular CIT; less generous accounting rules.	**Corporate AMT** 20% for all corporate income subject to the tax less the AMT credit for that tax year.	**Corporate AMT** Corporations compare regular CIT to corporate AMT liability and pay the greater of the two.
Social insurance taxes	**Social security** First $90,000 of employee wages.	**Social security** 6.2% employee contribution. 6.2% employer contribution. 12.4% for self-employed.	**Social security** Employers withhold taxes from employee paychecks. The self-employed remit taxes themselves.
	Medicare All wages.	**Medicare** 1.45% employee contribution. 1.45% employer contribution. 2.90% for self-employed.	**Medicare** Employers withhold taxes from employee paychecks. The self-employed remit taxes themselves.

(Continued From Previous Page)

Type of tax	Tax base	Tax rates	Collection points
Unified transfer tax—estate, gift, and generation skipping tax (GST)	**Estate tax** Fair market value of the decedent's cash and securities, real estate, trusts, annuities, business interests, and other assets included in the decedent's estate at death less allowable deductions in excess of $1.5 million in 2005. There is an unlimited deduction for transfers to a surviving spouse.	**Estate tax** Rates range from 45% to 47% in 2005. As a result of recent tax legislation, estate tax rates will fluctuate before the estate tax is eliminated in 2010. However, the estate tax will be reinstated in 2011.	**Estate tax** Decedent's estate is responsible for filing returns and remitting payment to the government.
	Gift tax Tax is imposed on the value of lifetime taxable transfers of gifts of property. Applicable exclusion amount of $1 million for 2005. In addition, there is an annual exclusion of $11,000 per donee and an unlimited exclusion for tuition and medical payments.	**Gift tax** Rates range from 41% to 47% in 2005. Rates fluctuate in the same manner as for the estate tax in coming years. Gift tax will be retained following repeal of estate and GST.	**Gift tax** Gift donor is responsible for filing returns and remitting payment to the government.
	GST Total generation skipping transfers (such as from a grandparent to a grandchild) in excess of $1.5 million in 2005.	**GST** 47% (or highest statutory marginal tax rate for the estate tax) in 2005. GST rates decrease until the tax is repealed in 2010. GST is reinstated in 2011.	**GST** Depending on the form of the generation skipping transfer, gift donor, donee trustee, or decedent's estate is responsible for filing returns and remitting payment to the government.
Excise and other taxes	Selected goods, services, and other items (i.e., gasoline, alcoholic beverages, tobacco, airline tickets, etc.).	Various rates apply to different goods, services, and other items.	Generally collected by businesses, which remit payments to the government on a quarterly basis.

Source: GAO analysis of Internal Revenue Service information.

The revenue raised by the major federal taxes is determined by the size of their bases, their rates, and their levels of compliance. In addition, each tax base is affected by the size and growth rate of the economy.

Although called income taxes, the current federal individual and corporate income taxes have some features characteristic of a consumption tax. The current income tax system taxes the income of individuals and corporations, such as wages, interest, **dividend income**, **capital gains**, and other types of business income, including that of sole proprietorships and partnerships. (Some income is double taxed—corporate

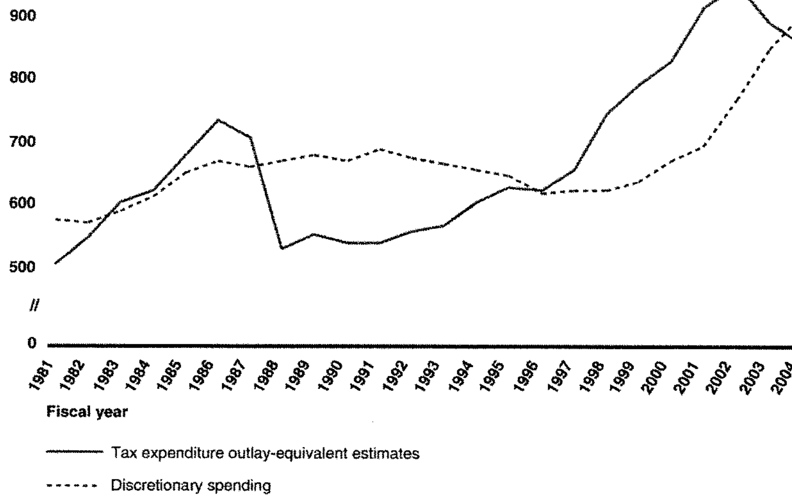
earnings are subject to the corporate income tax and are taxed again under the individual income tax when they are distributed as dividends or as realized capital gains when shareholders sell their stock.) However, some income is treated as it would be under a consumption tax where income that is saved or invested is exempted from tax until it is consumed. For example, up to certain limits, income that is contributed to **individual retirement accounts** and **defined contribution pension plans** is tax-deferred during accumulation. The result is a hybrid income-consumption tax base wherein some types of savings and investment are exempt from taxation, but other types are not.

The current tax system includes tax expenditures, also called tax preferences, which reduce the size of the tax base. Tax expenditures are usually justified on the grounds that they promote certain social or economic goals. They grant special tax relief (through deductions, **credits**, exemptions, etc.) that encourages certain types of behavior by taxpayers or aids taxpayers in certain circumstances. Tax expenditures can promote a wide range of goals. For example, individual retirement accounts, discussed above, promote the goal of increased personal savings and investment, and the tax expenditures for owner-occupied homes encourage homeownership.

Summing one measure of tax expenditures, called outlay-equivalents, indicates that the aggregate value of tax expenditures was about $850 billion in fiscal year 2004. Outlay-equivalents are budget outlays that would be required to provide the taxpayers who receive the tax expenditures with the same after-tax income as would be received through the tax expenditures.[1] As an indication of the size and impact of tax expenditures, figure 3 compares them to **discretionary spending**. In some years the outlay-equivalents for income tax expenditures exceeded federal discretionary spending.

[1]Summing outlay equivalent estimates is controversial because doing so does not take into account possible interactions among tax expenditures. In addition, there are several ways to define and measure tax expenditures. The size of a tax preference can change over time. For example, accelerated depreciation of machinery and equipment drops out of the list of the top 10 tax expenditures in 2006. Moreover, what is considered a tax expenditure depends on the tax base. Some provisions of the tax code that are considered tax expenditures under an income tax base would not be considered tax expenditures under a consumption tax base. For further information on how tax expenditures are defined and measured, see GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690 (forthcoming).

Figure 3: Sum of Tax Expenditure Outlay-Equivalent Estimates Compared to Discretionary Spending, 1981-2004



Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1983-2006.

A few large income tax expenditures account for most of the aggregate value. The 10 tax expenditures listed in table 2 accounted for over 60 percent of the outlay-equivalents in fiscal year 2004. The estimates in the table are for income tax expenditures. They do not include provisions that exclude income from other taxes, such as **payroll taxes**. For example, the income tax exclusion for health care permits the value of health insurance premiums to be excluded from employees' taxable earnings and also excludes this value from the calculation of Social Security and Medicare payroll taxes for both employees and employers.

Table 2: The 10 Largest Tax Expenditures in 2004, Outlay Equivalent Estimates

Dollars in billions	
Tax preference	**Outlay equivalents**
Exclusion of employer contributions to medical insurance premiums and medical care	$126.7
Deductibility of mortgage interest on owner-occupied homes	61.5
Net exclusion of pension contributions and earnings: 401(k)	58.2
Net exclusion of pension contributions and earnings: employer plans	57.3
Deductibility of nonbusiness state and local taxes (other than on owner-occupied homes)	45.3
Accelerated depreciation of machinery and equipment	44.7
Exclusion of interest on public purpose state and local debt	37.5
Capital gains (other than agriculture, timber, iron ore, and coal)	35.9
Capital gains exclusion on home sales	35.0
Exclusion of net imputed rental income on owner-occupied homes	32.8

Source: GAO analysis of Office of Management and Budget (OMB), *Budget of the United States Government, Fiscal Year 2006, Analytical Perspectives.*

In the current tax system, tax rates vary across types of tax. Individual income and corporate income above certain levels are generally taxed at graduated rates. Taxes on individual income have six statutory **marginal tax rates** (the rate of tax paid on the next dollar of income that a taxpayer earns), ranging from 10 percent to 35 percent. Income earned by corporations has a statutory marginal rate structure that ranges from 15 percent to 35 percent. A separate rate structure exists for the individual **Alternative Minimum Tax** (AMT)—a tax on individual income that was originally designed to keep taxpayers with higher incomes from taking advantage of various tax provisions in order to pay little or no income tax. The current tax system also includes social insurance taxes, which are applied to wages at flat rates and remitted in equal shares by employees and employers. However, currently the first $90,000 of an individual's wages is subject to payroll taxes for Social Security, while all wages are subject to payroll taxes for Medicare.

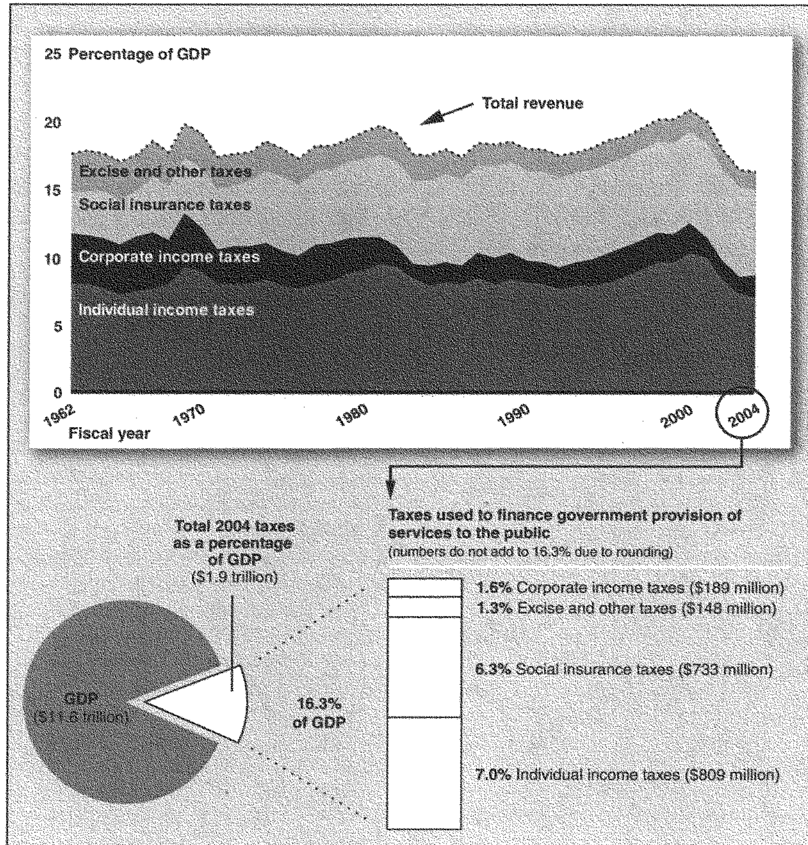
The government's administrative burden and taxpayers' **compliance burden** vary depending on the type of taxpayer, the type of tax, and the **collection point** of the tax. For the individual income tax and social insurance taxes, the primary collection point occurs at the business level: employers bear the burden of withholding employees' taxes from their wages and remitting the tax payments to the government. However, all individuals with income above certain thresholds based on personal allowances and a **standard deduction** still must file tax returns. The Internal Revenue Service (IRS) bears the administrative burden of monitoring taxpayer compliance and applying penalties to noncompliant taxpayers when necessary.

Historical Trends in Tax Revenue

Total federal tax revenues have fluctuated from roughly 16 to 21 percent of **gross domestic product** (GDP) over the last 43 years. In figure 4, total federal revenue is highest in 2000 at 20.9 percent of GDP and lowest in 2004 at 16.3 percent of GDP.

As figure 4 also illustrates, there have been important changes to the composition of federal revenues over the last 43 years. Corporate and excise tax receipts as a percentage of GDP have declined since 1960, while social insurance tax receipts have grown. The individual income tax and social insurance taxes have accounted for the majority of federal revenues during this period.

Figure 4: Federal Revenue as a Percentage of GDP and by Source, 1962-2004



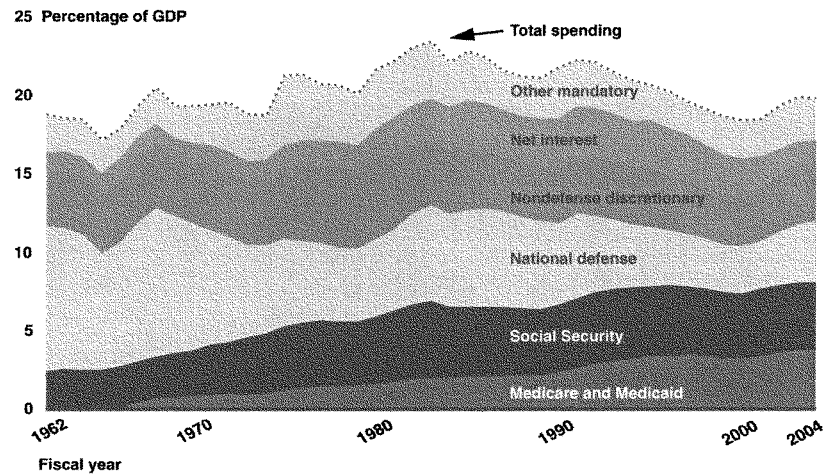
Source: GAO represenation of OMB data.

Historical Trends in Federal Spending

As figure 5 illustrates, over the last 43 years, federal spending as a portion of GDP has ranged from a low of 17.2 percent of GDP in 1965 to a high of 23.5 percent of GDP in 1983. In addition, figure 5 illustrates that as is the case with revenues, important changes to the composition of federal spending have occurred. For example, since 1962, the total share of federal spending devoted to national defense has decreased relative to the share devoted to Social Security and health care. Government

provision of Social Security and health care accounted for over 40 percent of government spending in 2004, a dramatic increase from the share before 1965 when the Medicare and **Medicaid** programs were enacted.

Figure 5: Federal Spending as a Percentage of GDP and by Spending Category, 1962–2004

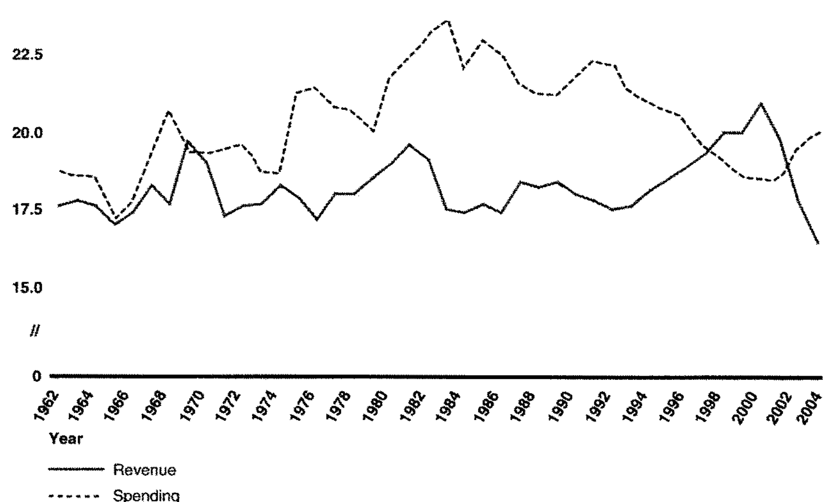


Source: GAO representation of OMB data.

Borrowing versus Taxing as a Source of Resources

The resources to fund government are raised primarily through taxes. However, borrowing is another source. Figure 6 combines figures 4 and 5 to show that the federal government has generally run a deficit in recent decades.

Figure 6: Federal Tax Revenue versus Federal Spending, 1962–2004



Source: GAO representation of OMB data.

Public sector resources, whether from taxes or borrowing, make the benefits of government possible. However, taxes and borrowing also have costs. Obviously, they transfer money from the pockets of the public to the government. But they also affect the performance of the economy. As will be discussed under the criteria for a good tax system, taxes affect the performance of the economy by altering decisions, such as how much to work and save, what to consume, and where to invest.

Federal borrowing has advantages and disadvantages that vary depending on economic circumstances. Borrowing, in lieu of higher taxes or lower government spending, may be viewed as appropriate during times of economic recession, war, or other temporary challenges. Federal borrowing might also be viewed as appropriate for federal investment, such as building roads, training workers, and conducting scientific research, that contributes to the nation's capital stock and productivity. If well chosen, such activities could ultimately help produce a larger economy. However, if not well chosen, such spending could displace more productive private sector investments.

Federal borrowing also can impose significant costs and risks. Borrowing for additional spending or lower taxes for current consumption improves short-term well-being for today's workers and taxpayers, but does not enhance our ability to

repay the borrowing in the future. In the near term, federal borrowing also absorbs scarce savings available for private investment and can exert upward pressure on interest rates. Over the long term, federal borrowing that restrains economic growth will also restrain the standard of living of future workers and taxpayers.

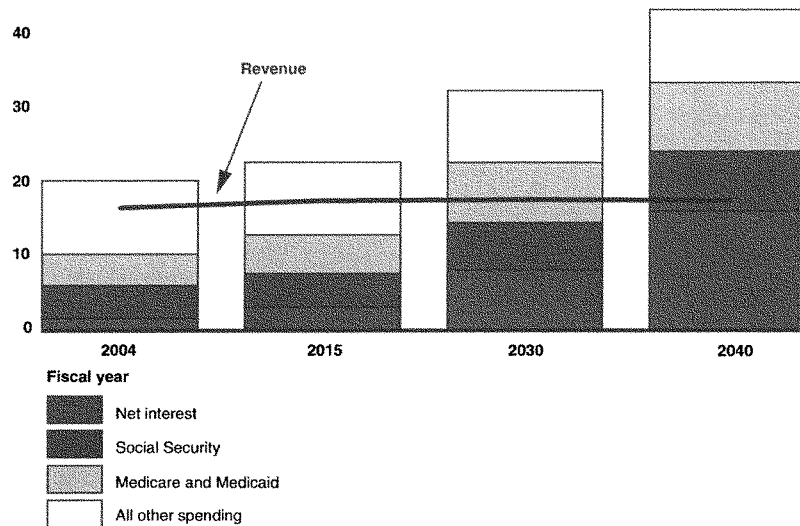
Long-term Fiscal Challenge

As discussed in our report on challenges facing the government, the fiscal policies in place today—absent substantive **entitlement** reform and changes in tax and spending policies—will result in large, escalating, and persistent deficits that are economically unsustainable over the long term.[2] In other words, given current forcasts for growth, government spending and resources, today's policies cannot continue and must change.

Over the next few decades, as the baby boom generation retires, federal spending on retirement and health programs, such as Social Security, Medicare, and Medicaid, will grow dramatically and bind the nation's fiscal future. Absent policy changes on the spending and/or revenue sides of the budget, a growing imbalance between federal spending and tax revenues will mean escalating and ultimately unsustainable federal deficits and debt. For example, as figure 7 indicates, if discretionary spending grows at the same rate as the economy and all expiring tax provisions are extended, federal revenues could be adequate to cover little more than interest on the federal debt by 2040.

[2]GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP (Washington, D.C.: February 2005).

Figure 7: Composition of Federal Spending as a Share of GDP, Assuming Discretionary Spending Grows with GDP after 2004 and That Expiring Tax Provisions Are Extended



Source: GAO representation of OMB data.

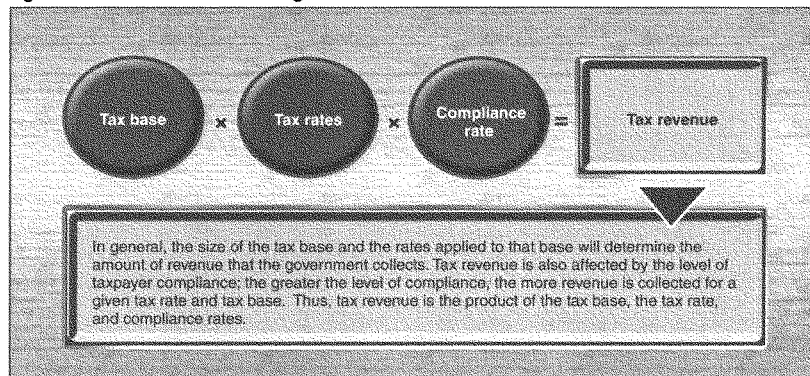
Notes: This figure is based on the assumption that discretionary spending grows at the same rate as GDP after 2004 and that expiring tax provisions are extended. Despite our assumption that expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers being subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Regardless of the assumptions used, reasonable long-term simulations indicate that the problem is too big to be solved by economic growth alone or by making modest changes to existing spending and tax policies. While entitlement reform as well as **mandatory** and discretionary spending cuts will likely be needed to close the long-term financial gap, the structure of the tax system should also be part of the debate as policymakers grapple with the nation's long-term fiscal challenge. As part of this process, consideration could be given to improving taxpayer compliance and enforcement efforts, expanding the tax base, increasing current tax rates and tax rates on future generations, or a combination of these.

Revenue Effects of Federal Tax Policy Changes

The amount of revenue raised from a tax is determined by the tax base, the tax rate, and the compliance rate, as shown in figure 8. Changes to the tax code can be **revenue neutral**, meaning that they are designed to raise the same amount of revenue as the current tax laws, or tax code changes can be designed to raise more or less revenue than the current tax laws. Additionally, changes to the federal tax system can have significant implications for state and local government tax revenues.

Figure 8: Formula for Determining Tax Revenue



Source: GAO.

Tax revenue can be affected by changing the current tax base, which could include replacing it with a pure consumption tax base or broadening the current tax base by eliminating certain tax expenditures. As we noted earlier, tax expenditures, which the government uses to encourage specific social and economic goals, reduce the size of the tax base. Tax expenditures may be justified because, in some cases, it may be less costly to achieve these goals through reductions to the tax base than through spending programs. The choice of whether to use tax expenditures or spending depends on which approach better targets and meets the program's objectives at the lowest cost. Even though spending programs show up in the federal budget and tax expenditures are not included as federal spending, taxpayers are paying for the program in either case. Both should be transparent and subject to periodic oversight concerning such factors as whether they meet the program's objectives or conflict with other government programs, grants, and regulations that have similar objectives.

The tax expenditure for **employer-provided health care**, discussed in text box 1, illustrates the importance of such oversight.

Text Box 1: Tax Expenditure for Employer Medical Insurance Premiums and Medical Care

The current U.S. tax system excludes employer-provided health insurance from individuals' taxable income even though such insurance is a form of income (noncash compensation). As table 2 showed, the Treasury Department estimates that the tax subsidy for employer-provided health insurance was over $126 billion in outlay-equivalents during 2004, not including forgone social insurance taxes and state taxes.

The tax exclusion increases the proportion of the population covered by health insurance. Currently, nearly 45 million Americans are without health insurance. The tax exclusion encourages employers to offer and employees to participate in health insurance plans, increasing the proportion of workers covered. The exclusion addresses a well-known problem with health insurance. Because individuals may be better able to anticipate their health care needs than insurers, health care plans may attract customers with higher risk of poor health, resulting in higher premiums. By encouraging the pooling of high- and low-risk individuals, the tax exclusion may help to reduce premiums below those that individuals would face if they purchased insurance on their own.

However, some question whether the tax subsidy for health insurance is the best way to increase health insurance coverage. For example, the tax exclusion provides the most assistance to taxpayers who have high marginal tax rates (those with high incomes)—the exclusion saves those taxpayers more in taxes owed than it saves those with lower marginal tax rates.

The tax exclusion for health insurance also contributes to higher health care costs. The exclusion, by lowering premiums, encourages more extensive insurance coverage, which compounds another well-known problem with health insurance. Because much of the cost of medical treatment is paid for by a third party (the insurer), patients and doctors are generally unaware of the total costs of health care and have little incentive to economize on health care spending.

Unlike the tax exclusion for employer-provided health insurance, an ideal health care payment system would foster the delivery of care that is both effective and efficient, resulting in better value for the dollars spent on health care.

Tax revenue can also be affected by changes in tax rates, where the amount collected depends on the definition of the tax base and taxpayer responses to changes in the rate. If the tax base is broad with few exclusions, deductions, and credits, then the tax rates required to generate a particular amount of revenue will be lower than if the base is narrow. The Tax Reform Act of 1986 broadened the current tax base, which is based largely on income, by eliminating some tax expenditures, which made more income taxable. Without any changes in rates, tax revenue would have increased, but instead, rates were lowered to keep revenue about the same. Within some range, rate increases bring in more revenue, but rates can become so high that a further increase discourages enough of the taxed activity to reduce revenue. A tax system is more adaptable to increased revenue needs to the extent that tax rates can be increased without other fundamental changes to the system and without excessively discouraging the taxed activity or increasing noncompliance.

Tax revenue is also affected by policies that change compliance rates. Noncompliance means that only part of the tax liability actually gets paid. Increasing compliance would bring in more revenue from the existing tax base without having to raise rates. IRS estimates that the **net tax gap** (the difference between taxes legally

owed to the government and what taxpayers actually paid to the government) was at least $257 billion in 2001, the most recent year available. This is about 13 percent of federal revenue. Some experts believe that simplicity and transparency can contribute to compliance, as **voluntary compliance** is likely to increase if taxpayers are less likely to make errors on their tax returns and have fewer opportunities to evade taxes.

While federal tax policy changes may alter the amount of revenue collected by the federal government these changes can also alter the amount of revenue that state and local governments collect. State and local governments collect nearly one-third of all the tax revenue generated in the United States each year.

In many cases, state governments link their tax bases to the federal tax base. For example, some states use a taxpayer's **adjusted gross income** from the federal tax return to calculate state income taxes. If the federal government enacted provisions that reduce the size of the tax base used to calculate a taxpayer's adjusted gross income, then absent policy changes in the affected states, these state governments would likely see a decrease in state tax revenues. Conversely, if the federal government reduced the number of tax expenditures, increasing the size of the tax base, state governments would likely see an increase in state tax revenues. Thus, major changes to the federal tax base could lead to a variety of challenging tax system changes at the state level. For example, if the federal government adopted a consumption tax base, many states may have to consider whether they wish to maintain state income taxes.

General Options Suggested for Fundamental Tax Reform

Recent years have seen a variety of proposals for fundamental tax reform. These proposals would significantly change the tax base, tax rates, and collection points of the tax.

Some of the proposals would replace the federal income tax with some type of consumption tax. The **retail sales tax**, **value-added taxes**, the personal consumption tax, and the **flat tax** are all types of consumption taxes. They vary in their collection points and structure. Similarly, collection points and rate structure will vary under an **income tax base**.

Text box 2 briefly summarizes the general categories of proposals.

Text Box 2: General Categories of Tax Reform Proposals

In recent years, lawmakers and analysts have suggested a variety of tax reform proposals that would change the way in which Americans pay taxes.

- *National retail sales tax (NRST)*: An NRST would be collected by businesses with, in most cases, no need for individuals to file tax returns (some taxpayers may be required to file tax returns in order to get back taxes that they paid on items for business use). The base would be retail sales of goods and services to final customers. Rates could not vary by individual.
- *Value-added taxes (VAT)*: VATs, now widely used in other countries, are collected by businesses with no need for individual tax returns. The VAT taxes all sales to both consumers and other businesses, adjusting for purchases from other businesses, which is equivalent to the base of an NRST. Rates do not vary by individual. Some experts believe a VAT would be easier to enforce than an NRST.
- *Flat tax*: A consumption flat tax would have the same base as an NRST or a VAT but would split collection between businesses and individuals by making wages deductible by businesses but taxable at the individual level. Generally, a single tax rate would apply to both individuals and businesses. Because of the individual component of the tax, wages up to some level can be exempted from tax, which would introduce some progessivity into this tax system.
- *Personal consumption taxes*: A personal consumption tax would look much like the current individual income tax. Individuals would report their income from wages, interest, dividends, and so on. It would differ in that borrowed funds would be included in the tax base, and funds that are saved or invested would be deducted. The base is equivalent to that of other consumption taxes. Rates could vary based on individual characteristics.
- *Reformed income tax system*: Over the years, the Department of the Treasury and others have discussed options for reforming the current tax system that would replace the current income tax with a more broadly based income tax. For example, proposals have been advanced to integrate the personal and corporate income tax and to eliminate preferences on certain types of income, which would broaden the tax base and could result in reduced tax rates (if the proposal were revenue neutral).

Key Questions

1. What current taxes would the proposal change?
   - Does the proposal change personal income taxes, social insurance taxes, corporate income taxes, and/or estate and gift taxes?
2. What is the nature of the proposed change to the tax system?
   - Does the proposal change the tax base from income to consumption?
   - Does the proposal include tax expenditures?
   - Does the proposal change the tax rates?
   - Does the proposal change the collection points for the tax?
3. How will the proposed change affect total revenues?
   - Are proposed changes to the tax code likely to be revenue neutral?

- If not, will they generate more or less revenue than the current tax laws?

4. What effect would the proposal have on the nation's projected budgets and long-term fiscal outlook?

   - Does the proposal take into consideration the sizable long-term fiscal gap that the country faces?

5. What tax expenditures are included in the proposal, and what tax expenditures, if any, have been removed from the current tax system?

   - Are the social and economic goals of the tax expenditures likely to be achieved and worth the cost in lost revenue?
   - When the total costs of a program are considered, would it be less costly to implement the program as a tax expenditure or as a spending program?

6. If the proposal changes the tax base, the tax rates, or the collection points, how would these changes alter the amount of revenue that the government is able to collect?

7. What implications, if any, would the proposal have on the ability of state and local governments to collect tax revenues?

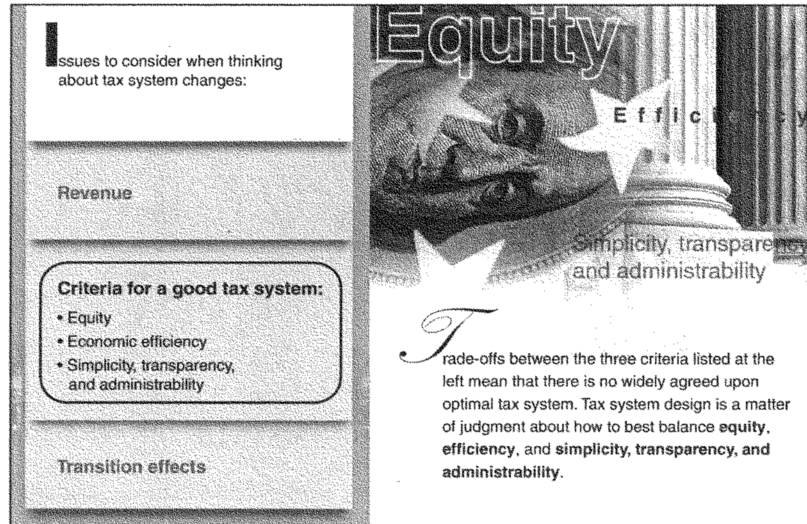
   - Would the proposal tax the same base that many states rely on?
   - Would the proposal allow many states to continue to rely on the federal tax base as a starting point for determining state taxes?

Criteria for a Good Tax System

How should a tax system be designed to raise a given amount of revenue? More specifically, what criteria should be used to evaluate the advantages and disadvantages of a particular tax system, or a particular tax policy proposal? The answers matter because various combinations of tax bases and rates can raise the same amount of revenue.

Three long-standing criteria—equity; economic efficiency; and a combination of simplicity, transparency, and administrability—are typically used to evaluate tax policy. These criteria are often in conflict with each other, and as a result, there are usually trade-offs to consider between the criteria when evaluating a particular tax proposal. Some of the criteria, such as equity and transparency, are more subjective while other aspects of some of the criteria, such as economic efficiency, can be defined more objectively. Additionally, people may disagree about the relative importance of the criteria. Consequently, citizens and elected officials are likely to hold a wide range of opinions about what the ideal tax system should look like. (See fig. 9.)

Figure 9: Trade-offs in the Criteria for Assessing Tax Reform



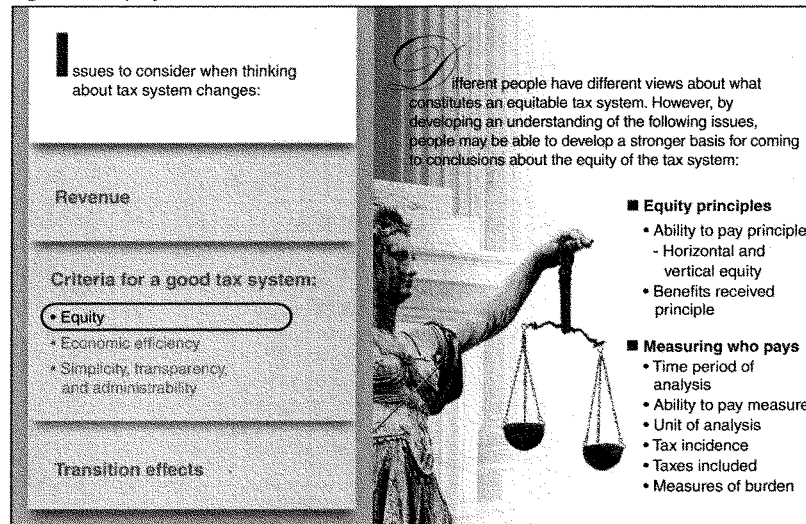
Sources: GAO (text); PhotoDisc (images).

In the following sections, we explain these criteria. The fact that a particular tax is viewed favorably from the perspective of one of the criteria is not an overall endorsement of the tax.

Equity

There are a wide range of opinions regarding what constitutes an equitable, or fair, tax system. There are principles—a taxpayer's ability to pay taxes and who receives the benefits from the tax revenue that is collected—that are useful for thinking about the equity of the tax system. However, these principles do not change the fact that conclusions about whether one tax is more or less equitable than another are value judgments. Similarly, analytical tools, such as **distributional analysis**, while providing useful factual information about who pays a tax and how much they pay, do not replace individuals' value judgments about what constitutes a fair tax system. (See fig. 10.)

Figure 10: Equity Overview



Sources: GAO (text); PhotoDisc, ©Corbis (images).

Equity Principles

Two principles of equity underlie debates about the fairness of different tax policies. The **ability to pay principle** and the **benefits received principle** do not identify one tax policy as more equitable than another, but they can be used to clarify and support judgments about equity. When making judgments about the overall equity of government policy, it is important to consider both how individuals are taxed and how the benefits of government spending are distributed. Even if some judge tax

policy to be inequitable, government policy as a whole may be considered more equitable once the distribution of both taxes and government benefits is accounted for. For the purposes of this report, we have confined our discussion of equity to the distribution of tax burdens.

Ability to Pay Principle

The ability to pay principle states that those who are more capable of bearing the burden of taxes should pay more taxes than those with less ability to pay. The ability to pay principle relates taxes paid to some measure of ability to pay, such as overall wealth, income, or consumption. However, ability to pay may vary depending on the measure chosen. For example, a taxpayer's ability to pay, measured by overall wealth, may differ significantly from his or her ability to pay measured by income. A taxpayer who worked for many years and then retired may have accumulated a significant amount of wealth and may, as a result, have a higher ability to pay taxes but may have low current income.

Some features of the current income tax can be viewed as reflecting attempts to account for differences in ability to pay. For example, two taxpayers with the same income may not have the same level of economic well-being—the same ability to pay—if one has high medical expenses and the other does not. For this reason, the current income tax allows deductions for large medical expenses. Other provisions of the tax code, such as the deduction for the number of dependents, may also adjust income to better reflect ability to pay. Some items that clearly affect ability to pay, such as the contribution provided by a nonworking spouse to a family's well-being, are not included in taxable income, in part because of difficulties in valuing these aspects of economic well-being. People have different views about the factors that affect ability to pay.

Additionally, some do not agree that income is the best measure of ability to pay. As noted above, some argue that consumption provides a better measure of a taxpayer's ability to pay taxes than income.

Horizontal and Vertical Equity

The concepts of **horizontal equity** and **vertical equity** are refinements of the ability to pay principle.

Horizontal equity requires that taxpayers who have similar ability to pay taxes receive similar tax treatment. Targeted tax expenditures, such as deductions and credits, could affect horizontal equity throughout the tax system because they may favor certain types of economic behavior over others by taxpayers with similar financial conditions. For example, two taxpayers with the same income and identical houses may be taxed differently if one owns his or her house and the other rents because mortgage interest on owner-occupied housing is tax deductible.

Vertical equity deals with differences in ability to pay. Subjective judgments about vertical equity are reflected in debates about the overall fairness of the following three types of rate structures, where for this example, income is used as the measure of ability pay:

- ***Progressive tax rates***: The tax liability as a percentage of income increases as income increases.
- ***Proportional tax rates***: Taxpayers pay the same percentage of income, regardless of the size of their income.
- ***Regressive tax rates***: The tax liability is a smaller percentage of a taxpayer's income as income increases.

Just because the statutory rate structure for a tax is progressive does not necessarily mean that the tax system is progressive overall. For example, when considering an individual income tax, if statutory marginal tax rates increase as taxable income increases the tax rate structure is progressive. However, as shown in text box 3, **statutory tax rates** are not the same as **effective tax rates**—progressive statutory tax rates could be offset by other features of the tax system. Average effective tax rates, or the amount of tax that a taxpayer actually pays as a percentage of his or her total income (after deductions, credits, and exclusions are removed from the equation) may make the tax less progressive if there are a variety of provisions in the tax code that reduce the taxable income of wealthier taxpayers.

Text Box 3: Examples of Different Types of Tax Rates

Conclusions about the overall equity of the tax system may be different depending on which type of tax rate one considers.

Statutory tax rates are the tax rates that are defined by law in the tax code and applied to taxable income. Effective tax rates differ from statutory tax rates in that they are typically measured using a broader definition of income, which includes items excluded under the current tax code in order to provide an estimate of what a taxpayer pays in relation to his or her overall total income.

Marginal tax rates are the rates that taxpayers pay on the next dollar of income that is earned. Marginal tax rates can be presented as both marginal statutory rates and marginal effective rates. **Average tax rates** are the total amount of tax a taxpayer pays divided by some measure of his or her income. In the current tax system, average tax rates are sometimes presented as the amount of tax a taxpayer pays divided by his or her taxable income. Average effective tax rates differ in that they are developed using a broader measure of total income than taxable income.

The following tax rates are often discussed when considering the equity of the tax system.

- *Marginal statutory tax rates*: The tax rate that a taxpayer pays on his or her next dollar of income earned as defined by law in the tax code.
- *Marginal effective tax rates*: The actual rate of tax that a taxpayer faces on the next dollar of income earned when all other provisions of the tax (deductions, credits, etc.) are included.
- *Average effective tax rates*: The overall rate of tax a taxpayer pays as a percentage of his or her total income after all other provisions of the tax system (deductions, credits, etc.) are included.

Conclusions about the progressivity of the tax system may differ, for example, depending upon whether they are based on an examination of the statutory marginal rate structure or on the effective marginal rate structure.

People hold different opinions as to whether the current rate structure is vertically equitable. Some believe that the rate structure should be more progressive, and that effective tax rates should rise with income more rapidly than they do under the current system. Others support a proportional rate structure. They believe that a tax system that imposes a single flat tax rate on income is more equitable because each additional dollar earned is taxed at the same rate.

Benefits Received Principle

In contrast to the ability to pay principle, the benefits received principle states that the amount of tax paid should be directly related to the benefits that a taxpayer receives from the government. In practice, the benefits received principle requires the government to identify who benefits from specific government services. As a result, the benefits received principle is usually not applicable when considering government programs intended to provide societywide benefits or redistribute wealth.

The federal tax on gasoline is an example of a tax that is sometimes justified on the benefits received principle. Gas taxes are paid by road users. This means that the people who pay the tax (drivers) are the same taxpayers who receive the benefits from the revenue collected in the form of both new and improved highways. User

fees, such as postage stamps or fees to enter national parks, are another example of taxes based on the benefits received principle.

Measuring Who Pays: Distributional Analysis

Distributional analysis, which shows tax burden by differing income groups, is used to measure how different tax proposals would affect taxpayers with varying ability to pay, or the way in which the tax burden is to be shared among various income groups. Some tax reform proposals may alter the distribution of taxes paid among various groups of taxpayers, while other tax reform proposals may be distributionally neutral, or maintain the same distribution of tax burdens as the tax system that is already in place. The Tax Reform Act of 1986 is an example of a tax reform proposal that was intended to be distributionally neutral.

The distributional analyses of a specific tax proposal may differ for a variety of reasons. Among the most important are (1) the time period included in the analysis, (2) the manner in which ability to pay is measured, (3) the unit of analysis, (4) assumptions regarding **tax incidence**, (5) the taxes included in the analysis, and (6) the measures of tax burden used in the table.

Time period of the analysis: Most distributional analysis tables use annual measures of income and taxes, although some use longer periods. However, a 1-year time horizon provides a limited perspective on the distributional effects of federal taxes. For example, consider the same individual at different points in his or her life. When he or she enters the workforce, income and wealth usually are relatively low but increase over time when prime earnings years are reached and assets and savings begin to be accumulated. With retirement, annual wages fall and savings are the primary support for the retirees lifestyle. As a result of fluctuations in income over time, annual tables measuring the distribution of tax burdens may group together people who have different lifetime economic circumstances.

Ability to pay measure: Most studies that measure distributional effects of alternative tax proposals include a broad measure of income that includes more than just taxable income to measure a taxpayer's ability to pay. Some types of nonwage income, such as investment income, are relatively easy to identify and include in distributional tables, while others are more difficult. For example, distributional analyses may attempt to adjust for such factors as the value of employer-provided fringe benefits in order to broaden the definition of income to better reflect ability to pay.

However, while income is the most commonly used measure of ability to pay in distributional analysis, other measures of ability to pay, such as consumption, may also be used to create distributional tables. As we mentioned earlier, some believe that consumption is a better measure of ability to pay taxes than income.

Unit of analysis: The unit of analysis used to group taxpayers together may also affect the outcome of distributional tables. Some analysts create distributional tables using individual taxpayers as the unit of analysis, while others group taxpaying units (people included on a tax return, families, or households) together. Distributional tables may differ if one table uses individual taxpayers and another table uses a taxpaying unit because a taxpaying unit may include more than one individual who pays taxes.

Tax incidence: The actual burden of a tax does not always fall on the people or businesses that actually pay the tax to the government, and assumptions about tax incidence may affect the results of distributional tables. The **statutory incidence** of a tax—the parties who are legally required to pay the tax—may not be the same as its **economic incidence**—the parties who actually bear the burden of the tax—because taxpayers who legally must pay the tax can sometimes shift the burden to others through changes in prices, wages, and returns on investments. For example, from a statutory perspective, the employee and employer contribution to the payroll tax are equal. However, most analysts agree that employees bear the entire burden of the payroll tax in the form of reduced wages.

Determining who bears the burden of the corporate income tax is an example of how difficult it can be to determine the incidence of a tax. Text box 4 illustrates some of the issues associated with identifying the incidence of the corporate income tax.

Text Box 4: Incidence of the Corporate Income Tax

Corporations do not actually bear the ultimate burden of the corporate income tax; instead, individuals bear the burden of the corporate income tax. A corporation writes a check to the U.S. Treasury to pay its tax liability, but the burden of the tax is shifted to other groups of people through lower incomes or higher prices.

The money to pay the tax must come from reduced returns to investors in the corporation, lower wages to the company's employees, or higher prices that consumers pay for the company's products. In the short term, the incidence of the corporate income tax is likely to fall on stockholders or investors in general. However, because corporate income taxes may lead to reduced capital investment, in the longer term some of the burden of the corporate income tax is more likely shifted to people who earn income from labor. Reduced capital investment can lead to lower productivity and, consequently, lower wages.

Due to the difficulty of identifying the incidence of the corporate income tax, some, including the Joint Committee on Taxation, often exclude the corporate income tax from distributional tables altogether.

Taxes included in the analysis: Some distributional tables include different taxes in the analysis, so when comparing two distribution tables, identifying which taxes are included in the analysis is necessary to ensure that a valid comparison can be made between the two estimates. For example, in table 3, one side of the table includes all federal taxes, while the other side only includes the federal income tax. Because it is often difficult to isolate the incidence of some taxes, analysts sometimes exclude those taxes from the analysis.

Measures of tax burden: Distributional tables may also produce different results based on the measures of tax burden that are used. Effective tax rates and share of tax liability (portion of total taxes that households in each quintile collectively remitted to the government), the measures used in table 3, are two common measures of tax burden. Some distributional tables show how effective tax rates would change if the tax code were changed.

Different Assumptions Lead to Different Distributional Analyses

The Office of Tax Analysis in the Treasury Department, the Congressional Budget Office (CBO), and the Joint Committee on Taxation are the three government sources of tax distributional analysis, and their distributional tables may differ based on the assumptions that they make about the issues we have outlined above.

