S. HRG. 112–464

DOES THE TAX SYSTEM SUPPORT ECONOMIC EFFICIENCY, JOB CREATION, AND BROAD-BASED ECONOMIC GROWTH?

HEARING

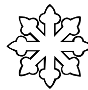
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

MARCH 8, 2011



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

74–868—PDF WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
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CONTENTS

OPENING STATEMENTS

Page

Baucus, Hon. Max, a U.S. Senator from Montana, chairman, Committee on Finance 1
Hatch, Hon. Orrin G., a U.S. Senator from Utah 3

WITNESSES

Auerbach, Dr. Alan, Robert D. Burch professor of economics and law, University of California Berkeley, Berkeley, CA 4
Hubbard, Dr. R. Glenn, Dean and Russell L. Carson professor of finance and economics, Columbia University Graduate School of Business, New York, NY 7
Galbraith, Dr. James K., Lloyd M. Bentsen, Jr. chair in government/business relations and professor of government, University of Texas Austin, Austin, TX 9
Graetz, Michael, Isidor and Seville Sulzbacher professor of law, Columbia Law School, New York, NY 11

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Auerbach, Dr. Alan:
- Testimony 4
- Prepared statement 41
- Responses to questions from committee members 50

Baucus, Hon. Max:
- Opening statement 1
- Prepared statement 56

Galbraith, Dr. James K.:
- Testimony 9
- Prepared statement with attachment 58
- Responses to questions from committee members 64

Graetz, Michael:
- Testimony 11
- Prepared statement 74
- Responses to questions from committee members 90

Hatch, Hon. Orrin G.:
- Opening statement 3
- Prepared statement 98

Hubbard, Dr. R. Glenn:
- Testimony 7
- Prepared statement 100

Rockefeller, Hon. John D., IV:
- Prepared statement 107

DOES THE TAX SYSTEM SUPPORT ECONOMIC EFFICIENCY, JOB CREATION, AND BROAD-BASED ECONOMIC GROWTH?

TUESDAY, MARCH 8, 2011

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

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Rockefeller, Wyden, Menendez, Carper, Cardin, Hatch, Snowe, Coburn, and Thune.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Jon Selib, Chief of Staff; Lily Batchelder, Chief Tax Counsel; Holly Porter, Tax Counsel; Jeff VanderWolk, International Tax Counsel; and Ryan Abraham, Tax Counsel. Republican Staff: Mark Prater, Deputy Chief of Staff and Tax Counsel; Chris Campbell, Staff Director; Nick Wyatt, Tax and Nomination Professional Staff Member; Tony Coughlan, Tax Counsel; and Jim Lyons, Tax Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

Dwight Eisenhower once said, “Neither a wise man nor a brave man lies down on the tracks of history to wait for the train of the future to run over him.”

That train of the future depends on a strong and growing economy, and today we face challenges to our economy on many fronts. Our economy is still recovering from the most significant recession since the Great Depression. U.S. debt as a share of the economy is at its highest level in 50 years, and it is projected to rise much higher in the coming years. At the same time, economic competition is stiffening, as the world economy grows increasingly globalized.

In 1960, exports accounted for 3.6 percent of American’s GDP. Today they account for almost 12.5 percent.

In the face of all these challenges, we cannot afford inefficiencies in spending programs or in the tax system. Our tax code must maximize job creation and widespread economic growth. It must be finely tuned to its objectives so we are driving that train of the future, not lying beneath it.

Last year, we began a comprehensive review of America’s tax system. We held hearings to look at the history of the code. We

contemplated lessons learned from the last major revision of the tax code in 1986. We considered historical trends in income and revenue. And we analyzed how the code has swelled in the intervening years, often failing to adapt to our changing world.

These hearings explained how we got to where we are today. Well, today, we begin a set of hearings asking, "Why do we need tax reform? Why?" These hearings will analyze what we expect our tax system to accomplish and whether it effectively meets those objectives.

Of course, the tax code should raise the revenue necessary to finance the operation of the country. We also want our tax system to stimulate economic development, encourage business activity, and promote fairness and certainty. We want it to minimize compliance costs and administrative costs to taxpayers.

So how does our current system rate? Today's witnesses will help us answer that question. They will examine the tax code's effect on job creation and broad-based economic growth.

Today, we have 7.5 million fewer jobs than when the Great Recession started. These lost jobs have caused unimaginable family hardships, and high unemployment has also meant less Federal revenue and a worsening debt crisis.

We need a tax code that supports putting Americans back to work. We also need a tax code that does all it can to ensure the long-term prosperity of our country.

I will be asking our panelists if the tax code encourages investors to take healthy risks and make sound investments or does it encourage unhealthy risk-taking and investing in underperforming assets?

For example, corporations currently receive a tax deduction when they pay interest, but not when they pay dividends. As a result, businesses may choose to obtain capital through borrowing rather than through issuing stock.

We need to know whether these incentives cause businesses to become overleveraged in a way that hurts our economy. We also need to know whether the tax code encourages individuals to make positive decisions that strengthen widespread economic growth.

For example, there are dozens of provisions in the tax code that incentivize individuals to save for major expenditures like retirement, education or health care spending. Incentives that help individuals save for specific expenses are the third-largest tax expenditure in the code. They cost more than $124 billion in 2011.

A recent White House report found that this plethora of choices can actually have a negative effect on individual investment, because many people are intimidated and confused by the range of choices and complicated rules for each.

So let us ask how the tax code is positively and negatively affecting individual and business decisions. Let us question what more we can do to incentivize job creation and widespread economic growth. And let us determine how we can ensure our tax system drives our economy into the future rather than putting the brakes on it.

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

The CHAIRMAN. Senator Hatch?

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Thank you, Mr. Chairman. I commend you for holding these hearings on tax reform. Tax reform is greatly, desperately needed by our Nation, and these hearings are a necessary first step in that reform process.

I want to make it clear that I do indeed believe that the tax system supports job creation for CPAs and tax attorneys. I am also confident that the tax system leads to broad-based economic growth, at least in China.

Our guiding principle for tax reform should be "do no harm." As bad as our current tax code is, it could actually be worse, and that is an awful thought, I know.

Now, these many hearings we will have on tax reform should reduce the chance of making the tax code worse and increase the chance of making it better. The topic for this hearing is economic efficiency, job creation, and growth.

I am really looking forward to what our four witnesses have to say on these topics, and I am sure we will gain some very helpful insights.

Allow me to first share, however, a few of my initial thoughts on this topic. There are necessary and proper functions for our Federal Government to perform, and these functions should promote economic efficiency, job creation, and growth.

A good example of a necessary and proper function of our Federal Government is, of course, providing for the national defense. By creating a secure environment at home and abroad for Americans, the military promotes economic efficiency, job creation, and growth. Federal taxation exists to fund these necessary and proper functions.

In general, I am inclined to believe that the effect of Federal taxes upon the taxpayer is to reduce economic efficiency, job creation, and growth, and I acknowledge that there may be very limited circumstances where taxes could reduce a given activity that has what economists call, "negative externalities."

Now, negative externalities exist when individuals sometimes engage in activity that, although helpful to the individual, has harmful consequences to society at large. Tax can discourage such harmful activity.

That is, a tax applied to negative externalities could actually enhance economic efficiency. The circumstances where this would be the case probably are quite rare or very rare indeed, Mr. Chairman.

I want to reiterate that, in general, the effect of taxes upon taxpayers is to reduce economic efficiency, job creation, and growth. Reduce them. But there still is a question of degree. Does one particular tax system reduce economic efficiency more or less than some other tax system?

It is my belief that high marginal taxes or tax rates can discourage at the margin productive activity and encourage more leisure and consumption. Now, this can reduce efficiency and growth and, along with it, job creation.

Many call for a more progressive tax system, and I think this just means higher marginal income tax rates for higher-income

people. If it means something other than that, I would like someone to just tell me.

Higher taxes for high-income people can, in turn, mean that such people opt for consumption and vacation rather than investment and work. The investment such people would have done in new plant and equipment and new business ventures would have led to additional job creation for others.

But because of progressive taxation, certain high-income persons will not invest. By not investing, some jobs that would have been created are not created. Some of these jobs would have been filled by lower-income people.

So, ironically and sadly, progressive taxation sometimes may hurt lower-income people the most. And I am sure that is not what anybody wants, but that is an unintended consequence of progressive taxation, at least in my view.

President Kennedy had it right when he said that, "A rising tide lifts all boats."

Again, Mr. Chairman, I want to thank you very much for this important series of hearings that you have called on tax reform.

Thanks very much.

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

The CHAIRMAN. Thank you, Senator. Now, let us go to work. I would like to introduce our witnesses.

First is Dr. Alan Auerbach, professor of economics and law at the University of California at Berkeley.

Next, Dr. Glenn Hubbard, dean of the Columbia University Business School. Dr. Hubbard is a professor of economics and finance at Columbia.

The next witness is Dr. James Galbraith, professor of government at the University of Texas. Thank you very much for coming.

And, finally, Michael Graetz, professor of law at Columbia University Law School. A lot of Columbia here. Thanks very much for coming, all of you.

You know our drill here. We will introduce your statements into the record. Speak about 5 or so minutes.

I encourage you, do not pull any punches. Let her rip. Say what is on your mind. Life is short.

Dr. Auerbach?

STATEMENT OF DR. ALAN AUERBACH, ROBERT D. BURCH PROFESSOR OF ECONOMICS AND LAW, UNIVERSITY OF CALIFORNIA BERKELEY, BERKELEY, CA

Dr. AUERBACH. With that introduction, Mr. Chairman, thank you for the invitation to be here, Senator Baucus, Senator Hatch, Senator Rockefeller.

It is a great pleasure to be here, I should say once again, to talk about tax reform, because this has often been an issue of importance before this committee. I think it is particularly important now.

Now, some might ask why, given two very significant problems that we have in the U.S. economy right now, why we should be thinking about tax reform. Those two problems I am thinking of are the very high unemployment we still have that the chairman

mentioned, as well as the very high and growing national debt that we have to deal with soon.

I think that tax reform is not necessarily inconsistent with economic recovery from the recession, and, perhaps of equal importance, I think it is complementary to dealing with the very large deficit problem we have, and I think there are three reasons for that.

First, as Congress thinks about very substantial cuts in discretionary spending, as it has been recently, it makes sense to think about cuts in tax expenditures, too, because there are a lot of programs which one might call discretionary programs which occur through the tax code as well, and thinking about those programs at the same time as one thinks about direct discretionary spending I think makes sense.

Second, additional economic growth can generate additional tax revenue. And, although that is not the most important consequence of economic growth, it is certainly something worth keeping in mind, given how desperately we need additional revenue.

Third, if it turns out to be the case that we do have to raise taxes as part of the solution to our deficit problem, then we need to have as efficient a tax system as possible to do so.

As I put it in my testimony, a bad tax system gets worse as we try to raise more revenue from it. So I think tax reform is certainly a relevant issue to be considering today, even in the face of our other economic problems.

Now, there are many issues that one can contemplate in thinking about tax reform. I focus on two areas in my testimony: one, tax expenditures and, the other, the corporate income tax, because I think these are both areas of importance in thinking about tax reform.

And with tax expenditures, I would just point out, first of all, the concept of tax expenditures has historically been somewhat controversial, because one person's tax expenditure is another person's normal provision or tax incentive. And I argue in my testimony that this dispute is really beside the point.

We do not have to call it a tax expenditure. We can call it a tax incentive. We can call it a normal part of the tax code. Whatever we call it, it is still worth asking whether this provision, if it costs a lot of revenue, is worth having, given how scarce resources are in our government budget.

Now, I give some examples where I think it is not, and one example I used is the home mortgage interest deduction. I do not mean to single that out as the worst or the only one, but it is just a good example.

And there are two problems with tax expenditures like this. First of all, to the extent that we have them there to accomplish a certain objective, for example, home-ownership, this provision does so in a very expensive way. That is, we could accomplish—promote home-ownership much more cheaply than we do through the mortgage interest deduction.

Moreover, the provision as it is currently structured does not simply cost too much to accomplish its objective, it actually leads to overinvestment in housing.

Now, you might say, “Well, what is wrong with housing?” Well, there is nothing wrong with housing, but, if it comes at the expense of investment in productive plants and equipment, it means lower productivity, lower wages in the economy. And so it comes at a cost, and that is true of any other tax expenditures, whether it is tax expenditures benefitting State and local governments, tax expenditures related to the exclusion of employer-provided health benefits, to mention a couple of other very large tax expenditures.

So I think it makes no sense to leave tax expenditures unscrutinized when so much attention is being paid to direct discretionary spending.

The other topic I focus on in my testimony is the corporate tax. There is no doubt that the U.S. corporate income tax right now is something of an outlier among leading economies. We have one of the highest corporate tax rates, and we are really the only leading economy that still attempts to tax the worldwide income of our resident corporations.

Now, that has led many to suggest that we should adjust both of those aspects of the corporate tax, lowering the corporate tax rate, moving to a territorial tax system, and perhaps paying for it within the corporate sector itself by reducing corporate tax expenditures.

I think there are a couple of problems in this approach. The first is that the corporate tax expenditures that might be reduced to pay for a rate reduction, moving to a territorial tax system, themselves might undercut the objectives of these reforms, and, particularly, raise the cost of capital.

For example, if you were to scale back accelerated depreciation in order to pay for a corporate rate cut, you would not necessarily encourage investment.

The second problem in moving to this kind of tax system is you would still leave many of the flaws of the corporate tax system in place. There would still be incentives for companies to engage in transfer pricing, shifting profits to lower-tax countries. In fact, that might even be exacerbated by moving to a territorial system. And there would still be the incentive for companies to borrow that the chairman mentioned associated with the interest deduction.

So I think one needs to focus also on domestic reforms. I suggest in my testimony moving in the direction of a corporate cash flow tax, which would perhaps even eliminate the interest deduction, but also increase depreciation allowances, going all the way perhaps to full write-off of investment to maintain incentives for companies to invest domestically.

And at the same time, one needs some sort of foreign tax provisions to deal with the transfer pricing problems which exist under our current system and would exist under a territorial system, as well.

The 2005 bipartisan President’s Advisory Panel on Tax Reform suggested border adjustments for a cash flow corporate tax. In a recent paper I wrote, I suggested an alternative approach, which I think would have the same effect to discourage companies from shifting profits and perhaps investment abroad.

In closing, let me say that I think both of the types of reforms that I have laid out in my testimony would be progressive in na-

ture, because many of the tax expenditures we have, if structured more properly and at lower cost, would be primarily benefits for lower-income individuals.

A lot of the other benefits that we currently have through these tax expenditures are unnecessary. And, if we can reform the corporate tax to encourage more investment in the United States and less investment abroad, then that will help productivity, investment in the U.S., and ultimately lead to higher wages for American workers, which is certainly progressive, as well.

Thank you.

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

The CHAIRMAN. Thank you, Dr. Auerbach. That is very interesting.

Dr. Hubbard, you are next.

STATEMENT OF DR. R. GLENN HUBBARD, DEAN AND RUSSELL L. CARSON PROFESSOR OF FINANCE AND ECONOMICS, COLUMBIA UNIVERSITY GRADUATE SCHOOL OF BUSINESS, NEW YORK, NY

Dr. HUBBARD. Thank you, Mr. Chairman and Senator Hatch, Senator Rockefeller.

I think you are holding this hearing at a particularly important time. For all the reasons that Alan has already mentioned, tax reform is likely to accelerate in its importance, and, indeed, it is probably the most powerful tool that the Congress has to promote economic growth.

Done right, I really cannot think of a single other area of public policy where you have that kind of significant potential to change the economy's growth rate. And it is especially vital at a time when, as a Nation, we are going to have to make a fiscal adjustment.

Most of the recent discussions of tax policy have centered too much, in my view, on the short term or debates over stimulus. A good tax policy is really about the long term, and getting the long term right affects our conditions in the short term, too.

As part of a general story, the Nation needs to rebalance itself a bit toward a greater emphasis on saving and investment, and tax changes can facilitate that transition. And I would note, for the concern you raised, Mr. Chairman, about unemployment, as well, that higher rates of investment would be the best antidote for our unemployment problem in the country.

So what I wanted to do briefly was just touch on three things with you: one, some benchmarks for thinking about this; two, some specifics about tax reform; and three, where to start.

In terms of benchmarks, Alan and I were kidding each other at the beginning, what is the quickest way to sum up for you, and it is broaden the base and lower the rates; that is still sound advice.

But to think about, more formally, what a benchmark is, it would be a tax reform where income is taxed no more than once. And there are income tax ways of doing this and there are consumption tax ways of doing this, but they share some features in common.

Addressing the distinction between debt and equity that is made in the tax code that you raised, Mr. Chairman, in your opening re-

marks, relates to the way we treat investment spending and depreciation and to the corporate tax.

Some specifics. Fundamental tax reforms typically share some basic things. One is that they tend to be a combination of a business-level tax—it could be a cash flow tax or a business income tax—and then a household tax. In an income tax version of that, we are trying to get depreciation right. In a consumption tax version of that, which I would urge you to consider and Alan has already mentioned, there would be complete expensing. So it would be a cash flow tax.

The business-level tax in either case, in a reformed system, would not distinguish between debt and equity financing, and that is very important in removing the over-leverage incentives that we have in the tax code.

Some examples of this, in the blended income and consumption tax, would be the President's advisory panel growth and income tax plan. A pure consumption tax version of this is something like the flat tax from Hall and Rabushka. But moving anywhere in this direction is an improvement.

So, how to start? I think for all the reasons Alan already mentioned and, Mr. Chairman, you raised and Senator Hatch raised in opening remarks, we need to focus first on the corporate income tax.

It is not just the case that the U.S. statutory corporate rate is too high. Despite some complaints to the contrary, the U.S. effective tax rates are also out of line. The U.S. corporate tax simply is a problem for investment and job creation in the U.S. It needs to be changed.

Estimates of revenue-maximizing corporate rates in industrial economies tend to be in the mid- to high-20s, suggesting that there are ways to cut the corporate tax without even a number of offsets, unless you want to really cut it to very deeply discounted levels from current law.

The second piece I would urge you to start with is territorial taxation. Not only is the corporate tax itself a problem, the way we tax multinational corporations is a problem. It is costing the country income and jobs, and there is an easy way to deal with this by really just moving toward a more territorial tax system, particularly in the context of shifting to something like that growth and investment tax plan that I mentioned earlier.

And the third step in how to start is doing what you are doing now, which is tackling fundamental tax reform with a series of hearings to build consensus, using reform of tax expenditures, as Alan mentioned, to assist both with the budget issues and with any distributional concerns that you rightly have.

Bold entitlement reform also, I think, will give you flexibility to do more on the tax side.

So to sum up, I commend you for these hearings. I would note, of course, that tax reform also requires presidential leadership, but you are starting in exactly the right place.

It seems the tax policy at the moment is stuck in the familiar maxim of "in the long run, we are all dead," but the long run really is not a rehab center for bad short-term policy.

Let me go to a non-economist to close, so what Thoreau said was, "In the long run, men only hit what they aim at."

Thank you, Mr. Chairman.

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

The CHAIRMAN. Thank you very much.

Dr. Galbraith, you are next.

STATEMENT OF DR. JAMES K. GALBRAITH, LLOYD M. BENTSEN, JR. CHAIR IN GOVERNMENT/BUSINESS RELATIONS AND PROFESSOR OF GOVERNMENT, UNIVERSITY OF TEXAS AUSTIN, AUSTIN, TX

Dr. GALBRAITH. Mr. Chairman, Senator Hatch, Senator Rockefeller, it is an honor to be here.

As you know, I hold the Bentsen chair at the LBJ school.

The CHAIRMAN. I did not know that. Very good.

Dr. GALBRAITH. It was very nice to see his portrait in the anteroom.

The CHAIRMAN. That is wonderful.

Dr. GALBRAITH. My statement has brief preparatory remarks on the deficit, and I argue that it is principally an outcome dependent on economic performance, and the goal, therefore, should be improved economic performance.

This hearing is focused on efficiency, and so I will pass rapidly to that topic.

As an opening remark, I should say I think there is no such thing practically as a neutral tax. The right question is not how to get rid of incentives, but which incentives are appropriate and for what purposes.

The Tax Reform Act of 1986, to take an example, evolved from work in which I was involved as staff director of the Joint Economic Committee from 1981 through 1984. It was a remarkable reform of a code overgrown with deductions and loopholes, and it was an adroit, bipartisan effort that saved the income tax.

But in the long run, I think we can see even from this effort at least two broadly undesirable and, I think, unintended effects.

The first is that the structure of lower marginal tax rates, which, of course, dates back before the 1986 act, helped to foster the explosion of CEO compensation. The previous structure of high tax rates had been put in place in the second World War to deter that kind of pay structure. And when that deterrent was removed, the pay structures that we have now emerged, with serious consequences for corporate governance.

Secondly, the compromise that left interest deductions in place only for housing, it seems to me, almost surely contributed something substantial to the overleveraging of American households, over-borrowing against their houses, and to the bubble, and to the subsequent bust, which has left a very large fraction of the American middle class essentially insolvent and under water on their mortgages.

There is, I think, no compelling evidence, in retrospect, that any of the tax law changes of the 1980s delivered the promised long-term improvement of accelerated economic growth, and there is no real reason to think that they should have, when you consider that

the major factors determining long-term economic growth are demographic and technological. And even the overall rates of saving and investment do not seem to be terribly amenable to being influenced directly or sustainably by changes in the tax code.

Going forward, therefore, I see very little reason from this experience to make lower marginal rates or the elimination of deductions, as such, goals for their own sake. Certain deductions which have remained in the code, the interest deduction on good mortgages, the earned income tax credit or the deduction for municipal bonds, it seems to me, serve important purposes well and should be preserved.

There are, of course, other taxes that have important incentive effects. The payroll tax is, in my view, a nasty piece of work that penalizes job creation, fosters tax evasion, and promotes the gray economy.

The estate tax, on the other hand, is a tax which has been part of our social architecture for a century and provides a powerful incentive to philanthropy, which has helped to build a sector in our country that exists, I think, practically nowhere else in the world and that provides about 8 percent of all of our employment. So much of the social tension that would otherwise be associated with very high levels of inequality is diffused by the vast amount of philanthropic activity that the estate tax helps to promote.

I am a skeptic about simplicity for its own sake. I think that there are issues that should be considered very, very carefully in thinking about any major change in the tax code; in particular, the effect on State and local governments that have integrated their tax systems into the Federal system needs to be considered very carefully, particularly at this moment when States and localities are suffering from a major, major fiscal crisis.

As far as the broad principle on which you may choose to proceed, what should be the objective? What should be the burden of taxation?

The classical political economist felt that it should not be either labor or profit, either wages or profits, but rather in conceptual terms, economic rent. That seems to me to be a sound principle, if one can design a system that focuses on rents.

Senator Hatch, in your opening statement, you noted that the tax system of China is effective in that way. One of the things that is interesting about China is that they do tax economic rent, principally because the government acts as a landlord and is able to do that, which gives municipalities and provinces in China access to resources that enable them to conduct massive investments without the distorting effects of sales or income taxes.

Our priorities going forward, as my colleagues have said, are jobs. I believe we have an important problem with energy security, important environmental problems; the need to rebuild our infrastructure is extraordinarily urgent.

We still need to address the problem of financial reform. I believe we have a problem of maldistribution of income and power. And all of these issues can be improved by suitable changes in the tax code.

Thank you.

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

The CHAIRMAN. Thank you very much, Dr. Galbraith.

Mr. Graetz, you are the cleanup hitter.

STATEMENT OF MICHAEL GRAETZ, ISIDOR AND SEVILLE SULZBACHER PROFESSOR OF LAW, COLUMBIA LAW SCHOOL, NEW YORK, NY

Mr. GRAETZ. Thank you, Mr. Chairman. I appreciate being invited back here, particularly——

The CHAIRMAN. I do not know if your microphone is on.

