Statement of Michael J. Graetz, Professor of Law, Columbia Law School
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on Tax Reform
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Mr. Chairman, Senator Hatch, and Members of the Committee---

Thank you for inviting me to testify here today on this important and difficult subject.[1] The call for this hearing puts to this panel the question: "Does the Tax System support Economic Efficiency, Job Creation and Broad-Based Economic Growth?" The answer to that question is such an obvious and resounding "*No*" that for a while I was puzzled why the committee had invited me, a lawyer, to join the distinguished group of economists testifying here today.

But then the answer dawned on me. The one area of the economy where the tax system is a robust job-creating machine is the area of tax return preparation and software, tax planning, tax controversies and tax compliance. The distortions in our tax law are so numerous, so rewarding to the well-advised, and frequently so complex to comprehend and comply with that they serve to produce millions of well-paying indoor jobs that not only require no heavy lifting, but also are immune from the ups and downs of the business cycle. In her most recent report, the National Taxpayer Advocate, Nina Olson, estimated that individuals and businesses spend 6.1 billion hours a year—full-time work for more than 3 million employees—on tax compliance alone. I was surprised that number is so small.

A week or so ago, *The Wall Street Journal* thought it was front-page news that some tax lawyers were billing clients more than $1,000 an hour. Investment bankers, along with some tax accountants and lawyers who read this article could not help but giggle: they view that $1,000 an hour number as embarrassingly low. They bill based on tax-savings results—by the boat load, not by the hour. Why do you think they make so much money when so many Americans are struggling just to pay this week's grocery and gas bills?

The tax profession is not inventing new drugs or medical devices, streamlining manufacturing or creating energy efficient vehicles. They are not, to borrow the President's felicitous phrase, helping this nation to "win the future." But do not think for a minute that their clients are easily duped rubes. No, they get real value for what they pay; the fees their advisers charge are a small fraction of the tax savings they obtain.

What are tax-induced distortions to my economics colleagues on this panel are business opportunities for tax planning and compliance companies and

[1] I am appearing here today on my own behalf, expressing solely my own views, not those of any institution or group with which I am or have been affiliated as an employee, counsel, or academic advisor.

tax professionals. Thanks to the Congress of the United States, such opportunities are abundant.[2] Let me start with business income.

I. Income Taxation of Business Income

Notice that I say taxation of business income, not corporate taxation. This is quite deliberate. It is well-known that it is the *combination* of tax rates and rules regarding corporations, individuals, and non-corporate businesses (including partnerships, limited liability companies and subchapter S corporations) that *together* determine the economic distortions that are dragging us down today. For shorthand, we call our system, under which income is taxed to corporations and to shareholders as distinct taxpayers, a “classical” corporate income tax system. But given its distortions, its sour notes, and its disharmonies, one should not confuse classical corporate taxation with classical music.

We say, again in shorthand, that we have a “double” tax system, one where taxable income earned by a corporation and then distributed to individual shareholders as a dividend is taxed twice, once to the corporation and again to the shareholder on receipt of the dividend.[3] But the actual U.S. tax system is considerably more complex. For example, some income earned through corporate enterprise is taxed only once—at the corporate level. This occurs for corporate taxable income distributed as dividends to tax-exempt shareholders, such as pension funds and charitable endowments. Other income earned through corporate enterprise is taxed only once—at the investor level. This occurs when corporate earnings are distributed as deductible interest payments to taxable lenders. Finally, some income earned through corporate enterprise is not taxed in the U.S. at either the corporate or investor level. This is, for example, the result for deductible interest paid to certain foreign and tax-exempt holders of U.S. corporate debt. Accordingly, corporate income is sometimes taxed twice in the U.S., sometimes once, and sometimes not at all.

The current U.S. system of taxing corporate and individual income distorts several economic and financial choices, of which the following four are most often emphasized:

1. *Disincentive for Investment in New Corporate Capital*: U.S. investors are discouraged from investing in new corporate equity because of the

[2] The ability of the tax bar to create and split hairs should not be underestimated. To take one recent example, in a lengthy and learned document—containing more than 200 footnotes—submitted by the Tax Section of the American Bar Association to the Treasury and IRS officials charged with writing regulations implementing the codification of the “economic substance” doctrine in Code section 7701(o), the lawyers argued that even if a transaction is a “complete sham,” it does not fall within this statute. See American Bar Association Section of Taxation, “ABA Members Seek More Guidance on Codification of Economic Substance Doctrine,” *Tax Notes Highlights and Documents*, January 19, 2011, 525-558, at 530-31.

