Hearing before U.S. Senate Committee on Finance
on
The Middle-Income Tax Relief Question: Extend, Modify, or Expire?
March 26, 2009

Statement of George K. Yin[1]

Mr. Chairman, Ranking Member Grassley, Members of the Committee,

Thank you for inviting me to testify at this hearing on the question of tax relief for middle-income taxpayers. It is a pleasure to see all of you once again.

1. *Expiring income tax cuts should lapse.*

The committee will soon have to decide whether to extend the Bush Administration income tax cuts for individuals. In general, they are due to expire at the end of 2010. I urge the committee to allow these cuts to expire.[2]

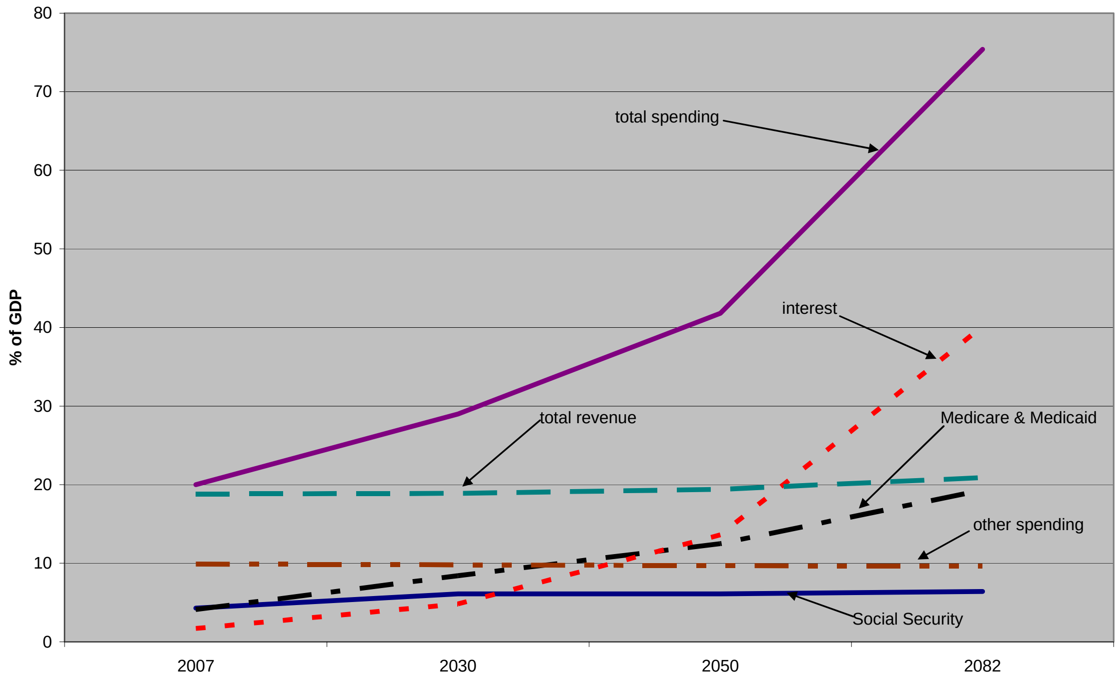
The reason is simple: the country cannot afford them.

Figure 1 below presents CBO projections of the spending and revenue in the U.S. as a percentage of GDP over approximately the next 75 years. It clearly shows a sharply widening gap between spending and revenue beginning immediately and continuing throughout this period. While revenues are estimated to hover around 20 percent of GDP, or slightly more than the historical average over the last 50 years, total spending is projected to increase dramatically and then to explode in the out-years.

[1] Edwin S. Cohen Distinguished Professor of Law and Taxation, University of Virginia, and former Chief of Staff, U.S. Joint Committee on Taxation, 2003-05.

[2] In general, the tax cuts referred to in this testimony that should be allowed to lapse are the expiring individual income tax rate reductions and increases to the child tax credit. The committee should also consider letting expire marriage penalty relief and reduced tax rates for dividend and capital gain income, although to some extent, those provisions were enacted to implement structural changes to the tax system and not merely tax relief. In addition, the committee should consider repealing the AMT but *not* providing a resulting tax cut by reforming the regular income tax to collect roughly the same amount of tax as if the AMT had not been repealed. Finally, if the committee decides to revive the "PEP" and "Pease" limitations, it should do so explicitly by raising the marginal income tax rates of the affected taxpayers. Consistent with the focus of this hearing, I do not consider other possible changes to the income tax or other taxes, such as the payroll and estate and gift tax.