The example in table 3, which shows two measures of tax burden, illustrates the fact that making different assumptions when conducting distributional analysis can lead to different results.

Table 3: Measures of Tax Burden: Distribution of Total Federal Taxes and Individual Income Taxes in 2004

	Total federal taxes		Individual income taxes	
Income quintiles	**Average effective tax rates**	**Share of tax liability**	**Average effective tax rates**	**Share of tax liability**
Lowest quintile	5.2%	1.1%	-5.7%	-2.7%
Second quintile	11.1%	5.2%	-0.1%	-0.1%
Middle quintile	14.6%	10.5%	3.5%	5.4%
Fourth quintile	18.5%	19.5%	6.6%	15.2%
Highest quintile	23.8%	63.5%	14.2%	82.1%
All	**19.6%**	**100.0%**	**9.0%**	**100.0%**

Source: Congressional Budget Office, *Effective Federal Tax Rates Under Current Law, 2001 to 2014* (Washington, D.C.: August 2004).

Note: In table 3, numbers do not always add due to rounding.

Both of the distribution tables were prepared by CBO using the same methodology to measure the distributional effects of the tax system in 2004 using 2001 income (adjusted for inflation and nominal income growth to reflect income in 2004) as the base for the analysis. The only difference between the left side of the table and the right side of the table is the taxes that are included in the analysis. The left side includes total federal taxes, excluding estate and gift taxes and several other miscellaneous sources of revenue, while the right side of the table only includes individual income taxes. The table that presents total federal taxes uses the assumption that individuals bear the burden of the employee and employer share of

payroll taxes, and owners of capital income bear the burden of the corporate income tax. The effective tax rates for individual income taxes are negative for the two lowest income quintiles because the table includes some offsets to tax liability, such as the earned income tax credit.

Key Questions

1. How is a taxpayer's ability to pay broadly defined:

   - Income?
   - Consumption?
   - A broader definition of overall wealth?

2. What factors other than income, such as medical expenses, number of dependents, and so forth, does the proposal account for when considering a taxpayer's ability to pay taxes?

3. Will taxpayers with equal ability to pay taxes pay the same amount?

   - If not, what provisions of the proposal do not adhere to the principle of horizontal equity?

4. How will the tax system tax people with differing ability to pay?

   - Are the statutory tax rates progressive, proportional, or regressive?
   - Are the average effective tax rates progressive, proportional, or regressive (accounting for credits, deductions, and other tax expenditures)?

5. Are there any components of the tax proposal that are justified on the benefits received principle?

   - If so, what mechanisms are in place to determine that taxpayers who pay taxes for a particular government program are the same taxpayers who benefit from the provisions of that program?

6. Does the proposal maintain the distribution of taxes (i.e., is the proposal distributionally neutral)?

   - If not, who will be paying more in taxes and who will be paying less?
   - If so, what features of the proposal are in place to ensure that it will remain distributionally neutral?

7. What type of distributional analysis was done?

- What time period is covered? For example, does the distributional analysis measure the lifetime or annual effects of the tax system?
- How is ability to pay (income, consumption, or wealth) measured?
- What is the unit of analysis (individuals, households, or taxpaying units)?
- What assumptions are made about tax incidence (e.g., who is assumed to pay the corporate income tax)?
- What taxes are covered in the distributional analyses?
- What measures (e.g., tax rates, share of tax liability) are being used to calculate the distribution of tax burden?

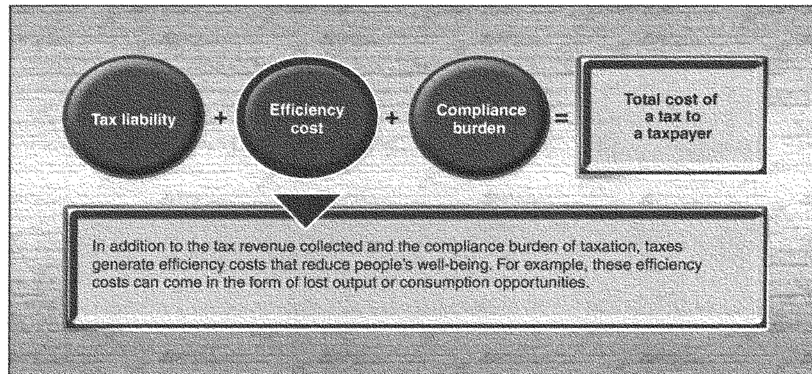
Economic Efficiency

One reason people bear taxes is they desire the benefits of government programs and services. As taxpayers, they balance the costs of taxes with the benefits of government. From a taxpayer's perspective, the cost of taxes includes more than the tax liability paid to the government. These costs include efficiency costs, which result from taxes changing the economic decisions that people make—decisions such as how much to work, how much to save, what to consume, and where to invest. These changes, referred to by economists as **distortions**, reduce people's well-being in a variety of ways that can include a loss of output or consumption opportunities. These reductions in well-being are efficiency costs, also called deadweight losses, excess burdens (excess because they are a cost in addition to the tax liability), or welfare losses.

Because taxes generally create inefficiencies, minimizing efficiency costs is one criterion for a good tax. However, the goal of tax policy is not to eliminate efficiency costs. The fact that taxes impose efficiency and other costs beyond the tax liability does not mean that taxes are not worth paying. The goal of tax policy is to design a tax system that produces the desired amount of revenue and balances economic efficiency with other objectives, such as equity, simplicity, transparency, and administrability. Moreover, as noted in the revenue section, the failure to provide sufficient tax revenues to finance the level of spending we choose as a nation gives rise to deficits and debt. Large sustained deficits could ultimately have a negative impact on economic growth and productivity.

Because taxes impose efficiency costs, the total cost of taxes to taxpayers is larger than their tax liability (the check they send to the U.S. Treasury). The total cost of taxes from a taxpayer's point of view is the sum of the tax liability, the efficiency costs, and the costs of complying with the system (which we discuss later), as shown in figure 11.

Figure 11: Efficiency Costs Are One Cost Taxpayers Face in Complying with the Tax System



Source: GAO.

From a national perspective tax revenue is not a cost. Tax revenue is not lost to the nation—it is moved from taxpayers' pockets to the Treasury in order to pay for the programs and services that the government provides. On the other hand, efficiency costs and compliance burden are costs from a national perspective because, for example, they can result in forgone production and consumption opportunities, as well as the loss of taxpayers' time spent on complying.

Tax systems can differ in the magnitude and nature of their efficiency costs. Differences in the base, rates, preferences, or tax-induced responses can all affect the extent one tax distorts when compared to another. Tax systems can cause distortions that affect both individual taxpayers and businesses. Figure 12 outlines some of the key issues to consider when thinking about the efficiency of the tax system.

Figure 12: Efficiency Overview

Issues to consider when thinking about tax system changes:

Revenue

Criteria for a good tax system:
- Equity
- Economic efficiency
- Simplicity, transparency, and administrability

Transition effects

An efficient tax system would not distort economic decisions. Tax-induced distortion of decisions to work, consume, and invest can reduce well-being. When thinking about **economic efficiency**, it may be helpful to consider the following issues:

- **Taxes and economic decision making**
- **Measuring economic efficiency**
- **Taxing work and savings decisions**
  - Work versus leisure
  - Savings versus consumption
  - Domestic versus foreign investment
  - Efficiency and economic growth
  - Efficiency versus fiscal effects
- **Realizing efficiency gains**

Sources: GAO (text); PhotoDisc (image).

Equity concerns may force a trade-off between fairness and efficiency. Progressive tax rate schedules are believed to have higher efficiency costs than a proportional schedule that raises the same amount of revenue. However, proponents of progressive rates are willing to trade off some efficiency in order to gain, in their view, more vertical equity. As will be shown below, efficiency costs, although they are hard to measure, often can be defined objectively. Nevertheless, they still must be balanced with the more subjective criteria like equity when reaching general conclusions about a tax proposal.

Taxes and Economic Decision Making

Economic efficiency can be thought of as the effectiveness with which an economy utilizes its resources to satisfy people's preferences. Economists generally agree that (from the perspective of efficiency and ignoring other considerations, such as equity) markets are often the best method for determining what goods and services should be produced and how resources should be allocated. Self-interest is assumed to motivate resource owners to try to use their resources in a manner that realizes the highest return. When resources are directed to their highest valued uses the economy is said to be efficient.

Inefficiencies reduce the economic well-being of people in the aggregate, since resources are not directed to their highest valued uses. By reallocating resources from lower valued uses to higher valued uses, the economic well-being of people can be increased. However, gains from reallocating resources from lower valued uses to higher valued uses may not be distributed in manner considered fair, that is, some people may lose because of the reallocation.

Generally, taxes alter or distort decisions about how to use resources, creating economic inefficiencies. By changing the relative attractiveness of highly taxed and lightly taxed activities, taxes distort decisions such as what to consume, how much to work, and how to invest. Households and firms generally respond to taxes by choosing more of lower taxed items and less of higher taxed items than they would have otherwise. The change in behavior can ultimately leave individuals with a combination of consumption and leisure that they value less than the combination that they would have chosen under a tax system that does not distort their behavior.

As a simple example of the effects of a tax distortion, suppose an investor is choosing between two investments, one that has an expected annual return of 10 cents on every dollar invested and a second that has an expected annual return of 15 cents. If the income from neither investment is taxed, or if the income is taxed equally, the investor will choose the second investment with its higher economic rate of return. However, if the first investment continues to be untaxed, while the second is subject to a 40 percent tax, the decision will be based on the investment's after-tax rate of return. In this case the after-tax return on the first investment continues to be 10 cents for every dollar invested, while the after-tax return on the second investment is now 9 cents. An investor would choose the first investment because it has a higher after-tax return. However, this results in a loss to the economy, or inefficiency. Society gains a 10 cent return from the first investment, all of which goes to the investor. Society would have gotten the 15 cent return from the second investment, 9 cents for the investor, and 6 cents for the government.

Note that a tax does not actually have to raise revenue to cause inefficiencies. In the previous example, the investor who chose the first investment would pay no tax. However, the tax system design has distorted the investor's decision-making and reduced output.

The example of the tax-preferred treatment of owner-occupied housing illustrates a trade-off between efficiency costs and using the tax system to achieve other social goals. Text box 5 presents some estimates of the efficiency costs of the tax treatment of owner-occupied housing due to large differences in effective tax rates across three major investment categories. However, even in situations such as the one outlined in the text box, where the tax preference imposes some efficiency costs, there may still be valid reasons for using tax preferences as a tool of government for achieving certain social and economic goals. As we note in the example, most economists agree that the tax-preferred treatment of owner-occupied housing distorts investment

patterns in the economy. The tax preference promotes the social goal of increased home ownership—a goal that many policymakers advocate.

Text Box 5: Tax Treatment of Owner-Occupied Housing Distorts Investment Choices and Lowers Wages

Compared to other types of investment, owner-occupied housing enjoys tax advantages primarily because the value that homeowners receive from housing services, which is a part of the return on their investment in housing, is excluded from taxation. Economists view these services, called imputed rent, as income in kind, which is valued at what the homeowner would receive as income if the house was rented. Under a pure income tax, imputed rent net of such costs as mortgage interest would be taxed. This tax treatment would help insure that investment in housing is taxed as other investments are taxed. As the table below shows, the tax advantages under the current system lead to lower marginal effective tax rates (METR) for housing relative to other investments.

METRs on Capital Income, by Source, in 2003

• Owner-occupied housing	2%
• Noncorporate investment	18%
• Corporate investment	32%

Source: Jane Gravelle, "The Corporate Tax: Where Has It Been and Where Is It Going?" *National Tax Journal*, vol. 57, no. 4 (2004): 903-23

Economists generally agree that the favorable treatment of owner-occupied housing, by lowering METR, distorts investment in the economy, resulting in too much investment in housing and too little business investment. The consequence of this is that businesses invest less in productivity-enhancing technology. This in turn results in employees receiving lower wages because increases in employee wages are generally tied to increases in productivity.

The resulting distortions from the tax-preferred treatment of owner-occupied housing lead to efficiency costs that have been estimated to be large. Gravelle's summary of estimates reports that the efficiency costs of the tax-preferred treatment of owner-occupied housing could be as much as 0.1 to 1 percent of GDP.

In addition to efficiency concerns, the tax treatment of owner-occupied housing also raises equity concerns. The current exclusions from income are more valuable to taxpayers in high tax brackets. Taxpayers in lower brackets receive a less valuable homeownership subsidy or no subsidy at all.

Although taxes generally result in efficiency losses, there are exceptions. In special cases, tax distortions may offset other inefficiencies, which can be caused by what economists call market failures. An example is an **externality** or **spillover**, where the benefits or costs of an activity are not fully captured by the individuals or firms undertaking the activity. Research and development is commonly cited as generating positive externalities—in some cases, the entity doing the research and development may produce knowledge that enters the public realm and is freely available to users. For example, some medical innovations, such as surgical techniques, cannot be patented. To the extent that benefits cannot be sold in a market, private firms that innovate will not reap the full financial benefits of the innovation and, therefore, will invest too little in research. Tax incentives for research might be one way to address the problem, but other governmental tools such as grants, loans, or regulations could also be considered. Efficient taxes are special cases—tax systems large enough to fund the federal government impose efficiency costs.

Measuring Economic Efficiency

While economists generally agree that the tax system imposes significant efficiency costs, estimating the magnitude of tax-related efficiency costs in an economy as complex as ours is extremely difficult. However, several attempts have been made to estimate the efficiency costs of parts of the tax system. For example, one study estimated the total efficiency cost of the personal income tax on labor income, which distorts labor supply decisions, to be from $137 billion to $363 billion in 1994.[3] A second study estimated the effects of the unequal taxation of savings and consumption to be about $45 billion in 1995.[4] Text box 5 summarized estimates of the efficiency losses associated with the tax treatment of owner-occupied housing as ranging from 0.1 to 1 percent of GDP. For further information on efficiency cost estimates, see GAO, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System*, GAO-05-878 (forthcoming).

These partial estimates indicate the significant uncertainty surrounding the magnitude of tax-induced efficiency costs. Nevertheless, they suggest that the overall efficiency costs imposed by the tax system are large—on the order of several percentage points of GDP.

As a result of these difficulties, simple rules of thumb are commonly used to provide rough estimates of the efficiency costs of taxes. Text box 6 describes two such rules of thumb.

Text Box 6:Rules of Thumb for Estimating Efficiency Costs

Because of the difficulty of measuring efficiency costs, several rules of thumb have been used to approximate efficiency costs in certain situations. These rules suggest that efficiency costs from taxes may be considerable.

Two commonly cited rules are as follows:

- According to OMB guidance, the efficiency cost of a tax increase, which should be included as part of the total cost when calculating the benefits and costs of a government spending project, is equal to 25 percent of the tax revenue collected used to fund the project.
- Some economists agree that the efficiency cost of a tax increases with the square of the tax rate: a 50 percent tax increase, for example, from 25 percent 37.5 percent, would more than double the efficiency cost. For this reason, progressive tax rate schedules, which have higher top marginal rates, are believed to have higher efficiency costs than a proportional schedule that raises the same amount of revenue.

[3]Martin Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," *The Review of Economics and Statistics*, vol. 81, no. 4 (1999).

[4]Jinyong Cai and Jagadeesh Gokhale, "The Welfare Loss From a Capital Income Tax," *Federal Reserve Bank of Cleveland Economic Review*, vol. 33, no. 1 (1997).

The extent to which tax reform can reduce such tax-induced inefficiencies and thus increase our economic well-being depends on the design of a reformed system. All practical tax systems distort some decisions so it is not possible to eliminate all the efficiency costs associated with taxes. The magnitude of the efficiency costs in a reformed tax system would depend on such design features as the treatment of savings versus consumption, the number of tax expenditures, and the level and progressivity of tax rates. While some economists believe that a pure consumption tax with no preferences and a flat rate would reduce efficiency costs relative to the current tax system, such a pure tax may not be a feasible alternative because of equity and other concerns.

In addition, as has been discussed, the revenue consequences of tax reform have economic effects. The efficiency gains from a reformed tax system could be offset if the new system increases long-term deficits.

Taxing Work and Savings Decisions

In part because of the difficulty of measuring the efficiency cost of taxes, discussions of the impact of taxes on the economy sometimes focus on the effect that taxes have on changes in the output of the economy, labor supply, or other such economic variables. However, such changes do not necessarily measure efficiency costs. Efficiency loss is the difference between individuals' well-being with a tax and individuals' well-being under a revenue neutral, hypothetical tax that does not distort, called a lump sum tax.

Three choices commonly discussed are the choice between work and leisure, the choice between consumption and saving, and the choice between domestic and foreign investment. Intertwined with effects that taxes have on these choices is the effect of taxes on economic growth.

Work versus leisure: Taxes—both income and consumption taxes—can affect the decisions that people make about how much time to devote to work or leisure in two ways. First, taxes may increase the incentive to work because workers must work more to maintain their after tax income. Second, taxes may reduce the incentive to work because workers earn less from an additional hour of work. The net effect may be no change to the overall supply of labor. However, even in this case, there is still an efficiency cost, which is determined by the second effect. By reducing hourly after tax earnings, income and consumption taxes distort decisions about how many hours to devote to work or leisure.

Empirical research generally shows that at least for primary wage earners, decisions about labor force participation are not very responsive to taxes. However, decisions about labor force participation by secondary wage earners have been shown to be more responsive to changes in the tax system.

Consumption versus savings: Taxes on capital reduce the after-tax return to savings. In effect, this makes future consumption (savings) more expensive relative to current consumption and thus has the potential to distort savings decisions. While research has shown that the demand for some types of savings, such as the demand for **tax-exempt bonds**, is responsive to changes in the tax system, there is greater uncertainty about the effects of changes in the tax system on other choices, such as aggregate savings.

Domestic versus foreign investment: Taxes on income from capital can affect the location of investment by changing the relative after-tax return on domestic and foreign investment. This matters because the location of investment can affect the income of U.S. citizens. The income of people working in the United States is closely tied to their productivity, which generally increases with the amount of domestic investment. At the same time, U.S. citizens who own capital can earn higher incomes by investing their capital—in the United States or abroad—wherever it earns the highest rate of return. In a world of increasing capital mobility due to increasing trade and decreasing communication and transportation costs, the effect of taxes on the location of investment is even more important than in the past

Efficiency and economic growth: Removing or reducing distortions caused by the tax system can affect the size of the economy. Increasing the efficiency of the tax system can expand the economy through a temporary increase in the rate of growth. An increase in efficiency is an increase in well-being that comes from using existing resources in a better way. Efficiency raises capacity to a higher level but does not necessarily continue to increase it without additional resources. Such an increase could show up as a temporary increase in the growth of the economy. However, the long-term growth rate depends on the rates of change in population, the capital stock, and technology. Changes to the tax system that would increase economic efficiency could increase the long-term growth rate if they increase the rate of technological change. Thus, tax changes that increase economic efficiency may or may not result in an increased long-term rate of economic growth.

Efficiency versus fiscal effects: As has been discussed, taxes may have both efficiency effects and fiscal policy effects. Government spending in excess of government revenues creates deficits, which if large enough and continued over a period of time will ultimately have a negative impact on economic growth and productivity to the extent that they absorb savings that would otherwise finance investment in the private economy. Thus, the gain from changing the tax system to increase economic efficiency could be offset if the tax changes increase the deficit.

Tax policies designed to enhance economic efficiency can be designed independently of fiscal policy. For example, the Tax Reform Act of 1986 was designed, in part, to achieve increased efficiency by broadening the tax base and lowering rates in a way that was revenue neutral. Such a revenue neutral change would have no effect on deficits and debt.

Realizing Efficiency Gains

The extent to which efficiency gains are realized by switching to an alternative tax system depends on at least two factors. First, the efficiency gains of switching to a new tax system depend on the extent to which that tax system reduces distortions caused by tax preferences, rate differences, sectoral differences, and switching the base from income to consumption. Second, the change to a new tax system may not improve the overall efficiency of the economy if the distorting tax incentives eliminated by switching to a new tax system are replaced with government spending or regulation that provides the same incentives.

Key Questions

1. Does the proposal tax income, spending, assets, and investments differentially?
   - Which types of income, spending, assets, and investments are tax preferred?
   - Which decisions are likely to be distorted?
2. What social goals, if any, is the tax proposal trying to promote?
   - Is there an efficiency justification for the goal, or is the goal justified on other grounds, such as equity?
3. Do estimates of the cost of achieving the goal include efficiency costs?
4. What are the trade-offs between equity, efficiency, and the other criteria?
5. Is the tax proposal accompanied by estimates of the efficiency gains or losses to be realized by the new tax system?
   - Is the tax proposal accompanied by estimates of economic activity (e.g., change in labor supply or change in GDP) that will be encouraged or discouraged by the new tax system?
   - Is the proposal accompanied by estimates of the efficiency loss or gain associated with these changes in economic activity?
6. How does the tax change affect leisure versus work decisions?
7. How does the tax change affect savings versus consumption decisions?
8. How does the tax change affect decisions about foreign versus domestic investment?

9. How does the tax change affect choices between different types of investments and different types of consumption?

10. Is the tax proposal likely to increase economic growth?

    - Is the growth achieved through a onetime rearranging of resources?
    - Is the growth achieved through a permanent increase in the rate of growth?
    - Does the tax proposal contain estimates of its effect on growth (often measured by changes in GDP) and estimates of the costs of achieving the growth (such as reduced leisure time)?

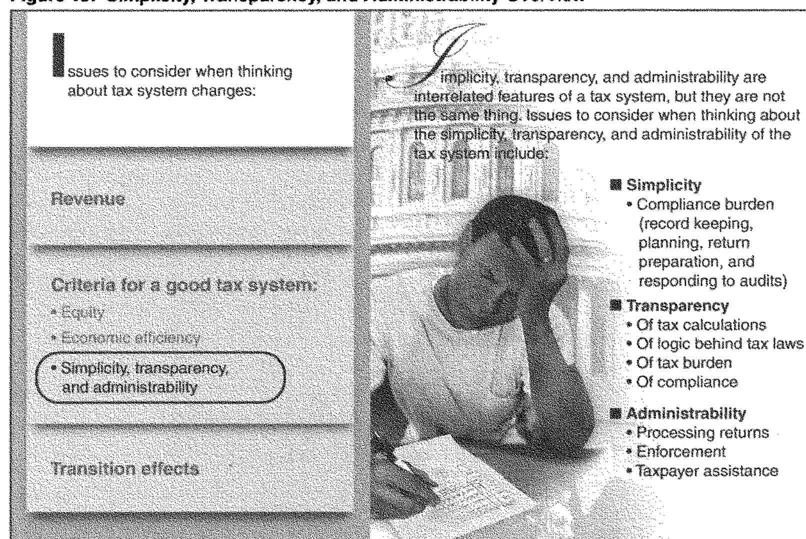
11. In addition to efficiency effects, will the proposal have other economic effects by increasing or reducing the deficit?

Simplicity, Transparency, and Administrability

Simplicity, transparency, and administrability are interrelated and desirable features of a tax system. Simple tax systems are, in many cases, the most administrable, and tax systems that are both simple and administrable are often considered to be the most transparent. However, even though there is considerable overlap between simplicity, transparency, and administrability, they are not identical. (See fig. 13.)

Because there is considerable overlap between these concepts, even though they are not the same thing, we combine simplicity, transparency, and administrability into one section and discuss them as a group. While others may not use the same terminology, the debates implicitly use the same or very similar criteria.

Figure 13: Simplicity, Transparency, and Administrability Overview



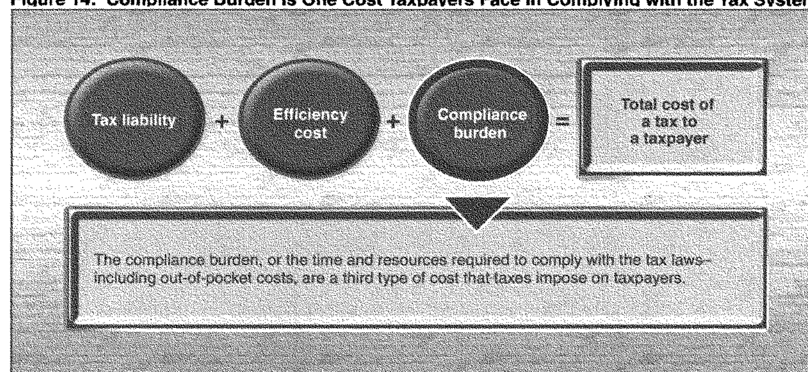
Sources: GAO (text); PhotoDisc (images).

Simplicity

Simple tax systems impose less of a compliance burden on the taxpayer than more complex systems. Taxpayer compliance burden is the value of the taxpayer's own time and resources, along with any out-of-pocket costs to paid tax preparers and other tax advisors, invested to ensure compliance with tax laws. As figure 14 demonstrates, in addition to the actual tax payments remitted to the government and

the efficiency costs of taxation that we discussed earlier, compliance burden is the third cost that the tax system imposes on taxpayers. Compliance costs include the value of time and resources devoted to (1) record keeping, (2) learning about requirements and planning, (3) preparing and filing tax returns, and (4) responding to IRS notices and audits. Taxpayers can either choose to fulfill these responsibilities on their own or they can hire paid preparers to aid them in complying with the tax code. According to IRS, over 61 percent of returns filed in 2003 included a paid preparer's signature, contributing to considerable out-of-pocket costs to taxpayers.

Figure 14: Compliance Burden Is One Cost Taxpayers Face in Complying with the Tax System



Source: GAO.

The current tax system has grown increasingly complex over time, and many believe that taxpayer compliance burden has grown accordingly. The amount of time that taxpayers actually spend filling out tax forms may only constitute a small amount of the overall compliance burden. For many taxpayers, the bulk of the compliance burden comes in the form of tax planning and record keeping. For example, taxpayers spend time determining how the growing number of tax expenditures will affect their respective tax liabilities. The Treasury Department listed 146 tax expenditures in 2004, up about 26 percent since the last major tax reform legislation in 1986. Frequent changes in the tax code reduce its stability, contributing to compliance burden by making tax planning more difficult and increasing uncertainty about future tax liabilities. Moreover, an increasing number of taxpayers are becoming subject to the individual AMT. Determining how the provisions of the AMT affect a taxpayer's tax liability adds to the compliance burden.

Compliance burden is difficult to measure in part because it is difficult to measure the amount of time taxpayers spend planning and preparing their returns and the value

of that time.[5] Nevertheless, researchers have made several attempts to quantify the costs that taxpayers incur while complying with the tax system. Most estimates suggest that taxpayer compliance burden falls between $100 billion and $200 billion each year.

Because compliance burden is difficult to measure, other, less direct measures of burden are frequently used. These include the number of pages in the tax code, the number of IRS forms to fill out, the length of tax instructions, and the number of lines on the tax form. These measures are believed to be correlated with compliance burden, but the correlation is recognized to be far from perfect. In some situations, longer instructions and more details on a form may reduce compliance burden by clarifying what a taxpayer must do to comply with the tax laws. These alternative measures of simplicity may provide some insight into the simplicity of the tax code, but they do not directly measure the impact that the tax code has on the costs to taxpayers of complying with the nation's tax laws.

The intergovernmental effects of tax policy changes can also affect compliance burden. Due to the close links between the federal tax system and the tax systems in many states, changes to the federal tax system could have implications for the compliance burden that taxpayers face when completing their state tax returns. For example, if the federal government switched from the current income tax system to a national retail sales tax, or a different type of consumption tax, but states—most of which have developed income tax forms that are based in large part on an individual's federal tax return—maintain their income tax requirements, then overall taxpayer burden would not likely be greatly reduced. Taxpayers might not have to file federal tax returns, but many, if not all, of the record keeping and administrative tasks would still exist when complying with the state-level income tax requirements.

Transparency

A transparent tax system is one that taxpayers are able to understand. Transparent tax systems impose less uncertainty on taxpayers, allowing them to better plan their decisions about employment, investment, and consumption. This leads to more confidence that they can accurately predict their future tax liabilities and contributes to the credibility of the tax system. Tax systems that are difficult to comply with and administer may lack transparency. A nontransparent tax system could be difficult to administer because tax administrators may have difficulty consistently applying the law to taxpayers in similar situations. In this sense, transparency is closely linked to

[5]It is difficult to measure the amount of time that taxpayers spend planning and preparing their returns because, among other reasons, when surveyed, taxpayers may overstate or understate the amount of time that they spent depending on how straightforward or complicated their returns were (i.e., how frustrating the experience was). Additionally, there is no consensus among researchers regarding the appropriate monetary value to be assigned to each hour of time spent on tax compliance activities.

the simplicity and administrability of the tax system. Transparent tax systems include the following elements:

- *Taxpayers can easily calculate their liabilities*: Taxpayers can easily follow instructions and tax rate tables in order to determine their tax base, their marginal tax rate, and their tax liability to the government.

- *Taxpayers grasp the logic behind tax laws and tax rates:* Taxpayers can look at a tax form or a tax rate schedule and understand lawmakers' reasoning. For example, whether or not they agree with it, taxpayers are likely to be able to comprehend the logic behind a progressive rate schedule.

- *Taxpayers know their own tax burden and the tax burden of others:* Irrespective of who actually writes a check to the government, taxpayers can identify who actually bears the burden of a tax. For example, the payroll tax is not transparent to the extent that taxpayers in general are unaware of the incidence of the tax. Even though payroll taxes are divided equally between employees and employers, economists generally agree that employees bear the entire burden of payroll taxes in the form of reduced wages.

- *Taxpayers are aware of the extent of compliance by others:* Taxpayers understand the extent to which the tax laws are enforced, meaning that they know how likely their friends, neighbors, and business competitors are to actually pay what they owe.

While the concept of transparency is closely linked to simplicity and administrability, they are not always the same. For example, some tax provisions may be simple but not transparent. The corporate tax rate schedule example in table 4 illustrates this. While determining taxable income under the corporate income tax is often a complex procedure, it is relatively simple for corporations to calculate their tax liabilities by referring to tax tables published by the IRS once this income has been determined. However, the logic underlying the marginal tax rates in the corporate tax schedule is not transparent. The marginal rate structure is progressive up to taxable income of $335,000, but marginal rates then decrease before increasing again and then decreasing once more.

Table 4: The Corporate Tax Rate Schedule: Simple but Not Transparent

Tax bracket (taxable corporate income)	Marginal tax rate in the tax bracket
$0 to $50,000	15%
$50,001 to $75,000	25%
$75,001 to $100,000	34%
$100,001 to $335,000	39%
$335,001 to $10,000,000	34%
$10,000,001 to $15,000,000	35%
$15,000,001 to $18,333,333	38%
Over $18,333,333	35%

Source: IRS instructions for Form 1120.

Some experts who have written on transparency believe that the tax code's transparency has declined in recent years. Numerous tax provisions have made it more difficult for taxpayers to understand how their tax liability is calculated, the logic behind the tax laws, and what other taxpayers are required to pay.

Administrability

Administrable tax systems allow the government to collect taxes as cost effectively as possible. Even though tax administration is usually considered to be IRS's responsibility, taxpayers, employers, and financial intermediaries such as banks and tax professionals play important roles in administering the tax code. For example, under the current system, banks file information returns about the amount of interest earned by deposit holders that assist IRS in determining tax liabilities. There is overlap between the simplicity and the administrability of a tax system, but simple tax systems are not always easier to administer.

Comparing the Administrability of Tax Systems

All tax systems have administrative costs. A more administrable tax system collects more of the statutorily required tax at a lower cost per dollar collected. However, there are trade-offs between the level of compliance and administrative costs to IRS. The costs of enforcing the tax code sufficiently to achieve complete compliance from all taxpayers are likely to be prohibitive. In addition, the costs of administrating the tax code are not limited to the budgetary costs of IRS. As noted above, some of these costs are shared by other parties in the form of increased compliance burden. Finally, the costs can be affected by the use of different enforcement policies.

The following summarizes the key tasks required for administering tax systems:

- *Processing tax returns and payments:* Currently, IRS processes over 130 million individual income tax returns each year, which taxpayers file electronically or through the mail. Under today's technology and any proposed alternatives to the current system, a return-free tax system may be difficult to implement.

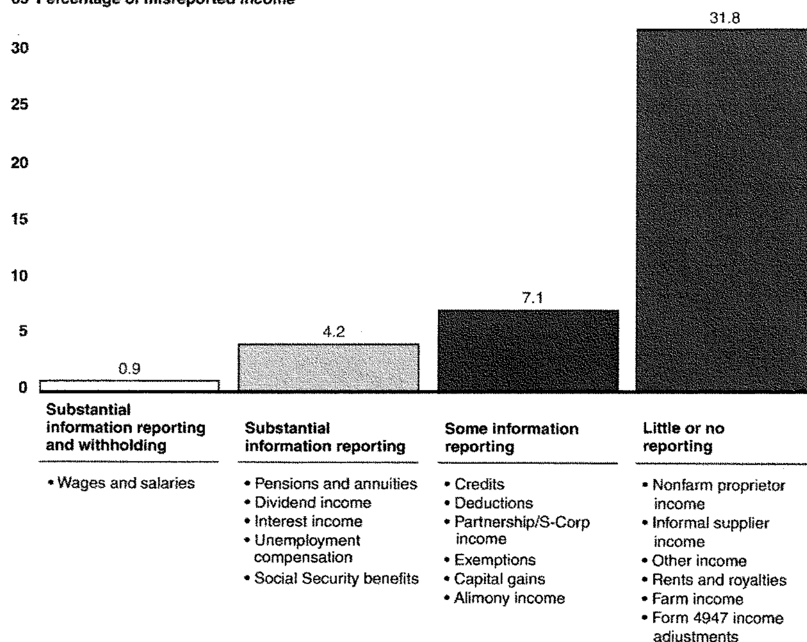
- *Enforcing the tax code:* Perhaps the government's most challenging role in administering the tax system is detecting and penalizing taxpayer noncompliance. Under the current system, withholding and information reporting are important enforcement tools that generally increase compliance rates. However, they are not sufficient by themselves, and IRS devotes considerable resources to collecting taxes owed but not remitted.

- *Providing taxpayer assistance:* In order to reduce compliance burden and increase compliance rates, tax administrators generally provide assistance to taxpayers by such means as publishing forms and answering questions.

A tax change proposal may reduce the cost of some administrative tasks but raise others. Compared to the current personal income tax, consumption taxes like an NRST or a VAT reduce the number of filers because only businesses file. As a result, they reduce processing costs and eliminate the compliance burden on individual taxpayers. However, other aspects of enforcement costs may increase because administrators would no longer be able to rely on withholding and information returns as enforcement tools.

The way the tax system is structured by Congress can affect how it is administered, and this can affect compliance. For example, taxes withheld from employees and taxes that have information reporting requirements have lower income misreporting rates than other taxes. As figure 15 shows, taxes on wage and salary income, which is subject to both withholding and information reporting, have the lowest rate of misreported income; whereas taxes on income from such sources as self-employment (nonfarm proprietor income) have the highest rate of misreported income.

Figure 15: Taxpayer Noncompliance Categorized by Amount of Withholding and Information Reporting, 1992



Source: IRS.

Regardless of the amount of withholding and **third-party information reporting** required, other government enforcement activities are likely to be needed under any proposed tax system in order to ensure that taxpayers comply with the tax code. Proposals that simplify the tax code and administrative efforts to aid honest taxpayers in complying with the tax laws could increase compliance; however, under any system, costly enforcement efforts, perhaps including face-to-face audits of taxpayers, will likely always be needed to help detect and penalize dishonest taxpayers.

Measuring administrative costs is difficult. Budgetary costs are easily measured: IRS's budget in fiscal year 2004 was $10.2 billion. However, as discussed earlier, the costs of other parties in tax administration are harder to determine. Compliance burden estimates range from $100 billion to $200 billion. Despite the uncertainty, the range of estimates indicates that compliance burden is likely to considerably outweigh IRS's budgetary costs.

Changes in the technology of tax administration and in the tax code may have had offsetting and, as yet, unmeasured effects on the costs of tax administration. On the one hand, recent innovations in computer software and electronic financial transactions have made it easier to administer the tax code. On the other hand, since the last major tax reform initiative in 1986, the number of special rates, credits, deductions, and other provisions in the tax code have increased. This added complexity has made the tax code more difficult to administer.

Trade-offs between Equity, Economic Efficiency, and Simplicity, Transparency, and Administrability

While the concept of administrability is closely linked to the concepts of simplicity and transparency, they are not always the same. For example, a national retail sales tax would be a relatively simple form of taxation for taxpayers to understand. At the same time, a national retail sales tax could present administrative difficulties because it would be difficult to distinguish between similar commodities that are tax exempt and those that are not, and to distinguish retail sales, which are taxed, from sales to other companies, which are not taxed.

Similarly, just because a tax is administrable does not necessarily mean it would be transparent. For example, although payroll taxes are fairly easy to administer, who pays them in an economic sense is not necessarily transparent. As we discussed earlier, many economists agree that employees bear the entire burden (both the employer and employee share) of payroll taxes, making the incidence of payroll taxes nontransparent.

Improving the simplicity, transparency, and administrability of the tax system may affect the equity and efficiency of the tax system. Simplified, transparent, and administrable tax codes are generally thought to enhance efficiency because (1) taxpayers can redirect resources that would have been used to comply with the tax code to other, more productive purposes and (2) these tax systems have fewer incentives that distort decision making about work, savings, and investment. However, proposals to simplify the tax system may reduce equity because many tax provisions that are complex and difficult to comply with are also designed to promote fairness.

Key Questions

1. What impact is the tax proposal likely to have on the compliance burden that taxpayers face?

    - Will more or fewer taxpayers be required to fill out tax forms and file them with IRS?
    - What information will taxpayers be required to provide on the tax forms?
    - Does the proposal contain any estimates of its effect on compliance burden?

2. Will taxpayers' planning responsibilities (record keeping, research, etc.) likely increase or decrease in comparison to those under the current tax system?

3. Is the proposed tax system transparent?

   - Can taxpayers identify their tax liability easily?
   - Can taxpayers understand the logic behind the tax that they are paying?
   - Do taxpayers know what their true tax burden is (i.e., do they understand the incidence of the tax system)?
   - Do taxpayers understand the incidence of the tax system in terms of the tax burdens of other taxpayers?
   - Are taxpayers aware of the extent of compliance by others?

4. How would the tax system be administered?

   - What would be the role of taxpayers, employers, information return providers, and the IRS under the proposal?
   - Does the proposal contain estimates of its effect on budgetary costs?
   - Does the proposal contain any information about how administrative costs would be shared?

5. What would be the proposal's impact on IRS?

   - How would IRS functions of processing, compliance, collections, and taxpayer assistance be affected?
   - What enforcement tools (e.g., withholding and information reporting) would be added or taken away from tax administrators?
   - Does the proposal contain information about its likely effect on compliance?

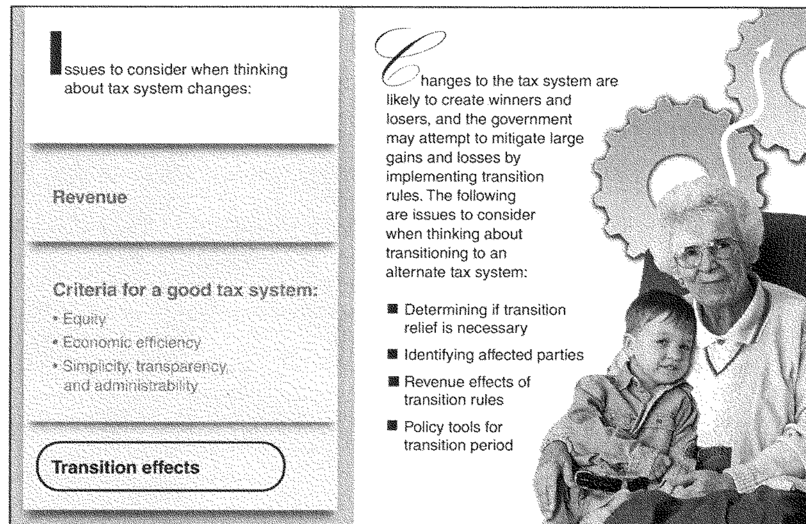
6. Are there trade-offs between the simplicity, transparency, and administrability of the proposed tax system?

7. Under the tax proposal, have efforts to enhance the simplicity, transparency, and administrability of the tax system resulted in trade-offs with respect to the equity and efficiency of the proposal?

Transitioning to a Different Tax System

Transition rules are sometimes proposed when switching to an alternative tax system. The rules are often intended to compensate certain people or entities whose losses are determined to be inequitable. However, not all tax experts agree that transition rules are appropriate when implementing changes to the tax code. Since transition rules are short-term tax policies, they should be judged by the same criteria for a good tax system that we discussed earlier. Many of the same trade-offs between the criteria that exist when considering tax reform proposals are also relevant when considering how to move from the current tax system to an alternative tax system. (See fig. 16.)

Figure 16: Transition Issues Overview



Sources: GAO (text); Dynamic Graphics (images).

Deciding if Transition Relief Is Necessary

Changes to the tax code can create winners and losers. Taxpayers' losses, which are more often discussed in debates than gains resulting from tax policy changes, may be more obvious when tax changes increase government revenues or if the changes are

designed to be revenue neutral. However, even tax decreases can create losers depending on whether the tax burden is redistributed, spending cuts are made, or the tax burden on future generations is increased. Deciding if transition relief is necessary involves how to trade off between equity, efficiency, simplicity, transparency, and administrability.

Decisions about whether to tax previously accumulated savings when switching to a consumption tax provide an example of the trade-offs that need to be considered when determining if transition relief is merited. Some argue that switching from the current tax system to a consumption tax would merit some transition relief for equity reasons because accumulated savings, which may have already been taxed once under the income tax system, would be subject to a second tax when used for consumption purposes. In other words, those who had saved previously would be taxed higher than those just beginning to save. Proponents for transition relief argue that taxpayers who accumulated savings have an implicit contract with the government that savings would not be taxed when withdrawn. The notion that taxpayers rely on the continued existence of government policy when they make economic decisions is one of the key equity justifications for offering transition relief.

However, not everyone agrees that transition relief is justifiable based on equity grounds. Opponents of transition relief argue that taxpayers knowingly accept the risk that government policy may change when they make decisions, such as how much to save, and therefore do not need to be compensated for any losses that result from switching to an alternative tax system.

There are also trade-offs between equity and efficiency that should be considered when thinking about transition relief. The efficiency gains that could be realized by switching to a consumption tax could be negated if the government offered transition relief to taxpayers. Taxing accumulated savings is economically efficient because doing so does not distort work or savings behavior—taxpayers cannot avoid paying the tax by changing their behavior to work or save less. Offering transition relief would reduce the revenue gain from taxing accumulated savings, thereby requiring higher consumption tax rates.

Finally, developing and implementing transition rules could add a significant amount of complexity to the tax system—a characteristic of the tax system that the switch to an alternative tax system was likely intended to reduce. The new complexity would be temporary, phasing out with the transition rules.

Identifying Affected Parties

Identifying winners and losers, the amount of gains and losses, and effective mitigation policies is complicated by the different ways tax changes can affect taxpayers. Tax law changes, by definition, affect taxpayers' future liabilities. In some cases, those future tax changes are capitalized into the prices of marketable assets.

For example, changes in the tax treatment of owner-occupied housing have the potential to affect current housing prices. In other cases, such as wealth accumulated in a savings account, tax law changes might affect the value of the wealth but do not change the price of a marketable asset. In still other cases, the after-tax return to future behavior, such as hours worked, is altered. Regardless of how taxpayers feel the impact of a tax change, the impact on their ability to consume over time is the same (assuming everything else is constant).

Revenue Effects of Transition Relief

If transition relief is provided to compensate taxpayers for financial losses due to changes in the tax code, then revenues equivalent to these losses will need to be found from other sources, assuming the proposal is revenue neutral. One alternative source of revenue would be to tax those who have received windfall gains from the policy changes. However, debates about transition relief typically center around how to handle taxpayers who are likely to suffer windfall losses and not on how to impose special taxes on those who experience windfall gains.

Policy Tools for Implementing Transition Rules

The two most commonly discussed policy tools for transitioning to an alternative tax system are **grandfather clauses** and **phase-in rules**.

- *Grandfather clauses*: Grandfather clauses are typically used to exempt people who would be subject to a new rule from the provisions of that rule. Grandfather clauses are generally used to exempt current assets or investments from new tax rules in order to protect taxpayers who purchased those assets from being penalized by unexpected changes to the tax system. One problem with grandfather clauses is that over time they can lead to unequal tax treatment of similar assets.

