1664

S. HRG. 104—560

ROUNDTABLE DISCUSSION ON TAX REFORM AND ECONOMIC GROWTH

HEARING

before the

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

June 10, 1996

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON: 1996

26-726 cc

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-053515-8

JOINT ECONOMIC COMMITTEE

[Created pursuant to Sec. 5(a) of Public Law 304, 79th Congress]

SENATE

CONNIE MACK, Florida,
Chairman
WILLIAM V. ROTH, JR., Delaware
LARRY E. CRAIG, Idaho
ROBERT F. BENNETT, Utah
RICK SANTORUM, Pennsylvania
ROD GRAMS, Minnesota
JEFF BINGAMAN, New Mexico
PAUL S. SARBANES, Maryland
EDWARD M. KENNEDY, Massachusetts
CHARLES S. ROBB, Virginia

HOUSE OF REPRESENTATIVES

JIM SAXTON, New Jersey,
Vice Chairman
THOMAS W. EWING, Illinois
JACK QUINN, New York
DONALD A. MANZULLO, Illinois
MARK SANFORD, South Carolina
MAC THORNBERRY, Texas
PETE STARK, California
LEE H. HAMILTON, Indiana
MAURICE D. HINCHEY, New York
CAROLYN B. MALONEY, New York

ROBERT N. MOTTICE, *Executive Director*
PAUL G. MERSKI, *Chief Economist*
LEE PRICE, *Minority Staff Director*

Prepared by DONALD C. EVANS III

CONTENTS

OPENING STATEMENT OF MEMBERS

Representative Mac Thornberry 1
Representative Pete Stark, Ranking Minority Member 4
Senator Robert Bennett 6

WITNESSES

Statement of Dale Jorgenson, Chairman of the Department of Economics, Harvard University 5
Statement of Steve Moore, Director of Fiscal Policy Studies, Cato Institute 5
Statement of Norman B. Ture, President, Institute for Research on the Economics of Taxation 8
Statement of William Gale, Senior Fellow, The Brookings Institution 9
Statement of Robert Johnson, Managing Director, Moore Capital Management 14
Statement of Ronald Edmondson, Small Business Owner 15
Statement of Martin Regalia, Vice President and Chief Economist, U.S. Chamber of Commerce 19
Statement of Bruce Bartlett, Senior Fellow, National Center for Policy Analysis 21

SUBMISSIONS FOR THE RECORD

Prepared statement of Representative Thornberry 54
Unleashing the American Spirit, a guide by The National Commission on Economic Growth and Tax Reform submitted by Representative Thornberry 57
Prepared statement and charts of Representative Stark 68
Information submitted by Dale Jorgenson: statement presented to the House Committee on Ways and Means and article entitled, "The Economic Impact of Fundamental Tax Reform" 79
Prepared charts of Steve Moore 113
Economic Policy Bulletin entitled, Restructuring the Federal Tax System by Norman B. Ture 116
Information submitted by Norman B. Ture: Impact of the Flat Tax on Tax Exempt Bonds by Steve Entin 130
Prepared statement of William Gale 134

ROUNDTABLE DISCUSSION ON TAX REFORM AND ECONOMIC GROWTH

Monday, June 10, 1996

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D.C.

The roundtable discussion convened at 9:00 a.m., in Room 106 of the Dirksen Senate Office Building, Representative Mac Thornberry presiding.

Present: Representatives Mac Thornberry and Pete Stark and Senator Robert Bennett.

Staff Present: Lou Zickar, Mynelii Saalfield, Paul Merski, Jeff Styles, William Buechner, Lee Price, Caleb Marshall, William Spriggs, Missy Shorey, Greg Williams, Roni Singleton, and Joe Engelhard.

OPENING STATEMENT OF REPRESENTATIVE MAC THORNBERRY

Representative Thornberry. The roundtable discussion will come to order.

My name is Mac Thornberry, and I represent the 13th Congressional District of Texas. Chairman Mack has asked me to serve as moderator for this rather unconventional hearing in Congress.

While I don't think any of us expect major tax reform to be enacted in Congress this year, it has been and will continue to be at the top of a lot of people's agenda.

I know in my own Town Hall meetings it has been among the most frequently raised issues. People are not really sure of the various details of this or that proposal, but they feel very strongly there ought to be some sort of reform.

Today we are not going to try to get into the details of all the various proposals, but we are going to try to step back and focus on what tax reform would mean to the American economy, to the American taxpayer and their families, and what it would do to the quality of life and growth in our economy.

My goal is to try to keep us on the subject at hand, as close as we can be, and we are going to do some things that are a little bit different.

We are going to dispense with the traditional opening statements by Members or by witnesses. I have a statement that I would like to be put in the record, and any witnesses or Members who have statements they would like to have put in the record, without objection it will be there.

[The prepared statement of Representative Thornberry and Unleashing the American Spirit, a guide by The National Commission on Economic Growth and Tax Reform, appear in the Submissions for the Record.]

We are also going to try to have time for questions from the audience. So we have some note cards around, and if you have questions that you would like to be submitted or for discussion, please write your question out and then we will try to get to it toward the end.

Finally, in order to have a discussion that is as full and as useful as possible, I hope that all Members of the Committee and all witnesses will try to avoid any lengthy monologues on the subject.

We are not going to have any set time limits, but that is going to require a little mutual respect and restraint by everyone. I think maybe that will do a better job of helping to illuminate some of the ins and outs of what can be a complicated issue, but it is something that is certainly at the forefront of the national debate.

Let me take just a second to briefly introduce our distinguished panel. Let me say that I appreciate very much each of you being here and participating with us.

Not necessarily in the order they are seated, they are:

Bruce Bartlett is Senior Fellow for the National Center for Policy Analysis based in Dallas -- to get a Texas connection in there. He was formerly in the Treasury, the White House, and associated with this Committee.

Mr. Ronald Edmondson is a small businessman from Amarillo, Texas. He is a part owner of office supply businesses in both Amarillo and Lubbock, and I appreciate very much his willingness to sit here on this panel and participate with us.

Dr. Dale Jorgenson is Chairman of the Economics Department at Harvard University.

Steve Moore is Director of Fiscal Policy Studies at the Cato Institute, and has been associated with this Committee, and is a frequent author.

Martin Regalia is Vice President and Chief Economist of the U.S. Chamber of Commerce and has previously been associated with the banking industry, including the Fed.

Dr. Norman Ture is president of the Institute for Research on the Economics of Taxation. He has served in the Treasury Department of various Administrations, as well as with several congressional committees.

Dr. William Gale is Senior Fellow at The Brookings Institution and has written a great deal on these issues.

And Dr. Robert Johnson was a strategist and investment manager with Moore Capital Management. He was also an economist for the Senate Banking and Budget Committees, and has also been with the Fed.

I appreciate Senator Bennett and Mr. Stark being with us here as we begin.

Let me just suggest that we start out this way, and that is: Do we need tax reform, or are any of the proposals that are on the table so full of holes that we are going to end up with so many problems that we might as well leave what we have got?

Put another way: Can we do better than what we have got now?

Representative Stark. Excuse me. Was it your intention to recognize either Senator Bennett or myself before you launched into the enlightenment on today's program?

Representative Thornberry. It was not. As I mentioned, I think, maybe just before you got here, we are going to try to dispense with opening statements other than a brief summary of the way this hearing would be different from most hearings. I thought that might be a good place to start, but if you have a particular question you would like to begin with, Mr. Stark, you are more than welcome to start.

Representative Stark. It is just that I stayed up late last night preparing a statement which your staff had suggested was going to be in order. But because Bob Bennett looks so rested, I am sure that he did not. So I would just ask, Mr. Chairman, consent that the opening statement that I labored so long on appear in order in the record.

Representative Thornberry. Absolutely.

Senator Bennett. Mr. Chairman, I would ask that we hear what kept Mr. Stark awake at night.

(Laughter.)

I sleep comfortably most of the nights. I want to know what is bothering him. How long is it?

Representative Stark. Let me just pass this down to the Senator.

(Laughter.)

Representative Thornberry. I have seen the Congressman's new son. It is worth staying up at night for.

If it is not too lengthy, Pete, why don't we just do that?

OPENING STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Representative Stark. Thank you.

I wanted to raise, and I guess we could raise it in inquiries, that we know that tax changes will come up as a campaign issue. While I must admit my prejudice both to my own candidate and to the candidate I hope he beats, I do not feel, as I know some Members of the Senate and, indeed, some of the House feel, that we should be dealing with tax cuts at all -- that is my prejudice -- until such time as we have completed work on balancing the budget.

But there is a great deal of difference among us as to where that should fit in. I hope that we can find out whether the negative effects of deficits would outweigh the positive effects of any potential tax changes or reductions that are in order.

That is really what I wanted to talk about. I would have gone into some historical detail that economists like to do. Going back to the 1980s, and a variety of cuts that we had, have not really done much to qualify the supply-siders as the leading economic philosophers, at least of the 20th century. Their turn may come in the next millennium, but we will see.

So the issue was that we should work to preserve the tax system. But the question, I think, that we have to balance it with all the time, and I hope we will this morning, Mr. Chairman, is: given some options, which we are always faced with in our business, it looks like any tax proposal, either by President Clinton or by Senator Dole, would impact on the deficit. There are some who may feel that that would not be the case. I hope to raise the issue today of what is the better choice for the country? That is what I really wanted to talk about.

Thank you. Thank you for indulging me.

[The prepared statement and charts of Representative Stark appear in the Submissions for the Record.]

Representative Thornberry. I think that there is a very real question that we need to discuss at some point and that is, if a particular tax reform proposal increases the deficit, is that a net plus or a net minus for the economy? Absolutely. I think that is a very real question.

But if we might start with any comments that you may have about where we are today and do we need to look at something different, I guess, can we do better than the current tax code as far as our economy goes?

If anyone would like to comment on that, and then I think we have a number of questions that we want to get into such as Mr. Stark has raised.

Dr. Jorgenson, do you want to begin?

STATEMENT OF DALE JORGENSON,
CHAIRMAN OF THE DEPARTMENT OF ECONOMICS,
HARVARD UNIVERSITY

Mr. Jorgenson. I think the main issue that we need to confront at this hearing is the growth issue. By switching to a consumption tax through fundamental tax reform, we could experience an increase in our national product of 13 percent. That is a huge impact on growth. It seems to me that is the main thing that is driving the move toward fundamental tax reform. At the moment this is not concentrated in either of the campaigns, either the Dole campaign or the Clinton campaign, but I think is making its way through public discussion around the country.

[The prepared statement of Mr. Jorgenson and article entitled, "The Economic Impact of Fundamental Tax Reform" appear in the Submissions for the Record.]

Representative Thornberry. Mr. Moore?

STATEMENT OF STEVE MOORE,
DIRECTOR OF FISCAL POLICY STUDIES, CATO INSTITUTE

Mr. Moore. If I could just follow up to what Dale is saying.

Representative Thornberry. Could you talk into your microphone both for the sake of the recorder and the audience?

Mr. Moore. If you look at this chart that I have passed out, and hopefully each of you has it in front of you, it shows the average real growth rate under various economic regimes going back to Eisenhower. What is not very well understood is that under the Bush-Clinton years, and this is not a partisan comment because it applies to both the

presidencies of Bush and Clinton, the last seven years have had the slowest economic growth rate in this country since the Great Depression.

This is something that is not well appreciated, but at 1.8 percent, we are growing substantially slower than we did in the 1980s. I think this gets to the point that Mr. Stark was making about, you know, can we afford a tax cut and balance the budget, and I think the one thing that we ought to always keep in mind is that if we keep growing at 1.8 percent per year or even 2.0 to 2.5 percent per year, no matter how much the Republicans want to cut the budget, we will never balance the budget because at a growth rate that low, we will never get to a balanced budget.

If we could make that economic growth rate, which is now about 2.0 to 2.5 percent per year, if we could make that growth rate increase by 1.0 percent to 3.0 to 3.5 percent per year, over the next six to seven years over half of the deficit would simply go away because of that increased economic growth.

So I do not think that it is necessarily one or the other. I like to consider myself a supply-sider and a deficit hawk. You may consider that, Mr. Stark, to be a contradiction in terms, but I think we need faster growth if we are going to reduce the deficit.

[The charts submitted by Mr. Moore appear in the Submissions for the Record.]

OPENING STATEMENT OF SENATOR ROBERT BENNETT

Senator Bennett. Could I follow up on that? Because I, too, consider myself a supply-sider and a deficit hawk. The thing that has been most distressing to me, coming to Congress from the business world, is that all of these discussions seem to deal with the economy as if it were a zero-sum game rather than an organism.

You recognize quickly, running a business, that it is not a zero-sum game. Running a business, there are ways I can increase my profits by increasing my prices, which, in government-speak, means increasing taxes. There are other ways where I clearly increase my profit by cutting prices, which, in government-speak, is supply-side economics.

I think in this government we should raise the admission prices at national parks. I think the amount of money we are spending on national parks is scandalously low. I am on the Subcommittee and the appropriations committee that deals with that. And you look at the attendance at national parks, and you say they are crying out for a price increase. This is a vacation opportunity that is not price-sensitive, to put

it in businessman's terms. Am I going to be attacked for being a tax raiser when I say we ought to increase the gate price at the national park?

There is a whole series of places where, as a businessman, I could say we could stand a price increase here, we could stand a price increase there. But there are other places where we clearly need a price cut, and one of them is in the income tax.

So, can we get in that arena that we are away from the straitjacket that says if you are a supply-sider you automatically say deficits do not matter, and if you are a deficit hawk you automatically say we cannot possibly cut taxes anywhere, and deal with the real problem that says we can in fact do both if we do it intelligently and get away from the cliches.

Mr. Moore. Well, I would certainly hope so.

If you look on the last table in this little packet that I handed out, if you look at what has happened with revenue growth, this compares revenue growth in the 1980s versus revenue growth in the 1990s, and one of Washington's best kept secrets is that revenue growth in the 1980s, even after Reagan's very large income tax rate reduction, has been substantially faster than revenue growth in the 1990s, with two very large tax increases. Again, one was by Bush and one was by Clinton.

Of course, the reason the revenues grew faster in the 1980s than the 1990s is because the economy grew faster. I am not making the extreme supply-side case that tax cuts are going to pay for themselves.

Representative Stark. Well, would this look any different, Mr. Moore, because you have an interesting Bush-Clinton relationship there, which seems an unusual marriage, if you lumped Bush in with Mr. Reagan and let Mr. Clinton fend for himself? Would this look much different?

(Laughter.)

Mr. Moore. Well, the reason we did this, put Bush and Clinton together, is because Bush and Clinton's economic policies have been virtually identical, at least with respect to fiscal policy. I mean, in 1990 we had a very large tax increase and a very large increase in domestic spending and a large cut in defense spending, and almost all analysts agree that the 1993 budget deal that we had was essentially a carbon copy of the 1990 deal.

I believe that what we had in the 1990s is sort of a Reaganomics in reverse under Bush and Clinton.

Representative Thornberry. Yes, Dr. Ture, did you want to jump in here?

STATEMENT OF NORMAN B. TURE, PRESIDENT,
INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. Ture. If I may, please. Let me see if I can't get the discussion back to your question, Mr. Chairman.

Certainly, I do not think anybody participating in a discussion of this sort will say we really ought not to be concerned about economic growth, but I do not think that this discussion ought to so focus on economic growth as to preclude your putting your attention to other reasons for tax restructuring.

We have an enormously complex income tax, and our payroll taxes are not all that easy to deal with, nor are our transfer taxes nor are our body of excise taxes. We incur enormous deadweight losses in complying with and administering and enforcing those taxes.

So certainly one of the major objectives of tax restructuring should be to see if we cannot reduce those deadweight losses by coming up with a tax structure that is a good deal less burdensome in this respect.

We have a tax system that, to my knowledge, nobody believes is fair. Now, I think there will be around this table and around any forum disagreements about what is the appropriate standard or measure of fairness, and therefore, there will be disagreements about what we ought to do to make the system fairer.

But certainly, nobody is going to sit back and say we ought to be content that this system is as fair as we can and should try to make it.

We have a tax system that I believe is enormously distorting the market system's outcomes, and it seems to me one of the things we ought to set up as a major goal of tax restructuring and certainly ought to be on this table is what do we do to make the tax system less of an impairment to the effective functioning of the free market system.

