

TESTIMONY OF PROF. EDWARD D. KLEINBARD

HEARING TITLED

**“THE ROLE OF TAX REFORM IN COMPREHENSIVE DEFICIT
REDUCTION AND U.S. TAX POLICY”**

U.S. Senate Committee on Finance

Subcommittee on Fiscal Responsibility and Economic Growth

September 13, 2011

Chairman Nelson, Ranking Member Crapo, and distinguished members,

Thank you for inviting me to testify at this hearing. My name is Edward Kleinbard and I am a Professor of Law at the University of Southern California’s Gould School of Law. From 2007-2009 I was privileged to serve as Chief of Staff of the Congress’s Joint Committee on Taxation.

I. SUMMARY OF TESTIMONY.

- There is a broad bipartisan consensus that the long-term fiscal policies of the United States are unsustainable.
- In grappling with the enormity of our adverse budget deficit trends, it is extremely helpful to divide our economic and fiscal problems into three time buckets: the short-term (perhaps the next two years), the medium-term (Years 2-10) and the long-term (the next several decades).
- The short-term crisis is about jobs; tax reform can do little to help here.
- The long-term problem is entitlements spending, particularly spending on healthcare. The United States today spends much more on healthcare per capita than does any other developed economy in the world. *If the United States were to expend per capita what Norway (the second place country) does on healthcare, our aggregate healthcare spending (public and private) would immediately*

decline by some \$800 billion/year. Our per capita government share of our total healthcare spending is the second highest in the world.

- While long-term entitlement spending reform is critical, we must “boil the frog slowly,” to borrow a phrase from Chairman Baucus. Both our citizens’ expectations and our healthcare delivery institutions are built around current policies. Change must follow a predictable path that starts in the near future, phases in slowly, and comes to rest with new institutions that will serve the needs of Americans for decades to come. The requirement that we boil the frog slowly in turn has important implications for tax revenues.
- Tax reform and tax policy are most relevant to the medium-term horizon. This period must serve as the bridge from where we are to the more sustainable package of government spending and taxing that we need to reach.
- Current levels of nondefense discretionary spending are modest by world norms. This “spending” includes some items, like infrastructure, that are bona fide investments with long-term economic benefits.
- Defense discretionary spending, by contrast, is the other great outlier in U.S. government spending policies. *By one estimate, the United States spends as much on its military as do the next 14 countries combined – 42 percent of the entire world’s military expenditures.*
- This implies that, unless we completely rethink our defense policies, spending cuts cannot by themselves fund all of our deficit reduction requirements in the medium term. Whatever the long-term world we transition to, we will need to finance the costs of getting there, and that in turns means higher tax revenues than those we currently collect.
- The United States is an extraordinarily low-taxed country by world norms – the fourth lowest in the OECD. And even by our own standards we are collecting historically low levels of tax – below 15 percent of GDP for 2009-2011. This level of revenues cannot be reconciled with our outsized spending on healthcare and defense.

- By all measures, the United States can afford to increase the total taxes it collects as a fraction of GDP. Just a decade ago, the country ran budget surpluses and enjoyed both a robust economy and job growth, while tax collections exceeded 20 percent of GDP.
- CBO budget projections show us running deficits (albeit relatively small ones) 10 years from now, even with the assumptions that (i) we enjoy uninterrupted growth over those 10 years and (ii) the “Bush tax cuts” (more neutrally, the “2001-03 temporary individual tax discounts”) will all expire at the end of 2012. *By contrast, extending these tax discounts indefinitely will add some \$4.6 trillion to our cumulative deficit.*
- We therefore have no practical choice but to raise the level of tax collections in the medium term to the range of 20 percent of GDP, as implied by the CBO baseline, to finance our gradual transition to more sustainable long-term entitlement policies. Discretionary spending cuts also will be useful, but cannot handle the entire burden if we are to maintain even minimum levels of developed country government services.
- *The CBO baseline effectively must also serve as the tax reform base case.* We should assume the lapse of the 2001-03 temporary tax discounts, and ask, how can we raise about the same amount of revenue, or maybe a little more, but in a smarter way?
- This in turn means that we have to abandon our nostalgia for the Tax Reform Act of 1986. That tax reform effort was revenue neutral, because it could afford to be. (It also was preceded and followed by major tax increases.) The fact that we have to raise revenue today means that this tax reform effort will look different, not that it is impossible. We should not hold ourselves prisoners to tax nostalgia.
- Specifically, I propose the following as the tax reform “Base Case” – the stalking horse that we can seek to improve, while maintaining the same level of revenues, or a little more:

- In general, allow the 2001-03 individual tax discounts to lapse at the end of 2012.
 - Restore the estate and gift taxes to their 2009 levels, preferably as of January 1, 2012. (This actually has a roughly \$260 billion cost relative to the CBO baseline.)
 - Maintain current policy's prescription that corporate dividends should be taxed at the same rates as long-term capital gain. (This proposal loses revenue relative to the CBO baseline but has strong policy justification.)
 - Add a new top marginal tax rate of, say, 42 - 44 percent for incomes above \$2 million. (The idea would be to find the income level that would raise revenues sufficient to fund the dividend tax reduction.)
- We can do better than this Base Case. The straightforward goals of an incremental reform of the personal income tax (which includes the 1986 Tax Reform Act) should be (1) to raise the targeted level of revenues with (2) the desired distributional consequences while (3) keeping *marginal* tax rates – the tax imposed on your last dollar of income – as low as possible.
 - Raising average tax rates without raising marginal rates (beyond the expiration of the 2001-03 tax discounts) requires broadening the tax base. Unlike in 1986, when the tax system overflowed with unintended tax shelters that could be cleaned up and traded off against lower rates, this means directly tackling some of the deliberate Congressional subsidy programs baked into the tax code, which is to say, tax expenditures.
 - Of all current law's tax expenditures, the most important to address in tax reform are the personal itemized deductions, such as the deductions for home mortgage interest, charitable contributions and state and local taxes. They are extraordinarily costly subsidies – about \$250 billion/year in forgone tax revenues. They are inefficient, in that they lead to major misallocations of economic resources, particularly with respect to housing. They are poorly targeted, in that the government subsidies go to individuals who would have behaved the same

without the subsidies. And they are unfair, in that they are “upside down” subsidies – they subsidize high-income Americans more than low-income ones.

- *Tax Policy Center has estimated that eliminating the subsidies for personal itemized deductions would increase tax revenues in the neighborhood of 1.5 percent of GDP, over and above the lapse of the 2001-03 temporary tax discounts.* This is an enormous revenue pickup; it could be used for deficit reduction or to mitigate the tax rates implicit in the Base Case. The elimination of these subsidies also would simplify the tax code greatly and increase its progressivity. Moreover, their elimination would large remove the need for an AMT “patch,” because it is these deductions that drive most taxpayers into the AMT in the first place.
- I fully recognize that the home mortgage interest deduction and other personal itemized deductions invariably are described as “sacred cows.” *But they are sacred cows that we can no longer afford to maintain.* Either we eliminate these sacred cows, or we allow them to stampede over us.
- The elimination of personal itemized deductions must be phased in. For example, the deductions could be removed ratably over the 5-year period 2013-17, ideally by turning them into tax credits where the credit amount declines to zero over that time.
- Tax reform also should address the corporate income tax. Its 35 percent rate is much too high by current world norms. At the same time, U.S. multinationals have become extremely adept at gaming the current U.S. system, and those of other high-tax countries around the world, through the production of what I call “*stateless income*” – income that is taxed essentially nowhere. The U.S. corporate tax base is being systematically eroded through these stateless income tax planning strategies.
- A revenue-neutral tax reform package should be fashioned along the following lines:
 - Eliminate business tax expenditures, all of which represent Congressional meddling in matters best left to the markets.