[3] For further elaboration, see Michael J. Graetz and Alvin C. Warren, Jr., “Integration of Corporate and Individual Income Taxes: An Introduction,” *Tax Notes*, September 27, 1999 at 1767-1776.

additional burden of the corporate tax, distorting the allocation of capital between the corporate and noncorporate sectors.

2. *Incentive for Corporate Financing by Debt or Retained Earnings*: U.S. corporations are encouraged to finance new projects by issuing debt or using retained earnings, rather than by issuing new stock, to avoid an additional level of tax. As we now know well, higher debt levels may increase the costs of financial distress.
3. *Incentive to Distribute or Retain Corporate Earnings*: There can be a tax incentive to retain or distribute corporate earnings, depending on the relationships among corporate, shareholder, and capital gains tax rates.
4. *Incentive to Distribute Corporate Earnings in Tax-Preferred Forms*: The tax system encourages U.S. corporations to distribute earnings in tax-preferred transactions, such as stock repurchases, that give rise to basis recovery and capital gains, rather than by paying dividends.

So, the classical corporate income tax system increases the cost of capital for U.S. companies, discourages new equity investments in corporate enterprise, creates incentives for share repurchases rather than dividends, and encourages the issuance of corporate debt.

In a 1992 report, the Treasury Department emphasized that our tax system's relatively high burden on corporate capital, as compared with residential housing, has resulted in a much lower ratio of corporate to residential investment in the United States than in other industrialized countries. And our individual income tax preference for home mortgage borrowing exacerbates this problem by encouraging families to borrow, using their homes as collateral. We are currently paying a large price for that folly.

Our current tax system also encourages business enterprises to organize as so-called passthrough entities—proprietorships, subchapter S corporations, limited liability companies, or partnerships—that avoid the corporate level tax. About 40 percent of U.S. business net income and more than 40 percent of the income tax on business income is now reported by individual owners of passthrough entities. The economist Marty Sullivan estimated just last week that the increase in passthrough entities since 1990 will shrink corporate revenues by about $140 billion in 2015, with only two-thirds of that amount recaptured through individual tax filings.[4] State limited liability corporation statutes allow these businesses to obtain all of the state law protections accorded to subchapter C corporations, while avoiding any requirement to pay corporate taxes.

We like to think of these noncorporate business taxpayers as small businesses, but that is only part of the story. Most passthrough entities are small businesses; they comprise more than 90 percent of all business entities. But the

[4] Martin A. Sullivan, "Passthroughs Shrink the Corporate Tax by $140 Billion," *Tax Notes*, February 28, 2011 at 987-989.

0.2 percent of partnerships that had revenues greater than $50 million accounted for nearly 60 percent of all partnership income that year.[5] Unless one needs access to the market for public capital, it is foolish not to organize a business entity to be taxed as a partnership rather than a corporation. Foreign corporations may also conduct their U.S. operations as a partnership to avoid the U.S. corporate level tax.

Given the flexibility in choosing whether and where to incorporate a business and the growing role of private equity in the world economy, creating greater parity between large corporate and passthrough businesses would be a valuable step to take. This would also allow much simpler, more favorable rules to be applied to small businesses.

But until now, I have told only part of the story—in many ways, the easier part. Our nation's basic tax structure came into place in the World War II era, when the United States essentially had all the money there was. Even a horrid tax system – with income tax rates up to 91% – could not then stall our economic progress. From 1946 through 1973, when OPEC quadrupled the price of oil, the economy grew by an average of 3.8% a year and unemployment averaged 4.5 percent. Since 1973, our economy has grown more slowly and so have the wages of middle income Americans. Now, the United States' economy must compete for the investment capital essential for economic growth – capital necessary to produce a rising standard of living for the American people – with many countries throughout the world, including not only Europe and Japan, but also Brazil, Russia, China, and India. Now, the venerable New York Stock Exchange can be transformed virtually overnight into an enterprise with a majority ownership in Germany and headquartered in the Netherlands. This was unthinkable when our international tax system was formed.