Fig. 1: U.S. spending and revenues as % of GDP, CBO projections, 2007, 2030, 2050, and 2082



source: CBO, The Long-Term Budget Outlook (Dec. 2007), p.5 (tbl. 1-2) ("alternative fiscal scenario")

The projected fiscal gap is both unsustainable and *imminent*. The projections show that by 2030, barely two decades from now, the total cost of just Medicare, Medicaid, Social Security, and interest on the national debt, will total 19.3 percent of GDP, or more than the historical average of total revenues. Thus, assuming that that level of revenue were to continue, there would be no money left for national defense, all discretionary non-defense spending, and all other entitlement programs, including federal employee and military retirement programs, food stamps, unemployment compensation, and veterans' benefits. All of that spending has totaled between 11-12 percent of GDP in recent years. Clearly, the nation is on an unsustainable path.

As shown by Figures 2 and 3, below, two of the principal reasons for the trend projected in Figure 1 are the aging of the U.S. population and the rising cost of health care. Figure 2 presents the ratio of the U.S. population age 65 and over to those ages 20-64, roughly the proportion of retirees to workers, from 1964-2084, based on historical data and CBO projections. The vertical line represents 2009, where we are today. The figure clearly shows that we are about to begin a roughly 20-year period during which the ratio will change dramatically, from about one retiree for every five workers to one for every three workers or less. The aging of the U.S. population is a reliable projection, barring some catastrophic event or dramatic change in the country's immigration policy.

Fig. 2: Ratio of U.S. population 65 or older to U.S. population ages 20-64, 1964-2084, historical data and CBO projections

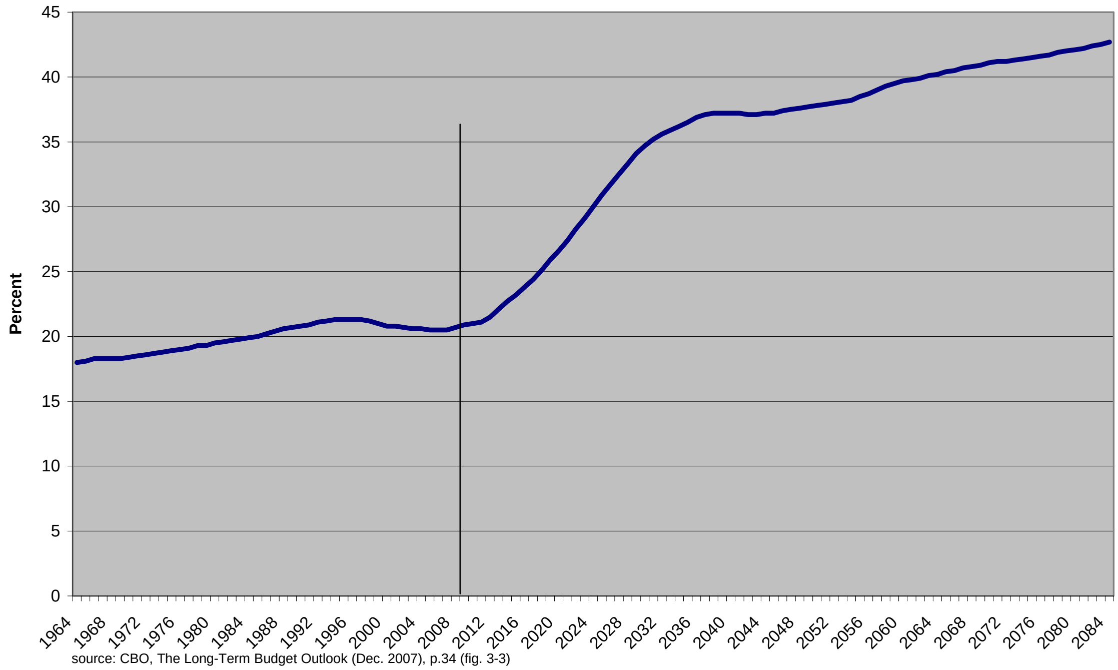


Fig. 3: Medicare, Federal Medicaid, and all other health care spending, as % of GDP, CBO projections, 2007-2082