- Reduce the corporate tax rate to something in the range of 25-27 percent.
- Tax multinationals on their worldwide income.
- The resulting corporate tax system would represent a huge competitive boost for American domestic firms, would attract inward investment, and would provide a fair tax environment for U.S.-based multinationals.

II. THINKING ABOUT THE DEFICIT.

There is a broad bipartisan consensus that the long-term fiscal policies of the United States are unsustainable. I therefore wish to make only a few brief observations about our overall deficit trends.

First, the passions of our fractious political dialogues often make it difficult for us to think objectively about our problems. Like a couple with marital difficulties, we might sometimes benefit from considering the perspective and advice of dispassionate outside professionals. In this regard the Organization of Economic Cooperation and Development (OECD) – a supranational organization of over 30 member countries, most of which have developed economies with at least some similarities to that of the United States – and other international organizations such as the IMF have done a great deal of useful work showing how the United States is doing in comparison to other countries, and drawing from that some straightforward advice. By concentrating on cross-country comparisons, this work supplements the nonpartisan and enormously valuable analysis provided by the Congressional Budget Office, the Congressional Research Service, and the Staff of the Joint Committee on Taxation.

Second, in grappling with the enormity of our adverse budget deficit trends, it is extremely helpful to divide our problems into three time buckets: the short-term (perhaps the next two years), the medium-term (Years 2-10) and the long-term (the next several decades). The issues in each time horizon are different, and so too are the best tools to apply to each.

1. *Short-Term.* The short-term fiscal crisis is not a crisis in financing the national debt; Treasury borrowing rates are at near-record lows. Nor is there a crisis in the

availability or cost of capital for the private sector, except perhaps in some continued difficulty in access to bank borrowings by small or less creditworthy firms.¹ Instead, we face an immediate jobs crisis. This topic, however, is far afield from my understanding of the purpose of today's hearing, and tax reform would have little immediate impact on this problem.

2. *Long-Term.* The long-term fiscal crisis confronting our country is in large measure a spending problem, driven to a surprisingly large degree by one paramount issue: healthcare spending, and to a much lesser extent by Social Security. The Congressional Budget Office has projected that government spending on Social Security and healthcare will amount to 12 percent of GDP in 2021. In 2007 that figure was 8.2 percent, and in 1970 3.8 percent.

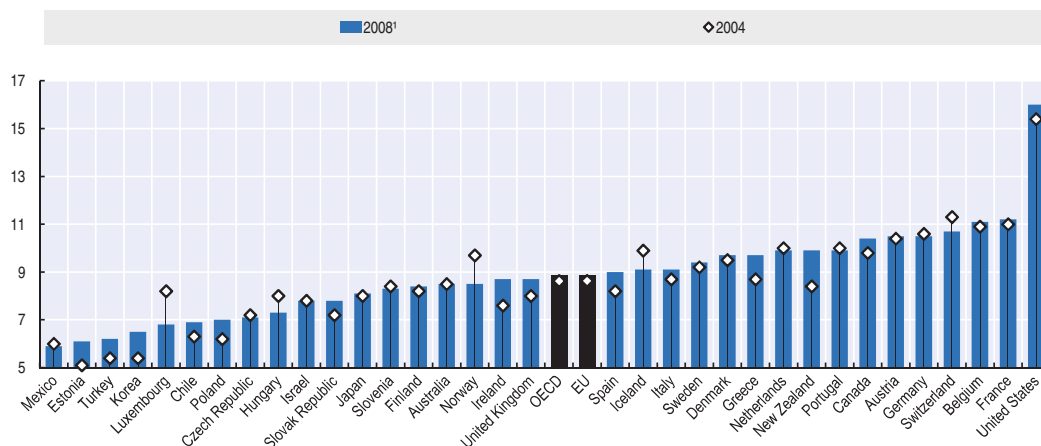
These adverse spending trends reflect to a significant extent the inescapable demographic fact that our population is growing older.² That fact in turn has direct implications for the level of tax revenues required to provide basic services to an aging population, and also to the design of these entitlements programs.

OECD data are extremely useful in helping us to see just what an outlier the United States is *today* in respect of healthcare costs. The United States today spends much more on healthcare than does any other developed economy in the world. This is true when measured as a percentage of GDP:

¹ See, e.g., Richard Bravo, *Bank Loans to Companies Defying U.S. Slowdown*, Bloomberg News, Sept. 7, 2011.

² This of course is a universal phenomenon in developed countries. See, e.g., OECD, *OECD in Figures 2009*, at 6-7.

Figure 3.23. **Health expenditure**
Percentage of GDP



Note: Users of the data must be aware that they may no longer fully reflect the current situation in fast reforming countries.
1. 2007 for Australia, Denmark, Greece and Japan; 2006 for Portugal.

Source: OECD (2010), Health Database.

StatLink <http://dx.doi.org/10.1787/888932373514>

(Source: OECD, *Economic Policy Reforms: Going for Growth 2011* at 174.)

It also is true when measured as dollars spent per capita. In 2009, the United States spent \$7,960 per capita on healthcare, by far the highest in the world; the next most profligate country, Norway, spent \$5,352 per capita.³ *If the United States were to expend per capita what Norway does on healthcare, our aggregate healthcare spending (public and private) would immediately decline by some \$800 billion/year.*

More remarkably, the United States today is second in the world (only to Norway) in *government* spending per capita on healthcare.⁴ Our federal, state and local governments today spend more per capita on healthcare than do the governments of Germany, Denmark, Switzerland or Canada. Our extraordinary profligacy in government spending on healthcare has nothing whatsoever to do with the Patient Protection and Affordable Care Act, which was not even enacted in the 2009 (the year covered by the data), and which in fact is projected by the CBO to mitigate somewhat the accelerating path of government healthcare spending.

³ OECD Health Database 2011, Table: *Total expenditure on health, /capita, US\$ purchasing power parity.*

⁴ Id, Table: *Public expenditure on health, /capita, US\$ purchasing power parity.*

And of course, in return for this profligate spending on healthcare, the United States enjoys poor health outcomes; our life expectancy, for example, is at the bottom end of the OECD, well below that of the countries mentioned above.

In short, the government's long-term *fiscal* health depends directly on grappling much more fundamentally than we have to date on how we provide *physical* healthcare services to our citizens.⁵ But change in this area will be challenging, and as Chairman Baucus has pointed out, in such situations it is important that you “boil the frog slowly,”⁶ by relying on long transition periods to move from where we are to where we need to be without unfairly upsetting settled expectations and modes of healthcare delivery systems. *In the meantime, however, the resulting costs must be financed.*

3. *Medium-Term.* Tax policy and tax reform are most directly relevant in the medium term (Years 2-10, for example), as we begin the transition from unsustainable long-term government entitlement program spending patterns to more efficient ones. The medium-term is the critical budget reform timeframe, because it can function as the bridge from where we are to a fundamentally different package of government services and revenues. By developing and implementing sensible long-term policies today with appropriate transition periods, we can reorient public thinking to accept this different long-term environment, demonstrate Congressional commitment to making hard choices, and address the concerns of the financial markets.

Government discretionary spending has been on a decades-long downward trend, interrupted only by the emergency spending to deal with the Great Recession.⁷ Regardless of what one thinks about the efficacy of those programs, they were in fact temporary and will not contribute further to the deficit in future years.

⁵ CBO, 2011 Long-Term Budget Outlook at 45-47 (June 2011).

⁶ Cf. http://en.wikipedia.org/wiki/Boiling_frog.

⁷ See, e.g., CBO, *The Budget and Economic Outlook: Fiscal Years 2011 to 2021*, Fig. 3-3 at 79 (Jan. 2011).