Mr. GRAETZ. Now it is on.

The CHAIRMAN. Yes. Thank you.

Mr. GRAETZ [continuing]. Particularly being the only mister on a panel of all of these doctors.

It is clear that the question that the chairman put at the beginning of this hearing, which is "Does the tax system support economic efficiency, job creation, and broad-based economic growth?" has an answer that is so obviously in the negative that even a lawyer can answer it. You do not need an economics degree to know this.

The one area of the economy where the tax system is a robust job-creating machine is the area of tax return preparation software, tax planning, tax controversies, and tax compliance.

The distortions that our economist friends talk about are so numerous, so rewarding to the well-advised, and frequently so complex to comprehend and to comply with that they serve to produce millions of well-paying jobs that are immune from the ups and downs of the business cycle. So we and our students thank you for that, and your colleagues in the Congress.

The tax distortions that we have talked about are important. I just want to say that I think that the task of this committee is much more complicated this time than it was in 1986, and, as you know, it was difficult enough then.

Let me mention three points along that line. First, we have never faced such a dangerous ongoing imbalance between revenues and spending. Our debt has reached a level that it had not reached since the post-war era. During that time, we owed all of the debt we had borrowed, virtually 98 percent of it, in fact, to Americans. Europe and Japan were in a shambles. China was entering a dark communist era. And now the CBO projects that the debt will be in excess of $20 trillion in 10 years. If we are able to borrow at 5 percent, that is $1 trillion a year that we will be paying to other people. And so we really have to get our debt in order.

That does not mean that we need to increase revenue in the first stage of tax reform. We can have a revenue-neutral tax reform, but we need to have a tax system that will promote economic growth and that will allow us in the future, if we need to, to produce more revenues without inhibiting economic growth.

Secondly, as some of my colleagues have pointed out, the American system is currently producing very unequal rewards to the American people. Distribution of income and wealth is more skewed toward the top than it has been at any time since the 1920s.

So that fairness in tax reform requires that we not shift the tax burden down the income scale, and, in fact, it would be nice if we

could conceive of a system that would allow us to have an even more progressive system, at least on the top small percentage of the wealthiest in the country, without raising tax rates in the way that Senator Hatch has suggested would be so detrimental.

Finally, the U.S. economy now has to compete for investment capital around the world, including not only Europe and Japan and China, but also Brazil and Russia and India and other countries.

The United States needs domestic investment by both foreigners and U.S. citizens, and we are now in a situation where corporations and other investors, including sovereign wealth funds from countries that may not all be our friends, can move money quickly and easily around the world at the click of a mouse, and this makes it much more difficult for the United States or any sovereign nation to tax income and to do so in a way that ignores what is going on in the rest of the world.

In fact, our international tax rules, which were designed in the early part of the 20th century, and the concepts of residence and source are now, where corporations are concerned, concepts built on quicksand. With the highest corporate tax rate in the world, we have an incentive for people to borrow here and shift income abroad. This is exactly backwards, in my opinion.

And as my other panelists have said, the classical corporate tax system that we now have increases the cost of capital for U.S. companies, discourages new equity investments in corporate enterprise, creates incentives for share repurchases instead of dividend payments, and encourages the issuance of corporate debt instead of new equity.

We have tried to solve some of these problems by reducing the tax on dividends at the individual level. Professor Hubbard and I were at the Treasury together when the proposal that the Congress ultimately adopted was designed.

I say in my testimony—I am happy to answer questions about it—that this was wrong. It is wrong now. It may not have been wrong then, but it is wrong now.

The way to get progressivity, the way to tax income from capital is no longer at the corporate level, in my opinion. It is at the individual level. And I suggest in my testimony a way to convert part of the corporate income tax into a withholding tax, a creditable, but non-refundable withholding tax on dividends and on interest paid on new corporate bonds.

I also talk in my testimony about the effect not only of borrowing in the United States, but of the countries where the investment which is funded through that borrowing occurs not allowing an interest deduction. So that we are, in effect, giving a break to borrowing here under circumstances where China is taxing more than the income if the investment is there because of not allowing an interest deduction.

Mr. Chairman, I think that one of the big differences between me and my colleagues—my economics colleagues on the panel—is that I believe that any tax reform that the U.S. engages in must fit well with international arrangements.

The cash flow tax, which has been suggested by Professors Auerbach and Hubbard, would violate our trade treaties. It would violate all of our income tax treaties, and it will be difficult enough

doing a serious tax reform through the U.S. Congress and the President of the United States without having to renegotiate every trade and tax treaty with the rest of the world.

I close my statement, as you know, Mr. Chairman, with a review of a plan that I have offered before, which involves imposing a value-added tax, using it to fund an exemption for $100,000 to remove 150 million Americans from the income tax altogether, lowering the corporate tax rate to 15 percent, and replacing the earned income tax credit with debit cards and payroll tax offsets.

The Tax Policy Center is in the process of estimating the revenue and distributional aspects of that plan pursuant to a contract with the Pew Charitable Trusts, and they have allowed me just to suggest that their early efforts suggest that all you need is a 14- or so percent rate on the value-added tax, you can have a 15-percent rate on income above $100,000, a 25-percent rate on income above $250,000, and a 15-percent income tax on corporations, and be revenue and distributionally neutral.

I know that there is great reluctance in the Senate of the United States and elsewhere to the idea of a value-added tax. It is used throughout the industrial world. We are the only OECD country that does not have one, but we are tying our hands behind our backs by relying only on an income tax.

We are a low-tax country, but we are not a low income tax country. And if we want to succeed in the global economy, we need to be a low income tax country, but maintain our standards of fairness in the process.

Thank you, Mr. Chairman.

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

The CHAIRMAN. Thank you, Mr. Graetz. That was interesting and provocative. Lots of questions.

One, just to begin, is the development of pass-through businesses in America. And, as we try to reform the corporate code, right away, you get into the question of pass-throughs, and that is the individual side.

I would like all four of you to just kind of talk about this a little bit. Is that symptomatic of a problem, development of pass-throughs, because we have many more—I mean, talking about large companies that are pass-throughs, not small, but larger.

I have been to other countries, OECD countries, and I have my ideas of why it has developed. I would just like you to tell us whether that is a problem, is it not a problem, pass-throughs.

You can approach it any way you want.

Dr. HUBBARD. I think you are absolutely right, Mr. Chairman. Absent reform, it could well be a problem, particularly if the top marginal personal rate and the top corporate rate were to diverge in changes that you make.

That is why in my remarks I said you should contemplate business taxation. So, whether you call something a pass-through entity, a C corporation, whatever you choose to call it, if it is engaged in business, it would face the identical tax structure.

Otherwise, you do very much have to worry about the problem that you mentioned.

The CHAIRMAN. Anybody else?

Dr. AUERBACH. Well, I would just say that it makes sense to—the U.S. is pretty unusual in having such a large and flexible provision for avoiding corporate tax by, for example, being an S corporation. And, if you were to reform the corporate tax and make the corporate tax less burdensome, first of all, I think it would lessen the problem of companies shifting out of C corporate form, but you also might contemplate extending the reformed corporate tax to large non-corporate businesses.

Non-corporate businesses now account for nearly half of all the income—all business income earned in the U.S. That is a much bigger share than it was a few decades ago. And it does not make sense to have two very different tax systems applying to businesses that operate in similar fashion.

Mr. GRAETZ. Mr. Chairman, two-tenths of 1 percent of the largest partnerships, which are those with over $50 million in revenue, accounted for 60 percent of all partnership income last year. And we like to think of these flow-through businesses as if they are small businesses.

But, in fact, both foreign corporations and large entities that do not need access to the public capital market, but who can raise their capital in a private way, are foolish if they do not organize themselves as non-corporate businesses.

So I argue in my testimony that we really ought to divide the world between large companies and small businesses, enable ourselves to really simplify the law for genuinely small businesses, but not allow the corporate tax to be elective for large businesses, whether they are domestically owned or whether they are foreign owned, so that new companies have the option whether to pay the corporate tax and where to pay the corporate tax.

And my students would not get a passing grade if they said, let's set up a new company that does not need public capital as a corporation, and they would not get a passing grade if they said, let's set it up with headquarters in the United States instead of in a different country.

The CHAIRMAN. Dr. Galbraith?

Dr. GALBRAITH. I have nothing to add.

The CHAIRMAN. Sorry?

Dr. GALBRAITH. I have nothing to add, Mr. Chairman.

The CHAIRMAN. So does the bias toward debt financing in this country have any effect on the development of pass-throughs or not? That is independent of whether you are a C corp or whether——

Dr. AUERBACH. Well, it actually reduces the use of pass-throughs because, to the extent that a C corporation is financed by debt, it effectively is a pass-through entity, because the earnings are only being taxed to the investors in the company, not to the company itself.

That is not a good reason for keeping the current imbalance between debt and equity, but, given the distorted current tax system, it does lessen the incentive to move out of the C corp.

The CHAIRMAN. Do you all four tend to agree it makes better sense to divide the tax system into two parts, those who have business income as opposed to non-business income, as Mr. Graetz suggests, irrespective of whether you are a C corp or a pass-through

or wherever you are? If you are big in your business, you should be taxed a certain way. If you are small, I guess to a business, that is a different way. And the third way, if you are just not in business, either large or small, then just be treated as an individual.

Dr. HUBBARD. I absolutely agree with that, Mr. Chairman. As I said in my opening remarks, you really should have a business tax system that is uniform across businesses and essentially a household wage tax, and you could do that in a very progressive way.

But I think keeping separate business taxes, distinctions between debt and equity financing, this is where you get the distortions in tax planning.

The CHAIRMAN. My time is up. But I guess you all agree there is too much distortion between debt and equity. That is to say, current tax law encourages too much debt expense and too little equity financing. Would you tend to agree? Does anybody disagree with that?

Mr. GRAETZ. Well, it encourages both debt—whether the tax law—let me say one thing. Whether the tax law encourages debt or equity depends on relationships and rates, and this is another reason that I do not think you can do corporate tax reform apart from individual tax reform.

It depends on what your dividend rate is, what your corporate rate is, and what your rate on your taxation of interest is at the individual level.

The current corporate tax certainly discourages financing through new equity compared to either retaining earnings or debt in the current system. And the debt problem is a serious problem.

The difficulty is that the corporate tax is owned—the corporations are owned and receive capital from both tax-exempt U.S. shareholders and tax-exempt foreign shareholders.

And so, if you reduce the corporate rate, you really are reducing the tax on those entities, which now pay tax on equity, which is not clearly a priority for tax reduction in this case.

And so I think that you really have to think about a proposal of the sort—assuming you are not going to a cash flow tax, which I assume you are not, since no one else in the world has such a tax. But maybe you will. But, if you do not go to a cash flow tax or you deny an interest deduction—which, as I say, would conflict with all of our treaties and international arrangements—if you do not go to denial of interest deductions, then something along the lines of the withholding idea that I suggest in my testimony is designed to narrow the gap between equity and debt.

The CHAIRMAN. Thank you very much. I am way over my time.

Senator HATCH. Thank you, Mr. Chairman. I would like this question to go to the whole panel.

The fundamental question that all of us have to answer is this one. Where do you think the top marginal tax rate should be? And we believe that efficiency is important in determining what the top rate should be.

Assuming revenue neutrality against current policy as one of the ground rules for reform, would any of you think that a top rate higher than the current 35 percent would yield efficiency gains?

I might as well start with you, Dr. Auerbach.

Dr. AUERBACH. I will speak for myself. I think it is obvious that it would not. Raising the marginal tax rates does not improve efficiency, certainly in this case. The argument for raising marginal tax rates would have to be based on a belief that it would lead to a more progressive tax system.

We have lived with higher marginal tax rates in the past. I do not think the world would end if top marginal rates went up. But I would not view that as a measure to be taken in isolation. I think if that were to be done, it should be part of a much broader increase in taxes, if an increase in taxes is what you decided you need. And there are a lot of other places I would increase taxes, as well, if I were to increase taxes.

Senator HATCH. Dr. Hubbard?

Dr. HUBBARD. Well, Senator Hatch, I would begin and end my answer with the word "spending" and then I will put "tax" in the middle. Begin in the sense that your first instruction needs to be how big you want government to be. The tax system is going to pay for that.

I think we are currently on a trajectory for a very, very large government, and that seems to me the first-order question for you.

On the tax piece, I think it is important what kind of tax system. If we had a broad-based consumption tax in place, we could deliver progressivity with modest marginal rates on income for high-income people. That is not a problem.

But, also, I want to close on spending on the progressivity side. Sometimes people talk about progressivity, speaking of only one side of the government's ledger. The spending side matters, too. We can change progressivity by changing tax expenditures, by changing the distribution of Social Security and Medicare benefits.

So I would urge you, as you think about how progressive you want the fisc to be, that you not lose sight of that.

Senator HATCH. Thank you.

Dr. Galbraith?

Dr. GALBRAITH. Well, Senator, I think it depends upon what level of income the higher marginal rates kick in, to what levels they apply.

When very high rates were instituted at the start of World War II, they were applied only to the very highest incomes, and their purpose was, in part, to deter entities from paying salaries that would be subject to those tax rates.

As you know, the history of that period was one in which, after the war, these rates were eroded de facto with exemptions and deductions until such time as 1986, when we got to the point where we could have a revenue-neutral comprehensive reform with lower rates and a broader base.

I think at the appropriate income level, there is no necessary efficiency loss to the economy as a whole with a higher marginal tax rate, and there may be reasons to go that way in the context of a broader package of reforms.

Senator HATCH. Mr. Graetz?

Mr. GRAETZ. Senator Hatch, I would try to keep tax rates low. I believe it is particularly important for the corporate rate, and I think if you get too big a disparity between the top individual rate

and corporate rates, people will move their income into the corporate form as a way of avoiding the high rate.

So I think there are limits on what you can do about rates. I do think that, if we tax both spending and income at the top, we would have a chance to do so at lower rates than we do. And there are some very serious anomalies in the current system.

The inability of the Congress, despite the Senate having passed it a couple of times, in my recollection, to tax carried interest of private equity as ordinary income instead of at 15-percent capital gains rates, for example, at the very, very top, seems to me to be very difficult to defend.

So I think there are ways to get more progressivity in the system by reform, but I would urge you to try to do it keeping the top rate as low as possible.

Senator HATCH [presiding]. Thank you. My time is up.

Senator Rockefeller?

Senator ROCKEFELLER. Thank you. Dr. Galbraith, I guess that I identify most with your testimony as written and given.

I am not comfortable with a $14-trillion debt. I do not think you are either. I am not comfortable representing a State like West Virginia where the unemployment rate is out of sight. Social problems are really spiraling upwards—or downwards, however you want to put it.

It is quite extraordinary to live there and watch what is going on. So I tend to look at things a little bit from that point of view, since I have been there for about 50 years.

I want to ask you a provocative question. Everything in the way of conversation in the Senate and the Congress tends to be about reducing debt, reducing the deficit, but most importantly, cutting spending. You cannot separate those, of course, but cutting spending, cutting spending on the very things that sort of give promise to the future, the America Competes Act, Head Start, all kinds of things like that——

So I want to ask you what ought to be actually a difficult question for you to answer. It may be or may not be, but I am going to ask it anyway just to find out what you think.

What, in your judgment, is a bigger threat to the American economy and its future: cuts to low-income programs like the earned income tax credit, which you mentioned, the child tax credit, which I think you mentioned, but I am not sure, or focusing, as appears to be the habit around here, virtually exclusively on reducing the deficit and debt?

Dr. GALBRAITH. I think we have seen, Senator, an enormous decline in the economic security and, to some degree, in the living standards of the working population of this country in consequence of the Great Recession, the financial crash, the rapid decline in the value of housing.

This is a problem which is going to be here with us for a long time, and I think it is playing with fire in important respects to aggravate that problem at this time by cutting those parts of the Federal programs which provide relief and assistance to working and low-income Americans.

In terms of the functioning of our economy and the level of our national debt, I think the experience is that the debt goes up in re-

lation to GDP when our economy is functioning at sub-normal rates and comes down in periods of growth. It came down—as a result of the war, it was over 120 percent of GDP in 1946, much higher than the present levels, and declined consistently to about 33 percent of GDP by 1980.

The way to achieve that is to have balanced economic growth, funded, in strong part, by a strong domestic financial sector.

And the financial sector is precisely what was most severely impaired in the last 3 years, and without restoring it to the function that it should be performing of supporting economic activity and economic growth, I do not think what you do here with taxes and spending is going to effectively reduce the realized deficits. But I think they will more likely impair the functioning of the economy going forward, leaving you with just as large a debt, just as big a deficit or nearly so, as you would have had.

Senator ROCKEFELLER. In essence, then, you could be saying that we can reduce the deficit by cutting all kinds of huge programs, but that, if we ignore the future aspirations and capabilities—and I am thinking of the America Competes Act, all the things of that sort—that in the long run, we do our country more damage.

Dr. GALBRAITH. That is absolutely right, in my view, yes.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Carper, you are next.

Senator CARPER. Thanks, Mr. Chairman.

Mr. Chairman, I do not know if you all have been watching movies much lately, but my wife and I went to a little theater in one of the old DuPont buildings. They have an auditorium there called Theater N, as in November. And we went the weekend before last, before the Academy Awards, and there was a movie—they were showing a movie, it was like a documentary called "Inside Job."

And how many times do we hold a hearing where we actually have as a witness, one of the stars of an Academy Award-winning film?

Dr. HUBBARD. I did not get the statue, Senator. So I was concerned by that. [Laughter.]

Senator CARPER. Well, maybe later on, like in subsequent years when you win your second Academy Award, you can—who was the gal who used to play Gidget? Sally Field. Remember Sally Field, on her second Academy Award, she said—she accepted it, and she said, "You really love me, don't you?" And if it happens again, you can use that line maybe.

But that was an interesting film. I think you are to be commended for appearing in it, although it probably was not the most fun. This has to be a lot more fun than going through the filming there. So thanks for that. Thanks for this, too.

I want to go back to Mr. Graetz's comments. You are the one person here who is a professor or a dean or something who is a mister, not a doctor. And why is that?

Mr. GRAETZ. Well, I went to University of Virginia, and Mr. Jefferson insisted on being a mister. That is true, but I do not have a doctoral degree.

Senator CARPER. Good. Well, neither do I.

Mr. GRAETZ. I have a law degree and not a doctoral degree. I think now it is called a J.D., and you can claim to be a doctor, but I have never thought that was appropriate.

Senator CARPER. Well, you may not have a doctoral degree, but you have some interesting ideas.

And I just want to ask our other three witnesses to take a minute and just think out loud with us about what he is suggesting about this value-added tax. It is not something I have ever been a big advocate of, but we are going to have to be thinking outside the box as we move forward on deficit reduction and we try to figure out how to reconfigure our tax structure in ways that are fair, in ways that promote economic development, in ways that provide certainty, in ways that support exports.

And listening to you talk about this, it sounds to me like you think that the value-added tax could be constructed to actually do most of those things.

So try to set aside how difficult this might be to get done politically. My guess is because it is so different, it would require some really heavy lifting. But I just want—I am going to start with our first witness.

If you all would just tell us what is good about this idea or trash it, if you want to. Go ahead.

Dr. AUERBACH. Again, at your suggestion, leaving politics aside, a value-added tax is one way of accomplishing a move toward consumption taxation.

Unlike a personal consumption tax, a VAT tends to be a narrower base. That is the experience in Europe and other countries that have value-added taxes. A lot of consumption is not subject to taxation, which makes the tax raise less revenue and be less efficient.

Nevertheless, I think it certainly is something worth considering. Whether to increase revenue, if you deem that necessary, or as a replacement for components of the income tax, as Professor Graetz recommends, it would be a big change, as you suggest.

And it certainly is not the only way to go, but it is something that should be on the list of things that you consider.

Senator CARPER. All right. Thank you.

Dr. Hubbard?

Dr. HUBBARD. I would broadly agree with what Alan just said, Senator. Indeed, when Michael and I worked at the Treasury together in the early 1990s, then Secretary Brady advocated this, with such a reform in the early 1990s. These ideas are still very good ones.

I do not think the U.S. is likely to move toward a literal value-added tax of the credit invoice, European variety, for the reasons Alan mentioned, but something like a subtraction method value-added tax could be done right at the business level. It is just business receipts minus the purchases from other firms.

But that is identical to the sum of a wage tax and a cash flow tax, which is exactly what Alan and I were talking about, and would make it much more flexible to implement.

Michael and I were kidding each other in the back room—he claims this is not implementable, I claim it definitely is—if the U.S.

takes this position, I think there is definitely a way to make this compatible with our international treaties.

But I think the notion of moving to consumption taxes as opposed to income taxes is one you definitely should take seriously.

Dr. GALBRAITH. I would be concerned, Senator, about three issues. The first I think is one of the reasons why we have not moved to the value-added tax so far, which is that we are a Federal system and the value-added tax would exist alongside existing State and local sales taxes, which would complicate matters for them.

Secondly, if it replaced the income tax, it would undermine State and local income taxation. State income taxation is keyed to the Federal tax system.

So I think one needs to be very careful about the effects of a major change on the overall ecology of taxation in the United States.

And the third issue concerns, if you did go this way, what would it replace and what would be the net effect on progressivity of that choice, and it seems to me that the tax to replace, if a tax is to be replaced, would be the payroll tax. Take one tax which is not, at best, moderately regressive and replace it with another one which is also moderately or, in many ways, substantially regressive. That would be a better choice.

Senator CARPER. Mr. Chairman?

The CHAIRMAN. Senator?

Senator CARPER. Could Mr. Graetz have like 1 minute just to respond, please?

The CHAIRMAN. Certainly.

Mr. GRAETZ. Thank you, Senator. Let me say, in response to these questions, what they say is true about the European or old value-added taxes, but, if you look at the modern value-added taxes in places like New Zealand, Australia, Canada, South Africa, Indonesia, others, the base is actually quite broad.

It is quite neutral across different forms of consumption and raises a lot of revenue at very low rates. The regressivity problems at the bottom and the progressivity at the top are issues that I really addressed very explicitly. I agree with them, I understand them, but they can be solved and still get a lot of people out of the income tax.

Canada has shown that State retail sales taxes can operate very well alongside of a Federal value-added tax. Over time—it has now been a decade—the Canadian provinces have at their election moved to conform, and there are great advantages of them doing so.

The State sales taxes are very burdensome, and, as they increase in rates, they are going to be extremely burdensome on businesses because they tax businesses multiple times. Some estimates are that a third or 40 percent of State sales tax revenue is multiple taxes on business income.

Well, that is not productive of efficiency and growth. And so a value-added tax actually has advantages for the States, as the Canadian provinces have discovered over time.

So I really think this is something that we ought to take a hard look at.

Senator CARPER. Good. Thank you very much. And thank you all for coming in here and giving us your thoughts.

Mr. Chairman, I know I went over my time. Thanks for letting me have it.

The CHAIRMAN. That is very interesting.

Senator Coburn?

Senator COBURN. Well, thank you, gentlemen.

Going back to a consumption tax, what would be wrong with just a flat consumption tax at every level in this country, with a rebate back for the necessities of life to every citizen in the country? You would keep progressivity. You would eliminate regressive taxation in terms of the payroll tax. And you would also markedly advantage our exports.

We are at a distinct disadvantage in this country today through our tax system in terms of being competitively viable internationally because of these embedded income taxes, where our European counterparts and several of the others do not have that, when we go to compete on the world market.

Would you all care to comment on that?

Dr. HUBBARD. Senator, I think you are exactly right that that would be a movement toward much greater economic efficiency.

I think the way to address the problems of low-income families is less through rebates for necessities, if by that you meant different taxes on different goods, but more to do something like the late David Bradford suggested, which he called an X tax, which would be a consumption tax that would provide for payments to lower-income families.