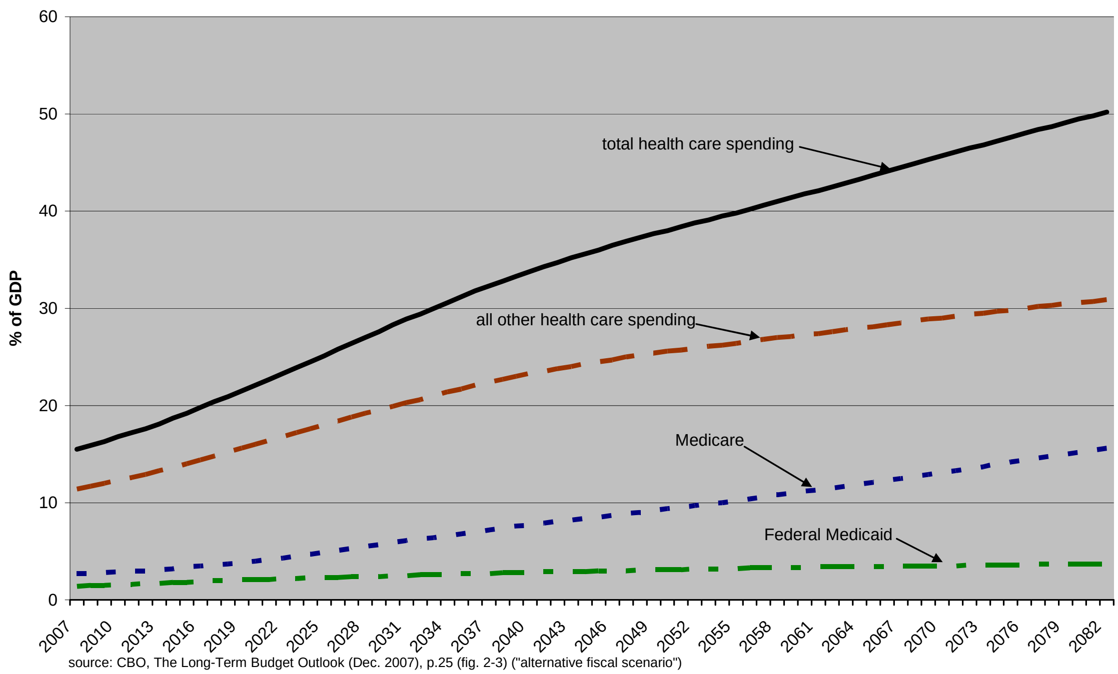


Figure 3 presents CBO projections of the increasing cost of health care in this country over the next 75 years, partly due to the demographic changes shown in Figure 2 and partly attributable to other factors. Although these projections are not as certain as those shown in Figure 2, they represent trends that have been continuing for the last 45 years, ever since Medicare and Medicaid were begun.

The other critical factors contributing to the huge fiscal gap forecast by the CBO are the tax and spending policies assumed to be followed in the future. Here, the CBO projections assume continuation of the exact same major tax and spending policies that the Obama Administration recently pledged to continue, with the sole exception of tax cuts for top-bracket taxpayers which the Administration would allow to lapse. The Administration indicated that it would provide for annual indexing of the AMT, prevent cuts in Medicare physician payments, and continue all of the other major Bush Administration tax cuts.

In short, absent a change in policy direction, essentially all of the factors underlying the doomsday scenario predicted by the CBO are, or shortly will be, in place.

Now for the really bad news: First, the CBO projections do not include any of the new spending and tax initiatives in the recent Administration budget release, including its proposals for health care and climate change. To the extent those initiatives result in net costs, they will make the future scenario even worse than projected.[3]

Second, the CBO projections were made in *December, 2007*, or *before* the financial and housing crisis, TARP, the rescue of Fannie Mae and Freddie Mac, all of the economic stimulus legislation, and the significant, resulting economic downturn. Thus, we should expect the actual fiscal outlook to be even bleaker than that shown in Figure 1, perhaps significantly bleaker.