- *Phase-in periods for new laws*: Another form of transition relief would be to phase in new legislation over a period of time in order to reduce the effects that new tax laws would have on taxpayers.

- *Combination of grandfather clauses and phase-in periods*: It would also be possible to develop transition rules that allow for certain assets/investments to be grandfathered and others subject to phased-in tax laws. One possible variant previously outlined by the Treasury Department would be to apply new tax laws immediately to all new assets but phase in the tax laws on existing assets.

Key Questions

1. Does the proposal include transition rules?

   - If so, what are they?
   - What gains and losses are the rules intended to mitigate?
   - Who bears these gains or losses?

2. What are the expected revenue effects of the transition rules?

   - If the proposal is intended to be revenue neutral, what additional revenue sources will be used during the transition period?

3. How will the transition rules affect the equity of the tax system as a whole?

   - Why were some taxpayers selected for transition relief but not others?
   - Who will pay for the transition relief?

4. How will the transition rules affect the overall efficiency of the tax system?

   - Do the transition rules have efficiency costs that offset some of the gains from changing the tax system?
   - Do estimates of these efficiency costs exist?

5. How will the transition rules affect the overall simplicity, transparency, and administrability of the tax system?

Appendix I: Key Questions

Section I: Revenue Needs—Taxes Exist to Fund Government

1. What current taxes would the proposal change?

   - Does the proposal change personal income taxes, social insurance taxes, corporate income taxes, and/or estate and gift taxes?

2. What is the nature of the proposed change to the tax system?

   - Does the proposal change the tax base from income to consumption?
   - Does the proposal include tax expenditures?
   - Does the proposal change the tax rates?
   - Does the proposal change the collection points for the tax?

3. How will the proposed change affect total revenues?

   - Are proposed changes to the tax code likely to be revenue neutral?
   - If not, will they generate more or less revenue than the current tax laws?

4. What effect would the proposal have on the nation's projected budgets and long-term fiscal outlook?

- Does the proposal take into consideration the sizable long-term fiscal gap that the country faces?

5. What tax expenditures are included in the proposal, and what tax expenditures, if any, have been removed from the current tax system?

   - Are the social and economic goals of the tax expenditures likely to be achieved and worth the cost in lost revenue?
   - When the total costs of a program are considered, would it be less costly to implement the program as a tax expenditure or as a spending program?

6. If the proposal changes the tax base, the tax rates, or the collection points, how would these changes alter the amount of revenue that the government is able to collect?

7. What implications, if any, would the proposal have on the ability of state and local governments to collect tax revenues?

- Would the proposal tax the same base that many states rely on?
- Would the proposal allow many states to continue to rely on the federal tax base as a starting point for determining state taxes?

Section II: Criteria for a Good Tax System

Equity

1. How is a taxpayer's ability to pay broadly defined:

    - Income?
    - Consumption?
    - A broader definition of overall wealth?

2. What factors other than income, such as medical expenses, number of dependents, and so forth, does the proposal account for when considering a taxpayer's ability to pay taxes?

3. Will taxpayers with equal ability to pay taxes pay the same amount?

    - If not, what provisions of the proposal do not adhere to the principle of horizontal equity?

4. How will the tax system tax people with differing ability to pay?

    - Are the statutory tax rates progressive, proportional, or regressive?
    - Are the average effective tax rates progressive, proportional, or regressive (accounting for credits, deductions, and other tax expenditures)?

5. Are there any components of the tax proposal that are justified on the benefits received principle?

    - If so, what mechanisms are in place to determine that taxpayers who pay taxes for a particular government program are the same taxpayers who benefit from the provisions of that program?

6. Does the proposal change the distribution of taxes (i.e., is the proposal distributionally neutral)?

    - If not, who will be paying more in taxes and who will be paying less?
    - If so, what features of the proposal are in place to ensure that it will remain distributionally neutral?

7. What type of distributional analysis was done?

- What time period is covered? For example does the distributional analysis measure the lifetime or annual effects of the tax system?
- How is ability to pay (income, consumption, or wealth) measured?
- What is the unit of analysis (individuals, households, or taxpaying units, etc.)?
- What assumptions are made about tax incidence (e.g., who is assumed to pay the corporate income tax)?
- What taxes are covered in the distributional analyses?
- What measures (e.g., tax rates, share of tax liability) are being used to calculate the distribution of tax burden?

Efficiency

1. Does the proposal tax income, spending, assets, and investments differentially?

   - Which types of income, spending, assets, and investments are tax preferred?
   - Which decisions are likely to be distorted?

2. What social goals, if any, is the tax proposal trying to promote?

   - Is there an efficiency justification for the goal, or is the goal justified on other grounds, such as equity?

3. Do estimates of the cost of achieving the goal include efficiency costs?

4. What are the trade-offs between equity, efficiency, and the other criteria?

5. Is the tax proposal accompanied by estimates of the efficiency gains or losses to be realized by the new tax system?

   - Is the tax proposal accompanied by estimates of economic activity (e.g., change in labor supply or change in gross domestic product (GDP)) that will be encouraged or discouraged by the new tax system?
   - Is the proposal accompanied by estimates of the efficiency loss or gain associated with these changes in economic activity?

6. How does the tax change affect leisure versus work decisions?

7. How does the tax change affect savings versus consumption decisions?

8. How does the tax system affect decisions about foreign versus domestic investment?

9. How does the tax change affect choices between different types of investments and different types of consumption?

10. Is the tax proposal likely to increase economic growth?

    - Is the growth achieved through a onetime rearranging of resources?
    - Is the growth achieved through a permanent increase in the rate of growth?
    - Does the tax proposal contain estimates of its effect on growth (often measured by changes in GDP) and estimates of the costs of achieving the growth (such as reduced leisure time)?

11. In addition to efficiency effects, will the proposal have other economic effects by increasing or reducing the deficit?

Simplicity, Transparency, and Administrability

1. What impact is the tax proposal likely to have on the compliance burden that taxpayers face?

    - Will more or fewer taxpayers be required to fill out tax forms and file them with the Internal Revenue Service (IRS)?
    - What information will taxpayers be required to provide on the tax forms?
    - Does the proposal contain any estimates of its effect on compliance burden?

2. Will taxpayers' planning responsibilities (record keeping, research, etc.) likely increase or decrease in comparison to those under the current tax system?

3. Is the proposed tax system transparent?

    - Can taxpayers identify their tax liability easily?
    - Can taxpayers understand the logic behind the tax that they are paying?
    - Do taxpayers know what their true tax burden is (i.e., do they understand the incidence of the tax system)?
    - Do taxpayers understand the incidence of the tax system in terms of the tax burdens of other taxpayers?
    - Are taxpayers aware of the extent of compliance by others?

4. How would the tax system be administered?

    - What would be the role of taxpayers, employers, information return providers, and the IRS under the proposal?
    - Does the proposal contain estimates of its effect on budgetary costs?
    - Does the proposal contain any information about how administrative costs would be shared?

5. What would be the proposal's impact on IRS?

- How would IRS functions of processing, compliance, collections, and taxpayer assistance be affected?
- What enforcement tools (e.g., withholding and information reporting) would be added or taken away from tax administrators?
- Does the proposal contain information about its likely effect on compliance?

6. Are there trade-offs between the simplicity, transparency, and administrability of the proposed tax system?

7. Under the tax proposal, have efforts to enhance the simplicity, transparency, and administrability of the tax system resulted in trade-offs with respect to the equity and efficiency of the proposal?

Section III: Transitioning to a Different Tax System

1. Does the proposal include transition rules?

   - If so, what are they?
   - What gains and losses are the rules intended to mitigate?
   - Who bears these gains or losses?

2. What are the expected revenue effects of the transition rules?

   - If the proposal is intended to be revenue neutral, what additional revenue sources will be used during the transition period?

3. How will the transition rules affect the equity of the tax system as a whole?

   - Why were some taxpayers selected for transition relief but not others?
   - Who will pay for the transition relief?

4. How will the transition rules affect the overall efficiency of the tax system?

   - Do the transition rules have efficiency costs that offset some of the gains from changing the tax system?
   - Do estimates of these efficiency costs exist?

5. How will the transition rules affect the overall simplicity, transparency, and administrability of the tax system?

Appendix II: Selected Bibliography and Related Reports

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Appendix III: Glossary

Term	Definition
Ability to Pay Principle	A concept of tax fairness that states that people with different amounts of wealth, income, or other levels of well-being should pay tax at different rates. Wealth includes assets such as houses, cars, stocks, bonds, and savings accounts. Income includes wages, interest, dividends, and other payments.
Adjusted Gross Income (AGI)	All income subject to taxation under the individual income tax after subtracting certain deductions, such as certain contributions for individual retirement accounts, and alimony payments. Personal exemptions and the standard or itemized deductions are also subtracted from AGI to determine taxable income.
Alternative Minimum Tax (AMT)	A separate tax system that applies to both individual and corporate taxpayers. It parallels the income tax system but with different rules for determining taxable income, different tax rates for computing tax liability, and different rules for allowing the use of tax credits.
Average Tax Rates	The total amount of tax a taxpayer pays divided by some measure of his or her income. In the current tax system, average tax rates are sometimes presented as the amount of tax a taxpayer pays divided by his or her taxable income. Average effective tax rates differ in that they are developed using a broader measure of total income than taxable income.
Benefits Received Principle	A concept of tax fairness that states that people should pay taxes in proportion to the benefits they receive from government goods and services.
Capital Gains	A capital asset's selling price less its initial purchase price. Investments that have been sold at a profit are called realized capital gains. Investments that have not yet been sold, but would yield a profit if they were sold have unrealized capital gains.
Collection Point	The individual or business that actually remits payment of taxes to the government.
Compliance Burden	The time and resources, including out-of-pocket costs, that taxpayers spend each year in order to comply with the tax laws. Compliance burden is often cited as a measure of the overall simplicity of the tax code.
Consumption Tax Base	A tax base where people pay taxes on goods and services that they purchase, or consume, effectively excluding savings and investment from the tax base. Capital assets are usually fully expensed when purchased under a consumption tax rather than depreciated over time, as is the case under an income tax.
Corporate Income Taxes	Taxes paid by corporations on net income, or the difference between corporate revenues and corporate business expenses.
Credit	An amount that offsets or reduces tax liability. When the allowable credit amount exceeds the tax liability, and the difference is paid to the taxpayer, the credit is considered refundable.
Deduction	An amount that is subtracted from the tax base before tax liability is calculated. Deductions claimed before and after the adjusted gross income line on the Form 1040 are sometimes called "above the line" and "below the line" deductions, respectively.
Deficit	The amount by which the government's spending exceeds its revenues for a given period, usually a fiscal year.

Term	Definition
Defined Contribution Pension Plans	A type of retirement plan that establishes individual accounts for employees to which the employer, participants, or both make periodic contributions. Employees bear the investment risk and often control, at least in part, how their individual account assets are invested.
Discretionary Spending	Outlays controlled by appropriation acts, other than those that fund mandatory programs.
Distortion	Changes in behavior, such as how much to work, what to consume, and where to invest, due to taxes, government benefits, or monopolies.
Distributional Analysis	An analytical tool used by government agencies and other analysts to identify how different tax proposals or tax systems would affect different groups of taxpayers with differing ability to pay taxes, usually measured by income.
Dividend Income	A taxable payment made by a company to its shareholders, often quarterly, out of the company's retained earnings. Dividends are usually given out in the form of cash, but can also be given out as stock or other property.
Economic Incidence	The person or group of people that actually bear the burden of a tax regardless of who remits payment to the government. For example, even though businesses remit tax sales tax payments to the government, individuals who purchase items may bear the actual burden of the tax.
Effective Tax Rates	The amount of tax that a taxpayer pays to the government expressed as a percentage of some overall measure of total income.
Efficiency Costs	A reduction in economic well-being caused by distortions, or changes in behavior due to taxes, government benefits, monopolies, and other forces that interfere in the market. Efficiency costs can take the form of lost output or consumption opportunities.
Employer-Provided Health Care	Insurance plans offered by employers to employees where the employer pays all or a portion of an employee's health insurance costs. Employer-provided health care payments are not counted as nonwage income, and therefore these payments are not subject to taxation.
Entitlement	Programs that require the payment of benefits to persons, state or local governments, or other entities if specific criteria established in the authorizing law are met.
Estate and Gift Taxes	Assets an individual owns at the time of his or her death or gifts made during the course of his or her life may be subject to transfer taxes, sometimes referred to as estate and gift taxes. Estate and gift taxes are more likely to affect wealthier individuals, and most citizens are unaffected by estate and gift taxes.
Excise Taxes	A tax on the sale or use of specific products or transactions.
Exemption	A part of a person's income on which no tax is imposed. It is the amount that taxpayers can claim for themselves, their spouses, and eligible dependents. There are two types of exemptions—personal and dependency. Each exemption reduces the income subject to tax. The exemption amount is a set amount that changes from year to year.
Externality	A benefit or cost that is not captured or paid by the individuals or firms creating them.

Flat Tax	A type of tax reform proposal that, in most cases would change the tax base to a consumption tax base and impose a single, or flat, tax rate on individuals and businesses. Most flat tax proposals would not really be "flat" because they grant exemptions for at least some earnings.
Grandfather Clause	Provisions that are typically used to exempt people who would be subject to a new rule from the provisions of that rule. Thus, in the case of tax law changes, only people who engage in certain activities after a tax law change will be affected by changes to the tax treatment of that activity.
Gross Domestic Product (GDP)	The value of all final goods and services produced within the borders of a country such as the United States during a given period. The components of GDP are consumption expenditures (both personal and government), gross investment (both private and government) and net exports.
Horizontal Equity	The concept that people with the same ability to pay should be taxed at the same rate.
Income Tax Base	A tax base where individuals are taxed on the basis of income, or both the goods and services they consume as well as their savings and investments. Under an income tax, capital assets are usually depreciated over time rather than being fully expensed at the time they are purchased, as would be the case under a consumption tax.
Individual Retirement Accounts	Investment accounts that allow people to save a certain amount of income each year and, in most cases, deduct the savings from taxable income, with the savings and interest tax deferred until the person retires.
Mandatory Spending	Also known as "direct spending." Mandatory spending includes outlays for entitlements (for example, food stamps, Medicare, and veterans' pension programs), interest payments on the public debt and nonentitlements such as payments to the states from Forest Service receipts. By defining eligibility and setting the benefit or payment rules, the Congress controls spending for these programs indirectly rather than through appropriations acts.
Marginal Tax Rates	Tax rate that taxpayers pay on the next dollar of income that is earned. Marginal tax rates can be presented as both marginal statutory rates and marginal effective rates.
Medicaid	A federal program that states administer to help pay medical costs for low income citizens. Each state in which applicants for the program reside establishes criteria for financial need. Medicaid supplements Medicare to pay for some of the costs that Medicare does not cover.
Medicare	A federal entitlement program that delivers medical care to eligible workers, spouses of workers, and retired workers when they reach age 65.
Net Tax Gap	The difference between taxes legally owed to the government and taxes actually paid to the government, less collected enforcement revenue.
Payroll Taxes	Often synonymous with social insurance taxes. However, in some cases the term "payroll taxes" may be used more generally to include all tax withholding. For the purposes of this report, payroll taxes are synonymous with social insurance taxes.
Personal Income Taxes	Taxes on income earned by individuals, including income from wages, interest, and nonwage income.

Phase-in Rule	A rule that allows for a new tax provision to be implemented gradually rather than immediately upon enactment of a new tax law. Phase-in rules help mitigate windfall losses during the transition to a new set of tax laws.
Progressive Tax Rates	A tax rate structure where tax liability as a percentage of income increases as income increases.
Proportional Tax Rates	A tax rate structure where taxpayers pay the same percentage of income, regardless of their income.
Regressive Tax Rates	A tax rate structure where tax liability is a smaller percentage of a taxpayer's income as income increases.
Retail Sales Tax	A tax levied on the sale price of a good and collected by the seller of the good.
Revenue Neutral	A term applied to tax bills or proposals are designed to raise the same amount of revenue as the system that is being replaced.
Social Insurance Taxes	Tax payments to the federal government for Social Security, Medicare, and unemployment compensation. While employees and employers pay equal amounts in social insurance taxes, economists generally agree that employees bear the entire burden of social insurance taxes in the form of reduced wages.
Spillovers	See externality.
Standard Deduction	A deduction that reduces income subject to tax and varies depending on filing status, age, blindness, and dependency. The standard deduction is taken instead of itemizing deductions.
Statutory Incidence	The party, usually an individual or a business, that is legally required to pay a tax to the government.
Statutory Tax Rate	Tax rates as written into law.
Tax Burden	See economic incidence.
Tax-Exempt Bonds	Bonds issued by state and local governments for public projects on which interest that is earned is exempt from federal income tax.
Tax Expenditures	A revenue loss attributable to a provision of the federal tax laws that grants special tax relief that encourages certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. The Congressional Budget and Impoundment Act of 1974 lists six types of tax expenditures: exclusions, exemptions, deductions, credits, preferential tax rates, and deferrals.
Tax Incidence	See economic incidence.
Tax Liability	The amount of tax that a taxpayer is legally required to pay to the government at a given time.
Tax Preferences	See tax expenditures.
Taxable Income	Income subject to tax that is used to determine tax liability. In the case of the federal income tax, taxable income is equal to a taxpayer's adjusted gross income less personal deductions and exemptions.
Third-Party Information Reporting	Information reported to IRS by third parties, such as banks or employers, that allows IRS to verify that information reported by taxpayers on their tax returns is accurate.
Value-Added Tax	A tax levied at each stage of production or distribution on the value added to the product during that stage of production. Value-added taxes are now commonly used in many Western European countries as a source of revenue.

Term	Definition
Vertical Equity	The concept that people with differing ability to pay taxes should pay different rates of taxes or different percentages of their incomes in taxes.
Voluntary Compliance	A system of compliance that relies on individual citizens to report their income freely and voluntarily, calculate their tax liability correctly, and file a tax return on time.
Windfall Gain	A sudden and usually unexpected gain for a taxpayer or group of taxpayers owing to changes to the tax system.
Windfall Loss	A sudden and usually unexpected loss for a taxpayer or group of taxpayers owing to a change in the tax system. Transition rules are often proposed to mitigate the effects of windfall losses.

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Questions for the Record for:
The Honorable David Walker
August 3, 2006

From Senator Grassley:

Mr. Walker, I have a three part question for you.

In your testimony, you state that fundamentally reforming our tax system has the potential to improve compliance—that the complexity of, and frequent revisions to, the tax system make it more difficult and costly for taxpayers who want to comply to do so.

First, wouldn't you agree that by reducing complexity, we should be able to reduce the amount of the tax gap attributable to unintentional noncompliance?

Yes, I do agree that tax system complexity is an important contributor to noncompliance and that a reduction in complexity would help to reduce the tax gap. The complexity of, and frequent revisions to, the tax system make it more difficult and costly for taxpayers who want to comply to do so and for IRS to explain and enforce tax laws. Complexity also creates a fertile ground for those intentionally seeking to evade taxes, and often trips others into unintentional noncompliance. Likewise, the complexity of the tax system challenges IRS in its ability to administer our tax laws.

Second, do you know of any studies that have looked at how much of the tax gap is attributable to unintentional noncompliance due to the complexity of the tax code?

We know of no studies that have been able to reliably measure the portion of the tax gap that is attributable to complexity. It would be difficult to make a reliable quantitative estimate of this relationship because the impact of complexity cannot easily be separated from the effects of other contributing factors. The difficulty is more basic than simply the limitations of available data and statistical methodologies. Complexity is difficult to define, let alone measure, and it is also difficult to distinguish between unintentional and intentional noncompliance. In fact, for many taxpayers who want to understate their tax, the complexity of the tax code gives them opportunity and cover. Nonetheless, our work suggests that complexity is a real problem. For example, in a 2002 study we estimated that as many as 2 million taxpayers overpaid their 1998 taxes by $945 million because

they claimed the standard deduction when it would have been more beneficial to itemize.[1]

And third, in your testimony you state that the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades. What impact did the Tax Reform Act of 1986 have on the tax gap?

IRS' estimates of the tax gap for tax year 1992 (the first estimates that would reflect the full implementation of the Tax Reform Act of 1986) do not show a dramatic change from the tax gap estimates for tax year 1985. Total noncompliance as a percent of true tax liability fell from 18.8 percent in 1985 to 17.3 percent in 1992, while the dollar value of the gross tax gap actually increased in real terms. The underreporting rate fell one-half of a percentage point or more for nonfarm sole proprietor income, informal supplier income, and capital gains; the rate increased by one-half of a percentage point or more for partnership and S corporation income and for tax credits. Not all of these changes can be attributed to TRA 1986 because many other factors could have influenced these percentages.

From Senator Hatch:

Do you think we gain more by focusing on reducing complexity or on structuring the tax code to maximize economic efficiency, or are both are vital?

Both of these goals are vital and, although in some cases we will have to decide between the two, there are many opportunities to make changes that would achieve both goals simultaneously. A basic approach to simplification would be to broaden the tax base by eliminating or consolidating many of the tax expenditures that currently fill the tax code. This base broadening would allow for a lowering of tax rates, which is the key to increasing economic efficiency. We need to be sure that the benefits achieved from having these tax preferences are worth the associated revenue losses and efficiency costs just as we must ensure that outlay programs—which may be attempting to achieve the same purposes as tax expenditures—achieve outcomes commensurate with their costs.

Do you believe that the transition costs involved in adapting either of the tax reform plans laid out in the Advisory Panel's report would approach the almost insurmountable level, as has been described by some of its critics?

We have not formally evaluated either of the panel's proposals. The panel's report indicates that it did consider a number of transition issues and costs. The costs of

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[1] GAO, Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing, GAO-02-509 (Washington, D.C.: Mar. 29, 2002).

transition provisions are said to be incorporated in the revenue estimates for each proposal, although those specific costs are not identified separately. As I have said previously, neither of the panel's proposals provides sufficient revenue to address our nation's large and growing long-term fiscal imbalance, and that is without taking into account all of the transition relief that some experts believe would be necessary. (For example, the proposal does not compensate businesses for the loss of deductions related to accumulated inventories that they would suffer under that plan.)

GAO has not taken a position on the amount of transition relief that would be appropriate under the Panel's proposals. Elsewhere we have noted that, since transition rules are short-term tax policies, they should be judged by the standard criteria for good tax policy—equity, efficiency, and a combination of simplicity, transparency, and administrability. Without more detailed information on the revenue effects of specific components of the proposals, it is difficult to say how much the tax rates of the proposals would have to be raised in order to provide appropriate transition relief to taxpayers while also raising sufficient revenue to fund expected future spending.

The Panel's report recognized that only people, not corporations, bear the burden of taxation. You acknowledged reports from economists at both the Treasury Department and CBO that indicate that corporate tax is initially borne by owners of capital and, over time, some of the burden is then shifted to workers and consumers.

It appears that the panel did not evaluate the merits of integrating corporate income tax and individual income tax. Because the tax is ultimately borne by individuals, does it make sense to integrate the individual and corporate tax structures? What do you see as the biggest impediments to such a system?

The avoidance of double taxation of the same income is only one of a number of reasons that advocates of tax integration have raised over the years. Economists have long recognized the efficiency gains that could be achieved by integrating the individual and corporate tax structures: less investment would be diverted from the corporate sector into the noncorporate business sector and into owner-occupied housing, which are tax advantaged; the use of debt-financing would no longer be favored over equity financing; and corporations would no longer be discouraged from distributing their profits in the form of dividends. (We should note, however, that some efficiency costs may be worth paying in order to meet other policy goals. For example, many policymakers advocate increased home ownership as a social policy goal.)

One major impediment to tax integration is that it would result in a substantial revenue loss if not offset by other changes in the tax system. Any offsetting changes are likely to generate their own efficiency costs, which Congress would have to weigh against the gains to be achieved through integration.

I would like to ask all the members of the panel what their priorities would be for tax reform if we were to undertake this task in the next two years.

My priority for tax reform would be the development of a tax system that will raise sufficient revenue over time to fund our expected expenditures. As I mentioned earlier, we will fall woefully short of achieving this end if current spending and/or revenue trends are not altered.

Other priorities, such as broadening the tax base and otherwise promoting tax neutrality while seeking to minimize overall tax rates consistent with overall revenue needs, could help improve economic performance. While economic growth alone will not solve our long-term fiscal problems, an improvement in our overall economic performance makes dealing with those problems easier.

From Senator Snowe:

The final report of the President's Advisory Panel on Federal Tax Reform suggests that the 1986 Tax Reform Act broadened the tax base by eliminating "more tax preferences than had been enacted in all tax legislation between 1913 and 1985," for example, the long-term capital gains exclusion, the investment tax credit, and the two-earner deduction.

Yet, the Tax Reform Act also created new tax incentives such as the Low Income Housing Credit program, which has since become the nation's largest and most successful production program of rental housing affordable to low- and moderate-income Americans, producing over 1.9 million units since its inception. Because of the public-private partnership created by the program, the Housing Credit is more successful than any direct spending housing program.

Does the panel feel there is still room within the Tax Code for such incentive programs while still achieving the goal of a more fair, simpler, and pro-growth tax system?

I would say that there is certainly room in the tax code for some tax preferences that promote important social and economic objectives. However, we need to be sure that the benefits achieved from having these special provisions are worth the associated revenue losses just as we must ensure that outlay programs—which may be attempting to achieve the same purposes as tax expenditures—achieve outcomes commensurate with their costs. And it is important to supplement these cost-benefit evaluations with analyses of distributional effects—i.e., who bears the costs of the preferences and who receives the benefits.

To date, we have not given the wide range of existing tax expenditures adequate transparency or scrutiny. I think it is safe to say that the cost-benefit of many of

them is questionable, or at the very least could be improved, while many others could be consolidated or better targeted.

From Senator Baucus:

The IRS estimates the tax gap, the difference between the taxes legally owed and the taxes timely paid, is $345 billion each year. This represents a voluntary compliance rate of 83.7%. To what extent should enforcing existing tax laws play a part in a comprehensive approach to tax reform? To what extent would the tax reform debate be impacted if the voluntary compliance rate was 90%?

As I noted in my statement, improving compliance and reducing the tax gap would help improve the nation's fiscal stability and sustainability. Even modest progress would yield significant revenue. Based on IRS' latest estimates for 2001 we estimate that each 1 percentage point increase in the voluntary compliance rate would likely yield roughly $18 billion annually and that raising compliance to 90 percent could bring in an additional $112 billion annually. However, the tax gap has been a persistent problem in spite of continued congressional and IRS efforts to reduce it, as the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades.

Although some progress on compliance with existing laws should be achievable by providing IRS with additional enforcement tools and ensuring that significant resources are devoted to enforcement, tax reform that includes a reduction in tax preferences and complexity and that increases the transparency of taxable transactions holds the potential for significant improvements in compliance. As it considers tax reform options, Congress should carefully reexamine the benefits and costs of existing provisions of the tax code that are characterized by complexity and high rates of noncompliance to determine which provisions may best by modified or eliminated and which provisions should be retained and targeted for increased enforcement.

The Committee has asked the IRS and Treasury to provide a credible, comprehensive plan by September 30, 2006 to close the tax gap. To what extent could this plan assist in identifying and developing tax reform options?

The IRS/Treasury plan was released recently. It does not identify or develop any tax reform options.

You mention that revenues from the current tax system are not sufficient to fund projected spending. You recommend that a bipartisan Tax and Entitlements Reform Commission be formed to help ensure that any decisions made on taxes and spending are well coordinated. Who should participate on the commission, what constraints should they operate under, and should representatives from the States

be included? Do you believe that the tax reform panel operated under assumptions or constraints that limited their ability to devise creative recommendations?

As I noted at the hearing, I have suggested that a carefully designed commission may well be required to deal with some aspects of our long-term fiscal challenge. Senator Voinovich has offered one such proposal in the Securing America's Future Economy Commission Act.

When we look at previous commissions we can see elements that increase the likelihood a commission will be successful and credible. Commissions are more likely to succeed when there is—or is perceived to be—some sort of "crisis" or real need to for action. A mix of bipartisan politicians and nonpartisan professionals increases the chances for success. This provides some "reality check" by elected officials and some analytic protection for/by experts and others. Obviously the membership must also be truly bipartisan and represent buy-in by both parties, both houses and the executive branch.

While a Commission needs a scope that is focused enough to permit the hope of success, it should not be limited in the range of options it can consider within that mandate. In requiring members of the Social Security Commission to support individual accounts—and to require that all options include those—reduced the credibility of the Commission's work. I also believe that the guidance the President's tax reform panel followed with respect to preparing revenue-neutral tax reform options based on the President's projections served to limit the usefulness of their proposals. Both of the two proposals the panel developed appear to provide much less than the necessary revenue to fund expected government spending. Although we have not evaluated the revenue effects of these proposals, other respected analysts have and they point to future revenue yields that would worsen the already difficult fiscal challenges the nation faces.

Any commission chartered to deal with our long-term fiscal crisis should certainly give close consideration to the views of the states, and there would be ample opportunity for such views to be expressed, but I do not believe it is necessary to have formal state representation on the commission.

Finally, I think that the time constraints proposed by Senator Voinovich-one year for the commission to produce its report and another sixty days to submit a legislative proposal-are reasonable. However, with the right players and if the new commission draws upon the good work already done by many others, a report could be produced in less time.

In discussing fundamental tax reform proposals, proponents of capital income tax cuts have argued that those tax cuts promote sufficient economic activity to actually pay for themselves. Do you agree with this hypothesis and it is a good strategy for fundamental reform? With economists arguing over modeling and behaviors, how can Congress be sure of the reaction to tax cuts?

We have not done any work in this area, since the Joint Committee on Taxation and the Congressional Budget Office are responsible for legislative branch revenue estimation. My understanding of the most recent relevant studies by JCT and CBO is that they do not support the conclusion that tax cuts pay for themselves. These studies conclude that, at best, any revenue offset due to growth in investment would represent only a fraction of the revenue foregone through a reduction in tax rates.

You correctly characterize the unsettled nature of the debate among economists over the macroeconomic effects of tax changes and how best to incorporate those effects into revenue estimates. In my view, given our current long-term fiscal outlook, it would be prudent to take a conservative approach in our budget projections. I think that JCT's current practice of presenting ranges of revenue estimates, based on multiple plausible assumptions and model specifications, as supplemental information for Congress is appropriate. And it would be best for Congress to be cautious and not expect to obtain the higher bound estimated revenue yields.

You have testified that you recently filled out your own tax return without the benefit of software. You stated that you found the process "confusing, complex, and extremely frustrating." To what extent are voluntary compliance and the tax gap impacted because a) taxpayers must pay for software or pay a preparer if they cannot, or will not, self-prepare their tax returns and b) the IRS does not offer electronic filing directly through its website without taxpayers having to go through an intermediary?

As I noted in response to an earlier question, it is difficult to quantitatively estimate the impact of any particular factor on voluntary compliance and the tax gap. I have no estimate of the extent to which the cost of tax preparation has affected compliance, but the complexity of tax requirements and the resultant compliance costs are a significant concern, not only for the potential effect on noncompliance but also because of the additional burden placed on taxpayers and the reduction in the perceived credibility and fairness of the tax code. Moreover, the use of tax professionals is no guarantee of being compliant or of being treated fairly under the tax system. In testimony earlier this year we reported the results of an undercover test that we gave to 19 paid preparers working for several commercial chain preparers. We found that nearly all of the mock tax returns that we asked these professionals to prepare were done incorrectly to some degree and several of the preparers gave us very bad advice.[2]

As further evidence that complexity poses a problem even for tax professionals--in a 2002 study we estimated that as many as 2 million taxpayers overpaid their 1998 taxes by $945 million because they claimed the standard deduction when it

[2] GAO, Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors, GAO-06-563T (Washington, D.C.: April 4, 2006).

would have been more beneficial to itemize, and half of these taxpayers used a paid preparer.[3] Similarly, a recent report by the Treasury Inspector General for Tax Administration estimated that there were approximately 230,000 returns filed by paid preparers where taxpayers appeared eligible for but did not claim the Additional Child Tax Credit.[4] In addition, a 2002 IRS study of the EIC for tax year 1999 returns estimated that some taxpayers claimed about $11 billion more than they were entitled to while others claimed $710 million less than they were entitled to.[5] The IRS reported that paid preparers filed more than 65 percent of all EIC returns. None of these studies tried to determine how many errors were the fault of the preparer and how many were the fault of the taxpayer. However, based on our earlier examples of paid preparer performance, it seems likely that preparers bear responsibility for at least some of the over-or underpayments. Taxpayers could be at fault if they provide the preparer with incorrect information.

It would be very difficult to say whether voluntary compliance would be affected appreciably if IRS were to offer electronic filing directly through its website.

You testified that 70% of Americans pay more employment tax than income tax. To what extent would tax reform impact on the solvency of the Social Security Trust Fund?

The issue of Social Security Trust Fund solvency is one of the reasons why it is important to address tax and entitlements reform as an integrated effort, rather than as separate efforts. This approach would allow policy makers to consider on a more comprehensive basis the extent to which members of different economic and social groups should contribute toward and benefit from important government programs. It would also better ensure that the reform effort yields a sustainable solution under which future revenues are sufficient to fund expected spending. In the final analysis, whether and to what extent the solvency of the Social Security Trust Fund would be impacted by tax reform would depend on whether and to what extent the reform would affect trust fund revenues (e.g., payroll tax base and/or rates).

[3] GAO, Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing, GAO-02-509 (Washington, D.C.: Mar. 29, 2002).
[4] Treasury Inspector General for Tax Administration, Analysis of Statistical Information for Returns With Potentially Unclaimed Additional Child Tax Credit (Washington, D.C.: January 2003).
[5] Department of the Treasury, Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns (Washington, D.C.: Feb. 28, 2002).

From Senator Wyden:

What is the value of employers' deductions of their contributions for employee health insurance and medical care?

The aggregate value of the deduction for private sector employers is not known, and the value for an individual employer would depend on its business type, its profitability, and its true tax rate. Total private-sector employer contributions for health insurance were $328.5 billion in 2004, according to Medical Expenditure Panel Survey data.[6] Private sector employers may fully deduct their contributions for employees' health insurance and medical care from their taxable income as a general business expense, like wages and other compensation. Determining the precise value of the health care contribution deduction may not be feasible because the calculation would depend on factors such as the employer's tax bracket and whether the employer had profits or carried losses forward from past years.

The exclusion of employer-provided health insurance and medical care from individual income for tax purposes is distinct from the employer deduction. The employer health insurance deduction is not a tax expenditure because business deductions for costs incurred to earn income are considered part of the normal tax baseline. In contrast, the exclusion of employer health insurance contributions from employees' taxable income is a tax expenditure because these benefits are not subject to taxation like cash wages. While the employer deduction is only of value for taxable private sector employers, the exclusion of employer contributions from income applies to workers in the private, public and non-profit sectors. Revenue losses arise because employer contributions are excluded from the calculation of employees' taxable earnings for income taxes as well as from the calculation of Social Security and Medicare payroll taxes for both employees and employers.

Both the Joint Committee on Taxation (JCT) and the Department of the Treasury (Treasury) report estimates of the income tax revenue loss due to the exclusion, but neither reports an estimate of the payroll tax revenue loss. According to JCT estimates, projected individual income tax revenue losses for 2005 were $78.6 billion.[7] JCT assumes that if the exclusion on employer-provided insurance premiums were eliminated, more premiums would be eligible expenses for the purpose of the itemized deduction for medical expenses greater than 7.5 percent of adjusted gross income, and the adjustment for this interaction reduces JCT's estimate. According to the Department of the Treasury's estimates without the adjustment, individual income tax revenue losses amounted to $118.4 billion for fiscal year 2005.[8] If the payroll tax exclusion were at least half of the income tax loss estimated by Treasury, the combined tax expenditure for

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[6] The Medical Expenditure Panel Survey (MEPS) Insurance Component, conducted by the Agency for Healthcare Research and Quality, is an annual survey of establishments about employer-sponsored health insurance. MEPS data about employer contributions are used by the Bureau of Economic Analysis and the Department of the Treasury in measuring individual income.

[7] Joint Committee on Taxation, Estimates Of Federal Tax Expenditures For Fiscal Years 2005-2009, JCS-1-05 (Washington, D.C. January 12, 2005).

[8] OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2007.*

employer contributions for health insurance premiums would be about $177.6 billion in 2005. For 2006, the Economic Report of the President estimated a combined revenue loss of more than $200 billion, including $133 billion for the income tax exclusion and $80 billion for the payroll tax exclusion.

While the exclusion of employer health insurance contributions from employees' taxable income is the largest single federal tax expenditure, the tax code also includes other smaller income tax expenditures related to health care as shown in table 1 below.

Table 1: Health-related Tax expenditures available for individual and corporate taxpayers (fiscal year 2005)

Dollars in millions

Tax expenditure	Federal income tax revenue loss		
	Corporate	Individual	Total
Exclusion of employer contributions for medical insurance premiums and medical care*	0	118,420	118,420
Self-employed medical insurance premiums	0	3,790	3,790
Medical Savings Accounts / Health Savings Accounts	0	1,050	1,050
Deductibility of medical expenses	0	6,110	6,110
Exclusion of interest on hospital construction bonds	410	1,470	1,880
Deductibility of charitable contributions (health)	160	3,190	3,350
Tax credit for orphan drug research	210	0	210
Special Blue Cross/Blue Shield deduction	710	0	710
Tax credit for health insurance purchased by certain displaced and retired individuals	0	20	20
Sum of Treasury estimates	1,490	134,050	135,540

*If the payroll tax exclusion were also counted here, the combined tax expenditure for employer contributions for health insurance premiums would be about 50 percent higher or $177.6 billion.

Source: OMB and the Department of the Treasury, *Analytical Perspectives, Budget of the United States, Fiscal Year 2007* (Washington, D.C.: 2006).

COMMUNICATIONS

Statement of
Leo Linbeck, Jr.[*]
on behalf of
Americans for Fair Taxation
before the
Senate Committee on Finance
On Fundamental Tax Reform

August 3, 2006

Mr. Chairman and Members of the Committee,

My name is Leo Linbeck. Thank you for the opportunity to provide this statement to the committee on behalf of Americans for Fair Taxation. Americans for Fair Taxation is the nation's largest grass roots citizens' organization dedicated to fundamental tax reform. We appreciate the opportunity to present our views. We applaud the committee for beginning the tax reform process and sincerely encourage the committee to undertake a comprehensive examination of the issues and possible gains from fundamental tax reform.

The witnesses today are primarily members of the President's Advisory Panel of Federal Tax Reform (the Tax Panel) or, in the case of Dr. Gravelle, a well-known opponent of meaningful tax reform. So perhaps one of the first questions the committee should ask itself is why did the Tax Panel's proposals achieve so little public interest and find virtually no support in the tax reform community, among citizens groups or among business or labor organizations.

The short answer is that the panel failed to identify the goals that fundamental tax reform should achieve and failed to measures its plans against objective goals. Without establishing meaningful criteria describing what constitutes genuine and constructive tax reform, it is impossible to assess the relative merits of various plans or even to decide whether a plan would be constructive. Moreover, it failed to seriously consider the FairTax plan which has, by far, the greatest public support. Furthermore, as discussed briefly below, in an attempt to discredit the FairTax and eliminate it from the national debate on tax reform, the Tax Panel's staff employed disingenuous methods to analyze the FairTax plan. Finally, the Tax Panel failed to attach sufficient importance to either the basic desires of the public or the goal of promoting economic growth that President Bush enumerated.

All the Tax Panel offered the public was tepid tinkering with the existing system. We have all been down this futile road before and very few are under any illusions that such tinkering will offer meaningful improvements to the way we fund the federal government. To be against meaningful reform is to be a proponent of the current code. It is time for a meaningful change so that the American people can have a tax system they deserve and one that serves their interest rather than serving the interest of well connected lobbying interests.

In this statement, Americans for Fair Taxation sets forth criteria that we believe that policy-makers should adopt for purposes of assessing fundamental tax reform plans. These criteria are not exhaustive but they are the most important. They also, not coincidently, are the goals that are most likely to achieve broad public support for a plan that achieves them because they are goals that most Americans share.

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[*] Chairman of FairTax.Org (Americans for Fair Taxation). FairTax.Org is the nation's largest nonpartisan, grassroots organization dedicated to replacing the current tax system. For more information visit the web page: www.FairTax.org, call 713-963-9023 or write PO Box 27487, Houston, Texas 77227-7487.

The Goals of Fundamental Tax Reform

In general, a reformed tax system should be fair and should minimize the adverse economic impact of raising the revenue that Congress decides is necessary to fund the federal government. A tax reform plan that meets the following twelve specific criteria will accomplish the twin goals of being fair and maximizing the economic prosperity of the American people. The FairTax best meets these criteria and, indeed, was designed to do so. Assuming the Tax Panel's proposals were enacted as proposed, they would constitute only a modest improvement over current law and would likely degenerate quickly into something barely distinguishable from the present system. The criteria for genuine fundamental tax reform are:

Prosperity Criteria

1. The plan should not be biased toward consumption and against savings and investment but rather it should be neutral between different types of consumption, savings and investment.
2. The plan should have the lowest possible marginal tax rates, removing to the greatest extent possible the disincentive to work, save and invest and providing the greatest opportunity for upward mobility.
3. The plan should be neutral between whether to produce in the U.S. or abroad; it should not provide an artificial incentive to move jobs and production overseas.
4. The plan should impose the same tax burden on all forms of productive activity and should tax each activity at a uniform rate.
5. The plan should treat human capital formation and physical capital formation alike.
6. The plan should dramatically reduce the administrative and compliance burden on the public.

Fairness Criteria

1. The plan should exempt the poor from tax and allow everyone to meet the necessities of life before paying tax.
2. Once the necessities of life have been met, however, the plan should treat people equally with favoring one set of taxpayers over another and by taxing the same proportion of goods and services they purchase for their own personal use.
3. The plan should not play favorites or reward the politically powerful or well connected.

Civic Criteria

1. The plan should be transparent and understandable so the public understands the tax system; it should not hide the true tax burden or obfuscate.
2. The plan should be politically stable, so that the reform will last.
3. The plan should have a manageable transition.

The prosperity criteria are those that will maximize economic growth and prosperity. The fairness criteria are those that we believe most Americans accept. The civic criteria are those that promote a healthy body politic and improve our political process.

The Plans

This testimony will consider:

1. The Tax Panel's Simplified Income Tax Plan (chapter six of the report)
2. The Tax Panel's Growth and Investment Plan (chapter seven of the report)
3. The FairTax (H.R. 25, S. 25)
4. A business transfer tax (BTT)
5. The flat tax (of the Hall-Rabushka type)

The FairTax has been introduced in the House and the Senate. It replaces the individual and corporate income tax, all payroll taxes and the estate and gift tax with a 23 percent national retail sales tax on all consumption of goods and service without exception. A rebate would be provided monthly in advance to all households equal to the poverty level times 23 percent. An extra amount is provided to married couples to prevent a marriage penalty.

The Business Transfer Tax is a subtraction method value added tax. The overall tax base is the value of all goods and services produced minus investment. It is collected from businesses using administrative means similar to the corporate tax. It is border adjusted. It has the same tax base, in principle, as a retail sales tax. It is used as the business tax in the USA Tax.

The flat tax is a form of value added tax where the tax on capital value added is taxed at the business level and labor value added is taxed at the individual level. Since investment is expensed and savings are accorded Roth IRA type treatment, it is a form of consumption tax. It is, like the income tax, an origin principle tax; thus imports are exempt from tax and exports are taxed. The administrative means used to collect the tax is similar to the current tax system.

Neutrality Between Consumption and Savings

Capital formation promotes greater productivity and output, higher rates of economic growth, and improved competitiveness. More capital per worker, embodying the latest technical innovations means more output, greater competitiveness and higher real wages. The current tax system, however, is very biased against savings and investment, often taxing the returns to savings or investment three or four times. This results in slower economic growth, reduced competitiveness and lower real wages. The solution is to adopt a tax system that is neutral toward savings and investment. The FairTax, the flat tax, a business transfer tax would address this issue decisively. In all three plans, labor and capital output is taxed equally and one time. In the flat tax and BTT this is accomplished by expensing capital investment and treating all savings effectively as if they were in Roth IRAs. In the FairTax, this result is achieved simply by taxing only final consumption and not taxing business inputs. Unlike in most state sales taxes, the FairTax does not hide taxes and impose a tax on a tax. It taxes goods and service once when sold to consumers.