You could also add progressivity at the top to that with high-end wage taxes, if that were your preference. But I think you are absolutely right. The best answer on pure efficiency grounds for the country would be a broad-based consumption tax.

Senator COBURN. But you would maintain a significant amount of progressivity, as the higher incomes actually consume more. Correct?

Dr. HUBBARD. Well, the distribution of a consumption tax looks like distributions of lifetime consumption. So they are not regressive. You could add to progressivity, if that is your goal, by having high-end wage taxes on top of that, and you can address low-income families—which I would urge you is the better progressivity goal to follow—by having direct payments.

Senator COBURN. Any other comments on that?

Mr. GRAETZ. Senator Coburn, I think there is a problem in moving to a sales tax and eliminating the income tax entirely at the top of the income scale.

I understand that the rebate or prebate that you are referring to takes care or could take care of the bottom in the same way that the debit card that you swipe when you go through the grocery store in my proposal would take care of the bottom end.

But I do not think this is the moment where one should really shift the burden from the very, very top of the income scale downward. It just does not seem to me that it is something the American people will or should regard as fair.

And that is why I have retained some income tax at the very top of the system. The system I am talking about is a system that is

very much like the system that we had in effect before World War II, where we had consumption taxes for most people and income taxes only at the very top for the highest-income people. It was a small income tax, and it could be at much lower rates, because you are also taxing their consumption.

But I do not believe that you can get rid of the income tax entirely without having a serious issue about fairness.

Senator COBURN. You think it would be much more regressive in its ultimate effect?

Mr. GRAETZ. I think that if you do not have some tax on income or wealth at the very, very top of the income scale, you are going to eliminate burdens on that top half of 1 percent, a quarter of 1 percent which is earning so much of the income, owns so much of the wealth, at the expense—if you are going to have a revenue constraint—of raising taxes on people below that.

And I do not think a value-added and a sales tax are basically the same thing, except for how they are collected. I do not think a sales tax alone can satisfy that issue.

Senator COBURN. One other question. Would a consumption tax help us in terms of the misdirection of capital formation in this country? We have tax expenditures of $1.1 trillion right now, and I would contend that we are incentivizing misapplication and misdirection of capital, where it does not—we do not have capital formation that gives us the best benefit for our country as a whole. Would you all comment on that?

Dr. AUERBACH. Senator, it would depend on how it was implemented. One of the things we observe in value-added taxes in Europe, for example, is that they exempt certain commodities that they deem socially beneficial. And, if you go down that road, then you can have the same kind of problem we have with the tax expenditures you cited.

But taxing consumption rather than taxing income does not necessarily solve that problem. You still can have a broad-based tax or a narrower-based tax, depending on what tax expenditures you put in.

Senator COBURN. Let me change the predicate. If you had no exceptions, would you, in fact, not have better capital formation?

Dr. AUERBACH. Certainly. But that could be true under the current tax system, as well.

Senator COBURN. If we eliminated tax expenditures.

Dr. AUERBACH. Yes.

Senator COBURN. Any other comments?

Dr. GALBRAITH. I would just say, Senator, that I think we should be careful of our current context. We are, I think, in the midst of massively reallocating away from investment in housing as a result of the slump, and we have a huge deficit in public capital of the country which needs to be dealt with.

And I think that anything that we do with respect to the tax code should keep those two facts very much in mind.

Senator COBURN. I am out of time. Thank you.

Mr. GRAETZ. Senator? I am sorry. I just wanted to say one word about border adjustments, if that is all right.

You mentioned border adjustments, and it is the case that, under a sales tax or a value-added tax, we could tax imports and exempt

exports without renegotiating our trade treaties, and I think this is important.

It would produce, at least under President Bush's estimates, maybe $1 trillion over a 10-year period in the current situation.

Now, at some point, this may reverse down the road when we are exporting so much and importing so little. But in the meanwhile, I think that this is a very important advantage of taxing sales in the way the rest of the world taxes them as opposed to taxing corporate income.

The CHAIRMAN. Senator Wyden, you are next.

Senator WYDEN. Thank you, Mr. Chairman. The four of you have done a lot of thinking about this issue. You have a lot of different approaches and a variety of creative ideas. And I want to go at it this way.

For me, the single-biggest concern in this tax reform debate is job growth and job creation. And when you go back and look at the 1986 legislation, in the 2 years after Democrats and Ronald Reagan came together in 1986, our country created 6.3 million new non-farm jobs, twice as many as were created between 2001 and 2008.

So there are a lot of issues that go into job creation, and I just want to ask you about the principles of 1986 and see if you think they are still a pretty good foundation, because I do.

The principles of 1986 were, number one, eliminate as many of the preferences as you possibly could, because they tend to be narrow and they are for special interest groups. They walk off with a lot of money, and they are very narrow.

The second one, Democrats and Republicans said you ought to broaden the base. That is going to be important, to generate as much growth as possible.

And then, to their credit, they said we have to keep progressivity.

So those were the three principles that, in my view, led to something that you would have to call historic, creating 6.3 million new non-farm jobs 2 years out of the box.

In terms of the four of you, because you have a variety of different approaches and a variety of different routes, do you all think those three principles are still a pretty good foundation? Getting rid of preferences, broadening the base, and keeping progressivity.

In fact, do any of you—the four of you, do any of you take exception to those being three of the key principles for the future; not the only principles, but three of the key principles.

Any exceptions among you four?

Dr. GALBRAITH. A moderate exception, Senator. As I said in my testimony, I was involved in the debates that led up to the enactment of the Tax Reform Act. In 1984, the Joint Economic Committee endorsed the Bradley-Kemp bill, which was the precursor to the Tax Reform Act of 1986. And I think the principles, as applied at that time, were, in fact, the correct principles.

Speaking of preferences, I think the term that you used just now is an extremely important one to bear in mind. You spoke of narrow preferences. There are, I think, important preferences in the tax code now which are broad-based preferences: the earned income tax credit, the mortgage interest deduction, the municipal bond deduction.

I would, in going forward, be very careful about changes that would dramatically impact those functions. If you restricted the mortgage interest deduction dramatically, one should think about the consequences for housing prices, the consequences for the banking sector, of that step.

A radical move would have potentially very serious consequences. So one should be very careful.

Secondly, with respect—I think you were quite right in pointing to preserving progressivity, keeping the overall incidence of the tax by income class roughly where it was before and after 1986. It was the major feature of the Bradley-Kemp plan and of the final bill.

That, I think, is a good principle and would weigh against the idea that one should always be going for a lower rate structure at the top. It seems to me there is room, if you, again, design the income levels at which higher rates apply effectively for a fairer sharing of the tax burden.

Senator WYDEN. Let me see if I can get another question in. And I think your point is a valid one. Not all preferences are created equal, and it is a valid point.

There is a lot of discussion now about, as the Congress looks at budget issues, that there be an enforcement mechanism put in place to make sure there is no backsliding and that you do not just go back on a spending spree after you enact major budget reform.

But there is very little said about how to stop backsliding when you get to tax reform. And literally, I have been told, my staff has been told that, when the 1986 bill was passed, virtually as soon as the ink was dry, you went out and saw folks working to make changes.

I think Chairman Baucus's figure is jaw-dropping, something like 15,000 changes, according to the chairman and his fine staff. So you get the thing done, you make this historic change—and the chairman is going to lead it. And what are you going to do to kind of come up with some way to prevent backsliding? This is hard. No current Congress can bind a future Congress.

But if you look at the chairman's figures on all these changes, at least we ought to be talking about it. You are a very distinguished group, and, if I have time, Mr. Chairman, they could just give an answer. I think your point is spot on.

Gentlemen, how do we prevent backsliding so that you do not just end up with another Swiss cheese tax code a few years down the road?

Dr. HUBBARD. Well, Senator, I think the greatest way to limit that—you will never avoid it, for all the reasons that you just correctly said—would be to have a very, very broad-based, modest-rate tax system. Where there are individual preferences involved and a lot of rate disparity involved, that is where games get played in the tax code, and that is where the pressure is.

Something that has a limited progression in rates and a very, very broad base, I think is the issue.

Mr. GRAETZ. Senator Wyden, the fat lady never sings in tax policy. I do not think that we are going to stop changing, but I do think that the point—I just want to emphasize a point that Professor Galbraith made earlier, which is that the big, large, difficult-to-change tax expenditures are not the ones for narrow special in-

terests. They are the ones for the general public. The complexity of education incentives that we have that no one knows how to deal with in terms of planning, are an example, in addition to ones that have been suggested.

I think the only way that you can have a tax system that does not have huge pressures for that, given the institutional arrangements in the Congress and in the president's office, is that, if you remove a lot of people from the income tax—this is really the concern that led me ultimately——

When I first started writing about this particular proposal that I had been advancing, I was in your camp. I was going to broaden the tax base and lower rates in a repetition of the 1986 act. And having watched it unravel as it did so quickly and so dramatically with all of the additional tax expenditures, if you look at the 100 or so that the joint committee last week said had been enacted since 1986—the ones that have real money in them are for general policies—many of them do not work. The energy tax credits, for example, are a perfect example of, I think, a very bizarre set of tax credits, but the goal was a broad public policy goal.

And I think the only way you get there is to get a very, very low corporate rate, so that they are not worth any money to the corporations, and to get most Americans out of the income tax.

The CHAIRMAN. Senator Thune? Thank you.

Senator THUNE. Thank you, Mr. Chairman.

Thank all of you for your expertise and for your willingness to share it with us.

I want to ask you—maybe this question has been asked already, but it is just sort of a general question about what you believe are the most pro-growth tax reforms that we could put in place.

If we want to see the economy take off again and grow—a more growth-oriented tax code—what are the elements or components of that, at least the top couple that you can think of?

Dr. HUBBARD. I think, Senator Thune, I would begin with policies to encourage investment. The Nation has to pivot toward being less reliant simply on domestic consumption and more reliant on investment.

The tax code is biased against many forms of investment. And so specifically where to start, if that is the problem you are going at, would be the corporate income tax and the financial biases that exist in the present tax code for debt financing, which tend to encourage a variety of unproductive investments. So I would definitely start there.

To your question about what is the most pro-growth, I think a broad-based consumption-type tax, the type that has been talked about this morning, in many variants, would clearly be the end of the line answer.

But if you were starting with something right now to focus on, I would say it would be the corporation income tax and investment incentives.

Senator THUNE. Does anybody else want to add anything to that? Yes, sir?

Dr. GALBRAITH. I would say, Senator, that the forces that drive investment are much broader than the tax code, and we face the problem now of the overhang of the financial crisis and the Great

Recession and the difficulty that companies have in seeing the basis for making profitable investments over the kind of time horizon that business needs to have.

And the tax incentives are always going to be a very small contribution in relation to that.

You could, I think, greatly improve job creation in the country by, as I said earlier, replacing the payroll tax. The payroll tax is a tax on jobs, and I think that Congress did something very sensible at the end of the last session in providing a 2-percent holiday on the payroll tax and holding the Social Security Trust Funds harmless.

This is a clear-cut benefit for both employers and families in providing more jobs than they otherwise would.

Mr. GRAETZ. Senator Thune, I think that the business tax, taxing business entities, is a bad way to get income economically. It is a bad way to try to get progressivity, because it can shift that tax to workers and to consumers. And, in the international economy, it is a bad way to attract capital to the United States.

So a dramatically simplified and relatively low-rate tax on small business, coupled with a dramatically lower rate on large businesses, would be, I think, to the great advantage of the United States.

The difficulty is that corporate taxes, in particular—in particular, large, multinational corporate taxes—are very popular politically and very easy for people to think are paid by somebody else, because they do not know who is paying them. So there is a political tension with the economic wisdom.

Dr. AUERBACH. Senator, if I could just add one more point which I do not think has been mentioned. There has to be a lot of uncertainty now about what tax rates are going to be in the future because of our unsustainable budget situation, and I think that uncertainty contributes to the uncertainty that comes from other sources in discouraging businesses from investing.

And having a more viable tax system that plays a role in a sustainable fiscal path, I think, can contribute a lot to economic growth and productivity.

Senator THUNE. Thanks. I just want to ask you about the exclusion for employer-provided health insurance. You have talked about, and the focus of this hearing really was about distortions in the tax code.

So let me ask you if you think that leads people to being tied to a certain employer? Does it lead to distortions in the labor market? And perhaps the final question, does it raise health care costs?

Dr. AUERBACH. Well, Senator, I mentioned that specifically in my testimony, and I think it definitely does contribute to the purchasing of too much medical care by some.

There is a very good justification for having some sort of benefit for the purchase of private health insurance, whether it be through an employer or directly, because individuals who do not have insurance will be cared for by the State or by charity care that comes at somebody else's expense.

But having an unlimited benefit or one that is very slightly limited, which will eventually come through last year's health care leg-

islation, goes way too far in terms of providing an incentive for health insurance.

So it is not only expensive on its own, and an expenditure we cannot afford in our current budget situation, but it actually encourages the excessive purchase of health care.

Dr. HUBBARD. I would definitely agree with that. Some recent work Dan Kessler at Stanford and I have done suggested you could have very large declines in U.S. health care costs as a level effect if you move toward capping the exclusion or, in the long run, eliminating it and replacing it with something else.

As Alan said, so much of the benefits go to Cadillac plans and to very high-income earners. We can assist with basic plans for low-income people at a fraction of this cost, and actually help our health care problems, as well.

It is a very, very big deal.

Dr. GALBRAITH. I have always believed, Senator, that the rest of the industrial world has come to a better solution for financing health care than we have. They have systems which are generally very good, operate at a much lower share of GDP, and they do this by avoiding the element of private insurance in health care.

Mr. GRAETZ. Senator, I just would like to agree. My statement describes the employer-provided health care as the Titanic of American domestic policy. I think it increases costs. It gobbles up the wages of individuals. It is inefficient.

If we could have done one thing in a major health reform, if we could have weaned ourselves away from employer-provided and subsidized health care, I think we would have really had something over a long period of time that would have helped the American economy and the American fiscal situation.

Senator THUNE. Thank you all. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

You were not on the committee at the time, but this committee, passing that health care reform, passed a cap on Cadillac plans. We felt it was just wrong and there should be a cap, there should be some limit. The current employer-provided exclusion should not be unlimited, and we were all agreed. The panelists agree on that one. But unfortunately, there is somebody else who did not agree, and we did not get that enacted.

I have a couple more questions. One is, do you think that, to some degree, our current tax code tended to lead to the recession insofar as there is so much overleveraging either by the household sector or Wall Street and banks and so forth? Some of these banks, they were leveraged 34-to-1, as I recall, 35, maybe higher, maybe hedge funds. I do not know which.

But to what degree might we have had this recession because of the ability to borrow so easily and deduct borrowing costs so easily in this country? Is that a factor or not?

Dr. HUBBARD. I think it definitely is a factor. It is not the only one, of course, Mr. Chairman. But I think it is a factor because the tax incentives for leverage create what you would call an externality in the sense that I, of course, as the CEO of a company, think about the effect of any tax policy that I take advantage of on my own company, but I do not take account of the effects of my actions on all the rest of you. That is classic externality.

And there is very significant over-leverage. In the past 25 years, many business people thought we were in a great moderation, where big shocks just were not very likely anymore, and they tolerated very high levels of debt, and the tax code made it very profitable for them to do so.

So, while it is not the only factor, it is certainly a significant one. And encouraging more reliance on equity financing is definitely something that you should consider quite strongly.

The CHAIRMAN. Anybody else? Dr. Galbraith?

Dr. GALBRAITH. I think the 1986 act helped to set the stage for the run-up in household debt burdens collateralized by housing. But I think the collapse that occurred over the course of the last decade was much more due to the de-supervision in the financial sector and the takeover of mortgage originations by entities that were essentially indifferent to whether those mortgages would ever be paid, and to borrowers who could not qualify and to houses whose values were systematically inflated by appraisers who were pressured to do so, and with the resulting instruments being sold off to the world financial market.

If that de-supervision and effective undermining of the integrity of the housing finance system had not occurred, then I think the collapse would have been—it might have been avoided, but in any event, would have been far less serious than it has been.

The CHAIRMAN. Thank you. Anyone else?

Next question. I tend to agree with you, Dr. Galbraith, that most investment decisions and growth by American companies are due probably to the tax code, but there are a lot of other factors that dictate whether or not a company is going to invest and where, and so on and so forth. There are just a lot of factors. But the code really is important.

But since we are now talking about the code, your thoughts about international competitiveness. We want our kids and grandkids to live in a system where we are prospering, we are growing, we have jobs, and incomes are higher than they are today. I cherish the thought.

What do we do? How do we make our system be more forward-looking so that we can deal with globalization and build products here?

It is not totally relevant, but I am reminded of an article I read not too long ago by a former Intel CEO, Andy Grove, who was saying that, in Silicon Valley, there is a trend which he finds disquieting; namely, that—and some U.S. commentators are part of this problem, and think that the answer is in education and startups. Just let 1,000 startups boom, and we will develop all these new technologies in America.

His point is that it is short-sighted, because the real question is, what happens after the so-called Valley of Death and so forth? Doing a start-up if it is a good idea, whether it is computer chips or whether it is Microsoft or whatever it is—the real problem is the next one, and that is sort of financing and staying power so the manufacturing is in the U.S., not overseas. Because a lot of venture capitalists today think, “Oh, gee, let us put a lot of this money into a start-up in”—wherever it is, Silicon Valley, or whatnot—“then we will develop it,” but they did not know the manufacturing would be

overseas. It would be in China and Taiwan. In fact, he mentioned the biggest company that makes something, I forgot what it was, is a Taiwanese company, never heard of it before.

But the point is, we need incentives so that manufacturing is in this country, because, when manufacturing is in this country, there are a lot of trade-offs and symbiosis, and people just work together, develop new ideas.

So it is probably the jobs, which is maybe the most important, but second, it is all the cross-cultural ideas that develop if manufacturing is here.

You mentioned batteries, for example. We just gave up on batteries. We are not going to get battery technology back. The manufacturing is going to be overseas.

That happened with solar panels. We developed solar panels here, but it is all overseas now. And he had some—as I recall, in the article, he wrote some fairly significant suggestions, even tax products that come into the United States and use that money to go back and finance job growth and manufacturing growth in the U.S., even if it is not legal. You have to find something.

So my main question is, what do we do to stimulate job growth in this country with respect to international challenges so that there is not all this big incentive to develop new, best stuff, whether it is batteries or whatnot, that then is manufactured overseas? What do we do?

Dr. AUERBACH. Senator, I am sympathetic to the view you have just expressed. I think we have to recognize that manufacturing employment has been declining in the United States for decades, and quite steadily. Not so much manufacturing output, because it has also become a more capital-intensive and efficient sector.

I think the question is not any specific manufacturing activity and where it is located, but the ones that should be in the U.S.—and some of the things we have talked about in terms of reforming the corporate tax and encouraging more corporate activity in the United States, in conjunction with other policies that are not tax-based, such as making sure our educational system provides the workers necessary for more modern technologies, will keep important manufacturing and other production activities in the United States.

There are going to be certain manufacturing activities for which it is just too compelling, given the cost differences, to locate abroad.

That need not worry us if we have a tax system that is conducive to the location of domestic production in the U.S. and an education system that provides the workforce necessary for modern technologies as they develop.

Dr. HUBBARD. I would say, Senator, that you are absolutely right that this is an issue. Corporate tax policy is a factor. I do not think it is probably the only or even the largest factor, but it is a significant one.

To that list, I would add litigation and regulation as being areas that have hampered the domestic corporate sector versus its competition.

I have a great deal of sympathy for what Mr. Grove says, in the sense that you lose something when you lose a shop floor. And while I agree with Alan that we do not want to keep all manufac-

turing in the United States, that is not what I am saying. In high-valued sectors, you lose clinical innovation when you are not doing it, when you are only investing in it somewhere else, and I do think that is partly our tax code, but these other things too.

One other very large non-tax factor, though, I would mention is openness. I work in a university. My best non-American students no longer feel like they can work in the United States, and that is going to be a problem for us going forward.

The CHAIRMAN. You are talking about the visa problem.

Dr. HUBBARD. The immigration and visa problems to work for a company here.

The CHAIRMAN. I hear this constantly. I hear that from so many people.

Dr. GALBRAITH. Very much on similar lines, I think it has always been our place as an economy in the world to be at the cutting edge, to innovate, to use our imaginations, and to stay ahead by doing things that other countries were not yet capable of doing.

A great deal of that happens because of the strength of institutions that are physically located here. The public sector, the Defense Department has played an important role, universities and other nonprofit institutions have played an extremely important role.

One thing that we might focus on as the challenges become more diverse is to take the institutional models that we know have worked in the past and apply them to these areas.

I think, also, that we should bear in mind that the physical conditions of the planet are changing, and energy, in particular, represents an extremely important challenge to us as an energy-importing country. It is going to affect the cost of everything that we do, and dealing with that as a strategic matter is both necessary for the competitiveness of our economy and to provide a stable framework for the private sector to make sensible investment decisions going forward.

The CHAIRMAN. As a Texan, you will know of Symantec.

Dr. GALBRAITH. Symantec? I was going to mention Symantec and MCC are important models of cooperative activity that were rooted in the U.S.

The CHAIRMAN. That is my impression.

Dr. GALBRAITH. Rooted in the U.S.

The CHAIRMAN. Right. Thank you.

Senator Cardin? I am sorry. My time is way, way over.

Senator CARDIN. Thank you very much, Mr. Chairman. And let me thank you again for conducting these hearings. I find them very informative.

I am going to follow up on a question that was asked or a comment that was made by Senator Carper as it relates to consumption taxes. But I want to put it into context first to this discussion about international competitiveness.

If you are a manufacturing company and you deal in export, it is easier from the tax code to be in a country that relies on consumption taxes, which you know you can take off and have a border adjustment when your product enters the international marketplace, than in the United States, where we rely on income taxes

and the company cannot take that off in the international marketplace.

But let me just give you another concern about the current tax code, and the chairman really got me interested in this when you mentioned, Mr. Chairman, that since 1986, we have provided 140-some provisions temporarily to the tax code that we have to extend every year or two.

And I am thinking that, let us say we really reform the income tax code, and we do it this year. It seems to me, next year, we will start down that line again, because it is easier at times to get something done on the tax side than on the spending side.

And I am concerned that, even if we clean up the tax code dramatically, we will be back in the same type of situation a few years down the road, because, in 1986, we supposedly cleaned up the tax code, and we saw what happened.

So there are many reasons to consider a consumption tax, not as an exclusive tax, but as part of our tax code, to allow us to encourage more savings, to raise the same amount of revenue we would raise under the income tax that would take out the dollar number here. And, also, we can put provisions in, although it will make it a little bit less efficient, we can put provisions in to deal with progressivity, because I am committed to doing everything I can at the end of the day to make sure our tax code is more progressive than our current tax code.

So, putting those issues as given, I would like to get your view as to whether we should be seriously looking at the consumption tax as part of the equation of tax reform in Congress.

Now, let me just qualify that. I have one more thing. I asked the same question a few minutes ago to Erskine Bowles and to Senator Simpson, and I asked, "Why didn't you consider it?" And their answer was very simple: "Congress took up a resolution in the Senate and passed it overwhelmingly against it." I said, "Well, suppose I would have brought up a resolution that you can't take up Social Security. I would have gotten 85 votes on the floor of the Senate on that resolution." So I am not so sure that is a good enough answer.

In fact, I got very complimentary responses as to the policy merits of that type of proposal.

But while we have you all here, we would welcome your further comment as to whether it would make sense from a policy and efficiency point of view to consider a consumption tax, under the conditions that I laid out.

Dr. AUERBACH. Senator, first, I do not want to suggest that you would be devious, but there are many ways of accomplishing a move toward consumption taxation, and they do not all have to be called consumption taxation.