In general, our nondefense discretionary spending today is modest by world standards.⁸ Moreover, our standard budget presentation of discretionary “spending” is a hopeless muddle, because it mixes what in a private business would be treated as current expenses (salary for government employees, for example) with items that a private firm would properly characterize, not as an expense, but as the purchase of an asset. In effect, we confuse income statement and balance sheet items. In doing so, we overstate government nondefense discretionary spending.

By contrast, the U.S. military budget is a discretionary spending outlier. We all are proud of our Armed Forces and are grateful for their work in keeping our country secure, but I nonetheless suspect that it would come as a surprise to many Americans to learn that, by at least one third-party estimate, we spend more on our military services than do the next 14 largest militaries *combined* (in fact, 42 percent of the world’s total military expenditures), and more per capita than does Israel, for which existential threats are arguably much more immediate.⁹

This suggests to me that, with the possible exception of our defense spending, discretionary spending cuts can make at most only a modest impact on the federal budget deficit in the medium term. And if one further accepts the maxim that one must boil the entitlements spending frog slowly, that leaves larger tax revenues as the only means of financing the policies to which we largely are committed.

In this connection, an OECD Economics Department Working Paper from a year ago that reviewed the U.S. federal budget trajectory offered a useful suggestion for our medium-term fiscal goals. That study suggested that our medium term goals should be a budget deficit of 3 percent by 2015 and zero by 2020; to do so, the report concluded, will require some “modest” increases in tax revenues.¹⁰

⁸ This is particularly the case if veterans’ benefits and services are properly recharacterized as a component of defense spending, rather than as nondefense discretionary spending (the current budget presentation).

⁹ Stockholm International Peace Research Institutue, *Yearbook 2011*, at 183.

¹⁰ Patrick Lenain, Robert Hagemann and David Carey, *Restoring Fiscal Sustainability in the United States*, OECD Economics Department Working Paper No. 806 (Oct. 25, 2010), at 12-14.

To be clear, both the American people and the financial markets want to see that the United States has reoriented itself to long-term fiscal sustainability, but that does not mean that we have to reach budget surplus in three years, or that we have to rip out our healthcare system overnight. What we do need in the medium-term is to establish a coherent long-term plan, demonstrate a commitment to stick with the plan, and be willing to finance our transition to that plan.

III. TAX COLLECTIONS AND DEFICIT REDUCTION.

Bipartisan majorities on the recent deficit reduction panels (for example, the Bowles-Simpson and Rivlin-Domenici commissions), major nonpartisan studies (for example, the Peterson-Pew Commission on Budget Reform's report), the OECD, thoughtful budget experts like Robert Greenstein at the Center for Budget and Policy Priorities and fellow panelists at this hearing Alan Greenspan and Martin Feldstein have all agreed that tax revenues must rise from their current levels in order to finance our government. Bluntly, there is no other alternative.

The most recent CBO "baseline" projections show the United States continuing to run federal budget deficits over the next 10 years, albeit at levels that decline substantially, especially after 2012, so that by the end of the period deficits will be in the neighborhood of 1.2 percent of GDP per annum (assuming the effectiveness of the deficit reductions to come from the Joint Select Committee on Deficit Reduction) – a level at which federal debt held by the public (in effect, the cumulative tally of past deficits) will start to decline.¹¹ Given the uncertainty associated with all budget projections, and in particular their great sensitivity to unpredictable economic developments, these baseline projections can be understood as at best sounding a note of cautious optimism. Many observers no doubt would argue, to the contrary, that projections of any deficits at all 10 years in the future are wholly unsatisfactory, given that the projections assume continuous economic growth for the next 10 years.

¹¹ CBO, *The Budget and Economic Outlook: an Update* Summary Table 1-2 at 4-5. (August 2011).

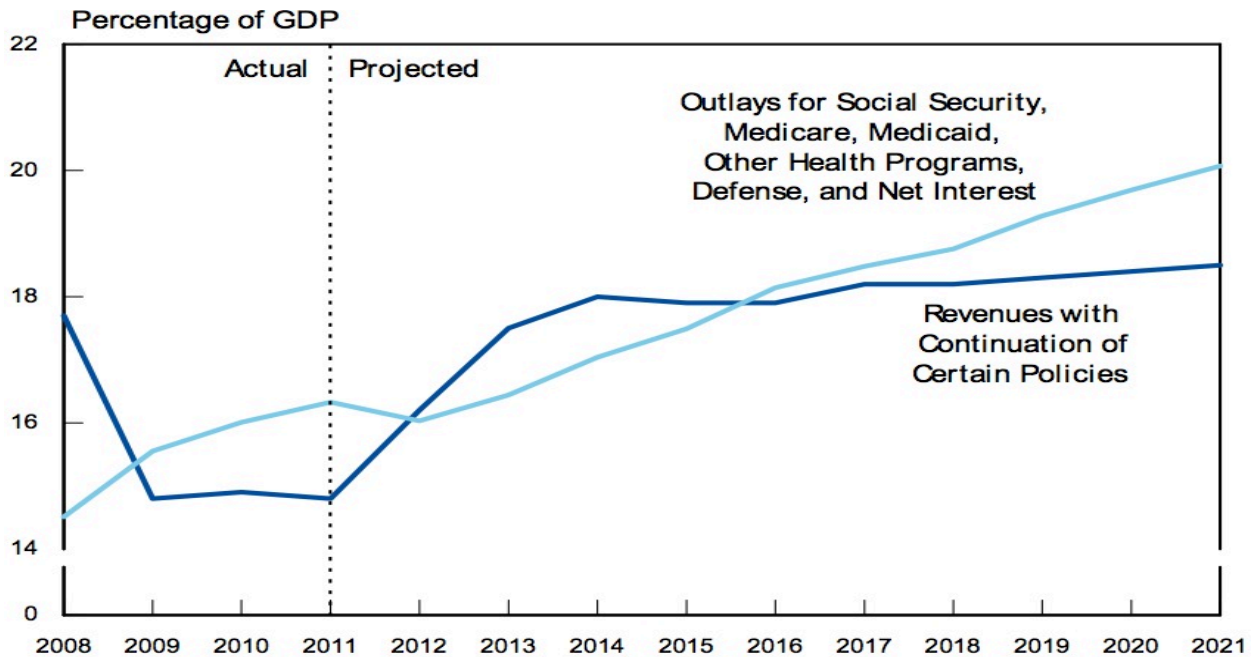
These baseline projections assume the expiration of the Bush tax cuts (or, perhaps more accurately, the “2001-03 temporary tax discounts”). As a result, the baseline projections predict that federal tax revenues will rise to just below 21 percent of GDP by 2021. This level of tax revenues is significantly higher than the historic average of the last several decades up to the Great Recession, of about 18.4 percent.

The prospect of tax revenues running at the rate of about 21 percent of GDP is plainly unpalatable to many. But to put matters starkly, extending the 2001-03 individual tax discounts indefinitely by themselves would add an additional *\$4.6 trillion* to CBO’s baseline deficits over the next 10 years.¹² And if the 2001-03 temporary tax discounts and other associated current policies were all extended indefinitely, then deficits at the end of the 10-year period would basically revert to levels approaching 5 percent of GDP per annum, and federal debt held by the public would spiral upwards.¹³ No one would recommend that the country set out to follow this budget trajectory.

Put another way, CBO projections demonstrate that the continuation of current revenue and entitlements policies would mean that the federal government would run a deficit in the coming decade even if it were to spend *zero* on all nondefense discretionary spending programs:

¹² CBO, *The Budget and Economic Outlook: an Update* at 26 (August 2011).

¹³ *Id.*, Summary Figure 1 at xii.