In conclusion, it is essential that this committee and the Congress take action to *change* the policy path leading to the predicted economic meltdown. An important first step would be to allow all of the Bush Administration income tax cuts, including those affecting middle-income taxpayers, to lapse. Those tax cuts may or may not have been wise in the first place, but that debate is now long past. The country simply cannot afford them in the future.

[3] Last week's estimate by the CBO that the President's preliminary budget request will more than double the estimated 10-year deficit from $4.4 trillion to $9.3 trillion is not additive to the projections contained in Figure 1 because unlike those projections, the recent estimate assumes a "current law" baseline in which all of the Bush tax cuts, the AMT patch, and the freeze on Medicare physician payment rates, expire as scheduled. See CBO, A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook (Mar. 2009), pp. 2 (tbl. 1-1), 4, 12 (tbl. 1-5), 14-16. Nevertheless, the CBO analysis certainly raises concern that the new policy initiatives will make the overall fiscal situation even worse.

2. *Other options for Congress are supplements, not substitutes, for expiration of income tax cuts.*

There are many other possible ways to address the country's fiscal crisis. On the spending side, options include entitlement program reform, including especially reform of health care expenditures, reductions in military commitments, and reductions in "wasteful" federal spending no longer serving an important policy objective. On the tax side, there are further increases affecting only top bracket taxpayers, reductions in the "tax gap," reform of tax expenditures, and higher taxes on multinational corporations doing business outside the U.S.

Although this committee and the Congress should take all of these options seriously, it would not be responsible to assume that any one of them will be enough to prevent the fiscal crisis. Health care is a good illustration. Although curbing the growth of future health care costs must clearly be part of any solution, that policy prescription has been true for many years yet very little progress has been made. Indeed, thus far in 2009, the few steps taken, including the extension and expansion of the CHIP program, the Obama Administration's recommendation to continue preventing future Medicare physician cuts, and the House's shutting off for all of the 111th Congress of the "budget trigger" that might otherwise stimulate cost savings in the Medicare Part D program, all point in a direction *opposite* to reducing health care spending.

Another example is the continuing tax gap problem of collecting appropriate taxes from small businesses which deal mostly in cash transactions. IRS studies have repeatedly shown this to be a major area of noncompliance, yet no initiative thus far has made any significant progress in stemming the problem.[4] The difficulty is the absence of any paper trail as well as reliable third-party reporters to the transactions. Thus, although I applaud the Chairman's commitment to this problem and believe the committee should continue to pursue it with vigor, it is simply unreasonable to expect that the fiscal crisis will be addressed in any significant way through collecting increased taxes from cash businesses.

Moreover, even if I am not correct in that assessment, the fiscal outlook is so bleak that we are really beyond debating which policy option(s) might be the ones to pursue. The truth is that this country will need to make important progress on *all* of the options mentioned and more. The country must find ways to make dramatic reductions in spending and to identify additional revenue sources. In this context, letting the income tax cuts lapse, including those applicable to middle-income taxpayers, is a comparatively easy option, and the committee should take it.

[4] A positive step was the passage last year of the provision requiring reporting of certain credit card information, estimated to raise about $9.5 billion over 10 years. See I.R.C. § 6050W; Staff of Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 110th Congress (2009), pp. 249-52, 597.

3. *Fairness considerations do not justify extension of the income tax cuts.*

Some members of Congress may feel that tax cuts for middle-income taxpayers should be continued as a necessary step to achieve fairness. They may believe that the Bush Administration tax cuts disproportionately benefitted the wealthy and that to correct this injustice, only the tax cuts for top-bracket taxpayers should be allowed to expire.

There is evidence of an increasing disparity in the after-tax incomes of Americans. What is not so clear, however, is the role played by *tax policy* in reaching that result.