I think in a free society we require efficient functioning of the free market, and we have a tax system that distorts market outcomes much more than it allows market outcomes to be accurately revealed to market participants.

One of the consequences of that is, of course, that we have a tax system that is heavily biased against saving and against capital formation in the private sector. I do not think that the cause of reducing that bias depends on how large an effect on the rate of economic growth we will get.

I would like to make this observation as sort of a statement of my preferences going into this discussion: Suppose that we were able to eliminate throughout all public institutions, all public policies, all public

arrangements and activities all of the devices and activities that had distorting effects on the markets' operation so that we were content that what the market cast up as price signals and the ways in which we reacted to them was as good as we could get; and suppose, having done that, bearing in mind that economic growth is not for free, that it involves undertaking costs, that with that essentially effectively operating free market system, we come up with a growth rate of, say, 1.5 percent. Under what circumstances would it be appropriate for any of us to say, "Oh, you people don't know what you're doing. The growth rate ought to be 2.0 percent or 3.0 percent or 5.0 percent."

[The Economic Policy Bulletin entitled, Restructuring the Federal Tax System by Mr. Ture appears in the Submissions for the Record.]

Representative Thornberry. Yes. "When are you going to be satisfied," in other words.

Mr. Gale, did you want to jump in on economic growth?

STATEMENT OF WILLIAM GALE, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. Gale. Yes. Thanks.

I do not think anyone would want to defend the current tax system as the best of all possible worlds. Certainly, if you were designing a system from scratch, you would not come up with the current system as the best tax system.

But the issue is where do we go from here? There are both benefits and costs to tax reform. It is pretty clear by now that this is not a situation where everybody wins in all time periods. So the essential issue is the trade-offs involved in tax reform or tax cuts, and that comes down to measuring the gains versus measuring the losses.

Obviously, one of the biggest potential gains, is in economic growth. I agree with Dr. Ture that that is not the only criteria and even if tax reform did not generate much growth, we might want to consider fundamental reform for other reasons.

But I think we need to have our eyes open on how big the growth effects might actually be and I just want to talk briefly about the handout that I have provided to offer a quick tour.

Page 2 looks at the effects of saving of a 15 percent across-the-board tax cut, which has been proposed by several people recently. What I do is show that applying Michael Boskin's well-known estimated saving elasticity of 0.4 implies about a $10 billion increase in saving. That is a fairly high saving elasticity, but a very small increase in saving. A $10

billion increase in saving in a seven trillion dollar economy basically does not show up on the radar screen.

That is just private saving; it does not address the budget deficit. So the net effect on national saving might actually be negative.

Page 3 looks at the effects of fundamental tax reform on economic growth. Here I think it is interesting, Dale Jorgenson noted a 13 percent increase in gross domestic product. I presume that is a long-term number.

Mr. Jorgenson. No, that is the immediate impact. The long-term number is less than that; it is around 9.0 percent.

Mr. Gale. Okay. Well, the estimated long-term increase is 9.7 percent, based on a paper by Alan Auerbach, presented at Brookings a couple of months ago.

But the issue here is we have a very complicated economy and a complicated tax reform, and the models that are used often omit crucial features of the economy; in particular, adjustment costs and the presence of pensions.

The models also look at unrealistic tax policy; for example, in the first line I look at a comprehensive consumption tax with no personal exemptions, no transition relief for existing businesses, and no deductions, such as those for mortgage interest, charity and health insurance.

That is where you get the 10 percent increase.

As you add in these crucial features of the economy and as you add in these realistic features of tax policy, if you look at the 10-year effect, even in the fourth row, the 10-year effect you get down to a 0.3 percent increase in output per person. That is almost nothing, and that has not accounted for the existence of additional deductions such as mortgage interest or charity or health, and it has not accounted for the fact that almost all the net saving in the country occurs right now in tax-preferred forms, in pensions and 401(k)s.

Let me just make one further note. The last two pages look at the effects of the Tax Reform Act of 1981. The standard supply-side story is that tax cuts would raise saving and thereby raise productivity and raise the growth rate. The simple fact is, despite the tax cuts in 1981, despite universal eligibility for Individual Retirement Accounts starting in 1981, and despite very high real interest rates following the 1981 tax cut, there was no increase in personal saving. This is not a partisan issue, this is

not a doctrinaire issue, it is just a fact. The graph at the bottom of page 4 shows that.

[The prepared statement of Mr. Gale appears in the Submissions for the Record.]

Senator Bennett. May I ask you a question here?

Mr. Gale. Yes.

Senator Bennett. When you say personal savings rates, this does not include capital formation or capital accumulation that occurs in Chapter S-Corporations or Partnerships?

Mr. Gale. It does. It does. Everything that is not -- Partnership income and Chapter S would show up in personal saving, not business.

The question is: How did we get growth in the 1980s? You see these wonderful statistics from 1981 to '89 or 1982 to '89, and the answer is on page 5. We got growth from five sources: One was the dramatic increase in the budget deficit.

The second is an increase in the utilization rate of existing capacity. That is, in 1982 there were a lot of machines out of service because we were in a deep recession. Those machines came back into service. By 1989 we had a pretty high capacity utilization rate.

The same thing with unemployment. We had a high unemployment rate in 1982. That gradually came down over the 1980s.

A fourth factor was a historic increase in the proportion of the population that worked. This is mainly, I think, due to changing mores about women in the labor force.

The last issue was a huge capital inflow, as is shown in the last line.

The point about these five factors as sources of growth is we either cannot or do not want to replicate this experience. We cannot increase the cyclical factors much more. Unemployment rate is low. Capacity utilization rate is high currently. Unemployment to population, we have sort of had the shift.

I do not think we want to try to finance economic growth with another doubling of the debt-to-GDP ratio. We may want to finance it with a huge influx of foreign capital, but, if so, we should be open and honest about what is going on in that case.

So I think the lesson from the 1980s is that the sources of growth in the 1980s are not available in the 1990s, and the increase in saving, which is alleged to have spurred the growth in the 1980s simply did not happen,

and I do not see any evidence for why it would also happen now in the mid-1990s.

Representative Stark. How much revenue would we lose on one of the popular flat-rate reforms? Let's take, I don't care, between Forbes and Majority Leader Armey, they have rates of 17 or 20 percent on incomes above 30,000. What would that cost us, roughly?

Mr. Gale. The 17 percent rate -- I did these estimates several months ago; I do not have them with me -- it is on the order of $100 billion per year. Now, that is with no deductions.

Representative Stark. What if we put those deductions in, if you got the popular pressure and put mortgage and charity and health insurance deductions in the calculations?

Mr. Gale. You either gut the revenue base of the government or you raise rates. The calculation I did was that if you have a 20.8 percent revenue-neutral rate in the Armey tax with no deductions, if you add in deductions for mortgage interest, charity, and state and local income taxes, you get up to 25 percent. If you allow transitional relief for existing businesses, which I think you would almost have to do, you get up to about 28 percent. That is 28 percent flat rate. Right.

Representative Thornberry. Has anybody else done revenue estimates on anything?

Mr. Jorgenson. Yes. I have done some calculations holding the deficit constant. I think Mr. Stark is onto a very fundamental point here. We do not want to discuss fundamental tax reform in the context of increasing or decreasing the deficit.

Representative Stark. Right.

Mr. Jorgenson. We will be at this, you know, until all of us have long since passed from the scene, unless we focus on the fundamental analytical device that was used in the 1986 tax reform -- Mr. Stark is very familiar with that -- which is that we ought to consider tax changes that are deficit-neutral, hold the deficit constant at the standard projections by the Congressional Budget Office.

If you do that, what you find is that, holding the deficit constant, the answer is that a plain vanilla consumption tax which would produce a 13 percent increase in the GDP gradually declining to the number that both Alan Auerbach and I agree on, which is around 9-10 percent, at the Federal level the tax rate would be 12 percent.

Now, just focus on that for a minute. This means nobody has a 1040 anymore. Nobody is filling out an income tax form. The income tax is

gone; we are replacing that by a consumption tax. What would be the rate of that tax at the Federal level? Twelve percent.

It does not take a lot of political imagination to understand the appeal of fundamental tax reform.

Representative Stark. If you are rich.

Mr. Jorgenson. It is something that is going to produce growth.

Representative Stark. It hurts the poor people tremendously, Mr. Jorgenson. I mean, that is a great theory for a Republican, but my constituents would all be destitute.

Mr. Jorgenson. There is something that your constituents benefit from a great deal, Mr. Stark, I hope, which is the earned-income tax credit. All one needs to do to deal with the distributional issue is to simply enhance the earned-income tax credit. That is something that has been proved in a bipartisan manner to be politically viable and to produce desired distributional effects, and I hope that your constituents benefit from it.

Mr. Gale. These estimates are based, as I understand it, on a model where all saving, let me talk about Alan Auerbach's model as familiar with Dr. Jorgenson's model. But based on a model where all saving is currently taxed and moving to a system where all saving is not taxed. Okay.

The fact of the matter is, in the current economy, 90 percent of personal saving is done in saving vehicles that already receive consumption tax treatment. Pensions, 401(k)s, IRAs and Keoghs account for 90 percent of personal saving.

All that saving would not be influenced in a first-order positive way at all, and if interest rates fell, as advocates of tax reform claim they would, that saving would actually earn a lower rate of return after tax reform than before tax reform.

So when you factor that out, you greatly reduce the impact of tax reform on saving and, therefore, on economic growth.

Mr. Jorgenson. The calculations that I have described incorporate all of the details of the tax law that Mr. Gale just mentioned.

Representative Thornberry. I guess I have a basic question, and Mr. Regalia or Mr. Johnson, if either of you would like to get in, what I hear mostly is tax reform is needed to create economic growth and that comes about by increased savings. That is kind of what we were talking about here.

Is increased savings the key to why tax reform could create economic growth?

And is it appropriate for us to prefer saving over consumption? And I know there may be some -- or to encourage saving versus consumption?

Mr. Johnson?

STATEMENT OF ROBERT JOHNSON, MANAGING DIRECTOR, MOORE CAPITAL MANAGEMENT

Mr. Johnson. When I have heard other panelists discuss this issue and discuss growth, enlargement of the economy, they have emphasized enlargement of the revenue base, which help us maintain current programs, consider new programs or avoid cutting programs that are scheduled to be phased out.

Working backwards from growth, we need productivity growth, population growth is an inherited bit of data with an 18-year lag or so, and productivity growth depends upon investment.

Now while I did a PhD in economics, I am not nearly as sophisticated as some of the other panelists in quantitative methods. But my reading of economic research is that the quality of the estimates on the linkage or the ability to affect savings or the ability to induce investment with changes in tax policy or changes in interest rates, is, let us say, the confidence is not high. Quantitative estimates are not particularly reliable.

Representative Thornberry. So there are a lot of uncertainties out there.

Mr. Johnson. There is a lot of uncertainty out there.

Now, it does not mean that any of the different perspectives is wrong. I cannot rule them out or rule them in. But what is bothersome to me is that when we work with accounting, ex-post accounting information, it was the case that productivity growth and investment and other things produced a better living standard.

The question is for you as Members of Congress: Can you induce those changes looking forward.

And I am particularly curious today to explore what we might say are the ingredients of Dr. Jorgenson's model because the magnitudes that he is talking about seem quite extraordinary to me, and I would really like to learn more about them, because if he is right, there is a lot about to be gained.

Now one other thing that came up in the context of Dr. Jorgenson's model. I have to take a little bit of issue with him in his exchange with

Mr. Stark. I worked here on Capitol Hill for five years, and saying we go to a consumption tax and the equity issues can be addressed by spending offset is what a benevolent dictator would do.

Putting that through the process here on Capitol Hill, as all of you know better than I do, is a much different matter.

I think, in light of much of the debate that probably inspired this hearing today relating to what some have called wage stagnation; we are near full capacity, we are growing, and yet we do not know why wages have not started to go up as they would at this point in the cycle. A tax change which amplifies or exacerbates the distribution of income and wealth may not be addressing the concerns that have inspired these reform movements.

Representative Thornberry. Mr. Edmondson, from your perspective as a small businessman who hires people and tries to make ends meet, what is the current tax system doing to you, and do you think we could do better?

STATEMENT OF RONALD EDMONDSON, SMALL BUSINESS OWNER

Mr. Edmondson. There is no question in my mind that we can do better. We have had some discussion here about models, and the model that I see is our business.

One of the things that I did in looking forward to our discussion today was to review our 1995 year-end financials. I added up how much money we took out of our business in profits and how much money the Federal Government took out of our business.

The Federal Government took out 50 percent more from our business when we include income taxes, FICA taxes, and the Federal unemployment taxes, than we did.

If we consider what the state and local government tax takes out of our business, it amounts to 200 percent of what we took from our business.

Now that is without any risk on the Federal Government's part. We bore all the risk for our business. I think that gets back to one of the issues Mr. Ture said about fairness. That just does not seem fair to me: for us to bear all the risk and the government agencies to get all the benefit.

The other thing that was brought up had to do with income growth for our employees. If we were not paying all this money out to the Federal Government, I think we would probably have richer employees.

Employees are what drive a business. Our business is made up of the best quality people that we can find, and we want to pay them a fair and

equitable wage. In fact, we would like to pay them more than a fair wage because we want to keep them.

If we keep good people, they create good customers. Our people are what make our customers happy, and I think most businesses look at it that way. If small businesses can have good, solid people on their staffs and in their organizations, they want to keep them.

Representative Stark. Mr. Edmondson, that is interesting, but I think most economists around this table would suggest to you that it is your employees who pay the FICA and the health insurance, the Medicare taxes. I know the business writes the check for part of it, but the economic balance on that generally, I think, is that that raises your cost of labor, but not your taxes.

Now it is just a fine point. I think that would get you closer to parity with the government.

Representative Thornberry. I guess the question is what would you do with the money if you did not have to send it up here.

Senator Bennett. Yes. Let me get to that because I come at it from the same paradigm as the small businessman, and I want to pursue this with the information in your chart, which, frankly, is very counterintuitive to my experience. I am not saying it is wrong.

I was involved in starting a business in the terrible years of greed, the Reagan years, when the only thing people were thinking about was ripping off their neighbor and all the rest of that, to quote the rhetoric.

When I joined the business as the CEO, they had four employees, they were doing $250,000 a year. The first year I was there, we did a $1.5 million, the next year we did $3.5 million, the next year we did $7.2 million, the next year we did $15 million, the next year we did over $30 million. We were doubling every year.

Now we were an S-Corporation, which meant we were paying Federal taxes, during those awful years of Reagan greed, at 28 percent. And we put every penny above that 28 percent that we earned back into the business to keep us surviving. I had shareholders who were absolutely terrified that I was driving the business into bankruptcy because we were growing so fast. They said there is no way you can finance that kind of growth with internally generated funds.

The answer was at a 28 percent tax rate, yes, there was, and we did. We had no long-term debt, and we did not have to sell any equity, and today the business employs 2,700 people. The main increase in

employment has occurred since I have left, and I am sure there is a direct cause-and-effect relationship there.

(Laughter.)

Senator Bennett. Now I have taken some of the money that I got out of the sale of some of that stock after we went public -- we are not listed on the New York Stock Exchange -- and invested it in another business in today's environment, where the effective rate on an S-Corporation is 42 percent, 42.5. When you take the 39.5 or 39.6 of the Clinton increase add it on the Bush increase and then add the Medicare increase, the effective rate for somebody who is doing this in an S-Corporation is not 28 but 42.5.

It is a 50 percent increase in taxes.

The business I have now invested the money in cannot grow nearly has fast as the business where the money was made because they are finding they cannot get capital accumulation to fund that growth and the problem of going out and borrowing the money instead of generating it internally to make up the difference between 28 and 42 is sufficiently a burden on the company that its growth is stifled.

So I have the two examples right in front of me of the one when you have got a 28 percent effective rate and the other one you have got a 42 percent effective rate and the first one doubled every year, and the second one, the growth is stymied because we have to pay that much more taxes.

Representative Thornberry. Mr. Bennett, what would your growth rate have been at 12 percent?

Senator Bennett. I am speculating at that point. I do not really know.

Representative Thornberry. Twelve percent. That is what we are really talking about: 12 percent.

Senator Bennett. I understand that, and I understand the issues that Congressman Stark is raising on the social circumstances, and I agree that getting that through Congress is going to be very difficult.