The Tax Panel's Growth and Investment Plan reduces the bias against savings and investment. The imposition of an extra 15 percent tax -- over and above the 30 percent business tax -- on dividends, interest and capital gains and the retention of the estate and gift tax constitutes a significant bias against investment and savings. The Simplified Income Tax Plan reduces the double taxation of corporate income but otherwise retains much of the bias against savings and investment inherent in current law.

Lowest Possible Marginal Tax Rates

High marginal tax rates reduce the incentive to work, save and invest and therefore reduce the amount people choose to work, to save and to invest. As tax rates are raised, overall economic output declines. Conversely, reducing marginal tax rates has dramatic positive economic effects.

The FairTax has the lowest marginal tax rates of any plan and is the most pro-growth of any plan considered. It has the broadest possible consumption tax base and a single tax rate. The FairTax base is equal to that of the BTT. The FairTax base is larger than the flat tax primarily due to the fact that the U.S. currently imports dramatically more than it exports. The FairTax is unique in that it replaces the 15.3 percent payroll tax and since the FairTax base is broader than the payroll tax base, it reduces marginal tax rates further than any tax plan being considered.

When comparing the FairTax to other tax plans it is important to remember that the FairTax repeals the 15.3 percent payroll taxes (both Social Security and Medicare employment taxes and self-employment

taxes). A flat tax with a rate of 17 or 20 percent, for example, is really a 32.3 or 35.3 percent tax on labor or self-employment income. Similarly, the Tax Panel's two proposals have top tax rates on labor income of 45.3 percent. In some cases, the Tax Panel's plans raise marginal tax rates. In most, the reductions are quite minor.

Neutrality Between U.S. and Foreign Producers

Our unique failure to adopt a destination principle consumption tax combined with our unusually high marginal corporate tax rates sends curious messages to multinationals: "Move your plants and facilities overseas, hire foreign workers, and then market your products back to the American consumers whose tax system favors consumption over investment and savings." To retailers: "Stock foreign inventory." To consumers: "Buy foreign products." The burgeoning trade deficit, the loss of American jobs, and stagnating blue collar wages are consequences of those policies.

The current tax system imposes high income and payroll taxes on U.S. producers and workers whether they are selling in the U.S. market or abroad. The current tax system imposes little or no tax on goods imported into the U.S or services provided to U.S. consumers or businesses from abroad. Compared to our OECD trading partners, this places American producers at a roughly 18 percent competitive disadvantage, courtesy of the U.S. tax system.

It is no wonder that firms that remain in the U.S. find it difficult to compete. It is no wonder that manufacturing output and employment have fallen roughly by half since our competitors started adopting border adjusted taxes. Even our agricultural surplus has largely disappeared. The U.S. government, through its tax policy is telling American firms that they should stop producing in the U.S. since the U.S. government will tax them heavily if they produce goods here but impose no tax on goods purchased abroad.

In contrast to the U.S., every other significant trading country in the world raises a large part of its revenue from destination principle, border adjusted consumption taxes. Most use the value added tax but some (for example Canada) rely to some extent on sales taxes. These taxes are not levied on exports from those countries to the U.S. but are imposed on U.S. goods imported into their country.

The FairTax would by the very nature of a sales tax remediate this problem by taxing foreign and U.S. goods alike when sold at retail. It would, for the first time, eliminate the advantage accorded to foreign producers by current federal tax policy. A BTT would also address this issue by excluding exports from its tax base and by imposing the tax on imports. The Tax Panel's Growth and Investment Plan would also be border adjusted. However, since the WTO only allows indirect taxes to be border adjusted, it is doubtful whether the Tax Panel's plan, which is structured like a direct tax, would survive a challenge at the WTO. Sales taxes are explicitly permitted under WTO rules. Neither the flat tax nor the Simplified Income Tax Plan would address the problem. Even the Tax Panel itself recognized that its proposal would probably fail WTO scrutiny.

Neutrality Between Different Types of Productive Activity

The FairTax treats all goods and services alike. Thus, it does not distort the marketplace and allows businesses to adopt the most efficient economic means to meet consumer wants. A plan that taxes economic activity uniformly will promote the most efficient, productive economy. The BTT would also do this (except, as mentioned below, as to labor income because of the retention of the payroll tax). The flat tax would largely address this issue except as to payroll taxes and with respect to international trade. Although the Tax Panel's plans would reduce these distortions, they retain major distortions in the marketplace, including the health care, housing and investment markets.

Neutrality Between Human Capital and Physical Capital

Human capital is a critical element in productivity and innovation. The FairTax is the only tax reform plan to grant human capital parity with physical capital. The FairTax accomplishes this result by not taxing tuition or job training or educational wages in either the government or private sector. This is appropriate since the primary reason most people pursue an education is to increase their future earnings capacity and the expenditures generated by those future earnings will be taxed. Tuition and job training are an investment in human capital.

The flat tax does not address this problem. Education is treated like a consumption good and must be purchased with after flat tax and after payroll tax dollars. The Tax Panel's proposals do not really address this issue; all they do is afford some savings for educational purposes consumption tax treatment.

Reduce the Compliance Burden on the Public

The current tax system has major tax evasion problems notwithstanding billions of tax and information returns filed each year, roughly 6 billion hours spent figuring out the tax due, and an army of tax preparers, tax accountants, tax lawyers and IRS personnel. We waste nearly $300 billion annually complying with the current tax system. The time spent figuring our taxes is more people than the hours spent working in the auto industry, the computer manufacturing industry, the airline manufacturing industry and the steel industry combined.

The Tax Panel's proposals would reduce this waste slightly. The flat tax would reduce it substantially, at least until the political process turned it back into something similar to what we have today. However, the flat tax does require all Americans to file tax returns and would retain withholding and payroll tax deduction rules.

The FairTax would radically reduce these costs and the complexity of the system. Individuals who were not in business for themselves would never need to fill out a tax return again. Moreover, the FairTax compensates businesses for the time required to fill out sales tax returns with a credit equal to ¼ of one percent of the sales tax remitted.

Under the FairTax, the question a business or auditor would need to answer is how much was sold to consumers. This is a simple question not that different from line 1 on a tax return today. Under the FairTax, that would effectively be that. All of the major sources of complexity today would be repealed. Gone would be payroll and income tax withholding, 1099 reporting, inventory tax accounting (including the uniform capitalization rules), tax depreciation accounting and recapture rules, tracking tax basis, the alternative minimum tax, qualified plan rules (including top-heavy, participation and vesting rules), international tax rules, capital gains rules, passive loss limitations, estate and gift tax planning and a host of other rules.

Small businesses are disproportionately harmed today by the large compliance burden imposed by the current tax system. They would disproportionately gain from implementation of the FairTax.

The FairTax would also substantially reduce tax evasion. The benefit from cheating would be less since marginal tax rates would be lower. The odds of apprehending tax evasion would increase. Given the systems simplicity, audit rates would increase dramatically if enforcement resources were held equal because audits would be so much simpler. Since the incentive to cheat would be dramatically less and the odds of being apprehended would increase, evasion would decline. In addition, a higher percentage of the underground economy and much of the economic activity by illegal immigrants would be taxed by the FairTax.

Exempt the Poor

It does not make a great deal of sense to impose taxes on poor people. Neither, however, does it make sense to hide from them the cost of government. The poor cannot even meet their basic needs and are receiving financial assistance in many ways. Yet today, they pay significant taxes. Part of those taxes are the payroll taxes imposed on the working poor. But the poor also bear the burden of paying higher prices for the goods they buy because of the taxes imposed on businesses and the cost incurred by businesses to comply with the tax system. Businesses, after all, must recover all of their costs, including taxes, in the price of the goods they sell. If they do not, they will quickly go out of business.

Because of the FairTax prebate, the FairTax is progressive. The effective tax rate climbs as expenditures climb. The effective tax rate is negative or zero for the poor, it is quite low for the lower middle class. The effective tax rate for a married couple with two children with taxable spending of $51,320 would have been 11 ½ percent in 2005. The very rich would pay nearly 23 percent on their spending.

The FairTax is the only plan that entirely untaxes the poor. It accomplishes this by providing every household in America with a prebate paid monthly in advance equal to 23 percent of the poverty level (plus an extra amount in the case of married couples to prevent a marriage penalty). This, in effect, protects every household in America from paying any tax on spending up to the poverty level which means that no poor person would pay any sales tax and that no household would pay sales tax on the necessities of life.

By repealing the payroll tax, the FairTax eliminates the greatest burden on the working poor and reduces the cost of hiring new, entry level workers. By repealing business payroll taxes, hidden taxes that must be recovered by businesses in the price of goods sold are repealed.

All other plans keep the payroll tax, which is the largest tax paid by poor Americans. No other plan is structured to ensure that no poor person will pay any tax. No other plan ensures that all households may meet the necessities of life without paying tax.

Equality of Treatment

The FairTax treats people equally on spending over the poverty level. It does not favor one set of taxpayers over another or one type of producer over another. It taxes everyone at a uniform rate on goods and services they purchase for their own personal use.

The flat tax moves in the right direction but retains the payroll tax which taxes labor income at different tax rates depending on the level of their income and does not tax capital income. The Tax Panel's proposals retain many tax preferences and treat people differently depending on the degree to which they are willing to structure their lives in a way approved of by government. In addition, the Tax Panel retains graduated tax rates which punish people who choose to work hard, study hard, save and invest.

The FairTax would eliminate the ability of people to use fancy tax gimmicks to avoid or evade taxes by hiding money in offshore tax havens.

Should Not Play Favorites

It is unfair for the government to play favorites, rewarding certain politically powerful and well-connected interests over others that do not have the same political pull. The tax system *should* be about doing what is right and just rather than what will help fill campaign coffers and satisfy interest groups. The FairTax treats everyone alike and does not exempt any person, any good or any service from tax. The rules are simple and clear and apply to everyone.

The Tax Panel's proposals continue the practice of rewarding certain interests, although the proposals do reduce the scope of tax preferences compared to current law. The flat tax would largely eliminate the

favoritism of current law. It does, however, retain on major favorite. Foreign produced goods are favored over U.S. produced goods. A BTT would not play favorites either and would treat foreign and U.S. produced goods and services alike.

Transparency and Comprehensibility

The FairTax is the easiest of any tax reform plan to understand. That is its virtue and its vice. It is a simple sales tax with a single tax rate.

It does not divide up the public's tax burden among four or five "low" tax rate taxes, some of which are hidden from view, that add up to very high tax rates. The FairTax has one very transparent tax rate which, in reality, is the lowest marginal tax rate by far of any tax reform plan. Yet because the FairTax is honest and transparent and the current tax system is anything but honest and transparent, FairTax detractors are able to obfuscate, demagogue and confuse by misrepresenting the facts.

Who knows who pays the corporate tax? Most people – small businesses and self-employed people being obvious exceptions – do not even know about the massive employer payroll taxes that drive their wages down. Most people have only the vaguest idea of what they pay in income taxes today and why since the taxes are withheld and, as often as not, they used paid preparers or software to figure their tax.

The Tax Panel's plans are complex and retain most of the complexity of the current system. The flat tax is relatively simple, yet even many of its most vocal proponents seem to think it is an income tax rather than a consumption tax. They do not even understand their own proposal.

Only the FairTax is simple and can be easily understood by anyone. Under the FairTax, people will understand for the first time in their lifetime how the federal government is actually paid for and who is paying for it.

Political Stability

If the flat tax is kept as it is but with graduated rates, it becomes what is often called the X-tax, a graduated rate consumption tax. Furthermore, the flat tax can be easily changed back into an income tax. Starting with the flat tax, if we depreciate capital rather than expense it, make inventory purchases deductible when the inventory is sold rather than when purchased, make interest taxable and deductible, then we have largely converted the flat tax into an income tax. Add a few special interest deductions, credits and exclusions and we are very nearly back to where we started. That is a very real problem with the flat tax. It is very easy to corrupt its design and eliminate many of the gains to be had from adopting the proposal in the first place. The entire administrative apparatus of the income and payroll tax system is retained and it would be very easy to go back. Attempts to do so would start immediately.

If the FairTax were enacted, it would much more difficult to go back to an income tax system. The entire massive and expensive administrative apparatus built up over nine decades would be dismantled. It is doubtful that people would want to go back. It is doubtful that they would want to invest the massive resources necessary to do so. The FairTax, then, is a stable reform. There will, of course, be the necessity to fend off those who want to exempt one category or another of goods or services. But if the prebate system is in place, the most commonly used line of argument (we need to help the poor) will fall flat. There will always be better ways to help the poor than exempting some category of goods.

Transition

The flat tax sidesteps transition issues. It is, however, unlikely that in the final analysis Congress will force businesses to lose trillions of dollars of basis on capital assets if the income generated by those assets remains subject to tax. To do so would amount to wealth loss for existing capital owners of well

over a trillion dollars. Addressing this transition issue, will force the flat tax rate (or a BTT rate) to climb considerably.

There is no need to be concerned with basis per se in the FairTax since income streams are no longer subject to tax. Businesses will not get far complaining that their tax rate has been reduced to zero. The analogous (but much smaller) problem in the FairTax is the sale of goods subject to FairTax that were not deducted for income tax purposes. Collecting sales tax and failing to allow an income tax deduction would effectively be double taxation. The FairTax legislation addresses this issue by providing a credit to businesses selling inventory held on the changeover date to prevent the double taxation.

There is a general danger, however, when considering transition to want to compensate every loss. In fact, in most cases where there are losses, there is someone experiencing an equal and offsetting windfall gain on the other side of the transaction. These gains should be taxed to compensate losses (if they exist) because if the loss is unjust then so is the unexpected and windfall gain at another's expense. Moreover, many of the claimed losses on capital assets will in reality be illusory because assets price will in general increase due to according consumption tax treatment to investment.

Small Businesses and Farms

The current system has a disproportionately adverse impact on small businesses because of the high compliance costs that consume a relatively large share of small business income and because of the many ways the current system singles out small businesses for discriminatory tax treatment.

The FairTax addresses this issue by radically simplifying the tax law, reducing compliance costs and compensating businesses for their time complying with the system. The FairTax also repeals payroll taxes, which have a disproportionately negative impact on small businesses both because of administrative cost, the self-employment tax and the increased cost of labor. Finally, the FairTax will help small manufacturers and farmers compete against foreign goods in U.S. or foreign markets by taking the taxes out of exports and by taxing U.S. and foreign goods alike in U.S. markets. Many larger U.S. companies have already outsourced a huge portion of their manufacturing or are planning to do so. Small companies located here do not really have the option of outsourcing their manufacturing since they do not generally have both manufacturing and distributional divisions.

No other plan addresses these needs of small businesses as directly and effectively as the FairTax. BTT proposals tend not to address payroll tax issues. The flat tax does not address either payroll tax issues or level the playing field with imports. The Tax Panel's proposals would only moderately improve the current system. Thus, it is the FairTax that has the most, and growing, support among small businesses and farmers.

Grading the Plans

The analysis above demonstrates that the FairTax is the most pro-growth and most fair tax plan being considered in Congress. It shows that the Tax Panel's proposals were seriously deficient. It shows that the BTT and the flat tax would constitute a significant improvement over current law. The chart below is a summary of these findings.

Tax Reform Report Card

Criteria	Tax Panel Income Tax	Tax Panel Growth	Flat Tax	Business Transfer Tax	FairTax
P1. Neutral Toward Savings and Investment	C	C+	A	A+	A+
P2. Low Marginal Tax Rates	C	C	B+	A-	A+
P3. Neutral Between Foreign and U.S. Producers	F	A	D	A+	A+
P4. Taxing Economic Activity Uniformly	C+	C+	A-	A-	A
P5. Neutral Between Human and Physical Capital	F	F	F	F (usually)	A
P6. Reduce Compliance Costs	C-	C	B	B	A+
F1. Poor Untaxed	B	B	B-	B-	A+
F2. Equal and Uniform Taxation	D	D+	B	B+	A+
F3. No Favorites or Special Exceptions	D	D	A-	A-	A+
C1. Transparency and Understandability	C	C	B	B-	A+
C2. Politically Stable	F	D	C	B	A
C3. Manageable Transition	A	A	B	B	B+
Overall Grade	D	C	B	B+	A+

The Tax Panel and the FairTax

The Tax Panel did not seriously analyze the FairTax. In fact, Chapter Nine of the report makes it clear that when conducting estimates of the "national retail sales tax" the estimates were conducted using a base much narrower than the FairTax base. The FairTax taxes all consumption one-time. The Tax Panel conducted its estimates assuming that large parts of the consumption tax base would be exempt. By so rigging its estimates, the reported revenue neutral tax rate was artificially increased. Furthermore, the sales tax proposal was the only tax plan where the rate was reported on a tax exclusive basis rather than a tax inclusive basis (the method that was used for the current system, the Tax Panel's proposals and the flat tax). This further misrepresented the facts. Finally, the Tax Panel assumed the FairTax would increase evasion when it is quite clear it would do the opposite. The FairTax would, in fact, reduce the tax gap by removing the complexity of the Code attributable to as much as half of the tax gap, reduce the number of collection points by about 200 million, lower marginal tax rates, increase visibility and through simplicity, narrow the line between cheering and avoidance. Furthermore, the odds of tax evasion being apprehended would increase. Given the current level of enforcement spending, audit rates would increase since audits would be so much simpler and less time consuming.

In short, it is obvious that the Tax Panel wanted to oppose a national retail sales tax and was willing to distort its analysis and mislead policy-makers to do so.

Conclusion

The proposals offered by the President's Tax Panel are a major disappointment. They represent very incremental tinkering with the current system by those who benefit most from the current system The progress they offer is quite small and unlikely to survive the first few months of the political process. This, I suggest, is obvious to both the public, the tax reform community and both business, farm and labor groups. Moreover, the Tax Panel's plans do not achieve the goals that most citizens believe that fundamental tax reform should and, therefore, has quite literally no public support. In short, the Tax Panel failed to achieve its mission..

The FairTax is the best plan being considered. It is extremely pro-growth. It would cause dramatically higher investment, large productivity gains and higher real wages. It would improve the competitiveness of U.S. producers. Unlike the current system and most competing plans, it enhances international competitiveness in a WTO compliant manner. It would improve the well-being of the average American dramatically. It would dramatically reduce the vast amount wasted each year on compliance costs. It would untax the poor and be progressive. It would tax people based on what they consumed for themselves rather than on what they invested in the community or gave to charities. It would get the government out of the business of playing favorites and rewarding politically powerful interests. It is transparent and understandable. The FairTax would eliminate the ability of people to use fancy tax gimmicks to avoid or evade taxes by hiding money in offshore tax havens. It will lead to a more just and more prosperous America. It is the best plan.

Because the FairTax meets the goals that most people share for fundamental tax reform, it has broad and rapidly growing public support from people in all walks of life. The more people that learn about the FairTax and understand the positive impact it would have on our economy and our society, the greater its support. We urge you to cosponsor the legislation and to work with your colleagues to enact it into law so that the American people can, at last, have the tax system they deserve.

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Testimony Presented to the Senate Committee on Finance

Kick-Off for Tax Reform: Tackling the Tax Code August 3, 2006

The American Society of Pension Professionals & Actuaries (ASPPA) appreciates the opportunity to submit our comments to the Senate Committee on Finance hearing, "Kick-Off for Tax Reform: Tackling the Tax Code." For the reasons stated below, we believe that certain savings recommendations made by the President's Advisory Panel on Federal Tax Reform (Advisory Panel) on November 1, 2005, would be devastating to the retirement security of millions of American workers.

ASPPA is a national organization of approximately 6,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants and attorneys. Our large and broad-based membership gives ASPPA unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small- to medium-sized employers. ASPPA's membership is diverse but united by a common dedication to the employer-sponsored retirement plan system.

The ASPPA Pension Education & Research Foundation (ASPPA PERF) report entitled "Savings Under Tax Reform: What Is The Cost to Retirement Savings?" (Report) examines several possible tax reforms and their impact on retirement savings.[1] We ask that the Report be included as an attachment to this testimony.

The Advisory Panel's Recommendations

"Save at Work" Accounts

The Advisory Panel set forth two savings proposals for fundamental tax reform: the "Simplified Income Tax" and the "Growth and Investment Tax." Both plans would eliminate all employer-sponsored defined contribution plans [*e.g.*, 401(k), 403(b), 457, SIMPLE plans, etc.] and replace them with a "Save at Work" account. In addition, a significant and controversial aspect of the Growth and Investment Tax plan would have contributions to the

[1] The Report and its Executive Summary can be found at **http://router.asppa.org:8765/cs.html?charset=iso-8859-1&url=http%3A//www.asppa.org/pdf_files/govpdffiles/2005-05-17-report.pdf&qt=tax+reform&col=aspa&n=6&la=en**.

Save at Work account made on an after-tax basis, although distributions would be tax-free (similar to today's Roth accounts).

With a Save at Work account, without an upfront tax deduction, many workers currently saving in their 401(k) will choose not to save. In its report, the Advisory Panel admitted that it was able to finance lower tax rates on taxpayers with the highest incomes by eliminating the pre-tax deduction for retirement plan contributions. ASPPA believes that it is unacceptable to lower tax rates for higher income individuals by sacrificing the savings tax incentives for American workers.

America is not inherently a nation of savers. Even today, about a third of workers are not saving for retirement and many who are saving have retirement accounts that are inadequate to fund a comfortable retirement. Further, demographic shifts illustrate a growing retiree problem: approximately 85 million Americans will be 65 or older in 2050 compared to 36 million in 2000.

Our nation's existing income tax system provides incentives for long-term retirement savings that has encouraged a significant number of Americans of modest means to save for retirement. In fact, the current employment-based retirement plan system, which has made middle-income Americans significant investors in the stock market,[2] has been a major contributing force to the "ownership society" to which the President often refers.

Simply put, employer-sponsored retirement plans have been the only effective means to get low- to moderate-income workers to save. According to the Employee Benefits Research Institute, low- to moderate-income workers are almost 20 times more likely to save when covered by a workplace retirement plan. Of workers who earned $30,000 to $50,000 and were covered by an employer sponsored 401(k)-type plan, 77.7 percent actually saved in the plan, while only 4 percent of workers at the same level of income, but not covered by a 401(k)-type plan, saved in an individual retirement account.[3] This stunning disparity cannot be overlooked when evaluating our nation's savings policy. In large part, the difference is due to the convenience of payroll deductions, the culture of savings fostered in the workplace and the incentive of the matching contributions provided by the employer.

Certainly, no one is suggesting that the employer-based retirement plan system is perfect. Coverage rates still need to be improved. In 2003, only 64.9 percent of full-time workers were employed by a firm sponsoring a qualified retirement plan.[4] The lack of coverage is most acute among small business employees who comprise the overwhelming majority of our nation's workers. In 2003, at firms with less than 25 employees, only 31.4 percent of full-time workers had access to an employer-sponsored qualified retirement plan.[5]

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[2] As of July 2003, an estimated 36.4 million US households, or almost 70 percent of all US households owning mutual funds, held mutual funds in employer-sponsored retirement plans. *Investment Company Institute, US Household Ownership of Mutual Funds in 2003, Vol. 12, No. 4 (October 2003).*

[3] Employee Benefits Research Institute (EBRI, based on 2003 data). It should be noted that this disparity exists notwithstanding likely eligibility for the Saver's Credit.

[4] Congressional Research Service (September 10, 2004), Pension Sponsorship and Participation: Summary of Recent Trends.

[5] Id.

The failure to achieve universal coverage, however, should not be an excuse to abandon a system that so successfully encourages savings, particular by those workers who otherwise are not likely to save. Improvements to the system can be made. From 1994 to 2003, the percentage of full-time workers at small businesses with less than 25 employees that sponsored a qualified retirement plan increased from 26.5 percent to 31.4 percent.[6] In many respects, this substantial increase in retirement plan coverage for small business employees is due to positive legislation enacted by Congress specifically designed to increase the number of small business retirement plans.[7]

When it comes to encouraging savings, the employer-sponsored retirement plan system has a proven track record. It is not surprising that one study showed that households covered by an employer-sponsored retirement plan are more than twice as likely to achieve retirement income adequacy as households not covered by a plan. As a result, any examination of our nation's savings policy must include consideration of new ways to expand coverage under the employer-sponsored retirement plan system.

"Save for Retirement" and "Save for Family" Accounts

The Advisory Panel's Simplified Income Tax and the Growth and Investment Tax Plans proposals would also eliminate IRAs and other savings vehicles (*e.g.*, education IRAs, section 529 plans) and replace them with "Save for Retirement" and "Save for Family" accounts that would allow for annual contributions up to $10,000 each. Combined, these accounts would allow a couple owning a small business to save $40,000 for retirement on a tax-preferred basis (compared to $10,000 under current law). ASPPA is concerned that many small business owners will forego adopting a workplace retirement plan for their employees if they can save that much on their own on a tax-preferred basis.

ASPPA encourages the Committee to examine the crucial role played by the employer-sponsored retirement plan system in promoting savings by low- to moderate-income American workers. We implore the Committee to be wary of any proposed tax incentives for after-tax investments that will potentially lessen the attractiveness of savings in a tax-qualified retirement plan. This is especially true in the context of small businesses, whose costs for maintaining a retirement plan are much greater on a per-employee basis than for larger firms. As the tax incentives for nonqualified investments become more favorable on a relative basis, ASPPA is concerned that many small business owners, faced with higher costs for maintaining a retirement plan, will instead forego the plan and invest on their own, leaving their workers without a meaningful opportunity to save.

Not all savings are alike. Through the special incentives afforded the qualified retirement plan system, Congress has *always* acknowledged, unlike the Advisory Panel, the importance of encouraging long-term retirement savings by our nation's workers. These plans are designed to ensure that savings will be available for retirement by restricting distributions and/or penalties for early withdrawal. The Panel's recommendations for tax incentives for

[6] Id.

[7] For example, the Small Business Job Protection Act of 1996 created the SIMPLE plan, a simplified retirement plan for small businesses with lower administrative costs. The Economic Growth and Tax Relief Reconciliation Act of 2001 included, among other things, a tax credit for the start-up costs for establishing a new small business retirement plan.

nonqualified short-term investments, however, run counter to that message. The zero capital gains and dividends tax rate for lower-income taxpayers that goes into effect for 2008 is a perfect example. The tax incentive of a zero capital gains rate is economically equivalent to a tax-deductible contribution to an IRA or 401(k) plan. Given that, why would workers contribute on a long-term basis to an IRA or 401(k) plan when they can get the same tax break outside of a plan and always have access to their money?[8] Without the savings discipline implicit in an IRA or 401(k) plan, how likely is it that savings in short-term nonqualified investment vehicles will be there for retirement? These are important questions the subcommittee should consider when formulating our nation's savings policy.

In considering our nation's savings policy, high priority must be placed in encouraging greater savings by low- to moderate-income workers. With increasing pressure on the solvency and continued viability of the Social Security system, it is this sector of Americans whose future economic security is most at risk. The empirical evidence clearly suggests that further strengthening our employer-based retirement plan system will most effectively and efficiently achieve that objective.

Dividends and Capital Gains Tax Exemption

Of equal concern to ASPPA is the Advisory Panel recommendation that 100 percent of the dividends paid by US corporations and 75 percent of their investments, including mutual funds in US corporations, be exempt from tax. This essentially means that investments made outside of a qualified plan could have an effective tax rate of less than 4 percent. Further, unlike retirement plan savings, these investments will not be subject to the distribution restrictions that help ensure that the funds are available for retirement. If investments outside of a qualified plan are taxed at an effective rate of less than 4 percent, for many small business owners, it will no longer make financial sense for them to adopt a retirement plan for themselves and their workers.

The reduction or elimination of tax rates for capital gains and dividends threatens small business retirement plan coverage. Small employers hesitate to offer retirement plans for several reasons, including administrative complexity and cost, and the unpredictability of their financial condition. These hurdles are offset partly by the knowledge that the small business owner cannot maximize personal retirement savings without providing a plan for workers as well. Any changes that allow small business owners to meet their personal retirement savings goals for themselves only, such as through a reduction or elimination of the tax on capital gains and dividends, would inevitably threaten the future of the plans they provide their workers.

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[8] It is true that the Saver's Credit provides an added tax incentive to American workers to save in an IRA or 401(k) plan. However, there are literally millions of American households that would be eligible for the zero capital gains and dividends tax rate that are not eligible for the Saver's Credit. The Saver's Credit is equal to 10 percent of contributions to an IRA or 401(k) plan up to $2,000 for married taxpayers with adjusted gross income between $32,500 and $50,000. The zero capital gains and dividend tax rate is available for married taxpayers with taxable income up to $58,100 and whose adjusted gross income could be well in excess of that in light of the standard deduction and personal exemptions. In addition, many working families have no tax liability. Since the Saver's Credit is not refundable, it offers no incentive to these families.

While opponents argue that these small business owners implement plans for their employees in order to remain competitive, it has been the longstanding experience of ASPPA members that profit-maximizing small business owners rarely adopt retirement plans due to employee pressure. The small business has usually operated successfully without a retirement plan for some time. Rather, the retirement security of the small business owner is the motivating factor for implementing a retirement plan, and the owner is typically happy to provide retirement benefits for workers if it makes financial sense from his or her personal perspective.

Also, because small businesses have fewer employees, the cost of maintaining the plan on a per-employee basis is higher as compared to larger firms. Costs are further heightened by ERISA-mandated nondiscrimination rules that generally mandate contributions (*e.g.*, matching contributions) be made on behalf of employees in order for the small business owner(s) to save in the plan.[9] For small businesses with less than 25 employees, the cost to the owner of these mandatory contributions (plus administrative costs) will typically be at least 30 cents for every dollar that he or she wants to save in the plan. Effectively from the small business owner's perspective, these costs are like a tax that must be paid in order for the owner to participate in the plan.

When capital gains and dividends were taxed at ordinary income rates, it always made sense for small business owners to save through a workplace retirement plan because the upfront deduction provides a greater financial incentive, notwithstanding the 30 percent cost for mandatory contributions for employees. That advantage, however, went away somewhat with the current 15 percent rate on capital gains and dividends and goes away dramatically if tax rates on capital gains and dividends are further reduced. Budget legislation recently passed in Congress now extends the current 15 percent rate on capital gains and dividends through 2010.

As noted earlier, although the Saver's Credit provides added incentive for lower-income individuals to save in a qualified retirement plan, there will literally be millions of American workers who will now have no real incentive to lock up their savings for retirement. It is true that many workers will be provided matching contributions by their employer, which will act as an incentive to invest in the plan. The matching contributions, however, may not be enough of an incentive for some workers, or workers may choose to invest outside of the plan once they have taken full advantage of the matching contribution.[10] Further, many employers do not offer matching contributions at all. Finally, there are tens of millions of working Americans who are still not covered by a workplace retirement plan and only have an IRA as an option. How many of these workers will choose to save on a long-term basis in an IRA where there is absolutely no tax incentive to do so?

ASPPA is very concerned that the permanent extension of the current reduced tax rates for capital gains and dividends, or any further reductions in such rates, will lead to reduced long-term savings. If long-term savings no longer enjoy a special tax advantage, low- to moderate-

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[9] In fact, there is a special nondiscrimination rule that is applicable only to small business retirement plans called the top heavy rule that often mandates that a small business must make a retirement plan contribution on behalf of lower-paid workers equal to 3 percent of their compensation. See IRC Section 416.

[10] For example, if an employer matches up to 3 percent of pay, a worker may choose to save just up to 3 percent of pay to take advantage of the match and then do any further saving outside of the plan.

income workers will save less for retirement. Instead, if they save at all, it will likely be in a short-term savings plan to which they will have ready access, making it more likely than not that these "savings" will be spent well before retirement, thereby threatening their future economic security.

Conclusion

As Congress evaluates the Advisory Panel's savings proposals, ASPPA asks that any reform to the federal tax system accommodate sound retirement policy. Sound retirement policy suggests that the most efficient and effective tax system must continue to provide sufficient incentives to employers to establish and maintain plans for their workers. The 401(k) has been a great success story introducing tens of millions of Americans to the benefit of saving. It is critical that we "Don't Take Away America's 401(k)."

A sound national savings policy must abide by the following three principles:

- Priority must be given to promoting increased savings by low- to moderate-income workers. These are the Americans who save the least and whose future financial security is most at risk.

- A national savings policy should favor long-term retirement savings with distribution restrictions to help ensure that working families have some needed savings when they reach retirement.

- Recognition must be given to the critical role played by the employer-sponsored retirement plan system in achieving the first two principles. Workplace retirement plans have been, by far, the most effective way to encourage long-term savings by low- to moderate-income workers.

As an alternative to promote savings, ASPPA supports a recent proposal by Senators Gordon Smith (R-OR) and Kent Conrad (D-ND) giving American workers access to an employer-based retirement savings program, specifically a payroll-deduction IRA, where they are not already covered by a qualified retirement plan. We believe that this essential legislative proposal, coupled with an expanded Saver's Credit, will likely persuade more employers, particularly small businesses, to offer a qualified retirement plan to their workers. It should also greatly improve the retirement savings rates of lower-income workers.

The policy implications of reduced long-term retirement savings by working Americans could be substantial, particularly given potential limitations of Social Security and the need for current and future retirees to supplement their Social Security benefits with personal savings. ASPPA stands ready to work closely with the members of this subcommittee and Congress to make sure this does not happen.

Savings Under Tax Reform: What is the Cost to Retirement Savings?

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ASPPA Pension Education™
and Research Foundation

Savings Under Tax Reform: What Is The Cost To Retirement Savings?

Summary—Retirement plans and personal savings, along with Social Security, are essential parts of the American retirement system. Policy changes that affect the ability to save or the composition of overall savings pose potential threats to retirement plan savings. There is a strong public interest in assuring that Americans have adequate resources during their retirement years; as policymakers consider alternatives to the current law tax system, it is important to consider whether potential reforms will put more Americans at risk of having inadequate savings during their retirement years.

Employers face substantial costs to establish and maintain qualified retirement plans for employees. These costs, coupled with the fact that employers are generally indifferent from a tax perspective whether an employee's compensation is provided as cash or tax-advantaged retirement savings, present a significant deterrent, even under current law, to retirement savings through employer-sponsored retirement plans.

Furthermore, our present tax system dilutes the demand for retirement savings by offering favorable tax treatment for investments that compete with qualified retirement plan savings.

Despite these impediments to retirement savings under current law, the employer-sponsored retirement plan system has proven effective for delivering retirement benefits to workers who would not otherwise save for retirement.

The President has established a tax reform commission that is exploring various alternatives to the current tax system. Many of the reform options under consideration would provide greater tax preferences for general savings such as consumption-style taxes or more targeted approaches such as those that eliminate the tax on capital gains and dividend income. Consumption taxes, in general, tax amounts consumed and, thus, do not tax amounts that are saved. Similarly, eliminating the tax on capital gains and dividends would provide a specific tax incentive for saving through investment in capital assets.

These reform proposals may increase aggregate savings by taxpayers. However, this increase in aggregate saving may come at the expense of retirement saving and may not provide uniform saving across all income classes. Evidence with lump-sum distributions from existing qualified retirement plans shows that employees, particularly lower income employees, who have access to their savings before retirement tend to spend these funds, rather than saving them for their retirement years. Thus, an overall increase in saving will not necessarily translate into an increase in saving for lower income individuals or to an increase in retirement savings.

Employer-sponsored qualified retirement plans generally offer all eligible workers the opportunity to save for retirement. The minimum participation and nondiscrimination rules guarantee that the tax benefits of qualified retirement plans are only available if the plan provides comparable benefits to all eligible employees. Many employer-sponsored qualified retirement plans provide additional incentives to workers to encourage savings, such as matching contributions. Indeed, under current law, an additional tax incentive (the SAVER's Credit) is provided to low-income individuals to help them save for retirement. As a result, qualified retirement plans provide the best opportunity for low-income workers to save for retirement. If qualified retirement plans were no longer offered by their employers, many low-income individuals would not possess adequate resources or motivation to save on their own for retirement.

Reform and targeted relief proposals that have been proposed will do little to alter the fact that individual savings tends to be very low among lower income individuals. Therefore, although tax reform potentially will increase overall saving, it is likely to come at the cost of retirement savings by lower-income individuals. As a result, providing favorable tax treatment for individual savings may erode retirement savings, leading to greater wealth disparities among retirees and threatening the financial security of a significant number of people.

I. Introduction

With the creation of the President's tax reform commission, there is increased debate about the advantages and disadvantages of the current tax system. Tax reform advocates are advancing proposals either to alter fundamentally or to eliminate the current law system. Among the proposals that are attracting the most attention is a consumption tax as an alternative or add-on to the current law system. In addition, there is ongoing interest in proposals to eliminate taxes on capital gains and dividends.

When considering tax reform proposals, policymakers need to be aware of the potential consequences of a consumption tax system on savings for retirement. Our current tax system provides a strong incentive for taxpayers to save for retirement by excluding from income contributions to a qualified pension plan or an Individual Retirement Arrangement (IRA). Even with this strong incentive, many people do not save enough for retirement and the saving that does occur tends to be positively correlated with income levels. However, if a consumption tax system is developed in which taxpayers are generally encouraged to save to avoid current tax, the current system's strong incentive to save specifically for retirement will be significantly reduced. Thus, it is reasonable to assume that under a consumption tax system, taxpayers will be less likely to favor saving for retirement because of the preference provided to savings in general. The implications of such a reduction in retirement saving could be devastating, particularly given the projected shortfalls in the Social Security system.

Employer-sponsored qualified retirement plans, personal savings and Social Security are all considered essential elements of the American retirement system (the so-called "three-legged stool"[1]). However, projected demographic trends and solvency concerns suggest that Social Security, if available, may offer lower benefits, which places greater emphasis on both qualified retirement savings and personal savings.[2] Encouraging retirement saving, through both employers *and* individual saving plans, remains critical to ensure the retirement security of future retirees.

In general, the current tax system provides the strongest incentive for retirement saving to occur through the employer-sponsored qualified retirement plan system. There is a substantially higher limit on the amount of permissible tax-qualified retirement savings if the savings occurs through an employer-sponsored plan. However, it is important to remember that employers are generally

[1] More recently, the three-legged stool analogy is changing to a four-legged stool to include wage income, as many retirees must continue to work in part-time positions throughout their retirement.
[2] The current Social Security debate focuses on the solvency of the system and the projected elimination of the trust fund in 2042. Proposals consider price-indexing benefits, delaying retirement age, as well as introducing personal accounts. In any event, any potential solution to the problems will likely reduce the amount of benefits that retirees will receive.

entitled to deduct compensation expenses, whether they are made in the form of cash or in contributions to a qualified retirement plan. Thus, an employer may be generally indifferent whether to pay employees in current compensation or to make contributions on their behalf to a qualified retirement plan. Furthermore, the costs of establishing and maintaining a qualified retirement plan can provide a significant deterrent to small and mid-sized employers.

Although the current tax system provides a strong incentive for employees to save through a qualified retirement plan, current law rules create substantial barriers to the establishment of such plans. The costs of establishing a plan can be significant. Once established, the plan must meet standards for participation and nondiscrimination so that the benefits are generally available to all eligible employees, regardless of income or ability to save. In the case of defined benefit pension plans, the plan also must satisfy annual minimum funding requirements. The costs of complying with these minimum funding requirements are significant.

Changes to the rules for qualified retirement plans occur with alarming regularity. Thus, employers are constantly facing the costs of amending their plans to comply with new laws and regulations. In recent years, the Congress has recognized that the incentives of current law may not be sufficient to induce employers to establish and continue qualified retirement plans. Thus, Congress has passed additional laws to assist smaller employers offer alternatives to defined benefit plans and expand existing retirement savings options. The available plans, from which employers may choose, each with detailed rules on participation and contributions, create a complex system.

Many people believe that some form of change or reform is necessary to reduce the barriers to employer sponsored retirement plans and expand further the coverage of workers. Yet, most discussions of reform focus on revamping the tax code through consumption or national sales taxes or through such targeted reform as decreasing the capital gains rate or eliminating tax on other forms of investment. These approaches may increase savings outside of qualified retirement plans and permit business owners to accomplish their savings objective without offering qualified retirement plans to their employees. Given the ambivalence of employers toward maintaining qualified retirement plans due to their costs and complexities, these changes are likely to have a detrimental effect on qualified retirement plans and, as a result, savings by employees.

Without careful consideration, both major reform and targeted preferential treatment of nonqualified investments could erode both sponsorship and participation in qualified retirement savings plans. Such tax policy could add further instability to an already unstable component of retirement security—qualified retirement plan savings—and place further pressure on personal savings and the Social Security system.

The following sections examine the potential impact of tax reform on retirement savings. The first section presents background information on the need for qualified retirement plan savings and examines available qualified retirement plans, providing an overview of the rules facing plan sponsors. The second section examines past tax provisions and the impact on qualified retirement plans. The final section looks ahead to reform, considering consumption based taxes and targeted preferential treatment of nonqualified investments.

A. Retirement Savings Reasons for Concern

Retirement saving remains an important policy issue for the US Congress. During the past ten years, the Congress passed major legislation that expanded qualified retirement savings, created new qualified savings vehicles and attempted to simplify existing policy. Changing demographics, low overall savings rates, inadequate savings for many retirees and problems with Social Security make retirement savings a critical policy issue; individually each issue raises important concerns for the retirement security of our aging populations, but collectively they underscore the need for maintaining a strong retirement savings system.

Demographic Shifts—During the next ten to 15 years, the largest birth cohort, baby boomers, will begin to retire.[3] The Census Bureau estimates that in 2050 approximately 87 million Americans will be aged 65 or older compared to 36 million in 2000.

Within the overall growth of seniors, another trend emerges. The number of people aged 85 and older increases five-fold in 2050 over the 2000 population as shown in Graph 1. By 2050, Census estimates that approximately 21 million Americans will be over the age of 85. This trend reflects not only the growing retiree population, but increased longevity.

The 2005 Social Security Trustees Report estimates life expectancy as 17.0 years for a man and 19.7 years for a woman who becomes 65 in 2005. By 2050, life expectancy increases to 19.7 years for men and 22.2 years for women. Compared to life expectancy in 1960, projected life expectancies for 2050 reflect an increase of 52 percent for men and 46 percent for women.[4]

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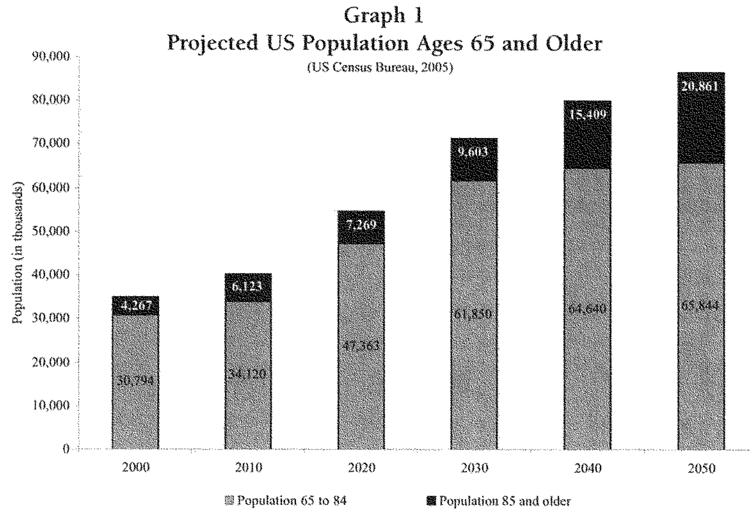
[3] The Census Bureau defines the baby-boomer cohort to include people born between 1946 and 1964.
[4] Social Security Administration, 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Dis.ability Insurance Trust Funds, March 23, 2005.



In addition to larger numbers of retirees who live longer, another trend emerges for seniors, that of declining retirement ages. In general, men are retiring earlier than previous generations. Since 1950, fewer men aged 55 to 64 were working or looking for work, as the proportion fell from 87 percent in 1950 to 68 percent in 1985.[5] Since 1985, this proportion remains stable fluctuating between 67 to 69 percent.

With respect to retirement savings, these trends mean increased pressure on public systems. To the extent that Social Security and Medicare are unable to provide the same level of benefits, retirees must rely increasingly on qualified retirement plan and individual savings. While a majority of Americans indicate they are saving for retirement, the question remains of whether amounts saved are adequate to meet growing retirement needs.

[5] See the US Department of Labor, Bureau of Labor Statistics Web site, 2005.

