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CONGRESSIONAL TESTIMONY

Individual Income Tax Reform

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J.D. Foster, Ph.D.
Norman B. Ture Senior Fellow
in the Economics of Fiscal Policy
Domestic Policy Studies
The Heritage Foundation

Mr. Chairman, Senator Grassley, Members of the Senate Finance Committee, my name is J.D. Foster. I am the Norman B. Ture Senior Fellow in the Economics of Fiscal Policy at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

I thank the Committee for the opportunity to convey my views on the vital matter of individual income tax reform. Though the federal individual income tax system works in the sense that it raises an enormous amount of revenue for the government – $1.2 trillion in 2007 – it is deeply flawed in many ways, all of which I suspect are known to the Members of this Committee.

Despite the many important issues to consider, I am going to resist the temptation to provide a catalogue of problems and recommendations, and instead first emphasize two broad principles. I will then turn to one specific area – the tax treatment of education expenses – about which I believe too little attention is given relative to its importance to the future of our economy generally, and to every American seeking to get ahead in this competitive global economy.

Application of First Principles

Traditionally, individual income tax reform discussions take place under the assumption of revenue neutrality. This convenient device focuses attention on the necessity of making choices, weighing alternatives. Policymaking is often about tradeoffs and so revenue neutrality imposes a useful discipline on the discussion.

Tax legislation and its consequences are not matters for the blackboard, however. Congress and the Administration must decide both the level of taxation, and how to structure the tax system. So, as the Committee considers individual income tax reform, among the many issues for consideration I believe these two guiding principles are paramount:

- The level of individual income tax collections should be low.
- The marginal rates of tax imposed should be low.

The great risk in tax policy, and for individual income tax reform, is that both of these principles will be significantly violated in the near future. Over the next two years Congress will debate whether to impose or prevent a massive tax hike on the American people, a tax hike centered largely on a significant increase in marginal income tax rates. This is individual income tax reform writ on a grand scale, but it threatens to move entirely in the wrong direction. Whatever other reforms this Committee considers and whatever other benefits might reasonably be expected to follow therefrom, if the Committee and the Congress fail to prevent this tax increase, the net effect will surely be profoundly negative for tax reform, for the economy, and for American taxpayers.

The issue arises, of course, because the 2001 and 2003 tax cuts are slated to expire at the end of 2010. This leads some to suggest that extending any or all of the tax provisions, provisions that will then have been in the law for eight or 10 years, is somehow a tax cut. Respectfully to those who make this argument, this is utter nonsense Washington style. Extending current law, or better yet, making it permanent, prevents a tax hike.

Make no mistake, the American taxpayer cannot be fooled, and despite all the rhetoric in the preamble to this debate, I doubt the Congress would ultimately be so foolish as to try to fool them. If these tax provisions were allowed to expire, it would be perfectly clear to the taxpayers that their taxes went up; it would be perfectly clear why they went up; and it would be perfectly clear who was responsible.

Flawed CBO Baseline Contributes to the Confusion

Some in this debate hope to use a fundamental and long-standing flaw in the way tax provisions are scored to provide a gloss of credibility to their argument that allowing tax relief provisions to expire is not a tax hike. The issue here is the construction of the revenue baseline by the Congressional Budget Office (CBO).

As it has always done, under both Republican and Democrat Directors, the CBO constructs the revenue baseline on the basis of current law. While not the correct approach, this has also not generally been a serious issue because in the past Congress has had in most instances the good sense to respect the importance of stability and predictability in the tax law. So, when the law was changed, the change was permanent at least in the sense that it was not accompanied by an expiration date. There are exceptions, such as the R&D tax credit, but these were few and by general agreement policy would be vastly improved in most cases by making them permanent.

In clear contrast, and correctly, when CBO constructs its spending baseline it assumes that current law will extend throughout the budget window even if the authorizing law expires during the budget window. The practicality of this assumption follows immediately in the case of appropriated spending and it extends naturally to other major programs, such as SCHIP, the farm bill, and the highway program. In each case, current spending levels are assumed to continue in the baseline even though the program expires. Consequently, the extension of current law is not shown to have budgetary consequences. This is sound practice, and is consistent with current services budgeting principles.

In the construction of baselines, revenue provisions should be treated the same way spending provisions are treated. This is a matter of leveling the playing field. It is a matter of basic fairness in budgeting. If revenue provisions and spending provisions are treated the same way, then the scoring of the extension of those provisions would accurately show that, in terms of policy changes, nothing happens, and in terms of the ongoing deficit picture, nothing changes.

AMT Patch a Current Example

Year after year we face a precursor of the consequences of the flaw in the CBO revenue baseline when Congress seeks to extend the AMT patch. There is strong and broad support for extending the patch, and many Members seem to understand, and many acknowledge, that allowing the patch to expire would impose a huge tax increase. They are right. Yet when the revenue tables are presented, extending the AMT patch is shown to be a tax cut. The same law cannot be both a tax cut and a tax hike. The Members are right; the baseline is wrong. Correct the baseline and extending the patch in its current form would then properly be shown to have no revenue consequences, no deficit consequences relative to today's law. It would still be necessary for Congress to enact legislation, there would still be ample opportunity to debate policy, to put forward alternatives, but the path would be straighter and more honest once the errant revenue baseline is corrected.