But I come back to the basic question and ask you to deal with it: Isn't there a fundamental difference between taxes at 28 percent and taxes at 42 percent that affects growth? Or does in fact the savings just drop off? I mean, there is a lot of growth that occurred at least in our circumstance. Nobody had any money when they founded that first company. It is now listed on the New Stock Exchange at half a billion dollars in market value. It seems to me that is a lot of growth.

Mr. Edmondson. Mr. Chairman, I would suggest that -- excuse me. I am sorry.

Representative Thornberry. No, go ahead, Mr. Edmondson.

Mr. Edmondson. What I was going to do is expand on one of the things that Mr. Bennett was saying. From the standpoint of investment into a small business, the current tax system, it appears to me, really encourages borrowing to finance a business rather than investing in it.

Senator Bennett. No question.

Mr. Edmondson. Because of your return on investment. If you are going to make a certain amount of money out of your business, what you are really considering when you borrow money is your return on investment, and that return is the difference between the tax rate as it is applied to the interest rate.

So you are really encouraged to borrow, particularly in a small business, because there is high risk involved in a small business.

Mr. Moore. It is a cheaper form of capital, too. I mean, equity is the most expensive capital you can get. So you do not want to cut us in on your business, do you?

Mr. Edmondson. That's correct.

Mr. Moore. If it is any good, you want to keep it. Right?

Mr. Edmondson. That's right.

Mr. Moore. All right. So low interest rates are what you want.

Senator Bennett. In our business we were not cutting anybody in. But we were generating the growth with internally generated funds, which the tax people make less possible.

Representative Thornberry. Well, let me ask this: Is that a good system to where the current system encourages small businesses to borrow if they are to grow? Is that the way we want it, or is it just a fact of life?

Mr. Ture. We want neutrality, I believe, and we do not have neutrality between whether these kinds of investments are financed through equity or debt.

Representative Stark. Oh, you do not want neutrality for equity. Don't you want to charge for the risk? Come on.

Mr. Ture. We want businessmen to make a decision about how to finance their investment. There should not be a bias in favor of --

Representative Stark. I have no problem. Mr. Reagan once suggested that we do away with taxing interest. We had a little way to change it in the '86 initial proposal. But that lasted about 13 seconds.

Mr. Ture. But if you look at either the Armey flat tax plan or what Professor Jorgenson is talking about with respect to a straight consumption tax, that would eliminate this kind of bias that Mr. Edmondson is talking about.

Representative Thornberry. Let me have a chance for everybody.

Mr. Regalia, did you want to comment on some of this discussion so far? You do not have to. I just wanted to be sure you had a chance.

STATEMENT OF MARTIN REGALIA,
VICE PRESIDENT AND CHIEF ECONOMIST,
U.S. CHAMBER OF COMMERCE

Mr. Regalia. I do not know if I want to get in the way of what is going on. I mean, I found myself agreeing with Congressman Stark when he said that he stays up at night worrying about the tax code. I do, as well. But I have found that reading it tends to correct that problem very quickly.

(Laughter.)

The issue here seems to be why should we want to change a tax code? I think that growth is certainly one reason and the intrusiveness, the waste that occurs in terms of compliance with the tax code are other reasons.

But it seems that every suggestion that has come up seems to run into some opposition. I guess I would like to know if Mr. Gale has a proposal that would meet his criteria and his distributional problems while at the same time reducing the intrusiveness and the compliance costs and contribute to growth, or are we just stuck with what is out there right now?

I tend to think we are not. But I think that if you are going to say that you are not willing to accept any of the distributional effects that Dr. Jorgenson suggests you are in effect not going to accept any fundamental change in the tax code. In that case, we can conclude this session very quickly.

Representative Stark. Mr. Regalia, what about some politically possible things that are an amalgam? Let us say Mr. Edmondson does not like the Medicare or HI tax. We are having trouble with the uninsured, and what if we -- and I do not like sales taxes as most politicians do not like them, but once they are there they do not hurt you much -- but what if we said, "Let us have a consumption tax to fund health care?" People would probably buy it if they knew where it was

going. You probably would not find a great political outpouring resisting that.

So we pull that off the payroll tax. That helps to some extent the business people. It gets us some funds that we peg toward health care and possibly then we find a way to deal with upper-income folks. Say that we let some of these things happen. But at death, or at some ascertainable point in the structure of money, there is a one-time tax; you cannot keep dying and getting a step up in basis and passing it on to kids who will not do much with it anyway. So we make some adjustments, some balance that will make it a little more fair, some adjustments that bring a consumption tax in that may help small business.

I think we could get there, but I do not think any one of these things we say, do away with progressivity or flatten it out.

Mr. Regalia. Well, I have not heard anybody say that, and all I hear in your suggestion is that we ought to add another tax, which does not do anything about correcting what is there.

Representative Stark. No, I say take one away. Take the payroll tax off, swap that

Senator Bennett. Altogether? You are going to fund social security out of a sales tax?

Representative Stark. No. I was starting with the health, which has to grow some, and by adding it, I think you would find you would have a broader base on which to attach it. But I would not preclude anything. I am just suggesting that if you bring the political mix in between the academic experts here, then you get a leavening. You cannot get to where I think we all want to go, and that is to pass something that will help people in the country proportionately and fairly, to accomplish growth in small business, to fund those social programs which we might agree we need, to fund defense, to fund infrastructure improvement, which will keep our roads going so we can have a trucking business.

Somebody has to pay for all those things, one way or another. We will get some economic suggestions here, which we cannot crank out into legislation. Mr. Jorgenson says, President Reagan had a great idea, he came pretty close to a flat tax, but in the end President Reagan said just do not go above a 27 percent marginal and I will sign anything you want. And we worked long and hard with Richard Darman, and we got a little higher than that, but he allowed the politicians then to make some adjustments that they needed to get the votes.

Mr. Jorgenson. I do not agree with Steve Forbes very frequently, but one thing I agree with him about is just what you said, Mr. Stark, which is that we ought to start with the '86 tax reform. That is the place to begin. That was the right idea.

It is just that the targets have changed and the opportunities have changed, and if we think about starting from a 12 percent rate at the Federal level, I think that we can make a lot of progress.

Now, I want to agree, however, with what Mr. Johnson said. He drew attention to the fact that I think we all need to focus on, which is that it is easy to give away the benefits of tax reform. You cut in, you know, grandfather this and cut in that and make this adjustment and that adjustment, that is not the way we got the benefits of the '86 tax reform, not that I view that as the end-all and be-all of tax policy.

But I think that we really have to start with something that is simple and something that is going to produce dramatic results and then ask ourselves the question: Do we really want to compromise our principles, aiming for growth, by giving away the benefits to specific targets?

Representative Stark. Mr. Jorgenson, I am the most highly principled Member of Congress, and my first principle is flexibility.

(Laughter.)

Unidentified Speaker. We have to.

Representative Thornberry. Mr. Bartlett, let me ask you, do you have a comment? Mr. Stark's suggestion is some combination of these two, and that is a little bit like this USA tax, and I do not want to get into the details of any of these particular things, but what do you think about a combination of part consumption, part income tax?

STATEMENT OF BRUCE BARTLETT, SENIOR FELLOW, NATIONAL CENTER FOR POLICY ANALYSIS

Mr. Bartlett. First let me make a point that Mr. Johnson brought up, which I think is very important, especially with reference to the things that Mr. Gale said. And that is that growth comes not from saving but from investment. Now, it is assumed that there is a linkage between saving and investment because they have to equal each other over some period of time.

But the relationship is very loose. If you do some cross-national comparisons, it does seem to show that over some period of time domestic saving and domestic investment are correlated with each other. But for quite long periods of time they do not have to be because if you have an open economy, you can import saving or, in the case of Japan,

for example, which has more saving than it has investment opportunities, they export the saving.

So, we need to be very clear on this relationship, and it relates to the point of this chart here also, which is that it is true that the savings rate, the personal savings rate, declined. But personal saving is only a portion of total national saving, and insofar as there is a relationship, it is the total amount of national saving that is available.

Mr. Moore. National saving also went down.

Mr. Ture. But if you look at what happened in the 1980s that you do not pick up, Bill, that Bruce is talking about, is that we had a half-trillion-dollar net infusion of foreign capital, and the reason that foreigners wanted to invest in the United States is because the tax rates came down.

Now, you are right, that it would be better if we financed it through our personal savings, but it is still good to have increased foreign investment. In fact, in the 1990s, with higher rates, foreign investment has gone down substantially.

Representative Thornberry. Did you finish your point, Mr. Moore?

Mr. Moore. If I could just finish my point, which is that the total national saving is a function of three things, which are: the personal savings rate; the business, the amount of business saving, which includes, very importantly, business retained earnings; and government saving, or as we have had in most of recent years, government dissaving, although it has been not nearly as much as most people think because state and local governments tend to run budget surpluses.

But the assumption has always been that the Federal budget deficit draws down saving dollar-for-dollar; that is, the economic linkages, the deficit reduces the supply of saving, that reduces investment, therefore that reduces growth.

But again that linkage is very loose and not at all clear-cut. I was looking at the CBO's latest forecast, which Professor Jorgenson referred to, and they present two baseline forecasts: one under current policy, and the other with the budget balanced in 2002 and continuing thereafter. The difference between those forecasts in real economic growth is exactly one-tenth of a percentage point per year. So that is what we are going to get in terms of growth out of balancing the budget.

Now, maybe a tenth of a percentage point is worth doing, but I think that there are other policies that would have a much more powerful effect on growth. Tax reform is certainly one of them. I certainly favor moving toward some kind of consumption-based tax system. But I think another

very important element should be tax reduction. I think that the overall burden of taxation is too high and ought to be lower, irrespective of the form in which that revenue is raised.

I would just conclude that there is a growing body of analysis published in the best economic journals by people like Sergio Rubello, Robert King, William Easterly, Robert Barrow and people like this, that do correlations between growth rates in a large number of countries and things like the size of the governmental sector, and these do not distinguish between whether they are income systems or consumption systems. They are just looking at taxes as a share of GDP, and they do show a strong correlation between the larger the government share of GDP the slower the growth.

Senator Bennett. Mr. Chairman, I have to leave and you are probably going to be all delighted at that, but let me just leave one thought with you. As we talk about all of these, remember that the Federal revenue comes from four different sources, not one. A lot of the debate, Forbes and et cetera, talk as if the income tax were everything.

Here are the numbers, and I will leave you with this to conjure. The personal income tax yields about $600 billion in today's budget; corporate income tax, about $150 billion; payroll taxes, $500 billion; and all the rest, gas taxes -- customs collection, everything -- about another $150 billion, to come to $1.4 trillion.

So when you are talking some of these tax circumstances, you are talking the $600 billion that is personal taxes, which is less than half of the total. And do not lose sight of Pete Stark's comment about the payroll tax.

And, Pete, sometime in the dark of night, I will be happy to sit down and talk to you about substituting a national sales tax for all payroll taxes, funding social security as well as Medicare out of a sales tax, and see what that would do to the tax distribution.

It would mean a substantial tax cut for all of the folks at the bottom of the economic ladder because they are currently, if you take your comment about the payroll taxes, Mr. Edmondson, really being the employees' taxes, not the business taxes, every wage earner, even those earning minimum wage, is paying a minimum of 16 percent effective tax rate right off the top.

If you went to a 10 percent sales tax, which is what it would cost to get you at about $500 billion, you would produce for the people on minimum wage a substantial 60 percent tax cut overnight.

The only trouble with that is that we politicians, once that was in, would then go back to payroll tax. So we would have a sales tax and a payroll tax and an income tax, and then we would be Germany and we would be cooked.

(Laughter.)

Representative Thornberry. Dr. Ture, I will come to you.

I think that is a key point, though, as to what it means to the regular folks who this payroll tax is a key problem. I know some of the proposals would have a credit on your payroll taxes for the national sales tax idea. I think that was one of the proposals in the House.

But, go ahead.

Mr. Ture. Let me see if I can respond to an observation that Bruce Bartlett made and then segue over to some of the other comments and do a little wrap here.

I think everybody at this table should agree that lower marginal income tax rates will increase saving and capital formation and that that will have some effect on the level of economic activity and for at least a brief period of time the measured growth rate. That is good. It is a plus.

I do not think we ought to sit around this table and try to estimate what the magnitude of that effect will be. There are too many models. They march to too many different drummers, and they will produce too many disparate results which you, Mr. Chairman, will not be able to reconcile and I would be with you scratching my head about them.

But I think I want to bring this back to the very good points that Mr. Johnson and Mr. Edmondson made. This is real world stuff. It is not merely the level of the marginal income tax rate that represents deterrence to their growth, the growth of their businesses and of the businesses that Senator Bennett was alluding to.

There is in the body of the Internal Revenue Code an enormous number of provisions which have the effect of distorting both household and business choices, that have the effect of making us use the resources at our disposal less efficiently, less productively, to produce less output than we otherwise would.

If we are really keen on eliminating the barriers in the tax system to the Nation's economic progress, we must not focus uniquely on the marginal tax rate.

Let's go beyond that, though. I am astonished that neither Mr. Johnson nor Mr. Edmondson alluded to all of the other public policy barriers to their efficiently conducting their businesses.

Wake up in the morning, and the first thing that hits you is a regulation or a mandate that tells you you must or you must not. It has nothing to do with the efficient conduct of your business. It has nothing to do with what you can do to increase the productivity of your labor force.

What it has to do with is certain other social goals that are never evaluated in terms of the costs that they impose. It is as if all these things, like economic growth, is for free. But none of them are free.

Representative Thornberry. Let me ask if anybody disagrees with the basic point that you just made, and that is regardless of what you think about savings, if you kind of set the savings growth aside, that either a flat tax or a national sales tax, if decisions are made on their economic merit alone rather than with the tax code in mind, does that not mean a more productive economy and better growth?

Mr. Jorgenson. We could be very simplistic about that.

Representative Thornberry. It is simplistic, I realize.

Mr. Jorgenson. Yes.

Representative Thornberry. But doesn't that help?

Mr. Jorgenson. Mr. Thornberry, there is an issue that has been overlooked here by everybody except Mr. Edmondson, which is that the major effect is not an effect on saving. There is certainly going to be a positive effect on saving.

The major impact is on labor supply. Now, you might ask, "Labor supply? Where does that come from?" Well, it is a relatively simple matter. Mr. Edmondson put it very well. His objective as a businessman is to have the best quality people, and for that purpose he is going to have to pay them, I hope I am quoting correctly, a fair and equitable wage.

If we were to shift from an income tax and my calculations include both the corporate and the personal tax -- I am sorry, Senator Bennett is not here to hear about the details -- it would substitute for both those taxes a uniform national sales tax at the Federal level that would amount to a 12 percent rate.

Now, you might ask, "Well, what is the rate that we are paying currently?" Mr. Ture has alluded to this, but let me just fill in some figures. The average marginal rate that is paid by one of Mr. Edmondson's employees, who I am sure are very adequately compensated, given the quality of his business, is 29 percent. We are talking about reducing that rate to zero. Repeat that: zero; nothing.

What will we have to do in order to achieve that? We will have to have a sales tax at a 12 percent rate. Ask yourself, what is this going to do to

real incomes? It is simple arithmetic: It is going to increase real incomes by 17 percent. Think of that as a method for fair and equitable compensation.

Needless to say, we are going to experience a surge in labor supply. Both Mr. Johnson and Mr. Ture have alluded to the fact that there are models coming out of our ears, and they are not reliable. You know, how can we compare the results?

The fact is that every major model that has been applied to the simple sales tax simulation that I have described agrees. In testimony that I presented to the Committee on Ways and Means in March, Alan Auerbach presented exactly the results that Mr. Gale has alluded to. Joel Prakken, who is a practitioner of macroeconometrics, got exactly the same results.

So the fact is that models are reliable, and the reason that they are reliable is because they are driven by simple economics, the simple economics of the fact that if we had a shift of this type from our existing income tax, which has an average marginal rate of 29 percent on labor income, to a sales tax that has a marginal rate flat across the board of 12 percent, we are going to experience a huge increase in real income and a surge in labor supply.

People are going to find it is profitable to postpone their retirement, they are going to find that they are going to re-enter the labor force more quickly when they drop out, people who are now working part-time are going to find it is profitable to work full-time. We may even get a few people to take on some extra employment in the sense of having more than one job.