We need to attract capital to create better conditions for American workers and businesses. In order to do that, the United States must be an attractive place for both foreign and domestic investments, and American companies need to be positioned to take full advantage of the global market for goods and services, labor and capital. But our tax system does not advance the competitiveness of American workers and businesses; it stifles it.

Our system of taxing international business income is truly archaic. The structure for taxing international business income came into the tax law in 1918 and 1921.[6] It was substantially modified in 1962 and again in 1986, and there has been quite a lot of tinkering since then. But we are in a very different world economy today. Corporations and other investors, including sovereign wealth

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[5] Unless otherwise indicated, the figures cited here come from testimony of Robert Carroll and Donald B. Marron before the House Ways and Means Select Revenue Committee on March 3, 2011.

[6] See Michael J. Graetz and Michael M. O'Hear, "The 'Original Intent' of U.S. International Taxation," 46 *Duke Law Journal* 1021 (1997).

funds investing on behalf of other nations, now move money quickly and easily around the world, making it much more difficult for any sovereign nation—including the United States—to tax their income.

How to tax multinational business enterprises has long been controversial. Recent disputes over the Obama Administration international tax proposals, dealing, for example, with cross-crediting of foreign taxes, the treatment of domestic expenditures that help produce foreign income, the treatment of U.S.-owned foreign entities, and transfer pricing, alongside the recent trend of countries with foreign tax credit systems to move to international business tax regimes that exempt foreign dividends, amply illustrate differences in policy preferences. The thrust of the 1986 Tax Reform Act was to limit the ability of U.S. companies to offset U.S. taxes on unrelated income and to restrict somewhat deductions for companies that invest abroad. Many proposals to tighten income tax rules for foreign investments by U.S. companies are being advanced today. But elsewhere around the world nations have instead embraced low corporate income tax rates, both to attract investments and to reduce the temptations of their domestic companies to shift income abroad through intercompany pricing or other techniques.

The difficulties are even more fundamental. As I have observed elsewhere, the basic building blocks of international taxation—the concepts of residence and source—are now foundations built on quicksand.[7] They may have drawn reasonable lines when they first became the basis for international income taxation early in the 20th Century, but in today's economy, with all of its innovative financial transactions, both corporate residence and source of income are easily manipulated. And there is precious little the United States can do unilaterally to address this problem.

I have come to believe that, absent broad, international agreement and cooperation foregoing tax competition to attract capital—a transformation that is certainly not on the horizon—a low statutory corporate tax rate is essential. This year we will have the highest statutory corporate tax rate in the developed world.

Businesses now not only have the ability to elect *whether* to be taxed as corporations, they also can elect *where* to be taxed. If you ask a law student in an international tax class where to incorporate a new business enterprise and he or she answers, "the United States," the student deserves a failing grade. As one savvy tax lawyer recently put it: deductions flock to high tax-rate countries and income flocks to those with low rates.

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[7] See Michael J. Graetz, "The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies," 54 *Tax Law Review* 261, 320 (2001) and Michael J. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expense," *Bulletin for International Taxation*, November, 2008.

Let me illustrate the international consequences of borrowing here with a simple example.[8] When a U.S. or foreign multinational borrows in the U.S. to finance an investment in, say China, and locates its interest deductions here we have a *negative* tax rate on that investment—we are providing a subsidy to the foreign investment—and *China*—with a 15% corporate tax rate—will, in essence, collect a much *higher* rate on the income from the investment there *since it will not allow the interest deduction*—in a typical example, a 45% tax rate. For 25 years now—since 1986—we have had rules attempting to respond to this problem but the problem persists. The "solutions" have solved nothing. The only real solution to this problem absent multilateral agreement—and to transfer pricing issues—is a much lower U.S. tax rate on business income.

So, our tax system not only promotes debt financing over new equity, but our relatively high corporate tax rate also gives companies an incentive to locate their borrowing here, along with its interest deductions, and to shift their income abroad. This is not sound policy.

Anticipating the ease with which multinational enterprises might be able to shift income from their valuable intangible assets abroad, Congress in the 1986 legislation told Treasury and the IRS to make sure that transfer pricing rules produce results "commensurate with income." As a former Treasury official, who in the early 1990s signed proposed regulations intended to implement that statute, I can testify that this legislation has failed miserably. A leaky bucket has become at least a sieve today. The only less successful endeavor that comes quickly to my mind is the Treasury's spectacular inability to write rules distinguishing corporate debt from equity, pursuant to a 1969 amendment to the tax code.