I mention in my testimony that a way of reforming the corporate tax would be to reduce the incentive to borrow by eliminating or cutting back interest deductions and, at the same time, preserving the incentive to invest by moving in the direction of immediate write-off of investment.

Now, we could call that a reformed corporate tax or a corporate cash flow tax. In fact, it also would represent a logical component of a consumption tax. It is not the value-added tax that Professor

Graetz would like to see, which is recognized to be a consumption tax, but consumption tax principles apply to any tax that taxes consumption and does not tax income, and it would have the same characteristics.

And I think that is important because, rather than get hung up on a particular tax and whether that tax is a consumption tax and whether a consumption tax has all the things we associate with it, some good and some bad, think about structural reforms that move in the direction that you want to go, and let others give a name to it.

Dr. HUBBARD. I would agree with that, Senator Cardin. I think that if you move toward cash flow taxes and wage taxes, once you add them together, they are the same thing as a VAT. You are just breaking them up into pieces. You can have simpler, more flexible reform. It is easier to implement and, arguably, will not get you into the fights of special rating for different goods and services.

And I would note that I actually questioned Erskine and Senator Simpson yesterday at the Economic Club of New York. I asked them the same question. I am delighted to report they gave the same answer.

Dr. GALBRAITH. Senator, I have always been skeptical that we would gain anything serious by way of economic efficiency by moving to consumption taxes at the Federal level.

I think we would lose a great deal in terms of fairness. I have to confess, I am somewhat intrigued by Professor Graetz's proposal along these lines, which takes care of some of my concerns. But my general view is that the—it is not the worst thing in the world that the Senate Committee on Finance has to meet every year and deal with these issues.

Problems change, and the tax code is one way of dealing with the challenges that you face from time to time. And I, as a general rule, would recommend proceeding very cautiously on large changes in the structure of taxation.

Mr. GRAETZ. Senator Cardin, my economists, particularly on my far right, just coincidentally, are behaving as politicians and not as economists. That is, they are telling you that you could politically enact a strange consumption tax that does not look like one anywhere else in the world that they are willing to call corporate taxes or cash flow taxes or X taxes or growth and investment taxes or flat taxes. The names are endless.

The point is that those taxes do not fit within our international trade or tax arrangements, and it is going to be difficult to come up with a system in the U.S. Congress and in the White House that taxes consumption, that allows us to make border adjustments and tax imports in the United States and not tax exports as they are exported under existing international trade arrangements without getting into a 25-year fight with the WTO, with trade responses and so forth or, worse, coming up with a consumption tax which maintains an origin-based tax, like our income tax.

Professor Auerbach has produced a very creative corporate tax which he describes as an effort to come up with a border-adjustable tax by taxing only domestic items and allowing deductions only for domestic items. It is wonderfully creative. It obviously does not tax exports. It obviously taxes imports. It obviously allows a deduction

for wages and no deduction for interest, which violates the WTO existing agreements, which violates all of our income tax treaties.

The President's commission wanted to do the same thing. They called it a growth and investment tax. They studied it. They said it had to be border-adjustable. And they acknowledged that they were going to have to renegotiate all of these treaties in order to get there.

So, in that sense, I think that that ground has been plowed. It has great political advantages to impose a consumption tax in a way that the American people find invisible. On the other hand, it is not a service to the American people not to let them know what is being taxed. The reason our corporate tax is as bad as it is today is the American people think somebody else is paying it. And they do not think they are paying it, and, therefore, a 35-percent rate or an excessive rate on investment in the United States by domestic and foreign taxpayers is fine, because it looks like it is a tax on somebody else.

It is the classic example of Senator Long's "Don't tax you, don't tax me, tax the man behind the tree;" and Dan Rostenkowski added the last verse, which said, "tax the corporations across the sea."

Well, the problem is that we have a system and we are creating incentives—and I think this is very important—we are creating incentives for the ownership of our intellectual property and the headquarters of our companies to be located somewhere else.

To transfer the patents, to transfer know-how, to transfer technology, to transfer pricing is the everyday business of the tax bar and the corporate community. And you locate borrowing here and income and assets abroad, and, if the intellectual property is owned in Europe, then it is much easier to choose to build and invest in Europe.

I think that the chairman's earlier comments were exactly right, that there are many manufacturing and other activities that must be performed abroad. There are certain things you are not going to make here and ship to China. Diapers is always my favorite example from my friends at Proctor & Gamble.

But there are things that we could be doing here, but our tax system is organized in a way that creates advantages for borrowing here and disadvantages for everything else.

Senator CARDIN. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thanks.

I just have one question about savings, personal savings rates and all the provisions in the code which are designed to encourage personal savings, individual savings. We have 401(k)s, IRAs, and you name it, there is something there.

Your thoughts about all of them. Do they actually increase personal savings? Do the benefits of saving go to those who most need to save, or are they preferences that simply steer higher-income savers from one form of savings to another?

Some think there are just so many that it just causes confusion. I saw this very interesting article some time ago where psychologists point out that we have lots of choices. When you get to the point where you have too many choices, then nothing happens. Peo-

ple just get high-centered and stymied and they cannot go make a choice, because there are too many choices.

Your thoughts about that? Incentives to save currently in the code and how you might change, modify, consolidate. What would you do about them?

Dr. HUBBARD. A couple of thoughts. First, the psychologist is my colleague, Sheena Iyengar, whose book, "The Art of Choosing" I recommend to you.

But your question could be broken, I think, into two parts, the adequacy of saving for many people and then overall national savings.

I think savings incentives do have very positive long-term effects, but they are ridiculously complicated. We could do much better. Simple examples are in the President's commission report, but there have been lots of reform proposals over the years for simplification, and I would urge you to consider that.

But if the question is national saving, which is really important for the country, the best thing that the United States Senate and the U.S. Congress could do is to raise public sector saving, which would mean funding entitlement programs and bringing deficits under control.

The CHAIRMAN. Other thoughts?

Mr. GRAETZ. I would agree that we do not need as many as we have. And having spent a lot of time with my tax advisor and with a journalist at *The Wall Street Journal* going over the advantages and disadvantages of shifting from a regular IRA to a Roth IRA and how much and so forth, I can tell you, even the sophisticated who are prepared to try to choose cannot figure out what to do.

So I think there is an awful lot of simplification that could be done. But I do think it is important that the savings incentives that we have are predominantly targeted to retirement savings and to education savings. And I think these are places where the savings is long-term. And people really are myopic; they really do underestimate their needs in retirement.

And to the extent that there are going to be pressures, particularly for moderate- and higher-income folks, due to reductions in the Medicare provision for those people or more expenditures or more payments on their own for Medicare or similar things in the context of Social Security, in order to get those programs in balance, I think the tax provisions for retirement savings are very important.

Now, unfortunately, they are not distributed necessarily in a fair way, because they are only used by the top half of the population, but they are broad-based. And the elimination of defined benefit plans by the employers of the country, the private employers of the country and, soon, the public employers of the country, puts more and more pressure on the need for individuals to have a pot of money that they do not have easy access to.

So I would be reluctant, in fact, to say, "Well, we want to take this pot of savings and just have one savings incentive that you could use for anything you wanted." I think there is a lot to be said for simplifying, consolidating, making them more broadly based, and more fair, but maintaining their emphasis on retirement needs after you are no longer able to go back into the workforce, and on

providing for the costs of education, which are very, very huge for most American families.

Dr. GALBRAITH. Senator, very few—a great many working Americans get to the end of their working careers with no financial savings and go through retirement almost entirely reliant on Social Security. I think the number is something like 40 percent have no other significant source of income, and that tells you that these incentives for savings have had essentially no effect on the financial position of lower-income working Americans.

A significant savings incentive that worked for a long time was in housing, because, if you put your funds into a house and the house price appreciated, then you came out at the end of the day with an asset that you could sell, and you ended up with some financial resources in retirement.

That has been severely, obviously, impacted by the collapse of housing prices. The savings incentives have had no material effect on the private savings rate in this country, which has not, in fact, changed as we have enacted additional savings incentives.

And just a final point on Dr. Hubbard's comment. I think the accounting actually is the opposite of what he says, that the very sharp rise in savings that occurred immediately after the crisis was the accounting counterpart of the very big increase in public deficits.

As the government takes in less in taxes and puts out more in spending, the private sector has more in income and less in obligations, and the cash gets built up in private accounts, and you can see that is very clear in the national income account data over the last few years.

The CHAIRMAN. Have other companies in other OECD countries shifted away from defined benefit to defined contribution plans?

Dr. GALBRAITH. Not to nearly the extent that we have.

The CHAIRMAN. To what degree is the shift the cause of the problem in our country for employees who just will not have the benefits they otherwise might have?

Dr. GALBRAITH. I think it has created huge instability, Senator, because those who retired when they could cash out effectively are okay. Those who retired a few weeks later after the markets crashed, with exactly the same earnings and savings activity over the course of their careers, ended up much less well-off, through events that are entirely beyond their control.

Mr. GRAETZ. It has not only shifted risks to individual families away from large groups of employees, but it also creates difficulties during retirement, because, when you get a lump sum in retirement, the individual annuity markets do not work well. They do not protect you against inflation. There is a high risk of outliving your savings.

And so they create risks for people in their retirement, as well as in building up to retirement. But there is no, I think, in the United States, going back to defined benefit plans in the private sector, and I think all of the movement in the public sector is in the direction of defined contribution plans.

While I agree with Professor Galbraith that these have had no effect on the bottom 40 percent of the income distribution, they do

provide an important cushion and an important supplement to Social Security for the other 60 percent.

The CHAIRMAN. My time has expired here.

Senator Cardin, other questions?

Senator CARDIN. Well, Mr. Chairman I just want to follow up very briefly on the point that you are raising here.

To Professor Galbraith, I think your numbers indicate to me that we want to not only continue our current incentives for savings, but we want to make them stronger. We certainly do not want to make them weaker.

And to me, the fact that that number of 40 percent is not growing—and I believe it is not growing, if I look to the most recent numbers, knowing that we have reduced our defined benefit plans, which are the strongest help for the low-wage workers that have now been diminished dramatically in this country—tells me that we have done better than we would otherwise have done but for the efforts we have made.

And, if we did not have these supplements for retirement security and if we did not have the savings for college, the pressures on governmental programs would even be much greater than they are today.

So I think that we have been successful, but not successful enough, I guess is my point. We tried with the saver's credit to be able to really target to low-wage workers. We have the safe harbors that really help for low-wage workers.

And when we look at a successful model, we do not have to look further than the Federal Government's Thrift Savings Plan, because I can tell you by the participation of the Federal workforce, it has worked. It has caused a lot of low-wage workers to say, "Look, there is money on the table. I am not going to turn it away." And that is the psychology we have to encourage, Mr. Chairman, education and financial literacy education, because we find that the tax incentives alone will not motivate low-wage workers.

But if there is money on the table, that is, their employer is putting money on the table or the government is giving a credit, then it is much more likely that the lower-wage worker will participate in a retirement savings effort.

So I think your questions are right on. I think we need to take a look at it. It is way too complicated, the current number of savings incentives we have. And for a college professor to have to figure out whether they should go into a Roth IRA or not, then there is something wrong with the system on conversion.

So I agree with the point the chairman has raised, and I really look forward to trying to figure out how we can increase our national savings, including reducing the government debt.

Thank you.

The CHAIRMAN. Thank you.

Senator Menendez, welcome. Good seeing you.

Senator MENENDEZ. Thank you, Mr. Chairman. I was here earlier and had to have another hearing. So I appreciate that you are still here in session.

Thank you all for your testimony. I got to read it. So I appreciate your willingness to come forth.

I have one or two different lines of questioning. First, I look at the supporters of the 2001 and 2003 tax cuts who generally argue that the reason the cuts were weighted towards those with the highest incomes was to incentivize capital formation and investment.

And, Dr. Hubbard, I noticed in your testimony you reference a 2003 study showing that, hypothetically, had the 2001 and 2003 tax cuts been enacted from 1987 to 1996, middle-class families would have benefitted from tax cut rates on affluent taxpayers because there would have been, in your view, substantial upward movement in tax brackets.

And so, while I look at that in the theoretical world, I am wondering, in the real world experience, it seems to have played out quite differently over the last decade.

According to the Census, real median household incomes are 4 percent lower today than they were when the tax cuts passed in 2001; 25 percent more Americans live in poverty today than in 2001.

Even during the height of the housing boom in 2006, 9 million more Americans were living in poverty than before the tax cuts were passed.

So my question is, if a lower marginal tax income rate and lower tax rate on savings and investment really do lead to shared prosperity across the board, why has middle-class income been so stagnant, and why has poverty increased after we passed the 2001 and 2003 tax cuts?

Why is the record of a middle-class experience under these tax cuts so different than the theoretical studies done which show incomes rising and poverty falling?

Dr. HUBBARD. You ask a very important question Senator. To take it in two parts, first, to your question about stagnation. There is a very important, if subtle, distinction between wages and compensation.

Compensation in the United States has more or less kept pace with productivity, exactly like theory tells us. Wages have not. Now, is that a slight of hand? No. It is something called benefits, the difference between compensation and wages, and the very rapid growth in health insurance costs has indeed led, for many Americans, to see their wage income stagnate at time when compensation is rising.

As to your questions about the tax cuts themselves, it is very hard to estimate effects of tax policy because you do not know what the counterfactual is. You do not know what would have happened.

The argument for taxes and growth is through investment and productivity growth. The calculations that I referenced were really about the rate cuts.

As you know, the 2001 tax cuts had a number of provisions that are very costly, and I would argue have very little to do with economic growth. But the bang for the buck of the real economic growth provisions, I think, is quite significant.

As you know, a lot of things have happened in the world between 2001 and the present. It is just very hard to do the kind of calculation that you are doing.

Dr. AUERBACH. I just wanted to say, Senator, that there are very strong forces at work leading to more unequal income distribution in the United States, as has already been pointed out.

We have observed increasing returns to investment in education, higher-skilled workers benefitting, and others in the population benefitting much less. I do not think the specific changes in the tax code played a significant role in that. This has been going on for a few decades now.

It is a very disturbing trend, and it is something that tax policy should focus on. But while tax policy should focus on it, I think that is different from saying that tax policy is responsible for it.

Dr. GALBRAITH. I would just say, Senator, that I think what clearly happened in the last decade is that the broad American population funded itself and supported economic growth by taking on a completely unsustainable burden of debt, mainly against houses, and it was that process which had to do with the fact that incomes were not rising rapidly enough at the bottom and in the middle, and that credit was made too easily available and on terms that were highly destructive, that were essentially terms that were not going to be repaid in the way that ordinary credit relationships historically have been expected to function. And this is the system which collapsed in 2007 and 2008.

And I do not think that we are in a recovery from that collapse. I do not think we have dealt with the underlying problem. We are still facing very highly indebted households, with housing prices that are continuing to fall, and this problem, this adjustment, I think—hangover, in fact, from the consequence of the policies that you have described and as I am just describing them—is going to continue for a long time.

Senator MENENDEZ. Mr. Chairman, may I just pursue this a little bit further?

So I appreciate your answers, and I have a sense of agreement with various items that you presented. My concern is the view within the context of tax policy that simply reducing the top marginal rates is going to have a ripple effect across the spectrum, particularly to middle-class and lower-income individuals, and I am not quite sure that that proposition has been made in a way that, at least for me, makes the case.

So that is why I raise the question, because, as we are talking about what tax policy should be and what reform should be, I am concerned that that proposition, in and of itself, is one that does not necessarily produce the result that people suggest it does.

Let me ask one other question, if I may, with the chairman's indulgence.

Dr. Galbraith, I have been concerned about our subsidies for oil, for example. In your testimony you point out that the House fails to address some of the most egregious subsidies the Federal Government bestows, such as to oil companies. And it seems odd to me, at a time of record oil profits, that Federal taxpayers are providing the industry with subsidies totaling over $3 billion a year. Former President Bush, former Shell CEO John Hofmeister, both agree that oil subsidies are simply not needed when oil prices are this high.

Are oil subsidies adding anything to our economic growth, or is it simply the case that, when oil prices are this high, there is plenty of incentive for them without the subsidies?

Dr. GALBRAITH. I think that there is adequate economic incentive in the energy sector now, but I think the energy sector would benefit enormously from strategic guidance that it could rely on so that we had a strategy to deal with our dependence on oil, to deal with the alternatives that may or may not be viable and available, and to deal with the problem that the energy cost squeeze is not going to go away.

Senator MENENDEZ. And a strategy would be, what is it going to be that our energy portfolio looks like, and what are we willing to do to incentivize that portfolio to accomplish——

Dr. GALBRAITH. Absolutely. Absolutely. And over the time horizon that businesses need in order to make investments that will be effective.

Senator MENENDEZ. Thank you, Mr. Chairman.

The CHAIRMAN. As we flatten the rate and broaden the base.

Thank you all very much. I appreciate all four of you very, very much for your testimony. Thank you very much.

[Whereupon, at 12:16 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Tax Policy, Economic Efficiency, Job Creation and Growth

Testimony before the Committee on Finance, United States Senate

Alan J. Auerbach
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University of California, Berkeley

March 8, 2011

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to appear today to provide my views on the ways in which the U.S. tax system may be reformed to improve economic efficiency and promote job creation and economic growth. These objectives are always important in the design of tax policy, but they take on particular importance in the current environment, when unemployment remains high and severe budget pressure calls for a serious reconsideration of all spending programs, whether implemented directly or through the tax system.

My comments will focus primarily on two major tax policy areas, tax expenditures and the reform of the corporate income tax, but let me begin by discussing the role of tax reform in the current economic situation.

Tax Reform and Economic Recovery

Over the past three years, the main focus of U.S. fiscal policy has been to promote economic recovery from the 2007-9 recession through various measures that reduced federal taxes and increased federal spending. Opinions vary as to whether the mix and size of this policy response were appropriate, although I believe strong action was necessary, given the severity and length of the recession. But there can be no dispute that we face a daunting challenge of controlling the growth of our national debt and bringing spending and tax revenues into closer alignment now that a recovery is underway. On our current trajectory, the national debt will approach its postwar high relative to GDP by the end of this decade and far surpass this ratio shortly thereafter. This trajectory is unsustainable and must change soon. With our fiscal challenge in mind, it is appropriate to ask what the role of tax policy should be. As a matter of simple logic, tax policy can contribute to solving our fiscal problem only by increasing tax revenues. But

there are many ways in which tax revenues might be increased, and these have very different effects on economic efficiency – how well we utilize the resources at our disposal – on growth, on employment and, ultimately, on individual well-being. Whatever its *direct* effect on revenues, a tax policy that promotes growth produces a fiscal dividend in the form of the increased tax revenues generated by higher incomes. By contrast, tax policies that hinder growth make the job of deficit reduction harder by reducing the incomes on which taxes are paid. Thus, even a tax reform that is revenue-neutral without accounting for its growth effects can contribute to deficit reduction by increasing the tax base. This is certainly not the only reason, or even the main reason, for seeking growth-enhancing tax policies, for higher growth benefits society as a whole much more than it helps the government budget, but salutary budget effects do matter, particularly when deficit reduction seems so difficult to accomplish.

While a pro-growth tax reform may help us attack our fiscal problem, though, it can only be part of the solution. For example, if we were able through policy changes to increase real GDP growth by 0.5 percentage points per year over the next decade – a large increase, given historical variations – tax revenues would probably be around 1 percent of GDP higher at the end of the decade. That's a lot of money – around $150 billion relative to our current level of GDP. But it is still only a fraction of what we need in the long run, according to recent calculations I have done with William Gale.[1] So, we will still need a combination of substantial spending cuts and tax increases to close the fiscal gap and, to the extent that we rely on tax increases, tax reform again is relevant. Although tax increases are bound to hinder economic activity, the negative effects can be limited if the tax increases are effected within a broad-based tax system with low marginal tax rates. Put another way, a bad tax system becomes much worse as we seek to raise more revenue with it.

In summary, the need to deal with our fiscal imbalance makes tax reform more important. Further, tax reform need not conflict with our immediate objective of promoting economic recovery. For example, tax policies that encourage business investment not only spur capital accumulation and ultimately economic growth, but also increase the current demand for capital

[1] Auerbach and Gale (2011) estimate that, even under the most optimistic assumptions regarding current fiscal policy, a combination of tax increases and spending reductions (excluding interest) of 4-5 percent of GDP will be needed to prevent an explosion of the national debt to unsustainable levels. Under more realistic assumptions the needed adjustments are perhaps twice as large.

goods and the workers who produce them. Policies that promote economic efficiency can make workers more profitable for businesses to employ. The current state of the economy is certainly relevant as we consider the sequencing of tax reforms. For example, policies that might discourage consumer demand might appropriately be deferred. But there is no need to defer the considerable effort that tax reform requires and indeed good reason to act soon.

Tax Expenditures

Tax expenditures are reductions in tax revenue associated with provisions that encourage certain activities in which taxpayers engage. Because they must be measured relative to some "normal" tax base, tax expenditures lack an unambiguous definition. For example, provision of tax-favored savings such as through 401(k) plans is a tax expenditure if we view income as an appropriate tax base, but not if we start with household consumption as our baseline, for savings would normally be excluded from a consumption tax base to begin with.

Much of the traditional discussion of tax expenditures has focused on whether direct spending programs might serve better to accomplish objectives toward which tax expenditures are directed. For this discussion, the ambiguity of tax expenditure definition has proved a hindrance and a source of controversy. But in the context of tax reform and deficit reduction, this problem is really beside the point. Whether we choose to refer to a particular tax provision as a tax expenditure or as a normal tax incentive is completely irrelevant to the consideration of whether the provision should continue to exist. The relevant question in our current environment, for any tax expenditure *or* any direct expenditure, is whether the expenditure is worth the scarce government resources being devoted to it. In either case, there will be an increase in the budget deficit with which we must deal through further spending cuts or tax increases; and, if the provision is poorly conceived, it will also distort economic activity. In light of the ongoing consideration in Congress of very large cuts in discretionary direct expenditures, it makes sense to expand the evaluation to tax expenditures as well.

In addition to their revenue cost, tax expenditures influence economic behavior. In some cases, this is the point of the provision. For example, the Research and Experimentation credit was intended to encourage private expenditures on qualified activities, following the view and supported by some evidence that the private sector undervalues the social benefits that such

activities generate. In other cases, such as the mortgage interest deduction, the exclusion for employer-provided health insurance, and the deduction for state and local taxes and exclusion of state and local bond interest, to cite some of the largest tax expenditures in terms of lost revenue,[2] the provisions originally arose as byproducts of how the tax system defined income at the time; even so, defenders of these tax expenditures subsequently have cited social purposes in support of their continuation. But even with a social objective, there remains an important question of how a tax expenditure should be designed to achieve this objective.

We may wish to subsidize the purchase of health insurance because otherwise some people will rely on unreimbursed private care or government care, both of which come at other individuals' expense. But this rationale applies more to the purchase of a basic insurance policy, not a very generous one; and it does not necessarily suggest that the subsidy should be greater for those in higher tax brackets, as occurs naturally in the case of an exclusion from income. One could easily argue that a tax expenditure to encourage the purchase of medical insurance should be capped at the cost of a basic policy, provided by a credit rather than an exclusion, and applicable only below a certain income threshold, where there is a real likelihood of relying on government or unreimbursed care. The cost of this modified tax expenditure would be a small fraction of the cost of the current exclusion, even taking account of the very high cap scheduled (but not yet implemented) under last year's health care legislation.

Likewise, some advocates, perhaps not as many as a few years ago, may view the promotion of home ownership as a good social objective and the mortgage interest deduction as a means of achieving this objective. But, again, this is not an argument for an uncapped subsidy, or for a deduction rather than a tax credit, or for a benefit made available to all taxpayers. Once again, the claimed objective can be achieved at much lower revenue cost. A similar argument can also be made with respect to the targeting of subsidies to state and local governments; the existing tax exclusion for interest on these governments' obligations and the deduction for their taxes are expensive and poorly targeted.