All of those things combined are driven by a simple economic fact: We are looking at a 17 percent increase in real wages. That is what is driving the economics of this fundamental tax reform, and that, it seems to me, is where we ought to focus our attention. We can agree or disagree about the impact on saving, but it seems to me that we really have to focus on what Mr. Edmondson drew attention to, which is the impact on labor and the quality and quantity of labor supply in the U.S. economy.

Representative Thornberry. Which is separate from the savings question.

Mr. Jorgenson. Correct. Correct. And reinforces the point that I made.

Mr. Gale. I have a number of comments to make. Let me just start with Mr. Jorgenson's remarks.

In 1981 the highest marginal tax rate was 70 percent on labor income. In 1986 it was 28 percent.

Representative Thornberry. Which is like 50, Bill. There was a lower rate on labor income at that time.

Mr. Gale. Yes. I was talking about average marginal rates. You are talking about top marginal rates.

(Unidentified Speaker). No, he is talking about top marginal rate.

Mr. Gale. Let me start over again. A, we had tax reductions in the 1980s; we did not see anything like a 17 percent increase in labor supply. A lot of the reason is that male labor supply tends to be very insensitive to wage levels, after-tax wage levels, as numerous studies have shown.

The second point is that not every model agrees that moving to realistic consumption taxes in a realistic setting of the economy is going to generate large or even positive economic effects on economic growth. A study by CBO economists that looked in particular at the sensitivity of growth effects to various assumptions, given what we know about labor supply and saving, found that there is a good chance that the impact could be negative.

Table 3 of my handout again shows that if you look at realistic policies in realistic economic settings, you get down to zero very fast. You have to be very careful not to introduce additional deductions. You have to be very careful to ignore the pension side of issues.

The third point is that studies that have looked at whether retail sales taxes are enforceable at the aggregate level need to be thought about. The retail sales tax is not a new idea. Virtually every European country had a retail sales tax 40 years ago, and every European country gave up on the retail sales tax because it simply was not enforceable. It is a very easy tax to avoid. Once you avoid, you have to raise the rates to raise the same amount of revenue. Once you raise the rates, people avoid it more, et cetera, et cetera.

No European country now has a retail sales tax, although they all tried it. Why is it that we want to fixate on a sort of 40-year-old tried-and-failed European idea? I think it is probably a mistake.

Mr. Ture. Because, Bill, we want to replace an 80-year-old tax that has failed, and that is the income tax.

Mr. Gale. Well, wait, wait, wait. Whether the income tax has failed is another issue. *The Wall Street Journal* jumped on the fact that a

couple of days ago that the misery-index, the sum of unemployment and inflation, is at its lowest level in a generation.

Mr. Ture. The story said they are having the same kind of difficulty with the sales tax --

Mr. Gale. Just a second. Just a second. The stock market is at 5600. Now, these might not be proof that the income tax is doing a great job, but it is hard to say that the income tax is an absolute disaster when the misery-index is lower than it has been in a generation.

Now, that brings me back to my third point, which is I agree with Dale Jorgenson, which is, we should use the '86 tax cut as a model. The '86 tax cut broadened the base and lowered the rates. That is exactly what we should be thinking about now.

But '86 did the easy work. It cut out cattle shelters and real estate shelters and stuff like that. If we want to broaden the base now, we have to cut into social policy. And by that I mean mortgage interest, charitable deductions, health insurance. If we leave those deductions, we have basically undone almost all the effects of fundamental tax reform, especially if we allow personal exemptions, which we would have to allow, and we allow transfer --

Representative Thornberry. Did you have a comment?

Mr. Gale. Let me come back to the last point, though.

Representative Thornberry. Quickly.

Mr. Gale. Which is this issue about saving versus investment and funding the growth in the 1980s. It is true that we had an increase in investment that lasted till about the mid-1980s. It is also true that it was financed by an inflow of foreign capital.

If you look at page 5 of my handout, what we see is, in 1982, the ratio of public debt to GDP was 29 percent. It is currently 57 percent. The net international investment position of the U.S. was a positive 8 percent of GDP in 1982; that means we owned more foreign assets than foreigners owned of U.S. assets. It is now a negative 8 percent as of 1994.

When people talk about long-term economic growth, it is important to note that from 1979 to 1989 the economy did not grow any faster -- that is, business cycle peak to business cycle peak -- the economy did not grow any faster than it had in previous peak-to-peak exercises.

So what did we get from that? We got what is often called mortgaging our future. We got a much higher ratio of public debt to GDP, and we got a much higher ratio of obligations that we owe to foreign investors relative to GDP.

Think about net interest on the debt as causing a burden in the budget deficit. Net interest payments to foreigners are going to cause problems in the future in the same way. So it is not obvious that foreign-financed investment is as good as domestic-financed investment.

Mr. Bartlett. One of the points raised by Mr. Gale which I do not think we have talked about yet is this whole question of compliance. There is certainly an amount of tax money that we are not getting under the current system. Is there any reason to believe that we can get a bigger share of what should be coming in under some of these other systems?

The whole question of compliance and confidence in the system is something we have not really gotten to, and I think it is worth talking about.

There are some people who say there is two or three hundred billion dollars that we are not collecting now that we should collect. Is there a way to do that?

Mr. Gale. There are two issues. One is, would you collect that under the new system?

Mr. Bartlett. Sure.

Mr. Gale. And, second, would the new system create new ways of avoiding taxes that would be even tougher than the existing system?

Mr. Bartlett. Yes. The whole question of tax avoidance. Can we do better about collecting what we should collect?

Mr. Jorgenson. Well, the whole advantage of a flat tax approach, whether it is based on Armey's proposal or a retail sales tax, is that it changes the tax base in such a way that these compliance problems are reduced.

Mr. Bartlett. Right.

Mr. Jorgenson. You could administer this tax as a retail sales tax, you could administer it as a European-style Value Added Tax (VAT), the so-called credit and invoice method, you could administer it as the senior minority member of the Ways and Means Committee, Sam Gibbons, has proposed, as a subtraction-basis VAT, which is economic jargon for something that is administered like the existing income tax.

But the fact that you rule out of the tax base all financial transactions, all purely financial transactions involving sales and purchases of financial assets means that the compliance problems are reduced very drastically.

26-726 O - 96 - 2

I think you are absolutely right, Mr. Thornberry, that is a critical concern and that is exactly why we ought to focus on a consumption tax.

Mr. Ture. I think there are any number of devices for getting to a saving-neutral tax system that would simplify and reduce compliance problems. There is no unique case to be made, as Dale is suggesting, for any one of these particular forms.

Representative Thornberry. In that regard; in the compliance?

Mr. Ture. The real key to making the tax system neutral with respect to saving as opposed to consumption is to make sure that you tax either income that is currently saved and do not tax the returns on it, or do the reverse, do not include income that is currently saved but do tax all of the returns thereupon. You go one way or the other, and you can design a tax system that accomplishes that any number of different ways.

I think before you rule out sales taxes, I am opposed to sales taxes because I think they are the ultimate in blanketing the cost or the payment that people have to make for government services and we certainly ought to be heightening tax consciousness rather than blanketing it under a tax that nobody knows he or she pays.

Representative Thornberry. Okay.

Mr. Moore?

Mr. Moore. One of the benefits of reducing marginal tax rates under any plan, whether it is a straight consumption tax, a Value Added Tax, an Armey-style flat tax, and I would be in favor of any of those, is that as you bring the marginal tax rate down, your incentive to cheat is reduced because you have a much higher incentive to cheat on your income tax if your rate is 40 percent than 18 percent or 17 percent.

So, that is, I think, one of the added advantages of any kind of rate reduction, whether it is any of these plans.

The other point I wanted to make, responding to what Bill Gale was saying, is that the main kind of economic indicator, you are quite right that the misery-index is very low right now, but the reason that people like Pat Buchanan and Steve Forbes were able to tap into this kind of middle-class anxiety is because over the last seven years since Reagan left office, according to the official Census Bureau data, the average family, middle-class family in America, has lost $2,100 in take-home pay; $2,100. In the 1980s, the average family in America gained $4,000 in income.

Again, I think focusing on the individual is an important reason why we have to change the tax code.

Representative Thornberry. Mr. Johnson?

Mr. Johnson. I think it is important also to integrate another dimension here, and Mr. Edmondson talked about it at some length. I will refer to it as the people sitting at 23rd and Constitution, the Federal Reserve.

When you are interested in capital formation, you look at your after-tax return on taking action, but you also look at your borrowing costs. I think one of the lessons in the 1980s which underscores what Dr. Jorgenson is talking about, that things have to be deficit-neutral, was that we did not really have supply-side economics, we had investor-side economics.

What I mean by that was the foreign investor, he got a higher real interest rate because Paul Volcker and the members of the Federal Open Market Committee raised interest rates at the time to resist the overheating of the economy and growth so you had higher real interest rates and lower taxes, a higher after-tax rate of return, and the investors benefited.

Mr. Moore mentioned that lower taxes is what brought money into the United States. I think part of what brought money into the United States was the tax cuts producing economic activity, higher interest rates, Paul Volcker tightening interest rates, a wider interest differential vis-a-vis foreign securities, inspired people to run into the United States.

It also pushed the dollar up. We had a very substantial overvaluation of the dollar as this trend continued, and a very large trade deficit.

So, I am somewhat concerned, as I mentioned at the outset, about this linkage between savings and investment.

I have one alternative that I would like to throw on the table and hear what others believe, which is what about the old idea that I learned from Charls Walker, the investment tax credit? If you want to inspire investment, inspire investment, do not look for all kinds of indirect inducements. And once again, do it in a way that is deficit-neutral so that the guys down at 23rd and Constitution are not yanking up interest rates and retarding what it is you are trying to accomplish.

Representative Thornberry. Regardless of the savings issue, do you agree that it would be beneficial if people could make economic decisions based on what made sense rather than trying to apply for some credit?

I mean, we get back into credits and deductions and so forth, are we not getting even deeper into kind of what the problem is? Are we?

Mr. Johnson. Well, I think the questions of compliance and the questions of what we call annoyance over tax complications are quite real. It may be the negative side of what I suggest is in that department. But I do think if productivity growth is important and investment is important, we have to go right to that area to induce the change.

Mr. Jorgenson. Mr. Johnson, I think there is a very important issue that I think you need to focus on, and I like to argue with Charls Walker about this, the quality of investment. If we look at the quality of investment after the 1980-81 tax cuts, the Reagan tax cuts, which involved a major enhancement in the tax credit, essentially what happened is that we produced commercial real estate that is still vacant.

Mr. Johnson. Yes.

Mr. Ture. Commercial real estate never received the benefit of the investment tax credit.

Mr. Jorgenson. It received the benefit of all of the tax credit applied to the equipment which was internal to the buildings, as you are well aware, Norm.

Mr. Ture. Yes.

Mr. Jorgenson. But the point is that the tax credit was responsible for a very, very sizeable misallocation of investment resources and the commercial real estate was mainly due to the Accelerated Cost Recovery System (ACRS), Charls Walker's greatest day in tax policy: essentially, a lot of investment with no growth. And it seems to me that what we need to do is focus on a much more neutral system. This is the point that Mr. Ture is making now. Totally in contradistinction to the point that he was making when he was a government official.

Mr. Ture. I am sorry. What ACRS was intended to do is essentially what your proposal would accomplish in one fell swoop, which is to reduce the disparity among write-off periods among different types of assets.

Mr. Jorgenson. They didn't stay and do it. That is my point.

Mr. Ture. Well, we didn't get as far as we should have.

Mr. Jorgenson. You should have gone to zero. You could have gone to zero, Norm. It wouldn't have cost you anything.

Mr. Ture. Be that as it may, I want to make a different kind of point that has come up repeatedly during this discussion, which is '86 TRA ought to be regarded as the absolute standard for tax reform. I think that the Tax Reform Act of 1986, save for the reduction in individual and

corporate income tax rates, was one of the worst pieces of tax legislation that has ever been enacted in the history of the income tax.

I made some calculations shortly after that was enacted, on the basis of which I concluded that something like $300 billion of saving and the returns thereto were added to the tax base by the Tax Reform Act of 1986.

The base-broadening features of that Act were a pell-mell, mindless pursuit of additional revenue in order to finance huge increases in the personal exemption, the standard deduction, and the rate cuts. The consequences of that were enormously distortionary.

I do not think base-broadening has anything to do with constructive tax restructuring. Defining the right tax base, correctly defining taxable income, should be the name of the game. That has little, if anything to do, necessarily, with base-broadening.

Representative Thornberry. Well, I think there is a point that we need to address, and, Mr. Gale, I would like to know if you or Mr. Edmondson may have thoughts on this as well. It is how we get from here to there.

One of the complaints I have heard about the '86 Act was some of the transition rules. If we are going to go from one thing to another, obviously there has got to be a transition in some way. What does that do to the economy? What does that do to decisions that have already been made? And how do we compare that versus the benefits of it?

Mr. Gale. Transition in '86 was compared to moving to fundamental reform, transition in '86 was a relatively simple issue. You are moving from one income tax to another income tax.

If you think about, instead, transition from the current system to a flat tax, there are a number of other issues that arise. One is that the flat tax simply has a different objective than the income tax. The flat tax changes the tax base. It eliminates the role of social policy other than the exemption.

Transition rules, I would guess, would be needed sort of politically to adjust for all those things; in particular at a business level.

A business that just invested several billion dollars in the home district of, you know, someone. This was an example that came across recently. A business invested several billion dollars in the home District of a powerful Member of the Ways and Means Committee.

I happened to overhear the person saying, “If we move to a flat tax, I expect to continue to get depreciation deductions for that investment,”

whereas if you went cold turkey to a flat tax, those depreciation deductions would disappear.

Representative Thornberry. Yes. Part of that gets back to the political concerns that Mr. Johnson raised a while ago.

Mr. Gale. Yes.

Representative Thornberry. And some of that is never pretty, there is no question.

Mr. Gale. But ultimately the issue, the fundamental issue facing policymakers is the more transition relief that you give, the smaller is the tax base and hence the higher are the tax rates you need to raise the amount of revenues. So that there is an efficiency cost to having transition relief.

Representative Thornberry. Did you all look at that, or have you looked at that, Dr. Jorgenson?

Mr. Jorgenson. Yes. We have looked at the transition issue. I think that the thing that you should gather from all of the discussion here before we go into the specifics of that is that you can easily give away the benefits of tax reform. You can reduce it to zero, as Mr. Gale has emphasized. I agree with that completely.

My preferred alternative for the transition is to use one and only one transition method, which is the method that I refer to in my handout as the prepayment method for owner-occupied residential housing.

What is the prepayment method? It means that all existing homeowners would be deemed to have paid all taxes over the entire lifetime of their residential property due to the consumption of the housing that they receive as owners. What that means is they would not be subject to a tax. End of story.

How would you then preserve the existing benefits of the mortgage interest deduction? You would trade that off against something that is a far more burdensome tax from the point of view of most homeowners in this country, which is that you would eliminate capital gains taxation of residential property at the time that people move out of their home into an apartment or pass on to the next generation.

So the conclusion is that you do not need to maintain the mortgage interest deduction. You would reduce by the total burden on investment in owner-occupied housing to essentially the burden on any kind of consumption, and you could do that by this prepayment method that would have the effect of essentially no tax on any existing homeowner

over the whole lifetime of their property, both during their own personal lifetime and the lifetime in the future.

Well, what does that mean that you would do to tax housing? You would tax it at the point that it is newly produced. In other words, people who are in the development business of producing new residential housing would have to pay the tax like anybody else. How large would that tax be? At the Federal level it would be only 12 percent.

So my conclusion is that that is all that you need in terms of a transition measure, and therefore you can achieve the kind of gains that I am talking about here and the low marginal rates by essentially concentrating on moving to a broad-based consumption tax with no exemptions, no deductions, and with prepayment of all the taxes for existing owner-occupiers.

Representative Thornberry. Mr. Edmondson, from your experience, what concerns do you have about transition, based on either what you have heard today or what you have experienced?

Mr. Edmondson. I don't know that I am knowledgeable enough to discuss any of the specific tax proposals and what the effects would be with or without transition.

But I might say this, that businesses have to plan. One of the big impediments to the business community, particularly small businesses, has been that the Federal Government has gotten in the way of our planning. They change the rules constantly, and it makes it very difficult for us to set out a game plan.

I would, if I could, make one suggestion for any of these proposals, that they be very difficult to change. I think the business community would rather have a bad plan constant than a good plan that just keeps moving around. It is just a target you can't hit.