Are We Saving Too Little?—Evidence indicates that Americans have become increasingly aware of the importance of personal savings for retirement security. The Employee Benefits Research Institute (EBRI) 2005 Retirement Confidence Survey (RCS) reveals that seven in ten (nearly 69 percent) workers are saving money for retirement or starting to save for retirement. Nonetheless, many of those who are saving apparently are not saving amounts necessary to ensure an adequate retirement. Estimates indicate that most families are saving at only one-third the rate necessary to maintain their present standard of living in retirement.[6]

There are two commonly cited measures of personal savings, the National Income and Products Accounts (NIPA) and the Flow of Funds Accounts (FFA). The NIPA reports that the rate of personal savings declined steadily over the past few decades and is approaching historic lows. The FFA shows a decline, but not nearly as steep as that shown in the NIPA. The EBRI finds that while the rate of personal savings is declining, overall the personal savings rate of US workers generally is higher than typically reported.[7] However, the question of whether the current level of personal savings is adequate to meet future retirement needs still remains. The EBRI 2005 RCS finds that of the 69 percent that are saving for retirement, most do not have an idea of the level of savings necessary to live comfortably in retirement.

Although nearly 69 percent of American workers are saving to some extent for retirement, more than one-third of the working population is not saving for retirement at all. Ironically, of those not saving, almost half express some confidence in their ability to fund their retirement. Some indicate that they will save "later," while others believe they will obtain support from employers and family or friends.[8]

As retirement saving grows, through employer sponsored plans or through individual savings, other forms of savings decline. It is significant to note that retirement and other savings are largely substitutes for one another, not complementary. With respect to retirement security and the importance of both retirement and personal savings, this suggests that as people contribute to one form of savings, contributions to the other will decline.

EBRI reports that retirement savings as a percentage of total personal savings is growing. In other words, as workers save through employer-sponsored retirement plans they are less likely to save outside of those plans.

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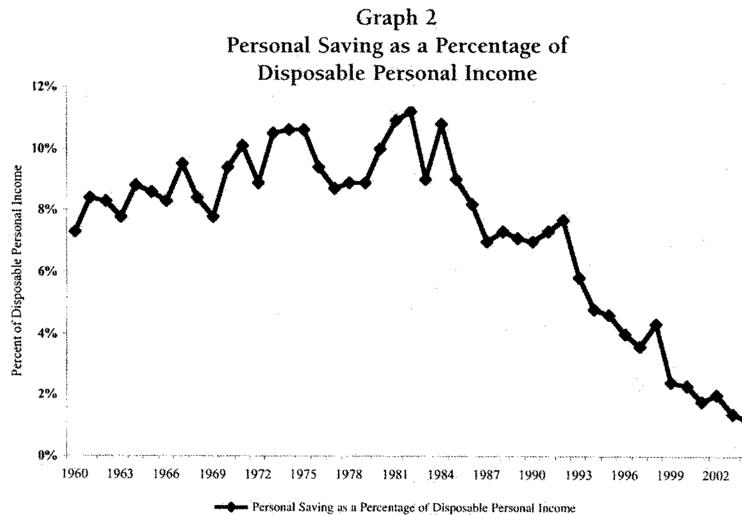
[6] US Congressional Budget Office, "Social Security and Private Savings: A review of the Empirical Evidence," July 1998.
[7] The National Income and Product Accounts shows a dramatic decrease in personal savings over the past ten years. However, Yakoboski and Devine indicate that NIPA does not measure realized capital gains on stocks and other assets which contributes to a significant increase in wealth.
[8] See EBRI Retirement Confidence Survey, 2005.



Graph 2
Personal Saving as a Percentage of Disposable Personal Income

Graph 2 shows personal savings as a percentage of disposable income from 1960 to 2004. As personal savings rates continue to decline, retirement savings becomes more and more important to retirement security. The EBRI analysis, coupled with the decline in personal savings, suggests that individuals are saving more through qualified retirement plans and less in non-qualified savings vehicles.

Research indicates that the likelihood of saving for retirement increases when the individual has access to an employer-sponsored plan. EBRI reports that 77.9 percent of workers making from $30,000 to $50,000 who are covered by an employer-sponsored 401(k)-type plan actually saved in that plan. However, only 7.1 percent of workers at the same income level not covered by a plan saved in an IRA. Low- to moderate-income workers are 11 times more likely to save when covered by an employer-sponsored plan.

A similar trend emerges when considering participation in the stock market and mutual funds. Many studies cite statistics indicating that half of all households participate in the stock market or own mutual funds. However, closer examination reveals that almost half of all households indirectly own such assets through their retirement account.[9] The Federal Reserve cites similar

[9] As of July 2003, an estimated 36.4 million US households, or almost half of all US households owning mutual funds, held such funds in employer-sponsored retirement plans. See Investment Company Institute, US Households Ownership of Mutual Funds in 2003, Vol. 12, No. 4 (October 2003).

statistics for stock market participation, reporting that individuals hold approximately 50 percent of all stocks through their retirement account. They find that as income falls, so does the likelihood of stock ownership outside a plan. They report that less than 25 percent of moderate-income and less than 10 percent of low-income households own stock outside of their retirement plan.[10]

Employer-Sponsored Retirement Plans—Many private-and public-sector employers offer either defined benefit or defined contribution retirement plans. Defined benefit plans offer a defined future benefit based on years of service and past salary levels. Defined contribution plans offer a future benefit determined by a defined level of contributions during the worker's participation.

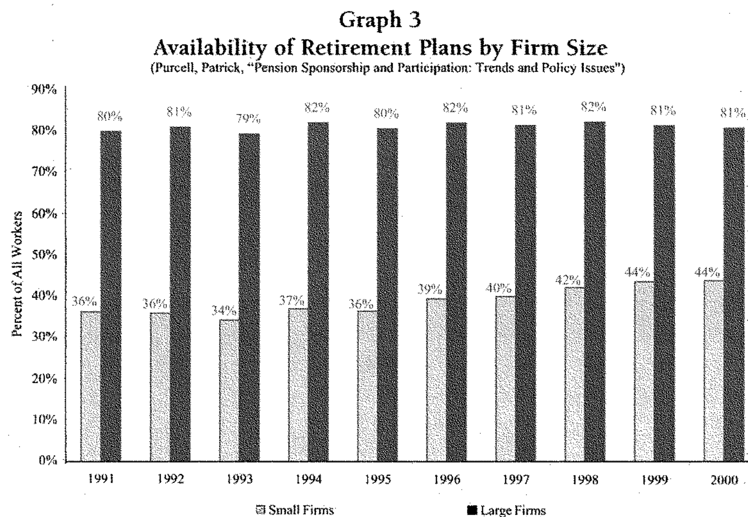
Recent statistics show that 66 percent of private- and public-sector employers make available some form of retirement plan to their employees (full-time and part-time workers). Public sector employers offer plans at a much greater rate than private sector employers with approximately 87 percent of public and 62 percent of private employers offering a retirement plan.

These percentages fall when considering plan participation as opposed to availability. Approximately 79 percent of public-sector and 50 percent of private-sector employees actually participate in their employers' plans.[11] In most cases, employees do not participate because they do not meet certain eligibility criteria (for example, some part-time workers may not work sufficient hours for eligibility or seasonal workers may not work sufficient weeks during the year). In other cases, surveys indicate that workers do not feel they have sufficient disposable income to participate or they lack the knowledge or an understanding of plan benefits. In general, participation rates are lowest among lower income workers and women, both of whom are likely to have periods of part-time work, high turnover or absences from the workforce.

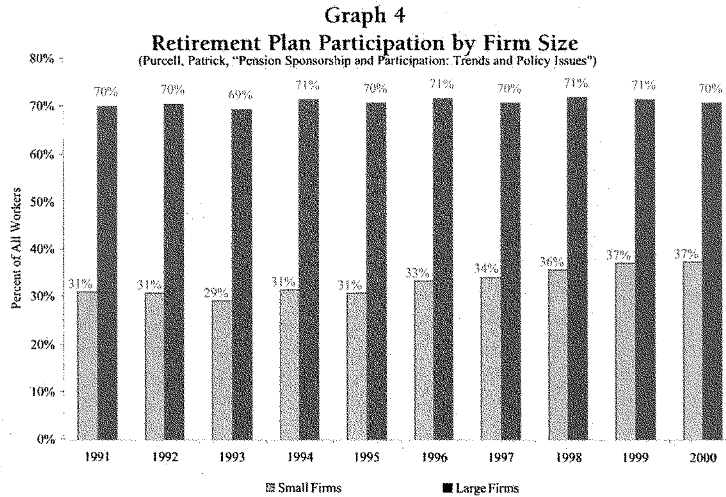
Worker turnover presents another problem for both employers that sponsor plans and employees wanting to participate. When worker turnover is high, employers often feel reluctant to sponsor or maintain a retirement plan. The employer faces ongoing costs when former employees leave small inactive accounts. When workers are entitled to the benefits, many plans do not want to hold inactive accounts for former employees. Also, workers with frequent job changes often are not fully vested when leaving the firm. In this case, they will forfeit some or all of their accumulated plan benefits. Further, workers with small vested accounts will frequently take their benefit in a lump sum distribution, pay the penalty and income taxes, and use the money for some other purpose (see the discussion below about this issue).

[10] See "Remarks by Governor Edward Gramlich at the National Savings Forum," July 2001.
[11] See Patrick Purcell, Pension Sponsorship and Participation: Trends and Policy Issues, Social Security Bulletin, Volume 64, Number 2, 2001/2002. Statistics include part-time workers.

Another area of concern with respect to the availability of employer-sponsored plans is firm size. Private sector employment is bimodal, meaning that approximately the same number of employees work in large firms as do in small. Therefore, when considering plan sponsorship among small employers, it is important to remember that nearly 50 percent of the private-sector workforce works for small employers.



In general, larger firms are more likely to offer pension plans compared with firms that employ fewer than 100 employees. Approximately 81 percent of firms that employ 100 or more employees offer some retirement plan compared to only 44 percent of employers with fewer than 100 employees as shown in Graph 3. Participation rates for larger firms are approximately 70 percent for full-time workers (about 30 percent for part-time workers). Participation rates in smaller firms are significantly less: approximately 37 percent for full-time workers (about 20 percent for part-time workers) as shown in Graph 4. As is discussed below, the barriers to plan sponsorship can be a particular problem for small and mid-sized employers.



The Leakage of Retirement Savings—Retirement assets do not contribute to retirement security if the assets do not accumulate. When workers take pre-retirement distributions and do not roll over their benefits to other tax-qualified savings, retirement assets begin to erode.

As mentioned, worker turnover often provides employees the ability to access their retirement savings balances prior to retirement. When workers change jobs, many receive the value of their retirement benefits in the form of a lump-sum distribution. Some will roll over such distributions to other tax-qualified savings to preserve their benefits. However, others may pay the income and penalty tax, taking pre-retirement withdrawals in lump sums to finance other spending.

With respect to lump-sum distributions resulting from a job change, EBRI finds that the size of the distribution and the recipient's age will influence the person's decision to spend or save the pension distribution.[12] As the size of the distribution increases, the individual is more likely to roll over the funds to another tax-qualified savings vehicle.[13] Not surprisingly, as the age at which a lump-sum distribution is received increases, the more likely the individual will preserve those assets rather than spend the assets. Approximately 25 percent of teens compared to 62 percent of those 50 or older saved their lump-sum distributions.

[12] EBRI Data Book, Chapter 9.

[13] The National Commission on Retirement Security Final Report indicates that individuals with smaller accounts are less likely to preserve those assets. Specifically, only 20 percent of distributions of less then $3,500 were rolled over into tax-deferred retirement accounts.

Many who receive lump-sum distributions report using those assets for a new home purchase, educational expenses, debt elimination or starting a new business. However, the most common use of pre-retirement distributions was other spending. Consequently, those individuals not only lost retirement assets, but also shortened their savings horizon and the corresponding gains from compounding interest.

Workforce turnover can also affect the accumulation of pension assets. It is not unusual for a worker to have many different employers throughout their employment history. Each transition to a new employer may mean a waiting period before the worker becomes fully vested in the plan. If the worker should move to another employer prior to vesting, the worker may lose accumulated benefits. Depending upon the type of plan, some benefits may move with the employee (fully portable); however, when workers are unable to transfer pension assets, the result is slower accumulations and lower yields for their retirement assets.

Accumulated Retirement Assets—Most studies confirm that about 60 percent of households have some type of retirement asset. However, it is more important to ask if the savings will be sufficient to maintain a person's or a family's pre-retirement standard of living. One general rule of thumb is that retirees will need to replace approximately 75 percent of their pre-retirement income to maintain their living standard. Circumstances will vary with each individual situation, suggesting that some will require greater savings and others less. For instance, the 75 percent replacement estimate assumes that retirees will have fewer household members during their retirement years and lower job-related costs in retirement. Often those owning their own home will have paid off their mortgage before retiring, lowering their overall need for higher income. One study estimates that only 44 percent of households will accumulate adequate retirement savings to maintain pre-retirement living standards throughout their retirement years.[14]

The likelihood of owning any retirement assets increases with age and educational attainment. As shown in Table 1, there is a greater prevalence of retirement savings as age and educational attainment rise.

Table 1

Prevalence of Retirement Assets by Age and Education

("Retirement Savings of American Households: Asset Levels and Adequacy", CP Montalto.)

Age	Reporting Any Retirement Asset	Educational Attainment	Reporting Any Retirement Asset
Less than 35 years	47.6%	Less than High School	37.5 %
35 to 44 years	67.1 %	High School	57.6 %
45 to 54 years	71.0 %	Some College	66.5 %
55 to 64 years	71.4 %	Bachelor's Degree	80.0 %
65 years and older	60.4 %	Graduate School	84.3 %

Estimates of adequate retirement savings rely on a life-cycle model that incorporates projected Social Security benefits, employer-sponsored and non-employer based retirement plans, as well as private savings. When evaluating the levels of saving and the adequacy of such savings, another important trend emerges. Specifically, higher income households are most likely to have adequate retirement savings. Approximately 54 percent of households with incomes between $50,000 and $100,000 will retire with adequate savings. Further, as income increases above $100,000, 69 percent of households will have adequate retirement savings.[14]

This direct positive correlation between adequate retirement saving and income makes intuitive sense. Low-income individuals frequently do not have the disposable income to make contributions to qualified retirement plans, even if they qualify to participate in such plans. The percentage of low-income individuals making IRA contributions is significantly lower than other income levels. Congress has recognized that low-income taxpayers face significant barriers to retirement saving by enacting a temporary tax credit (SAVER's Credit) to provide a greater subsidy for retirement contributions by low-income individuals. Under the temporary SAVER's Credit (which is due to expire in 2006), the Congress provides a special tax subsidy up to $1,000 for low-income individuals who make contributions to qualified cash or deferred arrangements, IRAs and certain other plans.

The likelihood of retiring with adequate savings also depends upon whether the individual participated in an employer-sponsored plan. Overall, 55 percent of households covered by employer-sponsored plans will have adequate savings compared to 24 percent of those without employer plans.[14]

Reliance on Social Security—When evaluating adequacy of retirement savings, most studies include Social Security. We know that Social Security is a pivotal part of most workers' retirement security. In fact, Social Security provided 43 percent of all income received by Americans aged 65 or older in 2002. Nearly two-thirds of the current 40 million Social Security recipients receive more than half of their retirement income from this source.[15] One current policy debate centers on reforming the Social Security system, which faces significant solvency issues in the future. Social Security will not have the legal authority to pay promised benefits when the trust fund balances are exhausted.[16]

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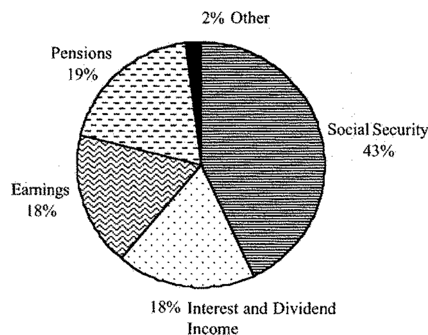
[14] See Montalto, CP, "Retirement Savings of American Households: Asset Levels and Adequacy," for a further statistics and analysis.

[15] EBRI Data Book, 4th Edition, Chapter 7. See also, Ettlinger, Michael and Chapman, Jeff, "Social Security and the Income of the Elderly," EPI Issue Brief #206, March 23, 2005.

[16] While estimates vary about when that may happen, it is clear that the spend-down of the trust fund will begin as more of the baby boomer cohort begins to retire.

When Social Security reform takes place, retirees may need to rely much more heavily on qualified retirement plan savings and personal savings, making these forms of savings an even more critical component of retirement savings. However, most studies indicate that retirement savings, both in qualified retirement plans and private saving, are inadequate to substitute for the potential loss of Social Security income. Graph 5 shows the composition of current retirement income by category.

Graph 5
Composition of Retirement Income
(EBRI Data Book, 4th Edition, Chapter 7)



As current retirees do now, future retirees will have to supplement Social Security payments with personal savings. Financial experts tell us, however, that current levels of personal retirement savings are not nearly adequate to ensure financial independence for most Americans when they retire—even *with* pension and Social Security income. According to some estimates, the oldest baby boomer cohort is saving just one-third of what they will need to maintain their current standard of living during retirement.[17]

B. Qualified Retirement Plan Rules

Under current law, federal tax benefits are provided to encourage employers to establish qualified retirement plans on behalf of their employees. These retirement plans are classified into two broad categories—defined benefit pension plans and defined contribution plans. A defined benefit pension plan generally promises a plan participant a specific annual benefit payable when the

[17] US Congressional Budget Office, "Social Security and Private Savings: A review of the Empirical Evidence," July 1998.

participant retires. Under a defined contribution plan, a participant is entitled to the contributions (plus earnings) in an account that has been established on the participant's behalf. Under a qualified retirement plan, contributions may be made to the plan by the employer, by the plan participants or by both.

A significant difference between a defined benefit plan and a defined contribution plan is that the employer sponsoring a defined benefit pension plan bears the risk of investment losses. Thus, plan participants are entitled to their promised benefits at retirement irrespective of whether there are adequate assets in the plan. A minimum level of pension benefits is guaranteed by the Pension Benefit Guaranty Corporation in the event that a defined benefit pension lacks sufficient assets to pay promised benefits.

The employer-based qualified retirement plan system is a voluntary system. Employers are not required to establish or maintain qualified retirement plans. An employer that chooses to establish a qualified retirement plan is required to comply with a complex set of rules that govern a wide range of issues relating to the plan's operation, including: (1) the employees who are required to participate in the plan, (2) benefits that may be provided under the plan, (3) the extent to which the plan can favor highly-compensated employees, (4) contributions that may or must be made to the plan, (5) the tax deduction that is permitted for employer contributions to the plan and (6) disclosure of information to plan participants and the federal government. The plan must meet the approval of the federal government both in form and in operation. The costs of complying with these rules are a significant reason why many employers either do not establish or decide to terminate qualified retirement plans.

Plan Participation, Vesting and Nondiscrimination—The qualified retirement plan participation rules require that employers permit employees to participate in a qualified retirement plan as long as the employee meets certain minimum eligibility requirements. In general, employees who have one year of service with an employer and have attained age 21 must be entitled to participate in an employer's qualified retirement plan. However, certain classes of employees (*e.g.*, part-time and seasonal employees) can be excluded from plan participation. Employers in certain industries (*e.g.*, fast food) have significant turnover so that a large percentage of employees leave employment before becoming eligible to participate in an employer's plan. In addition to the minimum participation requirements, qualified retirement plans also are required to satisfy rules to prevent the plan from discriminating in favor of highly compensated employees.

Employees who participate in an employer's qualified retirement plan are required to become fully vested (*i.e.*, entitled to receive 100 percent of their accrued benefit upon termination or other payment events) after either five years of service with the employer or, if the plan uses a graduated vesting schedule, after seven years of service.[18]

[18] Employer contributions made in proportion to the employee's own savings are required to be vested faster—after three years, or using a graduated six year vesting schedule.

General nondiscrimination rules also apply to qualified retirement plans. A qualified retirement plan cannot discriminate in contributions or benefits in favor of highly compensated employees. In the case of certain plans, such as qualified cash or deferred arrangements [*i.e.*,401(k) plans], these nondiscrimination rules contain very detailed testing requirements to ensure that highly compensated employees are not disproportionately benefiting under the plan.

Together, the participation, vesting and nondiscrimination rules are designed to ensure that employer-sponsored qualified retirement plans benefit a broad-based group of employees. This is the price that employers and employees pay for the higher contribution and benefit limits that apply to qualified retirement plan savings compared to other tax-favored forms of retirement savings (such as IRAs).

Benefit Limits—Qualified retirement plans are subject to dollar limits on contributions and benefits. For 2005, the annual limit on benefits under a defined benefit pension plan is $170,000. The 2005 annual limit on contributions to a defined contribution plan is $42,000. The 2005 elective deferral limit (*i.e.*, the amount of compensation that an individual employee can elect to defer) for a qualified cash or deferred arrangement is $14,000.

The dollar limits on contributions to qualified retirement plans are significantly higher than the limits on other tax-favored forms of retirement savings, such as IRAs. For 2005, the limit on contributions to an IRA is $4,000 ($4,500 for taxpayers who have reached age 50). Thus, individuals generally prefer to save for retirement through a qualified retirement plan because they are able to accumulate greater retirement savings. See the discussion below of the tax benefits attributable to a qualified retirement plan.

Funding and Deductions—Employers who establish qualified retirement plans are subject to specific rules governing the plan's funding and the extent to which the employer can deduct contributions to the plan.

The rules governing defined benefit pension plans are particularly detailed and complex. These rules not only specify the extent to which an employer is required to make annual plan contributions to ensure that there will be adequate funds available in the plan to pay promised benefits, but also provide limits on employer contributions designed to preclude overfunding of a plan. Substantial taxes are imposed on the termination of an overfunded defined benefit plan if the excess assets revert to the employer. Defined benefit pension plans carry significantly higher costs to establish and maintain than defined contribution plans. For small to mid-sized employers, the burdens of complying with the rules for defined benefit pension plans often are prohibitively expensive.

Treatment of Withdrawals—The amounts participants withdraw from qualified retirement plans by plan participants are subject to restrictions on both the timing and the nature of the benefit payments. Participants may be subject to a 10 percent tax penalty if they make a withdrawal prior to retirement or the attainment of age 59 1/2, unless the amounts withdrawn are used for certain specified purposes.

In addition, a qualified retirement plan participant who is no longer working is required to commence receiving retirement benefits and paying tax on such benefits at age 70 1/2 whether or not the individual needs the retirement income at that time. This provision encourages the depletion of retirement savings without regard to the individual's specific needs of the individual.

C. Tax Benefits of Qualified Retirement Plans

Under current law, an employer is permitted, within limits, to deduct contributions to a qualified retirement plan. The contributions are made to a trust that generally is exempt from federal income tax. Employees who participate in these plans are not required to include amounts contributed to the plans in gross income until the amounts are withdrawn by the employee.

From a federal tax perspective, an employer is generally indifferent as to whether current wages are paid to employees or whether contributions are made on behalf of the employees to a qualified retirement plan because the employer generally is entitled to a current deduction with respect to both payments. Certain employer contributions to qualified retirement plans are also not subject to Social Security and Medicare taxes (employment taxes), so the employer and employee share of these taxes may be reduced.[19]

On the other hand, employees generally should prefer to have contributions made to a qualified retirement plan on their behalf because the contributions will reduce their current tax liability.[20] However, employees should be indifferent to receiving compensation in the form of contributions to qualified retirement plans and other forms of tax-favored compensation that permit the accumulation of savings on a tax-free basis.[21] Despite the federal tax benefits for saving for retirement in a qualified pension plan, some employees might prefer to receive compensation in the form of current salary if they have insufficient disposable income to meet their current needs.

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[19] Economists generally believe that employees bear the incidence of these taxes.
[20] Certain employer contributions to qualified retirement plans are also excluded from income for purposes of calculating the employer and employee share of Social Security and Medicare payroll taxes. While this increases the incentive for retirement savings because it further lowers current federal tax liability, there is a trade-off for employees whose compensation is below the social security taxable wage base because their credits for social security benefits are reduced to the extent their current compensation is reduced. Thus, if an employer makes a contribution on behalf of an employee to a qualified retirement plan, the employee's current taxable compensation is reduced for income and employment tax purposes, but the employee's future social security benefits may be reduced as a result.
[21] Additional discussion of this issue is below. For example, under current law, certain tax benefits are provided for savings for education. These tax benefits not only provide a deferral of tax on the amounts contributed, but in some cases, the individual is entitled to a tax exemption for the withdrawal of amounts contributed. In such cases, the tax benefits of saving for education are more generous than the tax benefits attributable to qualified retirement plans.

Some of the reasons that an employer might prefer a qualified retirement plan over current wages include:

- The owner of the business might prefer to defer paying taxes on some of his or her own current income and a qualified retirement plan provides one mechanism for doing this;
- Employees have indicated their preference to have a qualified retirement plan; and
- The employer feels that it has an obligation to assist employees in saving for retirement.

The desire of a business owner to defer paying taxes on some of his or her own current income is likely a significant factor in the formation of a qualified pension plan by small and mid-sized firms.

On the other hand, employers might prefer to pay current wages instead of contributions to a qualified retirement plan because:

- There are significant regulatory burdens and costs to establishing and maintaining a qualified retirement plan;
- Certain types of qualified retirement plans (*e.g.*, defined benefit pension plans) require a long and ongoing commitment of contributions and the employer may be concerned for various reasons (*e.g.*, projected profits) to take on such a commitment; or
- Employees do not prefer to have contributions made to a qualified retirement plan (*e.g.*, if the employees generally are lower paid and cannot afford to save for retirement).

Value of Tax Benefits of Qualified retirement plans to Employees—From an economic perspective, the tax benefits of a qualified retirement plan are generally equivalent to a permanent exemption from tax of the earnings on contributions made to the plan. This principle can be illustrated with the following example:

> Assume that a $10,000 contribution is made to a qualified retirement plan on behalf of an employee. Assume that the employee's marginal tax bracket is 28 percent, so the employee would have $2,800 of current income tax if the contribution had been received as taxable compensation. Assume that the $10,000 earns an 8 percent return ($800) in Year 1 so at the end of Year 1; there is a balance of $10,800. Further assume that the $10,800 is withdrawn at the beginning of Year 2 and no penalty taxes apply to the withdrawal. In Year 2, the amount withdrawn is subject to $3,024 of tax ($10,800 times 28 percent), leaving a balance of $7,776.

If the taxpayer had received instead taxable compensation and invested in a taxable account, he or she would have had $7,200 [$10,000 minus $2,800 (the tax on the compensation)] to invest. The earnings on this amount at 8 percent would be $576, subject to tax of $161.28 for a net of $414.72. Thus, upon withdrawal, the taxpayer would have $7,614.72.

The difference in what the taxpayer has available under the two options ($7,776 versus $7614.72) is the $161.28 tax on the earnings. It should be noted that, if the taxpayer is in a different marginal tax bracket when the withdrawal is taken, the tax benefits will be different (see the example below).

In addition to the value of the exemption of earnings from tax, the contributions that are made on an employee's behalf to a qualified retirement plan may reduce the employer and employee share of employment taxes that are owed.[22]

The value of tax incentives for savings is further illustrated in Table 2. For this purpose, tax-preferred retirement savings refers to plans that allow taxpayers to deduct from taxable income their contributions to such plans and accumulate earnings on the account on a tax-deferred basis.[23] In this form of savings, withdrawals are fully taxed. Tax-free savings refers to plans (such as Roth IRAs) in which contributions are made on an after-tax basis (*i.e.*, no deduction or exclusion for contributions), earnings accumulate tax-free, and there is no tax on withdrawals.

Tax-preferred savings, through an employer plan and through personal savings, may have a positive effect on the saving decision. In general, the current tax incentives encourage tax-preferred savings (*e.g.*, retirement savings) over savings for other purposes. The advantages of tax-preferred savings are that taxpayers earn a tax-free rate of return on their investments and postpone their tax liability until retirement, when presumably they have a lower tax rate. Table 2 compares the benefits of tax-preferred and tax-free savings plans to a taxable savings plan. In this example, a taxpayer who is in a 28 percent marginal tax bracket has $10,000 of compensation available for savings and investment. The initial contribution (minus income taxes, where applicable) accumulates for ten years at 8 percent annual interest and is withdrawn when the taxpayer is in a 15 percent marginal tax bracket.

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[22] This exemption from employment taxes does not apply to elective deferrals under a qualified cash or deferred arrangement. In addition, the exemption may reduce the amount of social security benefits to which an individual is ultimately entitled.
[23] In addition to traditional defined benefit and defined contribution plans, this includes IRAs, 401(k) and other contributory savings plans.

Table 2
Compare Tax-Preferred. Tax-Free and Fully-Tax Savings Plans
Amount Available for Deposit = $10,000
Interest Rate = 8%
Tax Rates = 28% (pre-retirement) and 15% (retirement)
Years of Accumulation = 10

	Tax-Preferred	Tax-Free	Fully Taxed Savings
Initial Deposit	$10,000	$7,200	$7,200
Accumulated Balance	$21,589	$15,544	$12,605
Available after paying tax	**$18,350**	**$15,544**	**$12,605**

As the above example indicates, an individual saving $10,000 in a tax-preferred savings vehicle generally will have a greater amount to invest, because the dollars are pre-tax dollars. If the tax rate is, indeed, lower at retirement, the benefits of the tax-preference remain. It is important to note that the majority of taxpayers will face a lower tax rate at retirement. Therefore, the benefits of the tax deduction and inside buildup are measurable.

If a taxpayer faces the same marginal tax rate in retirement as he or she does when a contribution is made, the effect of the tax-deferred and tax-free savings vehicles would be equal. As noted above, these plans generally provide the equivalent of an exemption from tax for the earnings on the amounts contributed. In reality, most taxpayers face a lower tax rate in retirement than during their working years, so if all other things are equal, they should prefer the tax-deferred form of saving to the tax-free form.

Compared to other savings, tax-preferred or tax-free retirement savings may encourage individuals to save for retirement. However, as the types of tax-preferred savings vehicles increase, there is a danger that savings become diluted as individuals direct their tax-preferred savings to shorter-term savings needs (*e.g.*, first time home purchase or higher education for child or spouse).

II. Effect of Tax Reform On Qualified Retirement Plan Savings

The tax benefits available for retirement savings through an employer-sponsored qualified retirement plan often are not sufficiently large to overcome the substantial costs that employers must incur to establish and maintain these plans. This fact is particularly true for small and mid-sized employers. The statistics on plan formation and termination bear this out by showing that small and mid-sized employers are much less likely to establish qualified retirement plans (only 44 percent of employers with fewer than 100 employees establish plans) and much more likely to terminate the plans that they do establish (see graph 3).

In addition, certain statutory provisions that either provide tax incentives for non-retirement saving or specifically discourage retirement savings impact the amount of retirement savings that accumulate under current law. These provisions include preferential tax rates for capital gains and dividends, tax incentives for such other types of savings such as health savings accounts and education savings accounts, and limits on the amount of qualified retirement savings.

Despite the fact that there is a recognized need to encourage individuals to save for retirement, few policymakers focus on the devastating effect that various tax reform proposals may have on saving for retirement. While many focus on the advantages or disadvantages of a consumption tax as an addition to or alternative to the current law income tax system, few are aware that the switch to a consumption tax system or an elimination of the tax on capital gains and dividends will likely result in an alarming reduction in individuals' retirement saving.

This section provides an overview of the current tax provisions of current law that potentially affect a taxpayer's decision to save for retirement and provides an overview of the potential direction of various tax reform proposals.

A. Tax Provisions That Affect Retirement Savings

Capital Gains and Dividends—Reductions in capital gains rates have long been touted as a way to stimulate the economy, reduce the economic distortions of current law that favor debt versus equity and increase national savings. Reduced capital gains and dividend tax rates make investments in stock and other capital assets more tax favored relative to other investments.

Under current law, capital gains generally are subject to tax rates below the ordinary income tax rates. The gains are included in income when they are recognized, which generally occurs when the asset is sold or otherwise disposed of. Long-term capital gains generally are subject to tax at a maximum rate of 20 percent (10 percent for income that would be subject to ordinary

income tax at a 15 percent rate). From 2003 through 2008, these rates are reduced to 15 percent and 5 percent, respectively (the 5 percent rate is reduced to zero in 2008).[24] After 2008, the 20 percent/10 percent rate structure again applies.

These reduced tax rates also apply to dividends received by individuals for 2003 through 2008.[24] After 2008, dividends received by individuals are subject to tax at ordinary income tax rates.

Lower tax rates on capital gains and dividends can affect an individual's decision when making investments in retirement savings. All amounts withdrawn from qualified pension plans are subject to income tax as ordinary income.

There is a significant disadvantage to investing qualified retirement plan assets in stocks and capital assets because of the greater tax advantages available if the assets are held directly by individuals. For example, if a qualified pension plan holds a capital asset that was purchased for $1,000 and sold for $10,000, the $9,000 of capital gain will be taxed at ordinary income rates when it is distributed to a plan participant. A taxpayer in the 28 percent marginal rate bracket would pay $2,520 ($9,000 x .28) of federal income tax. If the same taxpayer held the capital asset directly, rather than through a qualified pension plan, he or she would pay $1,350 of federal income tax ($9,000 x .15) on the gain.

If the current tax provisions imposing a 15 percent/5 percent rate structure for capital gains and dividends expire as scheduled, the tax advantage to holding capital assets and stocks directly is reduced, but not eliminated, as the rates return to 20 percent/10 percent. Taxpayers still have an incentive to reduce their holding in capital assets in qualified retirement plans and increase their personal holdings in taxable capital assets. In the example above, the taxpayer would pay $1,800 ($9,000 x .20) of federal income tax if the capital asset is held directly, rather than $2,520 if the asset is held in a qualified retirement plan, which is still a substantial difference in tax benefits and one that makes saving outside the qualified retirement plan more attractive.

Furthermore, it is important to remember that withdrawals from qualified pension plans may be subject to an early withdrawal penalty if they occur prior to retirement. On the other hand, as long as a capital asset is held for at least one year, the reduced tax rates apply. In general, taxpayers can control the timing of taxation on capital gains by selling the asset when the gains are needed. Thus, an additional advantage of holding capital assets directly is that taxpayers can avoid paying any penalty taxes for accessing their gains.

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[24] Various other special provisions apply to specific types of capital gains, so lower or higher rates may apply depending upon the nature of the investment. For example, capital gains on collectibles generally are taxed at either 15 or 28 percent.

Similarly, taxpayers who invest directly in capital assets may hold the asset as long as they want, whereas taxpayers whose assets are invested in qualified retirement plans are generally required to begin receiving distributions (and, therefore, paying federal income tax) at the later of (1) attainment of age 70 1/2 or (2) retirement.

The bottom line is that taxpayers with adequate resources can effectively establish what amount they will accumulate for retirement by investing their money in capital assets and dividend-producing stocks. Taxpayers can time the recognition of their capital gains to match their income needs in retirement. Taxpayers who need to access funds at an earlier time will not be subject to any specific tax penalty as long as they have held a capital asset for at least one year. Furthermore, there are no limits on the amount of tax-favored investments that can occur in this manner, unlike qualified pension plans, which are available on a dollar-limited basis.

This incentive to invest outside of qualified retirement plans may, over time, reduce small business owners' decisions to offer qualified retirement pension plans as they find that the costs and administrative burdens of maintaining qualified retirement plans, combined with the favorable tax treatment of capital gains and dividends, make saving in qualified retirement plans far less attractive than personal savings.

This situation is most relevant to small employers, with one or two more highly compensated employees and several lower-compensated employees. As the costs and administrative burdens rise, the small employer is more likely to view other savings options as more attractive than sponsoring a qualified retirement plan. The small employer could eliminate the qualified retirement plan and offer bonuses to his employees. By depositing the after-tax bonus in stock or equity investment funds, the favorable capital gains and dividend tax treatment could provide benefits greater than or equal to those in the qualified retirement plan—with far less effort and expense.

In addition to the current tax incentives for saving for retirement, there are a number of tax incentives for "special purpose" saving. The two most significant "special purpose" federal tax incentives are the incentives for savings for education and those for health savings accounts (HSAs).

Tax Incentives for Education Savings—The tax incentives for saving for education may take one of two principal forms—Section 529 qualified tuition programs and Coverdell education savings accounts. A qualified tuition program is established by a state or a qualified educational institution to provide a mechanism for higher education saving.[25] Amounts contributed to such a program are not deductible, but the earnings accumulate on a tax-free basis and withdrawals used for qualified education expenses are not included in income. There is no dollar limit on contributions to a qualified tuition program. However, withdrawals not used for qualified

[25] Certain of the special provisions for qualified tuition programs expire at the end of 2011.

education expenses are included in income and subject to a 10 percent penalty tax. Because the exclusion from income is available only for withdrawals for qualified education expenses, there is an inherent limit on the amount of savings invested under these programs.

A Coverdell education savings account is a trust or custodial account where contributions are made for a beneficiary who generally is under age 18 (unless the beneficiary has special needs) to save for qualified education expenses. The maximum annual contribution to a Coverdell education savings account is $2,000 (after 2011, the annual contribution limit becomes $500). The annual contribution limit is phased out for taxpayers with income above certain levels. The amounts contributed to a Coverdell education savings account are not deductible, but the earnings grow on a tax-free basis and withdrawals used for qualified education expenses are not included in income. Like the qualified tuition program, withdrawals that are not used for qualified education expenses are included in income and subject to a 10 percent penalty tax. The allowable qualified education expenses for purposes of a Coverdell education savings account are broader than those for a qualified tuition program because they include expenses for elementary and secondary education.

In addition to the qualified tuition programs and the Coverdell education savings accounts, current tax provides an exclusion from income for interest earned on qualified US Series EE savings bonds issued after 1989 to the extent the proceeds of the bond do not exceed the qualified higher education expenses of the taxpayer during the year.

The tax benefits attributable to qualified tuition programs and Coverdell education savings accounts are similar to the tax benefits attributable to saving in a Roth IRA. Contributions are not deductible, earnings are excluded from income and withdrawals are not subject to tax (provided the withdrawals are used for the permitted purposes). If a taxpayer's marginal tax rate remains the same over time, this tax treatment is equivalent to the treatment accorded to qualified retirement plans in which the initial contribution is not taxed, earnings are tax free and withdrawals are included in income.[26]

The tax incentive for saving through a qualified tuition program or a Coverdell education savings account is in general equivalent to the incentive to save in a qualified retirement plan. However, fewer taxpayers are likely to anticipate that they will incur qualified education expenses eligible for the special tax treatment. While any taxpayer can ultimately utilize the favorable tax benefits of qualified retirement plan saving, only those taxpayers who actually have qualified education expenses will enjoy the full benefit from these education tax incentives. Thus, it is likely that the saving for education will attract a more narrow class of taxpayers who anticipate such expenditures.

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[26] In reality, the taxpayer who receives a withdrawal from one of these programs may be in a lower tax bracket than the taxpayer who made the initial contribution to the program or account.

Yet saving in these plans may encourage some taxpayers to divert retirement savings to educational savings, as most families have limited resources for savings. The addition of such plans provides a competing, not complementary, form of savings.

Also, because saving under a qualified tuition program is not dollar-limited, those taxpayers who anticipate incurring qualified higher education expenses have a substantial incentive to make contributions to such a program to take advantage of the tax saving.

In addition, taxpayers who do not anticipate incurring qualified education expenses might also find the vehicles attractive. This is because, under certain situations, the 10 percent penalty tax on withdrawals not used for qualified education expenses may not fully cancel the tax advantages of these programs relative to a taxable account. Thus, for a taxpayer whose retirement saving is limited by the dollar limits for qualified retirement plans, the education savings vehicles may still provide an attractive form of tax-favored savings.

Tax Incentives for Health Savings—Current law provides tax incentives for savings for health care expense through HSAs. These accounts are a tax-exempt trust or custodial account created exclusively to pay qualified medical expenses. The accounts are similar to IRAs. However, in some cases, the tax advantages of HSAs are more favorable than those for qualified requirement savings. Contributions to an HSA are deductible, earnings grow on a tax-free basis and withdrawals from the HSA for qualified medical expenses are excluded from income. Thus, by providing an exclusion from income for such withdrawals, an HSA provides a greater tax benefit than qualified retirement saving.[27]

An individual must have coverage under a high deductible health plan and have no other health plan to make contributions to an HSA. In general, the annual limit on contributions to an HSA is $2,650 (for 2005) for a taxpayer with self-only coverage and $5,250 for a taxpayer with family coverage. The annual limit increases for individuals over age 55. A high deductible health plan has a deductible of at least $1,000 for self-only coverage and $2,000 for family coverage.

While the annual dollar limits on the deduction are relatively low, HSAs are likely to be attractive savings vehicles, because they offer benefits that are greater than those offered by qualified retirement savings. Because HSAs are fairly new savings vehicles, it is likely that their use will continue to grow. It is too early to have any reliable statistics on HSA use.

[27] Withdrawals that are not used for qualified medical expenses are subject to both an income and a 10 percent penalty tax.

Limits on Qualified Retirement Plan Savings—Recent legislation has continued to erode the tax incentive for qualified retirement plan saving by introducing different tax incentives for different forms of saving. As more and more taxpayers begin to consider alternative tax-favored forms of saving, the dollar limits that apply to qualified retirement savings are likely to continue to be a deterrent to the establishment and maintenance of qualified retirement plans by small and mid-sized businesses.

It is important to recognize that a major impetus to small business owner forming a qualified retirement plan is the ability to shelter the owner's current income from tax. The limits on contributions and benefits under qualified retirement plans can be juxtaposed against the substantial costs of establishing and maintaining a qualified retirement plan.[28] Ultimately, a small business owner may conclude that other forms of tax-favored savings that do not entail such costs are a more efficient use of the owner's resources.

B. Direction for Reform

Advocates of tax reform—those seeking to overhaul the income tax system—are encouraging the move toward consumption taxes (pure consumption or national sales tax) and away from income taxes. Any minor tax change creates winners and losers. Such a dramatic reform would generate considerable change and inevitably, raises many questions about who wins or loses. We focus our attention on the effect major tax reform might have on retirement savings, both from the perspective of individual savings and retirement security and of the desire or willingness of employers to offer retirement plans as a part of total compensation.

[28] For 2005, the dollar limit on contributions to a defined contribution plan is $42,000. The dollar limit on benefits under a defined benefit pension plan is $170,000.

III. Closer Look at The Impact—Effect On Qualified Retirement Plans

A. Consumption-Based Taxes

In principle, the difference between a consumption tax and income tax is the treatment of savings. Consumption is income less savings. Conversely, income is equal to consumption plus savings. These simple identities form the basis for either taxing consumption or income.

Economists define income as anything that increases an individual's ability to consume. Thus, income includes compensation for services, rents, royalties, life insurance proceeds and alimony. Under a pure income tax, anything that increases the ability to consume is income that is subject to tax. Under a pure consumption tax, taxpayers must consume a portion of their income or savings to incur a tax liability. Therefore, if a person chooses to delay consumption and save their income, they will also delay the tax until such time as they consume their savings.

In a pure income tax world, all income (both from capital and labor) is subject to tax. In a pure consumption tax world, only amounts spent on goods and services are subject to tax. However, in the real world, any tax system—whether income or consumption tax—might exhibit characteristics of one or the other or combine elements of both tax systems.

For example, under our present income tax system, we treat certain tax qualified savings as if it were savings in a consumption tax world. In other words, we allow taxpayers to deduct from income amounts saved in a tax-qualified retirement plan and exempt from income any earnings on that savings until amounts are withdrawn at retirement when withdrawals are then treated as income.

Excluding contributions to qualified pension plans and IRAs from current income in essence provides consumption tax treatment for these amounts by excluding them from income when they are contributed and taxing them only upon withdrawal.[29] Because the contributions to these plans and accounts are limited under current law, the consumption tax treatment is limited to the permitted dollar limits on contributions. Similarly, current law provides consumption tax treatment for unrealized capital gains and to the extent that certain capital expenditures can be expensed by small businesses. However, because current law provides limited consumption tax treatment for specific items, many argue that current law provides consumption tax treatment for certain income as a way of encouraging specific behavior by taxpayers, such as retirement saving.

In general, consumption taxes tax the purchase or use of goods and services and therefore, by their nature, favor savings. Consumption taxes make it more expensive to purchase goods and

[29] It should be noted that Roth IRAs are essentially equivalent to deductible IRAs by taxing the income that is contributed to a Roth IRA and providing an exclusion from income for any withdrawals, as long as the tax rate faced by the taxpayer is the same when a contribution is made and when a withdrawal is taken.

services. Thus, the less a taxpayer consumes and, therefore, the more he or she saves, the less tax is paid. A consumption tax could replace the current federal income tax, or supplement the income tax with a separate revenue raising structure.