Table 1: Average Income Tax Rates, 1986-2006

year	(1) Top 1 percent	(2) Top 5 percent	(3) Second quartile	(4) Bottom 50 percent
1986	21.78%	19.52%	10.17%	5.61%
1987	24.71%	21.15%	9.44%	5.11%
1988	23.15%	20.50%	9.64%	5.09%
1989	22.08%	19.91%	9.80%	5.13%
1990	21.90%	19.54%	9.78%	5.08%
1991	22.54%	19.54%	9.59%	4.64%
1992	22.89%	19.84%	9.46%	4.42%
1993	25.69%	21.35%	9.43%	4.32%
1994	25.90%	21.58%	9.51%	4.38%
1995	26.60%	22.11%	9.57%	4.41%
1996	26.92%	22.65%	9.71%	4.45%
1997	26.03%	22.39%	9.86%	4.55%
1998	24.47%	21.47%	9.35%	4.48%
1999	24.87%	22.14%	9.36%	4.55%
2000	24.99%	22.46%	9.61%	4.65%
2001	25.19%	21.97%	9.27%	4.17%
2002	24.50%	20.98%	7.99%	3.28%
2003	22.10%	19.14%	7.37%	3.02%
2004	21.47%	19.06%	7.31%	3.03%
2005	21.39%	19.20%	7.23%	3.05%
2006	20.85%	18.92%	7.34%	3.10%
% change:				
1986-1996	23.60%	16.03%	-4.51%	-20.68%
1997-2006	-19.89%	-15.50%	-25.51%	-31.86%
2000-2006	-16.54%	-15.78%	-23.60%	-33.27%
1986-2006	-4.26%	-3.08%	-27.80%	-44.73%

source: Kyle Mudry & Justin Bryan, Individual Income Tax Rates and Shares, 2006, IRS SOI Bulletin (Winter 2009), pp. 41, 44 (tbls. 7&8), and author's calculations

Table 1, based on IRS income tax return information, shows the average income tax rates over the 21-year period, 1986 – 2006, of four groups of taxpayers, grouped by the amount of income reported on their returns relative to the income reported by all taxpayers with positive income in those years.[5] The average income tax rate is equal to the total income tax reported by the taxpayers in the group divided by the total income reported by them,[6] and is a measure of the income tax burden of each group. The first two columns show the average income tax rates of the top 1% and top 5% of all taxpayers (by income reported), roughly representing top-bracket taxpayers. The third column consists of the second quartile of taxpayers, those reporting income amounts between the 25th and 50th percentile of all taxpayers, and roughly represents middle-income taxpayers. Finally, the fourth column shows data for the bottom half of all taxpayers with positive income.[7]

The figures at the bottom of the table show the percentage change in the average income tax rate of these four groups during four periods. The first two periods divide the 21 years into roughly equal segments, reflecting changes in the income tax system between the Reagan and Clinton Administrations (1986-1996) and the Clinton and Bush Administrations (1997-2006). The third period examines the change between 2000 and 2006, to focus specifically on the effect of income tax laws enacted during the Bush Administration. Finally, the last line examines the change over the entire 21-year period.

As can be seen, average income tax rates declined for almost all of the groups during each of the periods examined. The one exception was between 1986 and 1996 when the average income tax rates of the top-bracket taxpayers increased while those of the middle-income and lower-income taxpayers declined. In each of the other periods, including the period focusing specifically on the effect of the Bush Administration income tax changes (2000-2006), the percentage decline in average income tax rates of the middle- and lower-income taxpayers exceeded that of the top-bracket taxpayers.

The data presented is only one way of measuring changes in the income tax burdens of different groups of taxpayers over time. Other analyses might usefully incorporate information on economic income and deduction amounts not showing up on tax returns as well as possible differences between nominal and real tax burdens. But for purposes of measuring the effect of income tax cuts in the form of rate reductions and increased credits, relying on tax return information may not be an unreasonable approach. Overall, Table 1 does *not* provide evidence that changes in the income tax system, including those carried out during the Bush Administration years, disproportionately benefitted upper-income taxpayers.[8]

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[5] The income measure is the "1979 Income Concept" developed by the IRS to provide a more uniform measure of income across tax years in order to facilitate comparison of tax results, including average tax rates, over time. It relies strictly on items reported on tax returns. In general, the 1979 Income Concept is similar to adjusted gross income except that it includes some nontaxable amounts of income reported on returns, disallows passive loss deductions, and permits only straight-line depreciation. See Kyle Mudry & Justin Bryan, Individual Income Tax Rates and Shares, 2006, IRS SOI Bulletin (Winter 2009), pp. 5-45.

[6] Total income refers to the 1979 Income Concept.

