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TAX REFORM OPTIONS: MARGINAL RATES ON HIGH-INCOME TAXPAYERS, CAPITAL GAINS, AND DIVIDENDS

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TAX REFORM OPTIONS: MARGINAL RATES ON HIGH-INCOME TAXPAYERS, CAPITAL GAINS, AND DIVIDENDS

WEDNESDAY, SEPTEMBER 14, 2011

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

The hearing was convened, pursuant to notice, at 10:08 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Bingaman, Wyden, Nelson, Menendez, Cardin, Hatch, Grassley, Snowe, and Kyl.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; and Tiffany Smith, Tax Counsel. Republican Staff: Chris Campbell, Staff Director; Jim Lyons, Tax Counsel; Maureen McLaughlin, Detailee; and Jeff Wrase, Chief Economist.

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

The CHAIRMAN. The committee will come to order.

Abraham Lincoln once said, "That some achieve great success is proof to all that others can achieve it as well."

Our country is built on the principle that everyone can succeed by working hard and playing by the rules. It is the American dream. But lately, more and more folks are finding that, as hard as they try, their success is further from their grasp. In fact, since 2007, Americans' real median household income has fallen by 6.4 percent. More than that, median household incomes in America fell last year to levels last seen in 1997. I think the *New York Times* today phrased it as "the lost decade."

I read a statistic that about 21 percent of American children now live in poverty. This is the United States of America, folks.

We are facing a struggling economy and record deficits. We need to do something to tackle these problems, but to do so in a balanced way that creates jobs in the process. But in tough economic times like these, taking on these problems involves difficult choices, and these choices are clear.

Putting the full load of deficit reduction on seniors, on veterans, and middle-class families, for example, when the wealthiest can afford to pay a little more, simply does not make sense.

With limited resources, however, it does make sense to allow these lower tax rates for the wealthiest in our society to expire rather than making major cuts to Social Security or Medicare. And it sure makes sense to let those rates expire rather than increase taxes on lower- and middle-income families.

Over the past 3 decades, the incomes of the richest 1 percent of Americans have risen much more rapidly than the other 99 percent of Americans, and that gap continues to widen both before and after taxes. During that time period, the after-tax incomes of the top fifth of taxpayers grew more than 8 times faster than those in the bottom one-fifth.

I introduced legislation last year to allow the current top two rates to expire for those with incomes above $200,000 and married couples with incomes above $250,000. This proposal would mean that the top income tax rates of 33 and 35 percent would return to 36 and 39.6 percent.

Historically, the top tax rates have been much higher than the current rates. In fact, over the last century, the average top rate has been 59.2 percent. That is the average, 59.2 percent.

The lower tax rate for capital gains and dividends further complicates the picture. A *Washington Post* article this week noted that many of the richest Americans pay taxes at a lower rate than middle-class families do, because much of their income comes from capital gains and dividends. This partially explains why the gap between the wealthy and the rest of the country continues to widen.

Capital gains and dividends are generally taxed at a rate 20 percentage points below the top income tax rate that high-income workers pay on their wages. And earnings from capital gains and dividends constitute a larger share of income for high-income taxpayers than for most Americans. In fact, capital gains make up 57 percent of the adjusted gross income for the richest 400 taxpayers.

Low capital gains and dividends rates helped these extremely wealthy taxpayers, who had an average income of $345 million in 2007. That is their average income. They pay an average tax rate of only 17 percent, a rate far lower than many middle-class families pay.

There are important reasons why it might make sense to tax capital gains at lower rates than ordinary income, for example, if the gain is on stock in a company that has already paid corporate income tax. But is it fair for someone with $345 million in yearly income to pay income tax at a rate lower than many middle-class families?

So, in these tough economic times, we must make these choices. Will we be forced to make real changes to programs that seniors depend on, like Social Security and Medicare? Will we be forced to cut programs or raise taxes on veterans, servicemen, women, middle-class families, or should we ask some of the wealthiest in our society to contribute?

We need to make the right choices to get America on sound economic footing, and the choice here seems clear. We began this summer by making real progress in cutting spending by $900 billion over 10 years. But more work remains to be done to get our economy back on track.

We need to make choices that will create job growth and expand our economy without throwing millions of Americans into further economic turmoil. We cannot let politics get in the way of commonsense solutions for our economy. We just must do what is right.

So let us make those right choices. Let us approach deficit reduction in a fair and balanced way. Let us set the top tax rates in a way that is appropriate for our current economic situation. Let us work to create jobs and provide opportunities for success for all who work hard.*

[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, for holding today's hearing. It is the latest in a critical and informative set of hearings that this committee has had in preparation for comprehensive tax reform.

I think we need to be clear with the American people, however, about what is really being considered at this hearing. The question that is raised by the witnesses' testimony today is whether we should raise marginal rates, as well as the rates on capital gains and dividend income.

Unfortunately, I think I know what the answer is from many of my friends on the other side of the aisle. I certainly know where the President stands on this question. Having already enacted over $1 trillion in new taxes through his health care law, he is ready for more.

Just the other day he offered up over $400 billion in new taxes to pay for his latest spending proposal, and, of course, he is intent on causing the Bush- and Obama-era tax rates to go up on small business owners and others in the top two tax brackets. That is over the objection of many in his own party.

President Obama said that he is tired of the same old accusations that Democrats are tax-and-spend liberals. But to borrow from the old saying, if it looks like a tax-and-spend liberal and talks like a tax-and-spend liberal, it is probably a tax-and-spend liberal. Or to borrow from Jeff Foxworthy, if you think the only problem with the first stimulus was that it was not big enough, you might be a tax-and-spend liberal.

If you talk about a "balanced approach" to deficit reduction, you might be a tax-and-spend liberal. And, if you argue that "revenues must be on the table" to bring down spending-fueled deficits and debt, you are definitely a tax-and-spend liberal.

There is a reason for these euphemisms. Those who promote tax increases do not come right out and announce their support because they know that the American people rightly believe that their taxes are heading higher than they have been historically. Even without any new tax increases, taxes are already heading higher than they have been.

As we debate the additional tax increases that the President and his congressional allies would like to enact, the American people

*For more information, *see also,* "Federal Tax Treatment of Individuals," Joint Committee on Taxation staff report, September 12, 2011 (JCX–43–11), *https://www.jct.gov/publications.html?func=startdown&id=4356*.

deserve a clear reckoning of just how high our taxes are heading, even if current tax policy is permanently extended.

Even if all of the Bush- and Obama-era tax rates are extended permanently, revenues as a percentage of gross domestic product will be 18.4 percent, according to the nonpartisan official scorekeeper for Congress, the Congressional Budget Office.

According to CBO, those revenues of 18.4 percent of gross domestic product are substantially higher than their recent historical average, which was 18 percent from 1971 to 2010.

So the question the American people are asking is: if taxes are already heading higher than they have been historically, should we raise them even more? From my perspective, the answer is a resounding "no."

In the short term, the tax increases that are already set to come online due to the President's policies are a significant drain on economic growth. Adding even more to the mix would only be a further drain on our economy, curbing growth in the economy and jobs both in the short term and the long term.

With unemployment at 9.1 percent, over 2.5 years after the President promised a stimulus bill would keep unemployment below 8 percent, should we really increase taxes on exactly half of all flow-through business income? Is that really a good idea, considering the fact that even the President agrees that small businesses create two-thirds of the new jobs in our economy, and small businesses employ 54 percent of American workers?

A truly informative debate about the impact of tax increases has to include facts like those above. Unfortunately, it is often easier to resort to talking points from wealthy liberals who seek to raise marginal rates, adversely impacting the small businesses that will be the engine of our economic recovery, because they feel guilty that they are not paying their fair share, I guess.

Instead of trafficking in economic reality and cutting to the effectual truth for small businesses, if we raise marginal rates, the President talks about raising rates on wealthy people like himself, because he has money he really does not need.

In addition to betraying a very odd understanding of how a modern economy works, talking points like these fail to present taxpayers with the real world tradeoffs that come from increasing marginal rates and rates on capital gains and dividends.

I think that this obfuscation is intentional. If tax hike proponents actually engage in a factual debate over whether taxes should be raised, even though they are already heading higher than their historical average, I am confident that they will lose.

The fact that congressional Democrats have not passed a budget in well over 800 days is all the evidence that we need of the unpopularity of the tax increase agenda. Democrats know that they have to, at least in theory, support deficit reduction and a balanced budget. But the left will not allow them to make any meaningful spending reductions, and the vast majority of taxpayers would revolt if the left came clean about the tax increases that would be necessary to finance the level of spending President Obama has signed onto.

So, caught between a rock and a hard place, my friends on the other side of the aisle have just declined to pass a budget for years.

The American people want Washington to get its spending under control, not to tax them more.

Those who promote tax increases deny that they want to raise your taxes. They are only ever interested in raising someone else's taxes. They only want to raise taxes on the so-called rich. Those who would advocate this course, in my opinion, are not being forthcoming.

Those who promote tax increases know that they simply cannot raise enough money to pay for their spending priorities only by taxing individuals and small businesses in the top two brackets. It does not come close. The tax hikes necessary to pay for the level of government spending that President Obama and most congressional Democrats want would be extremely large and extremely widespread.

To balance the budget through tax increases alone would mark another clear violation of the President's pledge not to raise taxes on the middle class.

Outlays shot up in this administration by over 4 percent of GDP in 2009 and now total 25 percent of our Nation's total output—a quarter of everything that we produced. OMB estimates that, in 2011, outlays will be over 25 percent of GDP, higher than any year aside from those surrounding World War II.

The disease that Congress needs to address is government spending. We need to stop looking to treat the symptom, which is the deficit, with a band-aid called tax increases.

As Congress considers proposals to raise taxes, the question for taxpayers is whether they are personally willing to pay a lot more in taxes to sustain current levels of government spending.

I know where I stand on that question. Taxes are already heading higher than they have been historically. I can confirm that many in Utah agree with me, and I suspect that the vast majority of Americans do as well.

Now, I appreciate the work of the chairman on this hearing schedule and on this hearing, in particular, and the testimony of our witnesses. This is an important discussion. These are important issues. There are differing points of view.

It is central, this discussion, to the key questions about economic growth and the proper size of government that the American people will have their say on in a little more than a year.

From my perspective, we have a government spending problem, and we cannot solve that problem by giving government more money to spend. That being said, if President Obama or any of his friends want to pay more in taxes, I am very happy to provide them with the IRS address where they can send their checks, or they can just Google it.

Thank you, Mr. Chairman.

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

The CHAIRMAN. Thank you, Senator. I think, clearly, in these challenging times, it is imperative that we really work together in a balanced way——

Senator HATCH. Well, I would like to do that.

The CHAIRMAN [continuing]. That we work together, because only by working together are we going to find some solutions here.

I find—I know you do, too, in your home State; I was home last weekend and, also, the preceding weekend—people want us to get this debt under control, and they want to do it in a fair, balanced way. They do not like all the squabbling back here. They do not like all the partisanship back here.

It is amazing to me the difference between Washington, DC and the rest of the country. And it is important for us. I am not trying to tell you something you do not already know; in fact, you know better than I. But while we are here, it is just really important we work together to get all this solved.

Senator HATCH. Well, I intend to work with you, Mr. Chairman, and I hope we can do it.

The CHAIRMAN. Thank you very much.

I will introduce the witnesses. Mr. Mehiel, thank you for joining us. Mr. Mehiel is the principal shareholder and chairman of U.S. Corrugated Company. Thank you very much, Mr. Mehiel, for being here.

Our second witness is Dr. Stephen Entin, currently president and executive director of the Institute for Research on the Economics of Taxation. Mr. Entin, thank you very much.

Our third witness is Bill Rys. Mr. Rys is tax counsel for the National Federation of Independent Businesses.

Finally, Dr. Leonard Burman, who is the Daniel Patrick Moynihan professor of public affairs at the Maxwell School of Syracuse University.

Thank you, gentlemen. Your prepared statements automatically will be included in the record. I ask each of you to proceed and try to summarize your statements in about 5 or 6 minutes. And I also urge you, do not pull any punches. Say what you think, say what is on your mind, all of you.

Mr. Mehiel, why don't you proceed?

Mr. MEHIEL. You want to start with me, Senator?

The CHAIRMAN. You bet. Thank you.

STATEMENT OF DENNIS MEHIEL, CHAIRMAN OF THE BOARD, U.S. CORRUGATED, INC., NEW YORK, NY

Mr. MEHIEL. Well, first of all, my thanks to you as chair, to the ranking member, to the other Senators, and the committee for providing me an opportunity to participate in your deliberations.

I concur with both Senators. We are at a watershed. We have, obviously, some very fundamental and threshold decisions to make.

It is my view that the tax code, as well as the expenditures that you deliberate on and undertake, are, at their core, an expression of our values as a country. Now, I am absent the formal education of my colleagues here. I make boxes. I run factories. And, because I make boxes—I am talking about brown boxes that you would find in the A&P—I am at the beltline of the manufacturing economy and have been for many, many years.

So my views are shaped not by education, but by my experience, and I do not say that to diminish at all how important it is that there is study and understanding of these issues by people who are very well-educated and understand the impacts of the decisions that you make with the code.

But what I can share is my experience. And I understand your focus today is the marginal income tax rates on so-called high earners. In my case, that is a relative expression, right? We always figure the other guy is the high earner and we are personally always generally struggling a little bit.

But my income comes from earned income, so-called; that is to say, money that I earn for managing a business: from real estate that I own; from dividends, capital gains, and interest; and investments.

So what we do is going to affect across the entire spectrum of the decisions you make, which are going to impact me personally. And I think I understand what would happen if my recommendations were adopted. And although they are in the record, I am going to say them very briefly.

I believe that marginal rates in our income tax system should be restored to those that prevailed after 1994. I think we should create a new marginal rate above that, about 4 points or so higher, maybe about 43 percent on adjusted gross income above $1 million, which would be a new category.

I think the carried interest treatment for what really amounts to earned income for many financial professionals in our financial services industry, so-called hedge funds and so on, is an egregious loophole that makes absolutely no sense. The 15-percent tax rate there is—the theory behind it is that they have capital at risk and should enjoy the long-term capital gains treatment of their earnings. But they do not have the capital at risk. And so that should be rectified.

The long-term capital gain rate should go up. It should be maybe half, at a minimum, half the highest marginal income rate, and we have had that situation in the past more than once.

And outside of today's focus, but I will just drop it in, I believe that, when it comes to incentives, the 10-percent investment tax credit that was enacted, I remember, back in the 1960s and had a significant impact on decisions I made then as a small businessperson, is something we could look at reintroducing as distinguished from accelerated depreciation, which I think is more of a timing issue on taxes.

And I think the corporate income tax rate, which we are not here to talk about, should be lowered. It ought to come down to maybe 27 percent. But that would have to be part of a very, very thorough elimination of all of the distortions in the corporate tax code, and I do not need to elaborate on those.

I will concede, to Senator Hatch's point, that, if we did everything I just said, it will not eliminate the structural deficit that this country faces, and it is clear that you have many responsibilities on the expenditure side of the ledger.

But what we hear a lot of is that small business needs to be protected, and job creators and so on. So I just want to go through one example.

If a small businessperson is earning half a million dollars a year and is being taxed through the process, as we understand it, at personal rates, and his taxes go up 4 percent, then, on average, if he is already paying maybe $150,000 or $160,000 in taxes, he will pay another $10,000.

It is inconceivable to me that any businessperson with a small business earning half a million dollars a year would refuse to invest in growth in that business, which would then create hiring, because his taxes went from $145,000 to $155,000 a year.

It simply does not stand up to logic, and I have made many of those decisions over the years about whether to invest. And I must share with you that how much tax I might pay if I earn a profit was never a significant consideration, in my mind, as I looked at business opportunities and how much I had to invest and what the outcome might be.

Lastly, we should turn to the issue of fairness. What is fair? Over the last 7 decades prior to the recent 7, 8, 9 years, our country had a progressive tax system. Higher earners paid a larger percentage. And that system, I believe, was one of the principal reasons that this country created an enormous middle class with enormous purchasing power that became the envy of the world. It just became the envy of the world.

That was the platform of demand of goods and services from that middle class that allowed people like me to succeed. So we can suggest that our success in business or industry is somehow in a vacuum and does not rely on the overall economy within which we operate, but I think that is quite foolish.

So, if we do not do the things necessary to repair that system, and we continue to diminish the middle class and reduce their purchasing power, never mind what happens to the people at the bottom of the economic ladder, which is much more severe. Then on what platform is the next person like me going to build a manufacturing business or a service business or whatever it may be?

So I believe that fairness and equity say that those who have benefitted the most from the conditions that exist in this great country ought to pay a little more. And by the way, it is in our self-interest, because, if we do not do it and the result is that we continue to place the large majority of the population under this significant economic pressure, then our own businesses are going to suffer as a result.

So that is my point of view. I admit, I like the U.S. Government. I got in business because you loaned me $8,000. I had to sign a paper to pay $144 a month for 7 years personally. And when we were failing and I knew about that payment stream, I was highly motivated to stay in business month to month to month as long as I could make those payments. And, absent that support from the government, which, by the way, only came after every bank rejected our application, even with a 90-percent government guarantee, they would not lend us the money.

But we did, in fact, succeed. We have employed thousands of people. We have paid tens of millions of dollars in taxes over the years.

So I like the Federal Government, with all its failings, and I think we ought to continue to appropriately fund our activities as a society as a whole.

Again, I thank the committee for the opportunity.

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

The CHAIRMAN. Thank you, Mr. Mehiel. I think you have had a pretty good education, frankly.

Mr. MEHIEL. Thank you.

The CHAIRMAN. Mr. Entin?

STATEMENT OF STEPHEN J. ENTIN, PRESIDENT AND EXECUTIVE DIRECTOR, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, WASHINGTON, DC

Mr. ENTIN. Chairman Baucus, Ranking Member Hatch, and members of the committee, thank you for the opportunity to testify today.

I will address two issues. First, what would raising tax rates on upper-income taxpayers do to the economy and the budget? Second, what is genuine tax reform and does it include such policies?

My conclusions are that higher marginal tax rates on any group, especially those already paying the highest rates, would reduce GDP and incomes across the board, not just for the people paying the initial tax bill.

Increasing the double taxation of corporate income by raising tax rates on capital gains and dividends would reduce capital formation and wages and would not raise the expected revenue.

Neither tax change has any place in real tax reform. It is not who you tax, it is what you tax. We should not repeat the Tax Reform Act of 1986, which tried to perfect the broad-based income tax. Rather, we should adopt a different tax base that is more neutral in its treatment of saving and investment relative to consumption.

It is important that any tax reform promote economic growth, because lack of growth is the source of lower incomes, higher unemployment, and much of the current deficit. Tax increases that raise the service price or hurdle rate of return on capital have been observed to reduce the capital stock; perhaps not in every company, but on average, over the economy, that is what they do.

That reduces wages and employment across all incomes. Taxing capital hurts labor. When you consider a bill, make the Joint Tax Committee tell you the effect on the service price. Otherwise, you will not know what the bill is going to do.

I estimate that raising the two top tax rates on ordinary income to 36 and 39.6 percent would knock half a percent off private sector output and labor income across the board, cut a percent off the capital stock, and lose about 40 percent of the expected revenue.

Raising the top tax rates on capital gains and dividends to 20 percent would be 2.5 times worse. It would virtually raise no revenue and cost more income and jobs.

Allowing the tax rate on dividends to revert to ordinary income tax rates, which might happen if nothing is done, would be hugely damaging. Revenues would fall instead of rise. And do not forget the 3.8-percent tax imposed by the Health Care Reform Act, which, if you add it to the 20-percent rate case on capital gains, would further reduce GDP and eliminate the revenue gain.

Tax reform must be done right to fight the deficit while improving the economy. The income tax is heavily biased against saving and investment. More neutral, growth-friendly tax alternatives exist, such as the cash flow tax in the report of President Bush's Advisory Panel on Federal Tax Reform or the flat tax or others of that ilk.

Real tax reform will take a few key steps to fundamentally shift the tax base from broad-based income to consumed income or cash flow, which are better measures of actual income. First, as in pensions or IRAs, either defer tax on all saving, or tax the saving up front and do not tax the returns. Second, adopt expensing or something of equal value. It could involve an investment tax credit instead of depreciation. Third, do not tax corporate-sector income twice. Fourth, eliminate the estate tax. And, fifth, move to a territorial tax system.

The Bowles-Simpson Deficit Reduction Commission plan merely patches the income tax. It plays "close the loophole" with the tax expenditure tables of the Treasury and Joint Tax Committee.

Many items on the list of tax expenditures are partial offsets to biases in the income tax that would otherwise destroy jobs and investment. These offsets include all the pension, retirement, and education savings arrangements, accelerated depreciation and expensing provisions, lower tax rates on capital gains and dividends, and most offsets to the corporate income tax and estate tax. These are not tax expenditures in a neutral or consumption-based tax.

The Commission's avocation of a 28-percent top tax rate for individuals and corporations is not nearly low enough to offset the damage done by some of the changes it would make to pay for it, including the taxation of capital gains and dividends at the same rate as other income, and the elimination of expensing with a move to longer asset lives.

The Commission's plan would slash GDP by about 3 percent and lose most of the $80 billion it hopes to raise. They are trying to mimic the Tax Reform Act of 1986, but this is not 1986. The starting point is very different.

The Tax Reform Act of 1986 was an income tax patch, not a shift to a neutral base, and it slightly reduced potential output. Nonetheless, TRA–86 cut the corporate rate 12 points. Bowles-Simpson would cut it about 4 to 7 points. TRA raised the top tax rate on capital gains from 20 percent to 28, but lowered the top tax rate on dividends from 50 percent to 28. It reduced the double tax on corporate income. Under Bowles-Simpson, both would rise from 15 to 28 percent.

TRA–86 eliminated the investment tax credit. Bowles-Simpson would eliminate the current expensing prevention—equally bad. The Bowles-Simpson Commission changes would be far more damaging than TRA–86. The Commission should have asked Treasury and Joint Tax for an estimate of what they would be doing to the cost of capital. They did not.

To compete in the global economy, the United States needs a tax system that is not anti-investment and anti-growth. Japan triggered its lost generation by adopting an anti-growth tax reform in the 1980s that mimicked our 1986 act, but went even further.

China now has a growth-friendly tax system on the mainland, as well as in Hong Kong, which is doing better.

The Nation needs a tax change to a better tax system with a better tax base, more neutral in its treatment of saving and investment. If Congress is not able to provide that, it should extend the current tax cuts and stick entirely to spending cuts for deficit reduction. Otherwise, you are going to be hurting the very people you are trying to help.

Thank you.

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

The CHAIRMAN. Thank you, Mr. Entin, very much.

Mr. Rys?

STATEMENT OF BILL RYS, TAX COUNSEL, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, DC

Mr. RYS. Good morning, Chairman Baucus, Ranking Member Hatch, and members of the committee. I am pleased to be here on behalf of the National Federation of Independent Business as the committee continues to look at options for tax reform.

In particular, I appreciate the opportunity to discuss individual tax rates, an especially important issue for small business owners.

NFIB is the Nation's leading small business advocacy organization, representing over 350,000 small business owners across the country. Taxes and tax rates are regularly a concern for small business owners. In fact, in our latest small business problems and priorities survey, tax rates ranked third on a list of 75 issues, so very high.

Individual rates are especially important to small business owners, because a majority of them, about 75 percent, structure their businesses as pass-through businesses. Business owners choose the pass-through business structure for a variety of reasons—liability and tax issues mostly.

The Tax Reform Act of 1986 and subsequent changes to tax laws promoted the growth of pass-through businesses and specifically the single layer of tax. A recent study highlights the role pass-through businesses play in the U.S. economy. Based on 2008 data, pass-through businesses represented 95 percent of all business entities. These businesses employed a majority—54 percent—of the total private sector workforce.

Pass-through businesses also report a considerable amount of income. Between 2004 and 2008, individual owners of pass-through businesses reported 54 percent of all business net income.

So how are small businesses impacted by individual tax rates? Small business owners fall into all of the current six individual income tax brackets. In 2001, the individual tax rates were lowered across the board, providing all small business owners with some tax relief. Extending some of these tax rates has received broad support, and that is a step in the right direction.

At the same time, some have proposed raising taxes on those pass-through businesses reporting more than $200,000 or $250,000 in income. The owner of a pass-through business may report a higher amount of income on their return than they actually take home. The income is money that is kept in the business and used to reinvest.

So exactly who are the businesses most likely to be impacted by an increase of higher individual tax rates? An NFIB Research Foundation poll, combined with U.S. Census Bureau statistics, indicates that the businesses most likely to face a tax increase are businesses that account for a substantial portion of the workforce.

The NFIB survey shows that, looking at overall small businesses, about 10 percent of small business owners are going to report about $250,000 in income, but the businesses most likely to report income above that threshold are firms with between 20 and 250 employees. In fact, it would be well over 30 percent of those firms that would be impacted by a tax increase.

In 2007, these businesses accounted for over one-quarter of the U.S. workforce, employing about 33.5 million workers. So the businesses most likely to be hit with a tax increase are successful growing businesses.

To create jobs in our economy, these businesses need the profits they earn to make new investments and hire new workers. A tax increase on these businesses, especially as they are growing, could have a negative impact on new investment and job growth.

The committee is focused on individual tax rates as an important part of tax reform. Much of the discussion around tax reform has focused on the corporate tax rate, and this is a very important issue. But any tax reform plan that wants to encourage economic growth should include individual rates and pass-through businesses. Focusing simply on the corporate rate could put the owners of pass-through businesses at a distinct disadvantage.

With a potential rate increase and a potential loss of business deductions, pass-through business owners could see a substantial change in their current tax position. Tax reform should support those business owners, making it easier to run their businesses, providing opportunities to grow and make new investment.

In addition, tax complexity and the cost of compliance is a major problem faced by all small business owners. Some of the complexities in the tax code are in deductions and credits. Simplifying the code by examining these credits and deductions provides Congress with the opportunity to possibly lower rates. This means small business owners could keep more of the money they earn and make the kind of investments that are best for their business.

Adding to the complexity are the constant changes in expiration dates in the tax code. Business conditions change, and business owners have to work through good times and bad. But they should not have to face these kinds of ups and downs because of constant changes in the tax code.

Finally, Congress should work to keep the capital gains tax rates low. Keeping the capital gains rates low is an incentive to invest in capital assets, with the certainty that any gain realized on that investment will be subject to lower tax rates.

Tax reform is an opportunity to address the major tax impediments that impact small business owners and to strengthen the overall economy. The current tax code is a challenge for all taxpayers, small and large businesses, as well as individual taxpayers.

The committee's focus on individual rates, capital gains, and dividends is an important step in examining the entire tax code.

We look forward to working with the committee to minimize the tax burden on small business and establish a simplified, more growth-oriented tax system.

Thank you.

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

The CHAIRMAN. Thank you, Mr. Rys, very much.

Your are batting cleanup, Dr. Burman. Why don't you proceed?

STATEMENT OF DR. LEONARD E. BURMAN, DANIEL PATRICK MOYNIHAN PROFESSOR OF PUBLIC AFFAIRS, MAXWELL SCHOOL, SYRACUSE UNIVERSITY, SYRACUSE, NY

Dr. BURMAN. I am going to swing away. Chairman Baucus, Ranking Member Hatch, and members of the committee, thank you for inviting me to testify on tax reform options affecting high-income taxpayers. I applaud the committee for its year-long work—actually, longer than that—on tax reform. I am honored to be asked to contribute.

I should just point out that I am not speaking for anybody but myself.

The question before the committee today is whether we should raise revenue by raising top ordinary income tax rates and rates on long-term gains and dividends.

In my view, the best option would be classic tax reform. Broadening the base and lowering tax rates could raise revenue while making the tax system simpler, fairer, and more conducive to economic growth.

There are several good models for that approach, including the Bipartisan Policy Center plan that I contributed to, and the Bowles-Simpson proposal.

I should point out to Dr. Entin that the Bipartisan Policy Center plan reduced the burden on capital, but in a progressive way.

Now, tax reform might not be feasible now. I know it is hard, you know it is hard. But I believe that there is a strong argument for raising tax rates on the affluent, taxing capital gains and dividends more like ordinary income, and closing corporate loopholes while cutting corporate tax rates.

The argument for raising tax rates is that demographics and rising health care costs will put unprecedented pressure on Federal finances.

There was a discussion about tax-and-spend liberals. I am not on the spend side, but there are enormous pressures on spending, and they do not have anything to do with runaway government. What they have to do with is that we have made a lot of promises to seniors, and there are going to be a lot more senior citizens in years to come.

Even if we are enormously successful in cutting spending on health care, which is a big part of the problem, overall spending will increase without any increase in the size of government.

The Congressional Budget Office did calculations that show that spending would reach 23–24 percent of GDP even if health care costs could be kept to the rate of growth of the economy. So somehow we are going to have to pay for that.

I will point out that current top tax rates are very low, by historical standards, and people with high incomes are the best able to bear additional tax burdens. I think tax reform is a good idea, and allowing top tax rates to rise could sustain support for traditional tax reform.

I like the idea of broad-base low rates. Right now we have narrow-base low rates, which, from a perspective of high-income people, is way more attractive. I think raising rates gets them interested in more systemic reform.

Some of the other panelists have raised concerns about the economic consequences of higher rates. In my view, those concerns are overblown. The Clinton-era tax rates clearly did not derail the economy, and the rate cuts in the last decade did not unleash robust economic growth.

That does not mean that tax rates do not affect growth—I think they can—but simply that other factors are more important. Growth is important, but it is not sufficient to guarantee that middle-income people prosper. Trickle-down does not work.

Higher tax rates could mitigate economic inequality, which has grown markedly over the past 30 years, as the chairman pointed out. Obviously, taxes are not the whole solution. Expanding opportunities for success by investing in education, for example, is also important. But the tax system plays an important role and might forestall more costly populist responses to inequality, such as trade restrictions, if we do not deal with the growing gap between rich and poor.

Furthermore, it would be hard to justify tax increases on the middle class right now for several reasons. First, the middle class has been in a 30-year recession. While top incomes have exploded, middle incomes have stagnated.

Second, tax increases now would cut middle-income family spending, which would be the worst thing to do during a recession. In contrast, tax changes affecting high-income people are more likely to come out of savings rather than current consumption.

Some would like to raise taxes on low-income households, but that would put an undue burden on working families struggling to get by, and it would not raise as much revenue. Those people are poor.

There is concern about how the affluent would respond to higher taxes. As I explain in my written testimony, their labor supply responses appear to be quite small. It is likely, however, that higher tax rates would encourage more tax avoidance, and the best way to deal with that would be to clamp down on tax shelters. And the biggest driver of individual income tax shelters is the lower tax rate on capital gains.

I have written an enormous amount about this, but the point that the arguments for lower tax rates seem to miss is that a lower tax rate on capital gains—20 percentage points lower than the tax rate on ordinary income right now—provides a huge incentive to make earnings look like gains rather than fully taxable compensation.

The poster child for such avoidance is the carried interest loophole, but that is just the tip of the iceberg. There is a whole tax shelter industry devoted to converting ordinary income into capital gains. The geniuses that come up with these deals might otherwise be doing socially productive work, like figuring out how to produce products that people want to buy.

Eliminating or reducing the incentive to devote productive resources into wasteful tax shelters would boost the economy. And, since capital gains are heavily concentrated among the affluent, it would also make the tax system more progressive.

There has been discussion about small businesses. I can tell you, from the academic literature, it is certainly a mixed bag. First of all, as Mr. Rys has pointed out, relatively few are in the top brackets.

The big impediment to small businesses right now is not tax rates, but a lack of demand, and the thing we have to do is get the economy going, and, if raising some revenue would allow the government to do some things that would boost overall demand, that would be helpful.

And also, raising top income tax rates makes going into business more attractive, and I would be happy to talk about that in Q&A, if you would like.

I will say something about the corporate rate and dividends. I think the best thing to do would be to close loopholes and use some of the revenue raised from taxing gains and dividends more like ordinary income to cut rates on corporations. It would remove much of the incentives for firms to relocate their activities overseas and could improve overall competitiveness.

Obviously, there is a lot more that I would like to talk about—it is in my written testimony—but I look forward to your questions.

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

The CHAIRMAN. Thank you, Dr. Burman. Thank you all.

I would like to explore a little bit the ordinary income/capital gain differential. You have touched on it, Dr. Burman, suggesting that, to a large degree, it causes a lot of the shelters and a lot of the game-playing, if you will, of just trying to convert ordinary to capital income.

Back in the Clinton years, for a period anyway, there was no differential between the two. And one can do anything with the figures, but there was a lot of job growth, et cetera.

I would like the panelists to just explore a little bit that phenomenon; that is, getting capital gains to ordinary income, closer to ordinary rates. The trouble is, if we raise the upper limits, it is going the other direction.

But how important is it to try to move toward a system where there is no differential between the capital gains and dividends or to get that gap down pretty low so there is a lot less, if you will, game-playing?