Consumption taxes may take a variety of forms. These include the value-added tax (VAT) or retail sales tax and consumed income tax. There are two features that distinguish the various types of consumption-style taxes—the source of the tax revenue and the source of the tax burden. In general, with a VAT the producer pays the tax and wages or workers bear the tax burden (depending upon whether there is a tax on old capital). With retail sales and consumed income taxes the consumer pays the tax and all consumers share the tax burden, regardless of their employment status.

Value Added Tax—The most common form of consumption tax used throughout the world is the VAT. A value-added tax generally is a tax imposed and collected on the "value added" at every stage in the production and distribution process of a good or service. Although there are various ways to compute the value added (*i.e.*, taxable base) for a VAT, in general the amount of value added are the difference between the value of sales (outputs) and the value of purchases (inputs) of a business.[30]

An important feature of a consumption-style VAT is that a company's investment is expensed rather than depreciated, causing the effective tax rates on investment to be zero with full expensing. Rather than taxing directly the investment, the return from the investment generates the tax. This return is the increase in value of the goods and services generated by the investment.

Another way to think about the VAT is in terms of the value of the inputs—labor and capital. During the production process, the labor and capital inputs add value as the product moves from raw materials to finished goods. If all new investment avoids tax through expensing, the labor through the value of their wages and old capital would bear the burden of the VAT.

When considering tax reform that relies on a VAT, it is important to consider the impact on old capital or capital acquired before tax reform. This distinction between old and new investment is an important one. Because of this distinction, the transition from an income tax system to a VAT system would not flow seamlessly. If the new VAT does not impose taxes on old capital, then the VAT becomes purely a wage tax. However, if old capital is subject to tax, then capital is taxed twice—once under the former income tax system and again through the VAT system.

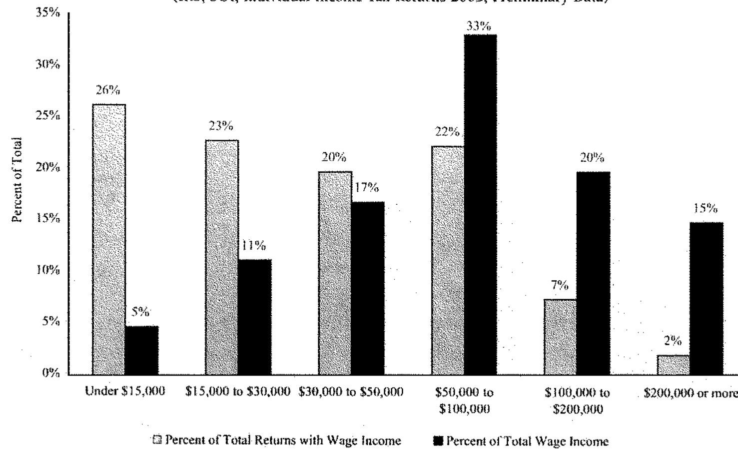
The VAT also differs from other forms of consumption taxes in the way that other assets avoid tax. Consider for example, a person who discovers a valuable resource on otherwise worthless land or a

[30] There are two primary types of VAT—the credit invoice method and the subtraction method (sometimes referred to as a business transfer tax).

person who develops an idea. Under a VAT, consumption from the proceeds of the resource or the idea would escape tax. Generally speaking, any consumption financed with savings acquired prior to the VAT would also avoid tax.

These simple situations suggest more complicated policy questions to consider when thinking of implementing a VAT under tax reform, specifically whether the VAT would be more or less progressive (regressive) than the current income-based tax system. While the answer to that question is complicated, some simple statistics provide an intuitive indication to that answer. Consider first the income distribution of those earning wages. Graph 6 shows the wage income (as a percentage of total wage income) and returns reporting wage income (as a percentage of total returns) distributed by income class. The percentage of returns is concentrated at the lowest income levels, but upper-middle income returns report the greatest share of wage income.

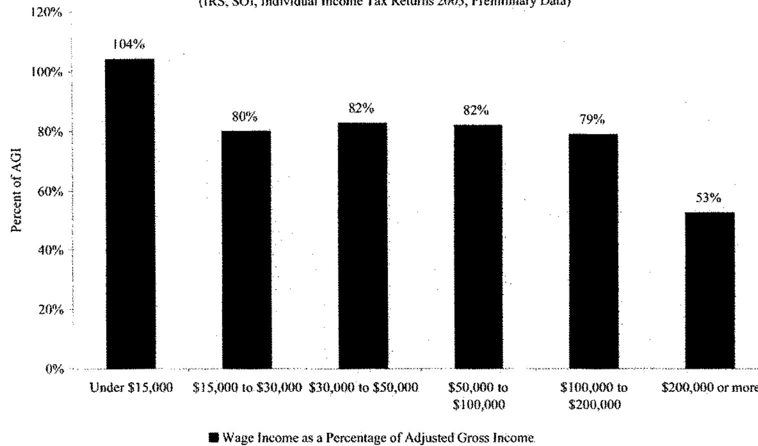
Graph 6
Wage and Salary Income, Percent of Total Return and Percent of Total Wage and Salary Income, 2003
(IRS, SOI, Individual Income Tax Returns 2003, Preliminary Data)



It appears based on gross reporting of wage and salary income that a VAT that derives its value from wages would derive its greatest source of revenue from higher income classes. However, consider wage income as a percentage of total adjusted gross income and a different picture emerges as shown in Graph 7. Wage income comprises the majority of income for the lowest income classes.[31] As incomes rise, the VAT derives tax on a smaller share of total income, as defined under the present system.

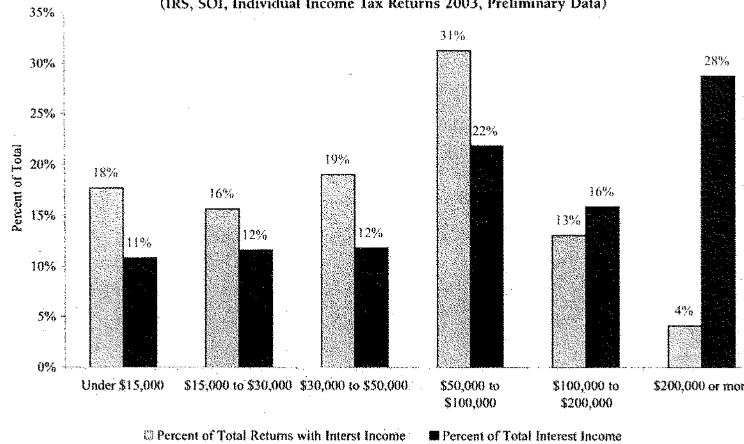
[31] Note that adjusted gross incomes for the lowest income classes typically include net capital losses, making wage income greater than the total.

Graph 7
Wage Income as a Percentage of AGI, 2003
(IRS, SOI, Individual Income Tax Returns 2003, Preliminary Data)



If a VAT does not tax old capital or assets accumulated before implementing a VAT consumption financed by such assets is not subject to tax. As one might expect, the accumulation of assets is positively correlated with income as Graph 8 suggests, which considers interest income as a proxy for the base of accumulated assets. As incomes rise, the percent of total taxable interest income also rises. This positive correlation reinforces the fact that savings is positively correlated with income and that lower income households generally do not save outside employer-sponsored plans.

Graph 8
Taxable Interest Income as a Percent of Total Returns and Total Interest Income, 2003
(IRS, SOI, Individual Income Tax Returns 2003, Preliminary Data)



National Retail Sales Taxes—Retail sales taxes are a common form of consumption tax used by state and local governments. Under a national retail sales tax, goods and services sold to households would be subject to sales taxes.[32] However, only the new sales or production is subject to tax. Sales of used goods or previously owned items would not constitute retail sales.

In general, a national retail sales tax would tax all goods and services. Note that state and local governments generally exempt from the base such items as food, housing and health care. However, if certain goods and services are exempt from the national sales tax, the rate must increase.[33]

Advocates of this approach believe that a flat tax would apply to all retail sales, and that this flat tax would greatly simplify the tax system. Further, they believe that a retail sales tax would eliminate the need for deductions, exemptions and tax preferences. Taxpayer compliance and tax administration would focus on the base of retail sales, rather than the income generated to pay for those sales. Advocates of national sales tax proposals suggest lower tax rates would be revenue neutral, but generally do not consider compliance costs and tax avoidance schemes.

[32] Business-to-business and household-to-household transactions would qualify as retail sales.
[33] Some studies estimate that a budget-neutral move to a national sales tax from the present income tax would require a 60 percent tax rate. The 60 percent tax rate is a "tax-exclusive" rate. The tax-inclusive rate is 38 percent. See Gale, William, "National Retail Sales Tax," Brookings Institute, 2004.

Whatever the sales tax rate, it is important to consider that most states impose sales taxes in addition to state income taxes. Eliminating the federal income tax system would require states to increase their sales tax rates.

With respect to existing savings, imposing a national sales tax raises equity issues. Consider a person in retirement that finances consumption exclusively from retirement savings and Social Security income. Assume that the individual's annual Social Security benefits are $9,000 and retirement benefits are $6,000 for a combined retirement income of $15,000. Under present law, with limited income, the Social Security benefits are not taxable. After a personal exemption and standard deduction, the retirement income is also not taxable. This retiree would not pay any federal income taxes under the present system. However, under a national retail sales tax, every dollar spent would include sales taxes. Regardless of the rate, 20, 30 or 60 percent, this represents a significant tax increase and a reduction in consumption for retirees.

Moving from an income tax system to a national sales tax system raises many questions with respect to the tax treatment of existing savings, both tax-preferred savings and after-tax savings. Such distinctions create the need for complex transition rules or potentially excluding certain items from the retails sales tax base. However, as mentioned above, reducing the tax base would increase the sales tax rate.

Consumption represents a larger share of income for lower income households. A recent Tax Policy Center publication estimated the amount of income spent on consumption. They estimated that households with incomes between $10,000 and $20,000 per year spend 75 percent of their total income on food, housing and clothing. Households with incomes greater than $200,000 spend approximately 16 percent on these necessities. Overall when considering consumption of both necessities and other goods, low-income families consume virtually all of their income, compared to their high-income counterparts that consume approximately 37 percent.[34] Implementing a flat national retail sales tax rate on all consumption would create a regressive tax system compared to the current income tax system, by taxing a greater share income earned by low income households compared to higher income households.

However, if policy makers wished to minimize the regressive nature of a national retail sales tax, they have limited options. Ideally, one might to impose different rates by income class. However, to do so means that tax rates would gradually increase with income to create a more progressive

[34] See Burman, Leonard and Troy Kravitz, "Lower-Income Households Spend Largest Share of Income," Tax Analysts, Tax Facts, Tax Policy Center, November 8, 2004.

tax system. Functionally, this would be impossible, because retailers would not be able to determine the right level of tax at the time of purchase. In order to make a retail sales tax more progressive, policy makers would have to exclude certain goods and necessities from the tax base. Again, excluding items from the base would necessitate increasing the tax rates that consumers would face.

Consumed Income Tax—In addition, a consumption tax could be constructed in a manner that retains the current law structure of the federal income tax, but imposes a zero tax rate on a taxpayer's savings; this is commonly referred to as a consumed income tax. For example, the current tax structure could be modified to provide an exclusion from the income tax for all amounts contributed by a taxpayer to a savings account. This approach would provide a current deduction for contributions to a specified savings account and an exemption from tax for earnings on the account. Under this approach, withdrawals from the savings account would be taxed as income because these amounts represent negative savings. Also, rarely mentioned, loans received by individuals and used for consumption would also be subject to tax.

The consumed income tax would again favor higher income taxpayers who consume only a small portion of their income. Further, from a policy perspective, this tax also raises issues about the distribution of wealth and wealth accumulation. Much of the wealth in our country remains concentrated in a small segment of our total population. Moving to a consumed income tax system would further this concentrated wealth accumulation and expand the wealth distribution. Since low income households spend all or most of their incomes, they are unable to save outside qualified retirement plans and would not accumulate any personal savings.

One might assume that taxing consumption and excluding all savings from tax might produce greater retirement savings and improve overall income security for retirees. However, looking more closely at the effects of tax reform on qualified retirement plan savings offers a very different conclusion.

Possible Effects of a Consumption Tax System on Qualified Retirement Plans—As we have discussed above, from a tax perspective, employers generally are indifferent with respect to whether they pay current wages or make contributions for employees to a qualified retirement plan. However, for a small employer, the regulatory and maintenance costs attributable to a qualified retirement plan are a significant deterrent to establishing and maintaining such a plan. Often, employers will establish the plans because the business owner or employees wish to use available tax benefits for themselves.

Current law can be viewed as having a consumption tax component to the extent that there is a tax benefit provided for savings. However, under current law, only specified types of savings are given favorable tax treatment, which provides a powerful incentive for savings to occur in the favored form. From an individual's perspective, saving for retirement is one of the more tax-favored forms of saving. The limits on the amounts that can be saved on a tax-favored basis are considerably greater for retirement savings than for other forms of savings, such as savings for education.

The introduction of a consumption tax, either as an alternative to the current tax system or in addition to such a system, fundamentally alters the decision to establish and maintain a qualified retirement plan. Under a consumption tax system, whether an employer makes contributions to a qualified retirement plan will not affect the employer's tax liability or the employee's tax liability. Consequently, there would no longer be any tax incentives to establish and maintain a qualified retirement plan within its accompanying distribution restrictions.

Effect of a Consumption Tax System on Withdrawals from Existing Qualified Retirement Plans—A significant issue to be addressed if a substantial consumption tax system is adopted is the proper treatment of existing assets in qualified pension plans. Under current law, if a participant makes a withdrawal from a qualified retirement plan, the withdrawal is treated as taxable ordinary income and may be subject to a 10 percent early withdrawal penalty tax.[35] The early withdrawal tax generally is intended to discourage the use of retirement savings for nonretirement purposes. However, if taxpayers are generally encouraged to save under a consumption tax system, will the penalty tax continue to apply? If the penalty tax continues to apply to qualified retirement plan withdrawals for nonretirement purposes, then taxpayers who want to consume a portion of savings will likely consume from general savings rather than from their retirement savings. In a sense, the continued imposition of the penalty tax would continue the current tax incentive to use savings in a qualified retirement plan for retirement purposes only.

On the other hand, if general savings face a potential consumption tax, some might argue that it is inequitable to impose a penalty on consumption from one source of savings rather than another. Since money is fungible, it does not necessarily make sense to impose a penalty on consumption from one particular source of savings.

[35] The early withdrawal penalty tax does not apply if the withdrawal is made (1) on or after the participant attains age 59 1/2, (2) to a beneficiary after the death of the participant, (3) on account of the participant's becoming disabled, (4) as part of a series of substantially equal periodic payments over the employee's (or the employee's and his or her spouse's) life or life expectancy, (5) after separation from service after attainment of age 55, (6) for certain medical expenses, (7) to a former spouse under a qualified domestic relations order or (8) to certain unemployed individuals for health insurance premiums.

B. Reduced Taxation of Capital Gains And Dividends

Under current law, a reduced tax rate applies to capital gains realizations and dividends received by an individual from a domestic corporation and from certain qualified foreign corporations. The reduced tax rate generally is 15 percent, except that it is 5 percent for taxpayers in the 10 or 15 percent income tax bracket. The 5 percent rate is reduced to zero in 2008. After 2008, the rates of tax applicable to capital gains realizations will be 20 percent (10 percent for taxpayers in the 15 percent income tax bracket). After 2008, individuals must report dividends as ordinary income making them subject to the ordinary income tax rates.

Some proponents would like to make permanent the reduced tax rate for capitals gains and dividends received by individuals. In addition, others would like to further reduce the rates to zero or eliminate entirely the tax on these sources of income. Both proposals assume that our current tax system remains intact, rather than considering these proposals as part of a larger reform that changes the tax system from income-based to consumption based.

Proponents believe that eliminating tax on capital gains and dividends will reduce economic distortions created by the income tax system. Relative to other investments, this approach would make investments in stock and other capital assets more tax favored than under current law and would end the current tax benefit of debt versus equity. Consequently, many argue that this proposal would increase savings and investments.

Because the proposal is assumed to occur as a modification to the current tax system, investments in qualified retirement plans would continue to be tax favored. However, because taxpayers generally could gain similar tax benefits by investing in capital assets, taxpayers may prefer to hold their savings outside of a qualified retirement plan by investing directly in stock and other capital assets. The owners of small and mid-sized businesses may particularly find that the costs of maintaining a qualified retirement plan outweigh the benefits of holding assets in a qualified pension trust if there are substantial benefits that accrue to direct investments in stock and other capital assets.

It is important to remember that taxpayers must include in income all amounts withdrawn from qualified pension plans and treat those withdrawals as ordinary income. Thus, it would not make sense to invest qualified retirement plan assets in stocks and capital assets because assets held directly receive greater tax advantages if the proposal eliminating tax on capital gains and dividends is enacted. For example, if a qualified pension plan holds a capital asset that was purchased for $1,000 and is sold for $10,000, the $9,000 of capital gain is taxed at ordinary income rates when it is distributed to plan participants.

Table 3 shows the potential erosion of qualified retirement plan benefits compared to saving outside of the qualified retirement plan when capital gains and dividends receive preferential treatment. Assume that the business owner contributes $1,000 per year to his qualified retirement plan. The plan invests in an equity fund and earns 7 percent each year on that return. Column two shows the benefits of the qualified retirement plan over 15, 20 and 30 year savings horizons. The results reflect the tax deduction received for the contribution and the tax-free accumulations over time. Further, the final balance from the qualified retirement plan is the after-tax balance (assuming a 35 percent ordinary income tax rate).

Column three shows the accumulated balance if the same person invests the funds outside of the pension plan. In this case, if the business owner treats the $1,000 as a bonus, the after-tax amount deposited each year is $650 [$1,000 x (1 - .35) = $650]. This example assumes that present law tax treatment of capital gains and dividends applies. Again, if the account invests in an equity fund earning an after-tax return of 6 percent [7 x (1 - .15) = 6], the accumulated balance is not subject to tax at the end of the time horizon. In this case, the qualified retirement plan maintains a slight advantage over the bonus account.

Column four shows the accumulated balance if the same person invests funds outside the pension plan, but the tax rate applied to capital gains and dividends falls to zero from 15 percent. In this case, the accumulated bonus is equivalent to those amounts accumulated in the qualified retirement plan after taxes paid upon distribution.

Consider one more situation that accounts for the administrative costs to maintaining a qualified retirement plan. If the business owner faces a 10 percent plan administrative cost of the plan, but decides to increase the bonus to account for this cost, then the after-tax amount of the contribution increases from $650 to $722. In light of zero capital gains and dividend taxes, the benefit of investing in an equity plan would exceed those of investing in a qualified retirement plan.

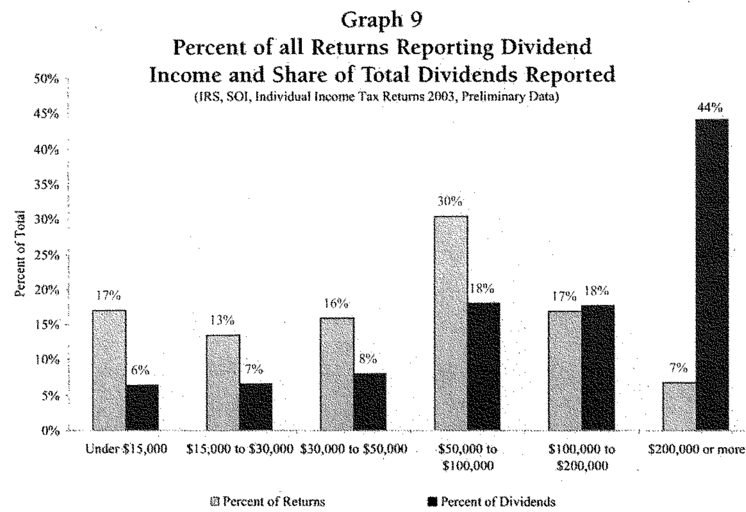
Table 3
Compare Accumulated Account Balances, Qualified Retirement Plans and Bonuses under Various Tax Treatments

	Qualified retirement plan	Bonus, present law capital gains and dividend tax rates	Bonus, zero capital gains and dividend tax rates	Bonus, increased for administrative costs, subject to zero capital gains and dividend tax rates.
15 years	$17,477	$15,969	$17,477	$19,419
20 years	$28,512	$25,198	$28,512	$31,680
30 years	$65,697	$53,969	$65,697	$72,997

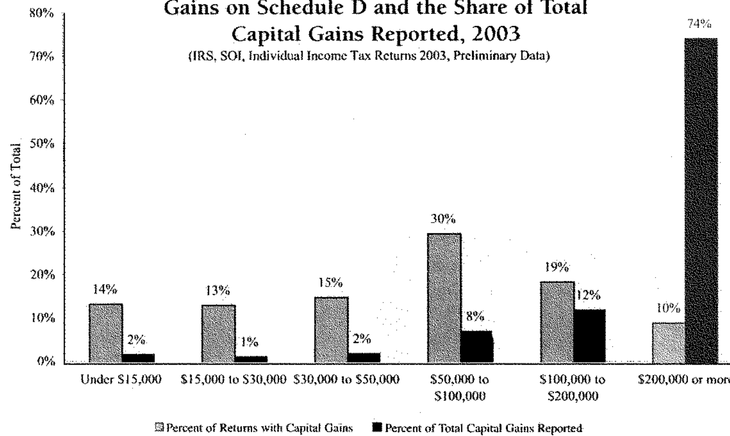
Eliminating taxes on capital gains distributions and dividend income has obvious benefits for higher income taxpayers. About 50 percent of all households report owning stock, either directly or through their retirement account.[36] But less than 10 percent of low income households own stock directly.

Referring to Graphs 9 and 10, in 2003, returns with adjusted gross income less than $15,000 reported only 6.3 percent of all dividend income. Returns with adjusted gross income in excess of $200,000 reported 43.8 percent of all dividend income. Similar trends are present in reporting of capital gains distributions. Returns with adjusted gross income less than $15,000 reported 2.1 percent of all net capital gains while returns with adjusted gross income in excess of $200,000 reported 74.4 percent.

The most important point is not that such a disparity in wealth exists, rather that eliminating tax on dividend and capital gains provides benefits to a select segment of the population. It is true that this targeted tax relief would increase savings, but only for a small segment of taxpayers.



[36] Comments made by Federal Reserve Governor Gramlich to the National Savings Forum, 2001.



The Joint Committee on Taxation estimates the tax expenditure or cost of the current reduced rates on dividends and long-term capital gains is approximately $357 billion over the next five years.[37] Estimates of eliminating the tax on dividends project a reduction in federal receipts by approximately $300 to $400 billion over the next ten years. Given the behavioral response of eliminating the capital gains tax on long-term gains, it is unclear how large the revenue loss would be.[38] However, given the magnitude of the current tax expenditure and the potential increased costs of eliminating taxes on dividends and capital gains, it is important to consider the effect on retirement savings and overall wealth accumulation. The purpose of qualified retirement plan incentives is to encourage retirement saving behavior and ensure retirement security for older people. However, targeted tax reform policies that increase savings for only a small segment of the population could potentially create greater problems as the wealth distribution widens.

[37]See JCS-1-05, "Estimates of Federal Tax Expenditures, 2005 through 2009," Joint Committee on Taxation, January 2005.

[38] It is likely that a zero rate of tax on capital gains and dividends would have substantial behavioral effects on taxpayers.

IV. Impact on Retirement Saving—Conclusions And Recommendations

Retirement and personal savings, along with Social Security, are essential parts of the American retirement system. Policy changes that affect the ability to save or the composition of overall savings pose potential threats to retirement savings. Our present tax system already dilutes the demand for retirement savings by offering some favorable tax treatment for investments outside qualified retirement plans.

When considering such major reforms as consumption-style taxes or targeted approaches that eliminate the tax on capital gains and dividend income, it is important to consider the impact on qualified retirement savings. Consumption-style taxes, in general, would tax amounts consumed and would not tax amounts saved. Targeted tax preferences would exclude capital gains and dividend income from tax, thereby treating the majority of investment as if it were in a consumption tax system. While it may be true that major reform or targeted policies would increase aggregate savings, it is also true that such policies would not provide uniform savings across all income classes.

One of the most important features of qualified retirement plans is that they offer the opportunity to save to all eligible workers. In light of minimum participation and nondiscrimination rules, workers receive equitable treatment and receive comparable savings incentives. Without qualified retirement plans, most low-income individuals would not possess adequate resources to save outside of their qualified retirement plan. Reform and targeted relief does little to alter that fact. With tax reform and targeted tax preferences, the potential exists to exclude savings from tax, while threatening financial security and creating greater wealth disparities among retirees.

With the baby boom generation less than ten years away from retirement, tax policy and tax reform should consider carefully the impact that reform would have on qualified retirement savings. Changing demographics and lower personal savings rates suggest that retirement savings through qualified retirement plans is becoming increasingly more important over time. Increasing savings through consumption-style taxes or through targeted tax-favored investments would do little to ensure that individuals enter their retirement years with adequate savings. Given the costs of such reform policy changes and their significant distributional impacts, it is important to consider the effect on retirement savings. As tax reform proposals eliminate or dilute the incentives for qualified retirement plans, it is likely that many employers will cease to offer qualified retirement plans and the prospect for adequate retirement savings for the majority of Americans will diminish significantly.

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Prior to founding her business in 2004, Ms. Schmitt was the Deputy Chief of Staff with the Congressional Joint Committee on Taxation where she worked for 22 years. Ms. Schmitt has extensive experience in all areas of Federal tax policy, with an emphasis on issues relating to retirement plans and employee benefits and insurance companies and products. In her position as Deputy Chief of Staff for the Joint Committee, Ms. Schmitt oversaw all substantive work done by the staff on federal tax legislation. Prior to joining the Joint Committee in 1982, Ms. Schmitt worked for five years for the Internal Revenue Service; first in a key district office reviewing the first round of ERISA determination letter requests and later writing employee benefit regulations in the Office of Chief Counsel.

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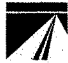

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ESCA

EMPLOYEE-OWNED S CORPORATIONS OF AMERICA

Statement for the Record
Senate Finance Committee Hearing: "Kick-Off for Tax Reform: Tackling the Tax Code"
August 3, 2006

As the Senate Finance Committee holds its first hearing on tax reform since the President's Advisory Panel on Federal Tax Reform issued its final report, the Employee-Owned S Corporations of America ("ESCA"), on behalf of member companies and their employee-owners, appreciates the opportunity to share our unique concerns and views on several important issues.

ESCA is the leading voice of the employee-owned S corporation community, serving to protect and promote employee ownership of private Subchapter S businesses for workers across the nation. ESCA was formed in 1999, and in its short history represents more than 45,000 employee-owners. Member companies operate in virtually every state in the nation, engaging in a broad spectrum of business activities that range from heavy manufacturing to hospitality. All sizes of companies are represented (from large firms with 7,000 employee-owners to small operations with as few as 50 employee-owners). ESCA companies are a hallmark of American entrepreneurship, providing jobs and a key retirement savings opportunity for tens of thousands of American workers.

Employee-owned S corporations have been in existence since 1998. They are pass-through entities owned in part or fully by an employee stock ownership plan ("ESOP"). As such, these entities offer their employees a "piece of the rock" as a retirement savings opportunity. In this sense, S corporation ESOPs are much more than standard retirement savings plans; hundreds of thousands of employees who own a stake in their employers through ESOPs are amassing impressive nest eggs – often hundreds of thousands of dollars or more – that enable them to retire from line jobs with dignity and free from the need for federal support.

ESCA is submitting this statement to the Finance Committee to call attention to several policy concerns of ESCA members regarding the treatment of ESOPs and S corporations in the 2005 report of the President's Advisory Panel on Federal Tax Reform.

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I. President's Advisory Panel on Federal Tax Reform

While S corporations are a tremendous benefit to employee-owners of these companies, they are also uniquely structured entities that are vulnerable to changes in the tax code and in pension laws. Indeed, the unique structure of employee-owned S corporations raises questions about how they might be treated under the new retirement security paradigm recommended by the President's Advisory Panel on Federal Tax Reform (the "Panel"). Given this, ESCA and its members are concerned, first, with the Panel's proposal to apply an entity-level tax on S corporations and all other non-C corporations (except sole proprietorships). Without an exemption for employee-owned S corporations similar to the exemption the Panel envisions for regulated investment companies ("RICs") and real estate investment trusts ("REITs"), an entity-level tax on an ESOP's share of S corporation income would eliminate the ability of the company's employee-owners to build up meaningful retirement savings.

Another concern of ESCA's members is that the Panel's employer-based "Save at Work" proposal does not address ESOPs. The omission of ESOPs in the Panel's proposal to streamline several current defined contribution plans into one "Save at Work" retirement plan suggests that ESOPs might be affected by this sweeping change. While we do not believe that the Panel intended to eliminate ESOPs, we do believe that any tax reform proposal put forward by the Congress should confirm the important function that S corporation ESOPs in particular have in helping the employee-owners of these companies amass substantial retirement income through their ownership stake in these companies.

A. Entity-Level Tax

Under the Panel's Simplified Income Tax Plan ("SITP"), all large businesses – those with more than $10.5 million in receipts – would be taxed at the entity level, paying a 31.5 percent rate. The Panel's report recognizes the importance of making certain exceptions to this rule, and exempts RICs and REITs from the entity-level tax. Under the Panel's Growth and Investment Tax Plan ("GITP"), businesses other than sole proprietorships would pay a corporate rate of 30 percent at the entity level, although it is unclear whether a tax-exempt shareholder's share of business income would be taxed.

If Congress does ultimately support an entity-level tax system similar to the SITP or GITP, it is critical that employee-owned S corporations be allowed to retain their current pass-through attributes and not be subjected to the entity-level tax with respect to the ESOP's share of S corporation income. Congress quite specifically designed the S corporation ESOP structure to ensure only one level of taxation, and adding another tax at the entity level would clearly go against Congress' intent, while undermining the retirement savings attributes of the S corporation ESOP to employee-owners of these companies.

The pass-through structure is especially important for employee-owned S corporations because it allows these companies to rapidly grow retirement wealth in the ESOP for their employees. An entity-level tax would, for many employee-owned companies, reduce by nearly one-third the amount of funds available for retirement savings in the ESOP.

Moreover, a tax paid at the entity-level by these companies is equivalent in substance to the qualified retirement plan (the ESOP as the owner) paying income taxes. This result runs counter to long-standing tax policy, whereby participants (employee shareholders in the case of employee-owned S corporations) in qualified plans are not taxed until income is received upon retirement.

B. Clarity Needed for ESOPs

A second concern raised by the Panel is that it did not address the role of ESOPs in the context of its proposed new tax treatment of defined contribution plans. The Panel's SITP and GITP call for the consolidation of the following employer-sponsored defined contribution plans into the "Save at Work" plan: 401(k), 'SIMPLE 401(k),' Thrift, 403(b), governmental 457(b), 'SARSEP,' and SIMPLE IRA. ESOPs are left out of the analysis. Although ESOPs are not explicitly singled out for consolidation in the Panel's report, some in the business community have expressed fears that the Panel envisions that all defined contribution plans, including ESOPs, should be consolidated into its "Save at Work" plan.

ESOPs are, as this Committee is aware, a key economic asset to thousands of companies and their employees. Employee-owned S corporations are an increasingly utilized business structure found across the nation and in every state, and with their proliferation has come an important increase in the retirement savings of the ESOP participants in these companies. Fuelled by the work and commitment of their employee-owners, these companies provide jobs for workers across the economic and industrial spectrum, including manufacturing, construction, health care, trucking and tourism. Indeed, a recent study by the National Center for Employee Ownership that surveyed nearly 2,000 employee-owners from S corporation ESOP companies around that nation found that:

- Have account balances three to five times higher than the U.S. average for 401(k) plans – with large numbers of these ESOP participants amassing $75,000 to $100,000 in their accounts;
- Have even higher account balances – five to seven times the average for 401(k) plans – when measured among employee-owners nearing retirement age; and
- Quit at a rate of half the national average, and are fired or laid off two-thirds less frequently than workers in other kinds of companies.

ESCA believes that Members of Congress recognized the tremendous promise of S corporation ESOPs when legislators first created these structures, and we note that employee-owned S corporations have long enjoyed broad bipartisan support on Capitol Hill. Indeed just five years ago, Congress reaffirmed its support for employee-owned S corporations during consideration of the Economic Growth and Tax Relief Reconciliation Act (P.L. 107-16). In 2001, the Ways and Means Committee said that it "continues to believe that S corporations should be able to encourage employee ownership through an ESOP."[1]

With this in mind, and given the pervasiveness of ESOPs and the major role they play in providing a secure source of retirement income for retirees, we respectfully urge members of the Finance Committee to ensure that any tax reform proposal put forward by Congress recognize and affirm the continued existence of ESOPs, and S corporation ESOPs more specifically.

* * *

ESCA appreciates the Finance Committee's consideration of the concerns and interests of S corporations. We would welcome the opportunity to discuss these issues further with Committee members and staff in the weeks and months ahead.

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[1] H.R. Rep. No. 107-51, part 1, at 100 (2001).

ESCA

EMPLOYEE-OWNED S CORPORATIONS OF AMERICA

ESCA MEMBER COMPANIES 2006

Member Company	*Headquarters Location*
Acadian Ambulance	Louisiana
Agron, Inc.	California
Albert C. Kobayashi	Hawaii
Alion Science and Technology	Virginia
Amerequip, Inc.	Wisconsin
Amsted Industries	Illinois
Antioch Company	Ohio
Appleton	Wisconsin
Appleton Marine	Wisconsin
Austin Industries, Inc.	Texas
BCC Capital Partners	California
Bimba Manufacturing	Illinois
Columbia Financial Advisors	Oregon
Community Bancshares, Inc.	Missouri
Crowe Chizek & Co.	Ohio
Deloitte	Illinois
The Dexter Company	Iowa
DuCharme, McMillen & Associates	Illinois
Duff & Phelps, LLC	Illinois
ESOP Services	Virginia
First Bankers Trust Services	Illinois
Ferrell Companies, Inc.	Kansas
Floturn, Inc.	Ohio
Freeman Companies	Texas
Garney Companies, Inc.	Missouri
The George P. Johnson Company	Michigan
GreatBanc Trust	Illinois
Greenheck Fan Corporation	Virginia
Herff-Jones, Inc.	Indiana
Hisco	Texas
Holborn Corporation	New York
Houlihan, Lokey, Howard and Zukin	Illinois
Inland Truck Parts Company	Kansas
Katten Muchin Rosenman LLP	Illinois
Keller Structures	Wisconsin
Krieg DeVault Alexander	Indiana
Lake Welding Supply Company, Inc.	Michigan

LaSalle Bank, N.A.	Illinois
Lifetouch, Inc.	Minnesota
McDermott, Will and Emery	Illinois
Messer Construction Company	Ohio
Molin Concrete Products	Minnesota
Moretrench American Corporation	New Jersey
Morgan Lewis and Bockius	Illinois
Muehlstein & Co., Inc.	Connecticut
Nathan Alterman Electric Co., Inc.	Texas
The Parksite Group	Illinois
Pavement Recycling Systems, Inc.	California
PERCS USA Inc.	Florida
Performance Contracting Group, Inc	Kansas
Phelps County Bank	Missouri
Pridgeon & Clay, Inc.	Michigan
The Principal Financial Group	Wisconsin
Richard Goettle, Inc.	Ohio
Round Table Pizza, Inc.	California
RSM McGladrey	Iowa
Schreiber Foods, Inc.	Wisconsin
Scitor Corporation	California
Scot Forge Company	Illinois
Segerdahl Corporation	Illinois
Social & Scientific Systems	Maryland
Sonalysts, Inc.	Connecticut
Spee Dee Delivery Service, Inc.	Minnesota
State Street Bank	Massachusetts
Stout Risius Ross, Inc.	Illinois
The Scooter Store	Texas
Sundt	Arizona
Thirdpage Services	Virginia
Thoits Insurance	California
Thybar Construction	Illinois
Vector Health Sytems, Inc.	Rhode Island
Vermeer Equipment of Texas Inc	Texas
Volkert & Associates	Alabama
Walman Optical Company	Minnesota
Williams Brothers Construction	Texas
Woodfold Inc.	Oregon

Kick-Off for Tax Reform: Tackling the Tax Code

Senate Committee on Finance
August 3, 2006

Statement Submitted by

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Chair Grassley, ranking member Baucus and members of the Senate Committee on Finance.

My name is J. Michael Keeling, President of The ESOP Association, a national 501(c)(6) trade association with over 2400 members that represents corporations that sponsor employee ownership through Employee Stock Ownership Plans, or ESOPs.

It is, as always, an honor to submit words to the Senate Finance Committee about employee ownership and our Federal tax system because the Senate Committee on Finance has a long and positive record in support of employee ownership in general, and ESOPs specifically. Those Senators with at least 20 years of service remember the concept of employee ownership through ESOPs originated in the Senate under the leadership of former Senator Russell B. Long.

Now, today, the Senate Committee on Finance is focused on the report released November 1, 2005, by the Presidential Panel on Federal Tax Reform recommendations for massive changes in how business and individuals are taxed under our Federal income tax system.

The ESOP community is very disappointed with the Panel's recommendations. Why? It is not just because of a recommendation it makes with regard to savings plans that would eliminate ESOPs if its precise words are transformed into legislative language, but because the Panel failed to recognize anything about ESOPs, and did not take notice of what ESOPs can do for American business, American employees, and American competitiveness.

For you see, the law is clear. ESOPs serve a dual purpose. Let us quote for the members 90 Stat. 1590. P.L. 94-455:

"(h) Intent of Congress Concerning Employee Stock Ownership Plans. – The Congress, in a series of laws (the Regional Rail Reorganization Act of 1973, the Employee Retirement Income Security Act of 1974, and the Tax Reduction act of 1975) and this Act has made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free private enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees. The Congress is deeply concerned that the objectives sought by this series of laws will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trust and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans."

As noted, this is the law; it is not a sense of the Congress resolution.

Our nation's courts have taken note of this law in law suits involving ESOPs since 1975, citing the law as the primary reason that ESOPs are to be judged by standards that are different from the traditional ERISA plan. A typical phrase used by courts is "ESOPs are intended by Congress to be tools of corporate finance as well as retirement savings plans". Often courts add, "ESOPs are to be ownership plans as well as retirement savings plans.". See *Moensch v. Robertson et al*, Federal, 3rd Circuit, 1995.

Keeping in mind the purpose of ESOPs, let us not abandoned the wonderful concept that America should have more owners, or a true ownership society. We ESOP advocates were thrilled to hear President Bush say on January 20, 2005,

"To give every American a stake in the promise and future... we will ...build an ownership society. We will widen the ownership of homes and businesses, retirement savings, and health insurance—preparing our people for the challenges of life in a free society.

By making every citizen an agenda of his or her own destiny, we will give our fellow Americans greater freedom from want and fear and make our society more prosperous and just and equal."

These very words resonate well with the Vision of The ESOP Association which provides,

"We believe that employee ownership improves American competitiveness... that it increases productivity through greater employee participation in the workplace... that it strengthens our free enterprise economy and creates a broader distribution of wealth... and that it maximizes human potential by enhancing the self-worth, dignity, and well-being of our people.

Therefore, we envision an America where employee ownership is widely recognized as a catalyst for economic prosperity... where the great majority of employees own stock in the companies where they work... and where employee ownership enables employees to share in the wealth they help create..."

So what is our purpose in submitting this testimony today?

We respectfully request that as the Committee reviews details of how to make Federal taxes more fair, and more simple, that the Committee not overlook that we have a set of laws to make the Federal taxes more fair by encouraging businesses to be broadly owned by more people, their employees.

It may be that the changes you decide to make, if you do, will rearrange those ESOP laws that encourage current business owners to share their wealth by letting employees become what we like to say, "players" in the best economic system ever devised. If that is the case, then let us consider new ways, new approaches that encourage a more fair, more effective, and more productive pattern of ownership by continuing the Senate Finance Committee's long standing posture of supporting broadened ownership of our nation's productive assets through ESOPs.

The ESOP community, as always, will stand ready to work constructively with the Committee and Committee staff to ensure laws promoting employee ownership are crafted in a manner to accomplish the goals of broad-based employee ownership.

On behalf of the ESOP community, I thank you for taking note of this testimony.

1040 TAXMAN TOM & SILVER DRAGON

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July 31, 2006

Senate Committee on Finance
Dirksen Senate Office Building
Washington DC 20510

Re: "Kick-Off for Tax Reform: Tackling the Tax Code"

Attention: Senator Charles E Grassley, R-IA, Distinguished Senators, Witnesses and Guests

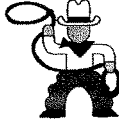
I pray, dear God in Heaven, hearings like this shall NOT become an annual affair. After former Senators Mack and Breaux finished hearings in 2005 on the subject of *fairness and the treatment of families*, the press reported the *'fairness'* recommendation, simply eliminate the 1098 Mortgage Interest deduction on Sch A. [see clipping] Check the enclosed $30,000,000.00 tax return – he loses ALL 5 his Exemptions, ALL his mortgage interest, and $120,000.00 off his state income write-off. Where's the *fairness* in that just because he's successful??? That also means the 2005 committee recommended 'just the middle people give up their 1098 Mortgage Interest deduction' because Mr. Biggie doesn't get to take the interest deduction anyway and the low income are net tax RECEIVERS. What's fair about that???

Needless to say President Bush, and all of the people with mortgages, didn't think that was a good idea. Further, Federal Reserve Chairman Alan Greenspan testified at that first hearing last year in Washington, ".....don't try for purity." For goodness sakes, what in heaven and hell would be wrong with some purity in Washington and across the land??? Let's look at the PURITY of the 3% NATIONAL SALES TAX – abolish completely the current 1040 system – double FAIR for everybody. PURITY for sure!!! Don't worry, *we need every IRS agent now on the payroll collecting the NST.* People won't voluntarily pay NST any better than income tax.

Let's press the *fairness* issue a little more. There are 11,000,000 to 12,000,000 who do not file 1040 income returns now, according to a tax lawyer in Ohio in 1981. What's *fair* about that??? The veterinary in MD gave me permission to use her enclosed 2004 1040 as evidence. She had to borrow money for college. Did we tell her when she borrowed the money she could not write off the interest if she made tooooo much money??? Did we tell her she loses 90% of her Child Tax Credit by making tooooo much money??? The Zscheiles gave me permissions to use their 2004 Form 2441. They paid $16,220.00 for childcare for the twins but got to take only a $1,200.00 tax credit. What's *fair* about that??? AND then the enclosed $30,000.00 tax return gets a $6,521.00 REFUND. This kind of *treatment of families* results in real serious class envy.....where's the *fairness* in that???

Still on *fairness*, the Fresno IRS letter wanting ANOTHER $4,533.00 was sent to a client because of stolen identity or duplicated Social Security card. What's *fair* about that??? I began income tax preparation in 1993. Green cards and social security cards have been For Sale for cash for over 15 years. None of that money is taxed under the current system and increases the issue of *unfairness*. Further, you have to prove to IRS you did NOT work in the state where the duplicated SS number was used. HOW do you prove you didn't make money in another state??????

CLICK. ZIP. FAST ROUND TRIP.



The idea of a National Sales Tax was born in the mid '70s. The National Chamber of Commerce in Washington told me their axiom is "a dollar turns itself in the community from 5 to 7 times". The 3% National Sales Tax would generate between 15% and 21% revenue annually; really and truly a FAIR tax system for Americans. Americans could take home their WHOLE paycheck. Every year the economists ballyhoo how the income tax refunds boost the economy. How much bigger would the economy grow by putting the WHOLE paycheck into the NST circulation???

i.,e., If you made only $10,000.00 your FAIR share would be $300.00 *IF* you spent the whole $10,000.00.......If you made $100,000.00 your FAIR share would be $3,000.00 *IF* you spent the whole $100,000.00......If you made $30,000,000.00 your FAIR share would be $900,000.00 *IF* you spent the whole $30,000,000.00......and on and on, ad nauseum. Who among us wouldn't abolish the current, debilitating 1040 system, all the record keeping and accounting expenses, for *three cents on the dollar* NST???? EVERY DOLLAR THAT CHANGES HANDS..................

A couple years ago a newspaper [probably liberal] story reported that IRS gives wrong answers 43%. In the story, IRS joked, "That means we give 57% correct answers". What's *fair* about that??? This whole committee loses their job when the people say their job approval is only 57%. We add insult to injury when we know IRS CANNOT be held accountable for their errors.