[2] According to the Joint Committee on Taxation (2010), in fiscal year 2011 the tax expenditure for the mortgage interest deduction is $93.8 billion; that for the exclusion of employer-provided health benefits is $117.3 billion; and those for deductions for state and local taxes and the exclusion of interest on public purpose state and local bonds sum to $96.8 billion.

In each of these instances, the tax law already includes some restrictions: the $1 million cap on mortgages, the recently enacted cap on excludable health benefits, and the disallowance of the deduction for state and local taxes under the Alternative Minimum Tax. But these limits are only small steps toward what reforms might achieve.

Let us also be clear that the cost of these and other tax expenditures is not simply that we are paying more than necessary to achieve our aims. We are also distorting private choices in a way that diminishes productivity and well-being. Americans have large houses and expensive medical care. But by investing more in housing, we may be investing less in productive plant, equipment, and ideas. By spending more on medical care, we may be spending less on other things we might value more.

In short, the reform of tax expenditures offers two important benefits. First, like direct expenditure reductions, cuts in tax expenditures help us toward our goal of deficit reduction. Second, modifying the incentives that tax expenditures provide can make them work better at achieving their desired ends and eliminate the economic distortions they now cause. I can think of no coherent rationale for ignoring tax expenditure reform when large cuts in direct spending are taking place.

Corporate Taxation

At the federal level, our corporate income tax runs a distant third to the personal income and payroll taxes as a source of revenue. But when thinking about growth and employment, we focus on the corporate tax because of its potential impact on the investment, production, and employment decisions that U.S. businesses make.

The basic form of the U.S. corporate income tax has changed little over time. But the environment in which U.S. corporations operate has changed markedly. With the growth in importance of international capital flows and multinational corporations, countries have been under pressure to modify their corporate taxes to remain attractive to business, and the result has been a change in the international corporate tax environment. Among the lowest tax rates in leading economies just after the Tax Reform Act of 1986, the U.S. corporate tax rate is now much higher than those in most of these other economies. We also stand basically alone in our continuing attempt to impose tax on the active worldwide income of our resident corporations;

countries that previously followed this approach, notably the United Kingdom and Japan, have recently adopted the territorial tax system already found elsewhere. It is therefore easy for some to recommend that we follow suit and join the race to the bottom, lowering our tax rate and adopting a territorial system. One obvious obstacle to doing so is the revenue cost.

It may seem apparent that cutbacks in corporate tax expenditures can be used to offset any revenue loss from rate reduction and the adoption of a territorial system, but among the important tax expenditures one finds listed for the corporate sector are such items as the R&E credit and accelerated depreciation – provisions that reduce the cost of capital and encourage domestic investment. Cutting back on these tax expenditures to offset the revenue cost of reducing the corporate tax rate could actually increase the cost of capital, since investment incentives are more directly tied to new investment. It is true that a lower corporate tax rate would also reduce the incentive for companies to use internal transfer pricing to shift profits abroad. But adoption of a territorial system could have the opposite effect. While a territorial system might make the United States a more attractive place for the location of multinationals – this is a key argument in favor of its adoption – it also provides an added incentive for these companies to shift profits abroad and permanently avoid any U.S. tax on these profits. Taken together, lowering the corporate tax rate and adopting a territorial system would have an uncertain impact on profit shifting, and paying for these changes by cutting back on corporate tax expenditures will not necessarily lead to a net increase in domestic investment. Given a choice between the current system and one with the combination of changes just described, it is hard to pick a winner. But we have more choices.

If we focus just on domestic activities, the corporate tax imposes important distortions that impede economic activity. The favorable treatment of debt finance provided by the deductibility of interest encourages corporate borrowing. While the favorable tax rates on shareholder dividends and capital gains partially offset this, a net tax benefit to borrowing remains. This can lead companies to distort their investments toward those more easily financed by borrowing and to borrow too much, given the added risk that borrowing entails. In light of recent events, it is very hard to believe that we are still wedded to a tax system that encourages borrowing.

Limiting the deductibility of borrowing would not only encourage equity finance and a more productive investment mix, but would also discourage investment overall by raising the

corporate cost of capital. To implement this reform without discouraging investment, then, one would want to couple it with an offsetting policy to encourage investment, such as through more generous accelerated depreciation allowances. In the extreme, one would eliminate the interest deduction entirely and allow immediate write-off of investment. The resulting tax system, known as a cash-flow tax, has been long recognized[3] to eliminate all net tax on new investments, and would therefore remove not only the corporate tax distortions associated with borrowing but also the tax wedge that currently discourages new equity-financed investment. That is, the corporate tax on equity-financed investment and the corporate *subsidy* of debt-financed investment would both be eliminated.

Moving all of the way to a corporate cash-flow tax would eliminate important domestic distortions; moving even part of the way would help. But the full or partial version of this reform does not deal with the international profit shifting incentives discussed above. The United States might become a more attractive place to invest, but other countries with low corporate tax rates would still be more attractive places to report profits and perhaps also to earn them, particularly in the case of investments with high rates of return.

To attack this important remaining problem, one needs some additional provisions to deal with cross-border transactions. One approach, proposed in 2005 by the President's Advisory Panel on Tax Reform in its "Growth and Investment Tax" plan, would be to ignore foreign source earnings (in the same way a territorial system would) and to impose border adjustments on cross-border transactions, of the form typically followed in other countries for existing value added taxes.[4] A simpler alternative I recently proposed (Auerbach 2010) would be to disregard both foreign earnings *and* cross-border transactions entirely in the domestic corporation's tax calculation. Either way, the resulting *destination-based* corporate cash-flow tax would retain the desirable properties already described with respect to domestic operations and also remove corporate incentives to shift profits abroad by eliminating the U.S. tax consequences of doing so.

[3] See Brown (1948).

[4] This approach is also advocated and discussed in a recent review of the UK tax system by Auerbach, Devereux and Simpson (2010).

As an extra bonus, provisions currently in place to prevent this activity, such as interest allocation rules, would be superfluous and could be repealed.[5]

Finally, some thought is needed about the borderline between C corporations and other business entities. Gradually over recent decades, the U.S. business sector has evolved into one that, to a considerable extent, is not subject to the corporate income tax. In 1980, C corporations accounted for 80 percent of U.S. business income, with the remainder being accounted for by partnerships, sole proprietorships, limited liability companies and S corporations. By 2007, the C-corporation income share had fallen to 53 percent, with the fastest relative growth experienced by S corporations, whose income share rose from 1 percent in 1980 to 14 percent in 2007.[6] Tax rules have played a role in this growth, for example around the Tax Reform Act of 1986, when relative changes in corporate and individual tax rates made corporate tax avoidance more valuable (Auerbach and Slemrod, 1997). Reforming the corporate tax alone will not eliminate the tax incentive for businesses to avoid the C-corporation form. Further adjustments would be required, either to the tax treatment of corporate distributions at the investor level or to the ability of entities like C corporations to avoid being taxed like them.[7]

Conclusions

I have concentrated here on two major issues in tax reform, tax expenditures and corporate taxation, because I view each as having a high potential payoff. For the individual income tax, there are items on the tax reform agenda beyond tax expenditures. There is also the question of whether some new vehicle, such as a value added tax or an environmental tax, should be introduced in place of some existing taxes or in addition to them. But, even without the comprehensive tax reform that seems so difficult to approach, there are major improvements in our tax system and the competitive environment it produces that can be achieved through

[5] It is quite possible that adoption of such a new system of corporate taxation, particularly with respect to cross-border transactions, would require modification of existing tax treaties which were not designed to deal with such a system. But there is no logical reason why adjustments akin to those permitted under VAT rules should not also exist under a destination-based cash-flow tax, which is closely rated in its underlying structure.

[6] See President's Economic Recovery Advisory Board (2010), Table 8.

[7] The 2005 Growth and Investment Tax Plan, discussed above, would have imposed the same business-level tax on all business entities except sole proprietorships. But, as discussed in Auerbach (2010), limiting the extension of coverage to large entities outside the C-corporation sector would accomplish much the same objective and leave most businesses unaffected.

sensible reform of tax expenditures and the corporate income tax. Substantial cuts in tax expenditures could be accomplished without harming their apparent objectives, while actually reducing economic distortions that hinder growth and employment and reduce economic well-being. Corporate tax reform could remove the economic distortions of corporate borrowing and investment decisions while at the same time alleviating the pressure to compete in a global race to the bottom.

While not focusing in my comments on the important issue of distributional equity, both sets of reforms I have laid out should be progressive in nature. At least in the examples cited above, modifying tax expenditures to eliminate unneeded subsidies and undesirable effects should leave a greater share of the remaining benefit at the lower end of the income distribution. And, by reducing the tax incentives for companies to locate their profits and capital in other countries, the prospect will be enhanced for higher labor productivity and wages in the United States.

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Senate Finance Committee Hearing
"Does the Tax System Support Economic Efficiency,
Job Creation, and Broad-Based Economic Growth?"
March 8th, 2011
Questions for Dr. Alan J. Auerbach

Questions from Senator Robert Menendez

1. Corporate Tax Revenues as a Percentage of GDP: As you know, the United States has one of the highest statutory corporate income tax rates in the OECD, but raises a lower than average amount of revenue from the corporate tax as a percentage of GDP. Revenues from the corporate income tax in the United States were 2.1% of GDP in 2009 while the OECD average was 3.5%.

    - Can you briefly discuss how we can have a system that imposes the 2nd highest statutory corporate tax rate in the OECD but raises below average total revenue as a percentage of GDP? If we were to measure levels of total business tax revenue as opposed to simply corporate tax revenues, would US business tax revenues as a percentage of GDP be closer to, or exceed, the OECD average?

There is no single accepted way of calculating a measure of "total business tax revenue" because in addition to the individual income taxes associated with pass-through entities one might also wish to include the individual taxes paid by the holders of the equity and debt of C corporations. However, the fact that C corporations have accounted for a declining share of U.S. business income over the years certainly contributes to the low U.S. ratio to GDP. This trend is more pronounced than in many other countries, where the share of business accounted for by the corporate sector started from a lower share and where simple pass-through alternatives like the S corporation do not exist.

Questions from Senator Bill Nelson

1. As you know, tax preferences play an important role in the housing sector. In fact, there are very few sectors of the economy that are more heavily affected by the tax code than housing. These tax preferences include the mortgage interest deduction, the capital gains exclusion on a primary residence, the low-income housing tax credit, mortgage revenue bonds, and until recently, the homebuyer tax credit. If you could rewrite the tax code, how would you deal with these housing-related provisions on a going forward basis? Keep in mind, 40 percent of homeowners in Florida are underwater on their mortgage, and any tax changes that further weaken demand for housing could make their situation only worse.

As I said in my written testimony, the mortgage interest deduction is an expensive and poorly designed provision for stimulating home ownership. In the long run, I would favor cutting it back in the manner indicated in my testimony. In the short run, of course, it is important to take account of the state of the economy, and in particular the construction and real estate industries.

The appropriate approach would be to phase in new provisions over an extended period of time, in order to minimize negative short-run consequences.

2. Our current tax system is based on the fiction that you can easily identify where income is earned. But knowing where income is earned is becoming much more difficult with globalization and electronic commerce. If a Florida consumer buys downloadable software from a company based in India through a website managed in California with servers located in the Cayman Islands, who's to say where the income is earned? Which authority has the right to tax that income? It seems to me that our tax system is not equipped to deal with these new developments. Technology is moving much faster than the tax law can adapt. How do we tackle these challenges?

In my written testimony, I suggested the adoption of a new approach to international taxation, based on the destination principle, as a way of overcoming this very real problem of identifying the source of income for a multinational company.

3. The Florida economy is a service-oriented economy. We do not have a lot of heavy manufacturing. Our industries tend to be labor intensive, not capital intensive – tourism is the perfect example. However, I feel like most of our effort in tax policy in recent years has been focused on heavily subsidizing capital expenditures – business equipment and machinery –the type of property used in manufacturing and other capital-intensive businesses. The December tax bill is a perfect example. It includes a bonus depreciation tax provision that will inject $110 billion into the economy over the next two years. Does federal tax policy distort the market and tilt the field against states like Florida that rely on service-oriented, labor-intensive sectors of growth?

At present, our tax system provides an immediate write-off for many of the expenses that generate income for companies that are not capital intensive, such as advertising. As a consequence, the tax system does not necessarily discriminate in favor of capital-intensive businesses, even in the presence of bonus depreciation.

4. We frequently hear that the uncertainty caused by expiring tax provisions and whether they will be extended, such as the Bush tax cuts, makes businesses less likely to invest, expand, and create jobs. Yet we are also told that a major problem with the tax system is that these special tax preferences are added to the tax code and never reviewed to ensure that they continue to be effective tools for achieving policy objectives. Isn't there a conflict there? On one hand we are told that tax code needs certainty. On the other hand, we need to regularly review tax expenditure to determine whether they should be retained. How should we deal with that dilemma?

There is always a conflict between the uncertainty that policy changes induce and the need to review policies and possibly change them if they are not working. The best solution to this dilemma is a comprehensive tax reform that eliminates as many inefficient and unneeded provisions as possible, to resolve as much uncertainty about the future as possible.

Questions from Senator Jay Rockefeller

1. Is it possible to structure a territorial system that protects American workers and prevents further outsourcing?

I believe this will be difficult and, as a result, have proposed an alternative approach based on the destination principle, outlined in my written testimony.

2. If you could make one change to the current tax code, with the goal of creating more American jobs, what change would you make?

I would adopt the reforms to the corporate tax laid out in my testimony.

3. How would you describe the consequences of a failure to raise the debt limit ceiling, and what would that situation mean for the people of my state?

For the people of West Virginia as well as those of other states, a failure to raise the debt ceiling would induce a costly disruption of federal government services and benefits. It would also disrupt private sector economic activity, which relies on the ongoing provision of government services.

4. Why should I trust that if Congress reforms the corporate tax code that corporate behavior with regard to offshore tax evasion like we see in the Caribbean will change at all?

The answer depends on how Congress reforms the corporate tax code. We know that corporations respond to incentives; the repatriation activity following the 2004 legislation is just one illustration. But the reform must be well-designed to provide the right incentives.

5. Could the housing market survive in the United States (short and long-term) without the subsidies provided by the tax code?

In the long run, the answer is certainly yes. Many other leading economies get along without our generous housing provisions. In the short run, however, the weak state of the housing market suggests that any measures taken to reduce housing tax benefits should be phased in over a period of time.

Questions from Senator Orrin G. Hatch

1. This question follows up the first question I asked during the hearing. In this question I want to focus on the high marginal rates that will kick in on January 1, 2013.

   Under current law, the top statutory marginal income tax rate will increase from 35 percent to nearly 40 percent in 2013. Moreover, for self-employed taxpayers, many of

them small business owners, Obamacare will push the rate up almost another full percentage point.

Lawrence Lindsey, former head of the National Economic Council, is quoted in a July 14, 2009, National Journal article, on the baggage these high rates would mean. Here's what he said:

"When marginal tax rates go over 40 percent, the evidence suggests that the excess burden of collecting additional revenue rises very sharply, making the cost to the private sector of moving additional funds from the private sector to the public sector several times the additional revenue raised."

I would like the panel to respond to Dr. Lindsey's point. Please discuss the implications of the statutory top marginal tax rate approaching 40 percent or higher, as a matter of efficiency.

Dr. Lindsey is quite correct in saying that the excess burden of collecting taxes rises with marginal tax rates. This principle is universally accepted by public finance economists. How rapidly the excess burden rises is subject to greater dispute. There is nothing special about a level of 40 percent. But it is important that base-broadening alternatives be sought before resorting to higher marginal tax rates.

2. I note that Professor Auerbach states that tax reform should be "progressive in nature," and Professor Hubbard talks about the importance of getting the marginal tax rates down – but doesn't a progressive tax code mean that higher-income taxpayers will have higher marginal tax rates than they otherwise would (than under a less progressive tax code, or than under a flat tax)?

   Perhaps we should have a more progressive tax code, or perhaps we should have lower marginal rates but don't those two different ideas cut in opposite directions?

My use of the term "progressive" refers to the distribution of the tax burden, not necessarily to the marginal tax rate schedule. For example, I view lowering the cap on the mortgage interest deduction as a progressive measure, because it preserves the full tax benefit for those with smaller mortgages and, in general, lower incomes. But this policy change would have no effect on the marginal tax rate schedule. I believe that a key focus of tax policy should be on providing a suitable degree of progressivity, as I have defined it, without resorting to a steeply rising marginal tax rate schedule.

3. Regarding the large partnership and other smaller flow-through entities, don't we have a bright line in effect right now? That bright line is access to publicly-traded capital. If a business wants access to publicly-traded capital, it pays the second layer of corporate tax.

   Taking a look at the flow-through entities, with the exception of things like REITS, these entities don't access publicly traded capital. They are financed by their owner's capital contributions and retained earnings. The individual income tax posture of the owner

bears on the after-tax rate of return on that capital. That relationship is relevant to the key decision-maker, the owner. It seems to me Congress recognized that distinction when, in the late 1980's it treated larger publicly-traded partnerships like corporations. In the earlier panel discussion, some panelists seemed pretty sanguine or supportive of Secretary Geithner's idea of imposing the corporate tax on so-called "large" flow-through entities. I've been critical of that idea. A couple questions:

- For those supporters of Secretary Geithner's notion, where would you draw the line?

There is no "right" place to draw the line, but I would focus on the largest pass-through entities, which account for a large share of the income generated by all pass-through entities.

- What would a large partnership look like?

Again, there is no cut-off that would be the obvious choice, but my aim would be to leave the vast majority of pass-through entities unaffected.

- Everyone agrees small business creates 670% of the new jobs. Since a small business is generally defined as those with 500 or fewer employees, wouldn't you want to be careful not to sweep them in?

Job creation is clearly an important consideration in the design of tax policy. Simply extending the corporate tax to a wider group of companies without making any other changes in the corporate tax code would not constitute a reform, in my view. I would hope that other changes in the corporate tax would help provide adequate incentives for businesses to create jobs.

Questions from Chairman Max Baucus

1. Professor Graetz stated his concern about a move to a cash-flow tax as being in violation of our tax and trade treaties and could result in 25 years of trade and tax disputes. Do you agree with Professor Graetz that a cash-flow tax would violate trade and tax agreements? Are there any other countries that have proposed or adopted a cash-flow tax system and if so how have they dealt with tax and trade issues? Do we run the risk of becoming an outlier again like with our worldwide system?

I am not a legal expert, but it is plausible to me that the United States would have to amend tax and trade treaties and agreements were it to adopt a corporate cash-flow tax. To my knowledge the corporate cash-flow tax has not been adopted by any major country. I think the risk of our becoming an outlier again would be less of a concern if we adopt a tax system that gives us a competitive advantage, for it should be in the interests of other countries to adopt such a system as well.

2. Professor Hubbard states in his testimony that the tax code's bias in favor of debt-financing favors low-risk investments over the risky investments. But Professor Auerbach argues that reducing the bias in favor of debt by eliminating interest deductions would discourage investment by raising the cost of capital. To prevent a reduction in

investment, he argues that eliminating interest deductions should be accompanied by offsetting measures like accelerated depreciation.

- Do you believe the corporate income tax creates incentives to invest in low-risk investments instead of high-risk investments? Is this effect good or bad for the economy?

The tax bias in favor of debt encourages low risk investments to the extent that these are more easily financed with borrowing than are high risk investments. But there is also an offsetting impact, that companies with limited liability that borrow have a "one-sided bet" that allows them to reap the positive rewards if very risky investments succeed but lay off some of the losses onto bondholders if the investments fail and drive the company into bankruptcy. This and other parts of the corporate tax system (including the limited ability to use net operating losses) have complex effects on the composition of investment, encouraging risk taking in some ways and discouraging it in others. But influences that distort the choices among investment projects are undesirable unless one can present a case that companies need to be influenced by the tax system to make the right investment choices.

- If tax advantages for debt-financing like interest deductibility were removed, would there be an overall decrease in investments? If so, what measures should we take to offset this fall in investment?

The cost of capital on debt-financed projects would rise, while the cost of capital on equity-financed projects would not change, so the overall cost of capital would rise if the only change in tax policy were to cut back on the interest deduction. Therefore, as I said in my testimony, it would be desirable to offset this decline in the tax benefit of borrowing with an increase in the tax benefit of investing.

COMMITTEE ON FINANCE
NEWS RELEASE

Max Baucus (D-Mont.)
http://finance.senate.gov

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding the Tax System's Current Effect on Economic Efficiency, Jobs, and Growth

Dwight Eisenhower once said:

"Neither a wise man nor a brave man lies down on the tracks of history to wait for the train of the future to run over him."

That train of the future depends on a strong and growing economy, and today we face challenges to our economy on many fronts. Our economy is still recovering from the most significant recession since the Great Depression.

U.S. debt, as a share of the economy, is at its highest level in 50 years, and it is projected to rise much higher in the coming years. At the same time, economic competition is stiffening as the world economy grows increasingly globalized.

In 1960, exports accounted for 3.6 percent of America's GDP. Today they account for almost 12.5 percent. In the face of these challenges, we cannot afford inefficiencies in spending programs or in the tax system.

Our tax code must maximize job creation and widespread economic growth. It must be finely tuned to its objectives, so we are driving that train of the future and not lying beneath it.

Last year, we began a comprehensive review of America's tax system. We held hearings to look at the history of the code. We contemplated lessons learned from the last major revision of the tax code in 1986. We considered historical trends in income and revenue. And we analyzed how the code has swelled in the intervening years, often failing to adapt to our changing world. These hearings explained how we got to where we are today.

Today, we begin a set of hearings asking: "Why do we need tax reform?" These hearings will analyze what we expect our tax system to accomplish, and whether it effectively meets those objectives.

Of course, the tax code should raise the revenue necessary to finance the operation of the country, but we also want our tax system to stimulate economic development, encourage business activity, and promote fairness and certainty. We want it to minimize compliance and administrative costs to taxpayers.

So, how does our current system rate? Today's witnesses will help us answer that question. They will examine the tax code's effect on job creation and broad-based economic growth.

Today we have 7.5 million fewer jobs than when the Great Recession started. These lost jobs have caused unimaginable family hardships, and high unemployment has also meant less Federal revenue and a worsening debt crisis.

We need a tax code that supports putting Americans back to work. We also need a tax code that does all it can to ensure the long-term prosperity of our country.

I'll be asking our panelists if the tax code encourages investors to take healthy risks and make sound investments. Or, does it encourage unhealthy risk-taking and investing in underperforming assets? For example, corporations currently receive a tax deduction when they pay interest, but not when they pay dividends. As a result, businesses may choose to obtain capital through borrowing rather than through issuing stock.

We need to know whether these incentives cause businesses to become overleveraged in a way that hurts our economy. We also need to know whether the tax code encourages individuals to make positive decisions that strengthen widespread economic growth.

For example, there are dozens of provisions in the tax code that incentivize individuals to save for major expenditures like retirement, education or health care spending. Incentives that help individuals save for specific expenses are the third-largest tax expenditure in the code. They cost more than $124 billion in 2011.

A recent White House report found that this plethora of choices can actually have a negative effect on individual investment because many people are intimidated and confused by the range of choices and complicated rules for each.

So let us ask how the tax code is positively and negatively affecting individual and businesses decisions.

Let us question what more we can do to incentivize job creation and widespread economic growth.

And let us determine how we can ensure our tax system drives our economy into the future, rather than putting the brakes on it.

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Statement by James K. Galbraith, Lloyd M. Bentsen, Jr. Chair in Government/Business Relations and Professor of Government, The University of Texas at Austin, and Senior Scholar, Levy Economics Institute, before the Senate Finance Committee, March 8, 2011, hearing on Principles of Efficient Tax Reform.