Economists and many government officials often tell us not to pay any attention to the statutory tax rate, that we should look instead at the lower "effective" tax rates. But, of course, average tax rates are meaningless when one is being asked about where to borrow or invest the next dollars. And the more relevant "marginal effective tax rates" are subject to debate and often difficult to calculate. Corporate clients respond to their knowledge that we tax corporate income at a 35 percent rate, while another country imposes tax at a much lower rate, say 15 to 20 percent. They do not need a computer to tell them where to locate their deductions and where to locate their income. Foreign-owned multinationals understand this as well as the U.S. companies.

To be sure, businesses often shift their income and deductions around the world without necessarily also shifting their employees or real investments in plant and equipment. But not always. Other governments may require that real economic activity actually take place there. In such cases, and whenever business activity is located abroad for business rather than tax reasons, there

[8] For elaboration, see Michael J. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expense," *Bulletin for International Taxation*, November, 2008.

may be incentives for companies to shift their foreign income to even lower tax countries—to so-called tax havens. Complicating matters further, it may well be in the U.S. national interest for our multinational corporations to engage in tax planning strategies that reduce their foreign income taxes and increase their cash flow. But when such strategies are turned on the U.S. tax system by either domestic or foreign-owned enterprises, our fisc and our economy is the loser.

Let me offer one specific example of how the internationalization of the economy may affect domestic tax policy judgments. In the early 1990s, when Glenn Hubbard and I were both serving there, the Treasury released a study of corporate integration ideas designed to reduce some of the distortions of the classical corporate tax system that I mentioned earlier. The Treasury wanted to eliminate the "double" tax on corporate earnings distributed as dividends and, in part for administrative reasons, urged that the single tax on business income apply at the entity rather than the individual level. That report recommended exemptions from individual taxation of dividends paid out of corporate profits that had already been subjected to U.S. corporate taxes.[9] President George W. Bush urged that Congress enact a similar proposal in 2003, and his recommendation led to the 15 percent rate that now applies to most corporate dividends.

I will not insist here that we were right when the Treasury report was issued, but even if we were right then, that policy is now wrong. It is far easier and, I believe now better tax policy, to collect income taxes from individual citizens and resident shareholders than from multinational business enterprises. We would be far better off, for example, if a 15 percent rate applied at the business level with a 35 percent tax on dividend recipients, rather than vice versa, which is what we now have. Even a 25/25 rate split would be a substantial improvement over current law.

Of course, because corporations do not distribute all of their earnings to taxable shareholders as dividends, there is not a one-to-one correspondence between the revenues from a percentage point of the corporate rate versus the individual rate on dividends. Indeed, only about 35 to 40 percent of corporate dividends are paid to taxable individuals and trusts; the rest are paid to tax-exempt domestic entities and foreigners. This means that a corporate rate reduction will benefit nontaxable recipients, while a reduction in tax rates on dividends will not. Moreover, amounts paid out as dividends are equal to only about 30 percent of corporate taxable income.

But this still leaves options available for shifting tax from corporations to their owners. The basic idea is to convert a portion of the current corporate tax into a creditable but nonrefundable withholding tax on distributions to the

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[9] U.S. Treasury Department, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (January 1992).

companies' shareholders (and bondholders).[10] If Congress, for example, were to impose a 10 percent nonrefundable withholding tax on dividends, this alone could finance about a 2 to 2 1/2 percentage point reduction in the corporate tax rate. Raising the individual-level dividend tax rate by the ten percentage points that would then be collected at the corporate level and credited to individual recipients could help finance an additional reduction in the corporate rate. The debt-equity distortion could be further reduced by also subjecting interest on corporate bonds to a similar nonrefundable withholding tax, which, in turn, could help finance even lower corporate rates. Although the details will be important,[11] my essential point is that it may well be possible to help finance a substantial reduction in the corporate income tax rate by shifting a portion of it to such withholding taxes.

The relationships between the taxation of distributed corporate income at the corporate level and its taxation to recipients, along with the important questions relating to the taxation of passthrough business enterprises, in my view, demonstrate the folly of thinking that it makes sense to consider corporate tax reform in isolation as some, including the president, seem to have suggested.