How many stock market dollars change hands every day??? How many Pepsi dollars??? How many gallons of gas??? How many real estate dollars??? How many automobile dollars??? How much drug money??? How many prostitution dollars??? How many attorney dollars??? How many washers, dryers, & tv dollars??? How many dollars of horses??? How many movie ticket dollars??? How many dollars of cows??? How many dollars of tobacco??? How many dollars of alcohol??? The estimated value of the equine industry in one small state, Pennsylvania, is $600,000,000.00.........How many dollars of Social Security are added to buying power??? How many tax dollars do we get from the $300,000,000,000.00 Underground Economy??? I am not opposed to letting garage sales escape the NST because that money finds its way into circulation anyway.

This list is as endless as the things we find to spend our money on. I've mentally calculated over the years the 3% NST would turn so much money into DC annually we could even build a trust account again to actually stabilize Social Security with the excess from NST.

More than 85% of the system to collect the NST is already in place – right beside the system that now collects state sales tax. The States can license the rest of the places where money is spent and 'sscchasamm', send the money to DC. Please see the attached National Sales Tax form. We can even call it 1040 National Sales Tax for nostalgia. We can pay a small commission to the timely filers. That is called an incentive to turn over the collected dollars. We can even escalate the punishment for the late/non filers, built into the one page form. We can raise NST ¼% to pay for anti terrorist security. When there is a surplus we can even let the low income have a reprieve through the Application for Refund.

Respectfully,

Form 1040 (2005) JOHN Q & JOYCE M TAXPAYER 555-12-1212 Page 2

Section	Line	Description			Line	Amount
Tax and Credits	38	Amount from line 37 (adjusted gross income)			38	30,037,520.
	39a	Check if: ☐ **You** were born before January 2, 1941, ☐ Blind. ☐ **Spouse** was born before January 2, 1941, ☐ Blind. **Total boxes checked** ▶ 39a ☐				
Standard Deduction for – • People who checked any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions.	b	If your spouse itemizes on a separate return, or you were a dual-status alien, see instructions and check here ▶ 39b ☐				
	40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			40	1,081,030.
	41	Subtract line 40 from line 38			41	28,956,490.
	42	If line 38 is over $109,475, or you provided housing to a person displaced by Hurricane Katrina, see instructions. Otherwise, multiply $3,200 by the total number of exemptions claimed on line 6d			42	0.
• All others:	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-			43	28,956,490.
Single or Married filing separately, $5,000	44	**Tax** (see instrs). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972			44	10,108,834.
Married filing jointly or Qualifying widow(er), $10,000	45	**Alternative minimum tax** (see instructions). Attach Form 6251			45	
Head of household, $7,300	46	Add lines 44 and 45 ▶			46	10,108,834.
	47	Foreign tax credit. Attach Form 1116 if required	47			
	48	Credit for child and dependent care expenses. Attach Form 2441	48			
	49	Credit for the elderly or the disabled. Attach Schedule R	49			
	50	Education credits. Attach Form 8863	50			
	51	Retirement savings contributions credit. Attach Form 8880	51			
	52	Child tax credit (see instructions). Attach Form 8901 if required	52			
	53	Adoption credit. Attach Form 8839	53			
	54	Credits from: a ☐ Form 8396 b ☐ Form 8859	54			
	55	Other credits. Check applicable box(es): a ☐ Form 3800 b ☐ Form 8801 c ☐ Form	55			
	56	Add lines 47 through 55. These are your **total credits**			56	
	57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- ▶			57	10,108,834.
Other Taxes	58	Self-employment tax. Attach Schedule SE			58	
	59	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137			59	
	60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required			60	
	61	Advance earned income credit payments from Form(s) W-2			61	
	62	Household employment taxes. Attach Schedule H			62	
	63	Add lines 57-62. This is your **total tax** ▶			63	10,108,834.
Payments	64	Federal income tax withheld from Forms W-2 and 1099	64	2,400,000.		
If you have a qualifying child, attach Schedule EIC.	65	2005 estimated tax payments and amount applied from 2004 return	65			
	66a	**Earned income credit (EIC)**	66a			
	b	Nontaxable combat pay election ▶ 66b				
	67	Excess social security and tier 1 RRTA tax withheld (see instructions)	67			
	68	Additional child tax credit. Attach Form 8812	68			
	69	Amount paid with request for extension to file (see instructions)	69			
	70	Payments from: a ☐ Form 2439 b ☐ Form 4136 c ☐ Form 8885	70			
	71	Add lines 64, 65, 66a, and 67 through 70. These are your **total payments** ▶			71	2,400,000.
Refund	72	If line 71 is more than line 63, subtract line 63 from line 71. This is the amount you **overpaid**			72	
Direct deposit? See instructions and fill in 73b, 73c, and 73d.	73a	Amount of line 72 you want **refunded to you** ▶			73a	
	▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings				
	▶ d	Account number				
	74	Amount of line 72 you want **applied to your 2006 estimated tax** ▶	74			
Amount You Owe	75	**Amount you owe.** Subtract line 71 from line 63. For details on how to pay, see instructions ▶			75	8,007,362.
	76	Estimated tax penalty (see instructions)	76	298,528.		

Third Party Designee Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete the following. ☒ **No**
Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation	Daytime phone number
▶		MANAGEMENT	
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	
▶		ADM AST	

Paid Preparer's Use Only

		Date	Check if self-employed	Preparer's SSN or PTIN
Preparer's signature ▶	Tom Houk	07/29/2006	☒	520-46-1471
Firm's name (or yours if self-employed), address, and ZIP code ▶	1040 TAXMAN TOM			
	2939 N MADISON PO BOX 209		EIN	
	LOVELAND CO 80539-0209		Phone no.	(970) 461-1040

Form **1040** (2005)

FDIA0112 11/07/05

Form **1040** Department of the Treasury — Internal Revenue Service
U.S. Individual Income Tax Return 2005 (99) IRS Use Only — Do not write or staple in this space.

For the year Jan 1 - Dec 31, 2005, or other tax year beginning , 2005, ending , 20 OMB No. 1545-0074

Label (See instructions.)	Your first name / MI / Last name	Your social security number
	JOHN Q TAXPAYER	555-12-1212
Use the IRS label. Otherwise, please print or type.	If a joint return, spouse's first name / MI / Last name	Spouse's social security number
	JOYCE M TAXPAYER	121-21-2555
	Home address (number and street). If you have a P.O. box, see instructions. Apartment no.	You **must** enter your social security number(s) above.
	ANY STREET	
	City, town or post office. If you have a foreign address, see instructions. State ZIP code	Checking a box below will not change your tax or refund.
Presidential Election Campaign	BEVERLY HILLS CA 90210	
	Check here if you, or your spouse if filing jointly, want $3 to go to this fund? (see instructions)	☐ You ☐ Spouse

Filing Status

Check only one box.

1 ☐ Single
2 ☒ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above & full name here
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here
5 ☐ Qualifying widow(er) with dependent child (see instructions)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a — Boxes checked on 6a and 6b: 2
b ☒ **Spouse**

No. of children on 6c who: • lived with you: 3; • did not live with you due to divorce or separation (see instrs); Dependents on 6c not entered above

c Dependents: (1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see instrs)
BILLY B TAXPAYER	121-21-2111	Son	☒
BETTY B TAXPAYER	121-21-2222	Daughter	☒
END OF THE L TAXPAYER	222-11-1111	Son	☒
			☐

If more than four dependents, see instructions.

d Total number of exemptions claimed — Add numbers on lines above: 5

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

Line	Description	Amount
7	Wages, salaries, tips, etc. Attach Form(s) W-2	30,000,000.
8a	**Taxable** interest. Attach Schedule B if required	37,520.
8b	**Tax-exempt** interest. **Do not** include on line 8a	
9a	Ordinary dividends. Attach Schedule B if required	
9b	Qualfd divs (see instrs)	
10	Taxable refunds, credits, or offsets of state and local income taxes (see instructions)	
11	Alimony received	
12	Business income or (loss). Attach Schedule C or C-EZ	
13	Capital gain or (loss). Att Sch D if reqd. If not reqd, ck here ☐	
14	Other gains or (losses). Attach Form 4797	
15a	IRA distributions — b Taxable amount (see instrs)	
16a	Pensions and annuities — b Taxable amount (see instrs)	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	
18	Farm income or (loss). Attach Schedule F	
19	Unemployment compensation	
20a	Social security benefits — b Taxable amount (see instrs)	
21	Other income	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income**	30,037,520.

Adjusted Gross Income

Line	Description	Amount
23	Educator expenses (see instructions)	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	
25	Health savings account deduction. Attach Form 8889	
26	Moving expenses. Attach Form 3903	
27	One-half of self-employment tax. Attach Schedule SE	
28	Self-employed SEP, SIMPLE, and qualified plans	
29	Self-employed health insurance deduction (see instructions)	
30	Penalty on early withdrawal of savings	
31a	Alimony paid b Recipient's SSN	
32	IRA deduction (see instructions)	
33	Student loan interest deduction (see instructions)	
34	Tuition and fees deduction (see instructions)	
35	Domestic production activities deduction. Attach Form 8903	
36	Add lines 23 - 31a and 32 - 35	
37	Subtract line 36 from line 22. This is your **adjusted gross income**	30,037,520.

BAA For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see instructions. FDIA0112 11/07/05 Form **1040** (2005)

Form 1040 (2005) JOHN Q & JOYCE M TAXPAYER 555-12-1212 Page 2

Tax and Credits

Standard Deduction for –
- People who checked any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions.
- All others:

Single or Married filing separately, $5,000

Married filing jointly or Qualifying widow(er), $10,000

Head of household, $7,300

Line	Description		Amount
38	Amount from line 37 (adjusted gross income)	38	30,000.
39a	Check if: ☐ **You** were born before January 2, 1941, ☐ Blind. ☐ **Spouse** was born before January 2, 1941, ☐ Blind. **Total boxes checked** ► 39a ☐		
b	If your spouse itemizes on a separate return, or you were a dual-status alien, see instructions and check here ► 39b ☐		
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	40	10,000.
41	Subtract line 40 from line 38	41	20,000.
42	If line 38 is over $109,475, or you provided housing to a person displaced by Hurricane Katrina, see instructions. Otherwise, multiply $3,200 by the total number of exemptions claimed on line 6d	42	16,000.
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	4,000.
44	**Tax** (see instrs). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972	44	403.
45	**Alternative minimum tax** (see instructions). Attach Form 6251	45	
46	Add lines 44 and 45 ►	46	403.
47	Foreign tax credit. Attach Form 1116 if required	47	
48	Credit for child and dependent care expenses. Attach Form 2441	48	
49	Credit for the elderly or the disabled. Attach Schedule R	49	
50	Education credits. Attach Form 8863	50	
51	Retirement savings contributions credit. Attach Form 8880	51	
52	Child tax credit (see instructions). Attach Form 8901 if required	52	403.
53	Adoption credit. Attach Form 8839	53	
54	Credits from: a ☐ Form 8396 b ☐ Form 8859	54	
55	Other credits. Check applicable box(es): a ☐ Form 3800 b ☐ Form 8801 c ☐ Form	55	
56	Add lines 47 through 55. These are your **total credits**	56	403.
57	Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- ►	57	0.

Other Taxes

Line	Description		Amount
58	Self-employment tax. Attach Schedule SE	58	
59	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	59	
60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	60	
61	Advance earned income credit payments from Form(s) W-2	61	
62	Household employment taxes. Attach Schedule H	62	
63	Add lines 57-62. This is your **total tax** ►	63	0.

Payments

If you have a qualifying child, attach Schedule EIC.

Line	Description		Amount
64	Federal income tax withheld from Forms W-2 and 1099	64	2,400.
65	2005 estimated tax payments and amount applied from 2004 return	65	
66a	**Earned income credit (EIC)**	66a	1,524.
b	Nontaxable combat pay election ► 66b		
67	Excess social security and tier 1 RRTA tax withheld (see instructions)	67	
68	Additional child tax credit. Attach Form 8812	68	2,597.
69	Amount paid with request for extension to file (see instructions)	69	
70	Payments from: a ☐ Form 2439 b ☐ Form 4136 c ☐ Form 8885	70	
71	Add lines 64, 65, 66a, and 67 through 70. These are your **total payments** ►	71	6,521.

Refund

Direct deposit? See instructions and fill in 73b, 73c, and 73d.

Line	Description		Amount
72	If line 71 is more than line 63, subtract line 63 from line 71. This is the amount you **overpaid**	72	6,521.
73a	Amount of line 72 you want **refunded to you** ►	73a	6,521.
b	Routing number XXXXXXXXX ► c Type: ☐ Checking ☐ Savings		
d	Account number XXXXXXXXXXXXXXXXX		
74	Amount of line 72 you want **applied to your 2006 estimated tax** ►	74	

Amount You Owe

Line	Description		Amount
75	**Amount you owe.** Subtract line 71 from line 63. For details on how to pay, see instructions ►	75	
76	Estimated tax penalty (see instructions)	76	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete the following. ☒ **No**

Designee's name ► Phone no. ► Personal identification number (PIN) ►

Sign Here

Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
►		MANAGEMENT	
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	
►		ADM AST	

Paid Preparer's Use Only

		Date	Check if self-employed	Preparer's SSN or PTIN
Preparer's signature ►	Tom Houk	07/29/2006	☒	520-46-1471
Firm's name (or yours if self-employed), address, and ZIP code ►	1040 TAXMAN TOM 2939 N MADISON PO BOX 209 LOVELAND CO 80539-0209		EIN	Phone no. (970) 461-1040

Form **1040** (2005)

FDIA0112 11/07/05

Form **1040** Department of the Treasury — Internal Revenue Service
U.S. Individual Income Tax Return 2005 (99) IRS Use Only — Do not write or staple in this space.

For the year Jan 1 - Dec 31, 2005, or other tax year beginning , 2005, ending , 20 OMB No. 1545-0074

Label (See instructions.) Use the IRS label. Otherwise, please print or type.		
Your first name / MI / Last name: JOHN Q TAXPAYER		Your social security number: 555-12-1212
If a joint return, spouse's first name / MI / Last name: JOYCE M TAXPAYER		Spouse's social security number: 121-21-2555
Home address (number and street). If you have a P.O. box, see instructions.: ANY STREET	Apartment no.	You **must** enter your social security number(s) above.
City, town or post office. If you have a foreign address, see instructions.: BEVERLY HILLS	State: CA ZIP code: 90210	Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund? (see instructions) ▶ ☐ You ☐ Spouse

Filing Status

Check only one box.

1 ☐ Single
2 ☒ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above & full name here ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here ▶
5 ☐ Qualifying widow(er) with dependent child (see instructions)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a — Boxes checked on 6a and 6b: 2
b ☒ **Spouse**

c Dependents:

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see instrs)
BILLY B TAXPAYER	121-21-2111	Son	☒
BETTY B TAXPAYER	121-21-2222	Daughter	☒
END OF THE L TAXPAYER	222-11-1111	Son	☒
			☐

If more than four dependents, see instructions.

No. of children on 6c who: • lived with you: 3; • did not live with you due to divorce or separation (see instrs); Dependents on 6c not entered above

d Total number of exemptions claimed — Add numbers on lines above ▶ 5

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

Line	Description		Amount
7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	30,000.
8a	**Taxable** interest. Attach Schedule B if required	8a	
b	**Tax-exempt** interest. **Do not** include on line 8a — 8b		
9a	Ordinary dividends. Attach Schedule B if required	9a	
b	Qualfd divs (see instrs) — 9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see instructions)	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Att Sch D if reqd. If not reqd, ck here ▶ ☐	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions — 15a — b Taxable amount (see instrs)	15b	
16a	Pensions and annuities — 16a — b Taxable amount (see instrs)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits — 20a — b Taxable amount (see instrs)	20b	
21	Other income	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	30,000.

Adjusted Gross Income

Line	Description		Amount
23	Educator expenses (see instructions)	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	One-half of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction (see instructions)	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶	31a	
32	IRA deduction (see instructions)	32	
33	Student loan interest deduction (see instructions)	33	
34	Tuition and fees deduction (see instructions)	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 - 31a and 32 - 35	36	
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶	37	30,000.

BAA For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see instructions. FDIA0112 11/07/05 Form **1040** (2005)

Form **1040** Department of the Treasury — Internal Revenue Service **U.S. Individual Income Tax Return 2004** (99) IRS Use Only — Do not write or staple in this space.

For the year Jan 1 - Dec 31, 2004, or other tax year beginning , 2004, ending , 20 OMB No. 1545-0074

Label (See instructions.) **Use the IRS label.** Otherwise, please print or type.

Your first name	MI	Last name	Your social security number
DEBORAH	A	LEVESQUE	575-13-8270
If a joint return, spouse's first name	MI	Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see instructions.		Apartment no.	▲ Important! ▲ You **must** enter your social security number(s) above.
29012 THOMPSON CORNER RD			
City, town or post office. If you have a foreign address, see instructions.	State	ZIP code	
MECHANICSVILLE	MD	20659	

Presidential Election Campaign (See instructions.) **Note:** Checking 'Yes' will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want $3 to go to this fund? You ☐ Yes ☐ No Spouse ☐ Yes ☐ No

Filing Status Check only one box.
1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above & full name here ..
4 ☒ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here
5 ☐ Qualifying widow(er) with dependent child (see instructions)

Exemptions
6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a — Boxes checked on 6a and 6b: 1
b ☐ **Spouse**
c Dependents:

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see instrs)
KAYLA A HAY	523-81-6744	Daughter	☒
			☐
			☐
			☐

No. of children on 6c who: • lived with you: 1; • did not live with you due to divorce or separation (see instrs); Dependents on 6c not entered above; Add numbers on lines above: 2

If more than four dependents, see instructions.
d Total number of exemptions claimed

Income
Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.
If you did not get a W-2, see instructions.
Enclose, but do not attach, any payment. Also, please use Form 1040-V.

Line	Description	Line	Amount
7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	87,650.
8a	**Taxable** interest. Attach Schedule B if required	8a	
b	**Tax-exempt** interest. **Do not** include on line 8a ... 8b		
9a	Ordinary dividends. Attach Schedule B if required	9a	67.
b	Qualfd divs (see instrs) ... 9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see instructions)	10	1,338.
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	3,812.
13	Capital gain or (loss). Att Sch D if reqd. If not reqd, ck here ☐	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions ... 15a — b Taxable amount (see instrs)	15b	
16a	Pensions and annuities ... 16a — b Taxable amount (see instrs)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits ... 20a — b Taxable amount (see instrs)	20b	
21	Other income	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income**	22	92,867.

Adjusted Gross Income

Line	Description	Line	Amount
23	Educator expenses (see instructions)	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	IRA deduction (see instructions)	25	
26	Student loan interest deduction (see instructions)	26	2496
27	Tuition and fees deduction (see instructions)	27	
28	Health savings account deduction. Attach Form 8889	28	
29	Moving expenses. Attach Form 3903	29	
30	One-half of self-employment tax. Attach Schedule SE	30	67.
31	Self-employed health insurance deduction (see instrs)	31	
32	Self-employed SEP, SIMPLE, and qualified plans	32	
33	Penalty on early withdrawal of savings	33	
34a	Alimony paid b Recipient's SSN	34a	
35	Add lines 23 through 34a	35	67.
36	Subtract line 35 from line 22. This is your **adjusted gross income**	36	92,800.

lost, to high income

BAA For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see instructions. FDIA0112 11/10/04 Form **1040** (2004)

Form **1040** (2004) DEBORAH A LEVESQUE 575-13-8270 Page **2**

Tax and Credits

Line	Description	Box	Amount	Line	Amount
37	Amount from line 36 (adjusted gross income)			37	92,800.
38a	Check if: ☐ **You** were born before January 2, 1940, ☐ Blind. ☐ **Spouse** was born before January 2, 1940, ☐ Blind. **Total boxes checked** ► **38a** ☐				
b	If your spouse itemizes on a separate return, or you were a dual-status alien, see instructions and check here ► **38b** ☐				
39	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			39	19,223.
40	Subtract line 39 from line 37			40	73,577.
41	If line 37 is $107,025 or less, multiply $3,100 by the total number of exemptions claimed on line 6d. If line 37 is over $107,025, see the worksheet in the instructions			41	6,200.
42	**Taxable income.** Subtract line 41 from line 40. If line 41 is more than line 40, enter -0-			42	67,377.
43	**Tax** (see instrs). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972			43	12,444.
44	**Alternative minimum tax** (see instructions). Attach Form 6251			44	
45	Add lines 43 and 44 ►			45	12,444.
46	Foreign tax credit. Attach Form 1116 if required	46			
47	Credit for child and dependent care expenses. Attach Form 2441	47			
48	Credit for the elderly or the disabled. Attach Schedule R	48			
49	Education credits. Attach Form 8863	49			
50	Retirement savings contributions credit. Attach Form 8880	50			
51	Child tax credit (see instructions)	51	100.		
52	Adoption credit. Attach Form 8839	52			
53	Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859	53			
54	Other credits. Check applicable box(es): **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Specify	54			
55	Add lines 46 through 54. These are your **total credits**			55	100.
56	Subtract line 55 from line 45. If line 55 is more than line 45, enter -0- ►			56	12,344.

(handwritten:) 900. lost to high income

Standard Deduction for —
- People who checked any box on line 38a or 38b **or** who can be claimed as a dependent, see instructions.
- All others:

Single or Married filing separately, $4,850

Married filing jointly or Qualifying widow(er), $9,700

Head of household, $7,150

Other Taxes

Line	Description	Box	Amount	Line	Amount
57	Self-employment tax. Attach Schedule SE			57	133.
58	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137			58	
59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required			59	
60	Advance earned income credit payments from Form(s) W-2			60	
61	Household employment taxes. Attach Schedule H			61	
62	Add lines 56-61. This is your **total tax** ►			62	12,477.

Payments

If you have a qualifying child, attach Schedule EIC.

Line	Description	Box	Amount	Line	Amount
63	Federal income tax withheld from Forms W-2 and 1099	63	17,290.		
64	2004 estimated tax payments and amount applied from 2003 return	64			
65a	**Earned income credit (EIC)**	65a			
b	Nontaxable combat pay election ► 65b				
66	Excess social security and tier 1 RRTA tax withheld (see instructions)	66			
67	Additional child tax credit. Attach Form 8812	67			
68	Amount paid with request for extension to file (see instructions)	68			
69	Other pmts from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885	69			
70	Add lines 63, 64, 65a, and 66 through 69. These are your **total payments** ►			70	17,290.

Refund

Direct deposit? See instructions and fill in 72b, 72c, and 72d.

Line	Description	Box	Amount	Line	Amount
71	If line 70 is more than line 62, subtract line 62 from line 70. This is the amount you **overpaid**			71	4,813.
72a	Amount of line 71 you want **refunded to you** ►			72a	4,813.
	► **b** Routing number XXXXXXXXX ► **c** Type: ☐ Checking ☐ Savings				
	► **d** Account number XXXXXXXXXXXXXXXXX				
73	Amount of line 71 you want **applied to your 2005 estimated tax** ►	73			

Amount You Owe

Line	Description	Box	Amount	Line	Amount
74	**Amount you owe.** Subtract line 70 from line 62. For details on how to pay, see instructions ►			74	
75	Estimated tax penalty (see instructions)	75			

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete the following. ☒ **No**

Designee's name ► Phone no. ► Personal identification number (PIN) ►

Sign Here

Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
►		DVM	
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	
►			

Paid Preparer's Use Only

		Date	Check if self-employed	Preparer's SSN or PTIN
Preparer's signature ►	Tom Houk	03/13/2005	☒	520-46-1471
Firm's name (or yours if self-employed), address, and ZIP code ►	1040 TAXMAN TOM		EIN	
	2939 N MADISON PO BOX 209			
	LOVELAND CO 80539		Phone no.	(970) 461-1040

Form **1040** (2004)

Form **2441** | **Child and Dependent Care Expenses** | OMB No. 1545-0068

► Attach to Form 1040.

► See separate instructions.

2004 21

Department of the Treasury Internal Revenue Service (99)

Name(s) shown on Form 1040: PHILIP B & AMY L ZSCHEILE

Your social security number: 523-37-6382

Before you begin: You need to understand the following terms. See **Definitions** in the instructions.
• **Dependent Care Benefits** • **Qualifying Person(s)** • **Qualified Expenses**

Part I **Persons or Organizations Who Provided the Care** — You **must** complete this part.
(If you need more space, use the bottom of page 2.)

1 (a) Care provider's name	(b) Address (no., street, apt no., city, state, and ZIP code)	(c) Identifying no. (SSN or EIN)	(d) Amount paid (see instructions)
ALMOST HOME	3136 LONGHORN CT		
KAY ELDER	FT COLLINS CO	84-1345998	16,220.

Did you receive **dependent care benefits?**
No ► Complete only Part II below.
Yes ► Complete Part III on page 2 next.

Caution. If the care was provided in your home, you may owe employment taxes. See the instructions for Form 1040, line 61.

Part II **Credit for Child and Dependent Care Expenses**

2 Information about your **qualifying person(s).** If you have more than two qualifying persons, see the instructions.

(a) Qualifying person's name First	Last	(b) Qualifying person's social security number	(c) **Qualified expenses** you incurred and paid in 2004 for the person listed in column (a)
ANDREW	ZSCHEILE	652-14-1814	8,110.
VANCE	ZSCHEILE	652-14-1815	8,110.

		Line	Amount
3	Add the amounts in column (c) of line 2. **Do not** enter more than $3,000 for one qualifying person or $6,000 for two or more persons. If you completed Part III, enter the amount from line 32	3	6,000.
4	Enter your **earned income.** See instructions	4	41,288.
5	If married filing jointly, enter your spouse's earned income (if your spouse was a student or was disabled, see the instructions); **all others,** enter the amount from line 4	5	73,854.
6	Enter the **smallest** of line 3, 4, or 5	6	6,000.
7	Enter the amount from Form 1040, line 37 — 7: 109,922.		

8 Enter on line 8 the decimal amount shown below that applies to the amount on line 7

If line 7 is: Over	But not over	Decimal amount is	If line 7 is: Over	But not over	Decimal amount is
$0	15,000	.35	$29,000	31,000	.27
15,000	17,000	.34	31,000	33,000	.26
17,000	19,000	.33	33,000	35,000	.25
19,000	21,000	.32	35,000	37,000	.24
21,000	23,000	.31	37,000	39,000	.23
23,000	25,000	.30	39,000	41,000	.22
25,000	27,000	.29	41,000	43,000	.21
27,000	29,000	.28	43,000	No limit	.20

8: X 0.20

		Line	Amount
9	Multiply line 6 by the decimal amount on line 8. If you paid 2003 expenses in 2004, see the instructions	9	1,200.
10	Enter the amount from Form 1040, line 45, minus any amount on Form 1040; line 46	10	11,769.
11	**Credit for child and dependent care expenses.** Enter the **smaller** of line 9 or line 10 here and on Form 1040, line 47	11	1,200.

BAA For Paperwork Reduction Act Notice, see separate instructions. Form **2441** (2004)

3. Changes to your Return

Note: We only show the items that have been affected by the information we received in the following chart. All other items are correct as shown on your return. Unless noted, line numbers always refer to the line number on your tax return.

Changes to Your Income and Deductions	Shown on Return	Reported to IRS, or as Corrected	Difference
TAXABLE WAGES	$ 18,632	$ 33,329	$ 14,697
		Income Net Difference	$ 14,697
		Total Change to Taxable Income	$ 14,697

Changes to Your Tax Computation	Shown on Return	As Corrected By IRS	Difference
Taxable Income, line 27	$ -337	$ 14,360	$ 14,697
Tax, line 28	$ 0	$ 1,456	$ 1,456
Child tax credit, line 33	$ 0	$ 1,000	$ 1,000
Total Tax, line 38	$ 0	$ 456	$ 456
Earned Income Credit, line 41	$ 3,384	$ 288	$ -3,096
Additional child tax credit, line 42	$ 813	$ 0	$ -813
	*Net Tax Increase		$ 4,365
Income tax Withheld, line 39	$ 978	$ 1,002	$ 24
	*Net Payment Increase		$ 24

Summary of Proposed Changes	
Amount of Tax Increase	$ 4,365
Payment Increase	$ 24
Interest, IRC Section 6601, From 04/15/2004 To 03/16/2005	$ 192
Total Amount You Owe	$ 4,533

*Increases to Payments decrease the amount owed.
*Decreases to Credits result in an increase to Tax.

March 10, 2005

FROM: 1040 TAXMAN TOM 970-461-1040 PO BOX 209 LOVELAND CO 80539

ATTENTION: SENATOR CONNIE MACK, Chair SENATOR JOHN BREAUX, V Chair

Gentlemen: This IRS Notice came to my office yesterday after I faxed your Office. This is most likely a case of a stolen or duplicated social security card. There has always been a huge market for selling green cards and social security cards for cash [never gets income taxed]. Even though a duplicate number is rare, this little office has had three cases of duplicated numbers. Think what it'd be like if it were your SS# that was duplicated. IRS now wants $4,533.00 from this couple who got a refund in 2003. I've blocked out the last four digits of the SS# for professionalism and file confidentiality.

(EX21) Page 10 CP2000 (REV. 11/2004)

This problem is gone if we abolish the 1040 system and go with the NATIONAL SALES TAX. I'd love to help your Advisory Panel. I can bring more examples to New Orleans IF IF you'd like.

1N0S4T0 NATIONALSALESTAX 1040NST

NATIONAL SALES TAX NST1040 NATIONAL SALES TAX

FORMS SHALL BE COMPLETED FOR EVERY MONTH AFTER 16TH BIRTHDAY OR AFTER EFIN START DATE

PERSON/BUSINESS ______________________ SPOUSE [IF JOINT] ______________________

SS#______________ DOB ____/____/____ SS#______________ DOB ____/____/____

EFIN NO. ______________ EFIN START ____/______ ADDRESS ______________________
(MM) (YYYY)

CITY ________________ STATE ______ ZIP ________ PHONE NUMBER (_____)__________

PERIOD COVERED BY THIS RETURN ________________ thru ________________
[MM/YYYY] [MO - QTR - S/A - ANNUAL] [MM/YYYY] [MO - QTR - S/A - ANNUAL]

LN 1 PRODUCT/GOODS/SERVICE ______________ GROSS DOLLARS [WHOLE DOLLAR] $__________

LN 2 NATIONAL SALES TAX – MULTIPLY LN 1 X 3% [X.O3] [WHOLE DOLLAR] $__________

LN 3 COMMISSION DUE FILER – MULTIPLY LN 2 X 5% [X.O5] [WHOLE DOLLAR] $__________

LN 4 BALANCE DUE PAY TO: U.S. TREASURY SUBTRACT LN 3 FROM LN 2 [WHOLE DOLLAR] $__________

1N0S4T0/1040NST FORM AND BALANCE DUE MUST BE POSTMARKED BY THE 15TH OF THE MONTH THAT FIRST FOLLOWS THE MODE USED IN *PERIOD COVERED* ABOVE TO EARN THE FILER COMMISSION. EVERY PART MONTH AFTER THE 15TH REDUCES THE FILER COMMISSION BY 20%. EVERY PART MONTH BEYOND 5 MONTHS WILL EARN A 10 PERCENT OF LN 2 PENALTY PLUS LEGAL INTEREST IN THE FILER STATE, i.e. 8% PER ANNUM, etc. EXAMPLES ONLY ARE SHOWN HERE & ARE BY NO MEANS INTENDED TO BE ALL CONCLUSIVE:

January 1 thru January 31 – 1N0S4T0 / 1040NST is due by February 15
January thru March – 1N0S4T0 / 1040NST is due by April 15
October thru December – 1N0S4T0 / 1040NST is due by January 15
January 1 thru January 31 filed in June before 15th will earn 1% commission
January thru March quarter filed in December will earn 60% penalty of Ln 2; NO commission

Internal Revenue Service [IRS] will compute the Penalty/Interest whenever Filer wishes; or whenever Filer inadvertently fails to complete Line 6. Internal Revenue service shall also compute and collect for any period NATIONAL SALES TAX form is due.

NATIONAL SALES TAX IS DESIGNED TO COLLECTIVELY ABOLISH ALL CURRENT 941/W-2/1040 SYSTEMS; TO SAVE SOCIAL SECURITY AT IT'S CURRENT PAY OUT SCALE; TO BE COMPLETELY 100% FAIR TO EVERY CITIZEN/ALIEN; TO GATHER REVENUE FROM THE LARGE UNDERGROUND ECONOMY & 1040 NON-FILERS; TO CONTINUALLY SPUR THE ECONOMY THROUGH FULL & WHOLE PAY CHECKS; TO CREATE MORE REVENUE FOR THE U. S. TREASURY; and TO CREATE MORE JOBS.

LN 5 PENALTY $________ INTEREST $________ TOTAL $________ ADDED TO LN 4 $__________

LN 6 MAILED TO IRS CENTER ______________________ ZIP ________ TOTAL $__________
TOTAL AMOUNT ON LN 6 MUST BE NEAREST DOLLAR

UNDER THE PENALTY OF PERJURY, THE ABOVE NAMED ENTITY OR PERSON[S] SWEAR AND AFFIRM THIS FORM IS TRUE AND CALCULATED CORRECTLY, TO THE BEST OF THEIR KNOWLEDGE.

______________________ ____/____/____ ______________________
PERSON/TITLE DATE SPOUSE

1N0S4T0 # NATIONALSALESTAX **1040NST**

NATIONAL SALES TAX | NST1040 | NATIONAL SALES TAX

FORMS SHALL BE COMPLETED FOR EVERY MONTH PERIOD AFTER 16TH BIRTHDAY OR EFIN START DATE

APPLICATION FOR REFUND

PLEASE PHOTOCOPY YOUR YTD PAY STUB[S] & ATTACH TO THE FRONT OF THE APPLICATION
DO NOT SUBMIT THIS APPLICATION IF YOUR YTD PAY STUB[S] EXCEED $30,000.00

PERSON ________________________ SPOUSE [IF JOINT] ________________________

SS#________________ DOB _____/_____/_____ SS#________________ DOB_____/_____/_____

ADDRESS ________________________ PHONE NUMBER [______] ______________

CITY ____________________ STATE ______ ZIP __________

PERIOD COVERED ____________________ thru ____________________
(MM/YYYY) [QTR - S/A – ANNUAL] (MM/YYYY) [QTR - S/A – ANNUAL]

AMOUNT OF REFUND $____________[CANNOT 3% OF ATTACHED YTD PAY STUB[S]

UNDER THE PENALTY OF PERJURY, THE ABOVE NAMED PERSON[S] SWEAR AND AFFIRM THIS FORM IS TRUE AND CALCULATED CORRECTLY, TO THE BEST OF THEIR KNOWLEDGE.

______________________ ________ ______________________
PERSON DATE SPOUSE

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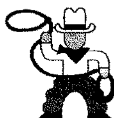

Tax panel advises dropping mortgage deduction

BY MARY DALRYMPLE
ASSOCIATED PRESS

WASHINGTON — That most sacred of tax breaks, the mortgage interest deduction that has helped millions buy homes, could vanish if President Bush and Congress follow the recommendations of his tax advisory board.

Nine tax experts, tasked with developing simpler and fairer tax laws, concluded that the deduction does more for wealthier taxpayers than for people struggling to buy a home. But mortgage bankers and real estate agents see irreparable harm if the tax break disappears.

The National Association of Realtors estimated that housing prices could decline 15 percent, bad news for owners who have seen the value of their homes increase.

"You're going to be taking away from Middle America," said David Lereah, the association's chief economist. "Everyone, whether you use the mortgage interest deduction or not, the value goes down. You've just reduced the retirement nest egg for everyone."

The idea is a long way from becoming reality, and several lawmakers have already declared their opposition.

SEE MORTGAGE ON 9C

BUSINESS NEWS
RENO GAZETTE-JOURNAL/RGJ.COM SATURDAY, OCTOBER 29, 2005

IRS to pay Buffett's firm more than $23M

ASSOCIATED PRESS

LINCOLN, Neb. — A federal judge on Friday ordered the Internal Revenue Service to pay billionaire Warren Buffett's investment company more than $23 million in taxes and interest for disallowing certain deductions.

The ruling by U.S. District Judge Lyle Strom ended some three years of legal wrangling between Berkshire Hathaway Inc. and the IRS.

The case stemmed from two lawsuits that alleged the IRS made an "erroneous, wrongful and illegal" interpretation of the U.S. Tax Code when it denied the deductions.

AP
Warren Buffett

The original lawsuit, filed in 2002, said the IRS wrongly assessed more than $16 million in taxes and interest against Berkshire in 1989 and 1990. A second lawsuit said the IRS wrongly assessed it nearly $7 million in 1991.

The two lawsuits were combined for trial.

The IRS first disallowed the deductions after tracing $750 million in borrowed money to Berkshire's purchase of stocks in several companies, including Coca-Cola Co., Time-Warner Inc. and Wells Fargo & Co., according to court records.

The IRS based the denial on a tax code passed by Congress that reduced deductions if borrowed money is directly attributable to investments in stocks that pay dividends.

Congress passed the code because of concern that some corporations were deliberately borrowing money for the purpose of buying dividend-paying stock, thereby converting pretax losses into after-tax gains.

Berkshire, based in Omaha, borrowed the money several times and put it into a principal bank account, according to court records.

But Berkshire said the money in that account came from several sources, was interchangeable and was used for thousands of transactions.

The company said its goal was not to buy specific stocks but to maintain and enhance its financial strength.

CLICK. ZIP. FAST ROUND TRIP.

Dorothy B. Coleman
Vice President, Tax and Domestic Economic Policy

August 8, 2006

Senator Charles E. Grassley
Chairman
Senate Committee on Finance
United States Senate
Washington, DC 20510

Senator Max Baucus
Ranking Member
Senate Committee on Finance
United States Senate
Washington, DC 20510

Dear Sen. Grassley and Sen. Baucus:

On behalf of the National Association of Manufacturers—the nation's largest industrial trade association, I submit the attached statement for the record of the Senate Finance Committee's August 3, 2006, hearing, "Kick-Off for Tax Reform: Tackling the Tax Code."

NAM members believe that the current tax code represents a major drag on our economy and strongly support efforts to move towards a simpler and fairer tax code that promotes economic growth. We applaud your interest in this important issue and your willingness to spearhead this effort. We very much look forward to working with you and your staff as the process moves forward.

Sincerely,

Manufacturing Makes America Strong

1331 Pennsylvania Avenue, NW • Washington, DC 20004-1790 • (202) 637-3077• Fax (202) 637-3182 • www.nam.org

NAM Principles on Tax Reform
January 2005

The National Association of Manufacturers applauds the Administration's current efforts to develop proposals to reform the nation's tax laws. The U.S. manufacturing sector accounts for about 13% of GDP and 11% of U.S. jobs. Because of the importance of manufacturing to our nation's economy, NAM supports the thoughtful consideration of an appropriate and timely path to make the tax code fairer and simpler. In developing a tax reform plan, policy makers should be guided by principles that will promote economic growth and job creation. To this end, the NAM offers the following policy guidelines. Specifically, any reform plan should:

- Encourage savings and investment while minimizing the double taxation of corporate earnings;
- Include rules that permit U.S.-based manufacturers to compete on a level playing field in the global marketplace;
- Recognize the important role of research and technology investment in the growth of U.S. jobs and innovation;
- Eliminate both the individual and corporate alternative minimum tax rules, which are inherently complex and unfair;
- Strive to raise the required amount of revenue for the government without distorting a business's decision to invest capital and hire new workers;
- Include broad and strong transition rules that provide fair and equitable treatment for taxpayers who have committed substantial resources based on current law.
- Not result in a net increase in business taxes; and
- Incorporate rules that make it easier for Treasury to administer the law and for taxpayers to comply with the law. Unnecessary complexity is not productive from an economic perspective and undermines taxpayers' confidence in the fairness of the law.

Statement on Corporate Tax Reform

By the
National Association of Manufacturers
1331 Pennsylvania Avenue N.W.
Washington, D.C. 20004-1790

Submitted to the
Committee on Finance
U.S. Senate

For the Hearing Record of August 3, 2006

"Kick-Off for Tax Reform: Tackling the Tax Code"

The National Association of Manufacturers — the nation's largest industrial trade association — represents large, mid-size and small manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing to America's economic future and living standards.

NAM members have long believed that the current tax system is a major obstacle to realizing the full potential of our economy. The NAM is pleased to participate in the dialogue over restructuring the U.S. tax code and applauds Congressional efforts to rewrite the tax code. While the NAM has not endorsed any specific proposal, we believe that the solution calls for a new tax system that is simpler and encourages, rather than penalizes, work, investment and entrepreneurial activity.

In anticipation of the current tax reform effort, NAM members developed the attached "Principles on Tax Reform" to serve as a framework for evaluating proposals and developments as the tax reform debate moves forward. The principles touch on several areas including international competitiveness, research and technology investment and the alternative minimum tax. They also incorporate the need for a tax code that both encourages investment and makes U.S. manufacturers more competitive in the global marketplace.

Business Tax Rates

A key issue that needs to be addressed in any tax reform effort is the U.S. corporate tax rate. With a combined federal and state corporate tax rate of 39.3 percent[1], the United

[1] Fiscal Fact No. 55, The Tax Foundation, 5/5/06

States has the second highest corporate tax rate among all countries in the Organization for Economic Cooperation and Development (OECD). Japan, at 39.5 percent, is the only OECD country with a higher tax rate than the United States. Moreover, the average corporate tax rate for OECD countries is 28.7 percent, more than 10 percentage points lower than the U.S. rate.

At the same time, a tax reform plan should not result in a net increase in business taxes For example, while both the Simplified Income Tax (SIT) and the Growth and Investment Tax (GIT) plans proposed by President's Advisory Panel on Federal Tax Reform[2] would reduce the top tax rate for corporations, many businesses could end up paying significantly more in federal taxes under either plan.

Under the SIT plan, a 31.5 percent rate would apply to a "clean" tax base—most credits and deductions—including the R&D credit, the deduction for state and local taxes and the deduction for domestic manufacturing income, would be eliminated, resulting in a tax increase for many companies.

The GIT plan would assess a 30 percent tax on a modified consumption basis, i.e., cash flow minus domestic inputs and wages. Moving to the GIT plan basically would move business taxpayers from a corporate income tax system to a subtraction method value-added tax (VAT), an entirely new system that would be unfamiliar to many business taxpayers and that could generate significant transition costs for them

Depreciation Reform

Capital investment is key to economic growth and job creation. In addition to lower tax rates, one of the most effective ways to spur business investment — and make U.S. manufacturing more competitive—is through an enhanced capital-cost recovery system that would allow all taxpayers to expense capital equipment in the tax year it is purchased.

Both the small business expensing and simplified accelerated depreciation for larger businesses in the SIT plan and the expensing provisions for all businesses in the GIT plan represent an improvement over current law.

Nonetheless, we do have some concerns. While the SIT plan would move toward a simplified depreciation system with four (rather than nine) class lives, businesses still would have to track four different categories of assets. In addition, a smaller number of class lives could result in longer recovery periods for some assets.

While we support the expensing provision in the GIT plan, we also are concerned that the elimination of the deduction for business interest would increase the cost to businesses to finance new enterprises or business expansions, thus limiting U.S. economic activity.

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[2] "Simple, Fair & Pro-Growth: Proposals to Fix America's Tax System," The President's Advisory Panel on Federal Tax Reform, November 2005

On a broader note, NAM members are concerned about the impact of the depreciation reform on existing investment. Many of our members have sizable amounts of remaining tax basis that might be lost altogether if they are not allowed to utilize accrued, but unused, tax attributes. We are pleased that, in enacting the "bonus depreciation" provisions in 2002 and 2003, Congress recognized this fact.

Tax Relief for Investment Income

The reduced tax rates on investment income enacted in 2003 have been a major factor in our country's recent economic growth. Since enactment of the lower rates on capital gains and dividends, more than four million new jobs were created and the GDP has grown more than four percent each year. In addition, the stock market has risen by about $4 trillion in value and an estimated 40 percent of the gain is attributable to the increase in the after-tax return on equities.

The NAM strongly supported recently enacted legislation that extended this important tax relief through 2010[3]. We encourage policy makers to make this tax relief permanent and go even further and totally eliminate the tax on investment income.

Eliminating the tax on dividends would significantly reduce the double tax on corporate income and minimize the bias toward debt over equity in the current code. However, in contrast to the SIT plan proposed by the tax reform panel, we urge policy makers not to limit the preferential tax treatment to dividends paid out of domestic earnings. With this limitation, large corporations paying dividends could face additional administrative burdens to ensure that the tax-free dividends are paid from income that has been subject to U.S. tax.

Similarly, eliminating the capital gains tax on sales of corporate stock also would further reduce the double tax on corporate income. In addition, this change would provide similar tax results for companies that pay out earnings as dividends or that retain earnings.