Chairman Baucus, Senator Hatch, Members of the Committee, it is an honor for me to appear before you this morning, to discuss the fundamental principles of an efficient tax reform.

1. **Taxes and Deficits.** Let me begin by noting that the realized budget deficit is an economic outcome, not a policy choice. So long as the economy faces high unemployment, there is no fiscal formula – no combination of tax increases and spending cuts – that can make it go away.

Our present very large budget deficits arise for two reasons. First, because of the collapse of private credit, the decline of employment and activity, and therefore the fall of tax revenues in the slump and recession. This is a problem we share with the whole world, as the International Monetary Fund's staff has recently shown. Second, in the (almost unique) case of the United States, part of our budget deficit is due to the global role of the dollar and the use by the rest of the world of Treasury bonds as a reserve asset. That they do so – "exorbitant privilege" – is greatly to our advantage.

Neither of these forces can be controlled by cutting spending or raising taxes. One can reduce *projected* deficits – for future years – by raising future tax rates or cutting programmed spending for those years. But this is an artificial and unreliable exercise. The actual realized deficits in the future will depend on economic performance at that time, and it is economic performance that actually matters, not the deficit or the public debt. Thus tax reform – and spending policy as well, in my view – should properly focus on economic performance and not on deficits.

On the broader question of deficits, I am attaching for your record a brief statement by Trustees, Directors and Fellows of Economists for Peace and Security, a professional association. It affirms that the US government is not broke, that budget deficits are normal, and that our pressing priorities are related to economic performance. The statement is signed by distinguished economists including Kenneth Arrow, Andrew Brimmer, Robert J. Gordon, and Alan Blinder.

2. **Tax Incentives.** When economists address tax policy, they often speak of "distortions." The implied claim is that distortions are bad, and should be removed from the tax code as a matter of principle. You will not hear this language from me. To economists, the phrase"tax distortion" generally implies comparison is to a system with a "lump-sum head-tax" – a poll tax – because that is the only kind of tax that cannot be reduced by changing behavior. Yet the poll tax is the most regressive and pernicious tax available. In the real world, practically every other tax is plainly superior to that one.

Tax incentives are therefore an inescapable fact of life. The proper question is: which incentives work best, for which worthy objectives? And how best to reconcile the incentives in the tax code with the other function of taxation, namely the regulation of demand? Let me begin with an example.

In the years 1981 through 1984, I served first as Executive Director of the Joint Economic Committee under Chairman Henry Reuss, and then as Deputy Director under Vice Chairman Lee Hamilton. The Senate Democratic Members were Senators Bentsen, Proxmire, Kennedy and Sarbanes. In 1984, in the Joint Economic Report, we endorsed the Bradley-Kemp Tax Reform Bill. That bill later evolved into the famous Tax Reform Act of 1986.

The concept of the Tax Reform Act was to promote simplicity and fairness, without changing the overall burden or incidence, by broad income class, of the income tax. The method was to reduce or eliminate many exemptions and deductions, mainly taken by wealthy people, and then to tax the expanded Adjusted Gross Income at a lower marginal rate. The effect was to redistribute tax burdens mainly within upper-income groups, to the benefit of those who had relatively simple earned incomes (a category that had at one time included Bradley, Kemp, and also President Reagan), and to the detriment of many whose incomes were related to tax-favored activity.

President Reagan deserves full credit for adopting the Bradley-Kemp principles, which he did on the recommendation of his Treasury Department after a year of study, intended to delay consideration of the issue past the 1984 election. During that year, the Treasury tax policy office had conducted among other things an analysis of the Value-Added Tax, and had rejected that alternative for reasons that remain, in my view, valid today. Bradley-Kemp achieved an important improvement in tax fairness.

The Tax Reform Act saved the income tax. But in retrospect it had at least two problematic effects.

The first effect – and here I speak broadly of the movement toward lower top marginal tax rates from 1978 through 1986 – was on corporate executive pay. It is probably not accidental that the years after lower marginal income tax rates took hold – along with lower rates on capital gains – saw the CEO pay explosion.

Why? In part, because lower marginal rates reduced the cost to companies of raising post-tax executive pay (just as the high marginal rates had deterred big pay packages in the first place). The new rules made it irresistible for those who controlled CEO pay to reward themselves in this way. Crudely put, companies quit building skyscrapers and their chiefs built themselves mansions instead. Many ills of American corporate governance can be traced to this new age of executive self-dealing.

Second, as a political compromise, the TRA disallowed deduction of consumer interest payments except for mortgages. This led to an inexorable rise in the use of homes as collateral for loans that supported consumer, student, vacation and health-care-related spending, and therefore to the depletion of home equity as an element in the financial security of the middle class. As the process unfolded over time, it helped produce the systematic abuse of mortgage lending that became pandemic in the middle years of the last decade and that produced the financial crisis.

On the whole, there is no reason to believe that the TRA improved economic performance. The aftermath of tax reform saw the market crash of 1987 and then the recession of 1989-91, from which the economy recovered only very slowly. There were no significant increases in private savings as a share in income, nor in work effort. Thus, I do not believe that the Tax Reform Act of 1986 should be viewed today as the single ideal for the tax code going forward. In particular, a new tax reform should not make a virtue of low marginal rates. If higher taxes are needed, one of the best ways would be to impose a new rate or rates on the highest incomes. And tax reform should not aim indiscriminately at existing tax preferences for middle class Americans, some of which serve their purposes well.

For example, the Reagan years invented and the late Clinton years saw major expansion of the Earned Income Tax Credit. The EITC stabilizes the incomes of workers in the lowest-paid and hardest jobs, and protects them from unstable employment. It is invisible to employers; therefore it is likely to have little effect on the proffered wage. It is a well-designed and effective program; there is no reason to cut it just to reduce "tax distortions," and also none to cut it for "deficit-reduction."

Equally, the home mortgage interest deduction worked for many decades to promote home ownership in stable communities and neighborhoods. It became pathological only when it became the vehicle for all forms of lending, and when mortgage originators took advantage of the law to create massively abusive and fraudulent mortgage instruments, including exploding ARMS, NINJA loans, liars' loans, no-doc loans, and the rest. The appropriate solution is not to eliminate the tax preference for a standard 15-to-30 year self-amortizing mortgage with a substantial required down payment. It would be more sensible to write the law so that only that type of plain-vanilla, fully-documented mortgage received tax-deductible status.

3. **Bad and good incentives: the payroll tax and the estate tax.**

The payroll tax was increased sharply in 1983 and is the largest direct tax paid by most working people. It tails off, as a proportion of income, for upper-income Americans on account of the cap on earnings, and the fact that non-wage incomes are not subject to the tax. The high payroll tax rates on working people – yielding revenues which were for many years vastly higher than benefit payments under Social Security – were partly intended to shield Social Security benefits from pressures to cut them when the baby boomers began to retire. But they were also a way to shift the burden of taxes in general onto labor and away from non-labor income.

The payroll tax penalizes job creation. By extension it fosters the gray economy, welfare-dependency and crime. This was not a serious problem in (say) the late 1990s, when strong credit creation propelled us to full employment. It is a major problem today. That is why a payroll tax holiday, with the federal government holding the Social Security Trust Fund harmless, was a good idea when enacted last year. On the employee side payroll tax relief helps increase household disposable income; on the employer side it helps cash flow and to reduce the cost of job creation. There may be more efficient job-creation incentives – the TJTC comes to mind – but they are also harder to implement.

In the United States, uniquely among nations, about eight percent of all employment is in the non-profit sector. Why? In substantial part, because for over a century we have given wealthy citizens a strong tax incentive to make philanthropic gifts to universities, hospitals, churches, museums, foundations and other not-for-profit organizations, in advance of the grim reaper. This is partly responsible for our broadly excellent employment performance (compared to Europe) over many years. It is partly responsible for the greatness of our universities and hospitals, and for the vibrancy of our religious life. It integrates wealthy Americans back into their communities, helping to foster and strengthen our democracy. It fosters a broad decentralization of important public activities: for example, higher education policy decisions that in other countries are often vested in a single cabinet ministry, are here made by thousands of independent university administrations.

These benefits and advantages are threatened by the campaign against the estate tax, pushed heavily by one group of wealthy citizens, yet opposed by many other wealthy citizens. History and experience support the second group. There is a very strong incentive-based case for an estate tax with a high tax rate, a high level of exemption, and a one-hundred percent deduction for qualified philanthropic contributions.

4. Simplicity? A frequent stated concern of tax reformers is how best to simplify the code. One proposal before you would reduce the income tax for most filers and to replace it with a value-added tax. An appeal of this proposal is that it would eliminate many income tax returns. But of course, a large number of lower-income filers use the short form. This is not a complicated document, and to eliminate it does not seem to be a pressing priority in itself.

Yet, eliminating the federal income tax for low-income filers would make state government taxation much harder, since state income taxes are keyed to the federal tax. Meanwhile the proposed VAT would force a major restructuring of state sales taxes, which would have to convert to piggy-back on the VAT at variable rates, depending on the amount of income tax that would have to be replaced. This, in turn, would create new location incentives for business, to the disadvantage of high-tax states. These changes would create impressive challenges for states and localities already in the grip of fiscal crisis.

As a rule, let me urge you to work slowly. Any truly radical reform is likely to have far-reaching effects. They should be studied carefully, and by analysts with a wide range of views. Actions in this area should always be cautious and incremental, and claims of great gains over the existing system should always bear a heavy burden of proof. Things are often not so simple as they seem.

5. **Growth**? Tax reformers often promise that their proposals will favor economic growth. But there is little evidence that this has ever happened in the past. In principle, this should be no surprise. The long-run potential for economic growth depends on the growth rate of our population, the cost of natural resources, technological progress and the rate of business investment. It is very difficult for any tax reform to change these factors materially. Business investment can sometimes be stimulated by tax favors in the short-run, such as the investment tax credit. Sometimes, this is desirable policy. But a one-time increase in investment does not yield a long-term increase in the rate of growth.

Despite the tradition of hype that suffuses this topic, the most any tax law change can reasonably promise is modest improvement in economic conditions in the fairly short run. History also teaches that most of that effect comes from increasing purchasing power when it is too low – that is, from the Keynesian effect and not the supply-side effects. Tax law changes do not supply magic bullets for financial crises, nor for a period of slow technological innovation or rising costs of energy.

6. **Should we tax capital, labor – or rent**? Is it a good idea to shift the tax burden from high-income to low-income Americans, in the guise of shifting the tax burden from capital to labor, in order to promote "saving and investment"? In particular, will this create new jobs? History say not: we have been shifting this burden for decades with no appreciable effect on savings, investment or jobs.

And there is also no shortage of capital in our economy. As the economist Mason Gaffney wrote in a paper delivered to the National Tax Association in 1978: "The key to making jobs is changing the use and form of capital we already have. Tax preferences for property income, in their present and proposed forms, bias investors against using capital to make jobs, doing more harm than good."

Economists from Smith to Ricardo to Mill understood that fixed investments, however useful, do not generate many permanent jobs. What creates jobs is the revolving capital that supports payrolls. A tax policy aimed at supporting employment would shift the tax burden away from labor, and off of short-term capital, and place it instead on long-term capital accumulations. If this reduces the investment in fixed capital that is desired for other reasons – in particular, investment with broad public benefits – then that sort of investment should be done by public authority, funded by an infrastructure bank.

Thus as a general rule fixed assets – notably land – should be taxed more heavily than income. The tax on property is a good tax, provided it is designed to fall as heavily as possible on economic rents. This basic argument, going back to Ricardo, remains sensible, for it aims to not-interfere where there is, in fact, no public purpose to interfere with private decision-taking. Payroll taxes and profits taxes do interfere directly with current business decisions. Taxes effectively aimed at economic rent, including land rent and mineral rents, and at "absentee landlords" as Veblen called them, do not.

An important question is how best to treat the "quasi-rents" due to new technology and thus the incentives for innovation. These are presently held as long-term capital gains and they tend to escape tax to a very large degree, with the consequence that a small number of successful innovators (and patent holders) have become an oligarchy of never-before-equaled wealth.

The incentive for innovation is an important public policy objective. But it does not require the vast prizes presently available. And it does not require that those prizes escape tax indefinitely. A sensible approach is to tax unrealized capital gains after a certain amount of time has elapsed – perhaps at fates that rise with time – and again subject to a full charitable deduction. In the final analysis – that is to say at death – once again setting the estate tax at a high rate with a high exemption encourages the early transfer of large quasi-rents to independent foundations or other non-profit institutions (universities, hospitals, churches), and into activities consistent with public purpose. I would also favor raising required foundation payout rates, so as to assure that foundations do not last in perpetuity unless they find new donors.

7. **Energy and Carbon**. I have explained why I do not favor substituting a value-added tax for the income tax. It might however be sensible to replace the payroll tax. In view of the oncoming crises of energy security and climate change, a tax on energy or on carbon would make a good substitute for the payroll tax, especially if it were designed to hold working families harmless, while increasing the incentives for conservation facing companies, retirees, and those with non-labor incomes.

8. **Summary.** Tax law serves two broad goals: the regulation of effective demand and the pursuit of public purpose. The Tax Reform Act of 1986 was gave us an income tax structure that is viable for the long run. But its purposes are not ours. We face four pressing priorities: to create jobs, to change how we produce and use energy, to restructure our financial sector, and to curtail the pernicious power of a small number of wealthy persons – our new American oligarchs – who have taken undue advantage of past tax reforms. A shift of the tax burden away from labor, onto energy, and onto accumulated wealth – with the philanthropic escape clause – would help give us back a healthier, more egalitarian, and more democratic society in future years.

The statement by my EPS colleagues follows. I thank you again for your time and attention.

FEDERAL SPENDING AND THE RECOVERY: A Statement by Directors, Trustees and Fellows of Economists for Peace and Security, (www.epsusa.org) February 28, 2011.

The budget adopted by the House of Representatives on February 19, 2011 does not make economic sense and is likely to do more harm than good. First, the rationale for the measure is based on a false premise. Secondly, the budget cuts being proposed will impede and may end the recovery. If the recovery fails, unemployment will increase and the financial crisis could re-emerge.

The premise that the US government is broke is false. The US government has never defaulted and will not default on any of its financial obligations. Deficit spending is normal for a great industrial nation with a managed currency, and it has been our normal economic condition throughout the past century. History proves, and sensible economic theory confirms, that in recessions, increased federal spending – not balancing the budget – is the tried and true way to return to a path of sustained growth and high employment.

Eliminating waste in government spending is desirable. But that is not what the House proposes; indeed the House budget failed to address the largest waste in federal government, namely in the military, and the House failed to remove our most egregious subsidies, such as to oil companies. To adopt a policy of deep budget cuts at this stage of recovery is to surrender to irrational fears in the service of a political, not an economic, agenda.

As economists, as citizens, and as long-time critics of waste in government, we call on the Senate to reject the House proposal and to craft an alternative that places first priority on sustaining economic recovery and on dealing with the country's true economic and social problems, which include unemployment, home foreclosures, the fiscal crisis of states and cities, our infrastructure needs, energy security and climate change.

Clark Abt, Brandeis University and Cambridge College
Kenneth Arrow, Stanford University, Nobel Laureate
Marshall Auerback, Madison Street Partners
Barbara Bergmann, American University and University of Maryland
Linda Bilmes, Harvard University
Stanley Black, University of North Carolina
Alan S. Blinder, Princeton University
Andrew F. Brimmer, Brimmer & Co.
Kate Cell, Principal, Kate Cell Consulting
Lloyd Jeff Dumas, The University of Texas at Arlington
Gary Dymski, University of California, Riverside
James K. Galbraith, The University of Texas at Austin
David Gold, The New School
Robert J. Gordon, Northwestern University
Michael Intriligator, UCLA
Richard F. Kaufman, Bethesda Research Institute
Ann Markusen, University of Minnesota
Richard Parker, Harvard University
Dimitri B. Papadimitriou, The Levy Institute of Bard College
Gustav Ranis, Yale University
Kathleen Stephansen
Lucy Law Webster, Center for War/Peace Studies, New York

Senate Finance Committee Hearing
"Does the Tax System Support Economic Efficiency, Job Creation and Broad-Based Economic Growth?"
March 8th, 2011
Questions for Dr. James K. Galbraith

Questions from Senator Robert Menendez

Tax Simplification: I believe tax reform should ensure that the incentives we choose to have in the code are effective and easily accessible to the families and businesses we are trying to help. For example, the current system includes at least 18 different provisions intended to help with education costs and to encourage savings for college. The confusion created by these overlapping provisions in many cases can lead families to make errors or miss out on valuable education incentives. In fact, a recent Treasury report noted that less than 40 percent of eligible families were estimated to claim the American Opportunity Tax Credit, despite the fact that it's generally the most valuable education tuition incentive. This is just one illustration of missed opportunities caused by a complicated tax system.

Could you briefly touch on one or two areas in the code that you think would benefit the most from simplification, either in terms of ease of use for taxpayers, or for overall efficiency?

A. An example is offered by my colleague at the University of Texas School of Law, Calvin Johnson: "No Deduction for Tax Planning and Controversy Costs." 129 TAX NOTES 333 (Oct. 18, 2010), http://tinyurl.com/4nkhzm4 Tax incentive schemes for saving are often rationalized by the argument that they increase resources for capital investment. This argument is based on a centuries-old fallacy ("Say's Law") – and there is also no good evidence that such schemes have in fact increased either the rate of personal saving or the rate of business investment. Let me refer you to another essay by Johnson: "Repeal Roth Retirement Plans To Increase National Savings," 128 TAX NOTES 773 (August 16, 2010), http://tinyurl.com/4hyv6gh What these preferences do, instead, is to make particular services, like education or provision for retirement, cheaper for those with higher incomes, since the deduction is only used by those who itemize deductions, and the value increases with tax bracket. Also, as you point out, the incentive is more effective for those who can maneuver through the complexities of the code. Calibrating the cost of education (for example) so that it is cheaper for people with higher incomes is poor tax policy from every point of view, including both efficiency and fairness. In general, repealing these preferences and expanding the tax base to reduce shelters currently used by the wealthy is a good way to achieve both simplification and fairness.

Questions from Senator Bill Nelson

As you know, tax preferences play an important role in the housing sector. In fact, there are very few sectors of the economy that are more heavily affected by the tax code than housing. These tax preferences include the mortgage interest deduction, the capital gains exclusion on a primary residence, the low-income housing tax credit, mortgage revenue bonds, and until recently, the homebuyer tax credit. If you could rewrite the tax code, how would you deal with these housing-related provisions on a going forward basis? Keep in mind, 40 percent of homeowners in Florida are underwater on their mortgage,

and any tax changes that further weaken demand for housing could make their situation only worse.

Renters and low-income homeowners who take the standard deduction get no benefit from the mortgage interest deduction, and the effect of that deduction in recent years has been to subsidize massive over-investment in high-end housing, often with mortgage products that were fraudulent in character. At the same time, as your question implies, drastic changes in the deductibility of mortgage interest would affect home prices, and therefore delinquencies and foreclosures including for many who are prime credits. It is not painless to escape even from a bad system. A cautious approach would be to limit the mortgage interest deduction going forward to plain-vanilla 15- and 30-year fixed-rate mortgage products with full documentation of income and credit history, and to cap the deduction at a reasonable value.

Our current tax system is based on the fiction that you can easily identify where income is earned. But knowing where income is earned is becoming much more difficult with globalization and electronic commerce. If a Florida consumer buys downloadable software from a company based in India through a website managed in California with servers located in the Cayman Islands, who's to say where the income is earned? Which authority has the right to tax that income? It seems to me that our tax system is not equipped to deal with these new developments. Technology is moving much faster than the tax law can adapt. How do we tackle these challenges?

A. In your example, the income was earned in Florida – that's where the consumer is. It should be taxed as such. Broadly the objective should be to repair and maintain the tax base; proposals to create a "territorial exemption," will simply further facilitate out-migration of corporate income. I note the case of General Electric, which according to the New York Times (March 25, 2011, page one) has mastered the art of corporate tax avoidance; this should not become the acceptable model. US residents should be required to report all their income regardless where it is earned; US-based companies likewise should be taxed on their global earnings. If it is too difficult to tax the profits of foreign companies selling into the US – the Indian company in your example – then there should be import tariffs – rough justice, perhaps, but better than allowing capital to escape tax.

The Florida economy is a service-oriented economy. We do not have a lot of heavy manufacturing. Our industries tend to be labor intensive, not capital intensive – tourism is the perfect example. However, I feel like most of our effort in tax policy in recent years has been focused on heavily subsidizing capital expenditures – business equipment and machinery –the type of property used in manufacturing and other capital-intensive businesses. The December tax bill is a perfect example. It includes a bonus depreciation tax provision that will inject $110 billion into the economy over the next two years. Does federal tax policy distort the market and tilt the field against states like Florida that rely on service-oriented, labor-intensive sectors of growth?

A. Yes. If you allow the interest deduction and also allow bonus depreciation or expensing, you have not a tax but a subsidy. The subsidy makes it rational to borrow to make investments that would not be made in absence of tax. Sometimes subsidies are desirable – for example when you are trying to spur the recovery of private business investment after a recession – but simply hiring people to provide needed services – such as home care for seniors – would be a more effective use of federal funds.

We frequently hear that the uncertainty caused by expiring tax provisions and whether they will be extended, such as the Bush tax cuts, makes businesses less likely to invest, expand, and create jobs. Yet we are also told that a major problem with the tax system is that these special tax preferences are added to the tax code and never reviewed to ensure that they continue to be effective tools for achieving policy objectives. Isn't there a conflict there? On one hand we are told that tax code needs certainty. On the other hand, we need to regularly review tax expenditure to determine whether they should be retained. How should we deal with that dilemma?

It is clearly in the interest of those who receive tax preferences to plead that they should be extended. There is however practically no evidence that these preferences in fact increase the overall rate of business investment. Further, the fact that tax expenditures evade ordinary budget review can be treated as reasonable evidence that they would not pass scrutiny under such a review. So the claim that "certainty" would increase investment needs to be treated with the deepest skepticism.

Questions from Senator Jay Rockefeller

How important is it to keep a progressive structure for any tax code that emerges from the tax reform process?

A. The long campaign to reduce the progressivity of the tax code has produced no perceptible economic benefits, and it is past time to call a halt to this trend in taxation. Our present brackets reflect the norm that half the country pays 15% tax, above that pay 38-35%, and below that pays 10%, 0, or gets an earned income credit. Shift over to a constant rate tax, and would you hurt the people who can least pay. I am advised, for instance, that Governor Huckabee's so-called FAIR tax proposal would have required tax rates to quintuple on average for the poorer 90 percent of the people of Arkansas. The failure to maintain progressivity at the very top is also a source of many evils, including the explosion of CEO pay and self-dealing, with its destructive effect on corporate governance. A new effort at tax reform should aim to restore progressivity, especially with a higher rate of income tax on very high incomes and an end to preferential tax treatment of dividends and capital gains. I would also urge that the estate tax be preserved, with a high exemption but with a high rate applied above that exemption.

If you could make one change to the current tax code, with the goal of creating more American jobs, what change would you make?

A. The non-profit sector currently supplies eight percent of employment, with the highest rates of growth in the recent past and the highest potential for new American jobs going forward. To encourage job growth in this area, why not institute a progressive rate structure on the estate tax, with a full philanthropic deduction, to further encourage the wealthiest Americans to support universities, hospitals, churches, cultural institutions and other non-profit activities? This is the group that has most benefited from tax policy for the past 30 years, on the theory that they would "work, save, invest" and create jobs. That theory didn't work out. It is time to shift the control over those resources toward institutions that do, in fact, create jobs. In a similar vein, the required rate of spend-out for foundations should be increased, and the ability of donors to take personal advantage of their wealth by controlling it after placing it in a philanthropic vehicle (such as a foundation) should be restricted.

How would you describe the consequences of a failure to raise the debt limit ceiling, and what would that situation mean for the people of my state?