Let me make one further point regarding business taxation. Companies keep two different sets of books, one for tax purposes and one for reporting to shareholders. Corporate tax shelter deductions, credits, and losses reduce tax liability without reducing the income reported on the company's financial statements to shareholders. Thus sheltering taxes gives a company the best of both worlds: lower taxes are paid to the government while higher profits are reported to shareholders. In the 1986 act, Congress linked the different corporate income statements, one for shareholders and one for taxes, in a corporate alternative minimum tax, but that linkage expired after three years. The IRS has recently expanded its required disclosures of book-tax disparities, but Congress should consider requiring greater conformity between book and tax accounting for publicly traded companies. Where Congress wants to maintain book-tax differences—such as for depreciation, research and development expenses, and foreign taxes, for example—these differences may be made explicit. Given companies' desire to report high earnings to investors, a stronger link between book and tax accounting would discourage tax shelters by publicly held companies, which pay the lion's share of corporate taxes. I believe that this linkage would generally increase the amount of corporate income subject to tax, also helping to finance a reduction in the corporate tax rate, although I understand that the official revenue estimators may have reached a different

[10] For a detailed elaboration of a similar idea, see Alvin C. Warren, Jr., *Integration of the Individual and Corporate Income Taxes* (American Law Institute, 1993).

[11] A withholding tax on corporate bond interest, for example, should apply only to bonds issued after the date of enactment, but a withholding tax on dividends could apply to all dividends paid after enactment. These transition issues would affect how the corporate rate reduction might be phased in.

conclusion based on their (in my view erroneous) belief that companies prefer reducing the income they report to shareholders over reducing taxes.

As if the substantive difficulties of designing sound corporate tax policies for today's global economy were not hard enough, taking political considerations into account—as you must—makes the task positively herculean. Corporate income taxes are popular with the public, despite the virtually unanimous view among economists and other tax policy analysts—for many of the reasons I have discussed here—that the corporate tax is a bad tax, if the goal is to enhance our nation's economic wellbeing. People believe that taxes remitted by corporations, especially large multinational companies, are paid by someone other than themselves. Years ago, Ways and Means Committee Chairman Dan Rostenkowski suggested adding a second verse to the tax reform classic coined by Senate Finance Committee Chairman Russell Long: "Don't tax you; don't tax me;/tax the fellow behind the tree." Congressman Rostenkowski added: "Don't tax you; don't tax me, tax the corporations across the sea." Treasury Secretary Geithner himself recently contributed to the confusion when he insisted that Americans should not have to pay one additional cent of taxes to reduce taxes on businesses. But as Paul H. O'Neill, George W. Bush's first Treasury secretary, observed, "Corporations don't pay taxes, they collect them."

The question of who actually bears the economic burden of corporate income taxes—who ultimately pays them—has tormented public-finance economists since the tax first came into existence. Three candidates come instantly to the fore: people who own the companies, people who work for the companies, or people who buy the companies' products. Since the tax may affect wages, prices, and/or returns to capital, economists believe that workers, consumers, and or owners of capital generally may bear the economic costs of the tax. For many years, the conventional wisdom among economists was that the tax principally reduced returns to capital, at least in the short run, and thus the tax was considered to be progressive, even if economically distortional. Government distributional tables have therefore tended to allocate the corporate tax burden to owners of capital. Even so, ultimately, however, any reduction in capital due to the tax might result in lower wages, so in the long run, workers may pay.

As the economy has become more open internationally, a number of recent economic studies have concluded that the corporate income tax is less likely borne by capital generally, but rather—at least in some substantial part—by workers in the form of lower wages. Owners of capital today have the ability to move their money anywhere in the world, but workers and consumers are considerably less mobile.

All the uncertainty in the economics profession contributes to the public view that the tax is probably paid by someone else. And it is child's play to characterize large corporations, especially large multinational corporations, as if they were villains. This is probably why the public seems to like a tax that economists hate. But high tax rates on corporate income in today's global economy are a very bad way to try to achieve economic growth or to obtain and maintain progressivity in the distribution of the tax burden. Indeed, simply shifting the tax burden from corporations to shareholders and bondholders may increase progressivity.