(Source: Congressional Budget Office; does not reflect August 2011 update)

All this means that, whatever the long-term world we transition to, we will need to finance the costs of getting there, and that in turns means higher tax revenues than those we currently collect.

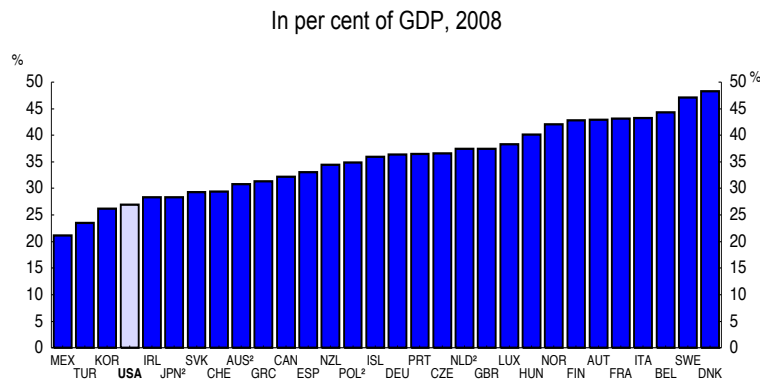
This conclusion sits badly with some. They like to point out that high taxes impede economic growth and job creation. These sorts of nostrums have as much policy utility as the old adage that, all other things being equal, it is better to be rich and healthy than poor and sick. Tax revenues need to increase not because higher taxes are desirable as an independent goal, but because there is no other choice as part of a transition from current policies, which in turn have been shaped by both political parties over many decades.

Fortunately, we begin with such an extraordinarily low level of federal tax collections in the United States that it is feasible to raise tax collections over the next several years without unduly disrupting the U.S. economy. CBO and the Staff of the Joint Committee on Taxation predict that for Fiscal Year 2011 revenues will equal only 14.8 percent of GDP; Fiscal Years 2009 and 2010 were also below 15 percent. Over several decades leading up to the collapse in revenue collections during the Great Recession,

revenue collections averaged about 18.4 percent of GDP; in 2000, when the United States last produced a budget surplus, revenues were well over 20 percent of GDP, yet the economy was robust and job creation was strong. If in fact we collected tax revenues for this year at the historic rate of 18.4 percent of GDP, then this year’s budget deficit would be some \$538 billion smaller than we currently expect.¹⁴

More generally, and without regard to the current collapse in tax revenues, the United States is an extraordinarily low-tax country by world norms. Here OECD comparative data (which combine national and subnational taxes) are extremely helpful:

Figure 4. The US tax-GDP ratio is low by OECD standards¹



1. The Revenue Statistics database contains data provided by the national tax authorities, which are generally based on standard national accounts definitions and methodologies. However, divergences with the national accounts exist in some areas. The differences are small for most countries and in most years, but are substantial in some cases. The most frequently used measure of the tax burden is shown in the figure (total taxes plus social security contributions as a percentage of GDP).
2. 2007 final data, provisional 2008 data not available.

Source: Revenue Statistics database.

(Source: Lenain, Hagemann and Carey, *Restoring Fiscal Sustainability in the United States*, OECD Economics Department Working Paper No. 806 (Oct. 25, 2010), at 15.)

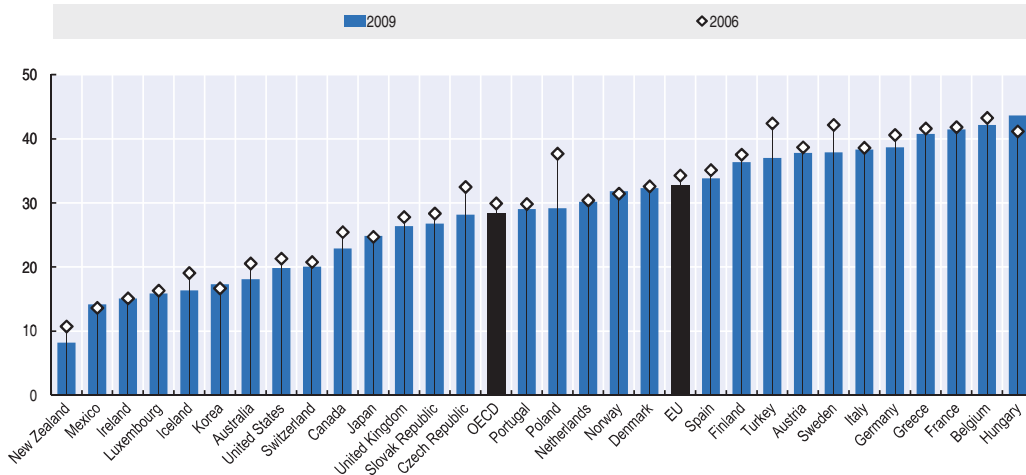
As described earlier, at the same time that the United States imposes tax burdens close to those of Turkey or Mexico, we finance a military bigger than the next 14 countries combined, and the most expensive healthcare system in the world. Why are we then surprised that we are running budget deficits?

Another way of getting a sense of our current levels of tax burdens is to look at the “tax wedge” on labor – the difference between what an employer pays (including

¹⁴ Obviously the text assumes that GDP would be unaffected.

social security contributions) and what an employee takes home as after-tax wages. Here again OECD data demonstrate that the United States is at the low end of developed country norms:

**Average Tax Wedge on Labor (As Percentage of Compensation)
(Couple with 100% of Average Earnings and 2 Children)**



Note: Users of the data must be aware that they may no longer fully reflect the current situation in fast reforming countries.
 1. Measured as the difference between total labour compensation paid by the employer and the net take-home pay of employees, as a ratio of total labour compensation. It therefore includes both employer and employee social security contributions.
 2. Average of three situations regarding the wage of the second earner.
 Source: OECD (2010), *Taxing Wages Database*.

StatLink <http://dx.doi.org/10.1787/888932373134>

(Source: OECD: *Economic Policy Reforms: Going for Growth 2011* at 156.)

For these reasons, the recent OECD “report card” on the United States concluded that: “Given that the tax-to-GDP ratio in the United States is among the lowest in the OECD area, even including taxes at the levels of state and municipalities, modest tax increases could be made while keeping the overall tax burden at a relatively moderate level.”¹⁵

Finally, and realizing that any mention of one Administration can be perceived as politically charged, the undeniable facts are that in the 1992-2000 period the economy grew much faster than it has since that time, and that the economy did so notwithstanding

¹⁵ Lenain, Hagemann and Carey, supra n. 10, at 14.

the burdens of tax rates that did not reflect the application of the 2001-03 tax discounts. All other things being equal, lower taxes are better than higher taxes (just as being rich and healthy beats being poor and sick), but whether viewed from the perspective of world norms or our own recent history it is simply not credible to argue that the U.S. economy cannot sustain higher levels of tax collections than the historically low levels of the last two years. Given that our “baseline” budget projections already have baked into them the lapse of the 2001-03 tax discounts, and that those baseline projections restore us only to deficits in the range of 1.2 percent at the end of the estimating horizon, the only reasonable question to debate is what form those tax increases should take.

IV. IMMEDIATE STRUCTURAL TAX REFORM.

A. The Tax Nostalgia Industry.

In recent years, a number of participants in the Tax Reform Act of 1986 have published essays recounting their roles in the legislative process and drawing from that one piece of legislation lessons that purportedly should govern current tax reform efforts. Chief among these is the observation that, since the 1986 Act was designed to be revenue neutral, so too must contemporary tax reform legislation. Other corollaries include the assertion that tax expenditures that survived the 1986 reform have by that fact alone become impregnable to future reform efforts.