Mr. Mehiel?

Mr. MEHIEL. Well, Senator, my understanding of this, and my experience with it over the years, is that it came into being to reward long-term investment and holding periods.

I concur with my colleague over here that it has given rise to a great deal of opportunity for abuse. However, if the committee felt that the capital gains rate needed to go substantially higher, then I would argue that the marginal earned income rate would have to come down a little bit.

My view is that if we were to impose that—I am suggesting 43 percent at the margin—on very high earners and to have no differential between that and the return on invested capital that is legitimately invested and held over time, I am not sure I could support that. The number would have to be lower.

To the extent we could eliminate that differential, we certainly would eliminate an awful lot of incentive for abuse. Only you can measure the capability to get a change like that done at a moment in time when we clearly have to act.

The CHAIRMAN. Mr. Entin, is that advisable or not to move in that direction?

Mr. ENTIN. No, I do not think so. First of all, let me mention something about the Clinton years. The Clinton marginal tax rate increases were fairly modest, and we were coming out of a downturn. The growth was going to look good anyway.

But please remember that President Clinton did sign the capital gains tax reduction in 1997, and a lot of the growth in that decade was due to that reduction in the cost of capital and to lower inflation. It dwarfed the adverse effect of raising the marginal rates.

Capital gains is part of the structure of the service price, and that has a major impact on capital formation, which is more sensitive to taxation than the labor force effects of the broader rate change. That is how you got that balance in the Clinton years.

I think it needs to be pointed out that capital gains is a double tax, even when there is no corporate tax involved. The corporate tax is really a triple tax, not a double tax. You must take the corporate rate into account in addition to the capital gains rate when you talk about a shareholder paying tax at too low a rate. He is paying both taxes on the same income. It is not two separate pieces of income, it is one.

But capital gains is a form of double taxation even without the corporate-level tax. An asset's value today is the present value—the discounted value—of its future earnings after tax. If there are increases in future earnings, they will be taxed in the future.

If you currently tax the shadow of that—the present-value reflection of that future added income—that will be taxed as a capital gain, and you are double-taxing that future income.

Capital gains taxation is double taxation right from word one. There are abuses where ordinary income can be translated into capital gains. Those largely disappear in consumption-based or consumed income or cash flow taxes, and Treasury does have to enforce those restrictions. But do not let the tail wag the dog.

The CHAIRMAN. I hear you. My time is quickly expiring.

Mr. Rys?

Mr. RYS. I think from the perspective of our members and small business owners, on the side of keeping capital gains rates lower, I think, is the element of risk.

There is a risk involved in starting your business. If you eventually sell that business, you are going to pay a capital gain on the increase in that.

One of the things we have seen with small business owners that we have really learned out of this recession is that they have been heavily invested in real estate, and the value of that real estate has gone down considerably in the last couple of years.

So they took the risk, and now they are going to have to deal with the fact that their balance sheets are much lower than they would have been.

So I think that lower capital gains does help compensate for some of the risks that our members——

The CHAIRMAN. Dr. Burman, your thoughts?

Dr. BURMAN. A few points. One is, you probably cannot raise the top rate, the capital gains rate, to 36 or 39.6 percent. The JCT would score that as losing revenue. You could certainly raise it to 28 percent, which is what it was during the Clinton years.

Dr. Entin and I just disagree about the incentive effects of taxation. I looked at the relationship between capital gains and gross domestic product over 40 or 50 years, both current and with lags. There is zero correlation.

If there is a relationship between the capital gains tax rate and the economy, it is really subtle. It does not just jump out of the data.

The argument that taxing capital gains constitutes a double tax is an argument that savings are double-taxed, because you tax the earnings when you get them and, also, the rate of return when you make the investment. That is true, and there is an argument for the consumption tax. The argument against it is that, it is hard to maintain the kind of progressivity we want if we did it.

But taking one step towards a consumption tax does not make things better. What it does is it creates a giant loophole, and it encourages you to take all sorts of income and make it look like capital gains. All sorts of investments—it would make no sense without taxes—become profitable even though they are not the kinds of things we would want to put our money into, and all sorts of resources go into that.

If we cannot have a kind of 1986-style reform, where you cut rates and tax capital gains the same as other income, a good compromise would be raising capital gains tax rates to levels they were in the 1990s.

The CHAIRMAN. Thank you.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

This question will be for Mr. Entin and Dr. Burman. President Obama and most congressional Democrats support raising the top two tax rates from 33 and 35 percent to 36 percent and 39.6 percent, respectively.

Now, this would subject 50 percent of all flow-through business income to a tax increase, according to the nonpartisan official scorekeeper of Congress and the Joint Committee on Taxation.

Now, this is especially harmful to small businesses, because the vast majority of small businesses are organized as flow-through entities. The President and I agree that small businesses create two-thirds of the new jobs in our economy.

Therefore, with 9.1-percent unemployment, why do President Obama and most congressional Democrats want to impose what I consider to be these job-killing tax increases on the job creation engine of our economy? And what do they propose to do to shield small businesses from their job-killing tax increases?

So far, I think their silence has been deafening. If they are proposing these tax increases, should not the burden be on them to shield small businesses, which they say they support, from their own tax increases? At least that is the question I would like to ask.

Mr. Entin, you first.

Mr. ENTIN. Raising those tax rates would increase taxes on entities that are, in part, providing labor services and capital services to the production process.

Senator HATCH. That is what I was wondering.

Mr. ENTIN. The effect on capital is higher than on labor. It is not quite as harsh an effect as raising the capital gains and dividends rates. It is, nonetheless, a negative. We estimate that it would knock about a half-point off the economy, and that would include a depression of wages all across the spectrum, not just for the business owner, and a reduction in employment.

Most of these taxes on capital and small businesses ultimately get shifted to the workforce in the form of lower hours and lower wages. So it does not just fall on the people you are pretending to impose the tax on.

These dynamic effects in the economy are not captured in the revenue-estimating methodology of the Joint Tax Committee. So they appear to raise revenue. They probably would raise revenue from the small business owners. They would probably lose revenue from the people not employed because of the reduction in capital-formation and hiring.

So that added effect is simply not addressed in the revenue estimates, and these increases appear to be more beneficial to the budget than they really are.

Senator HATCH. Dr. Burman?

Dr. BURMAN. A couple of points. One is that actually the Treasury Department just put out a recent study on the percentages of the amount of income that would be subject to the higher rate. It is still significant, but it is about half as much. And the reason is that a lot of people who report small business income are actually people like the people at this table who have maybe some consulting income or might be on boards of directors, but do not actually hire employees.

But the fundamental point about how raising taxes on small businesses would affect hiring is an important one, but the important thing is that labor costs are deductible.

So, if a worker can produce as much as it costs to hire him or her, it is worth doing because, after tax, they would still make money.

The big problem small businesses have right now is that there is not demand. It is not the tax regimen. Now, these increases could have some effect on investment over the long term, but I think those effects are small. When I read what Mr. Entin writes, I have this feeling that, if you believe this, you would think you had to have an absolutely perfect tax system to have the economy grow at all. And, if that were the case, we would be in really big trouble.

I think the fact is that we are much less responsive to tax rates than you might think from these theoretical models where people have very, very long horizons and are completely rational.

Senator HATCH. Mr. Rys, why don't you—I see you chomping at the bit there.

Mr. RYS. I am sorry. A couple of things on that. When you look at the Treasury Department study, one of the things they do is they cut an income line at $10 million. And for the businesses that are most likely to be impacted, that is fairly low.

So that is one challenge, that the businesses—the smaller businesses that you are likely to capture are the businesses that are growing, the businesses that are bringing in more revenue.

So one of the challenges with drawing those lines is, some of that is difficult to do in trying to figure that out.

What we have done is, when we have talked with business owners, when we looked into the survey, we have been able to speak directly to the business owners and ask, how much income did you take out of the business, and that shows us where the lines are drawn. And it is these businesses that employ a substantial number of employees, because they have the revenue coming in, because they have the demand to hire new workers.

And to get to Dr. Burman's point on the problems, the number-one problem facing small business owners in our survey is sales, and sales consistently. But when we found out what the number two problem is, it is taxes, and I do not think those two things are mutually exclusive, because, if you have less money to spend, you have less money to spend on whatever it is you are going to buy, which means the consumption continues to go down.

And the businesses that fall into the small business sector are providing the services and the goods that are going to drive that kind of demand. So their sales are way off.

So there are sort of two sides to this problem that work against one another.

Senator HATCH. My time is up, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Bingaman, you are next.

Senator BINGAMAN. Thank you, Mr. Chairman. Thank you all for being here.

Obviously, the threshold question that I think we are all sort of jumping past is whether or not, if we do tax reform, should it be revenue-neutral or should it raise revenue.

And I take it, just trying to understand each witness's testimony, Mr. Mehiel, you are saying it should raise revenue.

Mr. MEHIEL. Absolutely.

Senator BINGAMAN. Right. And, Dr. Burman, you are saying it should raise revenue.

Dr. BURMAN. Yes.

Senator BINGAMAN. And Mr. Rys and Mr. Entin are saying it should not. Is that accurate?

Mr. ENTIN. It should not necessarily raise revenue, in a static sense. It should improve the economy and let the growing economy raise the revenue.

Senator BINGAMAN. Right. You think tax reform, in and of itself, would be a good thing on a revenue-neutral basis.

Mr. ENTIN. If done right.

Senator BINGAMAN. Right.

Mr. RYS. I think tax reform is an opportunity to help support the economy. If we have more jobs, if we have more employees, we are going to see more revenue from that. I think that should be the goal of tax reform, and a number of people have stated that.

Senator BINGAMAN. But you do not believe that we should make changes in the tax code that the CBO would tell us will raise additional revenue.

Mr. RYS. Like I say, I think the focus needs to be on growing the economy. I think that is where revenue is going to come from.

Senator BINGAMAN. And you do not believe raising rates or eliminating a lot of the deductions that are being discussed for elimination would, in fact, grow the economy?

Mr. RYS. I think there is a balance there. If you are taking away a deduction or you are increasing a rate, it is less income that that business has. It is taking away a business decision they are going to make based on that deduction.

So I think there needs to be a balance struck between how you get towards the tax reform plan that promotes growth and promotes economic development.

I think one of the real challenges facing the economy is long-term confidence. This is an opportunity to create some long-term confidence. We have a real confidence problem in the small business sector among consumers.

Senator BINGAMAN. Well, we had a hearing yesterday, and Chairman Greenspan was one of our witnesses, and he said that he thought the concern about confidence in the economy was a real one and that, therefore, the top priority should be to bring down the deficit. And for that reason, he favored going back to the tax rates that were in place prior to the 2001 and 2003 cuts.

I gather, Mr. Mehiel, you said you agree with that. You agree with Chairman Greenspan on that.

Mr. MEHIEL. Absolutely.

Senator BINGAMAN. Dr. Burman, you said you think it would be a mistake to go back to those rates for the middle class at this point.

Dr. BURMAN. Right now, just because the economy is so weak and they would have less money to spend, it would exacerbate the demand problem Mr. Rys was talking about.

Senator BINGAMAN. And by right now, you mean at the end of 2013, when the current tax provisions would expire?

Dr. BURMAN. Unless the economy recovers much better than most economists think that it will.

Could I make just a point about the——

Senator BINGAMAN. Certainly.

Dr. BURMAN. One of the issues about cutting tax rates and its effect on the economy, this was actually looked at by CBO, JCT, the Treasury—all under Republican-appointed leadership—and they all concluded that, if you cut tax rates and could not control the deficit, so that ultimately tax rates had to be much higher than they would be otherwise, that the economy would be much worse off than if you just actually raised rates enough so you could raise enough revenue to pay for the economy.

One basic point is that there is this asymmetry that, when you raise rates by a lot, the cost of taxation goes up disproportionately. So it would be better to keep them steady at a level that is actually adequate to pay for the government.

So in other words, that is basically, I guess, another way of saying Chairman Greenspan's point that, if you could relatively quickly raise enough revenue to stabilize our public finances, that could forestall bigger tax increases in the future, and it would be good for the economy.

Senator BINGAMAN. That is all I have, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Next in line is Senator Kyl.

Senator KYL. Thank you.

And that assumes Congress will not spend the money generated by the extra taxes, which history suggests is not the case.

Chairman Baucus, in his opening statement, discussed the 400 highest earners in the country. He suggests that we should *ask* them to pay a little bit more, which is, I think, a nice way to say we would put this in the income tax code.

But the problem is that the top two rates apply today to about 3.6 million filers, and, in order to get real money, that is the folks you have to get. That is folks like Mr. Mehiel, I suspect.

There are only 319,000 who report $1 million of income or more. So you are not just hitting the millionaires and billionaires. You are hitting an awful lot of folks whom I think Mr. Mehiel was describing as the real productive middle class in the country, the small business entrepreneurs who create businesses, hire people, and so on.

And this brings me back to the point Mr. Entin was making, which I take it is, if you want to hurt the unemployed even more and put a big, wet blanket over the economy, then raise taxes on the job creators.

The reason people earn money and then pay taxes on it as dividends, capital gains, or in the top brackets is because they have invested it in businesses, the very folks who create jobs. And the economic theory of the chairman here that we should raise taxes because they can afford it, I think ignores the effects that raising the taxes would have on economic growth and on the unemployed and on job creation.

And here is one sentence from Mr. Entin's testimony. "The real concern about the tax system is not who sends the checks to Treasury, but what is being taxed and how that affects growth, employment, wages and income from savings."

Now, Mr. Entin, your research suggests that, if the top marginal rates are increased from current levels, we will pay an economic price of lower economic growth, less capital formation, lower wages, fewer hours worked, and less than expected revenues, and that the economic damage is even more pronounced when taxes on dividends and capital gains go up, as they are scheduled to do under existing law.

Why do rate increases on upper-income earners and increases in capital gains and dividends taxes, for example, reduce the income earned by average workers and harm economic growth?

Mr. ENTIN. Because they are not tax increases on upper-income workers. They are tax increases on saving and investment and capital formation. And, even if we all had equal incomes and we started taxing capital more heavily, there would be less capital. And with less capital, there is a lower level of productivity and demand for workers and, therefore, there are fewer hours worked, and the workers receive lower hourly wages.

And since they are producing less and everyone is producing less, there is less income and, therefore, less demand. We do not start out driving things by demand. We start out by increasing the incentives and rewards for production; then, when people produce, they are paid, and they turn around and buy their products.

Demand alone is not an independent tool. Again, it is not whom you tax, it is what you are taxing and what the base is. You can have a progressive, neutral tax. You do not have to beat up on capital formation to have a progressive tax system.

In chart 2, I mention that it depends on what you are doing, not whom you are doing it to.

We had a tax cut enacted in 2001 supposedly to avert a downturn. Most of the rate cuts were delayed. The first effect of it was to have a 10-percent bracket and a $600 rebate reflecting it.

We had a rebate under Ford that did not work. We have had two rebates since. They have not worked. Investment kept sliding, and that is what drove that recession.

Now, in 2003, we cut the tax rate on capital gains and dividends, went up to 50 percent bonus expensing, and brought all the rate cuts forward that had not been put in effect yet. That is when equipment spending, which was eligible for the expensing, turned around and soared, and that is when we began creating jobs.

It was what we were taxing, not who we were taxing, and it makes a difference. A junk tax cut will not stimulate demand, and spending increases will not stimulate demand if you have to borrow the money to pay for it. You are taking away with one hand what you are giving out with the other. It is how you are arranging the incentives to produce and whether the government is in the way with taxes and regulations.

Senator KYL. So it is not correct then that the 2003 reductions in certain taxes were not effective in helping job creation for a good part of the remainder of that decade?

Mr. ENTIN. Correct.

Senator KYL. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Menendez?

Senator MENENDEZ. Thank you, Mr. Chairman. Let me thank the panelists for their testimony that I have read with interest.

Dr. Burman, it simply amazes me that many conservatives still prefer placing the burden of taxation on a worker's labor or a family's consumption over an investor's profits.

Unfortunately, when you look at the numbers, it seems as though this theology is winning. In 2008, the average New Jersey family earned about $65,000 and paid 27 percent of their income in Federal taxes. The richest taxpayers in America, on the other hand—those who earned an average of $270 million in one year—paid about 18 percent of their income in Federal taxes, so a 9-percent differential between the $65,000 and the $270 million.

Is there any tax break that is more critical to creating this imbalance than the preferential tax treatment of investment income?

Dr. BURMAN. No. I think that the lower tax rate on capital gains is the single-most important factor. If you look at the table of the 400 highest-income people, the big factor—and Mr. Buffett made this point, as well—is they are taxed at 15 percent, yet middle-class people in New Jersey pay 15 percent in payroll taxes, between their share and the employer's, plus 15 or 25 percent in income taxes on top of that.

Senator MENENDEZ. You note that, in comparing recent tax reform proposals put forth by several bipartisan groups, as well as President Reagan's Tax Reform Act of 1986, they all had in common the tradeoff of lowering income tax rates across the board and ending the preferential tax rates on investment income.

That is, tax rates were lower, but the government would no longer pick favorites between a worker's salary and an investor's profit.

As this committee continues to debate tax reform, in your opinion, do you believe that equalizing the tax treatment of earned income and investment income would be an important piece to any balanced tax reform proposal?

Dr. BURMAN. I think a 1986-style reform makes a lot of sense, especially if you can figure out a way to make it stick.

One advantage of taxing capital gains in full is it allows you to lower tax rates on ordinary income, on small business income, while maintaining the overall progressivity of the tax system. It also makes the tax system a lot simpler. Tax lawyers tell me that half of the Internal Revenue Code is devoted to policing the boundary between capital gains and ordinary income, and you could potentially eliminate most of that complexity if you taxed them the same.

Senator MENENDEZ. Mr. Entin, let me ask you this. I am sure your economic models are well thought out, but your predictions almost hearken back to those that I heard from Newt Gingrich and my colleagues then in the House when President Clinton had the Deficit Reduction Act.

Here is a direct quote from former Speaker Gingrich about raising the top rate. It basically paraphrases your testimony. He said, "I believe that that will, in fact, kill the current recovery and put us back in recession."

Here is a quote from Chris Cox, who went on to be our SEC chair, from the same debate: "This is really the Dr. Kevorkian plan for our economy. It will kill jobs, kill businesses, and, yes, kill even the higher tax revenues that these suicidal tax increasers hope to gain."

Now, I was there in the Congress at the time, and I saw the President's Deficit Reduction Act lead to the first balanced budget in a generation, record surpluses, low unemployment, low interest, low inflation, and the greatest peacetime economy we have seen in a generation.

Do you believe those arguments came to fruition in the 1990s?

Mr. ENTIN. We discussed this a bit before you were able to come in. I have never expressed anything that strongly or in quite that exaggerated a tone.

The reductions in output and jobs that I am predicting would be the ultimate outcome over about a 5-year period of adjustments in the economy. This would not suddenly happen, but you would end up, longer-term, with a bit less capital formation and a bit lower employment if you have the higher rates.

Those rate changes in the top rates clearly would not completely pay for themselves. They are not 100-percent offset because of lost revenue when it is in the top rates. They would lose about 40 percent of their revenue—not 100 or 200 percent, not on the top rates going up. But you do lose some jobs because of it.

It is not the most efficient way to promote growth, but it does hurt you if you raise those top rates.

Mr. Clinton did raise the top rates. We were coming out of a bad patch, and the economy was growing fairly strongly at the time. So the damage was limited. These were small rate hikes.

However, he also signed a capital gains tax rate reduction which lowered the cost of capital considerably and gave considerable oomph to that decade. On balance, it was a pro-growth tradeoff. And so just simply saying, let us go back to Mr. Clinton's plan—the economy was growing—is not going to cut it.

From where we are today, if you raise those capital gains and dividend rates and the top rates, you are going to raise the cost of capital and give us a smaller capital stock than we are setting off to have right now under current rules. It depends on where you are starting.

Going in that direction is going to slow the economy down and give you less growth in capital and employment over time.

Senator MENENDEZ. Well, on the individual rates, I just see that the reality was that we had a much different result.

The final question, if I may, Mr. Chairman.

Mr. Mehiel, thank you for joining us today. Did you start taking half-days and laying off workers because of the Clinton tax policies?

Mr. MEHIEL. No, no. The changes that came in the early 1990s, the effects on my business were actually quite stark. What happened is that the cost of capital declined, not so much in Treasury rates, but we would borrow generally as a spread to Treasuries.

I think the capital markets just kind of said, "Wow, the government is going to pay its bills," you know. The deficits are going down. Indeed, there came a time when there were surpluses.

The cost of capital came down. Therefore, I could borrow more. Therefore, I could invest more. My business went from employing 1,200 people to employing 12,000 people between 1993 and 1998–1999. So it was exactly the opposite.

Senator MENENDEZ. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Next, Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

Mr. Rys, your organization, obviously, is the largest voice for small businesses in America. What has been your response to some of the proposals that have emerged from Congress and also the President, for example, on raising taxes on those who earn more than $250,000, since we have all heard here today about 50 percent of that income above $250,000 is attributable to flow-through entities?

Mr. RYS. Respective of our membership, there has been a lot of concern about tax increases on those levels, because that is the operating capital that the business has to function on from year to year.

Cash flow is often a problem for small business owners. So, if you pull out the profit of the business, you are going to be taxed on it as income, yet you are going to save that money to meet your expenses from year to year. And this is something we hear from our business owners regularly and something that we have seen especially right now in what have been really tough economic times.

Senator SNOWE. Well, it would be 50 percent or $1 trillion of business income above $250,000 that would be taxed at the top two tax rates.

And that has been the difficulty, I think, in this whole discussion nationally when we are talking about whom we are taxing, because there is no distinction made between those individuals and small businesses that are paying the individual tax rate.

Mr. RYS. Correct. And I think it gets back to a point Senator Kyl and Mr. Entin made, which is what are we taxing, which is the profits of the business, which is the money you are going to use to run the business in down years.

I have heard examples from many of our members who said, "I had a great year in 2006 or 2007, and I saved for tough times, and I didn't have to lay off any of my workers over the course of the last couple years because I had that money that I saved," because they were able to save that money.

They were able to offset the loss that they had in economic productivity because they had fewer sales, fewer customers, the economy just took a nosedive. So it is important to make sure that small business owners have those reserves to be able to work with.

Senator SNOWE. Another proposal that had been offered by the administration was with respect to their version of corporate tax reform and to require these conversions from S corps to C corps, the conversion to C corps and paying double taxation.

How damaging would that be?

Mr. RYS. I think it is a large concern for small business owners. They have had a lot of success being able to set up their businesses as pass-through structures. It is a much simpler tax system, it is a much simpler business structure.

Really, under the current code, no tax structure is simple, but in comparison, it is certainly easier. And I think some of the concern our members have is, if you reduce deductions to pay for that, that is also going to have a negative impact on those pass-through businesses, because their tax rate is going to go up; not only because their tax rate is higher, but they have also lost a deduction that they may have relied on.

So it really puts those pass-through business owners on an unequal footing. And when we look at these pass-through businesses, they really do produce a lot of the private sector employment in this country. It is 54 percent right now. In fact, there are six States that have over 60 percent, including Maine and Montana. Montana is the highest in the country at 69 percent.

So there are a lot of workers, a lot of employees working in these businesses, and it is a structure that has worked very well for small business owners.

Senator SNOWE. And, as I understand it, it would be 20 million workers who would be affected by these higher tax rates.

Mr. RYS. The top tax rates—well, it would be a substantial number of the workforce. When we have looked through our survey data, the businesses most likely to get hit are those businesses with between 20 and 250 workers, and those businesses accounted for a quarter of the American workforce, 33.5 million workers.

These businesses are generating jobs. These businesses have—across the sector, they have hit a rough patch, but these businesses are generating jobs. They are generating opportunities. They are providing economic growth. And that is going to be diminished if tax reform is done in a way that increases their rates and reduces the deductions that they rely on.

Senator SNOWE. Well, on this whole issue of tax reform, I happen to believe we should do tax reform this year. I think it is crucial, rather than putting out pieces here on the margin and approaching it in a piecemeal fashion, that we should have a comprehensive overhaul, without question.

I think that is one issue that might address certainty and might be the very issue that could resuscitate this economy for the long term.

I know Dr. Burman says it is a lack of demand, but I think that this does dovetail with those issues because, in talking to my constituents—and primarily small businesses and businesses across the country—as ranking member of the Small Business Committee, I can assure you the issues I hear the most about are taxes and regulatory reform, both of which really do have a profound effect on running a business and on surviving in this economic climate.

So I am hearing all of these ideas about tax reform, but I am concerned about doing it in a piecemeal fashion. Rather, we should be doing it in a comprehensive fashion.

Do you think it is possible this year to do that?

Dr. BURMAN. Tax reform this year?

Senator SNOWE. Yes.

Dr. BURMAN. It is hard. I actually came to Washington to work on what became the Tax Reform Act of 1986 at the Treasury. I actually lived in Maine when I moved here.

But I completely agree with you that fundamental tax reform is really sorely needed. The tax system is a mess. It is extremely complicated.

People perceive it as really unfair. There are all these things that people get through credits and deductions, but people think they are not getting their fair share, and they do not really understand how it affects them.

So I think, actually, tax reform—my perspective is that tax reform ought to be a way to help deal with the budget problems along with significant spending cuts. And I think if people saw it as some sense of shared sacrifice so that we could leave the economy not a basket case for our children and grandchildren, that they would be willing to participate in that.

Senator SNOWE. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Mr. Rys, you got my attention when you said, what, 69 percent?

Mr. RYS. Yes. Of the employees who work in Montana, 69 percent of them work at pass-through businesses. That is the highest in the country.

The CHAIRMAN. That makes sense, because we do not have a lot of big companies.

I will not intrude on your time, Senator, very much here, but my understanding is that, nationwide, 3 percent of pass-through income is income where the taxpayers are in the top two brackets, or half of income was 3 percent of taxpayers.

Mr. RYS. When we have surveyed on this, we have found overall, on small business owners, it is around 10 percent. But I think the question becomes——

The CHAIRMAN. So my figure is wrong.

Mr. RYS. I think the figure is low, because I think, when we have looked at the 3 percent number, there are too many businesses——

The CHAIRMAN. I am taking Senator Cardin's time here.

Senator Cardin, you are next.

Senator CARDIN. I appreciate the point that you are making, Mr. Chairman. And let me thank all of our witnesses. I found this panel to be very interesting.

Mr. Mehiel, first of all, I found your testimony to be not only credible, but very understandable, and I thank you for that.

Mr. MEHIEL. Thank you.

Senator CARDIN. I am not surprised, because your business roots are in Maryland.

Mr. MEHIEL. That is true. We started my business in Baltimore.

Senator CARDIN. I am well-aware of it. I remember when you had a lot fewer employees than you have today. Believe me, I visited your plant at that time.

But let me just point out the very simple fact that you make, and that is the advantage of progressivity when we are trying to stimulate growth in our economy.

The point that you made about, when you received a tax increase, it did not affect your consumption—I am not picking on your income right now, but it did not affect your consumption. And when you got a tax cut, it still did not affect your consumption. So, if we really want to use the tax code to help grow our economy, then we have to concentrate on those who are at the marginal rates where it makes a huge difference to them to have more money in their paychecks.

Which brings me to, I guess, one of the fundamental problems of capital gains taxation. The truth is that those who take advantage most of capital gains on their personal tax rates are those in the higher incomes.

So, when you look at what we are trying to do to help grow our economy, the side effect is that we are giving tax relief to those whose own decisions are not going to be very much impacted by the tax rate itself. And your proposal deals with that by creating an additional rate and giving preference to capital gains, but making the tax code more progressive in the balance.

I thought that was a fair way of looking at trying to deal with this inconsistency. If we are not able to raise rates beyond perhaps the pre-Bush years, what do you believe is the appropriate tax rate on capital gains?

Mr. MEHIEL. I probably would argue to bring it up to 28 percent, where it was. And what drives that, Senator, is my fundamental belief that the Federal Government needs more revenue and, if we believe that we no longer have the capacity to borrow on an unlimited basis, if there is going to be a limit to what we should or can borrow—and I believe that day is coming—then the question becomes, if we collect some more revenue, what is happening to it? What is happening to it is the government is going to send it back into the economy, and the people who ultimately get it are, in fact, going to spend it, and we are going to drive economic opportunity.

But we have to—I mean, it is clear we have to address the fiscal imbalances and find a way to bend that expense increase curve over time, no question about it.

But right now, if you raise the rates, capital gains rates, which, generally speaking, those are rates that affect people at the upper end of the income ladder, so to speak. That is a generalization, and, clearly, there are exceptions. But if you do that, and if you raise the marginal rate on earned income, as it is called, it is my fundamental belief—and I am convinced of this—it is going to have zero impact on the personal spending decisions and consumption of the people who are hit with those increases.

In addition to that, I am not surprised that, in the organization that Mr. Rys surveyed, everybody said, "We don't want to pay any more taxes." I do not want to pay any more taxes either. Nobody wants to pay more taxes. But I do not subscribe to the theory that this modest increase in flow-through income is going to have any dampening effect on the ability of small business to invest and grow.

If it was going to 80 percent, 90 percent—we have experienced those rates in the past—certainly, those kinds of rates would have an enormous impact on decision-making.

But going from 35 to 39, the businessperson is going to do what is the interest of the business and worry about paying the extra 3 percent later.

Senator CARDIN. I think your point is very well-taken. If we were to ask the public how they feel about the deficit, they want to eliminate it. And if you ask them if they want to pay more taxes, they are going to say "no."

Mr. MEHIEL. Of course.

Senator CARDIN. We know that that is an intuitive answer. But I think Chairman Greenspan underscored the point that you made, that predictability in getting our deficit under control has a much more important impact on our economy than either the psychological or real impact of revenues.

So I think that point—and it has been, of course, shown during the Clinton years, where we did make tough decisions. We reduced spending, and we did bring in more revenues, and we did reduce the deficit, and we had an incredible job growth.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Next, Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. Another very good hearing.

What was striking to me yesterday about Mr. Greenspan's testimony is, I asked the panel—I essentially started with Governor Engler—about the toll that the uncertainty and the lack of predictability has brought to our economy.

And Governor Engler, Mr. Greenspan, the entire panel talked about this, because, of course, we are just lurching from kind of one change to another, and the main thing that business needs is some predictability.

Do all of you essentially share that view?

Mr. Mehiel, you are trying to grow a business. How do you make investments for the next 5, 8 years when the Congress is talking about yet another temporary patch or another temporary band-aid?

Mr. MEHIEL. Senator, I concur with Chairman Greenspan's point of view, as you have relayed it to us and as we heard earlier.

The uncertainty—it is sometimes intangible—but I know right this minute, I am considering where I am in the development of the business: should I be selling, should I be selling off a major portion to a larger enterprise and kind of taking chips off the table?

And I do feel driven to give a lot of consideration to that, because it is not clear to me that we have our house in order or that we are going to have our house in order anytime soon given the enormous disparity and polarization in the points of view that we hear articulated from the responsible members of our government here in Washington.

So that is a very serious issue. Whatever we do, I think that, on a real-time basis, it ought to be clear, it ought to be comprehensive, and people should believe that that is going to be the regime for an extended period of time, and they will then adjust their behavior and their decisions to whatever that protocol is.

Senator WYDEN. Your thoughtful response took me right to Dr. Burman on this question of polarization because, to me, what is so appealing about the 1986 model which cut marginal rates but kept progressivity is, it brought together Republicans and Democrats.

And we went and looked at the Bureau of Labor Statistics' numbers, and, in the 2 years after the 1986 tax reform legislation, our country created 6.3 million new jobs.

So, obviously, it stimulated activity, which helped to put people to work. That is the number-one concern of our constituents today.

Dr. Burman, because you have been a supporter of the 1986-type approach, as many of us have, is there any reason to believe that a similar kind of approach would not stimulate economic activity again? It puts dollars into the pockets of middle-class people. So it responds to the demand agenda that you are talking about, and will increase the competitiveness of American businesses in global markets. Would we not get growth again?

Dr. BURMAN. It is actually hard to—from an economist's perspective, it is hard to tie growth to a particular activity. But the one reason that economists find the 1986-style tax reform to be particularly attractive is that, conceivably, you could raise revenue to help deal with the deficit, along with spending cuts, without raising marginal rates, even cutting marginal rates and eliminating a lot of the loopholes and preferences that lead to inefficient tax avoidance behavior, not to mention a great deal of complexity.

So both of those things actually would be pro-growth, and you can do them in a progressive way. You have been a great leader in the tax reform effort in the Senate, and I applaud what you are doing. I think it would be tremendously important.

But the real challenge—well, it will be hard to get tax reform to begin with. The real challenge will be figuring out how to make it stick, and I have not entirely figured that one out myself.

Senator WYDEN. And no current Congress can ever bind a future Congress, clearly. I have had at least some preliminary discussions with Chairman Baucus about this, because, clearly, if we get tax reform, we have to figure out a way to at least make it tougher to unravel it.