Let me now turn briefly to the individual income tax.

II. Income Taxation of Individuals

Needless to say, one can find much to complain about on the individual income tax side as well. In June 2007, for example, I offered extensive testimony here concerning the Alternative Minimum Tax, but temporary "patches" continue annually. Other witnesses before this Committee last week properly lamented the uncertainties caused by the astounding number and importance of provisions soon scheduled to expire. A "temporary" and ever-changing income and estate tax law does not well serve the American people or the U.S. economy. And serious structural problems abound: huge tax penalties remain on marrying, for example, for low-income working single parents eligible for the EITC. Such burdens conflict with fundamental American values, and are not only counterproductive but also engender disrespect for our tax system and the government that designed it.

The complexities of our income tax law are astounding and confront taxpayers at every income level. This too sows confusion and creates the perception that the well-advised—if not everyone else—escape paying their fair share of taxes. All of this, in turn, makes a tax system that depends as heavily as ours on the goodwill and honesty of the populace ever more vulnerable to deliberate noncompliance. Not to mention the time and dollars wasted—even by low and moderate income Americans—on complying with the income tax, time that could be much better spent with one's family, dollars that could go for rent, utilities, or groceries.

Our current individual income tax is a mess largely because our presidents and the Congress ask it to do too much. The result is a level of complexity that baffles experts, let alone ordinary Americans at tax time. Presidents and members of Congress from both political parties have come to believe that an income tax credit or deduction is the best prescription for virtually every economic and social problem our nation faces. In the process, we have turned the Internal Revenue Service from a tax collector into the administrator of many of the nation's most important spending programs. In her most recent report to the Congress, the National Taxpayer Advocate highlighted the difficulties for the IRS of having to implement "social benefits" programs enacted in the Tax Code. As she put it, the IRS "will have to shift from being an enforcement agency that says, in effect, 'you owe us' into an agency that places much greater emphasis on hiring and training caseworkers to help eligible taxpayers receive benefits and work one-on-one with taxpayers to resolve legitimate disagreements." Today, of course, we rely principally on tax return preparation providers to supply such services to low and moderate income taxpayers.

To keep track of all the tax benefits, the federal budget each year is required to contain a list of "tax expenditures," defined as all tax credits, deductions or exclusions that deviate from a "normal" income tax. The basic idea is that many tax benefits are substitutes for and the equivalent of direct government spending. According to a February 2011 report of the Staff of the Joint Committee on Taxation, the number of these tax expenditures has grown enormously since 1986, from 128 to 202. The JCT also points out that, once enacted, no matter how effective or distortive, tax expenditures "tend to stay in place." Their total cost in lost revenues is estimated to exceed $1 trillion a year.[12]

When we talk about tax expenditures, bear in mind that we are not talking here about narrow special-interest tax loopholes. Mostly, these are tax breaks widely available to broad segments of the general public—tax cuts for the large middle-class. The largest of these are very popular: tax advantages for employees' payments for health insurance and retirement savings, deductions for home mortgage interest, state and local taxes, and charitable contributions, and low or zero rates on capital gains.

And yet we know that trying to solve the nation's problems through "targeted tax breaks" often does not work. Take health insurance, for example. Our nation, contrary to others throughout the world, has long relied on a tax benefit for employers and employees as its main mechanism for covering Americans who are neither poor nor aged. What has been the result? Our health-care costs are the highest in the world and about 50 million Americans have been uninsured. Moreover, these costs make American businesses and products less competitive in the world economy and are gobbling up wage increases of American workers. Nor have our tax-based energy tax breaks produced better results. Nor do tax credits for working parents produce affordable childcare. I could go on and on, but I shall not.

Historically when competing policy ideas aimed at a common goal emerged in Congress, the leaders of the tax writing committees would fashion a compromise provision. Now, Congress often compromises by enacting *all* of the ideas, leaving unsophisticated taxpayers bewildered about how to cope. For a vivid illustration, consider the income tax incentives for paying for higher education. There are eight tax breaks for current year education expenses: two tax credits, three deductions and three exclusions from income. Five other provisions promote savings for college expenses. In 1987, there were only three

[12] Staff of the Joint Committee on Taxation, "Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates, JCX-15-11, February 28, 2011.

provisions encouraging college expenditures or savings. The 1997 Act alone added five provisions that were estimated to cost $41 billion over five years; together they represented the largest increase in federal funding for higher education since the GI Bill.