These exercises in tax nostalgia are unhelpful and lead in general to bad advice. The 1986 Act was fashioned at one moment in time, now a full generation in the past, through a complex process that reflected economic, political and demographic factors that no longer are relevant.

In contrast to the environment surrounding the 1986 Act (itself preceded and followed by major revenue-raising legislation), tax revenues need to rise from their current depressed levels. Moreover, the economy is very different from what it was in 1986 (for example, in the rise of cross-border business activity and the creation of whole new industries). At the same time, tax policy analysis has advanced substantially in the last 25 years, and we have a better understanding of the tradeoffs between different

policies than we did in 1986. We therefore should put to one side our nostalgic impulses and focus instead on the problems we face today.

B. The Baseline As the Base Case.

As previously noted, CBO “baseline” budget projections assume that the 2001-03 individual tax discounts will lapse. Some observers think that the budget deficits reflected in those baseline projections (in the range of 1.2 percent of GDP by the end of the 10 year horizon, assuming the effectiveness of the new provisions relating to the Joint Select Committee on Deficit Reduction) are still too high. Extending the 2001-03 individual tax discounts indefinitely would add an additional *\$4.6 trillion* to those baseline deficits over the next 10 years.¹⁶

For all the reasons developed earlier, I believe that we need to accept the CBO baseline as the tax reform base case: tax revenues will need to rise to levels in the neighborhood of 20 percent of GDP, or even a bit more, over the medium-term horizon. Our current entitlements and defense programs, particularly the trajectory of healthcare spending, require this level of funding, and it will take years of substantial revenues both to pay down the debt hangover from the Great Recession and to fund the transition to some as yet unspecified package of less expensive entitlements programs and/or reduced defense spending.

I further submit that the most pragmatic way of reaching tax revenues in line with the CBO baseline is in fact to follow the baseline, more or less! Specifically, I recommend that tax reform begin by postulating the following individual revenue package:

1. In general, allow the 2001-03 individual tax discounts to lapse at the end of 2012.

¹⁶ CBO, *The Budget and Economic Outlook: an Update* at 26 (August 2011).

2. Restore the estate and gift taxes to their 2009 levels, preferably as of January 1, 2012. (This actually has a roughly \$260 billion cost relative to the CBO baseline.¹⁷)

Tax reform should build on this tax revenue “Base Case.” That is, we can appropriately talk about “revenue neutral” tax reform, so long as revenue neutrality is measured against this revenue base. The goal should be to see whether through other reforms we can improve the distributional fairness or economic efficiency of the individual tax system while preserving revenue neutrality, *all relative to this Base Case.*

For example, I would propose two modifications to this base case, designed to be a revenue neutral pairing:

3. Maintain current policy’s prescription that corporate dividends should be taxed at the same rates as long-term capital gain. (This proposal is discussed below; it loses revenue relative to the CBO baseline but has strong policy justification.)

4. Add a new top marginal tax rate of, say, 42 - 44 percent for incomes above \$2 million. (The idea would be to find the income level that would raise revenues sufficient to fund the dividend tax proposal).

Others might have their own pet reform ideas, but again the rule should be that they must be revenue neutral relative to the Base Case described above.

C. The Central Importance of Tax Expenditures.¹⁸

The straightforward goals of an incremental reform of the personal income tax (and I put the 1986 Tax Reform Act into this category) should be (1) to raise the targeted level of revenues with (2) the desired distributional consequences while (3) keeping marginal tax rates – the tax imposed on your last dollar of income – as low as possible. The intuition here is simple: people are more sensitive to the tax rate imposed on their last dollar of income than to their average tax burden. The deadweight loss of taxation

¹⁷ CBO, *Reducing the Deficit: Spending and Revenue Options* at 216 (“Alternative 2”) (March 2011).

¹⁸ Some of this subsection is abstracted from Edward Kleinbard, *The Hidden Hand of Government Spending, Regulation* (Cato Inst., pub.), Fall 2010, at 18.

can be minimized by keeping marginal tax rates as low as possible, consistent with the other two goals.

Raising average tax rates without raising marginal rates (beyond the expiration of the 2001-03 tax discounts) requires broadening the tax base. Unlike 1986, the individual income tax today has not been eroded through suspect tax shelters or other schemes to avoid the tax system that Congress anticipated when drafting the tax code. (There are of course exceptions, but they are not significant to the overall revenue picture.) This means that the only way to raise significant revenues (perhaps enough to “buy back” some of the tax increases contemplated by the base case summarized earlier) without raising marginal tax rates is to tackle directly some of the deliberate Congressional subsidy programs baked into the tax code, which is to say, tax expenditures.

As you know, tax expenditures, particularly those that can be phrased as “tax subsidies,” are a form of government spending, not tax reductions.¹⁹ Tax expenditures dissolve the boundaries between government revenues and government spending. They reduce both the coherence of the tax law and our ability to conceptualize the very size and activities of our government.

Tax expenditures serve many different purposes. Some (the earned income tax credit, the special tax rates on long-term capital gains) really function as adjustments to the tax rate tables; others (the child credit, the refundable portion of the EITC) serve important social and distributional goals; still others (pension plan contributions) can be explained as moves towards a consumption rather than an income tax.²⁰ But many fall into the category of well-intentioned but ultimately inadvisable instances of

¹⁹ The history and theory of tax expenditure analysis is developed at length in the Staff of the Joint Committee on Taxation’s publication, *A Reconsideration of Tax Expenditure Analysis*, JCX-37-08 (May 12, 2008). Since that date the Staff of the Joint Committee on Taxation has retreated from some of the modes of analysis proposed therein to its traditional presentations of tax expenditure analysis. I think that this is a mistake, because reverting to an excessive reliance on a “normal tax” as the analytical starting point weakens the case for bipartisan agreement on the central importance of tax expenditure reform.

²⁰ One of the principal contributions of *A Reconsideration of Tax Expenditure Analysis*, supra n. 19, was to urge that tax expenditures be grouped into different conceptual buckets, so that each could fairly be analyzed in accordance with its overall purpose. The current JCT Staff’s retreat from this mode of analysis unfortunately weakens the utility of tax expenditure analysis in general.

Congressional meddling, by subsidizing different forms of personal consumption or business activity. These latter sorts of tax expenditures typically introduce economic inefficiencies, miss the target of their intended beneficiaries, and waste a great deal of money.

The magnitude of tax expenditures is staggering: the federal government spends today almost twice as much through tax expenditures as we do through old-fashioned explicit non-defense discretionary spending programs. In fact, we spend more in tax expenditures than we collect in cash through the personal income tax. It's as if our tax base were twice as large as it appears, and then we gave half or so of those revenues back through various ersatz subsidies that in many cases are poorly targeted and result in misallocations of economic activity.

Tax expenditures dissolve the boundaries between government revenues and government spending. As a result, they reduce both the coherence of the tax law and our ability to conceptualize the very size and activities of our government. To see how, consider a little example involving the small but self-reliant country of Freedonia. Its economy is comprised of 10 fruit and vegetable growers, each earning \$1,000 pre-tax, for a total gross domestic product of \$10,000. Each grower pays income tax to support the Freedonian army at a flat rate of 15 percent, for total tax revenues of \$1,500.

Freedonia's sole kumquat producer is particularly resourceful. Armed with scientific reports showing the many health benefits of kumquat consumption, he convinces the Freedonian legislature that kumquat production deserves tax incentives, to bring kumquats within the reach of every Freedonian family. The legislature responds by effectively exempting kumquat production from its income tax through an innovative kumquat production tax credit.

But Freedonia is not a profligate state, and it believes in fiscal discipline in the form of pay-as-you-go budget rules. Therefore, to keep the kumquat credit revenue-neutral, the legislature pairs the new preference with an 11.1 percent tax hike on the other producers, to maintain tax revenues at \$1,500. (Freedonian tax policy allows for rounding error.) That means that the other fruit and vegetable farmers will each pay \$167 (instead of \$150) in tax on their \$1,000 of income.