Mr. Johnson. Can I bring in one other dimension on transition?

Representative Thornberry. Sure.

Mr. Johnson. It pertains to the current circumstance, and once again to financial markets.

We turned the corner into 1996 believing that the Congress with some probability was going to engage in seven-year balanced budget, entitlement reform, and so forth. As of about a month ago, it seemed to the financial markets that the bidding is on now for who is going to give away tax cuts, and there is not a lot of confidence in what we might call discipline vis-a-vis the deficit.

The consequences of those perceptions and change in perceptions is that the 30-year bond is now yielding over a percent higher than it was at the turn of the year. As a matter of fact, last Friday, coupled with some strong economic growth numbers, people in the financial markets are quite concerned.

I do not think one should avoid a change to a healthier tax regime because the financial markets get scared. But the financial markets are scared now. Interest differentials vis-a-vis foreign countries are widening. The dollar is going up.

People are talking about if this is done and it is not deficit neutral, the Fed will tighten and what we may see is interest-sensitive sectors in the short run are not able to count on the benefits of tax relief but they are forced to cope with higher interest rates. And it may have a dampening effect on the economy right now.

Representative Thornberry. Well, maybe that is a key question on how others view major tax reform. If they view it as necessarily increasing the deficit, you have the Fed react and you may have Wall Street react.

Mr. Bartlett, do you think that is necessarily the case that whatever tax reform might come about would worsen the deficit?

Mr. Bartlett. Well, my assumption has been that if only for political reasons it is simply not viable to enact any kind of major tax cut that is not fully paid for with spending cuts. I just think that is unrealistic to think about that.

I think the world has changed. I mean, I think one could justify a tax cut without spending cuts, but I just don't think you could ever pass it through Congress, either Congress or one that might revert to the other party. So I think that that is really a non-issue.

I think a more important concern is this bugaboo that I keep hearing from financial market types about we are at full employment, faster growth is per se inflationary, that the Fed will automatically react to keep the real growth rate at its present anemic level, and I just don't think there is any evidence for that.

I have spoken to Fed officials, Fed governors, and they all say, "Look, we would love to see faster growth, and we would accommodate it. It is just that it is not there."

So I think that that is just not right. There is a lot of evidence from just recent history in the 1980s in which growth went up, inflation came

down. I just really think that this is a bugaboo that just has no validity in experience.

Representative Thornberry. Mr. Regalia, do you want to comment on this, because it does bring in things that Congress cannot necessarily control, how the Fed reacts, how the markets react, are they going to be so suspicious at any effort at tax reform, thinking that it will increase the deficit, that they could undo the good that comes with tax reform?

Mr. Regalia. Well, I think that the markets will be much more skeptical of tax cuts than they will of tax reform. If you talk about deficit-neutral tax reform and you talk about fundamentally changing the tax system, I think you have a different debate, but yes, there will always be some skepticism.

I think that Mr. Edmondson put his finger on the real skepticism from the business community, and I hear from 215,000 businesses, big and small on this point continuously, and that is that it doesn't make a darned bit of difference what the Congress does because it will change the tax code again tomorrow anyway.

As long as there is no credibility that the tax change that is enacted is going to be maintained, you are not going to get an awful lot of support from people that have spent years and years and years co-opting the tax system to their own particular advantage. You know what has happened in the past two adjustments.

If somebody comes to me as a businessman and I have spent the last 10 years getting the tax code to where I can live with it and somebody says, "Do you really want tax reform," my answer would be, "Yes, as long as it doesn't change anything that I have gotten over the last 10 years."

So I think that unless you can demonstrate that the reform you are looking at is going to be substantive and is going to be maintained for a significant period of time, you cannot ask businessmen to risk their businesses and their livelihood on the fickleness of the Congress.

Representative Thornberry. And I guess that you could make an argument that if you had a simpler system where everybody could see it, it might be more difficult to change it in some way. I don't know, but you get a lot of political calculations there that it is probably hard to know for sure.

Do you agree with that or not?

Mr. Regalia. Yes. I think that simplicity and openness are desirable. I think that using the tax code to effect a certain social engineering tends to remove the tax code from the realm of the apparent and easily

understandable into the realm of the sophisticated tax wonks. I think that that type of change tends to breed a certain skepticism on the part of the business community in particular. I believe that if you address something in a simple, open fashion it makes it a little bit harder to change because everybody can see the changes. There tends to be somewhat greater credibility that that type of a change will maintain itself for some time.

Representative Thornberry. Do you want to comment on simplicity?

Mr. Gale. The stability and visibility of the tax system. Stability of a tax system is undoubtedly a good thing. My concern is that if we were to go to a radical tax overhaul -- that is, you know, completely rewrite the tax code literally, you know, throw away the IRS Code -- that might not be exactly the time we want to make an incredibly difficult change in the tax system because, honestly, we are not going to get it exactly right the first time.

Clever attorneys, accountants, are going to figure out ways to game the system. We always have technical corrections bills to tax reform acts. And the technical correction bill to a fundamental tax reform act would end up being gigantic.

On this issue of whether more visible taxes are less likely to go up or simple flat taxes are more likely to go up or not, I guess I would just provide two pieces of evidence. One is that despite all the grumping about the income tax, much of it justified, income tax revenues as a percentage of GDP have gone down over the long haul. They were higher in the fifties and sixties and seventies than they are now.

So the system may be a mess, it may be complicated, but it is not true that income tax revenues have gone up as a proportion of GDP. The taxes that have gone up as a proportion of GDP both in the U.S. and in European countries are simple flat rate taxes: the payroll tax in the U.S. and the Value Added Tax in European countries.

So there is nothing sacrosanct about a flat rate or a simple, understandable tax that guarantees that it won't go up over time.

Representative Thornberry. Okay.

I think we have got enough time here to get some questions or comments from the audience, and I think we have some of those arranged.

If you want to step up to the microphone and ask your question or make your comment, and then we will throw that open.

Audience Question. My name is Cindy Huang, and I am from the National Republican Senatorial Committee.

Actually, I have a question for Dr. Jorgenson.

I was wondering, you said that there would be an increase in the labor supply, and just from first-year economics, you know, that seems to lead to the fact that the real wage would also be decreasing.

I would like you to address that, and as well, how you would fund -- it seems that social welfare will also have to increase because people who are unemployed are not gaining from the decrease, and so it seems that we will have to increase their payments as well.

Mr. Jorgenson. I think the thing to focus on here is the idea that this is again simple elementary, basic economics. What we are talking about here as a result of the tax change is an increase, not a decrease in the real wage.

How much would that be at the margin? It would be a 17 percent increase in the after-tax real wage, which is the trade-off between dropping the income tax, which currently on labor income is at an average marginal rate of 29 percent, and replacing that by a tax on consumption at the Federal level of only 12 percent.

That produces the 17 percent increase in the real wage. That is what is going to produce all of these changes in people's decisions about whether or not to supply their labor. It is something that will produce a surge in the kind of people that Mr. Edmondson needs to hire in order to maintain the quality of his business and have it grow in the way that Mr. Bennett's business grew during the period when we had relatively low marginal rates.

So this is simple basic, elementary economics. An increase in the real wage produces an increase in labor supply. Now, what does that do to economic growth? Well, if you couple that with the increase in saving that is going to take place, you have an increase in economic growth and the size of our economy of 13 percent. That is something that is at the outer limit of what we could expect because, as Mr. Gale reminds us, we could easily give away all of those benefits.

All we have to do is to start increasing the personal exemptions of the style that you see in the Armey-Shelby flat tax. We have to introduce all kinds of deductions. We have to grandfather various things. We could easily get that gain of 13 percent down to zero.

So, what we really have to focus on is what our objective is. Our objective, as I stated at the outset, is economic growth. And we can

achieve that by greater labor supply, a less burdensome tax system, and by greater saving. And those are the two mechanisms that underlie this tremendous opportunity that we have for fundamental tax reform here.

I think, in terms of the restraints that are likely to be imposed by the financial markets, Mr. Regalia and Mr. Johnson have drawn attention to that and I think that is rightly the case. If people focus on the kind of tax proposal that are now under discussion in the campaign, *The Wall Street Journal* day-to-day reporting on the campaign, we are looking at something that is totally different. We are looking at, you know, a tax credit for tuition on the Clinton campaign, we are looking at 15 percent across-the-board reduction in tax rates in the Dole campaign. Neither one of those goes in the direction of fundamental tax reform.

I think the financial environment as of January 1, when the presidential campaigns are over and the winner is at last announced, will be totally different, and then we will be able to sit down and consider fundamental tax reform. So I don't look at the current debate that is going on in the campaign or what I anticipate will go on in the next five months as something which ought to spook the financial markets very much. And it has not. As Mr. Gale pointed out, we are still very, very close to the record in terms of the Dow-Jones.

The reason for that is that people don't take this very seriously. They know that this is just campaign rhetoric. When we get to fundamental tax reform, I think the prospects for economic growth are going to be so substantial that the business community and the financial markets will react, and in a very positive direction.

Representative Thornberry. Let me ask briefly, does your model have an estimate on the unemployment rate?

Mr. Jorgenson. Yes. It has an estimate on the unemployment rate, that the unemployment rate would be maintained at the nonaccelerating-inflation rate, which is around 5.5 percent.

Representative Thornberry. I see. That is an assumption.

Mr. Jorgenson. That is an assumption. That is an assumption.

Representative Thornberry. Yes.

Mr. Jorgenson. In other words, it produces economic growth that is consistent with this nonaccelerating-inflation rate.

Representative Thornberry. I see.

Mr. Jorgenson. Let me just mention one more point, and that is the role of the Fed in all this. The Fed is not in the business, as any Federal Reserve Board Governor or any staff member would tell you, of

promoting economic growth. The Fed is assigned a different target in our fiscal system, which is: maintaining a low inflation rate. That is something that has enormous economic benefits, as we are all aware.

Tax policy is something that ought to be focused on growth. And our expenditures policies, which we have alluded to here in terms of government programs, unemployment support, the earned-income tax credit, that ought to focus on distributional issues.

So we have to be very careful to think about the different role of the different elements in our economic policymaking system, and we have to focus on the fact that the tax policy is the one instrument that we can use to achieve the objective of economic growth.

Representative Thornberry. Let's go ahead and get our next question right quick because I think he also takes off on trying to get these various factors together.

Go ahead.

Audience Question. Yes. Hi. My name is Stefan Gleason. I am a graduating senior at the University of Florida.

Dr. Jorgenson, how politically feasible is the institution of a Federal consumption tax, especially when it is considered state turf? And also, what impact would this have on state revenue raising in our 50 states?

Mr. Jorgenson. The calculations that I have done are predicated on the idea that the states will be able to raise exactly the revenues that they currently raise but that they would raise those revenues in the same way as the Federal Government.

What do I mean by that? If you look at the way that state income taxes are administered at present, they use the Federal tax statutes to describe the tax base and, in many cases, to describe the exemptions and the deductions that are allowed. And if there is a change to a Federal consumption tax, it seems to me the rules that the states are going to adopt very quickly are going to be comparable to those that are put in at the Federal level.

Now, in terms of the amount of administrative burden here, it seems to me that there are different ways that we could approach this. If you have the kind of reservation that some people do, that Mr. Gale does, for example, about the possibility of a 12 percent sales tax at the Federal level being collected at the retail level, then you could shift to an alternative method. Simply collect it by a subtraction method VAT.

Or, to put it another way, our existing income tax with our existing Internal Revenue system, but report that on a postcard the way that it is

described in the Armey flat tax plan, except there would be one line fewer. That line is where you get the family exemption because that is something that has tremendous economic costs if you look at it in terms of the impact on growth.

It seems to me that that would be a simple way for the Federal Government to proceed from its existing system and its existing administrative structure to a system that would have the kind of economic benefits for growth that I have described.

Representative Thornberry. Let me get one more question because this is a very similar question to what we are talking about, and then let's go around and make comments because it is bringing it all together, state and local governments.

Go ahead, please.

Audience Question. My name is Sarah Oberlies. I am from the Public Securities Association.

I am also worried about the impact of Federal tax reform on state and local governments. My question is involving the impact of tax reform on the marketability of state and local debt instruments and state and local governments' ability to finance capital infrastructure development.

Representative Thornberry. Which is related to all this.

Do you have a comment on that?

Mr. Ture. I am sorry I was taking a note at the time you were asking your question.

Representative Thornberry. Let him start and then we will go back to you.

Mr. Jorgenson. May I make a remark on that? The existing system for municipal finance is one that would be extended to all financial instruments under the kind of tax reform that we are talking about here because state and local finance is not subject to a subsidy, it is simply exempted from the income tax. So what we are talking about here is simply putting other issuers of debt onto exactly the same basis.

This doesn't change the access of municipalities or states to the bond market; quite the contrary, it puts them onto the same basis as everybody else. And in addition to that, it promotes through the mechanisms that Mr. Ture has described as lifting the tax burden, greater opportunities for saving that would have the impact of making a greater pool of saving available to both municipal and state and county borrowers as well as to the private sector.

So it seems to me that the state and local governments ought to be strongly in favor of this because it is going to create a greater supply of savings on which they can draw to finance their needed investments in infrastructure.

Mr. Ture. Had I not been taking the note and paid close attention to the young lady, I would have given her Dale Jorgenson's answer.

My colleague, Steve Entin, who is sitting in the row behind you, has done a paper on this subject. We will be happy to supply it.

I want to put on the table, though, a dissent from Dale's statement that tax restructuring or reform is the only public policy instrument that is available to the Congress for promoting economic growth.

I would say we have an awful lot to do by way of getting rid of the huge amount of Federal spending that preempts resources that should be in the private sector. It would cost less to private sector users, the people around this table, and that in itself would promote growth.

I think you ought to put your attention to the enormously burdensome regulatory and mandatory system that we have that raises the cost of saving, that enormously enhances risk of the operations of any randomly selected business. These are the kinds of things not uniquely tax policy that I think should command your attention if you really want to go after a long-term growth policy.

[The information submitted by Mr. Ture, Impact of the Flat Tax on Tax Exempt Bonds authored by Mr. Steve Entin, appears in the Submissions for the Record.]

Representative Thornberry. I suspect Mr. Edmondson agrees that we could probably do a little bit in the field of regulations that might get some of the burden off his back as well.

Mr. Johnson?

Mr. Johnson. I wanted to address the question on municipal finance. I think in all likelihood municipal finance rates, the spread relative to U.S. treasuries would narrow. Currently the tax wedge or the tax differential induces people to buy municipal instruments, and that would be eliminated. I think that is the price effect of what you said, put it on more equal footing.

I do think there could be a slightly negative impact on municipal finance by making government bonds a closer substitute. What I mean by that is that you have a lot of different municipalities in each issue of a bond, whatever is unique rated for its credit and also rated for its liquidity, which means its stability to be traded in the secondary market.

What tends to happen when the inducement to buy municipals at the expense of Federal securities is diminished is there is a smaller market of potential buyers who are out in the municipal woods and then the bid asks spreads that one pays day to day widened, reflecting the fact that if I do need to sell, there may not be as many people on the other side.

I am not saying that is a healthy social outcome to support state and local finance at the expense of Federal finance, but I do think that real liquidity would be one dimension of what we would experience.

Representative Thornberry. Yes. Okay.

Does anybody else want to comment on this, briefly?

Mr. Moore. State and local governments go through boom and bust cycles much more so than even the Federal Government. Their revenues are substantially based on the economy because they are mainly based on consumption taxes.

In the 1980s it was the best decade ever for state and local governments in terms of a vast boom in their revenues because the economy grew. If you had anything like the kind of economic growth rate that Dale Jorgenson is talking about, then this kind of tax transition would be a huge boon to state and local governments. It would create a windfall, essentially, for state and local governments.

But I wanted to make one point about what Dale has been talking about so that this point is not confused, and maybe he could clarify this as well.

When he has been talking about his results on a consumption tax, I think that your results would also apply to something like an Armey flat tax. The only major difference between, say, what Dale is talking about and, say, an Armey-style flat tax is this big deduction that the Armey plan provides for low-income people.

So I think that -- and this is an important point -- that your results are generalizable to almost all of these consumption-based taxes. Isn't that so?