Comprehending the tax savings provided by these provisions, their various eligibility requirements, how they interact, and their recordkeeping and reporting requirements is mind-boggling. Each of the provisions has its own eligibility criteria and definition of qualified expenses. For example, they do not provide consistent treatment of room and board, books, supplies and equipment, sports expenses, nonacademic fees, or the class of relatives whose expenses may be taken into account. A student convicted of a felony for possession or distribution of a controlled substance is not eligible for one of the education credits, but such a conviction is no bar to another one. And this is just the tip of the iceberg.

Our income tax is a mess. No matter what their income, Americans confront extraordinary complexity in filing their taxes. The Form 1040 instruction booklet spans more than 100 pages and the form itself has more than 10 schedules and 20 worksheets. No wonder more than 60 percent of income tax filers hire tax preparers (and many of the rest rely on computer programs**)** to tell them what to do. And tax return preparers have become notorious for peddling other products of dubious value to their customers, most notoriously so-called “refund anticipation loans,” which often advance tax refunds by a few days at an exorbitant interest cost.

Relying, as we do, on income tax deductions and credits is about as successful a solution to our national needs as handing out more gunpowder at the Alamo. We must be weaned away from using tax deductions or credits as a cure-all for our nation’s ills. But the largest tax expenditures are very popular with the public. To be sure, they could be trimmed: a floor on deductions here, a ceiling or haircut there, but I am convinced that the only path to real tax reform success is to remove most Americans from the income tax altogether.

III. A Plan for the Future

Mr. Chairman, as you and many of your colleagues on this Committee know, I do not believe that a tax reform following the income tax base-broadening precedent of the 1986 Tax Reform Act is an adequate response to the tax policy challenges this nation faces in the 21st century. My main ideas about tax reform and my analysis and views about many alternative suggestions are described in my book *100 Million Unnecessary Returns: A Simple, Fair and Competitive Tax System for the United States* – the paperback edition of which was published last spring.

For those unfamiliar with my Competitive Tax plan, it has four key pieces:

- First, enact a value added tax – a broad based tax on sales of goods and services now used by more than 150 countries worldwide. We are the only OECD country that does not have a VAT or, as it is sometimes called, a goods and services tax.

- Second, use the revenues produced by that consumption tax to finance an income tax exemption of $100,000 of family income and to lower substantially the individual income tax rate on income above that amount.

- Third, lower the corporate income tax rate to 15%, or at most 20%.

- Fourth, replace the earned income tax credit and provide low and middle income families with tax relief from the VAT burden through payroll tax offsets and debit cards.

This plan has many significant advantages over current law and other tax reform alternatives:

- First, this competitive tax system would encourage saving and investment in the United States, stimulating economic growth and creating additional opportunities for American workers. This plan would take advantage of our status as a low-tax country by making us a *low-income tax* country.

- Second, a 15% corporate income tax rate would be among the lowest in the world and would solve the most vexing issues of international tax policy.

- Third, the plan would eliminate more than 100 million of the 140 million income tax returns and would free more than 150 million Americans from ever having to deal with the IRS.

- Fourth, with only a relatively few high-income Americans filing tax returns, there would be far less temptation for Congress to use income tax exclusions, deductions, and credits as if they offered adequate or appropriate solutions to the nation's most pressing social and economic problems. They do not.

- Fifth, a value-added tax would be border adjustable under WTO international trade rules, which means that we could tax imports and exempt exports. VATs can be imposed on such a "destination-basis," but business income taxes cannot. (As this Committee well knows from longstanding WTO disputes over the DISC, the FSC, and ETI, income taxes must be imposed on an "origin" basis which means that we must tax goods produced here, even for export, and we cannot tax imports.) Economic theory and most economists insist that border adjustments make no difference in international trade due to offsetting changes in exchange rates, but business owners do not accept that exchange-rate adjustments happen as readily in practice as theory suggests. In any event, destination-based taxes have major advantages for tax compliance, for example, with regard to transfer pricing. Moreover, given the size of our nation's trade imbalances, border adjustments would likely result in hundreds of billions of dollars of additional revenues to the U.S. Treasury over the 10-year budget period and beyond.