In a world without tax expenditure analysis, Freedomian legislators can argue that nothing has changed: government revenues are constant, and there is no increase in government spending or borrowing. But this is plainly wrong; things have changed, in both the private and public sectors.

First, the tax incentive increases kumquat production and consumption. The equilibrium price and quantities sold of kumquats will be different relative to other fruits and vegetables after the tax incentive. Economists believe that, in the absence of some identifiable market failure, markets set prices better than legislatures do, but the kumquat credit alters the quantity of kumquats sold relative to the case in which the tax burden of all fruit and vegetable growers was equal. Unless the health of Freedomians really is improved by the kumquat credit (perhaps due to prior rampant borderline scurvy among the population), the result will be a less efficient allocation of our collective resources.

Second, the introduction of the kumquat credit in an apparently virtuous “revenue neutral” fashion has another profound economic effect: tax rate increases on the incomes of all the fruit and vegetable producers who do not receive targeted tax relief. All taxes, no matter how beautifully implemented, impose “deadweight losses.” That is, some transactions that are rational in a world without taxes become too expensive in a world with those taxes and do not take place. And deadweight loss increases faster than the tax rate — in standard presentations, in fact, at the square of the tax rate.

What all this means is that, by virtue of granting “revenue neutral targeted tax relief,” the Freedomian government may raise the same aggregate revenues as it did previously, but impose more deadweight loss on the remaining taxable Freedomian private sector. This result is one of the great ironies of many tax expenditures, particularly those that fall into the category of business incentives — once the incentive’s impact on tax burdens *for others* is considered, it impoverishes the country even more than it enriches the beneficiaries of the legislative largesse. (Deadweight loss of course cannot be avoided for long by electing “targeted tax relief” without revenue offsets. Unfortunately, recent U.S. tax history has some of this flavor.)

Third, by virtue of its new kumquat credit, the Freedomian government just got bigger, even though aggregate nominal tax revenues remain constant. The best way to

analogize the new kumquat credit to a uniform 11.1 percent tax hike on all of Freedonia's fruit and vegetable producers, followed by a \$167 kumquat crop farm subsidy payment to the kumquat producer. By recasting the tax expenditure in this way, as a constant tax burden and a separate transfer payment, the two different functions of government are restored to their customary formal presentation, and the words "revenue" and "spending" can be applied consistently to economically identical (but formally different) modes of implementation. As so recast, it is easy to see that Freedonia's economic handprint on the private sector is no longer \$1,500 in tax revenues, but rather \$1,667 in economic terms. The government is bigger in every meaningful sense of the word.

D. Healthcare Tax Expenditures.

The two largest clusters of tax expenditures are those for healthcare and those for owner-occupied housing. Each has had a large and profoundly negative allocative effect on the economy – that is, each has distorted what goods and services we all purchase, by changing relative prices through hidden government subsidies. Each also is poorly targeted, in the sense that the subsidy often goes to taxpayers who would have purchased those goods or services without the help of the subsidy.

The most important healthcare tax subsidy is the treatment of wages paid by an employer in the form of healthcare benefits (whether called insurance or out of pocket reimbursements) as tax-exempt in the hands of an employee. This "exclusion" from employees' incomes of wages paid in the form employer-provided healthcare will cost some \$117 billion in forgone income taxes in 2011 alone (and \$161 billion in 2014, when the economy is projected to be more robust),²¹ but even these enormous costs understate the true picture, because they do not include the payroll tax revenues forgone by the exclusion. In 2008, the JCT Staff estimated these payroll tax costs at some \$100 billion for one year alone.²²

²¹ Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014*, JCS-3-10 (December 2010).

²² Staff of the Joint Committee on Taxation, *Tax Expenditures for Healthcare*, JCX-66-08 (July 2008).

In short, the total value of this government subsidy for one mode of healthcare delivery is on the order of \$250/billion year. Yet precisely because this subsidy is delivered as an income “exclusion,” its recipients are largely unaware that they are the beneficiaries of a hidden government handout. The result is a terrible distortion in public discourse, as seen in the debate surrounding the Patient Protection and Affordable Care Act. Many Americans believed that the Act represented an unprecedented government intrusion into the private sector, but were unaware that the government had long been subsidizing their healthcare (but not necessarily those of other Americans with different employers). This is why in my academic writing I have emphasized the corrosive effects of tax expenditures on our ability to conceptualize the role of government in our lives.²³

Substantively, the subsidy for employer-sponsored distorts our spending patterns, by encouraging us to take compensation in the form of generous healthcare programs (its allocative consequences), does so inefficiently (by subsidizing higher-income Americans more, since tax-exemption is more valuable to them – the classic “upside down” subsidy pattern of many tax expenditures), and does so unfairly (because its availability depends on the programs offered by your employer, not consistent national standards available to everyone).

For these reasons, every health economist of whom I am aware believes that the tax subsidy for employer-sponsored health insurance is both unaffordable and bad policy. Many I believe were acutely disappointed that the Patient Protection and Affordable Care Act left the subsidy largely intact (except for certain “Cadillac” plans).

The difficulty is not with this ultimate conclusion, but rather with the frog boiling procedure. The tax subsidy for employer-provided healthcare is so deeply engrained in the healthcare delivery system that it cannot be removed except through a carefully thought-out transition to a different system. Whether the Patient Protection and Affordable Care Act is that system, or only a steppingstone to a more comprehensive rewriting of how healthcare is delivered in the United States, is a complex question, but the unwinding of the tax subsidy for employer-sponsored healthcare should take place in

²³ E.g., Edward Kleinbard, *The Congress Within a Congress: How Tax Expenditures Distort Our Budget and Our Political Process*, 36 Ohio Northern L. Rev. 1 (2010).

the context of a plan that assures Americans that healthcare will not become less available or wholly unaffordable.

E. The Sacred Tax Cows of Personal Itemized Deductions – It’s Them or Us

Employer-provided healthcare is the largest single government subsidy program delivered through the tax system. As a group, though, the personal itemized deductions – in particular, the deductions we claim that subsidize our homes (the home mortgage interest deduction, the deduction for property taxes, etc.), our charitable contributions, our state and local income taxes, and so on – are even larger. These three tax subsidies alone are projected to cost at least \$240 billion in forgone revenues for just the current fiscal year, and that cost will climb as the economy recovers.

I propose that we phase out the tax subsidies for these activities over the five years from 2013-2017. The most elegant way to do so would be to convert the deductions into tax credits, and then phase down the credit rate to zero ratably over that five-year period.

I recognize that all of these items are frequently described as political “sacred cows,” but they are simply unaffordable luxuries in the current environment. Either we eliminate these sacred cows, or they will stampede us.

The elimination of the personal itemized deductions, together with the lapse of the 2001-03 tax discounts, will by themselves yield enough revenue to address our deficit concerns for the medium-term, and thereby buy us the time we need to develop and gradually implement long-term entitlement spending reforms. Moreover, their elimination would large remove the need for an AMT “patch,” because it is these deductions that drive most taxpayers into the AMT in the first place.