Dr. BURMAN. Actually, the Senate does have a good track record of setting rules that they agree to follow from one Senate to the next. So, conceivably, you could have rules.

And one thing, I came across this table or chart that the JCT, Joint Committee on Taxation, has on their website showing the numbers of requests for estimates, revenue estimates, since 1986. In 1986, there were something like 440 revenue estimates. In 2009, there were 7,000.

So I think there has to be—to some extent, there has to be a change in mentality that maybe we should figure out how to fix the tax system and leave it alone and move on to other things.

Senator WYDEN. I had one other question, Mr. Chairman, but I will wait for the second round.

The CHAIRMAN. Go ahead.

Senator WYDEN. Mr. Rys, let me ask you a question about the business rates, because you, of course, have many of the pass-throughs that the chairman talked about as your members, 8 to 10 employees, and we have been trying to figure out a way to come up with a competitive rate structure for the three major kinds of businesses.

We have American businesses, large businesses that operate in the United States, we have small businesses that operate in the United States, and then we have the multinationals. And it seems to me competitive rates would help in all three brackets, and one way to do it is to chip away some of those tax breaks—there are hundreds of billions of dollars for, in effect, the businesses that operate overseas—and use that money to dramatically slash rates for businesses here in our country.

So, for example, one of the areas you have been interested in is being able to expense permanently in the first year for small business. We could do that while, at the same time, giving a competitive rate somewhere in the low- to mid-20s for all the other businesses.

Would something like that not make sense for you all?

Mr. RYS. Yes. I mean, I think it depends. We certainly would have to look at where the deductions come from and what impact that is going to have as well. So I think there is a balance that needs to be taken there.

But I think you are headed in the right direction; we do need to look at this holistically. One of the challenges that we have seen going forward, and you talk about certainty and confidence, is, when we hear talk about tax reform, it has been, we are going to reduce all your deductions and reduce the corporate rate.

Then a lot of that has been followed by, we are going to raise certain tax rates, but we are also going to eliminate those deductions. So some of the smaller businesses, even if they are below the income thresholds that have been targeted for having their taxes raised, could see their tax rates go up because now they have lost deductions.

So there does need to be a balance to this, both on the pass-through side and the corporate side. So I think that does kind of make sense, and you have to look at what those deductions are.

If I could comment, just really quickly, on expensing. I think the real—I am way over the time, so I apologize—the real advantage there is not only that it puts the money back in the business immediately, but it also simplifies the tax code. And the tax code is just such a confusing monstrosity for small business owners to wrap their arms around.

What expensing does is, it eliminates some of the depreciation rules. So it just makes it easier to manage your business, to manage the paperwork, and deal with your accountants.

So, not only does it promote the investment side of things, but it also simplifies things, and that is an important double benefit.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

Mr. Rys, it is true that Mr. Mehiel's business was a C corporation, not a flow-through corporation. So would the business have been hit with the Clinton tax hikes on the top 2 percent?

Mr. RYS. It depends on what kind of income he takes out of it.

Senator HATCH. No. But, I mean, his——

Mr. RYS. Depending on what kind of income——

Senator HATCH [continuing]. Business would not have been hit.

Mr. RYS. His business would not have been, and I think that is——

Senator HATCH. Well, that is what I am——

Mr. RYS [continuing]. That is the challenge. And I think, going back to that, the 1990s, we had a dot-com boom, we had Y2K, a lot of money being spent there. So we had much stronger economic winds pushing——

Senator HATCH. I agree.

Mr. RYS [continuing]. Pushing in a way we do not have right now.

Senator HATCH. I agree, but my point is——

Mr. RYS. That is going to be a challenge.

Senator HATCH. My point is, this was not a flow-through business.

Mr. RYS. Right.

Senator HATCH. Which is what we are talking about here.

Mr. RYS. Absolutely.

Senator HATCH. Now, in the bill sent to Congress this week, President Obama proposes capping the value of itemized deductions at 28 percent for families making over $250,000.

Now, let us be clear. This is a tax increase on millions of American taxpayers. Right now, these taxpayers get a deduction equal to their marginal tax rate of 33 or 35 percent.

Now, under this proposal, the value of itemized deductions—I am going to ask you this, Mr. Entin. Under this proposal, the value of itemized deductions would be reduced 20 percent down to 28 percent, and they will get even worse if the President and congressional Democrats are able to raise these rates to 36 percent and 39.6 percent.

Now, the Obama 28-percent limitation would reduce the benefit of the home mortgage deduction, which would put downward pressure on home prices, it seems to me, at a time when it is very difficult for homebuilders and that particular industry.

The Obama limitation would also reduce the benefit from the charitable contribution deduction, and this would reduce the amount of contributions people would make to churches, soup kitchens, universities, et cetera.

Now also, this administration that tries to boast about how transparent it is, it certainly did not make clear that it was proposing to tax health insurance benefits of workers in the top two brackets.

It is odd that President Obama would propose such a thing, since he ran one negative campaign ad after another against Senator McCain for a very similar proposal.

Now, this seems to me to be another attempt by the administration to raise taxes on the American people to support more of the same old proposals that have been offered by this administration before.

Now, Mr. Entin, can you please comment on the likely economic effect of this proposal? It is a broad question, I have to apologize.

Mr. ENTIN. I think the question ought to be, what is the appropriate tax base? I think it is proper, if you are giving money to someone else, for it to come off of your tax return and go onto the recipient's return. If that recipient is deemed too poor to owe tax or is a tax-exempt organization, as determined to be in the national interest by the Congress, so be it. They should receive it tax-free. To then turn around and raise the tax on the giver simply because of whom you are giving it to is simply not correct.

Income should be taxed where it is finally available for consumption. If I give money to someone else, it should be off my return and on theirs.

I think that curbing the charitable deduction has the effect of implicitly raising the marginal rate, because more of the income is being taxed. I do not know what the tradeoff would be in the form of a lower rate for the elimination of the deduction or the health insurance exemption. So it is hard to say how it would come out economically.

But you really need to get your tax base straight and then let the rate fall where it should be to fund what government is supposed to be doing. And I think most of these transfers from one person to another should be deductible.

Curbing the home mortgage deduction would have an impact on home prices. It is one of the very few areas in the tax code where we just about have it right. We are treating the house as it would be treated in, basically, a cash flow tax, and I would not want to see that interfered with.

Might I have a second to comment on capital gains?

Senator HATCH. Sure.

Mr. ENTIN. The 1986 Act raised the capital gains rate from 20 to 28 percent. There was a rush to take gains before it took effect, and then there was a collapse in gains afterwards.

There is a table and a chart in my testimony.

CBO and the Treasury routinely suggest that those little timing effects all around a rate change are temporary and then you get back to your normal realizations of gains.

The economic effect, however, that is calculated on what the tax rate change does to capital formation and the cost of capital and how much capital we want to have and on the price of assets, suggests that the effect on gains and tax revenue is more permanent.

After 1986, capital gains realizations collapsed below 1985 levels as a share of GDP for a decade until President Clinton signed the tax reduction on capital gains and it became effective in 1997.

The effect of the rate changes was not temporary. You are not going to get a dime raising the capital gains rates up to 20 or 28 percent.

Where is the revenue maximizing rate? Feldstein has it in the mid-teens. A paper that was done by Paul Evans of Ohio State recently suggested it was slightly below 10, and that was just on the realizations, not on the economic cost.

I would be cautioning you not to rely on raising capital gains rates for revenue.

The CHAIRMAN. Let me ask a question that——

Senator HATCH. Mr. Chairman, my time is up.

The CHAIRMAN [continuing]. Senator Wyden talked about, and I think it is on the minds of a very great number of people. That is, how do we reform the code in a way that is fair and balanced, et cetera—and everybody talks about broadening the base, lowering the rates—but in a way where there is more certainty and more predictability?

In fact, I have forgotten who it was, maybe Dr. Burman mentioned it, there are like 7,000 requests for revenue estimates or something like that, and, my gosh, that is appalling.

Do we need to change our system gradually? Where are we going to end up? That is, in the long run, we are all dead. But the next 10, 15, 20, 30 years? Other countries have their own systems, some have territorial corporate systems, but we do not. Other countries have consumption taxes. We do not.

If we are going to be competitive 10, 15, 30 years from now, 5 years, 10 years from now, and we are going to hopefully have a little more predictability and a little more certainty, is it worth thinking about going in a different direction here or not?

We do not have a lot of time here. I just raise the question, because I think we are kind of at a semi-crossroads here in our country. And with the debt as high as it is, we have this supercommittee created to try to reduce the deficit, and it is all about this question of how we do it and so forth.

There is an opportunity to perhaps go in a little bit different direction, if that makes sense.

Dr. Burman?

Dr. BURMAN. I think it is a great question. The Bipartisan Policy Center put together a proposal—and this was a bipartisan group of Republicans and Democrats and wonks—and their proposal actually had a value-added tax as a way to lessen the burden on capital and allow lower tax rates on ordinary income, but in a way that was progressive.

I have written that I surely think it would be a good idea to have a value-added tax that was dedicated to paying for health care. Every other developed country in the world has one.

A lot of people are concerned that if we had a value-added tax, it would be a money machine.

The CHAIRMAN. Right.

Dr. BURMAN. It would cause an enormous growth of government. I think if you actually had an earmarked tax, just like payroll taxes that are earmarked for Social Security now, if it were earmarked to pay for health care, it would make it very apparent to people the consequences of not controlling health care costs, because the rate would go up.

And I think that would actually build support for limiting the growth of government, and it certainly could allow for radical reductions in other income taxes.

The CHAIRMAN. Mr. Rys, what do you think?

Mr. RYS. I think it is a broad question, and I do not know if right now, with a lot of economic uncertainty, that a major change and a different direction is the way to go.

I think what our membership is really looking for is some kind of certainty, to know what the tax rates are going to be a year from now, 2 years from now. And I think, when you look in the different provisions of the code, as well, some of the provisions that they rely on most tend to phase in and out. I think we get back to section 179; it jumps all over.

The CHAIRMAN. There is so much variation. Rates are up and down. I mean, it is just incredible, and all these tax extenders. If I were a businessman, I would ask myself, "Holy America, what are those guys going to do next?" It would make it very difficult, it would seem to me.

Mr. Entin?

Mr. ENTIN. Certainty would certainly help. But if you are in the emergency room and a loved one is taken behind the curtain and you do not know what the outcome is going to be, it is not just the certainty you are concerned with. It is the outcome.

I think if we certainly and definitively raise taxes substantially on capital, we would end up in trouble. I think if we certainly and definitively lowered taxes on capital and promoted investment and job creation, we would be better off.

So which way you go to create the certainty——

The CHAIRMAN. So, in answer to my question, you think we should just lower taxes on capital, period. That would create the certainty.

Mr. ENTIN. I think people who are trying to invest need to know whether the taxes are going to go up or down on capital. And, if they go up, there will be less, and, if they go down, there will be more.

The CHAIRMAN. Mr. Mehiel?

Mr. MEHIEL. Senator, I think if we could begin to migrate a significant portion of our collection of revenue toward a consumption tax over time, that would be a very good thing. Obviously, there are a lot of details around that and what is it and where are the exemptions and how does it affect people in different economic circumstances.

I mean, there is detail behind that that would have to be sorted out, but if we could tax consumption and, thereby, reduce taxes on capital that is invested and reduce tax rates on so-called ordinary income and move in that direction, I think that, over time, that would be a huge benefit to the Nation.

The CHAIRMAN. That is very interesting.

I think that is enough for today. Thank you all very, very much for coming. I appreciate it very much. Some of you have come great distances. You have all worked hard to prepare for this hearing, and I thank you very much for your time. It is very much appreciated.

The hearing is adjourned.

[Whereupon, at 11:53 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding Tax Rates on High-Income Earners, Capital Gains and Dividends

Abraham Lincoln once said, "That some achieve great success is proof to all that others can achieve it as well."

Our country was built on the principle that everyone can succeed by working hard and playing by the rules. It's the American Dream. But lately, more and more folks are finding that as hard as they try, this success is further from their grasp.

In fact, since 2007, Americans' real median household income has fallen by 6.4 percent. It's the lowest income we've seen since 1997. The New York Times today called it a lost decade. And 21 percent of children live in poverty.

We are facing a struggling economy and record deficits. We need to do something to tackle these problems, and do so in a balanced way that creates jobs in the process.

But in tough economic times like these, taking on these problems involves difficult choices. And these choices are clear.

Putting the full load of deficit reduction on seniors, veterans and middle class families, for example, when the wealthiest can afford to pay a little more, simply doesn't make sense.

With limited resources, however, it does make sense to allow these lower tax rates for the wealthiest in our society to expire, rather than making major cuts to Social Security or Medicare.

And it sure makes sense to let those rates expire rather than increase taxes on lower and middle-income families.

Over the past three decades, the incomes of the richest one percent of Americans have risen much more rapidly than the other 99 percent of Americans. That gap continues to widen both before and after taxes. During that time period, the after-tax incomes of the top fifth of taxpayers grew nearly eight times faster than those of the bottom fifth.

I introduced legislation last year to allow the current top two tax rates to expire for those with incomes above $200,000 and married couples with incomes above $250,000. This proposal would mean that the top income tax rates of 33 and 35 percent would return to 36 and 39.6 percent, respectively.

Historically, the top tax rates have been much higher than the current rates – and these proposed rates. In fact, over the last century, the average top rate has been 59.2 percent.

The lower tax rate for capital gains and dividends further complicates the picture.

A Washington Post article this week noted that many of the richest Americans pay taxes at a lower rate than middle-class families do, because much of their income comes from capital gains and dividends. This partially explains why the gap between the wealthy and the rest of the country continues to widen.

Capital gains and dividends are generally taxed at a rate 20 percentage points below the top income tax rate that high-income workers pay on their wages, and earnings from capital gains and dividends constitute a larger share of income for high-income taxpayers than for most Americans.

In fact, capital gains make up 57 percent of adjusted gross income for the richest 400 taxpayers.

Low capital gains and dividends rates helped these extremely wealthy taxpayers, who had an average income of $345 million in 2007, pay an average tax rate of only 17 percent, a rate far lower than many middle-class families pay.

There are important reasons why it might make sense to tax capital gains at lower rates than ordinary income, for example, if the gain is on stock in a company that has already paid corporate income tax.

But is it fair for someone with $345 million in yearly income to pay income tax at a rate lower than many middle-class families?

So in these tough economic times, we must make these choices: will we be forced to make real changes to programs seniors depend on like Social Security and Medicare? Will we be forced to cut programs or raise taxes on veterans, servicemen and women and middle class families? Or should we ask some of the wealthiest in our society to contribute?

We need to make the right choices to get America on sound economic footing and the choice here seems clear. We began this summer by making real progress and cutting spending by $900 billion, but more work remains to get our economy back on track. We need to make choices that will create job growth and expand our economy without throwing millions of Americans into further economic turmoil.

We can't let politics get in the way of common-sense solutions for our economy.

So let us make the right choices. Let us approach deficit reduction in a fair and balanced way. Let us set the top tax rates in a way that is appropriate for our current economic situation. And let us work to create jobs and provide opportunities for success for all who work hard.

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Statement of

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Before the
Senate Committee on Finance

Tax Reform Options: Marginal Rates on High-Income Taxpayers, Capital Gains, and Dividends

September 14, 2011

Chairman Baucus, Ranking Member Hatch, Members of the Committee. Thank you for inviting me to testify on tax reform options affecting high-income taxpayers. I applaud the committee for devoting much of the past year to examining ways to make the tax code simpler, fairer, and more conducive to economic growth, and I'm honored to be asked to contribute to those deliberations.

In summary, here are my main points:

- Economic theory suggests that the degree of progressivity should balance the gains from mitigating economic inequality and risk-sharing against the costs in terms of disincentives created by higher tax rates. The optimal top tax rate depends on social norms and the government's revenue needs.
- Experience and a range of empirical evidence suggests that the rates in effect in the 1990s would not unduly diminish economic growth. However, a more efficient option would be to broaden the base (reform or eliminate tax expenditures and eliminate loopholes) to achieve distributional goals while keeping top rates relatively low.

- The biggest loophole is the lower tax rate on capital gains. Several bipartisan tax reform plans, including the Bipartisan Policy Center plan that I contributed to, would tax capital gains at the same rate as other income. Combined with a substantial reduction in tax expenditures, this allows for a cut in top income rates while maintaining the progressivity of the tax system. That was also the approach taken by Ronald Reagan in 1986.
- Different economists reach diametrically opposite conclusions about the taxation of dividends. I find most compelling a recent analysis that suggested that concerns about tax avoidance activities of multinationals (e.g., moving headquarters and jobs overseas) would argue for fully taxing dividends and using the revenue raised to cut corporate tax rates.
- Finally, there has been much hand-wringing about lower-income families that don't pay income tax or even receive net subsidies. Some of these families are retired and I can't imagine that taxing them is feasible or desirable. The lower-income working families receive tax subsidies that encourage work, which is consistent with the prescriptions of optimal tax and transfer literature. To clarify the distinction between tax obligations and benefits, I suggest that the IRS produce a tax and subsidy report for all filers showing what their true tax liability is—before tax expenditures—as well as the value of their tax subsidies.
- Bottom line: allowing the top tax rates to return to their pre-2001 levels after the economy has recovered would not be economically disastrous and might help build support for tax reform that would broaden the base and lower rates while maintaining the progressivity of the tax system (and hopefully contribute to reducing the debt).

1. Top Income Tax Rates

Next year, if not sooner, Congress will again have to address the question of whether to allow the "Bush tax cuts" to expire for some or all households. The president has proposed to allow the top two income tax brackets to return to their Clinton-era levels. The top rate would increase from 35 to 39.6 percent and the second bracket would increase from 33 to 36 percent. Doing nothing would allow all the rates to return to Clinton levels.

Three questions must be answered to determine the top income tax rates. First, how much revenue does the government need? It seems obvious to me that when the economy is doing well, revenues should be close to the level of spending. That certainly does not imply a balanced budget every year or even necessarily over the business cycle, but it does rule out large persistent deficits as we have experienced over the past decade. That said, there is a strong argument for running deficits while the economy remains weak, because raising taxes or cutting spending reduces aggregate demand and could plunge the economy back into recession. That argument holds with special force now when monetary policy appears to be tapped out. And, even when the economy is at full employment, there might be an argument for a modest deficit if much of government spending is in the form of investments that pay returns over many years. On the other hand, if the government is accumulating obligations without adequately funding them, there might be an argument for running surpluses.

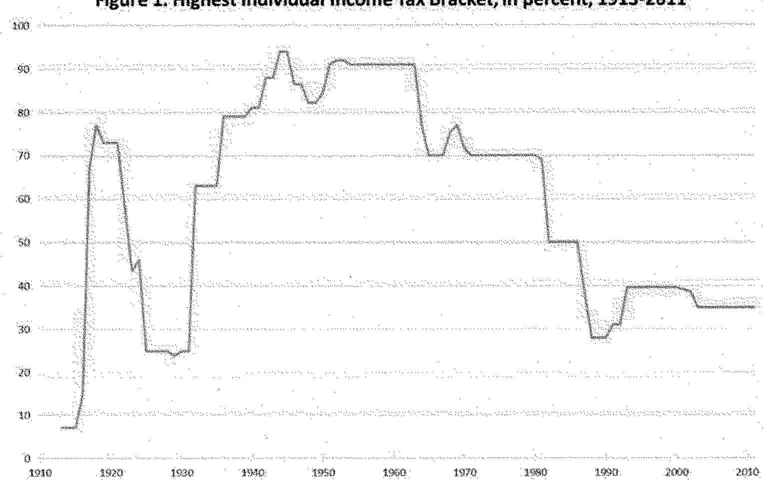
Second, how broad or narrow will the tax base be? Currently, the income tax code includes around a trillion dollars of tax subsidies or tax expenditures. The exact number could be larger or smaller depending on what is considered a tax expenditure, but my point is that they are quantitatively quite significant. Most economists' preference would be to eliminate or reform many tax expenditures so that rates can be kept as low as possible while still meeting distributional and revenue objectives. Every recent tax reform, dating back at least to the proposals made by President Bush's tax reform commission, would significantly scale back tax expenditures and use at least some of the savings to cut income tax rates.

Third, how should the tax burden be distributed? The answer to this question balances normative considerations reflecting social values against the economic incentive effects of higher tax rates. Less well understood is the fact that taxes provide a kind of insurance whose value offsets to some extent the negative incentive effects.

It is certainly not my role to opine on social values, but I can provide some data that might be relevant to you in your considerations.

Top tax rates are low by historical standards. Although higher than they were in the immediate aftermath of the Tax Reform Act of 1986, top tax rates are now (and were during the Clinton Administration) lower than at any time between 1932 and 1986. (See Figure 1.) While it is possible that the economic costs of taxation have grown since 1986—for example, because the technology of tax avoidance has improved—it is unlikely that returning tax rates to their levels in 2000 would entail a huge economic cost. Despite predictions that the economy would collapse in 1993 when tax rates increased, economic growth was quite robust until 2000. And notwithstanding forecasts that the Bush tax cuts would turbocharge the economy, growth was anemic throughout the last decade (even before the Great Recession). This certainly does not prove that economic growth is independent of tax rates, but it does suggest that, at least at current tax levels, other factors are more important.

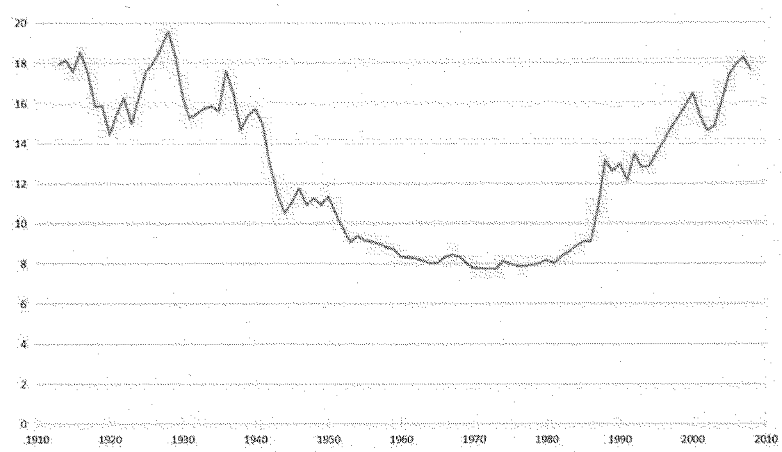
Figure 1. Highest Individual Income Tax Bracket, in percent, 1913-2011



Source: Tax Policy Center, http://taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=543

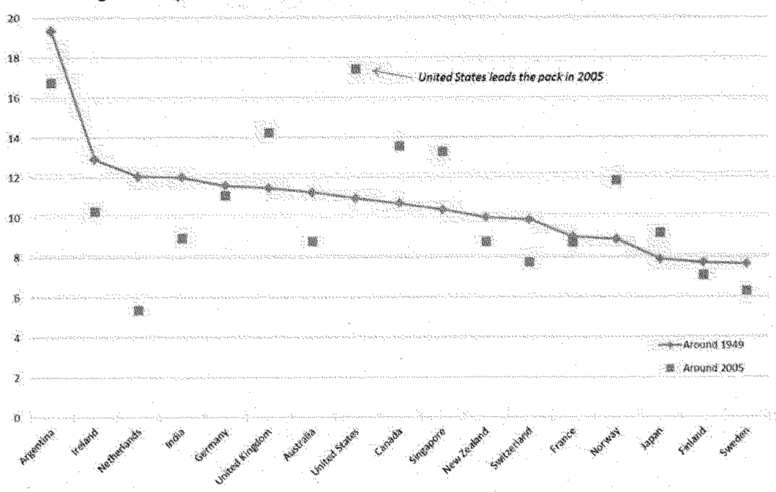
Inequality in 2007 was at its highest level since the great depression. Before the Great Recession, both income and wealth inequality had reached the highest levels in almost 80 years. For example, data collected by economists Thomas Picketty and Emmanuel Saez (see figure 2) show that, in 2007, the top 1 percent of households earned over 18 percent of all income (excluding volatile capital gains) for the first time since 1929. The income share of the top earners plummeted during the great depression falling below 10 percent from the 1950s through the 1970s before rising steadily starting in the 1980s. Income inequality in the United States is now among the highest in the developed world. (See figure 3.)

Figure 2. Income Share of Top 1 Percent, Excluding Capital Gains, in Percent, 1913-2008



Source: Thomas Picketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," Quarterly Journal of Economics, 118(1), 2003, 1-39. Updated data at http://elsa.berkeley.edu/~saez/TabFig2008.xls.

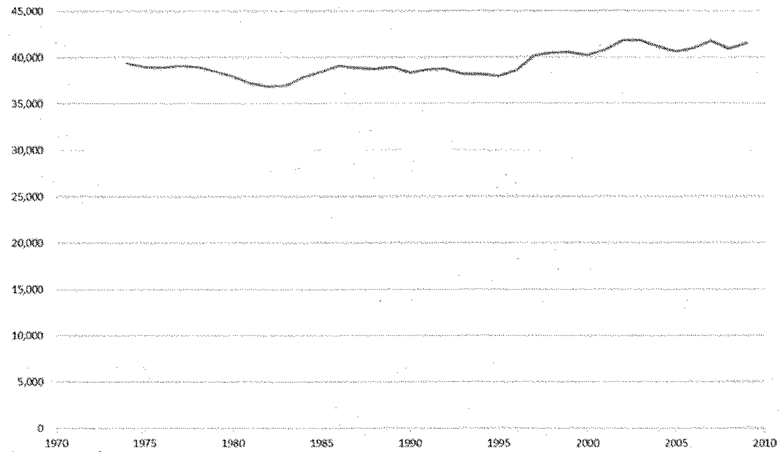
Figure 3. Top Income Shares in Selected Countries, in Percent, 1949 vs. 2005



Tony Atkinson, Thomas Piketty, and Emmanuel Saez, "Top Incomes in the Long Run of History", Journal of Economic Literature, 49(1), 2011, 3-71.

<ins>The middle class has been in a 30-year recession.</ins> There is great concern about the tremendous harm caused by the financial meltdown and ensuing recession, but the middle class in the United States has experienced almost no income growth for the past 30 years. Incomes by a variety of measures have grown barely faster than inflation. For example, figure 4 shows that median earnings for full-time, full-year workers grew by only 0.15 percent per year from 1974 to 2009 after adjusting for inflation. Some point out that total compensation has grown faster because most workers still get health insurance at work and the cost of health insurance has far outstripped inflation. But I doubt that workers perceive more economic gain when it's explained that almost all of their pay increases have gone to pay for increasingly expensive health insurance.

Figure 4. Median Earnings for Full-Time, Full-Year Workers, in 2009$
1974-2009



Source: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements.

Extreme inequality may lead to worse economic policy. As an economist, I'm in awe of the magic of the capitalist system. It is unsurpassed for producing great abundance at low cost, but it doesn't guarantee that the benefits will be widely shared. President Kennedy's famous metaphor is not robust. A rising tide doesn't necessarily lift all boats.

While I view this as undesirable in its own right, I'd argue that even those who do not care about inequality *per se* should be concerned about this trend. If the bottom 60 or 80 percent of the population feels like they're not getting their fair share, that could lead to a populist revolt. Voters might be tempted to support populist calls for trade restrictions, more regulation, or throwback policies like a return to the gold standard. Any of those responses could be extremely detrimental to economic growth. For that reason, those who benefit most from the current system have an incentive—completely beyond any notion of altruism—to try to mitigate extreme inequality in ways that entail less economic cost.

To be sure, the best approach is to provide more economic opportunities, such as better and more affordable education, but not everyone can or should go to college. The income tax plays an important auxiliary role. It's second best because it adjusts outcomes rather than opportunities, but equalizing opportunity is simply impossible. Some people are born smart, rich, good-looking, or with the ability to jump very high or throw a baseball very fast.

The progressive income tax represents a balancing act. A progressive income tax does a number of things. It mitigates inequality, provides a form of insurance, and weakens economic incentives. The first point is obvious. A schedule of rising tax rates means that high-income people pay a much larger share of their income in taxes than lower-income people.

The insurance aspect of progressive taxation is less well understood. With taxes, government becomes a kind of partner—albeit an involuntary one. When taxpayers do well, they pay a lot of tax. When things go badly, they pay less (or even get a net subsidy). Even a flat tax reduces the variance of after-tax returns (since the government takes on a fraction, t, of any gain or loss, where t is the tax rate), but a progressive income tax allows for a higher level of consumption when things go badly than a flat tax system that raised the same amount of revenue. Effectively, it provides insurance in the case of bad luck. (And, just like real insurance, it also provides less incentive to avoid bad outcomes—a cost that I discuss below.) To the extent that the income distribution reflects luck, most of us would prefer a system that smooths after-tax incomes (for the same reason that we buy insurance).

Economist Hal Varian, who developed the theory of taxation as insurance in a seminal paper, argued that this aspect of taxation might argue for especially high tax rates on people with very high incomes—say over $1 million per year. The logic is that incomes that high must have a substantial luck component. It is not plausible that people reach that level of income simply by working especially hard or saving more much than their neighbors. To the extent that very high incomes derive from factors outside taxpayers' control, taxing those incomes at high rates might have little or no effect on their behavior. However, that theory did not account for the possibility of tax shelters that may be especially attractive to those with high incomes.

As noted, the obvious downside of progressive taxation is that it weakens economic incentives. However, most economic evidence suggests that taxpayers' real responses to the individual income tax are small. One might expect high tax rates to deter work and saving, but in fact, the effects are ambiguous. On the one hand, a higher tax rate reduces the reward to both activities. (Economists call this the substitution effect.) On the other hand, by making taxpayers feel poorer, taxes can ironically provide an incentive to work or save more. (This is called the income effect.) For example, a taxpayer whose living expenses are inflexible may need to work harder to make ends meet when take-home pay falls. Someone saving for retirement needs to save more to reach a target level of retirement income if the after-tax rate of return declines. The overall response of both work and saving to taxation is the sum of the substitution and income effects. Empirically, the total response appears to be very small or even zero on average. Surely some people work or save less when taxes go up, but others choose to work or save more.

There are two parts to the labor supply response: participation and hours. Evidence suggests that hours worked is not very responsive to tax rates, but participation (the decision of whether to work or not) is somewhat more sensitive, especially for second earners and those with low incomes. Recent policies tend to encourage participation in both groups. Marriage penalty relief enacted over the past 10 years reduces the marginal tax rates facing many second earners, providing more incentive to enter and stay in the work force. The earned income tax credit and the refundable portion of the child tax credit are contingent on earnings, providing a strong incentive for low-income people to work . Without earnings, they cannot claim the credits.

As for those with very high incomes, their labor supply is unlikely to be very responsive to taxation. Otherwise, people earnings millions of dollars a year would be working hundreds or thousands of times as hard as people with moderate incomes, which is implausible. (One theory of wage inequality at the top is the "winner take all" model, which suggests that the people at the very top echelons earn many times as much as people who are quite talented, but a rung below. This suggests that the penalty to slacking off, even a little bit, would be much more than could be effected by taxation. Compare the salaries of vice presidents with CEOs, triple-A baseball players with major league starters, summer stock actors with Broadway stars. It seems highly unlikely that top performers would slack off in response to higher taxation. And, as noted earlier, luck plays a larger role in the incomes of the super-rich than the rest of us. Overall, evidence suggests that their labor supply is insensitive to tax rates.

However, there are other ways to skirt tax liability, legally and not, and those appear to be more responsive to taxation. Those responses are not typically as economically costly as real responses. If a corporate executive chooses to squirrel away a few hundred thousand dollars in deferred compensation, there may be a loss to the Treasury but there's unlikely to be much of an effect on the real level of economic activity. However, if that executive invests in complex tax shelter arrangements, those might entail a real cost to the economy for several reasons. First, some of the kinds of investments that make good tax shelters would make no sense absent tax considerations. As a result, capital may be allocated to less productive investments than it would without the tax incentives. Second, the kinds of people who invent complex tax shelters could otherwise be doing productive work. Their work on shelters, as creative as it might be, does nothing to make us more competitive or produce goods and services that real people might want to buy. So tax avoidance is wasteful.

In some cases, the avoidance might reflect Congress's priorities. For example, if I decide to save more for retirement to avoid tax, presumably that's exactly what Congress had in mind when it created tax-free retirement accounts. The pay-off for such activities is greater at higher tax rates. And some people might decide to take a chance on starting a business because it is a good way to avoid tax. Businesses can deduct expenses that employees can't, and many of them choose not to report all the income that the IRS thinks should be taxed. Both legal avoidance and shadier evasion activities are more profitable at higher tax rates. If you want to encourage people to go into business for themselves, raising tax rates would provide a boost.

However, to the extent that tax shelters become more prevalent at high incomes, the economic cost of raising top rates will increase at the same time that the revenue yield diminishes. The best ways to address this problem are to eliminate loopholes that enable tax avoidance and raise the likelihood of detection and penalties for illegal tax evasion. And the biggest loophole is the lower tax rate on capital gains, as I discuss in the next section.