Education

Education, or human capital formation as scholars refer to it, is widely understood to be essential to our future as a nation and to the future of our economy. Capital formation, investing in new plant and equipment, and sometimes in new infrastructure, is vital to improving real wages and our standard of living. Investing in human capital formation is certainly no less vital.

While we may all have different notions about how best to invest in the education of our children, of college students, of technical and professional school students, and of those already in the workforce who seek new or better skills, it is clear the Congress and the nation understand the importance of education. It is clear in the debates over funding of pre-K education. It is clear in the debates over No Child Left Behind. It is clear in the debates over Pell grant amounts. It is clear in the recent debates over student loans in the context of the credit crunch.

The federal individual income tax has in recent years begun to reflect more fully the importance of education. The greatest examples include the Hope and lifetime learning tax credits. The Hope tax credit allows individual taxpayers a nonrefundable credit of up to $1,800 per student per year for qualified education expenses during the first two years of post-secondary education. The credit is 100 percent of the first $1,200 of expenses, and 50 percent of the next $1,200 of expenses. The credit phases out ratably for married filers with adjusted gross incomes between $96,000 and $116,000. The credit can only be claimed for one student per tax filing family per year.

The lifetime learning tax credit is a 20 percent nonrefundable credit, up to $2,000 a year, for qualified education expenses. The lifetime learning tax credit may be used for as many qualifying students as are included on the family's tax return, and may be claimed for an unlimited number of tax filing years. Like the Hope tax credit, the lifetime learning tax credit also phases out for married filers with incomes between $96,000 and $116,000.

The Congress has more recently added an additional provision, the higher education tax deduction. This is an above-the-line deduction of up to $4,000 for qualified education expenses. The deduction phases out for married filers with incomes between $130,000 and $160,000. In addition to these three, the individual income tax includes a host of other provisions, some of which are highly significant such as the exclusion for employer-provided educational assistance, the above-the-line deduction for student loan interest, and tax benefits for higher-education saving.

I believe this collection of provisions reflects a budding understanding of the fundamental importance of tax policy to education. This is not just a matter of providing tax relief to struggling families, as important as that is. It is the evolutionary adoption of sound tax policy. This collection of provisions also reflects a highly confusing and uneven area of tax law long in need of simplification and rationalization.

Unfortunately, tax policy voices seem to be among the last in the nation to understand the concept of human capital formation and its implications for income tax policy as evidenced by a recent Joint Tax Committee (JTC) report[1]:

> Other subsidies for education [aside from direct assistance, etc.] provided by the Code permit students to receive tax-free qualified scholarships, tax-free employer-provided educational assistance, tax-free cancellation of certain governmental student loans, and a deduction for student loan interest. Students and parents also are provided the benefits of the Hope and Lifetime Learning tax credits, the exclusion from income of earnings on Coverdell education savings accounts and qualified tuition programs, and the exclusion from income of the interest on U.S. savings bonds used to pay for post-second education.

The critical and errant word in this paragraph from the JTC is the second – "subsidies". Eliminating the tax on income used for investment purposes is not a subsidy.

In tax policy we debate the appropriate amount of a deduction a business should take in a given year for the purchase of a piece of equipment, but there is no real debate that some deduction should be allowed and that the deduction is not a subsidy. Depreciation deductions relating to capital formation are a fundamental attribute of the income tax levied on business. Similarly, deductions for human capital formation expenses ought to be a fundamental attribute of the income tax levied on individuals.

This testimony is not the proper place and this hearing not the proper time to be fully prescriptive in how the individual income tax ought to be reformed to reflect the reality of education as investment. However, there are some broad principles the Committee should consider to simplify, rationalize, and make more comprehensive the tax treatment of education expenses. These include:

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[1] Present Law and Analysis Relating to Tax Benefits for Higher Eduation, Joint Committee on Taxation, April 29, 2008, http://www.house.gov/jct/x-35-08.pdf.

- Taxpayers should receive a deduction (or credit equivalent) for their own education expenses or those of their children.
- The deduction ought to be available for all qualified expenses irrespective of the level of education.
- The deduction should be computed on a family-wide basis.
- Taxpayers ought to have a single, simple means by which they can save for future education expenses.
- Earnings accruing in the accounts should be tax-free.
- States, educational institutions, and private financial institutions ought to be able to offer like services relating to educational savings accounts.
- Neither the deduction for current education expenses nor the treatment of saving for future education expenses ought to be subject to unfair and complicationg income phase-outs.

Conclusion

The first rule in individual income tax reform should be "first, do no harm". In application to the current situation, this rule means Congress should prevent taxes from increasing with the expiration of the changes made 2001 and 2003. Raising individual income taxes is a form of tax reform, and a bad form. Raising marginal tax rates as would occur if these taxes are raised is precisely the wrong course to take.

Doing no harm, however, is not enough. There are many areas of the individual income tax requiring significant reforms, each of which if done properly would help strengthen our economy and improve the finances of America's families and workers. Among those of the highest priority should be the correction of the tax treatment of education for expenses incurred at all levels. This would create a more neutral tax system, and it would lead to a more educated, more competitive, more flexible workforce.

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