In December 2010 the Tax Policy Center was kind enough to produce some estimates for me of the revenue impact of repealing the personal itemized deductions. The data speak for themselves:

**Revenue Consequences of Eliminating Personal Itemized Deductions
Assuming Lapse of 2001-03 Tax Discounts and No Transition Relief**

	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>
GDP*	16,705	17,760	18,630	19,508	20,398
Total Deficit*	-525	-438	-507	-585	-579
Eliminate All Itemized Deductions Eff. 1/1/2013**	<u>253</u>	<u>268</u>	<u>283</u>	<u>297</u>	<u>311</u>
Revised Deficit	-272	-170	-224	-288	-268
<u>Memorandum</u>					
Baseline Deficit as Percentage of GDP	-3.10%	-2.50%	-2.70%	-3.00%	-2.80%
Revised Deficit as Percentage of GDP	-1.60%	-1.00%	-1.20%	-1.50%	-1.30%
* CBO August 2101 Projections. Reflects expiration of all 2001 + 2003 tax cuts					
** Tax Policy Center Dec. 30, 2010. Estimates are static; they do not include a behavioral response					

Source: Tax Policy Center

These figures admittedly are imperfect. They are a year old, and they are “static,” in the sense that they do not account for any behavioral responses. Moreover, the figures do not incorporate any transition relief along the lines I propose. They do, however, reflect “tax form behavior,” which is to say they reflect the fact that affected taxpayers will switch from itemizing their deductions to the standard deduction. Nonetheless, the data do capture the order of magnitude of these public subsidies for personal consumption decisions.

The fact that we are today forgoing revenue on the order of magnitude of *1.5 percent of GDP per annum* for these government subsidies of personal expenses suggests to me that, whatever their political appeal, they are simply luxuries we cannot afford.

And as I noted already, their repeal largely resolves the current crisis over what to do with the individual AMT, because it is these deductions that drive most taxpayers into the AMT in the first place.

By phasing out the deductibility of personal itemized deductions, we not only raise a very large amount of revenue, but we do so efficiently. We raise this incremental revenue *without* raising marginal tax rates. The elimination of the tax preferences for these items also will add to the progressivity of the tax system, because itemizers generally have higher pretax incomes than do taxpayers claiming the standard deduction.²⁴ (Only about one-third of tax filers are eligible to claim itemized deductions today.)

Moreover, by eliminating these sacred tax cows we directly address a fundamental misallocation of capital in the private sector, which is our overinvestment in single-family homes compared to other forms of capital investment.²⁵ We also will eliminate the inefficiencies by which we provide these subsidies to those who would have bought their homes (or made charitable contributions, or chosen to live in high-tax states) regardless of the tax incentives.²⁶

At bottom, the personal itemized deductions, as the name implies, are all *personal* expenses. Their elimination would make the tax system more progressive, more efficient, less distortive and simpler. Doing so also would raise a heck of a lot of money without adding unduly to the deadweight loss from taxation, and raising a heck of lot of tax revenue in general is something that we have no choice but to embrace.

²⁴ See, e.g., Testimony of Robert Greenstein Before the Senate Committee on Budget, March 9, 2011, Table 1 (listing distributional consequences of itemized deductions by income quintiles).

²⁵ Robert Carroll, John F. O'Hare and Phillip L. Swagel, *Costs and Benefits of Housing Tax Subsidies*, Pew Charitable Trusts (June 2011); Evridiki Tsounta, *Home Sweet Home: Government's Role in Reaching the American Dream*, International Monetary Fund Working Paper Wp/11/191 (August 2011).

²⁶ For example, Tsounta, *supra* n. 24, finds (Table 8 at 28) that Canada's tax subsidies for home ownership are perhaps 1/5 as large as a percentage of GDP as those of the United States, yet Canada has a higher rate of home ownership.

The reason to eliminate *all* of the personal itemized deductions is that it is impossible to choose among them. Each can be defended as an incentive for one desirable goal or another. Our only practical hope is to round up and eliminate all these tax sacred cows at once.

The incremental revenues that would result from eliminating personal itemized deductions can be used to speed the transition to a different set of long-term government spending and tax policies, or to pay down the federal debt, or to “buy back” some of the tax increases contemplated by the Base Case I posited earlier. Regardless, closing down these inefficient, poorly targeted and unfairly top-weighted government subsidy programs would constitute a major achievement in tax reform.

Martin Feldstein, who is on the panel with me today, has an even more ambitious proposal, which he describes as a 2 percent cap on the tax benefits that an individual taxpayer can claim from tax expenditures.²⁷ Marty and I share a common emphasis on the importance of addressing tax expenditures as the right way to raise revenue, but I do not agree with his recommendation.

First, the Feldstein proposal would be extremely complex to implement, much more so than suggested by the NBER paper I reference in a note. Second, whether by design or not, the Feldstein proposal would impose very large tax burdens on many lower income working Americans.

The reason is that he effectively would reverse the current tax subsidy for employer-provided healthcare and the child credit, except to the very limited extent of his 2 percent floor. By his own calculations (in a Washington Post op-ed, not in the NBER paper), *54 percent of all taxpayers who today claim the standard deduction would pay higher taxes under his proposal*. A single mother of two working full time at the minimum wage would lose more than \$1,400 of her \$2,000 child tax credit under the Feldstein proposal— more than 80 percent of her current credit. Meanwhile, a family of

²⁷ Martin Feldstein, Daniel Feenberg and Maya MacGuineas, *Capping Individual Tax Expenditure Benefits*, NBER Working Paper 16921 (April 2011).

four earning \$60,000 would lose about \$800 of their \$2,000 child tax credit, or 40 percent of it.²⁸

By contrast, the elimination of personal itemized deductions by definition would affect only taxpayers who today itemize their deductions, not those who claim the standard deduction. That is why the elimination of personal itemized deductions is not only an efficient reform from an economic perspective, but increases the progressivity of the tax code.

I understand completely the impulse to dismantle the tax subsidy for employer-provided healthcare, but as I emphasized earlier in my testimony, we should do so only in the context of a completely secure path to a superior healthcare delivery system that is still affordable. I also am concerned that any tax reform legislation not burden the poorest Americans. For both reasons I think that the Feldstein proposal goes too far.

F. Business Tax Reform.

As noted earlier, one important exception that I would make to my general base case of allowing the 2001-03 individual tax discounts to lapse relates to the tax burden on dividend income. Keeping that tax at the same rate as the rate on long-term capital gains, rather than allowing to revert to the tax rate on ordinary income, is highly desirable for the simple reason that it will not distort corporate dividend policy (because otherwise investors would insist on taking their returns through stock sales). A great deal of corporate tax planning in the past was devoted to converting dividend income into long-term capital gain; failing to maintain tax rate parity will simply invite tax lawyers to dust off those old planning stratagems. Moreover, dividend income and long-term capital gains on corporate stock can plausibly be linked as the only two cases of genuine double taxation in the tax code; there is merit in mitigating that phenomenon in both cases.

The U.S. statutory corporate tax rate today is too high, and should be lowered. Here is an area where roughly *revenue-neutral* tax reform makes sense: broaden the business tax base and lower the rate. The business sector also is riddled with government

²⁸ Tax calculations kindly provided by Center for Budget and Policy Priorities, based on 2011 tax law.

subsidies in the form of tax expenditures. In the income tax area, those subsidies amount to roughly \$100 billion/year, of which about 80 percent are captured by corporations and the remainder by noncorporate businesses. In addition, there are numerous excise tax subsidies that are not even scored in the annual tax expenditure roundups. These subsidies, with all their poor targeting and allocative distortions, should be traded in for lower corporate tax rates.

Implicit in this suggestion is the idea that, to some extent, noncorporate businesses will pay more in tax so that corporations will pay less. I believe that this is appropriate, for a number of reasons. First, as noted, most business tax expenditure benefits are claimed by corporations, not pass-through entities. Second, noncorporate businesses today generally enjoy lower rates on capital income than do corporations.²⁹ For example, gain on sale of a noncorporate business generally is taxed as long-term capital gain, even though there is no double taxation of the firm's earnings, the purchaser can obtain a step-up in tax basis without further cost, and those long-term capital gains in fact often relate to the labor contributions of the owner-operator. Third, small noncorporate businesses in general have had a long and troubled tax compliance history, including mingling of personal and business expenses and nonreporting of cash income.