[7] IRS data was not sufficiently differentiated to permit separate analysis of the third quartile of taxpayers.

[8] Table 1 does not reflect the effect of non-income tax changes during the 21-year period.

But just as we are beyond the point of debating whether the Bush Administration tax cuts were wise in the first instance, we are also past the time of worrying about their distributional effect. Letting *all* of the Bush Administration income tax cuts expire across-the-board would return the country approximately to the tax system of the last Democratic Administration.[9] That policy decision would address possible concerns that recent tax cuts have disproportionately benefitted the wealthy, be fiscally responsible, and be consistent with a principle of "shared sacrifice" during this very challenging time for the country.

4. *Tax cuts should expire as soon as target level of economic growth is achieved.*

Presumably, Congress should hold off allowing any of the tax cuts to expire until the economy is healthy enough to permit that change. This need, however, creates a huge dilemma for the Congress. It exacerbates the extremely difficult challenge of developing political consensus in favor of letting the tax cuts expire. No matter how well and how quickly the economy recovers, there will no doubt be concerns, some bona fide, that the economy remains too fragile to permit an expiration of the tax cuts.

One possible solution would be for the Congress to agree *now* on a target level of economic growth that would have to occur before any tax cuts would be allowed to expire. The agreement would provide for continuation of the cuts until the target is achieved, *but also* expiration of the cuts once the target is met. It may be easier to reach agreement now committing to this balanced and responsible future action, while the committee and the Congress are somewhat blind to the precise timing, than to wait and try to obtain consensus at the future time.

Some might worry that any current announcement of a plan to allow tax cuts to expire in the future would slow the economic recovery. But the exact opposite might occur if forward-looking markets have already anticipated higher future taxes due to the extremely dismal fiscal forecast. In that case, a current announcement might have the positive effect of reducing uncertainty and increasing confidence in the economic stability of the country. Moreover, the sooner taxes are adjusted to meet the looming fiscal challenge, the more gradual and smoother the adjustment can be, which should reduce the distortionary effect of the adjustment.

5. *"Current law" baseline should be used to measure budget effects of tax changes.*

Finally, I urge the committee to measure the budget effect of any tax changes against a "current law" baseline, as was done in the CBO analysis released last week of the President's preliminary budget request,[10] rather than the "current policy" baseline

[9] Some differences would remain, such as those caused by the AMT.

[10] See supra note 3.

used by the Obama Administration in its budget release.[11] As explained by then-CBO Director Peter Orszag when he testified *against* the Bush Administration's proposal to switch to a "current policy" baseline, such a switch substantially undermines the integrity of the legislative process by allowing the costs of proposals to disappear from the process.[12]

6. *Conclusion.*

I recognize that my policy prescriptions today are politically unappealing. No one likes taking the steps I have advocated; I certainly don't.

But the core numbers indicative of an imminent fiscal crisis do not lie. We are beyond the point of being able to kick this problem down the road a little further. As our nation's leaders, you must persuade the American public that unless steps like the ones I have described are taken immediately, we risk such serious economic disruption in this country as to make recent events look like child's play, and even worse, we risk the possibility of triggering worldwide instability and geopolitical conflict.

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I am happy to respond to any questions of the committee.

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[11] See OMB, A New Era of Responsibility: Renewing America's Promise (2009), pp. 36, 121 (tbl. S-5).

[12] Perspectives on Renewing Statutory PAYGO: Hearing before H. Comm. on the Budget, 110th Cong. at 18 n.10 (2007) (statement of Peter R. Orszag, Director, CBO). For the same reason, the budget effects of changes in spending should be measured in the same way. In particular, the special baseline rule permitting temporary entitlement programs to be scored as if the change were permanent, as was used recently in connection with the temporary extension of the CHIP program, should be abandoned and replaced by the same budget estimating treatment of temporary tax programs. See CBO, Cost Estimate: H.R. 2—Children's Health Insurance Program Reauthorization Act of 2009, at 3–4 (2009), available at http://www.cbo.gov/ftpdocs/99xx/doc9985/hr2paygo.pdf (explaining application of special baseline rule); George K. Yin, Temporary-Effect Legislation, Political Accountability, and Fiscal Restraint, 84 N.Y.U. L. Rev. __, n. 26, 37, 62 (2009).