There is an upper bound on productive tax rates—in the sense that higher rates could actually reduce revenue (an effect made famous by Arthur Laffer and his napkin). A new survey by economists Peter Diamond and Emmanuel Saez estimated that the revenue-maximizing federal income tax rate was "conservatively" 48 percent assuming the existing tax base and could be as high as 76 percent if the tax base were much broader. Evidence from other studies also suggests that current rates are safely below the unproductive level.

The "right" rate ultimately depends on spending. After the economy recovers, government should be paid for (although small deficits might be justifiable as I explained earlier). If the low marginal tax rates lead to larger deficits, even if the lower rates boost the economy in the short run, the much higher tax rates required to pay back the debt with interest in the future will entail a far bigger economic cost than setting rates at the level required to tame the deficit. Studies by the nonpartisan staffs of the JCT, CBO, and Treasury (all under Republican appointees) reached this conclusion. Policymakers must figure out what government needs to do and, after the economy has recovered from this deep recession, pay for it. That will probably require higher tax rates or significant tax reform.

2. Tax Rates on Capital Gains

Long-term capital gains (those on assets held at least one year) and qualifying dividends are taxed at a top rate of 15 percent. By comparison, the top tax rate on other income is 35 percent. If Congress does nothing, the rates on gains will increase to 20 percent in 2013 and the top rate on dividends will return to 39.6 percent. Moreover, the Affordable Care Act included a surcharge on investment income of 3.8 percent, which would raise the effective rates to 24 and 43 percent.

While long-term capital gains have been taxed at lower rates than other income for most of the history of the income tax, dividends have only been taxed at a lower rate since 2003. The argument for a lower dividend tax rate is that corporation income is already taxed at the company level. Taxing the dividends again corresponds to double taxation. A similar argument is often made to justify lower capital gains tax rates. However, the lower rate is a very imperfect offset. While some corporations pay a lot of tax, some are able to use tax breaks to significantly reduce their effective corporate tax rate.

The ideal adjustment for corporate double taxation — at least from the economist's perspective — would be to "integrate" the individual and corporate taxes. In other words, corporate income would be allocated to shareholders and taxed at individual rates. For technical reasons, however, this is much easier said than done.

While double taxation is a plausible rationale for tax breaks on corporate capital gains and dividends, the lower tax rate also applies to many non-corporate capital gains. This is harder to justify. Proponents support capital gains tax breaks for several reasons: (1) a significant portion of capital gains simply represents inflation and we shouldn't tax that; (2) a lower tax rate on capital gains encourages risk-taking and entrepreneurship; and (3) high capital gains tax rates create an inefficient "lock-in effect."

None of these arguments is compelling. While a significant fraction of capital gains represents inflation, that is also true of other forms of capital income and expense. For example, at a 3 percent inflation rate, the first $3 of interest on a $100 savings account simply offsets inflation, but it is taxable nonetheless. Interest expense is also overstated when there is inflation for the same reason. If capital gains are taxed at lower rates, then interest expense should also be deductible at lower rates. Otherwise, there are large incentives for tax sheltering. (See box.)

Capital gains taxes have mixed effects on risk-taking. To the extent that losses are ultimately deductible (and my research with Alan Auerbach and Jonathan Siegel found that they almost always were), the capital gains tax includes the kind of insurance feature discussed earlier. Investors have to share gains with the government, but losses are also shared. Moreover, economist James Poterba has found that much of the

The Simplest Tax Shelter

- Borrow $10 million at 5% interest
- Invest $10 million that will pay $10,500,000 in a year
- Borrowing generates $500,000 interest deduction. At a 35% tax rate, that reduces your federal income tax by $175,000. (There may also be state tax benefits.)
- The $500,000 capital gain is taxed at 15%. That adds $75,000 to your tax bill.
- On net, you save $100,000.
- Because of the tax savings, this deal would be worthwhile even if the investment paid less than $500,000 (even though, absent taxes, it would make no sense)

Note: this scheme is so obvious that it is not permitted. However, a whole industry is devoted to finding economically equivalent tax shelters.

"A tax shelter is a deal done by very smart people that, absent tax considerations, would be very stupid." -- Michael Graetz, Columbia University Law Professor

capital that finances new investment comes from foreigners and pension funds and is thus not subject to capital gains taxes and unaffected by capital gains tax breaks. Moreover, the reckless behavior that led to the financial meltdown raises the question of whether damping risk-taking would necessarily be a bad thing.

One other area of concern is the effect of the tax on entrepreneurial activity. In fact, the income tax treats investments of "sweat equity" very favorably. Entrepreneurs do not have to pay tax on the value of their labor until it produces income. Effectively, investments in one's own business are expensed in the sense that tax is avoided altogether on the value of the uncompensated labor invested. Like an IRA or 401(k), this makes entrepreneurial capital tax-free. To the extent that entrepreneurial capital ultimately produces returns in the form of capital gains, entrepreneurs effectively pay a negative tax rate on their own labor input because the contributed labor is expensed while the ultimate return is only partially taxed. And capital gains that are classified "small business" might even be taxed at a zero rate.

There is one special case where this extremely favorable tax treatment seems especially problematic: hedge fund managers and private equity investors who have a "carried interest" in a business deal. These transactions have gotten a lot of attention because the people who engage in them are ultimately taxed at low capital gains tax rates, often on enormous incomes. They argue, with some justification, that their tax treatment is the same as other entrepreneurs (although they should be taxable on the value of the "carried interest" when it is granted them at the outset of the deal). But it offends taxpayers' sense of fairness that multi-millionaires can often earn giant incomes and pay the same tax rates as lower-income working people.

Treating carried interest like other wage and salary income is one approach to diminishing this inequity, but a better and more consistent one would be to tax all capital gains the same as other income.

Another argument made in favor of lower capital gains tax rates is that taxing capital gains produces a "lock-in effect" because a capital gains tax discourages asset selling. Investors can postpone the tax indefinitely simply by holding. However, my research with William Randolph and the research of other scholars has found that the "lock-in effect" is surprisingly small. This may seem surprising, but one admittedly casual bit of evidence in favor of a small effect may be found on the pages of any financial publication. Not the editorial page, which might rail endlessly against the incentives created by capital gains taxation, but the finance and investing section, which often reports financial strategies that involve much buying and selling with little if any discussion of the tax consequences.

The argument against providing capital gains tax breaks is that removing them could improve both efficiency and equity. Lower capital gains tax rates fuel inefficient tax shelters that entail a significant economic cost. Second, it is unfair to favor people like hedge fund managers and investors who earn a substantial portion of their income from capital gains rather than other more highly taxed forms of income. Third, the vast majority of capital gains are realized by people with very high incomes. Thus, tax breaks on capital gains undermine the progressivity of the tax system. (See Table 1.)

Table 1. Distribution of Net Long-Term Capital Gains and Qualified Dividends, 2010

Cash Income Group	% with Gains	% of Gains	Average ($)	% with Dividends	% of Dividends	Average ($)
Lowest Quintile	1.0	0.3	4,008	5.2	1.2	1,013
Second Quintile	1.9	0.5	4,178	8.5	2.9	1,525
Middle Quintile	3.9	1.3	5,493	13.3	4.9	1,843
Fourth Quintile	7.6	3.0	7,792	23.2	8.8	2,283
Top Quintile	21.3	94.1	100,623	48.7	81.6	11,511
All	5.9	100.0	56,690	17.1	100.0	5,923
Addendum						
80-90	14.5	5.1	15,896	38.1	9.9	3,513
90-95	21.0	3.9	17,392	47.8	7.0	4,165
95-99	32.0	15.6	55,460	67.9	18.8	9,460
Top 1 Percent	47.6	69.5	646,110	82.8	46.0	74,281
Top 0.1 Percent	63.9	46.6	3,225,323	90.0	26.8	397,067

Source: Tax Policy Center, http://www.taxpolicycenter.org/T09-0490

Equating the tax rate on capital gains with the tax rate on other income would allow a high degree of progressivity with lower top income tax rates. Indeed, that was what made the 28 percent tax rate on top income possible in the Tax Reform Act of 1986. The Simpson-Bowles and Bipartisan Policy Center's deficit reduction plans both paired full taxation of capital gains with a substantial cut in top income tax rates, while maintaining progressivity.

Failing such a sweeping reform, if a tax break for capital gains is retained, it would make sense to limit it to corporate stock (to address double taxation).

3. Tax Rates on Dividends

Additional issues surround the taxation of dividends. The economists' ideal solution to the problem of double taxation remains the same: imputation of the corporate tax to individuals. That, however, does not appear to be constructive advice for policymakers in the real world.

A recent paper by economists Raj Chetty and Emmanuel Saez suggested cutting the dividend tax rate in exchange for raising taxes on corporations. The logic was that this would enhance economic efficiency because it would reduce or eliminate the incentive corporate managers currently have to invest retained earnings in unproductive pet projects rather than pay dividends.

Of course, just as under the individual income tax, raising corporate tax rates amplifies the incentive to engage in tax sheltering. This can be especially damaging to our economy when corporations operate in an international environment. For that reason, Rosanne Althshuler, Benjamin Harris, and Eric Toder of the Tax Policy Center suggested almost exactly the opposite approach: Tax gains in full (up to 28%) and dividends as ordinary income and use the revenue gained to lower corporate rates. This would allow for a substantial cut in corporate tax rates and, they argue, would be a progressive change, especially if much of the corporate tax is ultimately borne by workers in the form of lower wages. That strategy could be especially effective if paired with a significant corporate tax reform aimed a closing loopholes and further rate reduction.

4. Tax Treatment of Lower-Income Families

Although not explicitly the subject of this hearing, the tax treatment of low-income families is relevant. The economic discussion of optimal taxation generally concludes that raising the after-tax incomes of low-income families is socially desirable if the costs in terms of incentive effects are not too great. However, some commentators and at least one presidential candidate have expressed alarm about the nearly 50 percent of families that do not pay income tax, so I am uncertain about whether helping low-income working families and retirees is universally accepted as a policy objective.

A couple of observations: First, many of these people are retirees and most of the rest are low-income working families, many of whom receive refundable tax credits. The people who get back more than they pay in taxes all work. It is a requirement for claiming the credits. While they might be exempt from the income tax, they pay payroll taxes. (Payroll taxes are bigger than income taxes for most workers.) As I noted above, encouraging low-income people to work reduces the distortions created by the income tax. In addition, connection to the labor force is important for building job skills (human capital) as well as maintaining personal dignity. And from my perspective making it possible for low-income working families to support themselves despite paltry wages seems only humane.

Moreover, most of us receive more from government than we pay for. That's a consequence of the skewed income distribution and progressive tax rates. How much is a robust national defense, research on life saving medicines and basic science, national highways and parks, food safety, air traffic control, the legal system, etc., worth? The only difference between us and the low-income "lucky duckies" (so called by the Wall Street Journal) is that only some of our benefits are claimed on income tax returns. Many are supplied by traditional government programs.

And then, of course, since we have the option to work in low-wage jobs to avoid tax, but the "lucky duckies" don't have the option to be senators, college professors, or lobbyists, it's clear to me who the real lucky duckies are. It's us.

However, it is potentially problematic if half of Americans think that government is free. One solution might be to clarify the division between tax obligations and government programs, which are currently commingled on income tax returns. Every year, the IRS could send taxpayers a statement letting them know what they paid in income and payroll tax before subsidies (tax expenditures) as well as the value of those tax subsidies. This would make a few things clear. People might discover that they pay much more in tax than they think, although they get a portion of it back after jumping through the hoops required to claim exclusions, deductions, and credits. Some might decide that they'd rather pay less tax and jump through fewer hoops. (That is, tax reform might become a more attractive option.)

Some might be surprised to see how little they benefit from tax breaks. For example, some homeowners are thrilled that they get to deduct their mortgage interest, charity, and taxes, but many have total deductions not much bigger than the standard deduction. Their mortgage interest is only a benefit to the extent that it (plus the other itemized deductions) exceeds the standard deduction. If that excess is only a few hundred dollars and they're in the 10 or 15% bracket, they might not save enough money to pay for a nice dinner out.

And some people might notice that the IRS is not just in the tax collection business, but in the business of administering 200 or so extraneous public programs. A little thought might suggest that some of those programs are not worth the cost and some others might be better run through traditional agencies that can better administer them.

5. Political Economy of Tax Rates

As I noted earlier, most economists think that the best way to meet revenue and distributional targets is with a broad-based income tax with relatively low rates—the kind of thing accomplished in 1986. However, many high-income people would prefer the current system—narrow base and low rates—which creates an impediment to reform. Returning to the Clinton-era tax rates could make high-income people more interested in tax reform. Trading narrow base, high rates, for broad base, low rates, then might become an attractive deal.

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Senate Finance Committee Hearing
"Tax Reform Options: Marginal Rates on High-Income Taxpayers, Capital Gains and Dividends"
September 14, 2011
Questions for Dr. Burman

From Chairman Max Baucus

Mr. Entin argues in his testimony that shifting the tax base from "broad-based income" to "consumed income" would boost economic growth. Furthermore, Mr. Entin claims that the income tax is designed to redistribute income at the expense of thrift and production.

- Do you agree with Mr. Entin's assessment?
- What are your views on a consumption tax?
- What are the drawbacks of a consumption-based tax system?
- Mr. Entin also references the Chinese system as a viable alternative to the income tax. Please provide your own thoughts on the advantages and disadvantages of the Chinese tax system.

The advantage of a consumption-based tax is that it removes the current tax system's bias against savings. The disadvantage is that it tends to be very regressive since low-income people consume all of their income while high-income people consume only a fraction. Thus, a consumption tax exempts 2/3 or more of the incomes of those with very high incomes from tax. It is likely that shifting from an income tax toward a tax based on consumption would produce a modest boost to the economy over the long run by encouraging saving. The effects would be very small, however, because capital is supplied in an interconnected global market and the savings of Americans only represent a small part of the total. The biggest gain would come because shifting from an income tax to a consumption tax produces a big tax increase on existing wealth. For example, old people who consume much more than they spend would face much higher taxes. Economists think such a retroactive tax increase is efficient because it is pretty much unavoidable. However, those affected by the transition may view it as unfair.

It has never occurred to me to look at the Chinese tax system as a model for the US. Yes, China has grown very fast, but that is much more likely to be the result of massive investment—much of it government led—and the fact that China started from such a low base. China has slowly privatized its economy from a socialist model, which I suspect Mr. Entin would agree should have a positive effect of economic performance. It has slowly relaxed regulatory restraints and built infrastructure. The Chinese government has run enormous budget surpluses and Chinese citizens save a large fraction of their incomes. China has used those surpluses to keep its currency artificially weak and boost exports, which expands the economy, but doesn't do that much to improve the living standards of most Chinese. All of these factors have contributed to the boost in productivity. If tax policy has played a role, it has to be a relatively modest one compared with all of the other enormous changes that have occurred in China over the past few decades.

You have written in support of a VAT that is dedicated to paying for the federal government's healthcare obligations, much like the payroll tax is currently earmarked to pay for Social Security and Medicare. A lot of members are worried that a VAT would fuel an explosive growth in government, as has occurred in Europe.

- Why do you believe that your earmarked VAT wouldn't just become a money machine leading to bloated government?
- Isn't a VAT regressive?

If a VAT were earmarked to pay for healthcare, it would have several advantages. First, it would address the concern of some of your colleagues that many Americans don't feel they have skin in the game of government. If health care, the largest and fastest growing component of government, continued to grow faster than the economy, the VAT rate would have to rise. This would build support for sensible measures to restrain health care costs. Under the present system, most Americans feel like someone else is paying for their health care—employers or the government—and thus resist efforts at slowing health spending. The Health-VAT would serve as a very visible price tag for government-sponsored health care costs, and one that everyone would have to pay. For that reason, I think it would actually restrain the growth of government rather than fuel it. Moreover, it would allow substantial income tax cuts in a fiscally responsible way.

It is true that a VAT is regressive, but a VAT that paid for health care would be less so since the benefits provided tend to be very progressive. Moreover, the regressivity can be mitigated by building tax credits into the income tax to offset the average cost of the VAT for low-income families. This might sound like a liberal proposal, but this is basically what proponents of the FairTax (national retail sales tax) have proposed. Michael Graetz has also proposed refundable credits to offset the regressivity of his VAT proposal.

<u>From Ranking Member Orrin Hatch</u>

Capital Gains Tax Rates as Preferential Rates and a Tax Expenditure

Your testimony states that "the biggest loophole is the lower tax rate on capital gains," but the Joint Committee on Taxation (JCT) and the Office of Management and Budget (OMB) seem to disagree. Exclusion of employer contributions for health care and the deduction for mortgage interest, to name two so-called "tax expenditures" or what you might call "loopholes," are far bigger than tax expenditures associated with capital gains. And, of course, what constitutes a tax expenditure depends on what the so-called "normal" tax system might be against which we measure effects of the existing tax system. Why do you say that tax rates on capital gains represent the biggest loophole in the tax system, in apparent disagreement with measures provided by JCT and OMB?

I don't believe that loopholes and tax expenditures are the same thing. Tax expenditures are subsidy programs run through the tax code. In general, when people take advantage of those subsidies—for

example, by getting health insurance at work or taking out a mortgage—that is what Congress intended. I call the lower tax rate on capital gains a loophole because it is the lynchpin of almost every individual income tax shelter. The main purpose of the shelters is not to start a new enterprise or invest capital in some worthwhile activity, but to generate deductions to shelter current income from tax and to ultimately have any income taxed at much lower rates than ordinary income. Most individual income tax shelters are basically convoluted ways to convert ordinary income, such as earnings from employment, into capital gains. For a top-bracket taxpayer, this saves 20 cents on the dollar of such transmogrified income. For that reason, high-income taxpayers are willing to pay large amounts to use such schemes. This is extremely inefficient and not what I believe Congress intended (as evidenced by periodic legislation aimed at closing particular tax shelter schemes).

Tax Rates and the Economy

Your testimony identifies that economic growth was robust during the 1990s and that the economy did not collapse in 1993 when tax rates were increased. You also say that "notwithstanding forecasts that the Bush tax cuts would turbocharge the economy, growth was anemic throughout the last decade." And you take that as a suggestion that other factors are more important than tax levels. That may be true, but even though you hedge somewhat, your argument invites confusion between correlation and causality. Growth in the 1990s surely was not caused simply by higher tax rates. Those who recall the Clinton economy with fondness often seem to fail not to recall that federal outlays were brought down significantly from over 22% of GDP in 1992 to 18.2% of GDP by fiscal year 2001. Perhaps curtailing federal expenditures was more important for growth than the tax hikes. And, since the much-heralded economy of the 1990s, which ended with a bursting of the technology stock bubble, certainly the emergence of China and India, and the resulting massive labor infusion into global trade, had at least something to do with growth in the U.S. since 2001. Professor Burman, do you believe that higher taxes on capital and labor income would not have important effects on economic growth and do you believe that higher taxes would be safe given the current state of the economy?

I certainly do not believe that raising tax rates in 1990 and 1993 , by themselves, boosted the economy, although they probably had an indirect positive effect by helping to reduce the budget deficit (as did the spending cuts, as you note). The best way to raise taxes would be to eliminate tax expenditures and close loopholes—that is, broaden the base—rather than raise tax rates. However, our current taxes are near historic lows. Modest increases in tax rates would not substantially affect economic growth.

As for the current economic situation, tax increases might entail a risk to the extent that they deter spending or investment. I judge tax increases on high-income people as entailing less risk because the rich spend only a fraction of their incomes (and the primary impediment to hiring and investment right now is lack of demand, not inadequate after-tax profits). In particular, if such tax increases made possible increases in spending along the lines the president has recommended or subsidies targeted at lower-income people who are most likely to spend, they could produce a net boost to the economy in the short run.

Income Inequality

Your testimony alludes to increased inequality in America and provides some supporting evidence. Recent research by Northwestern University economist Robert Gordon concludes that "The rise of American inequality has been exaggerated in magnitude, and its impact is now largely in the past. Standard commentary laments the slow growth of median real household income and concludes that over the past three decades the gap between growth of income and productivity has been 1.46 percent per year. But this 'conventional' gap measure is riddled with measurement and conceptual inconsistencies." "Not only has the increase of inequality been exaggerated, but it has ceased." What is your assessment of Professor Gordon's analysis and conclusions?

I have not read Professor Gordon's paper. Numerous indicators—not just median income—point to rising inequality of both income and wealth. Economists Thomas Picketty and Emmanuel Saez have measured the share of income going to the top 1% since 1919. They find that the share had risen to 18% by 2007, the highest level since the eve of the Great Depression. I hope Professor Gordon is right that this trend has ceased, but even if the gap didn't continue to widen, it is an extremely wide disparity.

Taxes and Economic Activity

Your testimony includes the following:

- Most economic evidence suggests that taxpayers' real responses to the individual income tax are small;
- Empirically, the total response [of both work and saving to taxation] appears to be very small or even zero on average;
- And, overall, evidence suggests that labor supply of what you call the "super-rich" is insensitive to tax rates.

These statements appear, at best, to be selective assessments of evidence on responses of economic activity, including labor supply and capital formation, to tax changes. There is a large empirical and theoretical economics literature that concludes that a capital income tax rate of zero, or close to it, leads to the best macroeconomic outcomes. Many of those studies do not analyze normative distributional issues, though some do. Plenty of macroeconomic studies show that higher taxes on labor and capital serve as a drag on economic growth. Nobel prize winning macroeconomist Robert Lucas has written that the gains in economic growth from eliminating taxes on capital amounts to what he says is "the closest thing to a free lunch" that he has seen in his research career. Nobel Prize winning macroeconomist Edward Prescott concluded from his research that sluggish growth and high unemployment in many European economies relative to the U.S. in the post-World War II period can be accounted for mostly because of higher taxes in Europe relative to the U.S. during the period. And several states in the U.S. have found that they become subjected to a highly volatile and unstable tax base when they move toward a base that relies more heavily on upper incomes. Do you agree that there is a substantial body of economic research supporting significant adverse macroeconomic consequences of tax increases on labor and capital, or do you believe that labor and capital are largely invariant to tax rates?

My testimony reflected my reading of the evidence. The macroeconomic studies that conclude that capital should be untaxed are based on very elegant theoretical models that are largely divorced from evidence about how actual people make decisions. In those models, people live forever (or behave as if they do) and the power of compounding swamps any other effects. Even a small tax on capital has enormous cost over a sufficiently long time horizon. In the real world, people are short-sighted and behave in many ways that deviate from the theoretical models. I find these models valuable in helping us to understand the implications of various theoretical constructs, but not particularly useful as a guide to policy.

The other source of evidence you mention is cross-country comparisons trying to tie economic performance to some aggregate measure of tax burden. While it is certainly possible that taxes help explain differences in economic performance among countries, so many other things change at the same time that it is very difficult to identify the effect of a single policy instrument. For example, the regulatory environment, the role of the state, and even the integration of Europe clearly also played a role over the same interval. And there has been enormous variation in economic performance. Denmark, for example, has one of the highest tax burdens in world, and also has per capita income virtually identical to ours (with much less income disparity).

Upper Income Tax Rates

Your testimony refers to recent writings of economists Peter Diamond and Emanuel Saez, who have identified that the current top marginal income tax rate on earnings is about 42.5%, when you combine the top 35% federal rate with the Medicare tax and average state taxes. Those economists offer an economic analysis of tax progressivity using a static model with no capital to try to make a case that the top federal income tax rate could be as high as 76%, a number that you cite in your testimony, without doing harm to economic activity. Are you comfortable with advocating federal tax increases that could set some tax rates as high as 76%?

No.

Taxes and Economic Performance: Europe vs. the U.S.

Nobel Prize winning economist Edward Prescott studied differences in economic performances of European countries and the U.S. in the post-World War II period. He identified in 2004 that "Americans now work 50 percent more than do the Germans, French, and Italians. This was not the case in the early 1970s, when the Western Europeans worked more than Americans." These are large differences in labor supply across major industrial countries. According to Prescott's empirical analysis, labor supply fell significantly in European countries in the post war period relative to the U.S. and the major explanation came from increased taxes on income in Europe relative to the U.S. over the period. Do you believe that Professor Prescott's results should make us cautious about crushing labor supply in the U.S. by raising taxes in efforts to change the income distribution, especially as we now see how Europe has fared with its high-tax, high-spending, and high-debt model of government?

I'm unconvinced by Professor Prescott's research for the reasons I outlined above. I suspect institutional factors are much more important than taxes. While I believe that very high tax rates can certainly entail an economic cost, I don't think tax rates within the recent historical range would pose a threat to growth.

Over to 50% Pay No Income Taxes

You argue that upper income earners should be vested in worrying about income distribution issues because, at least, if the distribution gets too distorted and skewed, there could be social unrest that no one would want. When it comes to the income tax system, you seem to have an asymmetric view. Indeed, you decry and almost make fun of concerns about an income system moving to where 51% of earners do not pay any federal *income* taxes. Yet as the distribution of federal net income tax payers gets increasingly skewed, there could be concerns by some about too large a fraction of earners having no skin in the game that would have an incentive to favor higher federal taxes for others while capturing social benefits, if any, of the spending resulting from those taxes. Why are you concerned with the former skewness, but not the latter?

I believe that the income tax plays an important role in rewarding work for those with low incomes, but I also share your concern about the perception that government is free. As I mention in my testimony, one approach to dealing with that would be to separate the wage support (and other subsidy programs) in the tax code from the parts involved in actually raising revenue. I think it would be a good idea for the IRS to report to taxpayers what they owe in income tax—before tax expenditures—and also what they get back in subsidies. This would clarify that most workers actually do pay income tax before credits, deductions, and exemptions.

Of course, for taxpayers to have a sense that they have skin in the game, Congress would have to decide that there was a connection between tax payments and government spending, something they have been unwilling to do for the past decade. Congress has repeatedly voted for more spending and lower taxes. It would be reasonable for everyone, not just the lowest-income taxpayers, to think that new government spending won't cost them anything.

Taxation of "Carried Interest"

You argue for a change in the tax treatment of so-called "carried interest" for hedge fund managers and private equity investors. Of course, income accruing as carried interest applies not just to hedge funds, but also to venture-capital funds and others. Do you advocate elimination of treating "carried interest" earnings as capital income for all those who have such earnings?

Yes.

Higher Taxes on Capital Will Reduce Economic Growth

Nobel Prize winning macroeconomist Robert Lucas has said that eliminating taxes on capital amounts to "the closest thing to a free lunch" he has seen in his distinguished research career. Do you agree, and do you think that ever higher taxes on capital income can end up hurting workers, who in the long-run will bear the burden of lower living standards stemming from lesser capital accumulation, and not simply the so-called "rich?"

No. While it's possible in theory that capital taxes can ultimately fall on labor, I don't see evidence of that. Lucas's inferences are based on theoretical computable general equilibrium models that rely on implausible assumptions. (See my answer to *Taxes and Economic Activity* above.)

<u>From Senator Robert Menendez</u>

James Baker, former Secretary of the Treasury under Reagan recently commented on the issue of some working families not having a final income tax liability, saying he doesn't believe "the fate of the Republic" rests on asking lower income people to pay more in tax. Yet we hear so many today who focus on these working families as the problem in tax reform who need to pay more taxes. These same voices seem to have no problem however when the average tax rate for the richest 400 families is less than 20 percent.

Which do you believe is more important to the sense of fairness in taxation, raising taxes on a full-time minimum wage worker supporting a family on less than $15,000 or the fact that the average New Jersey family pays a higher tax rate than the richest Americans earning an average of $270 million?

My personal preference, which is consistent with the views of most Americans according to polls, is that higher income people should bear a larger share of the tax burden. As for the low-income family that benefits from the refundable earned income tax credit and the child tax credit, I think it is appropriate for the tax code to subsidize the earnings of those with limited ability to earn income. The fact is that, while the capitalist system is an amazing income generator, there is no guarantee that those incomes are fairly distributed. Millions of Americans work full time and earn an income below the poverty threshold. The refundable tax credits encourage them to keep working and help them to live with dignity. In my view, that is good thing.

Distributional Issue in Tax Reform

I found the conclusion to your written testimony particularly interesting. You write, "returning to the Clinton-era tax rates could make high-income people more interested in tax reform." One of the central questions to putting together any tax reform proposal is the distribution of the tax burden amongst the income groups. The '86 tax reform act was roughly distributionally neutral, that is middle class and wealthy taxpayers paid about the same amount of taxes after reform as they did before. But things have changed since then, the wealthiest taxpayers have seen their tax burdens decrease while their incomes have skyrocketed at the same time the middle class is going on a decade without a raise in pay.

Looking at how out of control income disparity has gotten, what are your thoughts on how tax reform proposals should handle the distributional issue.

The income tax plays an important role in mitigating income inequality. It's not the only or necessarily the best tool to accomplish that. Expanding access to education and job training is also extremely important. But the income tax can reduce inequality. Under a progressive income, the distribution of after-tax incomes will be less disparate than the distribution of before-tax incomes. Given the extreme rise in economic inequality over the past few decades, there is certainly an argument for more progressivity. At a minimum, in my view, tax reform proposals should not make the tax system less progressive.

<u>From Senator Chuck Grassley</u>

You state in your testimony that the biggest loophole in the tax code is the lower rate on the capital gains. For more than ten years, while I was Chairman and then Ranking Member of the Finance Committee, Senator Baucus and I worked closely with other members of this Committee and the Senate, and the Ways & Means Committee, ***<u>on a bipartisan basis</u>***, to shut down loopholes. The 2004 Jobs bill included a sweeping package to end tax avoidance abuses. Examples of these abuses included:

- Corporations claiming tax deductions for taxpayer-funded infrastructure such as subways, sewers, and bridge leases;
- Corporate and individual expatriation to escape taxes;
- Corporate inversions;
- And, individuals taking inflated charitable deductions for donations of used cars.

There is no doubt that these abuses were loopholes. They involved taxpayers exploiting the tax code to achieve results that Congress did not intend. They are very different from a policy adopted on a bipartisan basis by Congress to encourage investment and entrepreneurship.

You acknowledges in your testimony that tax shelters and avoidance activities are more common when tax rates are high. Well, history also shows that tax increases don't increase revenues.

We've had a 93-percent marginal tax rate -- then 70 percent, 50 percent, 30 percent, 40 percent and now a 35-percent marginal tax rate. But, regardless of the rate, we get the same amount of revenue.

During all of these tax increases and decreases, the amount of revenue as a percentage of gross domestic product stayed the same – about 18%.

Let's agree to disagree that a lower capital gains rate is a loophole, please provide responses to the following.

- What loopholes that are like the ones we shut down in the 2004 Jobs bill currently exist in the tax code? That is, what tax code provisions result in **unintended consequences** that we should shut down?
- Also, new tax shelters are likely to be created if marginal rates are increased. So, in addition to the disclosure and penalty tools we already provided to the IRS, I would like to know what, if any, other tools we should consider.

I am not a tax lawyer or accountant so don't know about the intricacies of tax shelters. I know that every tax lawyer I've spoken with has said that the lower tax rate on capital gains is the lynchpin of individual income tax shelters. The game basically amounts to converting ordinary income at tax rates of 35% to capital gains taxed at 15%. And taxing capital gains at the same rate as other income—ideally as part of a reform that broadened the tax base and cut marginal tax rates—would be far more effective at stemming tax avoidance than anything else I can think of.

In terms of stemming tax shelters, probably the best thing you could do for the IRS would be give it funds for more auditors and litigators and raise penalties so the pay-off from engaging in questionable tax shelters would decline. Increased information reporting would likely also help, although you need to compare costs and benefits (costly reporting that is likely to yield little in additional revenues probably is not worth doing).

I'd also like to respond to your comment that tax revenues seem to hover around 18% of GDP regardless of the rate, I know that the Wall Street Journal opinion page finds this really meaningful, but I don't. Tax revenues are a function of rates and the base. When revenues surge, Congress faces enormous pressure to give money back to the taxpayers. (That was George W. Bush's mantra.) When revenues fall short, there is pressure to find new sources of revenue, which often includes expanding the tax base. There's no doubt that revenues could rise substantially from their current levels if policy makers so desired. For example, you could introduce a VAT, which is used in virtually every other country in the world. Or you could repeal major tax expenditures or increase income tax rates. All of those would increase revenues.

Testimony of

Stephen J. Entin
President and Executive Director
Institute for Research on the Economics of Taxation

before the

Senate Committee on Finance
hearing on
Tax Reform Options: Marginal Rates on
High-Income Taxpayers,Capital Gains, and Dividends

September 14, 2011

Chairman Baucus, Senator Hatch, and Members of the Committee, my name is Stephen J. Entin. I am President of the Institute for Research on the Economics of Taxation. Thank you for the opportunity to testify today on the subject of marginal tax rates on upper income individuals, the tax treatment of capital gains and dividends, and their relationship to tax reform.