A. Failure to raise the debt ceiling could precipitate defaults by the US government on many obligations – to employees, contractors, Social Security beneficiaries and even bond-holders. Any delay in such payments will hurt economic activity and kill jobs. If the failure affects the debt markets, it could unnecessarily raise fears about the liquidity of the market for US Treasury bonds, with potentially nasty consequences for the stability of the foreign exchange markets.

Why should I trust that if Congress reforms the corporate tax code that corporate behavior with regard to offshore tax evasion like we see in the Caribbean will change at all?

A. I can think of no reason. And a territorial tax exemption would make it practically impossible to collect income tax from any corporation.

Could the housing market survive in the United States (short and long-term) without the subsidies provided by the tax code?

A. Not in its present form, though that would not necessarily be a bad thing, and major changes are inevitable in any event. Certainly there is no justification for continuing tax subsidies to corrupt mortgage practices. However, it does follow that with fewer preferences house prices would fall, more mortgages would default, some lending institutions would probably fail, and there would be even less construction since construction costs could no longer be covered by the sale price of a new home. As noted, though, it may be that the market for new home construction is already doomed by the oversupply resulting from the past corrupt financial practices.

Questions from Senator Orrin Hatch

This question follows up the first question I asked during the hearing. In this question I want to focus on the high marginal rates that will kick in on January 1, 2013.

Under current law, the top statutory marginal income tax rate will increase from 35 percent to nearly 40 percent in 2013. Moreover, for self-employed taxpayers, many of them small business owners, Obamacare will push the rate up almost another full percentage point.

Lawrence Lindsey, former head of the National Economic Council, is quoted in a July 14, 2009, National Journal article, on the baggage these high rates would mean. Here's what he said:

> "When marginal tax rates go over 40 percent, the evidence suggests that the excess burden of collecting additional revenue rises very sharply, making the cost to the private sector of moving additional funds from the private sector to the public sector several times the additional revenue raised."

I would like the panel to respond to Dr. Lindsey's point. Please discuss the implications of the statutory top marginal tax rate approaching 40 percent or higher, as a matter of efficiency.

A. We have in the past had top marginal tax rates much higher than 40 percent, for the very highest incomes, alongside strong economic growth and performance. There is no compelling reason why marginal rates of 45 or even 50 percent could not now be applied to the highest incomes. However, expanding the tax base, so that it actually reaches the incomes of the wealthy in whatever forms they earn it, is probably the more effective approach. In particular special preferences for capital gains and dividends have been tried, without beneficial results for economic activity. Eliminate them.

Professor Galbraith, you believe there to be an overemphasis, or even a hysteria, of concern regarding the problem of the federal government's debt. You are relatively blasé about what most Americans consider to be unacceptably high levels of federal government debt. But I would like to ask you a bit about your views.

Do you believe a balanced budget to be a worthwhile goal?

A. No. So long as the US dollar is in demand as a reserve asset in the world economy, then the US government must run a current account deficit to meet that demand and (assuming no change in private domestic financial balances) there must be a corresponding US budget deficit. This is a matter of accounting, not theory. In addition to that, to maintain economic growth the government must almost always spend more than it takes in as taxes – as it has done throughout the past century and for most of the time since the founding. The only exceptions to this rule are during brief periods when the private sector is accumulating debts very rapidly – credit

bubbles, as in the late 1920s and late 1990s – and these periods are necessarily brief and unsustainable. Balanced budgets are actually a dangerous objective; their attainment has always been followed by economic contraction and a return to deficits.

Doesn't the goal of a balanced budget force some sort of prioritizing as to what government programs are worthwhile, and which ones are not? Wouldn't such a process of prioritization be healthy for the economy and the political process?

A. Government should prioritize its activities. For instance, in my view it should curtail unneeded military programs – many of them largely unchanged and functionless since the end of the Cold War – and increase investment in energy security, the mitigation of climate change and the creation of jobs. The objective of a balanced budget adds nothing to these goals, and in some ways makes them more difficult to achieve.

Would you be willing to express, as a percentage of GDP, what you consider an acceptable long-term average government deficit to GDP ratio?

A. The long-term average deficit/GDP ratio is not a policy objective. With nine percent unemployment, the right question is: how large an effort do we need to make to restore high employment, and how can we finance this through both the public and the private (banking) sectors? The answers to these questions will produce a budget deficit as a resultant. Whatever deficit meets the objective is the "right" policy. In bad times, the deficit both should and will be high and the debt/GDP ratio will rise, as it did after 1980 and after 2000. In better times, the deficit will be smaller and the debt/GDP ratio will fall, as it did continuously from 1946 to 1980 and from 1994 to 2000. Having said that, it's easy to calculate that with (for instance) a 60 percent initial debt/GDP ratio and a five percent nominal GDP growth rate, starting from full employment, a deficit/GDP ratio of three percent entails no change in the debt/GDP ratio. If the initial debt/GDP ratio is 80 percent, then four percent is the no-change value. If the initial debt/GDP ratio rises to 100 percent, then five percent is the no-change value of the deficit/GDP ratio, with the same five percent nominal GDP growth.

Professor Galbraith, you wrote in your written testimony, in part:

> "Thus as a general rule fixed assets – notably land – should be taxed more heavily than income. The tax on property is a good tax, provided it is designed to fall as heavily as possible on economic rents. ... Payroll taxes and profits taxes do interfere directly with current business decisions. Taxes effectively aimed at economic rent, including land rent and mineral rents ... do not."

I believe there would most likely be a constitutional barrier to having a federal tax based on land values. That is, generally "direct taxes" must be apportioned amongst the states, according to the population of each state.[1] (An exception to this requirement was

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1 *See* U.S. Const., Art. I, sec. 2, clause 3.

provided for income taxes by the 16th Amendment.) Generally, ad valorem real property taxes are considered direct taxes that still must be apportioned.[2] But perhaps an ad valorem land tax is not what you were suggesting – or was it? Can you be more specific as to "taxes effectively aimed at economic rent, including land rent" that would not be direct and thus would not have to be apportioned amongst the states? Are there any taxes the federal government currently levies that are consistent with your recommendation to be "effectively aimed at economic rent, including land rent"?

A. My colleague Calvin Johnson advises that there is no constitutional impediment to a land tax. He writes, in private correspondence: "Direct tax originally meant a requisition, directly on the states to satisfy their quota. The purpose was not that Congress had to apportion any tax, but that if it did apportion a tax it had to follow the slave-nonslave state compromise over taxes under which slaves would count at 3/5ths. In 1796, the Supreme Court (US v. Hyton) when still manned by the Founders who had participated in the debates directly, held that the defining characteristic of a direct tax was reasonable apportionability and if the tax could not be apportioned without unfairness, it was not direct. Polloch v. Framers Trust (1896), which held that income tax was unconstitutional has been overruled on almost every point and it was terrible history int the first place. Congress can go forward in distain of Polloch. Land taxes were presumed to be apportionable in 1787 because land and people were the alternative measures of wealth, neither exact. But if land is held with per capita value that is unequal among the states, it need not be apportioned." However, "economic rents" go beyond land taxes, to cover also what are known as "quasi-rents," or returns to other fixed assets including knowledge, technology, patent and copyright protection. Though it operates with a lag, the estate tax is our most effective federal tax on these rents, either capturing them directly or causing them to be recycled into non-profit institutions, a major source of job creation. The tax on capital gains touches them as well; a tax that touched unrealized capital gains, after a certain time lag, would be even more effective.

Regarding the large partnership and other smaller flow-through entities, don't we have a bright line in effect right now? That bright line is access to publicly-traded capital. If a business wants access to publicly-traded capital, it pays the second layer of corporate tax. Taking a look at the flow-through entities, with the exception of things like REITS, these entities don't access publicly traded capital. They are financed by their owner's capital contributions and retained earnings. The individual income tax posture of the owner bears on the after-tax rate of return on that capital. That relationship is relevant to the key decision-maker, the owner. It seems to me Congress recognized that distinction when, in the late 1980's it treated larger publicly-traded partnerships like corporations.

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2 *See* Murphy v. CIR, 493 F.3d 170, 181 (2007) ("Only three taxes are definitely known to be direct: (1) a capitation, U.S. CONST. art. I, § 9, (2) a tax upon real property, and (3) a tax upon personal property.")

In the earlier panel discussion, some panelists seemed pretty sanguine or supportive of Secretary Geithner's idea of imposing the corporate tax on so-called "large" flow-through entities. I've been critical of that idea. A couple questions:

For those supporters of Secretary Geithner's notion, where would you draw the line? What would a large partnership look like? Everyone agrees small business creates 670% of the new jobs. Since a small business is generally defined as those with 500 or fewer employees, wouldn't you want to be careful not to sweep them in?

A. I'm advised that Secretary Geithner's business tax proposal has a great deal of thoughtful support in the academic tax community. The major justification for the corporate tax is that it is a tax that entities are willing to pay in order to give their owners access to a public market when they sell their shares. Publicly-traded partnerships are within the appropriate scope of a corporate tax. I do not have an answer for your second question. As for the third question, it's a scandal that the literature (and the law) treats a firm with nearly 500 employees as a small business. This elastic definition is also largely responsible for the "finding" that "small" businesses create the largest quantity of jobs. Policy preferences for small businesses may be justified, but they should be maintained only for businesses that are genuinely small, and should take the form, primarily, of lending services (underwriting, credit supervision, guarantees and so forth) that the private banking sector is unwilling to supply.

Professor Galbraith, you mentioned a number of times in your testimony that the payroll tax is very harmful to job creation. I am open to that view. However, to eliminate the payroll tax would have some profound policy implications. The Social Security tax is accounted for on an individual basis and helps determine one's Social Security benefits. That is, there is a connection between the amount one puts into the Social Security system, and the amount one takes out. If Social Security were instead funded by general fund revenues, this connection would presumably be lost.

According to a 2007 GAO report on the topic of General Revenue Financing of Social Security:

> President [Franklin] Roosevelt rejected the idea of using general revenue in [Social Security] financing. He endorsed payroll tax financing on the grounds that it would ensure the new program would be 'self-supporting.' Using general revenue would make the [Social Security] program welfare – in President Roosevelt's words, 'the dole by another name.'

So, how could we make the payroll tax less harmful to job creation, but still preserve proper incentives by tying higher-income-production to higher retirement benefits?

A. As an accounting matter, it would not be difficult to detach the Social Security earnings record from FICA tax collections. So I don't see why the connections between earnings and later benefits would be lost if the FICA were reduced or even repealed.

Do you believe that President Roosevelt was right about using general revenue to finance Social Security would make Social Security "the dole by another name"?

A. I would never substitute my political judgment for FDR's. Today however I believe that the value of Social Security is sufficiently well-recognized that it could not be stigmatized as a "dole." And so long as Social Security benefits are related to past qualified earnings, I believe it will be understood that the benefits have, in fact, been earned.

Put differently, if we think that the payroll tax is harmful to job creation, that would seemingly be because potential employees (that would have taken a job but don't because of the onerous payroll tax) believe they are being forced to save for their retirement at a level higher than they would choose to do if left to their own devices – do you agree? That is, if an employee would have taken a job but for the payroll tax, then doesn't this necessarily imply one of the following things: i) he believes the return (i.e., his Social Security benefits) on his Social Security tax is too low; or ii) perhaps the return is adequate, but he simply wanted to consume the money (rather than have it taken in Social Security tax) prior to his being eligible for Social Security benefits? Or is there some other way that the Social Security tax harms job creation? Many economists believe that even the employer portion of the Social Security tax is effectively paid by the employee in that the employer pays lower wages. Do you agree? Wouldn't that necessarily imply the only way the payroll tax is harmful to job creation is that potential employees turn down jobs they otherwise would have accepted but for the payroll tax?

A. I suppose that in a purely competitive marketplace under full employment, the payroll tax would reduce wages without affecting job offers. No such marketplace exists; the actual wage structure is strongly influenced by the minimum wage and by norms, including those established under collective bargaining. Therefore, in the real world to some degree the payroll tax falls on employers and encourages them to substitute capital for labor, reducing job offers. In present conditions however the more important effect is simply on effective demand: a lower payroll tax (or a larger holiday) on employees will help restore household balance sheets, borrowing power, and therefore spending and employment.

Professor Galbraith, you mentioned in your testimony that Congress should be very reluctant to repeal/restrict the home mortgage interest deduction.

I would value your opinion regarding the President's proposed 28% limitation on itemized deductions, including the mortgage interest deduction. Some commentators have pointed out that an itemized deduction is generally worth more to a person in a higher tax bracket than it is to a person in a lower tax bracket.

Illustration: Assume John is in the 15% tax bracket, and Mike is in the 35% tax bracket. An additional itemized deduction of $100 will reduce John's tax by $15, but will reduce Mike's tax by $35.

President Obama proposes to cap itemized deductions as if one were at most in the 28% tax bracket. That is, in the example above, John's tax would still be reduced only $15, but Mike's would be reduced only $28. Do you believe that if such a proposal were enacted, it would tend to depress housing prices? Do you have other thoughts regarding this proposal?

A. As a note, John in your example may not itemize, in which case he gets no benefit from the itemized deductions. I agree that this proposal would tend to depress housing prices, particularly at the high end. However, such prices are already falling sharply for other reasons, and it's not clear that anything can be done to stop that decline, given the oversupply of and weak demand for these houses. The policy priority is to keep people in the houses, not to regulate their market value; at the same time measures that would gratuitously diminish the remaining equity of middle-class homeowners should be avoided. As stated in my testimony, I would in general proceed cautiously in reducing *broad-based* exemptions in the tax code; this step however seems to me to meet the standard of a cautious move. As incremental moves are considered, I would also recommend consideration of the two suggested earlier: restriction of the mortgage interest deduction to well-documented, plain-vanilla mortgages, and a cap on the deductible loan amount.

**Statement of Michael J. Graetz, Professor of Law, Columbia Law School
At a Hearing of the Senate Finance Committee
on Tax Reform
March 8, 2011**

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 federa 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.

Senate Finance Committee Hearing
"Does the Tax System Support Economic Efficiency, Job Creation and Broad-Based Economic Growth?"
March 8th, 2011
Questions for Mr. Michael Graetz

Questions from Senator Robert Menendez

1. Retail Sales Tax Vs the Progressive Income Tax: We hear a lot of talk about abolishing the IRS and creating some sort of retail sales tax to take the place of the income tax. Mr. Graetz, in your book, *100 Million Unnecessary Returns*, you seem to take a very dim view of fully replacing the income tax with a national sales tax, writing about its regressive effects as well as the "truthiness," to borrow your word, of the advocacy campaign behind the FairTax. To document the FairTax's impact on families, you cite the Bush administration's Tax Reform Panel which found that: "A hypothetical married couple with two children making $40,000 per year would pay an additional $6,553 in taxes, an increase of more than 110 percent of total federal tax liability. In contrast, a hypothetical married couple with two children and $300,000 of income... would pay about $72,000, a tax cut of 19 percent."

    - Do you believe that a comparable amount of progressivity to the current tax system could be achieved under by the FairTax, and if not does it make economic sense to shift a greater burden of funding the federal government onto middle class families?

Answer: It is clear that an amount of progressivity comparable to that under the current income tax cannot be achieved under the Fair Tax, which is a national sales tax that completely replaces the corporate and individual income taxes. Given the great inequality in the distribution of pre-tax income and wealth that this country is now experiencing, it would not be fair or appropriate to shift a greater burden of funding the federal government down the income scale by eliminating the income tax altogether as Fair Tax proponents recommend.

- Can you explain why, under the FairTax, you believe American families would either see prices go up or wages go down? Do you believe this reality would affect the type of economic growth trumpeted by FairTax advocates?

Answer: Under the Fair Tax, either prices will go up, which is the typical response to be expected from enacting a sales tax, or—because the Fair Tax would be replacing existing taxes on wages, including payroll taxes—wages in this case might go down. I cannot comment specifically on the economic growth estimates that Fair Tax advocates claim for their proposal, because many Fair Tax advocates deny that either of these two effects would take place. However, to be fair, a national sales tax or its equivalent would be more conducive to economic growth than some of the taxes we now impose, such as the corporate income tax.

Questions from Senator Bill Nelson

1. As you know, tax preferences play an important role in the housing sector. In fact, there are very few sectors of the economy that are more heavily affected by the tax code than housing. These tax preferences include the mortgage interest deduction, the capital gains exclusion on a primary residence, the low-income housing tax credit, mortgage revenue bonds, and until recently, the homebuyer tax credit. If you could rewrite the tax code, how would you deal with these housing-related provisions on a going forward basis? Keep in mind, 40 percent of homeowners in Florida are underwater on their mortgage, and any tax changes that further weaken demand for housing could make their situation only worse.

Answer: Senator Nelson, you are certainly correct that tax preferences have played an important role in the housing sector. And one should be very careful about the potential effects on housing prices of modifying the tax benefits now directed to that sector at a time like this when housing prices have declined precipitously and, as you say, many homeowners are underwater on their mortgages. On the other hand, many of these provisions are both inequitable and inefficient in terms of the overall U.S. economy, and it would be sound policy to begin to reduce or eliminate them slowly over time so that we might have a more efficient and equitable income tax going forward.

2. Our current tax system is based on the fiction that you can easily identify where income is earned. But knowing where income is earned is becoming much more difficult with globalization and electronic commerce. If a Florida consumer buys downloadable software from a company based in India through a website managed in California with servers located in the Cayman Islands, who's to say where the income is earned? Which authority has the right to tax that income? It seems to me that our tax system is not equipped to deal with these new developments. Technology is moving much faster than the tax law can adapt. How do we tackle these challenges?

Answer: As you suggest, it is very difficult in today's economy to identify where income is earned. Indeed, the "source" of income has no grounding in economics. The example in your question of downloadable software certainly illustrates the difficulties with the source concept. One thing that we can be sure of is that the rules concerning source, which were enacted early in the twentieth century, are now badly out of date. One need only look to the different rules that affect different kind of financial instruments to be sure of that. Tackling this challenge is one of the most important tasks now facing the Congress.

3. The Florida economy is a service-oriented economy. We do not have a lot of heavy manufacturing. Our industries tend to be labor intensive, not capital intensive – tourism is the perfect example. However, I feel like most of our effort in tax policy in recent years has been focused on heavily subsidizing capital expenditures – business equipment and machinery –the type of property used in manufacturing and other capital-intensive businesses. The December tax bill is a perfect example. It includes a bonus depreciation tax provision that will inject $110 billion into the economy over the next two years. Does

federal tax policy distort the market and tilt the field against states like Florida that rely on service-oriented, labor-intensive sectors of growth?

Answer: Senator Nelson, I agree with you that federal tax policy to stimulate economic growth has been focused largely on increasing depreciation deductions to induce capital expenditures. And I also agree that focusing our tax policy so heavily on capital expenditures is questionable given an economy like ours, including in Florida, which relies so heavily on the service sector to create jobs. This is one reason why I emphasize cutting tax rates on business income rather than increasing allowances for capital purchases.

4. We frequently hear that the uncertainty caused by expiring tax provisions and whether they will be extended, such as the Bush tax cuts, makes businesses less likely to invest, expand, and create jobs. Yet we are also told that a major problem with the tax system is that these special tax preferences are added to the tax code and never reviewed to ensure that they continue to be effective tools for achieving policy objectives. Isn't there a conflict there? On one hand we are told that tax code needs certainty. On the other hand, we need to regularly review tax expenditure to determine whether they should be retained. How should we deal with that dilemma?

Answer: The dilemma that you describe between the uncertainty caused by expiring tax provisions and the need for Congress periodically to review tax preferences in an effort to make sure that they are continuing to serve their intended purposes—or that they are serving their intended purposes at all—is important. Congress has now tilted the balance way too far in the direction of expiring provisions and have created excessive uncertainty. It is not just the tax preference provisions that are now expiring, it is the entire structure of the tax law itself, including tax rates, basic tax credits for families, etc. Moreover, the history of the research and development credit well illustrates that Congress often simply rubber stamps extensions of expiring provisions, rather than carefully reexamining them. So the research and development credit has become something of a sacred cow, despite the fact that it is inefficient and ineffective in accomplishing its intended objectives. On balance, I would urge Congress to take seriously its obligation to review tax preferences periodically and, at the same time, you should attempt to create fundamental parameters for the code that will be stable at least for the foreseeable future.

Questions from Senator Jay Rockefeller

1. Do strong Estate Tax rates stifle growth or cost Americans jobs?

Answer: Based on my review of the evidence, I do not believe that our estate taxes stifle growth or cost American jobs.

2. Why should I trust that if Congress reforms the corporate tax code that corporate behavior will change at all?

Answer: Businesses have demonstrated that they are very sensitive in making investments and other decisions based on the tax consequences they face. It seems quite clear to me that if the corporate income tax were substantially revised, business behavior would also change in response.

3. If you could make one change to the current tax code, with the goal of creating more American jobs, what change would you make?

Answer: I believe the greatest barrier to job growth in the United States resulting from the current tax system is due to our excessive reliance on income taxation and in particular our relatively high rates of tax on business income. I therefore would urge a much lower rate of tax on business income, both to promote jobs and facilitate U.S. investments, and also as a way to address the thorny and so far insoluble issues of international taxation.

4. How would you describe the consequences of a failure to raise the debt limit ceiling, and what would that situation mean for the people of my state?

Answer: Failure to raise the debt ceiling would be foolish in the extreme. It would not only potentially cause chaos in the credit markets for U.S. debt, but it would also signal to the rest of the world that our system of government is incapable of acting responsibly. I have no doubt that such a failure would increase the cost of borrowing by the United States and in so doing would increase the size of transfers of wealth and income away from the United States to foreigners from whom we have borrowed so much of our nation's debt.

5. Why should I trust that if Congress reforms the corporate tax code that corporate behavior with regard to offshore tax evasion like we see in the Caribbean will change at all?

Answer: In my opinion, offshore tax evasion needs to be dealt with both directly and through lower corporate income tax rates. In order to have a serious effect on the choice between locating income in the United States and in low-tax countries, I believe we need a corporate tax rate in the range of 15 percent. At this level, I am confident corporate behavior would change substantially. At significantly higher rates, I am far less certain.

6. Could the housing market survive in the United States (short and long-term) without the subsidies provided by the tax code?

Answer: I am confident that the housing market in the United States could survive well over the long term without the subsidies now provided in the tax code. On the other hand, given our short-term economic and financial pressures and the instability in housing prices, any repeal of those subsidies should be phased in slowly over time.

Questions from Senator Orrin G. Hatch

1. This question follows up the first question I asked during the hearing. In this question I want to focus on the high marginal rates that will kick in on January 1, 2013.

   Under current law, the top statutory marginal income tax rate will increase from 35 percent to nearly 40 percent in 2013. Moreover, for self-employed taxpayers, many of them small business owners, Obamacare will push the rate up almost another full percentage point.

   Lawrence Lindsey, former head of the National Economic Council, is quoted in a July 14, 2009, National Journal article, on the baggage these high rates would mean. Here's what he said:

   "When marginal tax rates go over 40 percent, the evidence suggests that the excess burden of collecting additional revenue rises very sharply, making the cost to the private sector of moving additional funds from the private sector to the public sector several times the additional revenue raised."

   I would like the panel to respond to Dr. Lindsey's point. Please discuss the implications of the statutory top marginal tax rate approaching 40 percent or higher, as a matter of efficiency.

Answer: Larry Lindsey is certainly right that the economic burdens of collecting additional revenue rise with increases in tax rates. Therefore, we should strive to achieve as low income tax rates as possible, given our revenue needs. This is why, in my book, *100 Million Unnecessary Returns*, I suggest replacing the income tax substantially with a value added tax through an exemption of the first $100,000 of income and reducing the corporate income tax rate to 15 percent and the individual income tax rate to around 25 percent.