Mr. Jorgenson. That's right. But what I would say, though, is, just to amplify what Bill Gale has said several times, if you give away a substantial part of the tax base by introducing the system of family allowances, you are talking about much higher marginal rates. I calculate, for example, that whereas the sales tax which is completely comprehensive would have a 12 percent rate to achieve the same deficit neutrality that would be required as the current tax system already has. The Armey flat tax gives away enough of that tax base so that the rate would have to be exactly what Armey say it is, namely, 20 percent.

If you look at the difference between 12 percent and 20 percent, you are eating away 8 percent out of that 17 percent increase in real wages. Mr. Edmondson can tell you what that is going to do to the people who are working for him. They are going to cut their benefits in half of the tax reform. You are going to have a lot harder time finding people, you are going to have a lot harder time financing investments.

So I think that is not a trivial distinction.

Mr. Jorgenson. Although some people forget the point that the Armey plan is a consumption-based tax system.

Mr. Moore. Yes. Absolutely. And I am probably as guilty of that as anyone because it does not tax savings or investment income and that sort of thing. Though it also taxes consumption, which is interesting.

Mr. Gale. The question about what happens to state and local governments is a really important question not just for the specific sector but because it exemplifies a broader question which stems from the following:

Right now, we subsidize various sectors of the economy: State and local governments, housing, charity, health care, et cetera. And then we penalize other sectors: business, business especially.

If we moved to a neutral system, we would reduce the penalty on the people we penalize, we would eliminate the subsidy on the people that we subsidize. Okay.

The way the medicine is supposed to work is the people that are currently subsidized would be worse off, other things equal. I mean, that is what we mean when we talk about making the economy more efficient. We mean moving resources away from state and local governments, charity, health, housing, et cetera, and into business. That is how it is supposed to work.

So it is a really important question, and if you really want to advocate tax reform, the way to advocate it is to say that taking away the current penalties on business and other things would have a big effect but taking away the current subsidies would not have any effect.

All right. If that seems inconsistent to you, it seems inconsistent to me also.

The way that the state and local government sector would be penalized is the following: One is the deduction for the property tax would be lost.

Second, the deduction for state and local income taxes would be lost.

Third, if we eliminated the mortgage interest deduction, it is likely that housing values would fall, which would cause a further deterioration in property tax revenues.

And, fourth, Dale Jorgenson is right, we are not making the tax treatment of municipal bonds worse off in an absolute sense but we are making them worse off relative to other taxable bonds.

Again, that should not be a source of controversy, that is exactly the way tax reform is supposed to work.

So, I think there would be some sort of silver linings for municipal bonds, namely, they would get pensions interested in them as an investment vehicle; but the net effect of taking away the tax subsidy has to be negative in the absence of 13 percent economic growth.

I agree with Steve and Dale, if we got 13 percent economic growth, we would not have to worry about any of these sectors. The issue is precisely how much growth we are going to get out of it, and that is why I agree with what Dale Jorgenson said at the very beginning, that growth is absolutely key to this whole debate.

Mr. Ture. Mr. Chairman, several times during the course of this discussion from several quarters around this table the notion has been implicitly, if not implicitly, expressed that, say, the Armey flat tax is the flat tax, that the USA tax is the value added tax combined with the universal IRA, that there is a single consumption tax.

I do not think any of us, when we really focus on it, means that to be the case. I think a properly defined, as you put it, consumption-based tax, although I would say neutral income tax, a properly defined such tax would certainly not include in its tax base taxes paid by the taxpayer to the Federal Government in the form of any other tax, and certainly not taxes paid to states and localities.

Any kind of income over which you cannot retain control and use to your purposes, including income that you chose to give away, like in the form of charitable contributions or income that a state court says you must pay to somebody else, or income that the Federal Government takes away from you in the form of another tax, should not be included in the base of a properly designed income tax, a neutral income tax.

Many of the things that are identified, incidentally, as tax subsidies are, when properly examined against the criterion on which Dale's and Steve's and I think everybody who really wants to have the right kind of tax restructuring proposals are based do not show up as subsidies, they show up as, at best, moderations of penalties.

The right way to treat capital outlays is to expense them. The so-called accelerated depreciation that we now have a bit of does not represent a subsidy, it represents a moderation of a penalty against that kind of use of saving.

Is that right, Dale?

Mr. Jorgenson. Exactly.

Representative Thornberry. Let's see, we have another question ready, I think, or maybe you may just read it. We are about to run out of time, so I will try to get a couple more questions in right quick.

Audience Question. My name is Matt McCulloch. I am an intern at Empower America. My question is directed toward Dr. Jorgenson.

I was wondering what has guided you away from a flat income tax and more toward a consumption tax. Moreover, isn't a consumption tax harder to regulate? And do any of your economic forecasting methods account for the amount of revenue that will be collected from a consumption tax as opposed to an income tax?

Mr. Jorgenson. Well, all of these methods are really based on the idea that you would collect the same amount of revenue that you are collecting now and you would be able to fund the existing government programs. Therefore, there are additional opportunities that Mr. Ture has drawn attention to here for raising the question about which government programs ought to be retained and which should be terminated. But that is a different issue, and it seems to me that that is something which should be isolated from tax policy where we really ought to focus specifically on minimizing the burden on the economy, again using Mr. Ture's ideas here, minimizing the burden on the economy of raising the amount of revenue that we do raise.

In terms of consumption tax versus an income tax, I think we are at a fundamental pass here. Most of the tax proposals that have been in discussion around this table and are discussed under the rubric of fundamental tax reform have been tax proposals based on a consumption tax. So we have a retail sales tax, we have a flat tax administered through the income tax system but changed to a consumption tax base by expensing capital expenditures that Mr. Ture just pointed out, we have the possibility of some kind of European system Value Added Tax.

However, it would be possible to achieve many of the same goals by means of a flat rate income tax, and it would be a very simple way to achieve a lot of the goals that people are interested in here, and at the same time have all the simplicity of a flat rate tax.

Let me just illustrate how this would work:

We are all familiar with the idea of a postcard. The idea is that you report your income tax on a postcard, reducing the compliance costs. You could very easily change simply one line on that postcard from investment as a deduction, the only deduction, to economic depreciation as the only deduction.

Things have changed since the days of ACRS. The Department of Commerce instituted in September of 1995 a system for measuring depreciation which could be immediately adapted to the tax code and could be used as a basis for a flat rate income tax. And that, it seems to me, would produce many of the same benefits.

Ideas along these lines have been advanced by people who, unlike Mr. Ture but more like myself, see the benefits of the 1986 tax reform. Steve Forbes is apparently one of them. And that idea would be essentially to build on the approach that was developed in 1986 of having a flat rate income tax, and that could be done and could achieve many of the same goals that we are talking about here that could be achieved by means of a flat rate consumption tax.

So I do not want to give the impression that I have changed my mind. I am prepared to go either way. It is just that I feel that we ought to focus on the basic goal of economic growth and the means that we choose can depend on other considerations.

Representative Thornberry. Let's go to the next question, please, sir.

Audience Question. My name is Dale Weighill, and I am also an intern at Empower America. My question is on economic growth.

The Kemp Commission's January report suggested a single-rate tax and sort of went in the direction of a single-rate income tax would double the yearly growth rate in the United States from roughly 2.0, 2.5 percent up to upwards of 5.0 percent.

I am wondering if any of the panelists disagree with that conclusion.

Mr. Jorgenson. I disagree radically. I think that's nuts.

(Laughter.)

Mr. Moore. I think I think that we could easily see an increase in the growth rate. I mean, we have had kind of a neat, nice economic experiment in this country with sort of supply-side policies in the 1980s and anti-supply-side policies in the 1990s. We saw a surge in the growth rate in the 1980s with respect to, you know, again if you look at this graph, now, 3.2 percent isn't fantastic, but it is awfully good, especially compared to what we have had since the '90 Bush tax increase.

So can we see an increase in growth? Yes, and even if it is, by the way, a 1.0 percent increase in growth, that has a very large impact on what you are trying to do on the budget side in trying to balance the budget.

Representative Thornberry. How much difference does a 1.0 percent or a half percent growth have not only on government revenue but on people's pockets?

Mr. Moore. Well, let's start with the first question about what impact it would have on government revenues. And I think I made this point earlier, but it is worth repeating, that if over your next horizon for balancing the budget, if you had a 3.5 percent growth rate rather than a 2.5 percent growth rate over the next 6-year period, then the deficit, if you did nothing on the budget, if you just left everything in place, half of the deficit would disappear. That would make your job a lot easier.

Mr. Gale. I disagree strongly with the Kemp Commission's conclusion. I would hardly call it a conclusion. I think they said basically, "Imagine an economy where the growth rate doubled." But that has been taken as a conclusion.

I just want to mention a couple of things. One is, the Kemp Commission had generous personal exemptions. They basically kept the mortgage interest deduction, the charitable contribution, and transition relief. They added a deduction for payroll taxes. So you would need a tax rate of around 27 percent to implement the Kemp Commission's proposals.

There is no way you would get double the growth rate.

What I did recently was look back to the most recent period when we had no income tax in the United States and the growth rate of GDP per capita was nowhere near double what it is now. So that seems like an upper ground on the possible effects of moving to a flat tax.

The third issue is the expansive growth we had in the 1980s, I just want to remind people, was largely, if not completely, a business cycle phenomenon, not a long-term growth phenomenon.

The fourth point is, even a one-percentage-point change in the growth rate is a big, big percentage. It is a big change. If you're thinking of a growth rate of about 2.0 percent right now, according to Steve's figures, a one-percentage-point increase in that is a 50 percent increase. That is a gigantic increase due to playing with the tax code.

Representative Thornberry. Then does that have a gigantic effect on people's pocketbooks, on government revenue?

Mr. Jorgenson. It would have a moderate effect. It would make the economy, you know, 10 percent bigger after 10 years. But if you look in my handout, the estimates from the Auerbach paper modified for some various realistic factors, you get down to tenths of a percentage point or maybe even zero impact on growth pretty rapidly.

Mr. Bartlett. Can I just make a point quickly?

Representative Thornberry. Sure.

Mr. Bartlett. Bill Gale makes a point that I have heard other people make, which is that somehow we can't compare the experience today with the 1980s because the growth, the much more rapid growth we had in the 1980s, was somehow a business cycle phenomenon. But it seems to me that begs the question. I mean, we have been in recovery or expansion since 1991. The last time I checked, that is when the National Bureau of Economic Research said the recession ended. And we have not seen anything remotely like the growth that we had after the end of the previous recession to that, which ended in 1982.

I think it is kind of foolish to imply, as I think Bill did, that the business cycle somehow is endogenous, it just comes from nowhere. I think that growth rates are a function of policy. Now, it may have been partly due to the Fed policy or it might have been due to other kinds of policies other than tax policy.

Mr. Ture. See, I think growth rates are due to a huge number of phenomenon, not merely policy. I think public policy has an influence on the way in which the business sector and the household sector behaves and, therefore, on the growth rate.

Now, it seems to me the prudent approach for policymakers to take is that if we do something along the lines that have been discussed this morning in the area of tax policy, we certainly ought to see in a relatively short period of time the economy achieving a higher level of output and income, possibly employment and real wage rates, than otherwise would be the case.

But the tilt of the economy's expansion would be, we should expect, shortlived. So that if we really want to see the growth rate always going up, we are going to have to do the kind of thing that we are talking about over and over again.

What you really want to be focused on are what are the things built into the whole body of public policy instrumentalities that impair the growth impetus that make the market function less efficiently than it otherwise would, and methodically go about attacking them.

I do not think you ought to be looking for instantaneous doubling of growth rates. Nor should you aspire to that.

Mr. Johnson. And also the short period of measurements that you see such as on this chart are a little bit artificial in the sense that Bush-Clinton inherited the after-effects of Reagan. I think what you are looking for is what is happening to the living standard and growth rate over 15 years. If we all go out tonight, everybody in America, and buy a car on credit, in five years the auto industry might be standing around saying, "How come nobody is buying any cars," because you just have drawn consumption forward in time, you have made an intertemporal substitution.

It may or may not be the case that the Reagan tax cuts and deficit blow-up created a retarding effect in the later years, but these short-period samples do not really give you a result of one regime versus another.

If you cut taxes today for three years, you are going to get more growth than if you had not cut taxes when you enlarge the budget deficit. You are just injecting some short-term purchasing power. But how you deal with that over 15 years and how it improves the living standard in the United States is a different question, and I do not think these bar charts address that.

Representative Thornberry. But what we are here to discuss, I guess, are the more fundamental questions like savings and investment and the cost of labor and those are fundamental things that do transcend the momentary ups and downs. And I think that is the purpose of what we are trying to do here today is figure out what does matter most for long-term growth and see if there isn't a way that, with the tax system, we can help encourage the good things that matter most, agreeing all the while, at least I do, that regulations and other things that government gets involved in are very important in this whole deal.

We are going to have to wrap up real quick.

Mr. Gale. All right. The point about the 1980s is not that business cycle expansions come out of thin air, it is that if you look at how we expanded in the 1980s, it was due to business cycle things. It is easier to reutilize unused existing capacity than it is to build new capacity. Building new capacity is the hard way to get growth. In the 1980s we got it the easy way, we reused existing capacity.

It is easy to stimulate growth with a massive increase in public debt and a massive increase in borrowing from overseas. That is called mortgaging your future. That is what we did in the 1980s.

Mr. Bartlett. We did that in the 1990s, too, Bill.

Mr. Gale. Well, I agree.

Mr. Bartlett. And yet we don't have the growth.

Mr. Gale. Okay. We either can't or do not want to, I think, pursue these things further in the 1990s. In that sense, it is harder to get growth when the economy is doing pretty well. It is going along at 5.6 unemployment rate. It is much harder to get rapid growth now than it was in 1982 when the unemployment rate was 9.7 percent.

Mr. Bartlett. Simply increase the deficit from 1990 forward. We would have the kind of growth rates that we had in the 1980s. Is that what you are saying?

Mr. Gale. I am saying the 1980s -- the way to generate growth is to raise the saving rate -- in the 1980s, what happened is the saving rate did not go up. Therefore, we did not get any increase in potential output. If you looked at the growth of potential output over the 1980s, it basically stayed the same. All that happened is the economy came back to potential output. Now, that is good, it is better to be in a boom than a recession. But we need to distinguish business cycle effects from long-term growth effects. That is my only point.

Representative Thornberry. Well, that might be an interesting point to leave on unless somebody else has something that you really need to say.

Mr. Johnson. One last point. I still think that the key question is on Dr. Jorgenson's paper, the response of labor to the tax cuts. If you have a very aggressive response, in other words, "If they pay me more, I am going to work longer hours," you can expand output and the Fed can take that with stable prices.

The other school would say, "I am already working flat out. You pay me more, I am not going to work any more hours because I am already working those hours." Or they might say, "Hey, I have already covered all my bills, let's go to the beach." When I learned economics, there was a labor/leisure trade-off, and something called backward-bending labor supply.

I think a real sensitivity that is embedded in Dr. Jorgenson's model is how does labor react to the incentive of greater takehome pay? And that is worthy of a whole hearing in itself.

Representative Thornberry. Well, it is, and we did not have as much time as I would have like to have investigated the whole question of to what extent high tax rates discourage people from working longer and

harder, and to what extent lightening that burden might encourage them to do more. And it is certainly an important point.

I think Mr. Gale's last point is something that I take a fair amount of agreement from everybody around the table, and that is the way to increase growth is to increase the savings rate. We may agree or disagree on to what extent specific proposals might do that.

But it seems to me, in trying to take some notes with some assistance back here on things we had agreement on, that that is one that most everybody agreed on.

I found few people who say that the current tax system is as good as it is going to get and that we ought to not try to improve upon it and that while growth is a key toward determining how it is all going to work, there are some other, very good reasons that I think you all mentioned in particular and, of course, Mr. Edmondson, too, on why tax reform is something that ought to be considered, stability and simplicity and making economic sense are also very important.

I think putting this whole thing in context, the point was brought up several times about looking at all taxes, including payroll taxes, including how this thing is going to affect state and local governments is also part of what we have to look at.

I tell you, just from what I hear, people in my district are working harder and harder and feel like they are having a tougher time making ends meet, they are very interested in some sort of major tax overhaul. I do not know for sure, because of the political system that Mr. Johnson talked about, I do not know for sure how this is going to come out, but I do believe that this is an area where the country is pushing Washington ahead to do something that is simpler and fairer that they feel better about and have more confidence in.

I don't know, I think it is a train that is going and our task is going be to do it in a way that makes sense and that encourages growth in the future. I hope that we can do that.