I hope to address two issues in the hearing title. First, what would raising tax rates on the upper income taxpayers' ordinary income, capital gains, and dividends do to the economy and the budget? Second, what is genuine tax reform, and does it include such policies? My conclusions, briefly, are:

- Higher marginal tax rates on any group, especially those already paying the highest rates, would reduce GDP and income across the board, not just for the people paying the initial tax bill. The burden of higher taxes on capital formation falls largely on labor in the form of lower wages and hours worked.[1]

- Increasing the double taxation of corporate income by raising tax rates on capital gains and dividends would dramatically reduce capital formation and wages, and would not raise the expected revenue.

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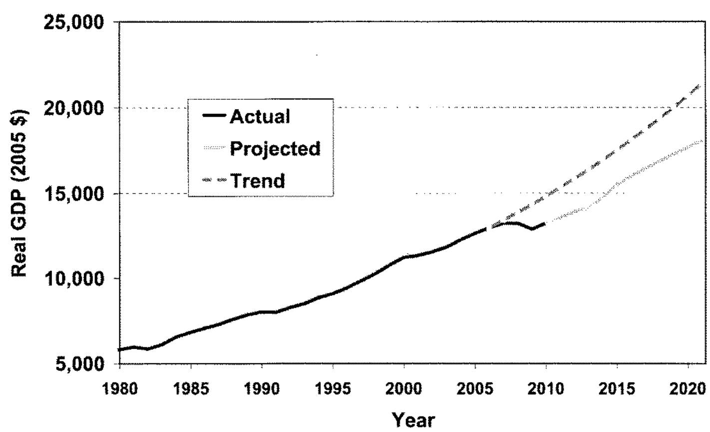
- Neither tax change has any place in a real tax reform. We should not repeat the Tax Reform Act of 1986, which tried to perfect the "broad-based income tax"; rather, we should adopt a different tax base that is more neutral in its treatment of saving and investment relative to consumption.

Please note that it is important that any tax reform promote economic growth, because lack of growth is the source of lower incomes, higher unemployment, and much of the current deficit. Chart 1 projects the GDP as if it had continued beyond 2006 at the trend rate of real growth since 1950. We are now some 12 percent below that level, due to the recession and the financial industry debacle. CBO does not envision a recovery to that trend line in its forecast under current policy. That is a shame, because the lower levels of GDP mean lower levels of income and employment for all. CBO assumes reductions in unemployment largely by assuming workers become discouraged and leave the labor force. There is more at stake than the federal budget. As for the budget, the growth shortfall is responsible for about 40 percent of the deficit. The jump in spending as a share of GDP since the recession adds about 13 percent more. With those two issues resolved, the deficit would be a more manageable 4 percent of GDP instead of nearer 8.5 percent.

Chart 1 Projected Real Gross Domestic Product (Real GDP) Falls — And Stays — Below Its Trend



Data: Congressional Budget Office for Actual and Projected Real GDP. Trend Line computed by author based on Real GDP growth over period 1950-2006.

It is tempting to tax the rich because they have only a few votes and "they can afford it." It is also important to note that the top income earners already pay a very high proportion of the income tax. The top 0.1% of taxpayers had 11.93% of adjusted gross income (AGI) in 2007 (before the stock market crash) and paid 20.19% of the income tax. The top 2% of taxpayers had 27.95% of AGI and paid 48.68% of the income tax. The bottom 50% of tax filers had 12.26% of AGI and paid 2.89% of the income tax. Half of tax filers now owe no income tax or receive a refundable credit. Many individuals do not have to file because of low income or types of income not subject to tax. But the real concern about the tax system is not who sends the checks to the Treasury but what is being taxed and how that affects growth, employment, wages, and income from saving.

Simulating tax increases on the upper income taxpayers.

Under current law, the two top tax rates of 33% and 35% will revert to 36% and 39.6% in 2013. The top 15% tax rate on capital gains will revert to 20%. The top tax rate on dividends, now linked to the capital gains rate, will revert to ordinary income tax rates. The health reform act will impose a 3.8% tax on capital income on upper income individuals, effectively extending a Medicare-related payroll tax to capital income for the first time. The two top brackets begin fairly close to the often-mentioned thresholds of $250,000 for joint filers and $200,000 for single filers who are to be subjected to higher taxes as a deficit reduction measure. The President has recommended extending the 2001 and 2003 tax cuts for lower income brackets. It seems likely that the link between the dividend and capital gains rates may also be extended.

I have run five potential variations of the pending tax increases on upper income taxpayers through a simple model of the economy and a tax calculator geared to 2008 income levels.[2] The results are displayed in Tables 1 and 2. The model is driven by the effect of the tax changes on the marginal tax rates on labor income, and on the effect of the tax rate changes on the service price of capital (the threshold rate of return an investment in equipment or buildings or other capital must earn to cover its cost, pay its taxes, and yield a normal after-tax return of a bit under 3% for the investor.) Tax increases that raise the service price reduce the capital stock, lower productivity and the demand for labor, and reduce wages and employment. Capital is especially sensitive to tax rate increases, more so than the supply of labor. People may respond to a drop in the after-tax return on capital in the United States by saving less, such that the capital that cannot meet the higher required pre-tax return is not formed, or it may be formed abroad instead of in the United States.

• Case 1: Raise the top tax rates on ordinary income to 36% and 39.6%. Leave the top tax rates on capital gains and dividends at 15%.

This tax increase on wages, interest, and non-corporate business income would knock half a percent off private sector output and labor income across the board (not just in the upper tax brackets), and cut a percent off the capital stock. The service price rises primarily for non-corporate businesses. (See Table 1). The reduced income and economic activity would reduce federal revenue from all types of taxes by about 40% of the expected static revenue gain. The loss of GDP and the tax payment to the government would cost the public $4 for each $1 collected in tax. A dollar of government spending funded in this manner must be worth a great deal more than its apparent budget cost of $1 to justify the outlay. The marginal tax rate increase on non-corporate business income is particularly high. (See Table 2.)

• Case 2: Leave the top tax rates on ordinary income at 33% and 35%. Raise the top tax rates on capital gains and dividends to 20%.

TABLE 1
EFFECT OF RAISING TWO TOP TAX RATES ON GDP, CAPITAL STOCK, LABOR INCOME, SERVICE PRICE, AND FEDERAL REVENUE
(Effects and revenue estimates are modeled at 2008 income levels.)

Tax options for two top brackets	1*	2*	3*	4*	5*
GDP	-0.47%	-1.19%	-1.63%	-6.09%	-2.10%
Private sector GDP	-0.50%	-1.23%	-1.71%	-6.33%	-2.18%
Capital stock	-1.05%	-3.24%	-4.20%	-15.68%	-5.68%
Wages	-0.26%	-1.01%	-1.25%	-5.04%	-1.79%
Hours worked	-0.25%	-0.22%	-0.47%	-1.36%	-0.40%
Service price					
Corporate	-0.02%	3.00%	2.95%	15.12%	5.36%
Non-corporate	1.90%	-0.09%	1.79%	1.54%	-0.16%
Total	0.55%	2.08%	2.60%	11.09%	3.72%
Static revenue ($ billions)	$37.7	$38.0	$75.9	$100.1	$66.3
Dynamic revenue ($ billions)	$22.5	$0.4	$22.8	-$98.7	-$1.1
% revenue loss to economic change	-40.2%	-98.9%	-69.9%	-198.6%	-101.6%
GDP loss per $ of revenue gain	$3.01	$418.66	$10.33	N/A**	N/A**
Cost of $1 of govt. spending	$4.01	$419.66	$11.33	$880.67	304.05

* Tax options:
1: Raise top tax rates on ordinary income to 36% and 39.6%.
Leave top tax rates on capital gains and dividends at 15%.
2: Leave top tax rates on ordinary income at 33% and 35%.
Raise top tax rates on capital gains and dividends to 20%.
3: Raise top tax rates on ordinary income to 36% and 39.6%.
Raise top tax rates on capital gains and dividends to 20%.
4: Raise top tax rates on ordinary income to 36% and 39.6%.
Raise top rates on capital gains to 20%; tax dividends as ordinary income.
5: Leave top tax rates on ordinary income at 33% and 35%.
Raise top tax rates on capital gains and dividends to 23.8%.

** Tax rate increase depresses GDP to the point of losing revenue.

TABLE 2
EFFECT OF INCREASES IN TOP TWO TAX RATES ON MARGINAL TAX RATES BY TYPES OF INCOME (2011 tax rates at 2008 income levels)

Case 1*				
Federal Marginal Tax Rates on:	2011 rate	Alternative	Point Incr.	% Increase
AGI	22.76%	23.43%	0.66%	2.92%
Wages	21.71%	22.10%	0.39%	1.78%
Dividends	12.28%	12.28%	-0.01%	-0.05%
Interest Income	23.41%	24.42%	1.01%	4.31%
Business Income	27.44%	29.41%	1.97%	7.17%
Long-term Capital Gains	13.48%	13.46%	-0.02%	-0.16%
Case 2*				
Federal Marginal Tax Rates on:	2011 rate	Alternative	Point Incr.	% Increase
AGI	22.76%	22.64%	-0.12%	-0.51%
Wages	21.71%	21.56%	-0.16%	-0.72%
Dividends	12.28%	14.90%	2.61%	21.28%
Interest Income	23.41%	23.40%	-0.01%	-0.04%
Business Income	27.44%	27.37%	-0.08%	-0.28%
Long-term Capital Gains	13.48%	16.72%	3.23%	23.98%
Case 3*				
Federal Marginal Tax Rates on:	2011 rate	Alternative	Point Incr.	% Increase
AGI	22.76%	23.30%	0.54%	2.37%
Wages	21.71%	21.96%	0.24%	1.12%
Dividends	12.28%	14.87%	2.58%	21.02%
Interest Income	23.41%	24.38%	0.97%	4.14%
Business Income	27.44%	29.32%	1.88%	6.84%
Long-term Capital Gains	13.48%	16.66%	3.17%	23.54%
Case 4*				
Federal Marginal Tax Rates on:	2011 rate	Alternative	Point Incr.	% Increase
AGI	22.76%	23.10%	0.34%	1.50%
Wages	21.71%	21.46%	-0.26%	-1.18%
Dividends	12.28%	27.06%	14.78%	120.29%
Interest Income	23.41%	25.01%	1.60%	6.83%
Business Income	27.44%	29.14%	1.69%	6.17%
Long-term Capital Gains	13.48%	16.73%	3.25%	24.09%

* Tax options:
1: Raise top tax rates on ordinary income to 36% and 39.6%.
Leave top tax rates on capital gains and dividends at 15%.
2: Leave top tax rates on ordinary income at 33% and 35%.
Raise top tax rates on capital gains and dividends to 20%.
3: Raise top tax rates on ordinary income to 36% and 39.6%.
Raise top tax rates on capital gains and dividends to 20%.
4: Raise top tax rates on ordinary income to 36% and 39.6%.
Raise top rates on capital gains to 20%; tax dividends as ordinary income.

This is a tax increase that falls very hard on capital, and on the sector where the tax is doubled up at the business and shareholder level. It is particularly hard on growth and employment. The tax increase on capital gains and dividends would lower private sector output by 1.23%, and trim labor income across the board (not just in the upper tax brackets) by the same amount. It would reduce the capital stock by 3.24%, mainly by increasing the service price in the corporate sector. (See Table 1). The reduced income and economic activity would reduce federal revenue from all types of taxes by almost 99% of the expected static revenue gain; that is, it would raise virtually no revenue while costing income and jobs. The loss of GDP and the tax payment to the government would cost the public $420 for each $1 collected in tax. Nothing the government buys is worth that much. The marginal tax rate increase on dividends and capital gains is very large. (See Table 2.)

• Case 3: Raise the top tax rates on ordinary income to 36% and 39.6%. Raise the top tax rates on capital gains and dividends to 20%.

Combining the first two cases makes the GDP and job destruction worse. Output and income are down 1.7% in the private sector. About 70% of the expected revenue is lost. A dollar of government spending costs the country about $11 in lost income and tax payments.

• Case 4: Raise the top tax rates on ordinary income to 36% and 39.6%. Raise the top rates on capital gains to 20%; tax dividends as ordinary income.

Allowing the tax rate on dividends to revert to ordinary income tax rates raises their marginal tax rate by 120%. (See Table 2.) It greatly increases the service price and the damage to the economy compared to keeping the dividend tax in line with the tax rate on capital gains at 20% as other rates rise (Case 3). The drop in GDP and labor income would be about 6%. The capital stock would fall more than 15%. This economic damage would offset nearly 200% of the expected static revenue; that is, revenue would fall instead of rise, and by a large amount.

• Case 5: Leave the top tax rates on ordinary income at 33% and 35%. Raise the top tax rates on capital gains and dividends to 23.8%, including the health reform tax on capital gains and dividends. (The tax increase on interest income from the health reform tax was not modeled.)

This case goes beyond the increase in the capital gains and dividends tax rate in case 2 by adding the 3.8% tax imposed by the health care reform act. It would further reduce GDP and labor income by about 0.9% compared to case 2. The added economic damage would fully eliminate the projected revenue gain from the two capital tax increases.

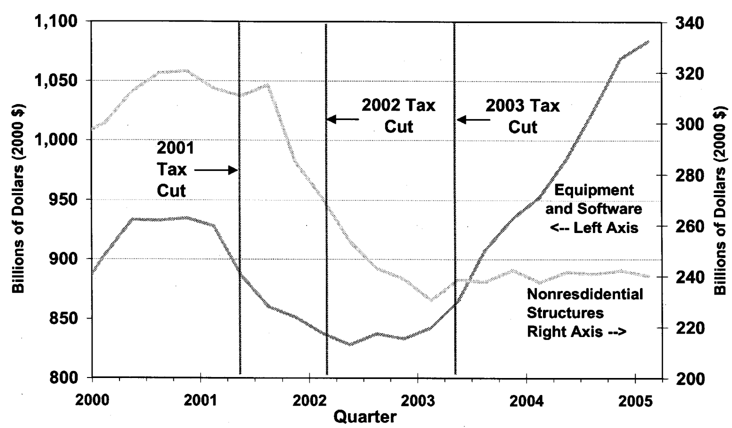
Other tax increases on upper-income earners are possible. One could add another tax bracket beginning at higher incomes than where the current top rate begins, perhaps a million dollars for a true "millionaire's surtax" or some lower figure. That would require a decision as to whether that number should be $1 million for single filers and $2 million for couples, or the same for both, continuing the marriage penalty that still exists in the upper brackets. In any case, narrowing the income range subject to higher tax rates would require raising the tax rate even more to make up for the reduced amount of income subject to the higher tax. That would make the economic damage more intense, destroy more jobs, lower wages further, and cause even more of the expected static revenue gains to be lost.

Response of the economy to changes in the service price.

Tax changes that lower the service price of capital have a major impact on investment, employment, and output. Taxes that have little or no effect on investment incentives do far less. Marginal tax rates on labor and other income matter as well, but are less powerful due to the relatively low labor supply elasticity. Taxes that are not at the margin, or not much at the margin, such as the 1975 Ford tax rebate, the 2001 rebate-like refund reflecting the 10% tax bracket, and the more recent stimulus rebates, make little difference to production and employment.

Chart 2 tracks the effect of the 2001 and 2003 tax cuts on investment. There was a very slow "jobless recovery" from the 2000-2001 recession in the first two years after the 2001 tax reduction. The marginal rate cuts were phased in so slowly that there was little initial incentive effect. It was not until the 2003 tax cut that there were significant incentives for saving and investment. In that year, the capital gains and dividend tax rates were reduced to 15%; expensing, introduced in 2002 at 30% of equipment spending, was boosted to 50% of equipment outlays; and the rest of the marginal tax rate cuts were brought forward. Estate tax relief helped too. After 2003, investment in equipment rose rapidly, and job growth accelerated.

Chart 2 Real Private Investment And 2001, 2002, and 2003 Tax Cuts



Data Source: BEA, National Income and Product Accounts, Table 5.3.6, accessed via www.bea.gov.

Response of capital gains realizations to higher tax rates.

The revenue estimates tied to changes in the capital gains or dividend tax rates described above are based on the effect of the tax changes on economic performance. The following table and chart deals with a different issue: how do changes in the capital gains tax affect the rate at which people choose to take gains. It offers additional support to the warning that raising these tax rates may lose revenue rather than gain revenue.

The table is from the Department of the Treasury, Office of Tax Analysis. It displays the amount of capital gains realized and the tax paid in dollars, the average effective tax rate, realized gains as a percent of GDP, and the maximum tax rate on long-term gains from 1954 to 2007. The numbers cover all types of capital gains, including those on real estate, corporate stock, non-corporate businesses, bonds, and other assets. The maximum rate includes adjustments for exclusions, surcharges, the minimum tax and alternative minimum tax, and the phase-out of itemized deductions as income rises. These are features of the tax code that have been in place at various times.

There have been four major reductions and two major increases in the capital gains tax rate since 1978. The Steiger Amendment lowered the top tax rate most commonly found on long term capital gains in mid-1978, from just under 40% to 28%. It eliminated capital gains as a preference item under the minimum tax and created a 60% exclusion of long term gains from taxable income. Realizations were 2.20% of GDP in 1978, and rose by about a fourth to between 2.58% and 2.86% of GDP in 1979-1981. The Economic Recovery Tax Act of 1981 reduced the top rate to 20% in the spring of that year. Realizations were 2.77% of GDP in 1982, rising to 3.47% in 1983 and 4.08% in 1985.

The longest and most interesting change occurred following the Tax Reform Act of 1986, which raised the top capital gains tax rate from 20% back to 28%. The rate hike was effective January 1, 1987. To beat the 1987 rate hike, asset holders realized a large amount of capital gains in the last months of 1986. Realizations surged from 4.08% of GDP in 1985 to 7.36% in 1986. There was a subsequent drop in realizations in 1987, to 3.13% of GDP.

This two-year rise and fall could have been due to a simple timing shift, moving gains from 1987 to 1986. However, gains remained depressed as a share of GDP for a decade. Realizations continued falling to 1.86% of GDP in 1991 (a recession year), and struggled back only to 3.34% of GDP in 1996, still below the 1985 share. Gains did not recover their 1985 share of GDP until 1997, when the capital gains tax rate was again reduced to 20% by the Taxpayer Relief Act of 1997, effective as of May 8th of that year. This episode of a decade-long depression in realizations and tax revenue simply cannot be dismissed as either short-term timing or a fluke.

Following the 1997 rate cut to 20%, realizations remained elevated until the dot-com stock market crash and economic recession in 2001. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the top rate from 20% to 15%. Realizations rose from 2.95% of GDP to 4.27% in 2004 and to 6.56% in 2007. In each of these years, government revenue estimators under-estimated the rise in the gains and the duration of the increase, and had to revise their projected gains and revenues up in each new year's budget work. Gains have undoubtedly swung widely since the latest recession and stock market crash in 2008.

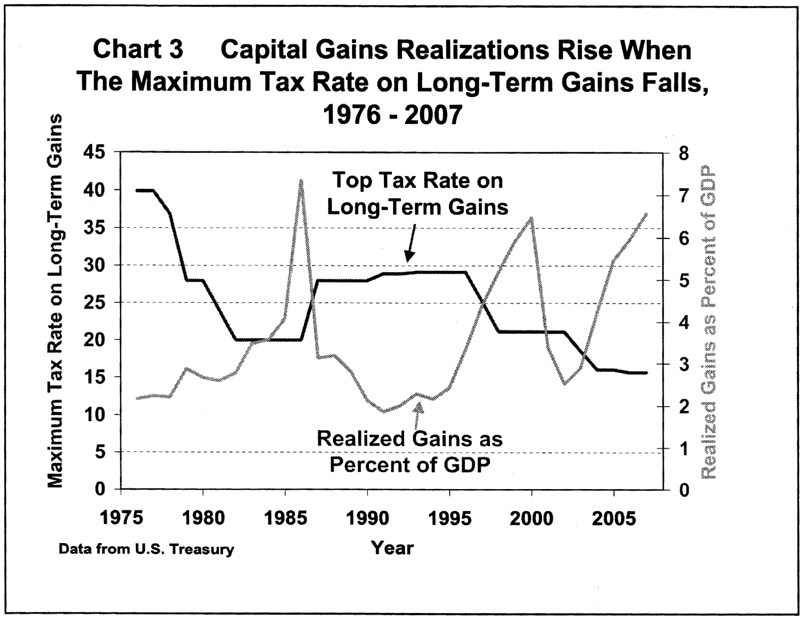
Capital Gains and Taxes Paid on Capital Gains for Returns with Positive Net Capital Gains, 1954-2005 (dollar amounts in millions)

Year	Total Realized Capital Gains	Taxes Paid on Capital Gains	Average Effective Tax Rate (percent)	Realized Gains as a Percent of GDP	Maximum Tax Rate on Long-Term Gains
1954	7,157	1,010	14.1	1.88	25.00
1955	9,881	1,465	14.8	2.38	25.00
1956	9,683	1,402	14.5	2.21	25.00
1957	8,110	1,115	13.7	1.76	25.00
1958	9,440	1,309	13.9	2.02	25.00
1959	13,137	1,920	14.6	2.59	25.00
1960	11,747	1,687	14.4	2.23	25.00
1961	16,001	2,481	15.5	2.93	25.00
1962	13,451	1,954	14.5	2.29	25.00
1963	14,579	2,143	14.7	2.36	25.00
1964	17,431	2,482	14.2	2.62	25.00
1965	21,484	3,003	14.0	2.98	25.00
1966	21,348	2,905	13.6	2.70	25.00
1967	27,535	4,112	14.9	3.30	25.00
1968	35,607	5,943	16.7	3.91	26.90
1969	31,439	5,275	16.8	3.19	27.50
1970	20,848	3,161	15.2	2.01	32.21
1971	28,341	4,350	15.3	2.51	34.25
1972	35,869	5,708	15.9	2.89	36.50
1973	35,757	5,366	15.0	2.58	36.50
1974	30,217	4,253	14.1	2.01	36.50
1975	30,903	4,534	14.7	1.89	36.50
1976	39,492	6,621	16.8	2.17	39.875
1977	45,338	8,232	18.2	2.23	39.875
1978	50,526	9,104	18.0	2.20	39.875/33.85
1979	73,443	11,753	16.0	2.86	28.00
1980	74,132	12,459	16.8	2.65	28.00
1981	80,938	12,852	15.9	2.58	28.00/20.00
1982	90,153	12,900	14.3	2.77	20.00
1983	122,773	18,700	15.2	3.47	20.00
1984	140,500	21,453	15.3	3.57	20.00
1985	171,985	26,460	15.4	4.08	20.00
1986	327,725	52,914	16.1	7.36	20.00
1987	148,449	33,714	22.7	3.13	28.00
1988	162,592	38,866	23.9	3.18	28.00
1989	154,040	35,258	22.9	2.81	28.00
1990	123,783	27,829	22.5	2.13	28.00
1991	111,592	24,903	22.3	1.86	28.93
1992	126,692	28,983	22.9	2.00	28.93
1993	152,259	36,112	23.7	2.29	29.19
1994	152,727	36,243	23.7	2.17	29.19
1995	180,130	44,254	24.6	2.43	29.19
1996	260,696	66,396	25.5	3.34	29.19
1997	364,829	79,305	21.7	4.39	29.19/21.19
1998	455,223	89,069	19.6	5.18	21.19
1999	552,608	111,821	20.2	5.96	21.19
2000	644,285	127,297	19.8	6.56	21.19
2001	349,441	65,668	18.8	3.45	21.17
2002	268,615	49,122	18.3	2.57	21.16
2003	323,306	51,340	15.9	2.95	21.05/16.05
2004	499,154	73,213	14.7	4.27	16.05
2005	690,152	102,174	14.8	5.46	16.05
2006	798,214	117,793	14.8	5.96	15.70
2007 1/	924,164	137,042	14.8	6.56	15.70

Department of the Treasury
Office of Tax Analysis

January 14, 2010

1/ Preliminary estimate, subject to revision.



Treasury, CBO, and Joint Tax Committee revenue estimators acknowledge and try to take account of short run timing effects of tax rate changes in their capital gains revenue estimates. In all these historical cases, however, there appears to have been a longer term response to the lower rates, in addition to a short-run unlocking event after a rate cut or a timing shift in anticipation of a rate hike. This thirty year period indicates that people hold assets longer, and take fewer gains over time, at higher capital gains tax rates than they do at lower rates. This is a permanent realizations effect that government revenue estimators should take into account.

Tax reform, the tax base, and tax expenditures

Fighting the deficit while improving the economy is not a simple task. Tax reform must be done right if it is to help the situation. It is important to understand two things. First, government spending does not increase employment and output; it crowds out private sector output, usually with a decrease in value to the public, and creates dead-weight losses from the taxes imposed to fund the spending. Second, "perfecting" the income tax by "broadening the base and lowering the rate" would hurt, not help, the economy; we need a more fundamental shift to a different tax base.

The current income tax system is heavily biased against saving and investment, and is seriously depressing output and income. There are several less-biased, more growth-friendly tax alternatives, such as the cash flow tax in the Report of the President's Panel on Tax Reform — the Bush panel — or the Flat Tax, various versions of the USA Tax, or the Bradford "X" tax, or the straightforward inflow-outflow tax developed by Norman Ture (on our web site at www.iret.org). Real tax reform would move toward one of these systems.[3]

The "broad-based" income tax hits income used for saving and investment repeatedly and more harshly than income used for consumption. Pay tax on your income (tax layer one) and consume the remainder, and there are few added federal taxes (other than alcohol, tobacco, and gasoline). But save your after-tax income (outside of limited pension and IRA options), and the profit, interest, dividends, or capital gains are taxed (tax layer two). Dividends and stock-related capital gains also face the corporate tax (tax layer three). For all businesses, corporate and non-corporate, investment expenses must be deducted over many years instead of when they are made (when expensing is not in force), overstating income, and creating a back-door increase in effective tax rates. Save too much, and you become subject to the estate tax (tax layer four).

Real tax reform would end these biases and over-statements or double counting of capital income by taking a few key steps. They would fundamentally shift the tax base from "broad-based income" to "consumed income" or "cash flow".

- Step 1: Give all saving the same treatment received by pensions; either defer tax on saving and its returns until the money is withdrawn for consumption, or tax the saving up front and do not tax the earnings.

- Step 2: Adopt expensing instead of depreciation; alternatively, adjust the depreciation allowances for the time value of money (index unused portions by an appropriate discount rate) to preserve their present value.

- Step 3: Tax income in the corporate sector either at the level of the firm or at the level of the shareholder, but not both; that is, integrate the corporate and personal income taxes.

- Step 4: Eliminate the estate tax.

- Step 5: Move to a territorial tax system.

The broad-based income tax was designed by its intellectual godfathers, Professors Robert Haig and Henry Simons, to redistribute income at the expense of thrift and production, not to foster economic growth. (Although even Haig and Simons thought the corporate tax on top of the personal tax was going too far.) Simons acknowledged that his tax proposals would dampen saving and reduce GDP. We do not need more of that. Perfecting the income tax by broadening the base by double or triple taxing the same income is not the answer to our tax problems.

If one is content with superficial solutions, it is very easy to lower tax rates. Here is the new IRS Form 1040:

Line 1. Enter your income.
Line 2. Multiply line 1 by three.
Line 3. Pay tax at half the old tax rate.

Presto! The tax rate is cut in half and the revenue jumps by half! Of course, it is too good to be true. The tax rates on the actual income have gone up by half due to the mismeasurement of the tax base. The economy will shrink due to the larger tax wedge on productive activity. Revenue will fall short of the hoped for gains.

The Bowles-Simpson Deficit Reduction Commission's preferred tax plan claims to maintain progressivity, reduce tax rates, raise revenue, and promote growth by closing tax expenditures and broadening the tax base. Merely playing "close the loophole" with the tax expenditure tables of the Treasury and the Joint Tax Committee will not do the job. These tables accept the anti-saving biases in the income tax as the norm, and do not distinguish between loopholes and genuine costs of production that must be allowed as a deduction from revenue to correctly determine income. They fail to distinguish provisions that avoid double-tax situations that would otherwise destroy jobs and income from blatant subsidies of money-losing activities that reduce jobs and GDP.

Taxes would be higher under the Commission Plan than under current levels. That cannot promote growth unless the revenue raisers are restricted to those items which are wasteful and non-growth related, while incentives for additional investment and employment are enhanced, a very tall order. The Deficit Commission did not make such distinctions, nor did it ask for or receive the quantitative analysis needed to determine whether the balance of its proposals would move the economy forward or drag it down.

The Commission advocated 28% top rates for individuals and corporations. To get there, it explicitly called for taxing capital gains and dividends at the same rate as other individual income. That would increase the double taxation of income produced by labor and capital in the corporate sector. The dividend tax is on top of the corporate tax, and the capital gains tax is largely a tax on after-tax retained earnings that raise the value of the company.

With a 35% corporate tax rate and a 15% tax rate on capital gains and dividends, shareholders keep 55.25 cents on a dollar of income in the corporate sector after taxes (57.93 cents with the manufacturers' credit). With two 28% top tax rates, shareholders would keep only 51.84 cents, a 6% (or 10.6%) drop in the rate of return. The tax rate at either the corporate level or the shareholder level would have to be much lower than in the Commission proposal for shareholders to break even (very low 20s, less for manufacturing). Otherwise, the tax hurdle for corporate capital would be raised. According to a macroeconomic analysis by IRET, the resulting reduction in capital formation would slash GDP by almost 3%, and the capital stock by $2.5 trillion, relative to levels they would otherwise reach. The dynamic damage would cancel out $70 billion of the $80 billion the Bowles-Simpson panel wanted to raise.

The Deficit Commission seems to have modelled its system on the Tax Reform Act of 1986 (TRA86), the last time we treated cap gains as ordinary income. But this is not 1986. The starting point is very different.

The Tax Reform Act of 1986 (TRA86) raised the net tax at the margin on capital and reduced it for labor. On balance, it slightly reduced potential output. It would have been a modest positive for the economy if Congress had followed the Treasury reform plan as submitted, but it did not. Treasury had recommended indexation of depreciation allowances for inflation. That would have helped to reduce slightly the required service price or "hurdle rate of return" that capital must earn in order to be a feasible investment, in spite of longer assets lives and repeal of the investment tax credit under the bill. Congress dropped the indexing provision, and the hurdle rate went up, discouraging investment.

Nonetheless, TRA86 cut the corporate rate 12 points from 46% to 34%; Bowles-Simpson would cut it from 35% or 31.85% (with the manufacturing credit) to 28%, only a 4 to 7 point cut. TRA86 raised the top rate on capital gains from 20% to 28%, but lowered the top rate on dividends from 50% to 28%, reducing the double tax on corporate income. Under Bowles-Simpson, both would rise from 15% to 28%, increasing the double tax from current levels. TRA86 eliminated the investment tax credit. Bowles-Simpson would eliminate the current expensing provision, equally bad.

TRA86 fixed some excesses within the framework of the income tax, but it did not change the character of the tax much. It was not the sweeping pro-growth reform of a shift to the neutral base of the Flat Tax, Bradford X tax, or the cash flow tax of the Bush panel. That type of fundamental reform has the potential to add ten percent to national output and income. The Bowles-Simpson Commission also rejected a major shift in the tax base, and its changes within the confines of the income tax would be far more damaging to tax neutrality between saving and investment than those of TRA86.

When TRA86 raised the capital gains tax rate, CBO and Treasury estimated it would cause a reduction in the taking of gains (realizations) only briefly. In fact, as discussed above, capital gains realizations crashed (after soaring in the year before the effective date to avoid the rate hike) and they remained depressed below their 1985 share of GDP for a decade until the rate was reduced again to 20% in 1997. The effect of the higher tax rates on realizations was permanent, not temporary. If Congress makes that mistake again, the Treasury will not gain a nickel.

The tax expenditure lists made up by Treasury and the Joint Tax Committee are based on deviations from the broad-based income tax. They assume the added tax layers and biases in the income tax against saving and investment are part of the ideal norm. Many of the items on the list of tax expenditures are partial offsets to the biases in the income tax. These offsets include all the pension and retirement and education saving arrangements, accelerated depreciation and expensing provisions, lower tax rates on capital gains and dividends, and most offsets to the corporate income tax. The credit against the estate and gift tax and exempt amounts for annual giving are also offsets to an extra tax layer of tax on capital. Perfecting the income taxes or estate levies by eliminating offsets to these added tax layers would increase the tax bias against saving and investment.

The anti-saving bias is more important, and more damaging to the economy, than many of the differences in tax preferences among industries. Eliminating the preferences by raising the tax on the partially protected sectors, rather than extending the tax relief to the sectors not now favored, would depress economic activity, not improve it.