International Competitiveness

Improving the ability of U.S.-based manufacturers to compete on a level playing field in the global marketplace is a major policy goal of the NAM. A territorial system, for example the one included in the SIT plan, generally would exempt from U.S. tax active business profits earned outside the United States and repatriated as dividends to the U.S. parent. This change would put the United States on the same page as most of our trading partners who also have territorial systems. While this plan would go a long way to address the problem of double taxation of foreign-earned income faced by U.S. multinationals, it would not result in significant simplification for either the government or the taxpayer.

---

[3] P.L. 109-222, enacted 5/17/06

In addition, a territorial system would require an even greater emphasis on transfer pricing and sourcing issues. As described in the panel's recommendations, it appears that the SIT territorial system also would retain some negative elements of the current system, e.g., subpart F, and, at the same time, weaken significantly some of the recently enacted pro-growth international tax reforms.

Moreover, the move to a territorial system could significantly increases taxes for some U.S companies. The SIT territorial proposal is a slightly modified version of a Joint Committee on Taxation proposal included in JCS-02-05 (January 27, 2005) that would raise an estimated $54.8 billion over 10 years from the general business community. Rather than making U.S. companies more competitive, a tax increase of this magnitude on the business sector would make it more difficult to compete.

In contrast to the SIT plan, the GIT plan would tax international transactions on a "destination basis" principle, with border tax adjustments. Under the GIT plan, taxes would be rebated on exports while imports could not be deducted from cash flow. In effect, this plan would impose a 30 percent tariff on imports, increasing taxes for businesses that import a significant amount of goods, including parts and components. For example, this approach could increase the price of imported oil by 30 percent. Because manufacturers depend heavily on oil—for heat, transportation and, in some cases, as a feedstock—this increase alone would have a huge negative impact on the manufacturing sector.

Other factors to consider are the impact of either the territorial system or the border adjustable system on existing U.S. tax treaties. In the case of a territorial system, most treaties contemplate a foreign tax credit system as opposed to a dividend exemption system. With the border adjustable system, countries with treaties using a foreign tax credit system might not view a consumption tax as a creditable tax.

Investment in R&D and Technology

The important role of R&D and technology investment in the growth of U.S. jobs and innovation cannot be overstated. The manufacturing sector continues to lead private industry in R&D — nearly 60 percent of all private industrial R&D in the United States is performed by manufacturers. For more than 20 years, the R&D credit—used by almost 16,000 companies— has been a proven incentive to spur incremental R&D in the United States that would not otherwise be done, with benefits spilling over to U.S. workers in terms of higher wages and a higher standard of living.

Unfortunately, the current credit expired at the end of 2005. The NAM is a leader in the current effort to push for Congressional action as soon as possible to seamlessly extend and strengthen this critical tax provision. Without incentives to encourage R&D, our economy's innovation and competitiveness are at stake. As illustrated in the attached chart, Canada, Ireland, China, France and many other economic competitors are actively courting U.S. R&D activity with a variety of more generous and permanent incentives. In 2003, foreign-based R&D spending grew faster than U.S.-based R&D spending. The

current lack of an R&D credit in the United States, coupled with strong incentives in other countries, are factors in the current trend for more U.S. based research to move overseas.

The Corporate Alternative Minimum Tax

For many years, the NAM has led the business community in advocating for repeal of the corporate alternative minimum tax, or "anti-manufacturing tax," a tax that distorts business decisions and imposes needless complexities and administrative burdens. Consequently, we believe strongly that any reform plan should repeal the corporate AMT and address the problem of accumulated, unused AMT credits that currently total more than $20 billion.

Companies with unused AMT credits essentially are making interest-free loans to the federal government, to be repaid only when the company has sufficient regular income tax liability in the future. Congress intended for the AMT to serve only as a pre-payment of tax, not as a permanent tax increase, which effectively becomes the case if taxpayers cannot use AMT credits. Consequently, it is critical that any tax reform plan that repeals the corporate AMT also allows taxpayers to utilize existing AMT credits on an expedited basis.

Transition Relief

Fair, adequate and workable transition rules for companies that have made business decisions based on existing law are critical to the success of an enhanced system. A move to a new system also raises some tax accounting issues that need to be addressed in transitioning to a new system. For example, proposed cuts in business tax rates and shortened depreciation lives would require companies to recalculate deferred tax assets and liabilities, resulting in a charge or increase in earnings when the legislation is enacted.

Another issue to consider is the reaction of states to a new federal tax plan. In many cases, states track federal tax laws. Depending on the federal tax reform efforts, some states would have to significantly alter their tax base if they wanted to continue piggybacking on federal laws.

Complexity and Administration

In order to both reduce the economic cost of tax administration and restore taxpayers' faith in the fairness of the system, it is critical that policy makers develop a tax system that makes compliance and administration easier. While the SIT plan when fully implemented likely would reduce compliance costs for nonbusiness taxpayers, compliance costs for all size businesses could increase. For instance, a smaller business could face additional requirements, particularly if they pay taxes on the shareholder level.

Similarly, large businesses would continue to deal with current compliance issues including those related to calculating depreciation and foreign taxes.

Conclusion

Tax reform is an important issue to manufacturers and we appreciate the opportunity to share NAM's views with the Subcommittee. We also recognize that the current series of hearings is just the beginning of the process and the hardest work lies ahead. As the process moves forward, NAM members will evaluate various tax reform proposals with respect to their likely impact on both international competitiveness and the crucial research and technology investment necessary for 21st century economic success.

Thank you in advance for giving thoughtful consideration to our comments. The NAM is committed to working with Congress, the Administration and others to develop a tax system that is far less complicated and far more likely to encourage broad based economic growth.

NATIONAL ASSOCIATION OF REALTORS®
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Hearing: Kick-off for Tax Reform
August 3, 2006

Comments for the Record on Behalf of National Association of Realtors®

The NATIONAL ASSOCIATION OF REALTORS® represents over 1.2 million real estate professionals who participate in our organization in their capacities as individuals engaged in real estate businesses as sales agents, brokers, leasing agents, advisors, property managers, developers, commercial and investment real estate specialists and as investors in their own real estate portfolios. Most are self-employed, with business organization forms fairly evenly distributed among Subchapter C corporations, Subchapter S corporations, sole proprietorships, limited liability companies and partnerships.

Each year, the real estate industry generates from 15% to 18% of the gross domestic product. Since 2000, the real estate sector has been one of the only growth sectors in the entire U.S. economy. For these reasons, the industry is a major stakeholder in tax reform. Far-reaching changes to the tax base and to the tax model could significantly alter the economics of this cyclical industry and could disrupt what has generally been, with some dramatic exceptions, a successful taxation regime over the decades. We note, as well, the record homeownership rate, which is currently nearly 70%. We reject tax law changes that would reduce this monumental achievement.

These comments are similar to those submitted to the President's Tax Reform Advisory Panel (the Panel). They describe in a general way the impact of various replacement tax reform models presented to the Panel. They also identify issues of note from the Panel's report that would adversely affect housing, homeownership and investment real estate. We will note, as well, the dilemmas of tax reform for self-employed individuals.

Housing and American Culture

Never dismiss or underestimate Americans' passion for homeownership. Calling homeownership the "American Dream" is not a mere slogan, but rather a bedrock value. Owning a piece of property has been central to American values since Plymouth and Jamestown. Homes are the foundation of our culture, the place where families eat and learn together, the basis for community life. The cottage with a picket fence is an iconic part of our heritage. Do not take such imagery or passion lightly.

The tax system does not "cause" homeownership. The tax system *facilitates* ownership. The tax system supports homeownership by making it more affordable. While it is true that only about

one-third of taxpayers itemize deductions, it is also true that, over time, more than one third of taxpayers receive the benefit. Over time, mortgages get paid off, other new homeowners enter the market and family tax circumstances change. Arguably, the standard deduction gives non-itemizing taxpayers a "better" answer than utilizing the mortgage interest deduction, so it is not clear that non-itemizers have been put at a disadvantage. Indeed, the standard deduction could be characterized as a *deeper* subsidy that itemizing taxpayers receive.

Tax Replacement Models and Housing

The federal policy choice to support homeownership has been in the Internal Revenue Code since its inception. We see no valid reason to undermine that basic decision.

NAR aggressively opposed the flat tax during the 1996 Presidential primary campaign of Steve Forbes. His model, based on the so-called Hall-Rabushka flat tax, would repeal all deductions, including the mortgage interest deduction and state and local tax deductions. Our internal research and the research of outside experts consistently has shown that an overnight or even a phased loss of these deductions would cause the value of existing housing to fall by as much as 25%. This is simply unacceptable, particularly because some research also has shown that this loss of value is never fully recouped.

Under current law, no federal-level tax applies to the purchase of a house. Thus, our policy opposes any transaction-type tax on the sale of a house. We have no formal position on the tax base and system included in the National Retail Sales Tax (H.R. 25, the Fair Tax), but we are dismayed that the sales tax rate of that model would likely range between 30 – 45% of the price on a tax-exclusive basis.

As we understand many of the consumption tax models that have been presented, the incidence of a retail or transaction tax would generally fall on the purchaser. We are unable to imagine how buyers, sellers or housing markets could bear a 30 – 45% tax burden. We question whether prudent lenders would be willing or able to finance the sales tax cost, as a long-term financing mechanism would almost certainly require mortgages that would exceed the after-tax value of the home. If a home that had been subject to the sales tax were sold before the tax liability had been extinguished (which we believe would be the general case), the owner would likely realize no cash, as the outstanding tax and mortgage liabilities could easily use up most or all of the proceeds from the sale. Thus, a tax on home purchase is ill-advised.

We note with interest Professor Graetz's proposals that would create a very high "Family Allowance" under an income tax, but that would retain all existing deductions for taxpayers. We are in the process of modeling the Graetz model's impact on housing and, again, will be pleased to share our findings. We note that the Graetz proposal would impose a VAT on new housing. We will be pleased to work with the Panel to assure that housing is not disadvantaged under the Professor's thought-provoking model.

Finally, the 1997 provision creating a $250,000/$500,000 capital gains exclusion on the sale of a principal residence is doubtless one of the most taxpayer-friendly provisions added to the Code in decades. We believe that this feature of current law (or some similar exclusion

mechanism that would also be adjusted for inflation) must be retained in some manner to help families preserve their capital.

Tax Reform Panel Recommendations – Housing

The housing market, while large, is a fragile, delicate instrument. For more than five years, housing has been the most lively and vibrant sector in the economy and fueled much of the 2001 – 2002 economic recovery. Some panelists expressed concern about real estate speculation and about the size of houses. We believe that penalizing current homeowners by reconfiguring the mortgage interest rules is a completely inappropriate mechanism for curtailing abusive lending practices or defeating local land use decisions.

Converting the Mortgage Interest Deduction to a Credit: We believe that this change will create winners and losers. For a benchmark, we have undertaken research projects assessing the impact of a tax credit measured against the current deduction rules. Our emerging conclusion is that, over time, there would be more losers than winners unless the credit rate is comparable to the higher brackets of the tax system. In all events, we believe that the value of the existing housing stock, particularly in high cost areas, would be diminished.

The Tax Reform Act of 1986 provided ample evidence that when the tax benefits associated with real estate ownership are curtailed, the value of real estate declines. A substantial decline in residential values would likely occur with a conversion to a credit that reduced the economic benefit of tax deductions for existing properties. The 1986 Act provided five-year transition relief for owners of investment real estate, but *even with the benefit of transition rules,* the loss of value in the commercial real estate sector was 30%. Observers will likely find it ironic that, in today's era of low savings, changing a deduction to a credit would sharply erode savings. We can identify no justification for such a diminution.

Reducing the $1 Million Cap on Indebtedness: The $1 million cap on mortgage indebtedness ($1.1 million when home equity debt is included) as a measure of allowable mortgage interest deductions was adopted in 1987. NAR supported that change from prior law, as it was a substantial simplification over the mortgage interest limitations that had been included in the 1986 Tax Reform Act. *The $1.1 million cap has not been modified or indexed for inflation since 1987.* Given inflation, the overall real growth in the economy, the substantial increase in the cost of housing and growth in the homeownership rate since 1987, we were startled that the President's Panel would even consider *reducing* that cap.

The Panel's proposals related to the $1.1 million cap would link the amount of tax benefits to the FHA loan limits. We would ask, "Which FHA loan limit?" Those loan limits range today from $172,632 to $312,895, depending on geographic location. (Note these limits can go as high as about $469,344 in Alaska and Hawaii, but not in any other high cost state.) Worse yet, FHA limits vary within a state. In California alone, more than a dozen FHA limits are in effect in various parts of the state.

We believe this change would have very uneven regional and community application. It is unclear how using FHA's community-based mechanism, measured based on Metropolitan

Statistical Areas, could be transposed fairly into the federal income tax system. We also believe that grafting the FHA system into the tax system would result in extraordinary complexity. Further, we believe that introducing regional differences into the Internal Revenue Code is a dangerous precedent.

Other Housing-related Issues

Second Homes: The Panel proposes eliminating tax benefits for second homes. We bring to your attention the fact that this is one of the more vibrant sectors of the housing market. Historically, it has been the general pattern that at least one Congressional district in every state (except Connecticut, where second homes are not concentrated in any particular district), has a lively REALTOR® second home/vacation property market. Eliminating the tax benefits associated with second homes would have a devastating effect in these communities as property values would inevitably fall and local financial institutions that finance second homes would experience significant defaults. Tax benefits have been available for second homes for as long as there has been a mortgage interest deduction.

Housing as a Productive Asset: Professor Poterba, a member of the Panel, has frequently stated that if less money were invested in owner-occupied housing, more money would be invested in "more productive" assets such as stocks and equipment. We note that neither stock nor equipment ownership provides the foundation for community life, that neither provides an impetus to encourage good schools, neither fosters lower crime rates and neither contributes to the tax base of local governments. Housing does those things.

Moreover, it is not a foregone conclusion that individuals who purchase residences for their families would necessarily have the requisite inclination or skills to choose and purchase stocks or other securities. Similarly, no family is likely to acquire manufacturing equipment to improve their community or schools. Professor Poterba stated that if families bought smaller houses they might buy more stock. We do not believe it is the function of the tax system to determine the size of a house for any family or its method of saving.

Investment Real Estate:

Depreciation/Expensing: The Panel recommended that investments in capital assets be expensed rather than capitalized and depreciated over a term of years. Over the course of the Panel's hearings, no witness specifically addressed whether expensing would extend to real estate. NAR has no formal position on expensing but does recommend that the Committee use caution when recommending the appropriate model for real estate cost recovery.

Real estate investors have generally found the traditional accounting model of matching income and expenses over a term of years to be valid and workable. Real estate, perhaps unique among capital assets, is generally acquired in anticipation of long holding periods that generate relatively stable and predictable income streams over a term of years. Further, investors anticipate that, over time, the improvements to real estate will become outdated or obsolete, but the land itself will remain and, depending on external factors, perhaps have appreciated.

These income and expense matching principles in the current tax system are consistent with investors' expectations. Thus, a fundamental question under an expensing model is whether expensing would be available only in the year of the investment or whether carryovers would be provided. Carryovers would be essential in an expensing regime for real estate, as acquisition costs far exceed the one-year cash flow of a project.

Expensing real estate would create a very front-loaded investment regime for this long-lived asset. In the recent past, the real estate industry, always cyclical, demonstrated the limitations of a cost recovery system that is too heavily front-loaded. The so-called "10-5-3" proposal emerged in 1981 to enhance capital formation and investment in a sluggish economy. Under that proposal, investments in real estate would have been capitalized and costs recovered over 10 years. While real estate professionals accepted this treatment for manufacturing plant and owner-occupied properties, the investment real estate sector, particularly in the nonresidential category, believed that a 10-year cost recovery period was overly generous and could lead to distortion and speculation in the marketplace. The outcome in the Economic Recovery Tax Act of 1981 was a 15-year cost recovery period for all real estate, increased to 18 years in 1984 and 19 years in 1985. The predicted speculation and abuse occurred.

The Tax Reform Act of 1986 radically changed the tax model for real estate investment, lengthening the cost recovery period to 31.5 years for nonresidential real estate (increased to 39 years in 1993) and 27.5 years for residential property. Moreover, to curtail the tax shelter industry that had grown up around real estate, the 1986 Act implemented the exceptionally complex, onerous and poorly understood passive loss rules.

NAR has no interest in repeating the scenario in which overly generous benefits are given to the industry, then abused, then abruptly removed. In 1986, the draconian changes to real estate taxation, the failure to provide protection for existing assets and the absence of realistic transition rules combined to cause severe dislocation and loss of value to investment property and grave danger to the financial system. *NAR has no position that would support or reject expensing.* NAR does, however, wish to remind the Committee that real estate investment has unique characteristics. Poorly designed cost recovery rules for real estate can distort investment and generate abusive investor behavior. Moreover, adequate transition rules are essential.

The second cost recovery model the Panel proposed for assets actually would make the cost recovery period for real estate *even longer.* We draw the Committee's attention to the findings of the 2000 Treasury depreciation study. We concur with its finding that the current 39-year tax life is unduly long for real estate and especially for leasehold improvements to real estate. The Panel's recommendation have the effect of extending the cost recovery period for residential real estate from 27.5 to approximately 33 years and the life of nonresidential property from 39 to about 45 years. (The exact period is actually infinite, as the Panel recommends use of the declining balance method with no apparent switch-over rule.) If current law unduly prolongs the cost recovery period for real estate, the Panel's recommendations make a bad rule even worse.

The 2000 Treasury study also validated the use of cost segregation studies for real estate. These studies have the effect of restoring the pre-1981 component depreciation model. Component depreciation is complex and may treat similarly-situated taxpayers very differently. Given the current 39-year life, however, the cost segregation studies enable investors to more accurately measure the economic value of their assets. The 2000 study made no specific recommendation as to what a more appropriate life would be. In 2001, NAR adopted policy supporting a cost recovery period for real estate between 20 - 25 years. None of the Panel's approaches to depreciation and cost recovery are consistent with either the Treasury recommendations or supportable policy objectives for fixed assets.

Interest Expense: Investment real estate is almost always acquired with debt. During the early 1980's, the debt to equity ratios were considerably higher than they are today and contributed to the harsh outcomes of the 1986 Act. Under current market practice, investors generally have equity in their projects ranging between 30 and 40%, with some owners investing as much as 50% equity. Nonetheless, leverage and interest expense deductions are intrinsic to real estate investment.

We acknowledge that a theoretical tax model that permitted expensing of capital investment would likely eliminate interest deductions. Again, however, we call attention to the utility of the matching principles of current law. As a general matter, we would oppose elimination of deductions for interest expense, but would be pleased to work with the Committee to achieve balance among matching principles, cost recovery periods and interest expense provisions.

Self-employed Persons

At the intersection of business taxation and individual taxation is a self-employed person who must comply with both regimes. Thus, the self-employed person, even a sole proprietor with no inventory and a business that relies mostly on cash payment, always faces more complexities than other taxpayers in measuring income, distinguishing personal and business use of various assets, tax compliance and payroll taxes.

To our knowledge, the witnesses at the various Panel hearings did not explicitly address the problems self-employed persons face. Rather, the witnesses noted that these individuals are less likely than others to have health insurance or pensions. Some commentary has also suggested that these individuals contribute to the so-called "tax gap." We note with pride that Realtors® have generally achieved high rates of compliance among the self-employed because of current law statutory protections that clarify the relationship between brokers and real estate sales agents.

We are not aware of any tax replacement model that mitigates the burdens of self-employed persons. The National Retail Sales Tax model eliminates all business-level taxation. While we agree with the maxim that "businesses don't pay taxes; individuals pay them," we acknowledge that tax avoidance is a sad fact of human nature. We believe that a model that eliminates all business taxation could compound the tax gap by tempting self-employed

individuals to characterize their personal consumption as business consumption. This would undermine the National Retail Sales Tax model.

The value-added taxes suggested by some witnesses would impose the tax on all goods and services. While there is presently no federal level transaction-type tax on services, NAR, in support of its state organizations, opposes sales taxes on services such as real estate sales and brokerage and all the services attendant to selling a house or building (e.g., termite inspections, title searches, home inspection, due diligence attorney's fees, sales commissions). In recent years more and more states have proposed taxes on services and our members have uniformly rebuffed those efforts.

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The NATIONAL ASSOCIATION OF REALTORS® appreciates this opportunity comment on the worthy goals of tax reform. Should you wish to discuss any real estate tax issues or questions these comments suggest, you may contact Linda Goold, Tax Counsel, at 202 383 1083.

United States Senate Committee on Finance
3 August 2006

Hearing on

"Kick-Off for Tax Reform: Tackling the Tax Code"

Written Statement of
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Introduction

Chairman Grassley, Ranking Democratic Member Baucus, and other Distinguished Committee Members:

Thank you for the opportunity to share my views with you. My name is Martin B. Tittle. I am an attorney with a practice centered on international aspects of U.S. taxation. This statement is submitted on my own behalf and not on behalf of any government or private entity.

A Federal VAT Could Be Harmful for America's Senior Citizens

At today's hearing, Prof. Elizabeth Garrett suggested that "a Value Added Tax, along the lines of the VATs used by the vast majority of our major international competitors, should remain on the table but as part of the reform of Social Security and Medicare. Replacing the payroll tax with a VAT would provide a more stable source of revenue for these important programs. It would appropriately expand the base of those paying for the programs past today's workers to all citizens."

Prof. Garrett is correct that a VAT would impose costs on all citizens, but she did not explain why today's senior citizens should be taxed twice for Social Security and Medicare on the same earnings: once while they were working, through payment of payroll taxes that limited their ability to accumulate after-tax savings, and again, after enactment of the VAT, through purchases when those after-tax savings need to be spent.

Younger citizens with decades to go before they retire would have time to adjust to the a new VAT system and make the trade-offs between consumption and saving that could allow a comfortable retirement.

For retired senior citizens and those very near retirement, however, there would be no opportunity to adjust and little to no benefit from elimination of payroll taxes. The purchasing power of their existing after-tax savings would be permanently diminished by the VAT, and the potentially offsetting effect of any income-related benefits beyond payroll tax elimination could be limited or nil, depending on individual levels of taxable income.

Witness Jane G. Gravelle confirmed the likelihood of this effect on America's seniors when she noted that "[c]onsumption taxes, such as the GIT [the Growth and Investment Tax Plan proposed by the President's Advisory Panel on Federal Tax Reform], inevitably shift the burden of the tax towards the current older generation and away from young and future generations. Essentially, those with assets who expect to consume out of these assets are subject to a substantially higher tax. This shifting across the generations is relieved to some extent by the transition rules that allow some recovery of depreciation, but this offset is quite limited. That shift means that older people pay a higher lifetime tax than younger or unborn generations."

A transition regime could help avoid this result. Such a regime might include a system of capital reporting that establishes the level of after-tax, pre-VAT capital for each taxpayer and then allows refunds for payments of VAT that are properly allocated to that pre-enactment capital. It is true that implementation of this or any transition system would necessarily make the tax system more complex.[1] It is also true that, without a budget surplus, a transition system involving refunds would require a higher VAT rate.[2] However, without some form of transition relief, the negative impact of a federal VAT on the buying power of retirees' after-tax savings would be both too high a price to pay for the VAT's advantages, and a price unfairly imposed on those least able to cope with it.

I urge the Committee to address this issue in future staff reports and Committee hearings that include consideration of a federal VAT.

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[1] A VAT refund system could be viewed as presenting problems similar to those involved in the cash grant program that the President's Advisory Panel on Federal Tax Reform examined in connection with its decision to reject both a National Sales Tax and a full replacement VAT. *See* "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, Report of the President's Advisory Panel on Federal Tax Reform" 208, 211-12, 214, 255-56 (November 2005).

[2] Witness James Poterba mentioned this aspect of targeted transitional relief in his testimony to the Committee, but he suggested that "[t]he equity benefits of transition relief must ultimately be balanced against the efficiency cost of such relief and its associated distortions." I, for one, would find such a comparison a bit one-sided in the case of America's seniors. I doubt I could ever conclude, in the name of efficiency, that they should suffer diminished purchasing power due to a federal VAT when they finally need to spend their after-tax savings.

TESTIMONY FOR SUBMISSION TO THE UNITED STATES SENATE COMMITTEE ON FINANCE REGARDING THE AUGUST 3 HEARING ON INTERNATIONAL TAX REFORM AND UNITED STATES COMPETITIVENESS

SUBMITTED BY

THE UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

(A BUSINESS ASSOCIATION)

Submitted by:

Michael Reilly
Chair, Taxation Committee

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TESTIMONY FOR SUBMISSION TO THE UNITED STATES SENATE COMMITTEE ON FINANCE ON INTERNATIONAL TAX REFORM AND US COMPETITIVENESS

The United States Council for International Business (USCIB) is pleased to present its views to the Senate Committee on Finance with respect to this extremely important subject of the need to reform the international tax regime of the Internal Revenue Code (the Code) to enable US multinational enterprises to enhance their international competitiveness vis-à-vis their foreign rivals. Although both this hearing and our statement focus on the international aspects of the Code, many other, non-international provisions therein need re-examination and possible amendment, for the same reason.

The USCIB advances the global interests of US business, both here and abroad, including, in many instances, the US operations of non-US enterprises. It is the US affiliate of the International Chamber of Commerce (ICC), the Business and Industry Committee to the OECD (BIAC), and the International Organization of Employers (IOE). Thus, it clearly represents US business in the preeminent intergovernmental bodies, where the many and complex issues that face the international business community are addressed, with the primary objective being to search for possible resolutions to these issues. The bottom line in all of this is to ensure the existence of an open and equitable system of world trade, finance and investment.

Introduction

The US income tax system was first enacted in 1913, following its authorization by a Constitutional amendment. The system evolved over the years by way of annual income tax acts, and three codifications culminating in the 1986 Code, which is the basis of the statute today (the earlier codifications occurred in 1939 and 1954). From the beginning, the Code subscribed to the so-called **Classical** system, applied on a **Global** basis (these terms and concepts will be described below). For many and varied reasons, the Code has become antiquated, reflecting an inability to deal effectively and efficiently with the modern day business models and practices. Therefore, most pundits in the area would agree that the Code is in dire need of a thorough overhaul at this time. In fact, this was corroborated by the Bush Administration, which gave a high priority to a fundamental tax reform project and appointed a blue ribbon panel (the Panel) to conduct such a study. (USCIB submitted a commentary to this Panel during its deliberations.) Although this statement deals primarily with the international provisions of the Code, as mentioned above, the domestic provisions need a thorough, critical review as well.

Conclusions

The USCIB envisages that the following goals should be accomplished by a major reform of the Code's international tax regime:

- A reformed tax system should aim to depart completely from the old Classical model, which doubly taxes corporate income. It should instead shift to an

integrated system, which avoids multiple levels of income tax on the same income.

- A reformed international tax regime should **not** result in an increase in the tax burden of US multinational enterprises. Thus, nominal tax rates should be reduced, not increased, and the situation where US multinationals encounter residual US tax on foreign source income after application of the foreign tax credit provisions should be the exception, rather than the rule.

- A reformed tax system should be broad based and apply consistently across industry lines. In other words, it should not discriminate against certain industries or specified groups of taxpayers. In addition, the revised regime must offer consistency in tax treatment to all forms of business organization availed of by multinational taxpayers to conduct business operations abroad, whether it be a controlled foreign corporation, a branch, a partnership, a joint venture (e.g., a 10/50 company), etc., so as not to unfairly penalize any taxpayer for selecting one form of business organization over another (presumably for valid business reasons.)

- A reformed international tax regime should ideally eliminate (but, at the very least, substantially cut back) the reach of the Code's Subpart F provisions, so as to restore the sanctity of the principle of deferral with regard to US taxation of foreign income earned through associated overseas entities. In other words, the acceleration of taxation of overseas non-repatriated earnings, including the active income of a foreign subsidiary of a US based financial services enterprise, puts US multinationals in a competitively more disadvantageous position than non-US multinationals. Likewise, an appropriate definition of "passive" income should be carefully crafted so as not to subject to tax, in the guise of passive income, what is really active business income, prior to repatriation (e.g., royalties from intangibles and technology developed by a taxpayer for use in its trade or business).

- A reformed international tax regime should strive to minimize, if not totally eliminate, international double taxation by offering to US multinational enterprises a **true** overall foreign tax credit limitation approach. In other words, the fracturing of the limitation into many different categories (baskets) defeats the goal of providing maximum relief from international double taxation, and adversely impacts the competitive position of US enterprises. Moreover, for the same reason (i.e., competitiveness), the regime should simplify and ease the requirements and relevant rules in allocating and apportioning expenses to foreign source income. The alternative approach to providing double tax relief is the so-called territorial (i.e., exemption) approach, which is common among the European (and certain other) countries. The particular exemption system proposal currently under consideration in the US is generally not favored by the USCIB membership; however, it is important to note that if structured appropriately, territoriality could achieve the desired goals.

- A reformed international tax regime should fully support and encourage the enhancement of the US tax treaty program, and strive to introduce innovative concepts which will serve the interest of minimizing double taxation for all taxpayers, US and foreign.

- A reformed international tax regime should retain the "place of incorporation" standard as the sole standard for determining corporate residency. A "place of management" test, as an alternative or replacement, is undesirable.

Classical Model and Double Taxation of Corporate Earnings

The United States has followed the Classical system model since the inception of the US tax law. Under such model, net corporate income after corporation income tax is again subjected to income tax in the hands of shareholders, with the exception of dividends eligible for the inter-corporate dividend exemption. The ultimate individual shareholders are subject to tax on corporate dividends, which are almost always paid out of income already taxed at the corporate level.

In contrast, many, if not most, of our trading partners (i.e., those nations in which the competitors of our US multinational enterprises are domiciled) use some form of integrated tax system. Although there are several different methods of achieving an integrated system, the imputation model has, over the years, been the most popular. Multinational enterprises that are resident in countries having integrated tax systems may well enjoy a competitive advantage over US multinationals by not being subject to the double taxation of corporate income, as under the Classical model.

Over the years, legislative efforts have been made to reduce the incidence of double taxation of corporate profits, through a combination of dividend credits and exemptions, most of which were repealed because of revenue concerns. The latest move to redress this flaw in our system took place in the 2003 tax legislation, i.e., the Jobs and Growth Tax Relief Reconciliation Act, which imposed a tax of 15% on portfolio dividends in lieu of a resident taxpayer's invariably higher marginal rate. This is indeed a step in the right direction of achieving a fully integrated system. However, full integration, comparable to that in many of our trading partners, is still the ultimate goal in this area. In our view, it would be a simple matter, at this point, of completing the job that the 2003 legislation started, and to provide, legislatively, for a zero rate on portfolio dividend income.

Although one might consider this issue more in the area of domestic tax policy, the elimination of the double tax on corporate income would make the Code more consistent with the approach of our trading partners and, thus, tend to level the playing field for US multinational enterprises.

Overall Tax Burden Concerns

In devising a rational and user-friendly international tax regime for US multinationals that will enhance their competitive standing in the world, there are two major themes that should be considered as guiding principles behind any proposed legislative amendments.

First of all, whatever shape reform in the international tax regime might take, the drafters of the statutory language must be sure that the changes do not impose higher tax burdens on US multinational enterprises than now exist. Although this may seem like a simplistic statement, a proposal for reform in the international area developed by the Joint Committee on Taxation in 2005, in which the JCT recommended replacing the current system with a territorial system for mitigating international double taxation, resulted in a tax increase of over $50 billion on US domiciled multinationals. In this case, the cure is worse than the disease.

Again, as a matter of domestic tax policy, if the rates of corporate tax must be tinkered with, they should not be raised so as to increase the tax burden. Ideally, they would be lowered, as the US is currently one of the higher tax countries in the world. Moreover, we submit that US multinationals should rarely be subject to any residual US income tax on their foreign earnings. This can be achieved by way of a properly constructed foreign tax credit provision or a carefully tailored territorial system.

The second guiding principle is that of consistency of treatment across the board. The tax system, as well as the international tax regime therein, should be broad based and have equal application across industry lines. In other words, the regime should not single out specific industries or groups of taxpayers for special, discriminatory treatment. Consider the current foreign tax credit provisions, which contain (in Section 907) punitive rules with respect to the petroleum industry, treating that industry more harshly in terms of additional limitations on their foreign income taxes that are available for the foreign tax credit. The standard of consistency also should apply to alternative forms of organization. Whatever form of organization a US multinational enterprise elects for the conduct of its overseas business activities, be it a controlled subsidiary (a wholly-owned or majority-owned controlled foreign corporation), a branch, a partnership, or a joint venture (e.g., a minority-owned controlled foreign corporation or a non-controlled foreign corporation or "10/50" company), it should be subjected to similar tax treatment. The choice of form of organization is, in general, a business decision, rather than a tax driven one.

Deferral/Controlled Foreign Corporation Rules

The principle of deferral has been an underlying tenet of the tax statute virtually since inception of income taxation in the US. Deferral is not defined in the statutory language, but is implicit in the structure of the law. Essentially, it stands for the proposition that earnings amassed by the overseas affiliates of a US taxpayer are not includible in the income of such taxpayer as earned, but only as actually paid out (or otherwise made available) to the US taxpayer. In other words, the income as earned by a foreign affiliate is deferred from US tax as long as it remains in foreign corporate solution.

In the United States, the principle of deferral was first violated by the introduction into the statute, under the 1939 Code, of the Foreign Personal Holding Company (FPHCo) provisions. This set of rules, together with its companion piece, the Personal Holding Company (PHC) provisions, targeted the incorporated pocketbooks of high net worth individuals who were attempting to reduce their personal tax burdens by shifting passive income-producing assets into corporate solution, either domestic (PHCo) or foreign (FPHCo). These provisions had no real

effect upon publicly held US multinational enterprises. It wasn't until 1963 (courtesy of the Revenue Act of 1962), when the Controlled Foreign Corporation (CFC) provisions became effective, that the large US international corporations began to feel the impact from a partial ending of deferral. These CFC rules introduced into the Code a novel concept, that of taxing all US taxpayers, including large multinationals, on certain specified income earned by CFCs in which such shareholders held a greater than 10 % voting interest. These new provisions went beyond the PHCo/FPHCo attack on passive income held by a closely-held corporation (i.e., the so-called corporate "pocketbook"), although passive income was included as an item of income to be covered under the new regime.

The main thrust of the CFC rules, in brief, was to treat low-taxed income earned by CFCs as dividends to the US shareholders. It was aimed at preventing US multinational enterprises from enjoying the tax deferral benefits arising from the use of tax havens or special tax incentive provisions in non tax haven jurisdictions to conduct bona fide business activities (e.g., product sales, services, etc). It is quite easy to see just how these changes adversely affected the competitiveness of US business abroad, even at a time when the US still dominated the world economy. Unfortunately, in the years since the Revenue Act of 1962, Congress has enacted a plethora of ill conceived, onerous amendments to Subpart F, having little relationship to the original purpose of the provisions. These changes have result in a further erosion of the competitiveness of US business abroad. Although many other capital exporting nations have since enacted their own versions of the CFC concept, the US version is, by far, the most burdensome to its multinational community.

The 2004 tax legislation did redress some of the issues and problem areas in the CFC rules. However, what is really needed to shore up the competitive vigor of US international enterprises is a complete repeal of the Subpart F provisions. The USCIB strongly supports this, which, in conjunction with the changes in the double taxation relief rules (to be discussed below) is just what the doctor ordered to cure the competitive ills of US business abroad.

International Double Taxation Relief

Credit Approach

Doubtlessly, the most important set of provisions in the Code with regard to restoring and enhancing the competitiveness of the US multinational community is the set of provisions aimed at granting such enterprises relief from the scourge of double taxation (by two or more jurisdictions) on the same income streams. The provisions so designed to carry out this mandate encompass the actual foreign tax credit mechanism (Sections 901-907 and 960) and the related expense allocation and apportionment principles (regulations under Section 861 and 862). The existence of a flexible and efficient system for the elimination of international double taxation is, in essence, the cornerstone upon which is built a suitable international tax regime for US multinational enterprises.

Initially, the foreign tax credit regime offered a country-by-country limitation (referred to in the Code as the per-country limitation), under which a taxpayer would be limited in the amount of foreign tax credit allowable each year to the aggregate of the amounts of US tax attributable to the taxable income from each foreign country in which the taxpayer incurred foreign income

taxation. In 1960, effective for calendar year 1961, the Congress enacted an overall limitation to replace the per-country limit, after a transitional period in which both limitations were in the law. This mechanism allowed for the averaging of all foreign income taxes, irrespective of the source country or the nature of the activity giving rise to such income taxes It proved to be a very effective shield for US corporations against the burdens of double taxation, in terms of maximizing the foreign tax credit relief and, thereby, minimizing the tax burden (US and foreign) on foreign source income. The ink was barely dry on the legislation enacting the overall approach when Congress took its first baby step toward diluting it, by enacting a separate limitation on certain passive interest income. From then on, Congress kept chipping away at the effectiveness of the overall limit. This culminated in the 1986 Code, which established a series of separate limitations so that the overall limitation existed in name only, not in fact. Naturally, the competitive position of US business was severely compromised by this development.

Like in the deferral area, the 2004 tax legislation provided some relief by reversing some of the damage done to the overall limit in the previous Congresses. However, more needs to be done to truly re-establish a level playing field for US multinationals. This should be a two-pronged program. First, the overall limitation needs to be reborn in its original (1960) configuration, i.e., absolutely no separate limitations, whether for passive income or for any type of operating income (e.g., oil and gas income covered now under Section 907). The second prong relates to expense allocation and apportionment, which is discussed in the ensuing two paragraphs.

Having a reasonable set of expense allocation and apportionment rules, for foreign tax credit purposes, is as important to US multinationals in ensuring competitiveness abroad as having a monolithic (non-fractured) overall foreign tax credit limitation. If anything can dilute the efficiency of the overall foreign tax credit relief, it would be an arbitrary and unreasonable set of rules for allocating and apportioning expenses against foreign source income to arrive at foreign source taxable income (the numerator of the foreign tax credit limitation fraction). We were pleased to see that the 2004 Tax Act introduced very sensible rules in the allocation and apportionment of interest expenses, which previously had been tilted unfairly against maximizing allowable foreign tax credits, as well as in the allocation and apportionment of general and administrative expenses. Such sensible rules should be retained and a similar approach should be utilized with respect to all other expense categories that require allocation and apportionment against foreign source income.

Exemption Approach

An alternative to the credit approach is the exemption approach, often referred to as the territorial method. This method has been under intense scrutiny of late, having been the subject of a US Treasury Department study as well as the recommended approach of the Presidential Advisory Panel on Tax Reform. In addition, a blueprint for such a system has evolved from a Joint Committee on Taxation (JCT) study thereof. In broad outline, the territorial system would operate to exempt US enterprises from income tax on the business earnings of their overseas entities, including subsidiaries, branches, joint ventures, etc., while continuing to tax them on their so-called passive income. The USCIB does not concur with a territorial system modeled along the lines of the JCT blueprint. If, however, a territorial system structured in the manner of those found in certain of our trading partners (e.g., the Netherlands and France) were to be discussed, it could well achieve similar results, i.e., relieving double taxation as discussed in the

immediately preceding section. Otherwise, retention of our present system will more likely enhance our nation's competitive position vis-à-vis these competitor nations.

It is important to note that the territorial system is only about mitigation of the potential international double taxation burden that arises from engaging in cross border trade and investment, nothing more. The question is: does this system more effectively provide for US multinational enterprises the maximization of double tax relief, and, therefore, the minimization of global tax burdens? The answer to this question depends upon the structure of the particular territorial model selected. We strongly believe, however, that any territorial system adopted should not be used for the purpose of raising additional tax revenue for the Government.

Should a territorial system be adopted, a number of industry specific issues will emerge. For example, for the financial services industry, the most important international issue is the allocation of interest. Careful attention must be paid to developing rules that do not result in the loss of interest deductions to members of the financial services community. In particular, the tax systems of our major trading partners and OECD countries must be analyzed to understand how they treat interest expense, so that our financial institutions are not put at a serious competitive disadvantage.

If one were to initially construct a tax system today, it would be a very close call as to whether to opt for a credit system or an exemption system. The answer would evolve about the design of the credit mechanism versus the design of the territorial exemption, and the comprehensiveness of the relief produced by each such approach. Although the territorial method would appear to enjoy the virtue of simplicity, this can be misleading. Although simplicity is desirable, it is not the primary goal. Rather, it is the effectiveness of a system in minimizing the double taxation burden. It should be noted that the credit system, even if amended as we suggest above, is very familiar to the managements of US multinationals, and, in particular, to the tax departments of these enterprises. Thus, taxpayers would be knowledgeable to many of the nuances of the system and comfortable with its application. There would be less growing pains to suffer as there would be in implementing a whole new approach to double tax relief.

The transition from the present system to a territorial system, involving an exemption from tax for business income and a foreign tax credit for other income would clearly be burdensome on the tax department resources of the US multinational community, both financial and human. Also, it would need complex transition rules with regard to the phase-out, over a relatively long period of years, of the existing foreign tax credit rules, so as to permit taxpayers the opportunity to somehow utilize credits accumulated in years in which the old system was in force. As a corollary, this would probably necessitate a gradual phase-in of the new system. The change thus could be a long, drawn-out affair, replete with complications as the two systems operated in tandem.

Importance of Tax Treaties

Tax treaties have been with us since the 1930's. Their number and importance has increased tremendously over the years. The foreign tax credit system (as well as territoriality) is a unilateral approach to the elimination of international double taxation. Treaties, meanwhile, present a bilateral approach for, *inter alia,* accomplishing this goal. All interested parties, e.g.,

government, business, investors, etc., support a vigorous, proactive and innovative treaty policy. In the context of these hearings, any legislation addressing the reform of our international tax regime should be carefully structured to ensure consistency with this goal of enhancing our international treaty program.

Corporate Residence

We noted that the Presidential Panel, in its report of November, 2005, made a recommendation to alter the long standing definition of "corporate residence". We do not concur with the Panel on this matter, and wish to express that concern should this Subcommittee (or its parent, the W&M Committee) decide to consider and recommend the Panel's position on this issue.

Since inception of the US income tax laws, the test of corporate residence has been the place of incorporation. Accordingly, an entity organized under the laws of one of the fifty states of the US (or under US federal law) was a US corporation, and, thus, resident in the US. This is a straight-forward objective test, simple to apply. The Panel has recommended adding to the mix an additional, much more ambiguous, standard, i.e., the place at which the entity is managed and controlled. This so-called "mind-and-management" test is, admittedly, used in more countries than anything comparable to our standard, but that doesn't make it right. This mind-and-management standard was developed under the legal principles of the United Kingdom. Under it, one looks to various indicia in an effort to establish the place from which the entity is managed and controlled, and thus resident.

The Presidential Panel recommended that the management and control test be included in the Code, in addition to the place of incorporation test. In other words, all US incorporated entities would be US residents by way of the long standing rule, while all non-US incorporated enterprises would be tested under the new management and control standard, however that would be implemented. Although it seems clear that the new standard would be aimed squarely at foreign controlled enterprises doing business in the US, it could prove to be a pitfall for US controlled enterprises as well, since it could easily be used by the IRS to assert a US residence with respect to their CFCs. Accordingly, we see the likelihood of increased controversy with the IRS, both with regard to foreign controlled enterprises operating in the US, and to US controlled enterprises with their CFCs. Such additional controversy will no doubt lead to additional and needless litigation, costly both to the IRS and taxpayers. The key concern is that a US enterprise's CFCs could be treated as US residents, for US tax purposes.

One should also note the distinct possibility that an amendment to the corporate residence rule along these lines would probably discourage decision-making executives of foreign enterprises, engaging in US business activities, from residing in the US. Although such an eventuality might not have an adverse impact on the competitiveness of US business, it could certainly have an adverse effect on inbound foreign investment in the US, which would hurt the US economy.

Conclusion—A Final Note

We urge the Congress to seriously consider the suggestions above in their effort to re-establish the strong competitive position of the US business community in the world. In other words, whatever reform legislation emerges from this current exercise, it should attempt to render, and retain, the US economy as a user-friendly jurisdiction in which to establish business operations.

Over the years, our country has been a leader in attracting foreign investment. As the global economy continues to expand, however, we face increasing competition from other countries for this investment. This means, of course, that we should strive to eliminate tax policies and rules that discriminate against foreign investment. After all, foreign investment in the US also creates jobs for US workers. Tax legislation that discriminates against foreign investors tends to breed the enactment of similar measures by our trading partners, which harms the interests of US enterprises operating or investing internationally.

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We thank the members of this Committee for the opportunity to present our views on this subject, which is of utmost importance to our membership and to the US multinational community.

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