I appreciate very much everybody being here. This has certainly been helpful for me, and I hope it has been helpful for our audience as well.

We will call the hearing adjourned.

[Whereupon, at 12:14 p.m., the Committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE THORNBERRY

My name is Mac Thornberry, and I represent the 13th District of Texas. Chairman Mack has asked me to serve as moderator for this rather unconventional type of congressional hearing.

As we all know, a lot of attention was focused earlier this year on the issue of tax reform in general and the flat tax in particular. Unfortunately, this being a presidential election year, the flat tax ended up being attacked more than being seriously debated and the overall issue of tax reform became a political football.

The purpose of this hearing is to show that tax reform is not a political football, and that a complete overhaul of our tax code -- whether it's through a flat tax, sales tax, or some other proposal for reform -- will prove to be not only good politics, but good policy as well that will bring about real economic growth in America and real benefits for America's families and businesses.

While we should all recognize that major tax reform will likely not be enacted this year, we should also recognize that it is an issue that has been -- and will continue to be -- at the top of many people's agenda. This is obvious in the polls that you read, which reveal that 80 percent of the American people support changing the current system in some way. And it's obvious in the people you talk to. I've got 38 counties in my District. Last year, I held a town meeting in each of them. At each of these town meetings, the most commonly asked question didn't have to do with welfare, balancing the budget, or any of the other issues being considered in Congress. It had to do with tax reform -- mainly what is Washington going to do, and when are they going to do it?

In short, people are hungry for a new tax system and a new way of doing things. This is really not all that hard to understand when you look at the burdens the current system puts on the American people. Today, the typical American family of four pays four times more in taxes than they do on groceries, and more in taxes than they do on food, clothing and shelter combined. But it's not just the amount we pay in taxes that's got people upset. It's the time and costs associated with complying with the tax code.

This past year, it took the average individual 12 hours to complete a standard 1040 form. For small business people, it took nearly twice as long -- 22 hours. The Tax Foundation estimated complying with the tax code in this way cost us all about $200 billion. It hasn't always been this complicated and expensive. In 1913, the tax code was just over 11,000 words long. Today, it's grown to over 555 million words. And in the last 10 years alone, the tax code has been changed 4,000 times.

Now this is neither the time nor place to talk about all of these changes and take apart each of these words. Nor is it the time or place to get into all of the details of the various tax reform proposals being discussed and how they could be implemented. What I'd like to do instead is take a broader look at what tax reform would do to economic growth.

Clearly, the groundwork for much of this was laid last fall by the Kemp Commission on Economic Growth and Tax Reform. It is my hope that we can take the Kemp Commission one step further today by projecting into the future some of the things they recommended and what this could mean for American families and businesses.

Joining me here today to participate in this discussion are:

Bruce Bartlett, who is a senior fellow of the National Center for Policy Analysis, which is based in Dallas. He formerly served in the Department of Treasury, the White House, and on the staff of this Committee.

Ronald Edmondson is a small business man from Amarillo, Texas. He is part owner of office supply businesses in Amarillo and in Lubbock, Texas.

Dale Jorgenson is the Chairman of the Economics Department at Harvard University.

Steve Moore is director of fiscal policy studies at the Cato Institute. He has also been associated with this Committee in the past and is a frequent author.

Martin Regalia is vice president and chief economist of the US. Chamber of Commerce and has previously been associated with the banking industry including an economist for the Board of Governors of the Federal Reserve.

Norman Ture is President of the Institute for Research on the Economics of Taxation. He has served in the Treasury Department of various administrations as well as in Congressional Committees.

William Gale is a senior fellow at The Brookings Institution and has also written a great deal on these issues.

Robert Johnson is strategist and investment manager with Moore Capital Management. He was an economist with the Senate Banking and Budget Committees and also with the Federal Reserve.

I appreciate each of these individuals for taking the time out of their busy schedules to participate in this most important discussion. We will dispense with the traditional opening statements by Members of the Committee and witnesses. We will delve right into a discussion or dialogue among Members and participants on our topic today.

My goal is to keep us on the subject at hand, which I believe to be very important, and to help our discussion illuminate the consequences of major tax reform for the benefit of the Members of the Committee and for the public.

UNLEASHING THE AMERICAN SPIRIT

A GUIDE to Tax Freedom for Americans &
Spectacular Economic Growth for America!

Facts, Figures & Citizen Testimonies

How & Why America MUST Throw Out the Current Tax Code and Implement the Genuine Reform Proposed by *The National Commission on Economic Growth and Tax Reform,* Appointed by Senate Leader Bob Dole and Speaker of the House Newt Gingrich

with Introduction by
Jack Kemp
Commission Chairman

The Tax Test

Six Points of Principle

- **Economic** growth to expand opportunity and create jobs
- **Fairness** for all taxpayers
- **Simplicity,** so everyone can figure it out
- **Neutrality,** so people — not government make choices
- **Visibility,** so people know how much government costs
- **Stability,** so people can plan for the future

Six Points of Policy

- **A single tax rate**
- **A generous personal exemption** to remove the burden on those least able to pay
- **Lower tax rates** for America's families
- **Payroll tax deductibility** for working men and women
- **An end to biases** against work, saving, and investing
- **A 2/3 super-majority** in Congress required to raise the rate

Setting the Eagle Free

"An economy hampered with high tax rates will never produce enough revenue to balance the budget, just as it will never produce enough output and enough jobs."
— John F. Kennedy

Like Kennedy, President Ronald Reagan grasped the "paradoxical truth" that only lower tax rates could lead to higher growth. His leadership was my inspiration as we launched the tax reform movement in the early 1980s with the Kemp-Roth tax cut, paving the way for the greatest peacetime economic expansion the world has ever seen.

Never has this example had more urgency than today. America stands at the edge of extraordinary possibilities. The passing of the Cold War offers an opportunity to lead the world into an era of democratic capitalism, rising prosperity and technological progress. We must embrace this future — but we are being weighed down by our past: the built-up barnacles of counter-productive tax policies that punish risk-taking, penalize investment, and destroy the link between effort and reward.

American taxpayers have had enough. In election after election voters have sent the message that taxes are too high and government spends too much. The message of this commission is: hang on, we hear you, help is on the way! Senator Dole and Speaker Gingrich told us to begin with a blank slate and chart a totally new tax structure for America's next century. We held cross-country public hearings to hear *your* concerns — weighing the advice of ordinary taxpayers in reaching our final conclusions.

How do we make sure everyone pays their fair share? How do we ensure enough revenue to balance the budget and meet basic needs? Most importantly, how do we double the rate of economic growth, create opportunity, and get America growing again? This synopsis of our report attempts to offer some answers by laying the groundwork for tax reform that restores working Americans' control over their pocketbooks, their businesses, their destinies, their lives.

John Gardner has said of the ingredients of great nations: "There occurs at breathtaking moments in history an exhilarating burst of energy and motivation...and a severing of the bonds that normally hold in check the full release of human possibilities. A door is opened, and the caged eagle soars." That eagle, the symbol of our nation, represents the infinite possibilities awaiting the American people. Our mission, the intent of our recommendations, is to open that door and set the eagle free.

Jack Kemp
Jack Kemp
Chairman
National Commission on Economic Growth and Tax Reform

Repeal the Tax Code: Highlights of the Commission's Report

- The Commission believes the current tax code is **beyond repair**...complex, wasteful, economically destructive — enforced by a bureaucracy many see as too big, too powerful, too intrusive.
- The Commission recommends **that the current Internal Revenue Code be repealed in its entirety.**
- **Replace the system with a single low rate, taxing income only once with a generous personal exemption and full deductibility of the payroll tax for America's working men and women.**
- This system will **reduce the tax burden** for all Americans...while removing it entirely from the poor.
- The new system will be **set in stone:** with **a 2/3 super-majority vote of the Congress required to raise the tax rate**.
- These changes can help **double the rate of economic growth** — create jobs, raise family incomes, expand ownership, entrepreneurship, and opportunity.
- Only a system which promotes economic growth can produce the needed revenues to **balance the budget and reduce the burden of our national debt.**

What's Wrong With the System? 3 Major Problems We Must Solve Now

1. ***Economically Destructive*** — Steeply graduated rates on labor and capital destroy jobs, penalize saving and investment, and punish personal efforts to get ahead.
2. ***Impossibly Complex*** — Mindboggling complexity places a huge burden on taxpayers while draining precious resources from our economy. Tax rules are so confusing that even IRS agents have trouble figuring them out.
3. ***Overly Intrusive*** — vast IRS enforcement powers are increasingly seen as infringements on privacy and personal freedom. Too many Americans feel the IRS says they are "guilty until proven innocent" — and resent being treated as criminals.

The Road to Tax Tyranny

"When men get in the habit of helping themselves to the property of others, they cannot easily be cured of it." — 1909, New York Times editorial protesting the first income tax.

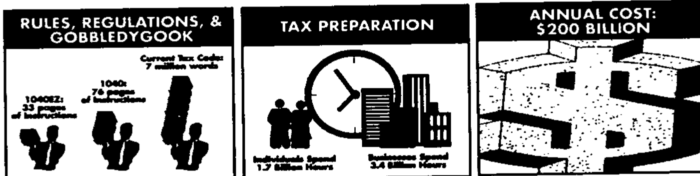
- The income tax was enacted in 1913 — and then, less than 2% of Americans were required to file. Rates ranged from 1 to 7% — the highest rate applying to those who made the equivalent of $7.7 million by today's standards.

- As America prepared to enter World War I the top rate soared to 67%. By World War II, **the top rate was 94%.**
- Throughout the 1950s the highest rate remained at more than 90%. John Kennedy cut that rate to 70%. Ronald Reagan cut it to 28%.
- Both tax cuts triggered unprecedented economic growth, new businesses and new jobs.
- Because of President Clinton's tax increases, today's rate is rising again — the top tax rate now hovers higher than 40%.

Complex, Confusing, Costly and Coercive

"The current tax structure is way out of date with the real world, too complicated with too many loopholes. [We] say dump it!" — Citizen's letter to The Commission

- The current tax code is *seven million* words (7,000,000). Lincoln's Gettysburg Address is 269 words; and the Declaration of Independence, 1,337 words.
- The IRS' "simplest" return, the EZForm 1040, has 33 pages of instructions. The IRS' Form 1040 has 76 pages of instructions.
- American business will spend 3.4 billion hours, and individuals will spend 1.7 billion hours, *simply trying to comply with the tax code.* That's equivalent to a "staff" of 3 million people working full time, year round, just on taxes.
- This costs our economy $200 billion each year — that's like taking every new car, van and truck General Motors builds in a year and dumping them into the ocean.
- Twice as big as the C.I.A. and five times the size of the F.B.I., the I.R.S. controls more information about individual Americans than any other agency.
- Without a search warrant, the I.R.S. can search personal financial records; without a trial, the I.R.S. can seize private property.
- Harvard economists estimate that average incomes in the U.S. could be 15-20% higher without the economic distortions caused by the tax code. That's as much as $6,000 per year for middle income families.



The Tax Test — A Checklist for Real Reform

The principles and recommendations contained in the report comprise "The Tax Test" — a blueprint that provides the foundations for legislative reform. We ask that Congress not pass nor the President sign any legislation that fails to meet this test.

I. *Economic Growth*: Because expanding prosperity and opportunity form the foundation of a free and healthy society.

- None of the challenges facing America — from poverty to crime to the budget deficit — can be solved without strong and continuing economic growth.
- And yet last year our economy grew at an anemic 2.1%! America cannot afford to limp into the 21st Century on such a feeble rate of economic growth.
- No nation in history has ever taxed its way into prosperity. Throughout the ages, lower taxes have meant higher economic growth, higher living standards and more jobs.
- Here at home we've had three periods of powerful economic growth:
  1. 1920s — After the Harding-Coolidge tax cuts, the economy grew at more than 5% per year.
  2. 1960s — After the Kennedy tax cuts, the economy grew at 5% while revenues rose 29% in 4 years.
  3. 1980s — Reagan tax cuts. From 1982-1989, 7 years of growth at nearly 4% annually. 21.5 million new jobs and over 4 million new businesses created.
- REMEMBER: Higher **tax** rates don't produce higher revenues — only higher **growth** rates do.

Tax rates have gone up, gone down, gone up again — but tax revenue as a *percentage* of national output has remained the same. Looking at the chart on the following page: government historically collects about 19% of the GDP — no matter how high the tax rate is pushed. Higher rates simply mean a smaller economy — and less income to tax. 19% of a booming economy brings in more revenue than 19% of a weak one — another reason why reform must spur economic growth.

II. *Fairness*: Because democracy is based on the principle of equality before the law.

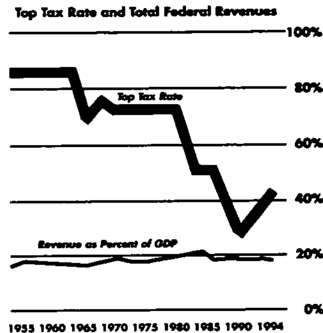
"*...I do not mind paying my fair share...but I feel that many, many people and companies are not paying their fair share because they have the money to hire smart accountants and lawyers.*" — Christine W. Perkowski, PA., Letter to Commission

In order to restore fairness, a new system must:

Tax equally: One rate respects equality before the law.

- Eliminate tax "loopholes" — the exemptions, deductions and credits that traditionally benefit the rich.

- Don't punish success — by slapping higher rates on hard work, creativity and entrepreneurial risk taking.
- If a man earns ten times the income of another, he should pay ten times as much taxes — no more, no less.



Tax progressively: A compassionate system must lighten the load on those least able to pay.

- Americans must be able to feed, clothe and house their families before they're asked to feed the federal spending machine.
- Today, the highest marginal tax rates in America are paid by those who are trying to move from welfare to work. When lost benefits are included, this effective rate can reach 100%.
- A generous exemption can provide individuals with an "economic head start" — letting them start to climb the ladder of opportunity before taxes take effect.

Lower tax rates: The rate must be low and kept low.

- Taxpayers are unanimous: taxes are too high, and government spends too much.
- By lowering taxes and restraining spending, we can restore the balance of power between the federal government and the citizens who pay its bills.

III. *Simplicity*: Because life is too short and peace of mind too precious to waste your time and lose your temper trying to figure your taxes.

- The tax code grows in complexity every year — making it increasingly impossible for average taxpayers to understand.
- A simplified, single rate system will let taxpayers file their return on one sheet of paper in less time than it takes to complete the morning crossword puzzle.

IV. *Neutrality*: Because the code shouldn't pick winners or losers, but let people make decisions based on their own needs and dreams.

- The purpose of taxes is to raise the revenue needed to run government — period.
- This should be done in a way that does the least possible damage to the economy.
- The most damaging aspect of today's code is the double and triple taxation of saving and investment.

V. *Visibility*: Because those who pay for government have a right to see the bill.

- Hidden taxes further the fantasy that government is free, leading many to "consume" more government than they otherwise would.

- A visible tax rate gives citizens an honest accounting of government's expense.
- By keeping the tax rate in plain view — we can make it harder for politicians to raise taxes without our consent.

VI. *Stability*: Because taxpayers should be able to plan for their future without the rules getting changed mid-game.

- Over the past 40 years, the tax code has had 31 "significant" reforms and more than 400 revisions through public law.
- These changes have created a climate of confusion and uncertainty.
- A stable tax code must let individuals start a business, buy a house or take out a loan without fear of constant changes in the tax code.

A New Tax Code For The 21st Century Key Recommendations

- Adopt a single, low tax rate with a generous personal exemption
- Lower the tax burden on America's working families and remove it from those least able to pay
- End biases against work, saving, and investment
- Allow full deductibility of the payroll tax for working men and women
- Require a two-thirds super-majority vote in Congress to increase the tax rate

Discussion

One Rate

One tax rate, combined with a generous personal exemption, produces a progressive average tax rate. Low-income taxpayers pay little or no tax — but above the threshold, everyone faces the same rate on additional income.

Lower the Tax Burden for All

The single rate should be *as low as possible* — and lowered over time as a growing economy yields higher revenues. Any extra revenue should be seen as a "growth dividend" to be paid out to the American people.

End Biases Against Work, Saving and Investment

Multiple taxation goes against the grain of basic American values — such as thrift, hard work, and entrepreneurial risk-taking. These biases must end — including elimination of the tax on capital gains.