During the last five years of President G. W. Bush's administration, U.S. Budget documents showed an alternative list of tax expenditures under a "saving-consumption neutral" tax. Most of the big ticket expenditures (other than health insurance) fell out, including all retirement plans, expensing or rapid depreciation, and lower tax rates on dividends and capital gains. Under a consumed-income or neutral tax system, the corporate tax is a "negative" tax expenditure, as is the ordinary tax treatment of saving outside of retirement plans. President Obama's budget document dropped that expanded coverage of the alternative view of tax expenditures. Now all we see is the broad-based income tax (and a closer-to-Haig-Simons variant) as the ideal tax base, and the tax expenditures associated with that base.

Real tax reform alternatives, which would treat saving and consumption evenly, such as a cash flow tax, Flat Tax, or national sales tax, are not on the table. Those taxes do not punish investment versus consumption. They regard pensions and immediate expensing of investment costs as the norm and not deviations from the "ideal." All saving would be taxed only once, with no double-taxation of corporate income and estates.

The Bowles Simpson Commission did not examine the economic benefits of a real tax reform, one example of which they briefly considered and dismissed. No estimates were provided by Treasury or the Joint Committee on Taxation of the effect of their proposals on the cost of capital. The economic damage from their net tax hikes on capital was not factored into the revenue estimates. No money would be raised, and the public would suffer a drop in income.

Competitiveness

The United States is part of the global economy. To be competitive, it needs to be a good place in which to produce goods and services. One of the requirements is a tax system that is not anti-investment and anti-growth. Tax differentials matter. Consider two cases.

In 1988 and 1990, Japan mimicked the U.S 1986 tax reform. It had been exempting interest on most savings from tax, and did not tax capital gains. In the reform, it ended the tax exempt interest for people below retirement age, and implemented a capital gains tax. Rate cuts were not sufficient to offset the raise in the service price. Japan also raised a national property tax on real estate. The tax increases pricked the stock and real estate "bubbles" and rendered the banking system insolvent. To this day, Japan regards its troubles as a banking problem, not realizing that it was triggered by a misguided move toward a more comprehensive income tax. The result has been a twenty year depression. Japan continues to have the highest corporate tax rate in the developed world.

The People's Republic of China has taken the opposite approach. It has a 25% corporate tax rate, and relies on a VAT for the remainder of its national government income. The VAT incorporates expensing. The income tax is reserved for the provinces. Capital gains on Chinese shares are not taxed, nor is bank interest. There is no estate tax. The Chinese tax system is closer to a consumed-income or saving-consumption-neutral tax base than to a broad-based income tax. China is lifting hundreds of millions of people out of poverty. The Chinese tax system has some other drawbacks, its state-supported industries absorb too much of its investment, and lack of secure property rights and personal freedoms are troubling. But the growth of the Chinese economy in recent years has been remarkable, especially compared to the stagnation in Japan.

Conclusion

The nation needs a change to a better tax system with a better tax base more neutral in its treatment of saving and investment. If the Congress is not able to provide that, it should extend the current tax cuts and stick entirely to spending cuts for deficit reduction.

Endnotes

1. See Stephen J. Entin, "Tax Incidence, Tax Burden, And Tax Shifting: Who Really Pays The Tax?" *IRET Policy Bulletin*, No. 88, September 10, 2004, available at http://iret.org/pub/BLTN-88.PDF.

2. The tax calculator was provided courtesy of Gary Robbins of the Heritage Foundation Center for Data Analysis, who also assisted with modeling advice.

3. A national retail sales tax or a VAT are equally "neutral" between consumption and investment. Both incorporate expensing and avoid multiple taxation of capital income. Their major drawback is that they tend to mask the cost of government from the taxpayer/voter, which is a bad policy in a democracy. It is also difficult to exclude the poorest citizens from these tax except by exempting large amounts of "necessities", which drives up the rate on other items.

Senate Finance Committee Hearing
"Tax Reform Options: Marginal Rates on High-Income Taxpayers, Capital Gains and Dividends"
September 14th, 2011
Questions for Mr. Entin

From Senator Olympia J. Snowe

Mr. Entin, during our hearing on Wednesday, September 14th, you commented during an exchange with Ranking Member Hatch that the home mortgage interest deduction is "one of the very few areas in the tax code where we just about have it right" and that current law treats "the house as it would be treated in basically a cash-flow tax." Would you please elaborate on why you say that it is correct (or nearly correct) as-is and provide any data you may have to support your point? Thank you.

Answer

An ideal tax system would treat income used for saving no more harshly than income used for consumption. It would either defer tax on amounts saved or invested and later tax all the returns on the assets, or there would be no deduction for saving and investment and no tax on the returns. Such a system is "saving/consumption neutral" or "consumption-based". Our current tax system operates this way for saving-deferred pensions and regular IRAs, and for returns-exempt Roth IRAs and tax exempt bonds. Equipment eligible for immediate expensing gets the full deferral treatment.

Owner-occupied housing fits into this neutral tax system category. The homeowner gets no deduction for the purchase of the home, but the shelter services (imputed rent) on the home are not taxed. This is consistent with a neutral tax system. One violation is that a capital gains tax is imposed when the house is sold if the profit exceeds certain limits. That tax should not be imposed unless the home is expensed (or at least depreciable).

The mortgage interest deduction is sound practice. In a neutral tax system, the financing of an investment can be handled in either of two ways. Note first that the real economic activity is the creation and use of the real asset (machine or building), not the financing. Neutral taxes such as a VAT or sales tax usually ignore interest; the borrower gets no deduction for the interest paid and the lender is not taxed on the interest received. The alternative method, used in income taxes and cash flow taxes, is to allow the borrower to deduct interest paid, while taxing the lender on interest received. As long as the borrower and lender are treated alike (both in or both out of the tax system as far as their interest is concerned), the result is consistent with appropriate tax policy.

The only ambiguity in the treatment of owner-occupied housing is the deduction for the local property tax. If the tax is thought of as a cost of owning a home, then it should not be deductible unless the imputed rent is taxed. However, the local property tax is a transfer to the local government for spending on items that ought to be deductible in a neutral tax. Over half of local government outlays go for education, a form of investment in human capital. Investment (including tuition) should be expensed in a neutral tax. Most of the rest of the local tax goes for police and fire protection (preventing deductible casualty losses) or for investment in local infrastructure. In short, the tax treatment of owner-occupied housing is closer to the ideal tax treatment than is the tax treatment of other types of property, which must be depreciated over decades rather than expensed, and that have earnings that are subject to tax as soon as they are received.

From Senator Jon Kyl

If the top two marginal rates and capital gains and dividend taxes are raised to their Clinton-era levels, which is scheduled to occur in 2013, you project a reduction in economic growth of more than 6% and reduced wages of more than 5%. This would make the drag on the economy twice as large as the revenue gained. In your estimation, would the net effect be a reduction or increase in the deficit?

Answer

Raising the two top tax rates to 36% and 39.6%, raising the capital gains rate to 20%, and putting the dividend rate equal to that of ordinary income, would retard the growth of the capital stock and wages significantly over time, and reduce the gains in national income we would otherwise experience. Within a few years, perhaps five or less, it would result in a revenue loss to the Treasury and an increase in the deficit. The greatest damage would be due to the increase in the double taxation of corporate income, especially from the large increase in the tax rate on dividends, with additional damage from the smaller capital gains tax rate increase. Capital gains tax collections would fall immediately as the valuation of stocks fell to reflect the lower after-tax returns. The reduction in GDP and national income would more than offset the static gains from the personal income tax rate increases. Instead of rising about $100 billion a year in 2008 dollars, income tax revenue would fall by about $24 billion. Reductions in collections from other taxes, such as the payroll tax, the corporate income tax, excises and tariffs, would shave another $75 billion from receipts, bringing the net revenue loss for the federal government to nearly $99 billion a year. As sad as that might be, note that the public would lose a lot more in reduced income (about $780 billion after tax) than the federal Treasury would lose in reduced revenue. In attempting to gain additional revenue by raising a destructive tax, the Congress would lose revenue and harm the public by slashing incomes even more.

How will the extra 3.8% tax on investment income from the health reform law affect economic growth, capital formation, and wages?

Answer

The extra 3.8% tax on investment income would reduce capital formation, which would lower productivity and wages. Its adverse effects would hit everyone, not just those who send the check to the Treasury. The impact is illustrated as the difference between cases 2 and 5 in the table in the testimony. The 3.8% tax would lower GDP by about 0.9%. Instead of raising about $28 billion in revenue (static), it would lose about $2 billion (dynamic).

Some tax reform proposals would tax dividends and capital gains at ordinary income rates. Does your research suggest that this would raise or lower revenues?

Answer

Taxing dividends and capital gains at ordinary income tax rates would lower revenues. The economy would be weaker, reducing taxable income and consumption. Fewer dividends would be paid and fewer capital gains would be realized, again reducing the tax base. According to a study by Professor Paul Evans of the Ohio State University (item No. 2 in the series cited below), the revenue maximizing tax rate from the capital gains tax by itself is probably a bit under ten percent, based solely on the speed with which people realize and report their gains. You will not raise a dime by increasing the rate from 15% to 20% or beyond.

Furthermore, counting revenue from all taxes, the revenue-maximizing capital gains rate is nearer zero, because this additional tax on capital income depresses capital formation, productivity, wages, and taxes on labor income and consumption. The economic damage and resulting revenue loss are in addition to the offsets due to slower realization of gains. (For more on this issue, see IRET's capital gains series Nos. 1-3: *The Effect Of The Capital Gains Tax Rate On Economic Activity And Total Tax Revenue*, http://iret.org/pub/CapitalGains-1.pdf; *The Relationship Between Realized Capital Gains And Their Marginal Rate Of Taxation, 1976-2004,* http://iret.org/pub/CapitalGains-2.pdf; and *Revenue Estimation Of Capital Gains Needs Improvement,* http://iret.org/pub/CapitalGains-3.pdf).

Taxes on capital gains are a form of double taxation. This is blatantly obvious in the case of corporate stock. A firm earns money and pays the corporate tax. It then either pays the after-tax income to its shareholders as a dividend that is taxable a second time to the shareholder, or it retains the after-tax income, which raises the value of the firm, and subjects the shareholder to capital gains tax on the rise in value when the shares are sold.

In fact, the capital gains tax is a form of double taxation even when there is no corporate tax involved. An asset has value because it yields income. It can be a financial flow (interest, dividends, profit) or income in kind (shelter provided by a home). The current price of the asset equals the present (discounted) value of the expected future after-tax income stream from the asset. If the expectation of future income rises, the current price will rise, generating a capital gain. If the higher future income materializes, it will be taxed when earned. To also tax the current increase in the price of the asset is to double tax the higher future income.

The additional tax on capital income due to the capital gains and dividend tax depresses the desired capital stock, which will shrink (or grow less than otherwise) to raise the pre-tax return by enough to restore the normal after-tax return. With less capital, labor is less productive, and wages are lower than otherwise. Capital is very sensitive to tax. It will shrink when a tax is imposed until, at its lower quantity, its returns are driven up to cover the added tax. The work force suffers the consequences.

From Senator Chuck Grassley

Mr. Burman states in his testimony that the biggest loophole in the tax code is the lower rate on the capital gains. For more than ten years, while I was Chairman and then Ranking Member of the Finance Committee, Senator Baucus and I worked closely with other members of this Committee and the Senate, and the Ways & Means Committee, ***on a bipartisan basis***, to shut down loopholes. The 2004 Jobs bill included a sweeping package to end tax avoidance abuses. Examples of these abuses included:

- Corporations claiming tax deductions for taxpayer-funded infrastructure such as subways, sewers, and bridge leases;
- Corporate and individual expatriation to escape taxes;
- Corporate inversions;
- And, individuals taking inflated charitable deductions for donations of used cars.

There is no doubt that these abuses were loopholes. They involved taxpayers exploiting the tax code to achieve results that Congress did not intend. They are very different from a policy adopted on a bipartisan basis by Congress to encourage investment and entrepreneurship.

Mr. Burman acknowledges in his testimony that tax shelters and avoidance activities are more common when tax rates are high. Well, history also shows that tax increases don't increase revenues.

We've had a 93-percent marginal tax rate -- then 70 percent, 50 percent, 30 percent, 40 percent and now a 35-percent marginal tax rate. But, regardless of the rate, we get the same amount of revenue.

During all of these tax increases and decreases, the amount of revenue as a percentage of gross domestic product stayed the same – about 18%.

Let's agree to disagree that a lower capital gains rate is a loophole, please provide responses to the following.

- What loopholes that are like the ones we shut down in the 2004 Jobs bill currently exist in the tax code? That is, what tax code provisions result in **unintended consequences** that we should shut down?
- Also, new tax shelters are likely to be created if marginal rates are increased. So, in addition to the disclosure and penalty tools we already provided to the IRS, I would like to know what, if any, other tools we should consider.

Answer

I agree with your statement that high tax rates lead to significant tax avoidance, and that history suggests that it is hard to collect a much larger share of the national income from the income tax. The biggest unintended consequence of the tax system is that it is decidedly anti-growth and reduces national income at all levels. Fixing that would require dropping the income taxes and moving to a "saving-consumption neutral" tax, as I discuss in my testimony. Adherents of the income tax are in a state of denial regarding these consequences, but the godfather of the income tax, Henry Simons, readily acknowledged that it would reduce GDP.

During the discussion, Dr. Burman worried that a lower tax rate on capital gains can lead to unintended tax avoidance. This is an enforcement issue for the Treasury, which the IRS can deal with. I certainly do not regard this as a legitimate excuse for raising the tax rate on capital gains to the level imposed on other income. It is important to distinguish between the tax treatment of genuine capital gains, and the enforcement issue of keeping people from making ordinary income look like a capital gain to take advantage of a lower capital gains tax rate. This enforcement issue is real, but it is very minor (orders of magnitude less) compared to the economic damage done by taxing capital gains as ordinary income, which would be very bad tax and economic policy. Please see my response to Senator Kyl's question on capital gains.

You have asked what unintended loopholes still remain in the tax code, and what additional tools the IRS might need. As you have pointed out, a great many abusive practices have been shut down by previous legislation. I must plead ignorance about what abuses the IRS has determined may remain. I was an economist at the Treasury Department for eight years (Deputy Assistant Secretary for Economic Policy). However, I was not in the IRS, and have no great experience with enforcement issues.

Nonetheless, I can suggest that virtually none of the so-called "loopholes" or tax expenditures relating to the tax treatment of saving and investment that are listed in the current Budget of the United States, Analytical Perspectives chapter on tax expenditures, would be considered "loopholes" under a neutral tax. In fact, that chapter of the federal Budget for Fiscal Year 2009 (issued in early 2008) had an expanded discussion of what is and is not a tax expenditure under different concepts of taxation. I highly recommend it. Unfortunately, that expanded discussion was dropped in later Budgets.

Under a cash flow or other neutral tax, the reduced tax rate on capital gains is not a tax expenditure. In fact, it is ideally zero on any saving that has not been given a deferral (as in a pension or IRA), or in the case of a corporate tax, which is regarded as a "negative tax expenditure" because of its double tax nature. Similarly, with a neutral tax system as the norm, the corporate tax itself can be considered a "negative tax expenditure" due to the double taxation of corporate income. In that sense, nearly all forms of accelerated depreciation, expensing, and other offset to the corporate tax may be regarded as inadequate countermeasures, rather than loopholes. All pension arrangements and IRAs would be considered tax expenditures in the income tax, but the norm under a cash flow tax. Perhaps the major tax expenditure that would be considered odd under both types of tax systems is the exclusion of health insurance premiums from tax when there is no tax on the benefits paid out.

From Chairman Max Baucus

You reference the Chinese tax system in your testimony as a viable form of consumption tax. Would you please explain your view of the Chinese system further?

Answer

The Peoples Republic of China has a tax system that does less damage to saving and investment than does the tax system of the United States. The Chinese system treats saving and investment less harshly than a broad-based income tax (which hits saving and income from capital several times), and relies more heavily on taxes on consumed income or consumption (which taxes saving and income used for consumption at the same rate).

A completely neutral tax system would have expensing of capital investment, no double taxation of corporate income, and no estate tax. It would also either tax saving and exempt the returns (as in a Roth IRA), or it would allow a deferral of tax on saving and tax the withdrawals, as with a regular IRA or pension. These methods are employed in a national sales tax, VAT, or consumed income tax (such as the USA tax or the Bradford X tax or the cash flow tax in the Bush tax reform panel report).

The national government of China derives most of its revenue from a VAT, in which investment spending is expensed. It has a corporate income tax with a rate of 25%, about the OECD average, and far below that of the United States (almost 40% when state and federal taxes are combined). The provinces have a personal income tax with parameters set by the national government. Capital gains on stock trades are tax exempt. Half of dividends from companies listed on Chinese stock exchanges are tax exempt. Bank deposit and government bond interest are tax exempt. Foreign investors are free from tax on capital gains and dividends. There is no estate or transfer tax. Some of these features resemble the tax bases of the Hall-Rabushka Flat Tax, the Roth IRA, or the Bradford X Tax. Rural workers own their social insurance accounts, as in many countries that have private accounts for social insurance rather than centralized tax/transfer systems.

China has put much of its ideology aside in order to encourage the investment and growth it needs to lift a billion people out of poverty. More detail can be found in IRET Policy Bulletin 94, *The Tax System of China*, available on the Internet at http://iret.org/pub/BLTN-94.PDF.

STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER U.S. SENATE COMMITTEE ON FINANCE HEARING OF SEPTEMBER 14, 2011 TAX REFORM OPTIONS: MARGINAL RATES ON HIGH-INCOME TAXPAYERS, CAPITAL GAINS, AND DIVIDENDS

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing examining marginal tax rates for high-income taxpayers, capital gains, and dividends:

Thank you Mr. Chairman, for holding today's hearing. It is the latest in a critical and informative set of hearings that this Committee has had in preparation for comprehensive tax reform. I think that we need to be clear with the American people, however, about what is really being considered at this hearing. The question that is raised by the witnesses' testimony today is whether we should raise marginal rates as well as the rates on capital gains and dividend income.

Unfortunately, I think I know what the answer is for many of my friends on the other side of the aisle.

I certainly know where the President stands on this question. Having already enacted over a trillion dollars in new taxes through his health care law, he is ready for more. Just the other day, he offered up over $400 billion in new taxes to pay for his latest spending proposal. And, of course, he is intent on causing the Bush and Obama-era tax rates to go up on small business owners and others in the top two tax brackets, over the objection of many in his own party.

President Obama has said that he's tired of the same old accusations that Democrats are tax-and-spend liberals.

But to borrow from the old saying, *if it looks like a tax-and-spend liberal and talks like a tax-and-spend liberal, it's probably a tax-and-spend liberal.*

Or to borrow from Jeff Foxworthy, if you think the only problem with the first stimulus was that it was not big enough, you might be a tax-and-spend liberal.

If you talk about a "balanced approach" to deficit reduction, you might be a tax-and-spend liberal.

And if you argue that "revenues must be on the table" to bring down spending-fueled deficits and debt, you are definitely a tax-and-spend liberal.

There is a reason for these euphemisms. Those who promote tax increases don't come right out and announce their support, because they know that the American people rightly believe that their taxes are heading higher than they have been historically.

Even without any new tax increases, taxes are already heading higher than they have been.

As we debate the additional tax increases that the President and his congressional allies would like to enact, the American people deserve a clear reckoning of just how high our taxes are heading, even if current tax policy is permanently extended.

Even if all of the Bush and Obama-era tax rates are extended permanently, revenues as a percentage of gross domestic product will be 18.4 percent according to the nonpartisan official scorekeeper for Congress, the Congressional Budget Office.

According to CBO, those revenues of 18.4 percent of gross domestic product are substantially higher than their recent historical average, which was 18 percent from 1971 to 2010.

So the question the American people are asking is, if taxes are already heading higher than they have been historically, should we raise them even more?

From my perspective, the answer is a resounding no.

In the short term, the tax increases that are already set to come online due to the President's policies are a significant drain on economic growth. Adding even more into the mix would only be a further drain on our economy, curbing growth in the economy and jobs both in the short term and the long term.

With unemployment at 9.1 percent — over two and a half years after the President promised his stimulus bill would keep unemployment under 8 percent — should we really increase taxes on exactly half of all flow-through business income? Is that really a good idea considering the fact that even the President agrees that small businesses create two-thirds of the new jobs in our economy and small businesses employ 54 percent of American workers?

A truly informative debate about the impact of tax increases has to include facts like those above. Unfortunately, it is often easier to resort to talking points from wealthy liberals who seek to raise marginal rates — adversely impacting the small businesses that will be the engine of our economic recovery — because they feel guilty that they are not paying their fair share.

Instead of trafficking in economic reality and cutting to the effectual truth for small businesses if we raise marginal rates, the President talks about raising rates on wealthy people like himself because he has money he doesn't need. In addition to betraying a very odd understanding of how a modern economy works, talking points like these fail to present taxpayers with the real world trade-offs that come from increasing marginal rates and rates on capital gains and dividends.

I think that this obfuscation is intentional. If tax hike proponents actually engage in a factual debate over whether taxes should be raised, even though they are already heading higher than their historical average, I am confident that they will lose.

The fact that congressional Democrats have not passed a budget in over 850 days is all the evidence you need of the unpopularity of the tax increase agenda. Democrats know that they have to, at least in theory, support deficit reduction and a balanced budget. But the left won't allow them to make any meaningful spending reductions. And the vast majority of taxpayers would revolt if the left came clean about the tax increases that would be necessary to finance the level of spending President Obama has signed onto.

So caught between a rock and a hard place, my friends on the other side of the aisle have just declined to pass a budget for years.

The American people want Washington to get its spending under control, not to tax them more. Those who promote tax increases deny that they want to raise your taxes. They are only ever interested in raising someone else's taxes. They only want to raise taxes on the rich.

Those who advocate this course are not being forthcoming. Those who promote tax increases know that they simply cannot raise enough money to pay for their spending priorities only by taxing individuals and small businesses in the top two brackets.

It does not come close. The tax hikes necessary to pay for the level of government spending that President Obama and most Congressional Democrats want would be extremely large and extremely widespread.

To balance the budget through tax increases alone would mark another clear violation of the President's pledge not to raise taxes on the middle class.

Outlays shot up in this administration by over 4 percent of GDP in 2009 and now total 25 percent of our nation's total output — a quarter of everything that we produced. OMB estimates that in 2011, outlays will be *over* 25 percent of GDP, higher than any year aside from those surrounding World War II.

The disease that Congress needs to address is government spending. We need to stop looking to treat the symptom, which is the deficit, with a band-aide called tax increases.

As Congress considers proposals to raise taxes, the question for taxpayers is whether they are personally willing to pay a lot more in taxes to sustain current levels of government spending.

I know where I stand on that question. Taxes are already heading higher than they have been historically. I can confirm that many in Utah agree with me, and I suspect that the vast majority of Americans do as well.

I appreciate the work of the Chairman on this hearing, and the testimony of our witnesses. This is an important discussion. It is central to the key questions about economic growth and the proper size of government that the American people will have their say on in little more than a year.

From my perspective, we have a government spending problem. And we cannot solve that problem by giving government more money to spend.

That being said, if President Obama or any of his friends want to pay more in taxes, I am happy to provide them with the IRS address where they can mail their check.

Or they can just Google it.

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TESTIMONY BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE
WASHINGTON, D.C.

DENNIS MEHIEL

SEPTEMBER 14, 2011

FIRSTLY, PLEASE ALLOW ME TO EXPRESS MY GRATITUDE TO THE MEMBERS AND STAFF OF THE COMMITTEE FOR PROVIDING ME THIS OPPORTUNITY TO SHARE MY VIEWS AS YOU CONSIDER CHANGES TO OUR NATION'S TAX CODE. I BELIEVE MOST OF OUR COUNTRY'S CITIZENS UNDERSTAND OUR CURRENT MODEL NO LONGER FUNCTIONS AS EFFECTIVELY AS IT MUST IF OUR FREE ENTERPRISE SYSTEM IS TO CONTINUE TO FLOURISH FOR THE BENEFIT OF SOCIETY AS A WHOLE. YOUR TASK IS A CRITICAL ONE AND THE ACTIONS YOU TAKE NOW WILL LIKELY SHAPE OUR FUTURE FOR DECADES TO COME. FOR AN AVERAGE CITIZEN LIKE ME IT IS AN EXTRAORDINARY EXPERIENCE TO BE ABLE TO ADD MY VOICE TO SUCH AN IMPORTANT DEBATE.

SECONDLY, IN THE INTEREST OF FULL DISCLOSURE, LET ME SAY AT THE OUTSET, I DO NOT SHARE THE DISDAIN FOR OUR FEDERAL GOVERNMENT THAT SEEMS TO PERMEATE SO MUCH OF OUR PUBLIC DISCOURSE TODAY. I KNOW THIS IS THE RESULT OF MY LIFE EXPERIENCE. I WAS RAISED

DURING THE 1940'S AND 1950'S. MY FATHER SERVED OUR COUNTRY'S MILITARY AS A PILOT DURING WORLD WAR II AND THEN IN MILITARY INTELLIGENCE UNTIL HIS RETIREMENT IN THE 1970'S. OF GREEK IMMIGRANT PARENTS, HE WAS IMBUED WITH A CLEAR UNDERSTANDING OF WHAT A PRIVILEGE IT IS TO BE AN AMERICAN, AND THAT WAS PASSED ON TO HIS CHILDREN INTACT.

WHEN MY BROTHER AND I WANTED TO START OUR OWN BOX MANUFACTURING BUSINESS IN 1966 WE HAD SAVED SOME MONEY BUT ALSO NEEDED TO BORROW. THE SMALL BUSINESS ADMINISTRATION TYPICALLY WOULD GUARANTEE UP TO 90% OF WHAT A COMPANY BORROWED FROM A BANK, BUT EVEN WITH THAT GUARANTEE NO BANK WOULD APPROVE A LOAN FOR OUR START-UP ENTERPRISE. FORTUNATELY FOR US, THE SMALL BUSINESS ADMINISTRATION ALSO HAD A PROGRAM UNDER WHICH WE COULD BORROW DIRECTLY FROM THE GOVERNMENT AN AMOUNT EQUAL TO WHAT WE HAD TO INVEST. WITH OUR $8,000 IN SAVINGS, WE BORROWED $8,000, PURCHASED OUR MACHINES, RENTED THE PROVERBIAL GARAGE (LITERALLY) AND OUR BUSINESS WAS BORN. FOR A TWENTY FOUR YEAR OLD WITH ONLY A HIGH SCHOOL DIPLOMA, IT WAS A LIFE CHANGING OPPORTUNITY.

OVER THE YEARS OUR COMPANY PROSPERED. WE BUILT NEW BOX FACTORIES AND PURCHASED EXISTING ONES, CREATING AND SAVING

THOUSANDS OF JOBS. WHAT NEVER CROSSED OUR MIND WAS HOW MUCH OUR TAXES MIGHT BE IF WE MADE MORE MONEY. I CAN ASSURE THE COMMITTEE MY EXPERIENCE IS NOT UNIQUE; IT HAS BEEN REPLICATED MANY THOUSANDS OF TIMES OVER THE DECADES AS THE SMALL BUSINESS ADMINISTRATION FULFILLED ITS MANDATE TO HELP ENTERPRENEURS BEGIN OR GROW THEIR COMPANIES. SO WITH ALL ITS FLAWS, OUR FEDERAL GOVERNMENT, AND THE PEOPLE WHO SERVE US, HAVE A SPECIAL PLACE IN MY HEART.

THIRDLY, I TURN TO THE ISSUE AT HAND, OUR PROGRESSIVE INCOME TAX SYSTEM AND THE MARGINAL RATES PAID BY OUR HIGHER INCOME CITIZENS. AT ITS CORE, I BELIEVE OUR PERSONAL INCOME TAX REGIME EXPRESSES OUR VALUES AS A SOCIETY. THE SAME CAN BE SAID FOR THE OTHER HALF OF THE LEDGER, EXPENDITURES, BUT TODAY WE CONCERN OURSELVES WITH TAXES, WHO PAYS AND HOW MUCH. I KNOW THERE ARE MANY WHO DO NOT BELIEVE IN PROGRESSIVE INCOME TAX RATES. THEY BELIEVE ALL SHOULD PAY THE SAME PERCENTAGE. THEY BELIEVE THE LOWER THE RATE THE STRONGER THE ECONOMIC ACTIVITY WILL BE. THIS THEORY HOLDS THAT GOVERNMENT REVENUE WILL INCREASE AS RATES GO DOWN AND ECONOMIC GROWTH ACCELERATES. DEPENDING WHERE ONE STARTS THERE CAN BE MERIT TO THIS AGRUMENT. I WILL LEAVE IT TO MY MORE LEARNED COLLEAGUES HERE TODAY TO MAKE THE CASE FOR OR AGAINST THAT THEORY IN THE ABSTRACT.

HOWEVER, I CAN TELL YOU FROM PERSONAL EXPERIENCE, THE REDUCTION IN MY MARGINAL TAX RATE THAT I RECEIVED IN 2002 HAD NO MEASURABLE IMPACT ON MY CONSUMPTION OF GOODS AND SERVICES. WHEN MY MARGINAL TAX RATE WAS INCREASED IN 1994, THERE WAS ALSO NO MEASURABLE IMPACT ON MY PERSONAL CONSUMPTION OF GOODS AND SERVICES. I WOULD REMIND THE COMMITTEE, AFTER THE 1994 INCREASE IN PERSONAL TAXES WAS IMPLEMENTED, THEN CURRENT INTEREST RATES DROPPED BY ABOUT THREE (3%) PERCENTAGE POINTS, BECAUSE THE CAPITAL MARKETS UNDERSTOOD OUR NATION HAD DECIDED TO RESTORE FISCAL BALANCE.

AS INTEREST RATES CAME DOWN, WE WERE ABLE TO BORROW AND INVEST MORE IN OUR BUSINESS. IN 1993 WE EMPLOYED APPROXIMATELY 1,200 PEOPLE. BY 1998 WE EMPLOYED OVER 12,000 PEOPLE. BECAUSE WE WERE IDENTIFYING AND REHABILITATING TROUBLED COMPANIES WITHIN OUR INDUSTRY I CAN ASSURE THE COMMITTEE THAT ALMOST NONE OF THOSE JOBS WOULD HAVE EXISTED ABSENT OUR EXPANSION. AGAIN, OUR EXPERIENCE WAS ANYTHING BUT UNIQUE. THE EXPLOSION IN INVESTMENT AND THE RESULTING ECONOMIC GROWTH CREATED 22 MILLION JOBS DURING THE SEVEN YEARS FOLLOWING THE INCREASE IN OUR PERSONAL MARGINAL INCOME TAX RATE. IRONICALLY, IN THE CONDITIONS THAT PREVAILED IN 1993, AN INCREASE IN PERSONAL

INCOME TAX RATES BECAME A KEY DRIVER OF SIGNIFICANT ECONOMIC GROWTH AND NEW JOB CREATION.

I BELIEVE MY EXPERIENCE IS NO DIFFERENT THAN THOUSANDS, INDEED MILLIONS OF MY FELLOW CITIZENS. MANY DID MUCH BETTER THAN I DID, BUILT MUCH BIGGER ENTERPRISES, MANY MORE WERE SMALLER. WHAT WE HAVE IN COMMON WAS THE OPPORTUNITY TO BENEFIT FROM AN ENLIGHTENED CAPITALIST SYSTEM THAT CREATED ECONOMIC MOBILITY FOR ITS CITIZENS UNEQUALED IN HUMAN HISTORY. THAT SYSTEM IS UNDER ENORMOUS PRESSURE TODAY FOR A VARIETY OF REASONS, WHICH INCLUDES THE CHANGES IN OUR TAX SYSTEM ENACTED OVER RECENT YEARS AS WELL AS THE FAILURE TO CORRECT SIGNIFICANT INEQUITIES THAT GO BACK FURTHER.

I HAVE HEARD MORE THAN ONCE THE PROPOSITION ADVANCED THAT SMALL BUSINESS OWNERS WILL NOT INVEST IN AND GROW THEIR BUSINESSES IF WE RESTORE THE MARGINAL RATES THAT PREVAILED IN THE 1990'S. LET'S TEST THAT THEORY:

IF A BUSINESS PERSON CURRENTLY HAS ANNUAL PRE-TAX INCOME OF $500,000, THE CHANGE WOULD INCREASE HIS OR HER INCOME TAX BY $10,000 PER YEAR. ARE WE TO BELIEVE A RATIONAL PERSON, EARNING A HALF MILLION DOLLARS A YEAR, WILL REFUSE TO GROW THE BUSINESS

AND HIRE PEOPLE BECAUSE THEIR TAX WENT FROM $135,000 PER YEAR TO $145,000 PER YEAR. I WOULD ARGUE THE ANSWER IS NO.