I have written extensively recently about our international corporate tax regime.³⁰ The long and the short of it is that I believe that U.S.-based multinational firms have vastly overstated the “uncompetitiveness” of the U.S. system for taxing foreign direct investment. To the contrary, sophisticated U.S. multinationals have succeeded in effectively gaming both the U.S. tax system and those of other high-tax jurisdictions through their adroit production of income taxed nowhere – what I call “stateless income.” At the same time, the real competitiveness story, which is the tax burden imposed on U.S. *domestic* corporations, has largely escaped attention.

²⁹ CBO, *Taxing Capital Income: Effective Rates and Approaches to Reform*, Table 1 at 8 (Oct. 2005).

³⁰ See, e.g. Edward Kleinbard, *Stateless Income's Challenge to Tax Policy*, 132 Tax Notes 1021 (Sept. 5, 2011), and the longer papers cited therein.

For all the reasons developed in my papers on the subject, the right answer here is to tax U.S. firms on their worldwide income, but at much lower tax rates. I believe that tax rates in the neighborhood of 25 to 27 percent are easily achievable. Rates at this level would provide U.S. multinational firms with a “competitive” tax environment while substantially improving the tax environment for domestic firms, and encouraging inbound cross-border investment. These arguments are developed at much greater length in the papers cited in note 30.

There is understandable concern that at some point, if individual marginal rates go up and corporate rates go down, the corporation will become a “tax shelter,” in that individuals will prefer to earn income through a corporation, to take advantage of its lower tax brackets. There are awkward technical solutions to this problem already in the tax code; the better answer, though, lies as part of a more ambitious long-term tax overhaul, as quickly outlined below.

V. LONG-TERM STRUCTURAL TAX REFORM.

If Congress were to allow the 2001-03 temporary tax discounts to lapse, phase out personal itemized deductions, and engage in revenue-neutral business tax reform along the lines outlined above, it would have done enough. It could then turn its attention to the difficult issues of long-term entitlements spending reform, in particular the structure of our healthcare delivery system.

Nonetheless, it is possible to imagine even more fundamental tax reforms. One direction, of course, would be to reorient the tax system more in the direction of consumption taxes. There are economic efficiency arguments that support a preference for consumption over income taxes, but of course there also are difficult transition and design issues.

In my research I focus instead on the income tax, which I believe is much sprier than do many of its critics. I believe that it is possible to imagine a much more economically efficient income tax than our current system, in the sense of one that would impose more consistent tax burdens on economically similar items of income, regardless

of their legal labels, and one that would tailor those burdens to the different kinds of income in question.

Policy discussions about fundamental income tax reform usually are highly fragmented. We debate capital gains policy, or the corporate tax rate, or “small business” taxation, or “carried interest,” as independent concepts, but this ultimately is silly. Notwithstanding the generations of law students who have been taught to the contrary in Tax 1 courses around the country, as a practical matter income really is derived from labor, from capital, or from the two combined.³¹ Very roughly, 2/3 of our GDP is contributed by (a “return to”) labor, and 1/3 by capital.³² “Capital” income includes interest and rental income, dividend income and capital gains, and also corporate income, because a corporation (at least a large publicly-held one) compensates its labor factor of production directly in the form of tax-deductible wages.

The corporate income tax in the first instance is thus a tax on capital income. It is a different (but of course important) question whether the incidence of that tax (the ultimate economic burden) is shifted to labor, in the way that the excise tax on gasoline actually is borne by consumers.

Our policy debates, overinfluenced by the tax ideologies reflected in the Tax Reform Act of 1986, tend to see an ideal income tax as one that taxes returns to labor and returns to capital on a single progressive tax rate schedule, but there is no reason why this should be so. To the contrary, the economic evidence suggests that labor and capital have different sensitivities, or if you prefer, aversions, to taxation. The only reason to insist on a common tax rate schedule as the ideal is because it is difficult to distinguish between returns to capital and returns to labor. For example, the local restaurant owner who invests her life savings and all of her working hours into her restaurant obtains economic

³¹ Treasure trove, the lucky fan who catches the record-setting home run baseball, and the purchase of an old piano that turns out to be stuffed with cash are important only for law school exams, not for tax revenues.

³² Recent CBO data would put the split at 60/40. CBO, *The Budget and Economic Outlook: an Update* Figure 2-13 at 56 (August 2011).

returns in the form of business profits from the combination of her labor and her capital, but all that we see is a single bottom line profit.

It turns out, however, that good research and even real-world experiments have been done on this question of distinguishing labor income from capital income, which in turn opens up the question of what the tax burden should look like on each. I group this work under the general rubric of “dual income taxes.”³³ (They are “dual” in that they have two rate schedules, one for labor income and one for capital income.)

At the same time, we also have learned a great deal about how to think conceptually about capital income. We now understand that it can usefully be broken down into three categories: “normal” returns (the bread and butter risk free returns from waiting, or, if you prefer, the return on marginal investments in competitive markets), “risky” returns (the compensation we demand for taking on uncertain projects) and “economic rents” (the supersized returns from owning some especially valuable asset that cannot simply be reproduced, like a valuable patent).³⁴

In a nutshell, it is possible to use these new insights and techniques to design an income tax system that first separates income into two buckets – capital income and labor income (which latter category would include treasure trove and all the other marginalia that animate tax law professors), and then applies coherent but separate rules to each. I call the core component of this reimagining of our income tax the “business enterprise income tax.”³⁵

The capital income side is the more difficult one. But one can imagine a feasible and administrable capital income tax system that is much superior to our current approach, including along the following margins:

³³ See, e.g., Edward Kleinbard, *An American Dual Income Tax: Nordic Precedents*, 5 *Nw. J.L. & Soc. Pol’y* 41 (2010).

³⁴ See, e.g., Edward Kleinbard, *Designing an Income Tax on Capital*, in *Taxing Capital Income*, The Urban Institute Press (2007).

³⁵ For early iterations of the idea, see Kleinbard, *supra* n. 32; Edward Kleinbard, *Rehabilitating the Business Income Tax* (The Hamilton Project, May 2007).

1. It would eliminate the tax preference for debt over equity financing.³⁶ It is an interesting insight into the limitations of traditional tax expenditure analysis that this enormously distortive tax subsidy is not even scored as a tax expenditure, because it is thought to be inherent in any income tax. But that is not correct.

2. It would achieve tax integration – that is, the elimination of double taxation on business earnings.

3. It would tax all business entities identically, rather than having different rules for different legal forms, and similarly would tax all forms of capital investment identically.

4. It would move the taxation of much business income (more specifically, “normal” returns) to the level of the individual rather than that of the firm. This has very important technical benefits both for the measurement of capital income and for practical international tax “competitiveness” concerns.

5. It would ground the taxation of capital gains on some principled basis, rather than our current instinct either to overtax or to undertax such instances of capital income, and apply a single consistent tax rate to all forms of capital income, whether earned over time or as a lump sum through a sale.

6. By providing a single tax schedule for all instances of capital income, it would greatly reduce the distortions arising from the collision of current tax law’s fixation with out of date legal constructs and commercial realities.

I find all of this to be an exciting prospect for my academic research, and hope one day to see it implemented into law. But none of this should detract from what should be the immediate focus, which is raising sufficient revenues as painlessly as possible to enable the country to buy the time required to revise its entitlement spending programs in a way that is fair to settled expectations and to our shared vision of what it means to be Americans.

³⁶Ruud A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, International Monetary Fund Staff Discussion Note SDN/11/11 (May 2011).