- Sixth, this plan would avoid most of the difficult issues of transition to an entirely new system that have haunted other proposals to replace the income tax with consumption taxation.

- Finally, by combining taxes commonly used throughout the world, this system would facilitate international coordination and fit well with existing tax and trade agreements—something that most other consumption tax proposals fail to do.

Opponents of value-added taxes often complain that they are regressive, and if such a sales tax were to fully replace our income tax, tax burdens would indeed be shifted down the income scale. So, I designed my Competitive Tax plan in a manner generally to change neither the progressivity of the tax system nor the amount of revenue produced under current law. This allows my proposal to be evaluated by comparing it directly to the current system, and it follows the important precedent of both distributional and revenue neutrality that facilitated enactment of the 1986 Tax Reform Act, our last major tax reform.

The Tax Policy Center, pursuant to a contract with Pew Charitable Trusts, is currently in the process of estimating the revenue and distributional consequences of my plan and has given me permission to describe their *preliminary* results. These estimates are for the year 2015. Without taking into account a nonrefundable corporate withholding tax of the sort I described earlier, they suggest that my proposal is essentially revenue and distributionally neutral with a VAT rate between 14 and 15 percent, a 15 percent corporate income tax rate, and tax rates for married couples of 15 percent on income between the $100,000 family allowance and $250,000 and 25 percent for income above $250,000. Offsets are provided for low and moderate income families. The Tax Policy Center, under this contract, is now working on a paper that will provide more detailed final results.

As a result of the recent financial crisis, the most significant recession since the Great Depression (with unemployment reaching a 25-year high), and a vast amount of government spending aimed at combating these problems, our nation’s short and long-term financial condition has deteriorated dramatically since I first advanced this proposal. Now our nation’s financial position is perilous. We have never in modern times faced such a dangerous ongoing imbalance between the levels of federal spending and revenues. Our federal debt as a percentage of our economic output is greater than it has been at any time since the end of World War II. And then Europe and Japan were in shambles and China was entering into a dark communist era. Our economy was poised to grow for decades at an unprecedented pace. And our government owed 98 percent of the money it had borrowed to finance the war to Americans. The Congressional Budget Office now projects that in a decade our national debt will exceed $20 trillion—roughly equal to our annual economic output (GDP)—with more than half owed to foreigners, many of whom we cannot count as friends. If we are able then to borrow at a 5% interest rate, interest on the federal debt alone would cost us a trillion dollars a year.

As you know, our long term fiscal situation is even more dire. Our population is aging with fewer workers for each retiree, and we still have no credible plan to control excessive and rapidly rising health care costs. So the nation’s financial situation is projected to get even gloomier in the longer term. If we fail to get control of the federal budget, rising interest costs will gobble up an ever-larger share. Public debt growing to such levels will also decrease the value of the dollar and lead to challenges to its role as the world’s reserve currency. Our growing national debt increases the risks of substantially higher interest rates, inflation, and another financial crisis. Over time, it will threaten the living standards of the American people. These are facts, not forecasts. We are heading toward a cliff, risking the economic wellbeing of our children and grandchildren. Once our economy recovers and resumes real growth, both substantial reductions in anticipated government spending and some tax increases will likely be necessary to address the looming disaster.

A great advantage of my Competitive Tax plan is that, by introducing a value added tax on sales of goods and services and thereby decreasing our nation’s need to rely so heavily on the income tax to finance our government’s spending, we will have a tax system that is fair and yet substantially more favorable to economic growth than our current system. If we should need additional revenues down the road, such a system would provide great advantages over our current reliance on income taxes alone. And the combination of taxes I have proposed would enable Congress to levy any additional taxes in a manner that is equally or even more progressive than our current system without having to rely exclusively on high income tax rates to achieve such results.

Despite the daunting challenges of our fiscal situation—challenges that a VAT can surely help to ease—I believe that it would be a mistake to enact a VAT without using a substantial portion of its revenues to help finance major reform and simplification of income taxes. That would indeed be an opportunity wasted.

Our nation's tax system is badly broken. No one quarrels with that. If we don't solve the problems of our grossly inefficient system of raising revenues, all the other challenges our government faces will eventually be overwhelmed by one over-arching reality: we will have too little money and will lack the means to raise it without damaging our economy. Doing nothing is no option.