IT IS MY RECOMMENDATION THE COMMITTEE TAKE THE FOLLOWING ACTIONS:

- RESTORE MARGINAL TAX RATES TO THOSE THAT PREVAILED DURING THE 1990'S
- CREATE A NEW MARGINAL RATE OF 43% ON ADJUSTED GROSS INCOME ABOVE ONE MILLION DOLLARS PER YEAR
- ELIMINATE THE "CARRIED INTEREST" LOOPHOLE THAT ALLOWS FINANCIAL PROFESSIONALS TO EARN ORDINARY INCOME FOR DOING THEIR WORK AS EVERYONE ELSE DOES, BUT TO PRETEND THEY HAVE INVESTED CAPITAL AT RISK AND SHOULD BENEFIT FROM CAPITAL GAINS THEATMENT ON THAT INCOME
- INCREASE THE CAPITAL GAINS TAX RATE TO 50% OF THE HIGHEST MARGINAL ORDINARY INCOME TAX RATE.
- REINSTATE THE INVESTMENT TAX CREDIT OF 10% ON PURCHASES OF CAPITAL EQUIPMENT MANUFACTURED IN THE UNITED STATES
- REDUCE THE CORPORATE INCOME TAX RATE TO TWENTY-SEVEN (27%) PERCENT WHILE REMOVING ALL OF THE INCENTIVES (NOW LOOPHOLES AS THEY HAVE OUTLIVED THEIR USEFULNESS) WITH THE OBJECTIVE OF <u>INCREASING</u> REVENUE.

I KNOW OUR NATION MUST REDUCE THE GROWTH IN EXPENDITURES TO ACHIEVE FISCAL BALANCE. THESE RECOMMENDATIONS ALONE, IF ENACTED, WOULD NOT DO SO. BUT I BELIEVE RESTORING OUR PROGRESSIVE TAX SYSTEM THAT HAS SERVED THIS NATION SO WELL, FOR SO LONG, IS ABSOLUTELY ESSENTIAL TO OUR RECOVERY.

I THANK THE COMMITTEE FOR ITS COURTESY AND ATTENTION.

TESTIMONY BEFORE THE UNITED STATES CONGRESS
ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

NFIB
The Voice of Small Business®

Testimony of Bill Rys, NFIB

U.S. Senate Committee on Finance

"Tax Reform Options: Marginal Rates on High-Income Taxpayers,
Capital Gains and Dividends"

September 14, 2011

Good morning, Chairman Baucus, Ranking Member Hatch, and members of the Committee. I am pleased to be here on behalf of the National Federation of Independent Business (NFIB) as the Committee continues to look at tax reform. In particular, I appreciate the opportunity to discuss individual tax rates, an especially important issue for small business owners.

The NFIB is the nation's leading small business advocacy organization representing over 350,000 small business owners across the country. We represent businesses in a number of industries and of various sizes, with the average member employing between 8 and 10 employees.

Taxes and tax rates are regularly a concern for small business owners. According to the most recent NFIB Small Business Economic Trends Survey (SBET), taxes rank third as the most important problem facing small business. For the majority of the last year, taxes have been the second most important problem after lost sales.

Tax rates in particular are a major concern for small business owners. Federal tax rates ranked third out of 75 issues in the most recent NFIB Research Foundation's Small Business Problems and Priorities survey.[1] In fact, noting how important taxes and reforming the tax code is to small business owners, four of the top ten issues identified in the survey are tax-related.[2]

Choice of Entity and Individual Tax Rates

Individual rates are especially important to small business owners because the majority of them – about 75 percent - structure their businesses as pass throughs.[3] No matter what business entity the small business owner chooses, you cannot separate the business owner from the business.

The business structure is chosen for a variety of reasons. According to an NFIB Small Business Poll of the few businesses that changed their business structure, 39-percent of small businesses changed to avoid liability and 27-percent for tax reasons.[4] Liability and tax issues were the top two responses. From a tax perspective, the pass through model makes sense for the typical small business. A small business has fewer financial resources than a typical larger corporation, so to pay a double tax – first at the corporate level and then on wages or on a return of business investment - would be especially onerous.

While a business structure like a sole proprietor or a partnership will protect the business from double taxation, the liability protection that a C-Corp offers is not available for these business structures. If the business is liable for a debt, the business owner's personal assets are also at risk. The Tax Reform Act of 1986 made several changes to the taxation of S-Corps, reducing the tax liability for small businesses, but also providing the liability protection of a C-Corp. The passage of those changes has led to a substantial increase in the number of S-Corps. In 1985 22-

[1] William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC series.
[2] Ibid.
[3] Firms of all size responded that 20.9-percent organized as sole proprietors, 5.8-percent as partnerships, 25.6-percent as C-Corps, 30.9-percent as S-Corps, 12.4-percent as LLCs, and 4.2-percent as other/DNK. *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation; Washington, DC; Volume 4, Issue 7, 2004.
[4] *Ibid.*

percent of all corporations were S-Corps, by 1990 the figure has risen to 43-percent, and today the majority of corporations are S-Corps.[5]

Pass Through Businesses and the Economy

As the Committee continues to consider tax reform, it is important to keep in mind the importance pass through businesses play in the economy.

Pass through businesses have been a growing source of entrepreneurship. From 1985 to 2005, the number of S Corps increased from 725,000 to 3.7 million and from 1993 to 2005 the number of LLCs taxed as partnerships grew from 17,000 to almost 1.5 million.[6] Many of these are small businesses, which account for about 50 percent of GDP and 50 percent of employment in the overall economy.[7]

A recent study further highlights the role pass through businesses play in the U.S. economy and how they may be impacted by tax reform.[8]

Based on 2008 tax data, pass through businesses represented 95 percent of all business entities. These businesses employed a majority – 54 percent – of the total private sector workforce.[9] In fact, in all but two states – Delaware and Hawaii – pass through businesses accounted for a majority of the private sector workforce. In six states – Idaho, Maine, Montana, South Dakota, Vermont, and Wyoming – they accounted for more than 60 percent of the private sector workforce.[10]

Pass through businesses also report a considerable amount of income. Between 2004 and 2008, individual owners of pass through businesses reported 54 percent of all business net income.[11]

Individual Tax Rates and Pass Through Businesses

Because of the important role these businesses play in the overall economy - and especially for small businesses - as the Committee focuses on tax reform, it is important to examine the individual tax provisions. As many have said, the goal of tax reform is to create a simpler tax code that encourages economic growth. To achieve these goals, individual tax rates must be part of any tax reform plan.

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[5] *SOI Bulletin*, Internal Revenue Service, U.S. Department of the Treasury, Selected Historical and Other Data – table 13, Winter 1999-2000.
[6] *Treasury Conference on Business Taxation and Global Competitiveness, Background Paper*, U.S. Department of the Treasury, July 23, 2007.
[7] *How Important is Small Business to the U.S. Economy,* Frequently Asked Questions, SBA Office of Advocacy. (http://www.sba.gov/advocacy/7495/8420).
[8] Carroll, Robbert and Gerald Prante, *The Flow Through Business Sector and Tax Reform: The Economic Footprint of the Flow-Through Sector and the Potential Impact of Tax Reform*, April 2011.
[9] Ibid.
[10] Ibid.
[11] Ibid.

Small businesses fall into all of the current six individual income tax brackets. In 2001, the individual rates were lowered across the board providing all small business taxpayers with some tax relief. Since those tax rates became law, many agree that keeping rates low for some taxpayers is important. That is a step in the right direction to promoting a pro-growth tax policy and ensuring that many business owners will not see a tax increase.

At the same time, some have proposed raising taxes on those pass through businesses reporting more than $200,000 or $250,000 in income. The owner of a pass through business may report a higher amount of income on their return than they actually take home, but that income is the money invested back into the business. This is the capital they use to purchase new equipment, pay the salary and benefits of workers, and meet day-to-day expenses.

Exactly who are the businesses most likely to be impacted by an increase in higher individual tax rates? An NFIB Research Foundation poll, combined with U.S. Census Bureau statistics, indicates that the businesses most likely to face tax increases are businesses that account for a substantial portion of the workforce. The NFIB survey shows that about 10% of small business owners report more than $250,000 in income and the businesses most likely to report income above that threshold are firms with 20 to 250 employees. In fact, over 30 percent of firms with between 20 to 250 employees would see their taxes increase if the individual rates are increased for those reporting more than $250,000 in income.[12] In 2007, these businesses accounted for over one-quarter of the U.S. workforce, employing about 33.5 million workers.[13]

Regardless of how many small businesses would be impacted by this tax increase, simply drawing a line in the sand at $250,000 is a blunt instrument, meaning that some small business owners will see their taxes increased. When state and local tax rates, many of which are also going up, and new taxes included in the Affordable Care Act are included these small business owners could see their tax rates climbing above 50 percent.

Tax increases can have a negative impact on business investment. As one study notes, a 5 percent increase in the individual tax rate, reduces by 10 percent the number of entrepreneurs making new capital investments and reduces the likelihood of hiring workers.[14] At a time when we are trying to promote business investment and job creation, why would we also be pushing policies that reduce investments and hiring?

An increase – or even the threat of an increase – in the taxes these businesses will pay can drive business decisions. The change could be delaying a one-time investment, since the more money that comes out of the business to make tax payments means less money the business owner has to spend on the business. Tax increases could also impact more complicated decisions like choice of business entity.

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[12] *Finance Questions – NFIB Small Business Poll,* NFIB Research Foundation, Volume 7; Issue 7: 2007.
[13] U.S. Small Business Administration, Office of Advocacy, based on data provided by the U.S. Census Bureau, Statistics of U.S. business 2006.
[14] Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, Harvey S. Rosen, "Entrepreneurs, Income Taxes, and Investment," Working Paper No. 6374, National Bureau of Economic Research, January 1998.

Of courses, as long as a business owner is paying taxes, they will factor the tax implications into their business decisions. As the Committee looks at the tax code, a goal should be to minimize the impact taxes have on business decisions as much as possible. With the economy continuing to struggle, especially for small businesses, the tax implications of various business decisions will be even more closely considered and the threat of an increase will drive even more decision making.

Tax Reform and Individual Rates

Small business owners are encouraged, but wary, that Congress is turning its attention to tax reform. Taxes are a consistent concern expressed by small business owners. While they are encouraged that Congress wants to address their concerns, they are wary because they continue to hear about tax increases.

Much of the discussion around tax reform has focused on the corporate tax rate. Addressing the current corporate tax rate, especially as it relates to the rate being paid in other countries, is important. In addition, many small business owners are organized as C corps, so addressing the corporate rate would be beneficial to them.

Any tax reform plan that wants to encourage economic growth should include individual rates and pass through businesses. Focusing simply on the corporate rate could put the owners of pass through businesses at a distinct disadvantage. With a potential rate increase and the potential loss of business deductions, pass through business owners could see a substantial change in their tax position. Such unbalanced changes could force business owners to make costly changes to their business.

Tax reform should support these businesses, making it easier to run their business and provide opportunities to grow and make new investments. As our economy continues to struggle, in particular as it relates to job creation, putting the businesses that account for more than half of the private sector workforce at a disadvantage makes little sense.

In addition, tax complexity and the cost of tax compliance is a major problem faced by small business owners. In fact, small business owners pay 67 percent more to file their taxes compared to larger businesses.[15]

Some of the complexities in the code are in deductions and credits, meaning for a small business owner to take advantage of a tax benefit they have to rely on accountants and other consultants. Simplifying the code by examining some deductions and credits provides Congress with the opportunity to lower rates. This means small business owners can keep more of the money they earn and make the kind of investments that are best for their business.

Adding to the complexity is the constant changes in the tax code. With many provisions expiring from year-to-year, it has become harder for business owners and their advisors to plan. A good example is the individual rates. While the extension of the current rates for two years

[15] Crain, W. Mark; *The Impact of Regulatory Costs on Small Firm*, Small Business Research Summary, SBA Office of Advocacy; September 2005.

was a step in the right direction, many small business owners are once again facing a tax increase if those rates expire. Business conditions change and business owners have to work through good times and bad. But they should not have to face the same kinds of ups and downs because of constant changes in the tax code.

Finally, Congress should work to keep the capital gains rates low. Keeping the capital gains rate low is an incentive to invest in capital assets with the certainty that any gain realized on that investment will be subject to a lower rate of tax.

Tax reform is an opportunity to address the major tax impediments that impact small business owners and to strengthen the overall economy. The current tax code is a challenge for all taxpayers – small and large businesses, as well as individual taxpayers. The Committee's focus on individual tax rates, capital gains, and dividends is an important step in examining the entire tax code. We look forward to working with the Committee to minimize the tax burden on small businesses and establish a simplified, more growth oriented tax system.

Senate Finance Committee Hearing
"Tax Reform Options: Marginal Rates on High-Income Taxpayers, Capital Gains and Dividends"
September 14, 2011
Questions for Mr. Rys

From Ranking Member Orrin Hatch

How Many Businesses Will be Affected by Increasing Upper Tax Rates

William Gale of the Brookings Institute has argued that less than 2% of tax returns reporting small-business income are filed by taxpayers in the top two income brackets—individuals earning more than about $170,000 a year and families earning more than about $210,000 a year. Because of that, he and the administration argue that increases taxes on the so-called "rich" will not have much of an effect on businesses. Interestingly, the rich seems to go down to someone earning $170,000 a year, which doesn't look to be really that rich if they live in a high-cost metropolitan area like Chicago, for example.

However, while Mr. Gale seems to be interested in counting the number of tax returns with business income potentially affected by higher taxes, the Joint Committee on Taxation identifies that the so-called "tax cuts for the rich," if allowed to expire, will increase taxes on 50% of the approximately $1 trillion of aggregate net positive business income reported on returns. There might not be a huge number of pieces of paper called "returns," but there is a huge amount of business income on those pieces of paper. Increasing taxes on $500 billion of business income is going to hurt business, reduce economic growth, and kill jobs. Do you believe that higher taxes on people earning about $200,000 or more would have little to no effect on businesses? And do you believe that higher taxes on those earning $200,000 or more would affect a significant amount of business income and activity?

Answer

Increasing tax rates on these individuasl would have a negative effect on business because more than 50 percent of business activity is conducted by pass through businesses, which pay tax on their business income at the individual rates. While the increased rates are on individuals, the tax is levied on the business income that the owners of pass through businesses use to run and grow their businesses.

As you note, the amount of income – 50% of approximately $1 trillion in income – is substantial. Our members understand the impact that tax increases will have on their business and this is why they rank concerns about the taxation of business income so high (3 out of 75 issues) in the NFIB Small Business Problems and Priorities survey.

It is important to look at who and what is being taxed. Raising taxes on these business owners will increase the tax on the capital they use to run their business. In addition, the businesses being taxes account for a substantial portion of the private sector workforce, with 54 percent of employees working at pass through businesses.

Effects on Businesses of Higher Upper Tax Rates

You identify in your testimony that: "The owner of a pass through business may report a higher amount of income on their return than they actually take home, but that income is the money invested back into the business. This is the capital they use to purchase new equipment, pay the salary and benefits of workers, and meet day-to-day expenses." So, when people talk about increasing taxes on someone earning $200,000 or more, it means taxing some business owners on amounts that they would otherwise be using to buy new machines and hire new workers and pay salaries and benefits of existing workers. The person putting down $200,000 of income on their return may not be using that income to buy yachts or corporate jets. They may be using it to hire other people. Some of the tax proposals I see from the administration, sold under the guise of "taxing the rich" and generating greater equality of incomes, will actually end up hurting an orthodontist in Salt Lake City trying to expand her business, or a veterinarian in Ogden Utah trying to continue to make payrolls. Do you agree that there will be adverse effects on businesses, many of which could be small upstarts, from higher taxes on those so-called rich people earning $200,000 a year or so?

Answer

There will be negative effects by raising taxes on the income of these business owners. As Dr. Entin mentioned during the hearing, what you tax is very important. In this case, what would be taxed is the earnings of the business, which the owner will use to meet future expenses and make new investments. Taxing more business income means less investment.

With the current condition of the economy, this is especially true. Small businesses are continuing to struggle to recover from the recession and that is having a negative impact on the overall economy. The impact is particularly significant in the case of job creation, since 2/3 of the net new jobs are created by small businesses. In particular, the economy is reliant on start-up businesses to create these new jobs. If business owners have fewer resources to take risks, it is less likely that they will make the new investments the economy needs. Higher taxes on the capital that will be used to make these investments will lead to less investment at a time when the economy is struggling to recover.

From Senator Chuck Grassley

Mr. Burman states in his testimony that the biggest loophole in the tax code is the lower rate on the capital gains. For more than ten years, while I was Chairman and then Ranking Member of the Finance Committee, Senator Baucus and I worked closely with other members of this Committee and the Senate, and the Ways & Means Committee, ***on a bipartisan basis***, to shut down loopholes. The 2004 Jobs bill included a sweeping package to end tax avoidance abuses. Examples of these abuses included:

- Corporations claiming tax deductions for taxpayer-funded infrastructure such as subways, sewers, and bridge leases;
- Corporate and individual expatriation to escape taxes;
- Corporate inversions;
- And, individuals taking inflated charitable deductions for donations of used cars.

There is no doubt that these abuses were loopholes. They involved taxpayers exploiting the tax code to achieve results that Congress did not intend. They are very different from a policy adopted on a bipartisan basis by Congress to encourage investment and entrepreneurship.

Mr. Burman acknowledges in his testimony that tax shelters and avoidance activities are more common when tax rates are high. Well, history also shows that tax increases don't increase revenues.

We've had a 93-percent marginal tax rate -- then 70 percent, 50 percent, 30 percent, 40 percent and now a 35-percent marginal tax rate. But, regardless of the rate, we get the same amount of revenue.

During all of these tax increases and decreases, the amount of revenue as a percentage of gross domestic product stayed the same – about 18%.

Let's agree to disagree that a lower capital gains rate is a loophole, please provide responses to the following.

What loopholes that are like the ones we shut down in the 2004 Jobs bill currently exist in the tax code? That is, what tax code provisions result in **unintended consequences** that we should shut down?

Also, new tax shelters are likely to be created if marginal rates are increased. So, in addition to the disclosure and penalty tools we already provided to the IRS, I would like to know what, if any, other tools we should consider.

Answer

As the Committee continues to consider tax reform, tax shelters are an important issue to keep in mind. In particular, simplifying the code can create fewer opportunities for tax planning and possible tax shelters. Many of the shelters you mentioned were the product of exploiting well-intentioned tax provisions.

Reform that is too narrow could create more such opportunities. For example, if tax reform focuses only on the corporate tax, this could create opportunities to shelter income inside a corporation. This could become an especially troubling problem if individual tax rates are increased. In fact, this was not uncommon in the past when individual tax rates were much higher relative to the corporate rate.

The best tool the Committee can consider to avoid tax sheltering is to simplify the tax code. The fewer places that tax planners have to hide income, the less likely it will be that new shelters will be established.

Tax simplification has the additional benefit of reducing the cost of compliance. Tax compliance is a major expense for small business owners. In fact, according to the SBA Office of Advocacy, small businesses pay about 67 percent more to comply with the tax code than larger businesses. This is money that can be better spent on running and growing the businesses. And business owners can spend more time managing their business and less time working with accountants, tax lawyers, and the IRS.

From Senator Jon Kyl

Other witnesses suggested that raising the top two rates to their pre-2001 levels after the economy has recovered "would not be economically disastrous" or would not have much impact on the decisions of businesses to hire and grow. Your testimony indicates that even the threat of a future tax increase drives business decisions.

The small businesses you represent play a significant role in the economy, and members of both parties acknowledge that small businesses create two-thirds of net new jobs. I understand that NFIB regularly surveys its small business members, so this is more concrete than speculative economic theory. From your interaction with actual small business owners, would small business decisions to hire and expand be indifferent to an increase in the top marginal rates or capital gains and dividend rates?

Answer

We are in regular contact with the 350,000 small business owners the NFIB represents. This interaction provides us with a good sense about the concerns of the small business community. From what we have heard from our members, their decisions to hire and expand would be negatively impacted by an increase in the top marginal tax rates or capital gains and dividend rates.

In fact, we conduct a monthly Small Business Economic Trends (SBET) survey to gauge the economic outlook of the small business sector. The optimism indicator has been down for the last six months. In addition, we ask what is the biggest problem facing your business and, over the last six months, taxes has consistently ranked in the top two.

Our members have told us specifically that increases in tax rates will have a negative impact on their investment decisions. For many members the concern is that increasing their tax rates will make it more difficult to manage their businesses. A number of members have told us about good years prior to the recession and that managing their finances wisely helped them make it through the last few years. Most importantly making sure their employees stayed on the payroll. Higher taxes would mean these businesses have less money to address unforeseen costs and changing economic conditions.

Even businesses that are not directly impacted by a tax increase are concerned about the negative impact that an increase in taxes may have on their customers. Lost sales has been the top problem facing small businesses since the recession began and they are concerned that increasing taxes will mean that their customers and clients will have less money to spend.

COMMUNICATIONS

The Alliance for Savings & Investment

THE ALLIANCE FOR SAVINGS AND INVESTMENT STATEMENT

TO THE SENATE COMMITTEE ON FINANCE FOR THE SEPTEMBER 14, 2011 HEARING RECORD REGARDING TAX REFORM OPTIONS: MARGINAL RATES ON HIGH-INCOME TAXPAYERS, CAPITAL GAINS AND DIVIDENDS

SEPTEMBER 27, 2011

The Alliance for Savings and Investment (ASI) is a diverse coalition of dividend-paying companies, investor organization and trade associations, formed in support of a common goal: to promote economic recovery, growth and job creation through policies that foster private savings and capital investment. ASI members include: AGL Resources, Altria, American Forest & Paper Association, American Farm Bureau Federation, American Gas Association (AGA), AT&T, Capital Research and Management Company, CenturyLink, Edison Electric Institute (EEI), Financial Services Forum, Frontier Communications, Investment Company Institute (ICI), Laclede Gas Company, Mass Mutual, National Association of Manufacturers, National Association of Water Companies, Qwest, Securities Industry and Financial Markets Association (SIFMA), Spectra Energy, RAI Service, UPS, U.S. Chamber of Commerce, USTelecom Association, Vanguard, Verizon, Windstream, and Xcel Energy.

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The Alliance for Savings and Investment (ASI) is a diverse coalition of dividend-paying companies, investor organizations and trade associations, formed in support of a common goal: to promote economic recovery, growth and job creation through policies that foster private savings and capital investment.

We thank Chairman Baucus and Ranking Member Hatch for the opportunity to comment on the impact of increased tax rates on capital gains and dividends. The ASI's top legislative priority is making permanent today's current tax rates on capital gains and dividends to provide certainty to investors, stability to the economy and a strong foundation for long-term economic growth.

In 2003, in an effort to boost economic growth, Congress lowered the maximum rate on capital gains and dividends to 15 percent. Unfortunately, those rates will sunset – increasing the capital gains tax from 15 percent to 20 percent and the dividend rate will more than double from 15 percent to 39.6 percent. Congress has already extended the rates twice in 2006 and 2010. But, without additional Congressional action to keep the rates in place, they will expire at the end of 2012. In addition, beginning in 2013 investment income will be subject to an additional Medicare HI tax of 3.8 percent, raising the top rate on dividend income from 39.6 to 43.4 percent and capital gains to 23.8 percent.

Impact on Economic Growth

A Cato Institute study found that annual dividends paid by S&P companies rose from $146 billion to $172 billion – thus injecting $26 billion into the U.S. economy each year. Lower rates for capital gains and dividends also caused an influx of capital investment in the business sector, and equity values rose more than $2 trillion after the tax cut.

In contrast, allowing the rates to increase will undermine economic recovery efforts. According to the Heritage Foundation, higher investment tax rates would lead to 270,000 fewer jobs in 2018. Had the rates been allowed to increase, the study also concluded that economic output measured by GDP after inflation would fall by $50 billion in 2012.

Further, Dr. Christina Romer, former Chair of President Obama's Council of Economic Advisors, concluded in a November 2006 study that "tax increases are highly contractionary" and that "the large effect stems in considerable part from a powerful negative effect of tax increases on investment."

Capital Gains

In addition to harming the economy, the impact of capital gains tax increases would be borne by millions of Americans, across all income levels. According to IRS data, in 2008, more than 8 million tax returns reported $528 billion of long-term capital gains. Sixty-one percent of those returns were from taxpayers with adjusted gross income of less than $100,000.

Farm and ranch owners are disproportionally impacted by capital gains tax increases. Nationwide, 40 percent of all agricultural producers report some capital gains; nearly double the share for all taxpayers. In addition, the average amount of capital gain reported by farmers is about 50 percent higher than the average capital gain reported by other taxpayers. The impact of capital gains taxes on farming and ranching is also significant because production agriculture requires large investments in land and buildings that are held for long periods of time.

Higher capital gains taxes also make the U.S. less competitive. According to a report by Ernst & Young LLP, the U.S. capital gains tax rate compares unfavorably with that of many other major economies. Even with current rates, more than half of the countries surveyed have individual capital gains tax rates lower than that of the U.S. Allowing rates to increase would undermine efforts to keep the U.S competitive with our trading partners.

Dividends

By synchronizing the tax rates of capital gains and dividends, Congress eliminated the tax bias toward investing in high growth-low dividend companies. Maintaining parity between the two rates is important to ensure that investors' decisions remain "tax neutral" A higher tax rate on dividends could lead investors to favor higher risk capital gains over lower risk dividend paying stocks.

Keeping tax rates low will encourage more companies to pay dividends. The Cato Institute found that 19 companies in the S&P 500 began paying dividends for the first time in the immediate aftermath of the tax reform enacted in 2003. The study also found that dividend payments by S&P 500 companies rose from $146 billion to $172 billion in the first year following the 2003 tax cut. The overall pay-out of dividends in 2005 was more than 36.5 percent higher than the payout before the 2003 tax cut, and dividend income reported by taxpayers increased by a similar margin.

In addition to promoting growth, lower dividend tax rates promote market stability. Keeping rates low helps to attract and keep shareholders who are interested in a more long-term buy and hold strategy, which benefits shareholders, companies and ultimately the economy.

When Congress reduced the rates on dividends in 2003, it took an appropriate step in the right direction to make U.S. tax laws with respect to dividends more competitive with the rest of the world. Taxes on dividends is plain and simple a double tax on corporate income. Most other developed countries provide some relief from the double tax, and the lower rates help bring the United States into a comparable position with our major trading partners. Indeed, the U.S. fully eliminated the double tax from 1913 until 1953, with the exception of three years in the 1930s.

Conversely, raising rates would have negative ramifications. Higher tax rates on dividends will encourage the use of debt financing versus equity financing. As dividend-paying stocks become less valuable, publicly traded companies will find it more difficult to finance investments through stock offerings. Deductions for debt related interest will make debt financing more advantageous.

According to the bipartisan Tax Foundation, raising dividend tax rates will disadvantage the largest dividend-paying companies and could reduce the level of dividends paid to shareholders. If this happens, all taxpayers who receive dividend income would be affected, regardless of their income level, by discouraging investment in dividend-paying companies and potentially lowering dividend payouts.

Adverse Impact on Retirees

Lower investment tax rates don't just benefit direct shareholders; they benefit the tens of millions of Americans who own stock indirectly through mutual funds and the value of stock held through life insurance policies, pension funds or 401(k) plans.

According to a January 2010 study by Ernst & Young, of the 27.1 million Americans who received dividend payments from utility companies in 2007, 61 percent were taxpayers age 50 and older and 30 percent were taxpayers 65 and older.

Further, according to IRS data older Americans and those saving for retirement would be disproportionately hurt by a tax increase on capital gains income. Older Americans rely on income from capital gains. For 2008, among taxpayers with capital gains income, 32 percent were over age 65. Further, 41 percent of taxpayers reporting capital gains income were between ages 45 and 65, saving for retirement. They earned nearly 50 percent of all capital gains income.

Raising taxes on investment income could depress the value of stocks held in various retirement savings plans, doubling the damage done to seniors.

Conclusion

If Congress does not act to extend or make permanent capital gains and dividend rates, the maximum tax rate on dividend income will surge by 164 percent, and the capital gains tax rates will increase by as much as 33 percent.

Tax increases on investment income disproportionately affect seniors, farmers and ranchers, and manufacturers and will directly impact middle class tax payers. Undoubtedly, this looming tax increase on investment income will affect asset values. Congress should avoid assuming that values won't be affected until very near the date of expiration. Instead, the market will begin to price in the expiration months in advance. As the committee considers efforts to improve the tax code and promote economic growth, we urge members to maintain current low rates on both capital gains and dividends and provide certainty to the market well in advance of the expiration dates of the current rates.

Statement of the
American Farm Bureau Federation

TO THE
SENATE COMMITTEE ON FINANCE
FOR THE SEPTEMBER 14, 2011 HEARING RECORD REGARDING
TAX REFORM OPTIONS: MARGINAL RATES ON HIGH-INCOME
TAXPAYERS, CAPITAL GAINS AND DIVIDENDS

SEPTEMBER 26, 2011

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The American Farm Bureau Federation appreciates the opportunity to file this statement on the impact of capital gains taxes on farmers and ranchers and the farm and ranch businesses they operate. With more than 6.2 million member families, our organization represents a diverse range of agricultural producers and supporters from all 50 states and Puerto Rico. More than 21 million American workers (15 percent of the total U.S. workforce) are involved in our industry producing, processing and selling our nation's food and fiber.

It is important to our members and our industry that capital gains tax rates are maintained at their current level. Low capital gains tax rates increase the incentive for U.S. farmers and ranchers to invest in assets to grow their businesses and help them remain productive and profitable. Higher capital gains taxes make it difficult for many family farms, which make up 98 percent of total farms across the United States, to obtain land, buildings and animals they need to stay efficient.

The impact of capital gains taxes on farming and ranching is significant because production agriculture requires large investments in land and buildings that are held for long periods of time. Land accounts for 84 percent of assets owned by agricultural producers, and agricultural production accounts for more than 46 percent of the U.S. land base. On average, farmers own their farmland for 30 years, during which time land values can increase significantly. From the current 30-year time period (1981-2011), real U.S. farmland prices have increased over 33 percent, and since 1969, real U.S. farmland prices have increased over 155 percent.

Farmers and ranchers must have the flexibility to change their businesses to be responsive to market signals from American and overseas consumers if they are to remain efficient and profitable. Because capital gains taxes are imposed when buildings and farmland are sold, it is more difficult for producers to shed unneeded assets to generate revenue to adapt and upgrade their operations. In many cases, potential capital gains tax liabilities give taxpayers an incentive to hold onto assets rather than selling and reallocating funds. With approximately 40 percent of farmland owned by individuals age 65 or older, many individuals hold land until they die to avoid capital gains taxes. Land is one of the most common assets affected by capital gains taxes, and high rates create a barrier for new and expanding farms and ranches.

Capital gains taxes also threaten the transfer of land to the next generation of farmers and ranchers and put the future of agriculture at risk for another reason. Farming and ranching is a business filled with risk caused by unpredictable weather and uncontrollable markets. Unprofitable years occur as often as profitable ones, yet, farmers and ranchers are willing to assume the risk because they know that at the end of their careers the sale of their business will finance their retirement. The average farmer today is 57 years old. Not only do higher capital gains taxes shrink retirement income, but producers also factor in the capital gains tax rate when selling land or other assets. The need to maximize profit from the sale increases the likelihood that farmland will be sold for development when young farmers and ranchers find it hard to match the offers of non-farm investors. At a time when land values are appreciating, non-farm investors are able to outbid beginning or expanding producers in the real estate market because non-farm uses often yield higher prices. When this happens, our industry not only loses the land base it needs for growth and expansion, but also land that is lost to development which will never return to open space or be available for agricultural production.

Keeping the top capital gains tax rate at 15 percent is especially significant for farm and ranch owners because they are much more likely to pay capital gains taxes than the population at large. Forty percent of all agricultural producers report some capital gains; nearly double the share for all taxpayers. The average amount of capital gain reported by farmers is about 50 percent higher than the average capital gain reported by other taxpayers. Holding lower income taxpayers harmless to capital gains tax rate increases does not mitigate the damage that will be caused to our industry if capital gains taxes are allowed to rise because the sale of farm assets produces a one-time surge in farm income more likely than not to push a farmers or rancher over the threshold for higher tax rates.

Comments for the Record

United States Senate Committee on Finance

Tax Reform Options: Marginal Rates on High-Income Taxpayers, Capital Gains and Dividends
Wednesday, September 14, 2011, 10:00 AM
215 Dirksen Senate Office Building

By Michael Bindner
Center for Fiscal Equity
4 Canterbury Square, Suite 302
Alexandria, Virginia 22304

Chairman Baucus and Ranking Member Hatch, thank you for the opportunity to address this topic. The Center for Fiscal Equity believes that dealing with marginal rates for high income taxpayers, capital gains taxes and dividends are key issues in constructing tax reform legislation and ultimately in achieving comprehensive deficit reduction. We would also add treatment of the estate tax to the issues which must be discussed in this context.

The key fact of the deficit reduction debate is that the entire exercise is only necessary to fund the extension of the 2001, 2003 and 2010 tax cuts. If these tax cuts were allowed to expire automatically, no further deficit reduction would be required. For the efforts of the Joint Select Committee to succeed, they must not only link cuts to permanent tax reforms, but they must also enact enough cuts and reforms to make extending the Bush cuts a non-issue.