2. Professor Graetz, it seems to me that one of the good things about reducing the tax on dividends, as done back in 2003 and up to the present, is that it reduces the corporation's ability to have an excuse for not paying dividends. That is, if shareholders are subjected to a high tax upon receipt of a dividend, then the corporation can mask its poor performance by effectively saying to its shareholders "Your corporation has made a lot of profits, and we'd like to distribute them to you. However, since many of you would be subjected to high rates of tax upon receipt of such dividends, we have decided it would be better for you if we don't pay you a dividend." So, as a matter of encouraging good corporate governance, there arguably shouldn't be a high tax on dividends.

   Put differently: Cash dividends are the ultimate audit, and Congress shouldn't discourage such audits.

   However, your written testimony suggests you are open to creating a new withholding tax on dividends, as well as allowing dividends again to be taxed as

ordinary income, so as to reduce the corporate tax. I'm very interested in reducing the corporate tax rate, but I do have some questions for you about your proposal.

- Do you believe such increases in tax on dividends would reduce the ability of shareholders to govern and oversee corporate management?

Answer: I do not believe that increasing the tax on dividends in exchange for reductions in the corporate tax rate would reduce the ability of shareholders to oversee corporate management. I should add, however, that I am not confident that with the low tax rates we now have on dividends that shareholders are particularly effective in overseeing corporate management.

- Would the withholding tax on dividends apply when paid to tax-exempt organizations as well?

Answer: I would apply the withholding tax on dividends to dividends paid to tax-exempt organizations as well as to those paid to taxable individuals. I do not see why we should now reduce the tax currently being paid by tax-exempt organizations on their equity investments in corporations.

- Could a new withholding tax on dividends be done consistently with current US tax treaties, most of which call for reduced withholding on dividends?

Answer: Depending on how a new withholding tax on dividends were structured, it might well raise issues under current U.S. tax treaties. Congress, of course, has the ability to override such treaties, but it should be reluctant to do so. There may be ways, however, of imposing a new tax on corporate distributions without violating these treaties, for example, by imposing such a tax as an excise tax rather than as a withholding tax.

- Do you have an opinion on proposals to allow a deduction to corporations when they pay a dividend? While that would likely lessen the current-law bias towards debt financing, and would also significantly ameliorate the problem of double taxation present in the classical corporate tax system, would it tend to cause "over-distribution" of corporate profits? (That is, would it have the opposite problem of what I suggest above could be a problem with a low corporate tax but a high dividends tax?) That is, would allowing a deduction upon payment of a dividend cause tax-motivated distributions? Would such a rule cause corporations to distribute dividends that, but for tax, would have been kept in corporate solution?

Answer: I do not favor allowing corporations a deduction for dividend payments. My reasons for this are principally because it would allow a tax reduction for payments of dividends to recipients who are now not subject to any tax, such as foreign shareholders and tax exempt entities. This is why I have long preferred an exclusion of dividends to the recipient over a deduction of dividends for the payor. I suspect that allowing a dividend deduction would increase the distributions of corporate earnings in the form of dividends, although I have no estimate as to how large that effect would be.

3. Mr. Graetz, towards the end of your testimony, you mentioned something to the effect of the Code's savings incentives for retirement and education being good things because people tend to be short-sighted and thus need savings incentives for events that may be a long time out in the future (such as college expenses or retirement).

    - Does this imply that large bodies of taxpayers behave this way? That is, if they can't save adequately for their children's education or for their retirement, doesn't this suggest they are not realistically planning? But doesn't a lot of economics assume that people behave rationally?

Answer: It is true that a lot of economic analysis assumes that people behave rationally in their decisions about how much to save and invest. However, in recent years the economics literature has also been concerned with behavior of individuals that is not economically rational. For example, there is now substantial evidence that people will invest more in their 401(k) retirement plans if that is the default provided by their employers than they will if they have to affirmatively make an election to contribute to such a plan. There is, of course, no rational basis for this difference. I do believe—and there is a lot of evidence in support of this position—that individuals are myopic about the amount of savings they will need for retirement and also to fund their children's education. That is one reason why I regard savings incentives for retirement and for education as important.

    - Maybe that is backwards? That is, in a world without high taxes on investment income, people would rationally save adequately for retirement and college. However, high taxes on investment income tip the scales to where the rational decision is to consume today, and not save for tomorrow. So, by the Code coming up with tax-preferred savings vehicles (such as IRAs and ESAs), it returns the balance so that the rational decision is to save for tomorrow. Could that be?

Answer: There has been a lot of empirical study of the effect of income tax rates on rates of savings by individuals. The evidence conflicts, however, and generally is inconclusive. I do agree, however, that tax-preferred saving vehicles for retirement and for large expenditures such as education offer important incentives for individuals to set aside earnings for these purposes.

Questions from Chairman Max Baucus

1. Professor, you mentioned that the difficulty of integrating a national consumption tax or VAT with an existing state-operated sales tax has been done in other countries. You specifically mentioned that Canada has state retail sales taxes that work alongside the national sales tax. How did Canada overcome any structural hurdles in adopting a national sales tax? What lessons can we learn from other countries who have adopted a modern VAT if we were to move in that direction?

Answer: Chairman Baucus, the Canadian experience in enacting a value added tax alongside retail sales taxes at their provincial level should be encouraging for the United States. While many of the Canadian provinces were initially reluctant to abandon their sales taxes and to harmonize their consumption taxes with the federal value added tax, over time the provinces have moved in this direction. I take two lessons from the Canadian experience: first, that retail sales taxes at the state or provincial level can operate alongside a value added tax at the national level, and second, that, if the right incentives are provided, over time the states will find it in their interests to piggyback on a federal value added tax in lieu of maintaining their state sales taxes. As for other lessons that we can learn from countries that have adopted value added taxes, the most important is that there are great benefits to having a single rate of tax and applying that tax to a very broad base of goods and services. The modern value added taxes, such as those enacted in places like New Zealand, Singapore, and South Africa, for example, are all structured like this, and all create far fewer distortions and are more economically efficient than the older, narrower base value added taxes that one finds in Europe. I would add one further point: if the United States were to adopt a value added tax, there is significant benefit in allowing an exemption for businesses that have gross receipts below, say, $100,000 to $500,000. This would eliminate the vast majority of American businesses from having to deal with such a tax while costing very little in terms of lost revenues. Singapore has led the way on this issue.

STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER U.S. SENATE COMMITTEE ON FINANCE HEARING OF MARCH 8, 2011 DOES THE TAX SYSTEM SUPPORT ECONOMIC EFFICIENCY, JOB CREATION, AND BROAD-BASED ECONOMIC GROWTH?

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered opening remarks at a committee hearing examining how the current U.S. tax code supports economic growth and job creation. Today's hearing is the second in a series this Congress examining America's inefficient and burdensome tax code and ways to improve it to spur economic growth and job creation.

A full copy of Hatch's remarks, as prepared for delivery, follows:

Tax reform is greatly, desperately needed by our nation, and these hearings are a necessary first step in the reform process.

I want to make clear that I do indeed believe that the tax system supports job creation ... for CPAs and tax attorneys. And I'm also confident that the tax system leads to broad-based economic growth ... in China.

Our guiding principle for tax reform should be: "Do no harm." As bad as our current tax code is, it could actually be worse. (That's an awful thought, I know.) These many hearings we will have on tax reform should reduce the chance of making the tax code worse, and increase the chance of making it better. The topic for this hearing is economic efficiency, job creation, and growth. I am really looking forward to what our witnesses have to say on these topics, and I'm sure we will gain some helpful insights. Allow me to first share, however, a few of my initial thoughts on this topic.

There are necessary and proper functions for our federal government to perform. Those functions should promote economic efficiency, job creation, and growth. A good example of a necessary and proper function of our federal government is providing for the national defense. By creating a secure environment at home and abroad for Americans, the military promotes economic efficiency, job creation and growth.

Federal taxation exists to fund these necessary and proper functions.

In general, I am inclined to believe that the effect of federal taxes upon the taxpayer is to reduce economic efficiency, job creation, and growth.

I acknowledge that there may be very limited circumstances where taxes could reduce a given activity that has what economists call "negative externalities." Negative externalities exist when individuals sometimes engage in activity that, although helpful to the individual, has harmful consequences to society at large. Tax can discourage such harmful activity. That is, a tax applied to negative externalities could actually enhance economic efficiency. The circumstances where this would be the case are quite rare. Very rare, indeed, Mr. Chairman.

I want to reiterate that, in general, the effect of taxes upon taxpayers is to reduce economic efficiency, job creation, and growth. But there is still a question of degree. Does one particular tax system reduce economic efficiency more or less than some other tax system?

It is my belief that high marginal taxes can discourage, at the margin, productive activity and encourage more leisure and consumption. This can reduce efficiency and growth, and, along with it, job creation.

Many call for a more progressive tax system. I think this just means higher marginal income tax rates for higher-income people. (If it means something other than that, I would like someone to just tell me.) Higher taxes for high-income people can in turn mean that such people opt for consumption and vacation, rather than investment and work. The investment such people would have done, in new plant and equipment, in new business ventures, would have lead to additional job creation for others. But because of progressive taxation, certain high-income persons will not invest.

By not investing, some jobs that would have been created are not created. Some of these jobs would have been filled by lower-income people. So, ironically and sadly, progressive taxation sometimes may hurt lower-income people the most. I'm sure that is not what anybody wants, but that's an unintended consequence of progressive taxation. President Kennedy had it right when he said that "a rising tide lifts all boats."

Again, Chairman Baucus, thank you very much for this important series of hearings you have called on tax reform.

Thank you.

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TESTIMONY OF GLENN HUBBARD
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
March 8, 2011

Thank you, Mr. Chairman and Ranking Member Hatch, for the opportunity to appear before the Committee today to discuss options for fundamental reform of the Nation's tax code. The discussion that you are having offers an opportunity for public policy to improve living standards for all Americans, while providing a simpler and fairer tax code. Indeed, given recent estimates that annual gains in household income made possible by tax reform are as high as nine percent, few policy changes you evaluate are as significant.

CAPITAL INCOME TAXATION AS A PROBLEM

The bulk of the considerable efficiency gains from fundamental tax reform are achieved by reducing the burden of capital income taxation, which arises from the multiple layers of taxation on certain forms of productive business investment. Capital income taxation is also at center stage in the complexity of the present tax system (for example, measurement of capital gains and depreciation and the numbing complexity of tax rules governing multinational companies).

The previous administration pursued an agenda of reducing the efficiency and complexity costs associated with capital income taxation. President Obama and the President's Commission on Fiscal Responsibility have also expressed interest in tax factors. Yet fundamental tax reform – moving from the current tax system to a broad-based income tax or consumption tax with a simpler structure and lower marginal rates – should be on the watch list for action even without the President's interest. Part of this emphasis reflects the concerns of economists and policy mavens that tax reform could improve the efficiency of the economy and generate extra income for U.S. citizens. But practical factors in policy debates loom much larger – the perceived declining competitiveness of U.S. firms and the low rate of saving by most Americans, for example.

These real-world pressures supported tax cuts for saving and investment in 2001 and 2003. The case remains, however, for a simpler tax system that would remove or at least sharply reduce the current-law tax bias against saving and investment. Indeed, the framing of the tax reform debate has corralled the real-world pressures for reform into a discussion of a consumption tax as a way of flushing out the familiar "simpler, fairer, flatter" goals of tax reform. And one would hope that this discussion will focus on how to broaden the tax base to make the marginal tax rates on investment (and work and entrepreneurship) as low as possible.

So, if capital income taxation is the "elephant in the room" of tax reform discussions, why is fundamental tax reform so difficult to accomplish? This framing will likely provoke loud outcries that consumption-based tax reform is unfair or, in the language of economists, "regressive."

One "fairness" concern about any fundamental tax reform that would broaden the tax base and reduce marginal tax rates is that top rate reductions would benefit only a handful of affluent taxpayers. This "snapshot" distributional analysis calls to mind the imagination of Tevye the Milkman in *Fiddler on the Roof,* who in the song "If I Were a Rich Man" thinks of one staircase just going up and another just going down. But in the same way that actual staircases allow for both upward and downward mobility, the tax system sees considerable income and tax rate mobility on the part of households. As a result, the reductions in marginal rates made possible by tax reform affect many more individuals than a snapshot would suggest.

The White House Council of Economic Advisers in the Bush administration used Treasury Department Data on households for the years 1987 to 1996 to study how households change income tax brackets over time (see Council of Economic Advisers, 2003, Exhibit 5.4). More specifically, the economists used the data to ask what tax rates would households have faced had President Bush's Economic Growth and Tax Relief Reconciliation Act of 2001 been in place over this period. The tabulations revealed that more than half of taxpayers were in a different tax rate bracket at the end of the period and that the upward and downward mobility was significant: Two-thirds of taxpayers in the lowest bracket had moved to a higher bracket after ten years, and four times more taxpayers were subject to one of the top two tax rates in at least one of the ten years than was indicated by the initial snapshot.

Another significant "fairness" concern about tax reform in the form of a consumption tax is the claim that such a tax would exempt income from saving from tax. To the extent that higher-income and wealthier houses save more, a shift to a consumption tax might appear to favor these households. Such an argument is intuitive – but wrong (see Hubbard, 2005). A broad-based consumption tax need not be more regressive than a broad-based income tax. The real challenge for tax reform is to accomplish either one.

BENCHMARKS FOR TAX REFORM

I suggest as benchmark tax reforms systems that would tax income once. To facilitate comparison between "income tax" and "consumption tax" versions of reform, I focus on two-part tax systems, with a business tax and a household tax. While I describe examples with a uniform rate of tax, it is easy to introduce progressivity with multiple tax brackets and an exemption in the household tax.

Proposals for fundamental tax reform typically suggest moving to either a more pure income tax or a more pure consumption tax. Although these two proposals appear to be on opposite ends of a spectrum, the purer income tax and the purer consumption tax may affect economic and corporate financing decisions in similar ways. Moving to a purer tax system of either type also would reduce tax-planning opportunities because tax-minimizing strategies often involve combining transactions with different tax treatments (that is, part of the transaction receives pure income-tax treatment, while another part receives consumption-tax treatment) or by taking advantages of disparities in tax rates across investors.

Broad-Based Income-Tax Reform

For economic and corporate financing decisions, the critical element of fundamental reform of the income tax is the integration of the corporate and the personal income-tax systems. In theory, integrating the systems would eliminate two distortions from the current tax system. First, integration would eliminate the distinction between corporate and noncorporate businesses by abolishing the double taxation of corporate income. Second, this reform would remove the differential taxation of debt and equity financing.

The U.S. Treasury Department's study of corporate tax integration (see U.S. Department of the Treasury, 1992) presents several alternative approaches to integrating the individual and corporate tax systems. One proposal, the Comprehensive Business Income Tax (CBIT) seeks is to tax business income once. CBIT is a business-level tax on the return to capital of businesses. Broadly speaking, the business-level tax base under CBIT is revenue from the sale of goods or real assets less wages, material costs, and depreciation allowances for capital investments. To conform to standard income accounting principles, the CBIT base uses depreciation allowances that follow as closely as possible economic depreciation. CBIT does not distinguish whether investment is financed by debt or equity. That is, in contrast with the current tax system, CBIT would not allow businesses to deduct interest payments from their tax base. Because CBIT taxes business income at the entity level, there is no need for investor-level taxes on capital gains, interest, or dividends received. CBIT can be thought of as the capital income tax component of a broad-based income tax that collects taxes form labor income through a household-level wage tax.

Converting the Income Tax into a Consumption Tax

Converting CBIT into a consumption tax turns out to be quite straightforward. Instead of measuring business income through depreciation allowances, a consumption-tax version of CBIT would allow businesses a deduction for capital investments when assets are purchased. This "expensing" adjustment converts the combination of CBIT and a wage tax into the Flat Tax proposed by Hall and Rabushka (1983).

Having described CBIT and the Flat Tax in this way, we can see that the Flat Tax does not exempt all of what is commonly called "capital income" from taxation (see also Gentry and Hubbard, 1997, 1998). Under the business cash-flow tax component of the Flat Tax, the present value of depreciation allowances for one dollar of current investment is one dollar, while the present value is less than one dollar under the income tax. For an investment project, the tax savings from depreciation allowances represent risk-free flows, which the firm would discount at the risk-free rate of interest. For a marginal investment (in which the expected rate of return just equals the discount rate), the upfront subsidy to investment provided by expensing equals the expected future tax payments. It is only in this sense that the "return to capital" is not taxed under a cash-flow tax or a consumption tax. But returns attributable to entrepreneurial skill or risk bearing are, in principle, taxed equivalently under fundamental income or consumption tax reform prototypes.

To summarize, then, I use the term "fundamental tax reform" to represent tax proposals with the following characteristics:

1. It is a combination of a business-level tax (with either cash flow or business income as the base) and a household wage tax.
2. For an income-tax version of reform, depreciation allowances are as close to economic depreciation as possible; for a consumption-tax version of reform, businesses will deduct capital expenditures.
3. The business-level tax does not distinguish between debt and equity financing.
4. In order to minimize the differences in marginal tax rates across business entities and investments, firms carry net operating losses forward with interest.
5. There are lower marginal tax rates with a single marginal tax rate across business entities and households; the household tax can have a personal or family exemption.

Fundamental income tax reform and consumption tax reform contribute to economic efficiency by accomplishing corporate tax integration. Returns to business investment would be taxed once at the business level and not again at the household level. Both reforms eliminate financial distortions under current law (that arise from the tax bias against corporate equity and dividends – see, for example, Gertler and Hubbard, 1993) and organizational distortions under current law (that arise from the tax bias against C corporations). Both reforms are consistent with a "dividend exemption" or territorial tax system for multinational companies, and this consistency is desirable (Devereux and Hubbard, 2003).

The consumption tax version of tax reform offers an added benefit: the benefit of expensing of business investment will stimulate investment, capital formation, and economic activity. Such a business tax system would also be simpler. While expensing entails a greater revenue cost than depreciation, one must be careful to note that over the long run, the difference is only the time value of money on depreciation allowances (that is, comparing the value of allowances all at once – expensing – versus allowances taken over time – depreciation).

Substantial efficiency gains estimated for corporate tax integration (see, for example, U.S. Department of the Treasury, 1992; Altig, *et al.*, 2001; and Hubbard, 2003) do not capture all the possible sources of economic gains. First, as noted above, expensing offers an incremental gain. Second, reductions in marginal tax rates can increase growth through human capital investment (as in Lucas, 1988) and entrepreneurial risk taking (Gentry and Hubbard, 2004; and Cullen and Gordon, 2002). A third channel arises if base broadening in tax reform permits a lower business tax rate. Lee and Gordon (2005) estimate using cross-country data that a lower corporate tax rate is associated with more rapid economic growth, a correlation they attribute to a lower corporate tax encouraging more entrepreneurial activity. And Hassett and Brill (2007) challenge the notion that corporate rate cuts necessarily require offsetting tax increases.

STARTING WITH THE CORPORATE TAX

Economists have long recognized that the corporate income tax reduces economic efficiency more than alternative tax instruments. The corporate income tax hinders capital accumulation and interferes with production efficiency in three ways: (1) favoring noncorporate over corporate investment; (2) favoring debt over equity finance; and (3) discouraging the use of capital goods produced by corporations. The economic efficiency costs of the corporate income tax are even larger than commonly recognized when three central features of the modern technologically-advanced economy taken into account: (1) the role of patents, know-how, and other sources of imperfect market competition, (2) risk, and (3) technological change. The corporate income tax discriminates against the risky ventures financed by equity investment favor of safer business ventures financed by debt or small enough to be financed by individuals or partnerships. Finally, the asymmetric treatment of noncorporate and corporate entities discourages entrepreneurship, and multiplies other disincentives created by progressive taxation of personal income. It is important to reduce the corporate tax rate.

Some critics of reducing the *statutory* corporate tax rate argue that the *effective* rate of tax in the United States is not out of line with other industrial economies. The United States indeed, has the highest corporate tax rate. According to the OECD, top statutory national tax rates in the OECD range from a high of 35 percent in the United States to a low of 8.5 percent in Switzerland. Combining national and subnational tax rates, the United States has the second highest rate of tax among OECD countries, just behind that of Japan.

Some critics argue that the effective tax rate in the United States is not out of line with effective tax rate in other OECD countries. While the United States compares somewhat better with respect to effective (marginal) tax rates, the U.S. effective rate is nonetheless substantially higher than the average for the OECD.

Finally, the high U.S. rates are not matched with higher revenues from corporate taxation. Indeed, while corporate income tax revenues relative to GDP have risen substantially since 1981 for the OECD on average, that pattern has not been true for the United States, suggesting the importance of analyzing the responsiveness of corporate tax revenues to changes in the corporate tax rate.

THE WAY FORWARD

Mr. Chairman and Senator Hatch, this Committee has the opportunity to reform the nation's tax code in ways that will enhance living standards, improve tax fairness, and reduce the enormous complexity that wastes billions of dollars each year. Reform of business taxation will be a major element of the overall reform debate, particularly given the overarching interest of tax reform in reducing tax burdens on saving and investment to promote economic growth. I urge you to begin your work by reducing the high rate of taxation of corporate income.

As you evaluate options for tax reform, I urge you to focus on prospects for improving growth. You can address tax fairness concerns as well by broadening the tax base of both the business and household tax systems. I also urge you to include estimated effects on economic growth and incomes of tax reform in your evaluation of revenue and distributional impacts of tax reform. While many interests will approach you for "transitional relief," the case for large "transition costs" of tax reform for businesses as a whole is more difficult to make than is often thought (see, for example, the discussion in Hassett and Hubbard, 2001). Finally, as you know well, it is possible to implement tax reform as a series of steps, necessitating caution in evaluating a "horse race" among proposals for fundamental tax reform.

Thank you, again, Mr. Chairman and Ranking Member Hatch, for the opportunity to appear before you today on the important subject of fundamental tax reform. I look forward to your questions.

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Senator John D. Rockefeller IV
Record Statement
March 8, 2011

Chairman Baucus, thank you for holding this important series of hearings on the issue of tax reform.

Tax is one of the most complicated – and controversial- issues we deal with as members of the Senate. Those of us who serve on the Senate's Finance Committee understand that every action we take with regard to the tax code can impact whether families can put food on the table or businesses can keep their doors open.

In the 25 years since the 1986 tax reform bill was signed into law, the tax code has become bloated and inefficient. Only 40% of Americans now do their own tax returns. Businesses are forced to keep two sets of books, one for taxes and another for profits. I have heard time and again from West Virginia families and businesses who say their time and money is too valuable to waste trying to make sense of the tax code. I couldn't agree with them more.

As our country continues to recover from a recession, and unemployment still hovers near 9%, Congress must step in and ease this burden the tax code places on the American people.
As this committee begins what will be a lengthy and spirited debate on the issue of tax reform, I want to take a few moments and address my priorities for the tax reform process.

I am completely committed to preserving a progressive tax system. A progressive system helps individuals pull themselves out of poverty and make better lives for their families. Credits like the Earned Income Tax Credit have helped families own a home and send their kids to college. We all win when our neighbors are able to make a better life for themselves.

I also want the tax code to promote domestic job creation. My state has been hit harder than most by outsourcing. I will not support international tax policies that make it easier for American companies to ship jobs overseas. I am troubled by the stories I have read about companies putting their headquarters in Caribbean post offices and doing their research and development here in the United States where it can be subsidized by American taxpayers, only to turn around and sell the patents for the products they have developed to foreign subsidiaries in low-tax jurisdictions to avoid repaying taxpayers for the investment they made.

I am coming to the tax reform process with an open mind will consider any proposal put before this committee. But I will oppose any plan that shifts the tax burden to low-income families or puts jobs in my state at risk.

I look forward to hearing what these witnesses and my colleagues have to say today and appreciate the opportunity to weigh in on behalf of the people of my state.