Cutting only $1.5 trillion on top of the previous $900 billion in cuts is inadequate for a master compromise, because no agreement is likely possible on which tax provisions to offset. If cuts are proposed to offset tax savings to preserve the 10%, 25% and 28% rates and the $1000 child tax cut, Republican members will never agree – as this would allow the President to veto any additional tax cut extensions. Democrats will never allow tax cuts at the high end to come to the floor unless low end cuts are enacted first. In order to enact any tax plan, some type of tax simplification is necessary, else gridlock will solve the deficit problem, provided the President refuses to compromise on temporary tax cut extensions.

In the long term, the explosion of the debt comes from the aging of society and the funding of their health care costs. Some thought should be given to ways to reverse a demographic imbalance that produces too few children while life expectancy of the elderly increases.

Unassisted labor markets work against population growth. Given a choice between hiring parents with children and recent college graduates, the smart decision will always be to hire the new graduates, as they will demand less money – especially in the technology area where recent training is often valued over experience.

Separating out pay for families allows society to reverse that trend, with a significant driver to that separation being a more generous tax credit for children. Such a credit could be "paid for" by ending the Mortgage Interest Deduction (MID) without hurting the housing sector, as housing is the biggest area of cost growth when children are added. While lobbyists for lenders and realtors would prefer gridlock on reducing the MID, if forced to chose between transferring this deduction to families and using it for deficit reduction (as both Bowles-Simpson and Rivlin-Domenici suggest), we suspect that they would chose the former over the latter if forced to make a choice. The religious community could also see such a development as a "pro-life" vote, especially among religious liberals.

Enactment of such a credit meets both our nation's short term needs for consumer liquidity and our long term need for population growth. Adding this issue to the pro-life agenda, at least in some quarters, makes this proposal a win for everyone.

Administration of an expanded child tax credit is an important issue as well. If administered within the context of personal income taxes, filers will continue to need the services of professional (and sometimes very-unprofessional) tax preparation services, which are often tied to predatory refund anticipation schemes because such credits are often seen as found money.

It would be preferable to instead tie this credit to an employer-based Net Business Receipts Tax (NBRT). Such a tax would be similar to a Value Added Tax (VAT), but would not appear on the customer receipt because it would have offsets for both the child credit and employer-provided health insurance (or direct services) for employees and possibly for retirees as well. As importantly, attaching this tax to the employer provides an incentive to adjust base pay downward for non-parents and parents whose children have left the nest – providing an incentive to have children for younger workers and providing an incentive to keep older workers on board, rather than replacing them with younger workers.

A separate VAT would also be established to fund discretionary spending occurring in the United States (both military and civil). This tax would make everyone conscious of supporting the operation of government and provide a direct incentive to save costs, because it could be made visible on the receipt at every level, including retail.

Both the NBRT and VAT would, as consumption taxes, burden both labor costs and profit. Enactment of both taxes would allow repeal of separate corporate income taxation, business income tax collection under personal income taxes, the hospital insurance and disability insurance payroll taxes and low rate personal income taxes on everyone, including higher income individuals.

In other OECD countries, all of whom have consumption taxes, capital gains taxes can be lower, since a portion of the taxation of capital already occurs as part of the VAT. The logic to enact lower capital gains and dividend taxes outside of a consumption tax environment is not as strong.

The Center for Fiscal Equity believes that lower dividend, capital gains and marginal income taxes for the wealthy actually destroys more jobs than they create. This occurs for a very simple reason – management and owners who receive lower tax rates have more an incentive to extract productivity gains from the work force through benefit cuts, lower wages, sending jobs offshore or automating work. As taxes on management and owners go down, the marginal incentives for cost cutting go up. As taxes go up, the marginal benefit for such savings go down. It is no accident that the middle class began losing ground when taxes were cut during the Reagan and recent Bush Administrations, both of which saw huge tax cuts. Keeping these taxes low is also part of why we are experiencing a jobless recovery now.

As long as management and ownership benefit personally from cutting jobs, they will continue to do so. Tax reform must reverse these perverse incentives.

In order to preserve vertical equity in a given tax year in a consumption tax environment, some form of progressive income and inheritance taxation is essential, otherwise the debt crisis cannot be avoided as consumption taxes will never be adequate to replace the lost revenue.

The Center suggests retaining surtaxes on high income earners and heirs. These would replace the Inheritance or Death Tax by instead taxing only cash or in-kind distributions from inheritances but not asset transfers, with distributions remaining tax free they are the result of a sale to a qualified Employee Stock Ownership Plan.

In testimony before the Senate Budget Committee, Lawrence B. Lindsey explored the possibility of including high income taxation as a component of a Net Business Receipts Tax. The tax form could have a line on it to report income to highly paid employees and investors and pay surtaxes on that income.

The Center considered and rejected a similar option in a plan submitted to President Bush's Tax Reform Task Force, largely because you could not guarantee that the right people pay taxes. If only large dividend payments are reported, then diversified investment income might be under-taxed, as would employment income from individuals with high investment income. Under collection could, of course, be overcome by forcing high income individuals to disclose their income to their employers and investment sources – however this may make some inheritors unemployable if the employer is in charge of paying a higher tax rate. For the sake of privacy, it is preferable to leave filing responsibilities with high income individuals.

Identifying deficit reduction with income and inheritance surtaxes recognizes that attempting to reduce the debt through either higher taxes on or lower benefits to lower income individuals will have a contracting effect on consumer spending, but no such effect when progressive income taxes are used. Indeed, if progressive income taxes lead to debt reduction and lower interest costs, economic growth will occur as a consequence.

Using this tax to fund deficit reduction explicitly shows which economic strata owe the national debt. Only income taxes have the ability to back the national debt with any efficiency. Payroll taxes are designed to create obligation rather than being useful for discharging them. Other taxes are transaction based or obligations to fictitious individuals. Only the personal income tax burden is potentially allocable and only taxes on dividends, capital gains and inheritance are unavoidable in the long run because the income is unavoidable, unlike income from wages.

Even without progressive rate structures, using an income tax to pay the national debt firmly shows that attempts to cut income taxes on the wealthiest taxpayers do not burden the next generation at large. ***Instead, they burden only those children who will have the ability to pay high income taxes. In an increasingly stratified society, this means that those who demand tax cuts for the wealthy are burdening the children of the top 20% of earners, as well as their children, with the obligation to repay these cuts. That realization should have a healthy impact on the debate on raising income taxes.***

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

Statement of Todd McCracken

on behalf of

The National Small Business Association

regarding

Tax Reform and Marginal Tax Rates, Capital Gains and Dividends

September 14, 2011

My name is Todd McCracken and I am the president of the National Small Business Association (NSBA), America's oldest small-business advocacy organization.[1] The NSBA is pleased to provide its perspective on marginal tax rates, capital gains and dividends in the context of tax reform.

The NSBA strongly believes that the present tax system is irretrievably broken and constitutes a major impediment to the economic health and international competitiveness of American businesses of all sizes. To promote economic growth, job creation, capital formation, and international competitiveness, fundamental tax reform is required.

There are three main factors that determine whether tax reform is constructive: (1) the tax base (what is taxed); (2) the tax rate(s) and (3) tax compliance costs (which are a function of the administrative simplicity or complexity of the tax system). The tax base should be neutral toward savings and investment and among different types of savings and investment. Marginal tax rates should be as low as possible. And the tax system should be as simple as possible consistent with *reasonable* enforcement requirements.

Marginal Tax Rates

Individual Rates Impact Small Businesses Directly

Most small businesses are sole proprietorships, subchapter S corporations or limited liability companies. Most of the remainder are partnerships (either limited or general). There are also some business trusts. All of these businesses are pass-through entities that are subject to individual tax rates not the corporate tax rates. Some small businesses are C corporations that are subject to the corporate income tax, but these are a relatively small percentage and a large portion of these companies' net income before compensating the owners' is usually consumed by paying the owners' salary.[2] This salary is also subject to the individual tax rates.

Thus, for the overwhelming majority of small businesses, individual marginal tax rates are much more important than corporate marginal tax rates.

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[1] 1156 15th St., NW, Washington, DC 20005. (202) 293-8830.

[2] For data on the composition of small business entities, see "Present Law and Background Relating to Selected Business Tax Issues," Joint Committee on Taxation, Part III, September 19, 2006, JCX-41-06.

Economic Impact on Jobs and Investment

High marginal tax rates discourage work, savings and investment. Conversely, reducing marginal tax rates encourage work, savings and investment. Reducing marginal tax rates also increase entrepreneurial risk-taking because less of the potential reward from the risk-taking will be taken by government. Furthermore, lower marginal tax rates reduce the cost of capital and increase productivity-increasing investment.

The economic loss associated with the tax system increases with the square of the tax rate increase.[3] Thus, doubling the tax rate will result in a four-fold increase in the adverse economic effect of the tax system. This effect is equally true in reverse. Lowering marginal tax rates has a disproportionately positive impact on the economy.

Small businesses are overwhelmingly pass-through entities and subject to individual tax rates. Small businesses also create most of the new jobs created in the U.S. economy. Raising the top tax rates on small businesses by increasing individual tax rates will have an adverse impact on small businesses, job creation and the economy.

Raising marginal tax rates will also increase the user cost of capital, reduce productivity-enhancing investment and reduce economic growth and real wages. Reducing marginal tax rates will have the opposite effect. Lower marginal tax rates will reduce the user cost of capital, increase productivity-enhancing investment, economic growth and real wages.

Although the tax base should be broadened and marginal tax rates on business reduced, the tax base should only be broadened to the extent that can be accomplished without imposing multiple levels of taxation on savings and investment. Lower tax rates should either be undertaken for their own sake or by reducing tax preferences that do not exacerbate the tax system's bias against savings and investment.

Adequate capital cost recovery allowances, preferably expensing, are critical to maintaining a reasonable cost of capital and to firms of all sizes being able to afford the capital investment necessary to compete in the international marketplace.[4] It is hard to overstate this point. Capital formation is critical to maintaining long-term competitiveness and preserving relatively high U.S. wage rates. Unless U.S. firms invest in productivity-enhancing or innovative cutting-edge equipment that provides new capabilities, U.S. firms will only be able to compete

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[3] Alan Auerbach, "The Theory of Excess Burden and Optimal Taxation," in the Handbook of Public Economics, Alan Auerbach and Martin Feldstein, Editors, 1985; Harry Watson, "Excess Burden," Encyclopedia of Taxation and Tax Policy, Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, Editors, 2005; John Creedy, "The Excess Burden of Taxation and Why It (Approximately) Quadruples When the Tax Rate Doubles," New Zealand Treasury Working Paper 3/29, December 2003.

[4] Expensing is always the correct answer in a consumption tax where either (i) interest is neither taxable nor deductible or (ii) debt proceeds are includible in the taxable base and principle and interest are deductible. In a hybrid system, such as the current U.S. system, some limits on debt financed investment in expensed property may be appropriate. As a practical matter, this will only be important in the case of large enterprises with large borrowing capacity.

by accepting lower returns and by paying workers less. If, of course, they fall far enough behind their domestic and foreign competitors, the firms will simply fail.

Section 179 expensing is of vital importance for smaller firms, particularly those in more capital intensives industries. It should be retained or expanded. For now, section 179 eliminates the tax bias against savings and investment for firms that can take advantage of it. It reduces the user cost of capital considerably for small firms. For 2011, up to $500,000 of investment purchases may be deducted. In 2012, the figure falls to $125,000. Thereafter, unless Congress acts, the amount deductible will fall to $25,000. This latter limitation dramatically limits the number of firms that can appreciably benefit and dramatically reduces the economic effect of the provision. Retaining the current $500,000 threshold should be high on the Congressional agenda.

Capital Gains

There are four reasons why a differential or zero capital gains rate makes sense. First, reduced capital gains rates are a spur to entrepreneurship and risk-taking and promote economic growth.[5] Second, a high capital gains tax rate, locks-in investors and therefore impedes the efficient allocation of capital. Third, high capital gains rates actually cost the Treasury revenue. Fourth, the capital gains tax is a double tax because taxing a capital gain means that both the increase in the present value of an expected future income stream and the future income stream itself are subject to tax. In effect, the same income is taxed twice. Once now, in anticipation of higher future income and once in the future as that income materializes.

A lower tax rate on capital gains realized due to investments in start-up ventures and growing small businesses is important to maintain the vitality of the venture capital markets and to draw capital into these inherently risky ventures. Especially because capital loss deductions are limited, in the absence of lower tax rates on capital gains, investors will seek safer places to invest their capital.

A tax is only due on capital gains when the gains are realized not when they accrue. Thus, taxpayers can indefinitely avoid paying tax on capital gains by holding their assets. This "lock-in" effect is more pronounced the higher the tax rate. This effect also impedes the efficient allocation of capital by locking investors into relatively low return assets and preventing them from investing in assets with a higher expected return. If the capital gains tax rate is lower, more people will choose to realize their capital gains and therefore pay the tax. Often, in the past, reductions in the capital gains tax rate have increased realizations so dramatically that capital gains tax revenue increased. Based on historical evidence, the revenue maximizing capital gains tax rate is no higher than 20 percent and may be as low as 9 percent.[6] The unlocking effect of

[5] See, e.g., William M. Gentry, "Capital Gains Taxation and Entrepreneurship," American Council for Capital Formation Center for Policy Research, November 2010.

[6] See Paul Evans, "The Relationship Between Realized Capital Gains and Their Marginal Rate of Taxation, 1976-2004," Institute for Research on the Economics of Taxation, October 9, 2009 for a recent empirical study.

reduced capital gains rate and impact on tax revenue is more dramatic than with other income sources because the realization rules make it, in effect, an optional tax.[7]

A capital gain occurs when the present discounted value of an asset's expected future income stream increases. This can occur for one of two reasons. First, the expected future income stream can increase. Second, interest rates (i.e. the discount rate) can decline, increasing the present value of income earned in the future. The income tax taxes both the higher future income stream when it is earned and increases in the capitalization of that expected future income stream. Therefore it double taxes that income stream.

Dividends

Dividends of S corporations are not double-taxed under current law. Dividends of C corporations are doubled taxed, however. Reducing this double taxation can be accomplished by reducing the tax rate on dividends (as is done under current law until 2013) or by various methods of integrating the corporate and individual tax systems.[8] Many foreign countries have partially integrated tax systems.[9] Although of limited direct importance to small businesses, reducing this double taxation is sound tax policy, enhancing capital formation and economic growth. Enhancing overall economic growth is important to the success of small businesses.

Compliance Costs

Compliance costs are the costs incurred by taxpayers complying with the tax system. The compliance costs incurred by businesses are estimated to be about $95 billion annually but may be as much as 50 percent higher.[10] Individual and not-for-profit compliance costs are, of course, quite substantial as well. In the case of small businesses these costs include the time of small business owners and their accounting staff devoted to collecting necessary information and filling out IRS forms and the costs incurred hiring outside accountants and lawyers for advice about how to comply with the tax law. Small business compliance costs relative to income or revenues are disproportionately high. A recent SBA study quantifies this disproportionate impact, showing that the impact on the small firms in terms of per employee costs is three times that of larger firms.[11]

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[7] In an income tax, the only way around this is to force every taxpayer every year to "mark to market" their assets. This would be an administrative nightmare and in the case of illiquid assets an administrative impossibility.

[8] See "Report of The Department of the Treasury on Integration of The Individual and Corporate Tax Systems: Taxing Business Income Once," January 1992 for a detailed analysis of the issue. See also, R. Glenn Hubbard, "Corporate Tax Integration: A View from the Treasury Department," *The Journal of Economic Perspectives*, Vol. 7, No. 1, Winter, 1993.

[9] See, ibid., Appendix B.

[10] Nicole V. Crain and W. Mark Crain, "The Impact of Regulatory Costs on Small Firms," U.S. Small Business Administration, Office of Advocacy, September, 2010, p. 29. See also, United States Government Accountability Office, "Summary of Estimates of the Costs of the Federal Tax System," August 2005, GAO-05-878 (business compliance costs are $40 to $85 billion annually); J. Scott Moody, Wendy P. Warcholik, and Scott A. Hodge, "The Rising Cost of Complying with the Federal Income Tax," Tax Foundation Special Report No. 138, December 2005 (business compliance costs are $148 billion annually).

[11] Nicole V. Crain and W. Mark Crain, "The Impact of Regulatory Costs on Small Firms," U.S. Small Business Administration, Office of Advocacy, September, 2010, Table I, p. 7.

Cost per Employee	All Firms	Firms with <20 Employees	Firms with 20-499 Employees	Firms with 500+ Employees
Tax Compliance	$800	$1,584	$760	$517

There will always be some compliance costs in any tax system. But today these costs are very high. And if there is one thing the NSBA membership is almost universally agreed on, it is that the current compliance costs are too high and that the tax system needs to be simplified.

We should aim to raise the revenue needed by the federal government in the least costly way. The costs of the current system represent a huge waste of resources that could be better spent growing businesses, creating new products, conducting research and development, or purchasing productivity enhancing equipment.

These costs also represent a significant drag on the economic growth, job creation and the international competitiveness of U.S. businesses. Compliance costs must be recovered by businesses in the sales price of their goods or services. Otherwise, the businesses will fail. Reducing these costs is within our control and it should be a priority of Congress. Furthermore, there is strong reason to believe that U.S. costs are substantially higher than those of most other developed nations.

<u>The FairTax</u>

There are a many ways to improve the tax system. To improve on the current system doesn't take a lot. But NSBA regards the FairTax (S. 13, H.R. 25) as the best fundamental tax reform proposal. It would have a dramatic positive impact on economic growth, job creation, real wages, investment and international competitiveness. A summary of why:

1. The FairTax would be simple and dramatically reduce compliance costs have a disproportionate negative impact on small firms. The resources currently used to comply with the present tax system can be better used growing businesses, creating new products, conducting research and development, purchasing productivity enhancing equipment or reducing prices to customers.

2. The FairTax would be neutral toward savings and investment and reduce the user cost of capital substantially. The capital stock would therefore grow. Productivity, innovation and real wages would increase.

3. The FairTax has much lower marginal tax rates than the current tax system and has virtually the lowest possible marginal tax rate consistent with a neutral tax treatment of savings and investment.[12] It would dramatically reduce the tax disincentive to work, save and invest. The double taxation of corporate income

[12] The only reason it does not have the lowest possible rate theoretically possible is the rebate that prevents the poor from paying any federal income or payroll tax and reduces middle class effective tax rates substantially.

(i.e. dividends and individual capital gains that are a function of retained corporate earnings) would be eliminated.

4. Entrepreneurial risk-taking and innovation would increase because more investment capital would be available and the tax on capital gains would be zero.

5. The U.S. would attract capital from throughout the planet. Investment in the U.S. whether by Americans or foreigners would not be taxed. The U.S. would, in effect, become the largest tax haven in the world. The "giant sucking sound" you would hear, to paraphrase Ross Perot's memorable metaphor, would be the U.S. attracting capital from throughout the world. Having adequate capital is important for all businesses but particularly important for small and start-up businesses.

6. For the first time, the tax system would impose the same tax burden on foreign produced goods and U.S. produced goods. The FairTax would eliminate the current origin principle system that places U.S. based firms at such a large disadvantage. This is because the FairTax is a destination principle tax (i.e. it is, in effect, border adjusted).

Appendix

Capital Gains Constitute Double Taxation

The price of a capital asset (C) is given by:

$$C = \sum_{t=0}^{n} Yt \,/\, (1+ r)^{t}$$

where Y_t is the expected future income the asset will generate in period t over n periods and r is the discount rate.

A capital gain is an increase in the value of C ($\Delta C > 0$). This can only occur if either Y increases or r declines. Thus,

$$C' = C + \Delta C = \sum_{t=0}^{n} Y't \,/\, (1+ r)^{t}$$

and

$$\Delta C = \sum_{t=0}^{n} Y't \,/\, (1+ r)^{t} \ - \ \sum_{t=0}^{n} Yt \,/\, (1+ r)^{t}$$

where $Y' > Y$ (i.e. a higher expected future income).

The income tax imposes a capital gains tax (τ) on both (ΔC) and an income tax on the increase in expected future income $Y' - Y$.

Thus, the new value of the asset in the presence of the income tax ($C(\tau)'$) is

$$C(\tau)' = \sum_{t=0}^{n} Y't \,(1- \tau)/\,(1+ r)^{t} - \ \tau\,\Delta C$$

Thus, the income is taxed twice $Y'\,(1- \tau)$ and $\tau\,\Delta C$. However, in a properly structured income tax, the value of the asset would decline by the same ratio as the future income so that:

$$(C + \Delta C)\,(1- \tau) = \sum_{t=0}^{n} Y't \,(1- \tau)/\,(1+ r)^{t}$$

In other words, the decline in the value of the asset ($C+ \Delta C$) due to the imposition of tax (τ) is greater than $(1- \tau)$ because of the extra double tax.

Statement
of the
U.S. Chamber
of Commerce

ON: **Hearing on Tax Reform Options: Marginal Rates on High-Income Taxpayers, Capital Gains and Dividends**

TO: **Senate Finance Committee**

DATE: **September 14, 2011**

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

INTRODUCTION

The Chamber thanks Chairman Baucus and Ranking Member Hatch for the opportunity to comment on the impact of increased tax rates on high-income earners and capital gains and dividends. The Chamber believes that the Committee should carefully consider the possible detrimental impact of increased marginal rates on pass-through entities and small businesses as well as the impact of increased investment taxes.

INDIVIDUAL TAX RATES

The Impact on Pass-through Entities

The Chamber believes that consideration of the impact of increased tax rates on those businesses that operate in pass-through form and, thus, remit tax under the individual code, is of the utmost importance. We believe increasing marginal rates threatens to harm a substantial number of businesses and, in particular, threatens to harm small businesses that are more likely to operate in pass-through form.

According to research by the nonpartisan Tax Foundation,[1] roughly one-third of all business taxes are paid by owners of pass-through businesses – the sole proprietorships, LLCs, partnerships, and S corporations that are often small in size and entrepreneurial – who report the income of these enterprises on their individual tax returns. Data from the National Federation of Independent Business indicates that 75 percent of small businesses operate as pass-through entities. These small businesses are a critical source of job creation and innovation, creating between 60 and 80 percent of net new jobs, and employing over half the labor force.[2]

The past 30 years have seen a significant increase in businesses that operate in these pass-through forms. During that time, the number of pass-through businesses, such as sole proprietorships, S-corporations, LLCs, and partnerships nearly tripled, from 10.9 million to 30 million.[3] The most numerous type of pass-throughs was sole proprietorships, growing from 8.9 million to more than 23 million. S-corporations and partnerships grew the fastest, from 1.9 million to more than 7 million. As a result, more business income is now taxed under the individual income tax code[4] than the traditional corporate code.[5]

This data makes clear that raising individual marginal rates would negatively impact a significant portion of the business community. Thus, the Chamber believes Congress must carefully consider the impact of increased marginal rates on these pass-through entities and small businesses.

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[1] See Tax Foundation, Fiscal Fact 182, The Economic Cost of High Tax Rates, available at http://www.taxfoundation.org/research/show/24935.html#_ftnref5.
[2] See Tax Foundation, Commentary: Small Business and the Personal Income Tax Rates, available at http://www.taxfoundation.org/commentary/show/23860.html.
[3] See Tax Foundation, News Release: Business Income to Shoulder over a Third of Tax Increase on Top Earners, available at http://www.taxfoundation.org/news/show/26702.html.
[4] All references to the "code" are to the Internal Revenue Code of 1986, as amended.
[5] See Tax Foundation, News Release: Business Income to Shoulder over a Third of Tax Increase on Top Earners, available at http://www.taxfoundation.org/news/show/26702.html.

Our Already Highly Progressive Tax System

As the Committee considers possible increased individual marginal rates or surtaxes, the Chamber urges you to remember that we already have one of the most progressive tax systems when compared with other OECD countries; our higher income earners and successful small businesses already shoulder more than their fair share of the income tax burden.

Our tax burden is already heavily skewed toward higher income earners and became more so after the 2001 and 2003 rate reductions. A 2009 CBO report shows that in 2006 the top 1% of households paid almost 30% of ALL federal taxes and the top 20% ("highest quintile") paid almost 70% of all taxes, increases over the amounts these groups paid in 2000. Conversely, the middle and lowest quintile paid only 9% and 0.8%, respectively, a decrease from 2000 shares and the lowest shares in the CBO's entire reporting period from 1979 to 2006. In fact, the data indicate that the top 5% have borne the brunt of tax increases during that time frame.

The imbalance in the tax distribution becomes more pronounced when only income taxes are considered. According to IRS Statistics of Income (SOI) data for 2007, the top 1% of taxpayers paid 40% of the total income taxes collected by the federal government. According to the nonpartisan Tax Foundation,[6] this is the highest percentage in modern history and a significant increase in the 25% of the income tax burden this group bore 20 years earlier. Further, the top 5% of taxpayers paid about 60% of income taxes in 2007, while the other 95% paid just short of 40%.

As the Tax Foundation[7] notes, this means that the top 1%, comprised of just 1.4 million taxpayers, pays a larger share of the income tax burden than the bottom 134 million taxpayers combined. Further, the top 50% of taxpayers account for more than 97% of income taxes paid, while the bottom half of all taxpayers pay less than 3% of all income taxes.

In other words, the Chamber believes our tax system is already progressive enough – a finding reiterated by a 2008 OECD study concluding that we have the most progressive income tax system among all OECD nations, relying more on the top 10% of taxpayers than any other nation and that those with lower incomes have the lowest tax burden of those in any nation.

INVESTMENT TAXES

Capital Gains

As with increasing individual marginal rates, the Chamber cautions the Committee about the detrimental impact of increasing capital gains taxes. Currently, capital gains are taxed at a rate of 15%. Any contemplated increase in the capital gains tax must consider that in 2013, capital gains will also be subject to the Medicare HI tax, adding another 3.8% tax to the capital gains tax rate.

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[6] See Tax Foundation, Tax Burden of Top 1% Now Exceeds That of Bottom 95%, available at http://www.taxfoundation.org/blog/show/24944.html.

[7] See id.

The impact of this increased tax rate would be borne by millions of Americans. According to the IRS SOI,[8] in 2008, over 8 million tax returns reported $528 billion of long-term capital gains. Taxpayers with adjusted gross income (AGI) of less than $100,000 accounted for almost 61% of those returns, while taxpayers with AGI of less than $50,000 accounted for 34% of those returns.[9]

Further, according to IRS SOI,[10] older Americans and those saving for retirement would be disproportionately hurt by a tax increase on capital gains income. Older Americans rely on income from capital gains. For 2008, among taxpayers with capital gains income, 34% were over age 65.[11] Further, 41% of taxpayers reporting capital gains income were between ages 45 and 65, saving for retirement. They earned nearly 50% of all capital gains income.[12]

In addition to harming older Americans and those saving for retirement, increase capital gains rates would hurt investment. According to the Congressional Budget Office (CBO)[13] and studies,[14] increasing capital gains rates could create a "lock-in effect" where investors avoid higher taxes by not selling assets. If investors are unwilling to sell taxable assets, the lock-in effect can reduce economic growth by preventing the reallocation of capital to more efficient investments. Further, as the CBO notes, "reductions in capital taxation increase the return on investment and therefore the formation of capital. The resulting increase in the capital stock yields greater output and higher incomes throughout much of the economy."

Finally, lower capital gains taxes have significant economic effects on economic growth, jobs and unemployment, inflation, savings, the financial markets, and debt. A 2010 study by Allen Sinai,[15] indicates that the net effect of lower capital gains taxation is a significant plus for U.S. macroeconomic performance. The study found that hiking capital gains tax rates would cause significant damage to the economy, reducing growth in real GDP, raising the unemployment rate, and significantly reducing productivity. The study concluded that these losses outweigh any gains in tax receipts from an increased capital gains rate. Further, the study concluded that higher capital gains taxes would not substantially reduce the deficit.

In sum, raising capital gains rates poses serious risks to the economy. Accordingly, the Chamber strongly opposes any increase in these tax rates due to the adverse impact it would have on investment, economic growth, unemployment rates and productivity.

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[8] See IRS Statistics of Income (SOI), Individual Income Tax Returns, 2008, available at http://www.irs.gov/pub/irs-soi/08inreturnsbul.pdf.
[9] See id.
[10] See Tax Foundation, Older Taxpayers Earn Lion's Share of Capital Gains Income, available at http://www.taxfoundation.org/blog/show/26525.html.
[11] See IRS SOI, available at http://www.irs.gov/pub/irs-soi/09in15ag.xls
[12] See id.
[13] See CBO, Capital Gains Taxes and Federal Revenues (October 2002), available at http://www.cbo.gov/doc.cfm?index=3856&type=0.
[14] See Heritage Foundation, Web Memo 1891, Economic Effects of Increasing the Tax Rates on Capital Gains and Dividends, available at http://www.heritage.org/research/reports/2008/04/economic-effects-of-increasing-the-tax-rates-on-capital-gains-and-dividends#_ftn2.
[15] See Sinai, Capital Gains Taxes and the Economy, available at http://www.accf.org/publications/139/capital-gains-taxes-and-the-economy.

Dividend Taxes

As with capital gains taxes and marginal rates, the Chamber cautions the Committee about the detrimental impact of increasing dividend taxes. Currently, dividends are taxed at a rate of 15%. As with capital gains taxes, any contemplated increase in the dividend tax must consider that in 2013, dividends will also be subject to the Medicare HI tax, adding another 3.8% tax to the dividend tax rate.

As with capital gains rates, millions of Americans – of all income levels – benefit from reduced dividend tax rates. According to the IRS SOI,[16] in 2008, 26.4 million tax returns reported $159 billion of qualified dividend income. Taxpayers with AGI of less than $100,000 accounted for 66% of those returns while taxpayers with AGI of less than $50,000 accounted for almost one-third of those returns.[17]

Also similarly to capital gains taxes, older Americans would be disproportionately hurt by increased dividend rates. According to IRS SOI,[18] for 2008, of returns filed by taxpayers age 65 and older, 42% reported dividend income. Of all dividend income earned, 48% was earned by taxpayers age 65 and older. Further, for 2008, 72% of all dividend income earned was earned by taxpayers age 55 and older.[19]

The negative ramifications of increased dividend rates do not stop there. According to the bipartisan Tax Foundation,[20] raising dividend tax rates will disadvantage the largest dividend-paying companies and could reduce the level of dividend paid to shareholders. Further, a September 2010 J.P. Morgan study[21] concludes that raising taxes on dividend income would create a disadvantage for dividend-paying companies and may cause companies to alter their current dividend strategies. This could lower the amount of dollars by which companies ordinarily increase their dividends and could reduce the stock value for all shareholders. If this happens, all taxpayers who receive dividend income would be affected, regardless of their income level, by discouraging investment in dividend-paying companies and potentially lowering dividend payouts.

The same J.P Morgan study[22] concludes that increased dividend rates could increase economic instability. The study finds that an increase in the dividend tax rate would lead to a higher pre-tax cost of equity. As a result, equity valuation might be under pressure, corporations may reduce their investing due to higher hurdle rates, and debt might become more attractive relative to equity. Further, the study concludes that increasing tax rates on dividends can make

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[16] See IRS Statistics of Income (SOI), Individual Income Tax Returns, 2008, available at http://www.irs.gov/pub/irs-soi/08inreturnsbul.pdf.

[17][17] See id.

[18] See IRS SOI, available at http://www.irs.gov/pub/irs-soi/09in15ag.xls

[19] See id.

[20] See Tax Foundation, The Economic Effects of the Lower Tax Rate on Dividends, available at http://www.taxfoundation.org/publications/show/26384.html.

[21] See J.P. Morgan, Unintended Consequences: How higher investor taxes impact corporate finance decisions, available at http://defendmydividend.com/docs/unintended-consequences-vfinal.pdf.

[22] See id.

investing in stocks less attractive to investors and can reduce a stock's perceived value. This decrease in perceived value coupled with the fact that interest on debt is a deductible corporate expense could cause companies to opt to finance new investments through debt offerings rather than stock issuances. Thus, as a result of this increased incentive to use debt financing, businesses may significantly increase debt levels as they attempt to optimize capital allocation. These increased debt levels could cause greater instability in the economy and increase risk of failure.

As with increased capital gains rates, increasing investment taxes in the form of higher dividend taxes comes with many adverse consequences. Thus, the Chamber strongly urges the Committee to avoid dividend tax hikes and the damaging economic ramifications associated with them.

CONCLUSION

The Chamber thanks the Committee for the opportunity to comment on the impact of increased marginal and investment tax rates. The Chamber believes that as the Committee considers fundamental tax reform, the detrimental effects of increased rates must be given the utmost consideration to ensure changes to the tax code allow businesses the opportunity to grow, compete, and innovate. We look forward to working with the Committee on this vital issue.