- At 28% — America's capital gains tax rate is one of the highest of any developed nation. It's not fair for America's workers and entrepreneurs to compete against nations with lower rates: France, 16%; Japan, 1%; Germany, South Korea, Hong Kong, 0%.
- By punishing risk-taking and shrinking the pool of seed capital — the capital gains tax destroys jobs and kills businesses before they have a chance to be born. Those hit hardest are not the wealthy, but those who have yet to realize their capital gains: the poor, the young, and minorities.

Eliminate "Death Taxes"

It makes little sense and is patently unfair to impose extra taxes on people who choose to pass their assets to their children or grandchildren. Families faced with these confiscatory taxes often are forced to sell off farms or businesses, destroying jobs in the process.

Full Deductibility of Payroll Taxes for All Working Americans

Many employees pay more in payroll taxes than in federal income taxes. When employer/employee payroll taxes of 15.3% are taken into account, a worker in the 28% tax bracket faces a brutal marginal rate of 43% on any additional income earned.

Making the payroll tax deductible means income taxes would be calculated on working families' real net incomes.

Simplify International Taxation

The current international taxation system is one of the biggest headaches for American businesses — damaging our competitiveness abroad, while encouraging businesses to reinvest profits overseas rather than bringing them home.

A new system must be clearer and simpler. It must not work to discourage investment in research and development in the U.S.

Strengthen Private Retirement Savings

Americans are not saving enough for their own retirement.

Even under a new tax system, there is no guarantee that all individuals or families will save enough to be secure in their retirement. Without sufficient retirement saving, many people will become dependent upon government in their old age, necessitating either sharp increases in taxes on future generations or a significantly diminished standard of living.

Therefore, any new tax system should encourage people to save for their own retirement.

Two-Thirds Super-Majority Vote to Raise the Tax Rate

The roller-coaster ride of tax reform in past decades has fed citizens' cynicism about the possibility of real, long-term reform. By safeguarding these changes with a two-thirds super-majority vote, we can rebuild Americans' trust in the system.

Deductions and Exemptions

The home mortgage interest deduction has spurred home ownership in America; an important goal of The Commission is to spread ownership to give more people a stake in the system.

And, at a time when America needs a renaissance of private giving and commitment to overcome those social problems which government programs have either failed to improve or made worse — we need a system which encourages people to take more responsibility for communities and neighbors in need.

America should debate the best way to protect these institutions and preserve the values they represent within the context of the dynamic new tax system The Commission envisions.

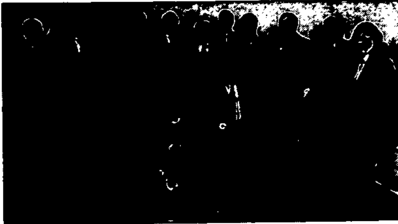
Conclusion

It is said that every breakthrough in human understanding has come in the form of a simplification. The complex, bureaucratic tax code of the 20th century will not help us keep pace with the challenges of the 21st.

The rewards of the 21st century tax code outlined in these pages go beyond the obvious simplicity and freedom a single-rate would afford. The impact on the economy would be immediate and profound: doubling our economic growth rate over the course of the next decade. The moment the dead weight and distortions of the current system are lifted, the explosion of new businesses and new jobs would transform the economic and social landscape of the country.

By freeing citizens from the costly encumbrances of the current tax code, by strengthening the link between effort and reward, by allowing individuals to keep more of what they earn, and by freeing the pent-up power of our economy, this new system can lead to Lincoln's "new birth of freedom" and launch us into the next American century.

Members of The National Commission on Economic Growth and Tax Reform



Chairman: **Jack Kemp**, Co-Director of Empower America. Former Secretary, The U.S. Department of Housing and Urban Development. Nine terms in U.S. House of Representatives from Buffalo, NY area. Played professional football for 13 years as quarterback for the San Diego Chargers and Buffalo Bills.

Vice Chairman: **Edwin J. Feulner, Jr.**, president of The Heritage Foundation, a Washington-based public policy group. Chairman of the Institute for European Defense and Strategic Studies in London.

Loretta H. Adams
President
Market Development, Inc.

J. Kenneth Blackwell
Treasurer
State of Ohio

Herman Cain
Chairman and CEO
Godfather's Pizza, Inc.

Carroll Campbell
President and CEO
American Council of Life Insurance
Former Governor of South Carolina

Pete du Pont
Policy Chairman
National Center of Policy Analysis
Former Governor of Delaware

Jack Faris
President
National Federation of Independent Business

Matt Fong
Treasurer
State of California

Theodore J. Forstmann
Founding Partner
Forstmann Little & Co.

Dean R. Kleckner
President
American Farm Bureau Federation

Shirley Peterson
President, Hood College
Former Commissioner of the IRS

John Snow
Chairman, President, and CEO
CSX Corporation

John Wieland
President
John Wieland Homes, Inc.

CLIP HERE CLIP HERE

WE WANT YOUR RESPONSE!

If you support the goals of this summary, you will want to read the complete Report of The National Commission on Economic Growth and Tax Reform.
Contact The Commission at:

The National Commission of Economic Growth and Tax Reform
1133 Connecticut Avenue, N.W. • Washington, D.C. 20036

PREPARED STATEMENT OF REPRESENTATIVE STARK

I want to thank you for calling today's round table discussion on one of the most far-reaching economic issues being debated in Washington today.

Recent newspapers are filled with reports that major tax changes will revive as a Presidential campaign issue. As a member of the House tax-writing committee for more than twenty years, I have been following those reports closely.

In recent testimony on tax reform Professor Jorgenson noted that "The first Issue in the debate will be the economic impact of the federal deficit."

Unfortunately, if you cut through the rhetoric, the Republicans' proposals for so-called "tax reform" are nothing but a Trojan Horse for deep tax cuts. They don't propose to raise taxes on anyone, but they all bestow huge tax cuts on many people. **As an economic matter, the negative effects of huge deficits would swamp any positive effects of reform itself.**

Republican tax reform proposals are budget busters because the alternative would be political suicide. To maintain current revenues with flat taxes or sales taxes would mean a whopping tax increase on middle and low income people, even as high income people would get a huge tax break. Faced with a choice of raising taxes on most voters or creating bigger deficits, Republican politicians do not have a difficult decision.

Last year, to finance a tax cut of $245 billion, Republicans found themselves sweating bullets and cutting Medicare by $270 billion.

The three most prominent Republican proposals for tax reform would make last year's tax and Medicare cuts look quite modest. As the chart shows, revenue losses would be more than $600 billion from cutting taxes across-the-board by 15 percent or from repealing the tax hikes of 1990 and 1993. [See Chart 1] That's 2-1/2 times the losses from the tax cuts in last year's budget. And, according to Dole's campaign, the Forbes flat tax plan would cost five times as much as last year's Republican tax cut plan.

Such enormous tax cuts would surely result in much deeper cuts for Medicare and many other vital programs. Deep cuts in Social Security could no longer be avoided. Even then, enormous budget deficits would remain.

Of course, some of the supply side economists here today would like us to believe that cutting taxes will largely pay for itself. To them I say "Been there, done that. It didn't work!" [See Charts 2, 3 and 4]

Ronald Reagan campaigned for huge tax cuts in 1980. Real long term interest rates soared immediately upon his election, they went up further when the details were announced in the spring of 1981, and went up still further when the cuts were passed in the summer of 1981 [See Chart 5]. The spike in interest rates and the dollar spun the economy into a recession that raised unemployment to almost 11 percent.

Until recently, Bob Dole has been a consistent critic of supply-side economics. Right after the 1992 elections, he appeared on *Larry King Live* and was asked about supply side economics. As Chart 6 indicates, Dole has had disdain for the supply-side camp.

> "I was never in that camp ... if you go back and look at the record I used to tell the story that somebody told me -- a good-news-bad-news joke. The good news was a busload of supply-siders went over the cliff. The bad news was there were three empty seats. I'm a traditional Republican who believes you ought to restrain spending if you're going to cut taxes. I don't think you can just cut taxes alone and get gain without pain. That's been my firmly held belief."

Nowadays, Dole likes to call the 1993 tax increase the largest in history. In fact, as the *Wall Street Journal* reported last February, Dole has voted for three previous tax increases that were larger in relation to the economy. [See Chart 7] **Dole was an architect of the 1982 and 1983 tax hikes, both of which exceeded the 1993 tax hike in size.**

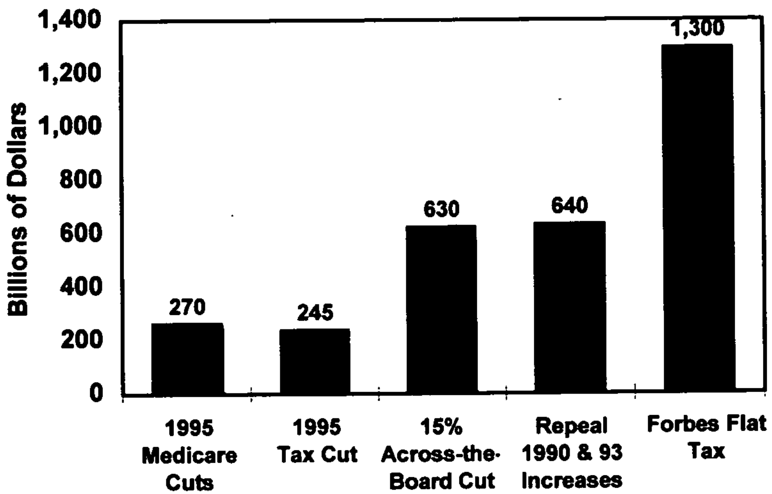
We have a hand out with 25 quotations of Dole criticizing supply side economics going all the way back to 1980.

But traditional fiscal conservative Bob Dole now seems to be at odds with the Bob Dole who is Presidential candidate and 20 points behind in the polls. Last month he proposed a tax credit for donations that will cost between $100 and $300 billion over seven years. He made no pretense of paying for it. If his supply side advisors have their way, he will propose even larger tax cuts soon and will make no serious effort to say how to pay for them, either.

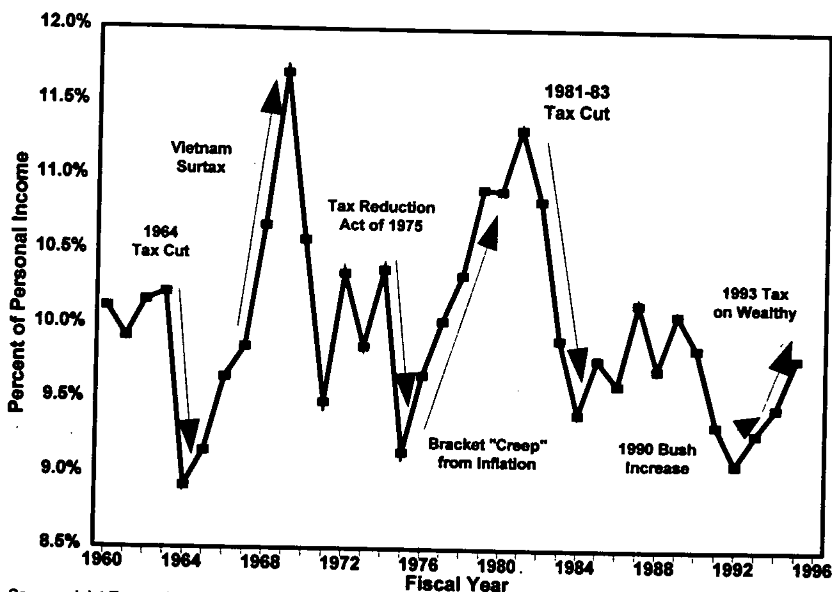
Herblock wrote a cartoon last week that neatly captures Dole's situation. [See Chart 8] He's trying to ride two horses -- balancing the budget and big tax cuts -- and they are running in opposite directions. He knows better.

We should work to improve the tax system. Of course, it is too complex and has many perverse incentives. But none of the current proposals would provide the jobs and income gains that ordinary working people are seeking.

I look forward to our round table discussion.

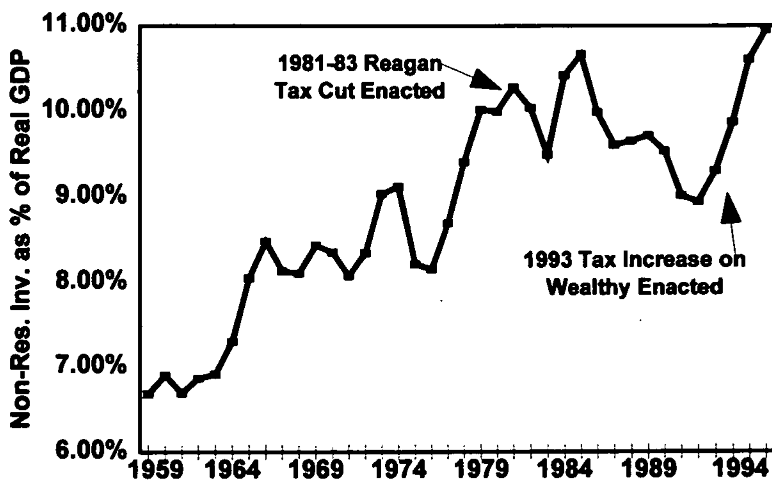


Source: CBO, CBO, Bruce Bartlett, Treasury, Dole Campaign

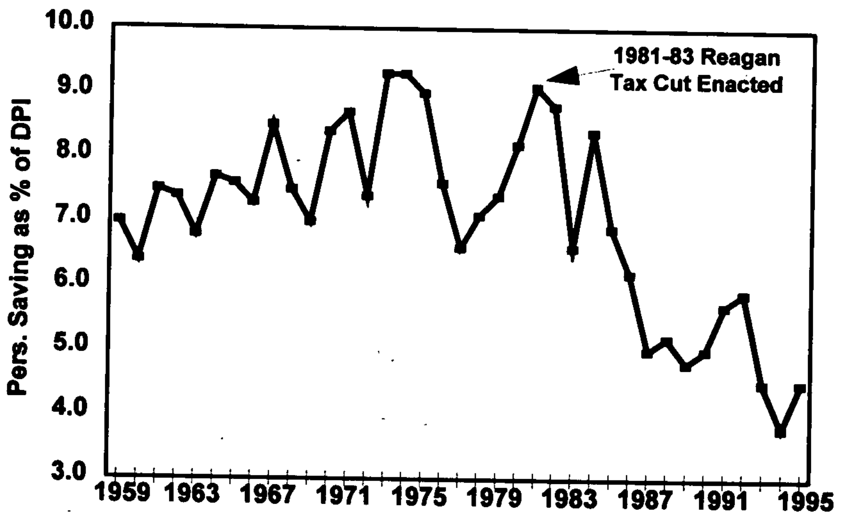


Source: Joint Economic Committee Democratic staff from Commerce and Treasury Dept. data

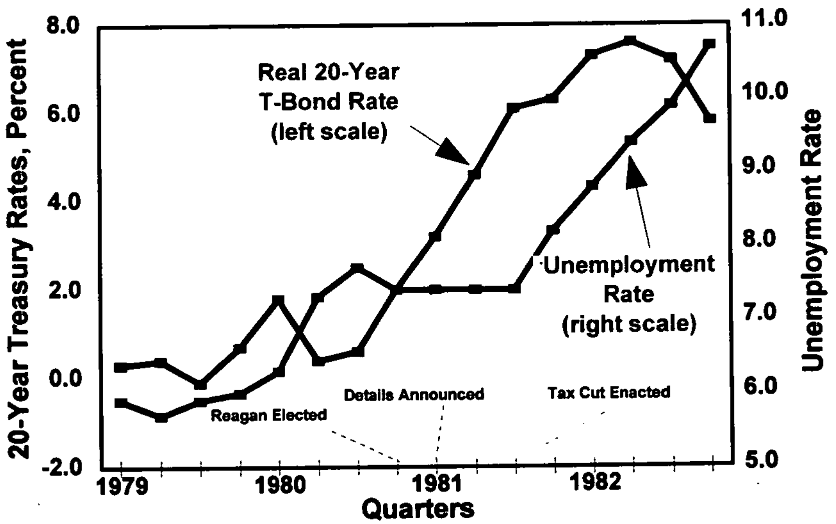
1981-83 Supply-Side Tax Cut Failed To Stimulate Investment



Source: Joint Economic Committee Democratic staff from Commerce Dept. data



Source: Joint Economic Committee Democratic staff from Commerce Dept. data

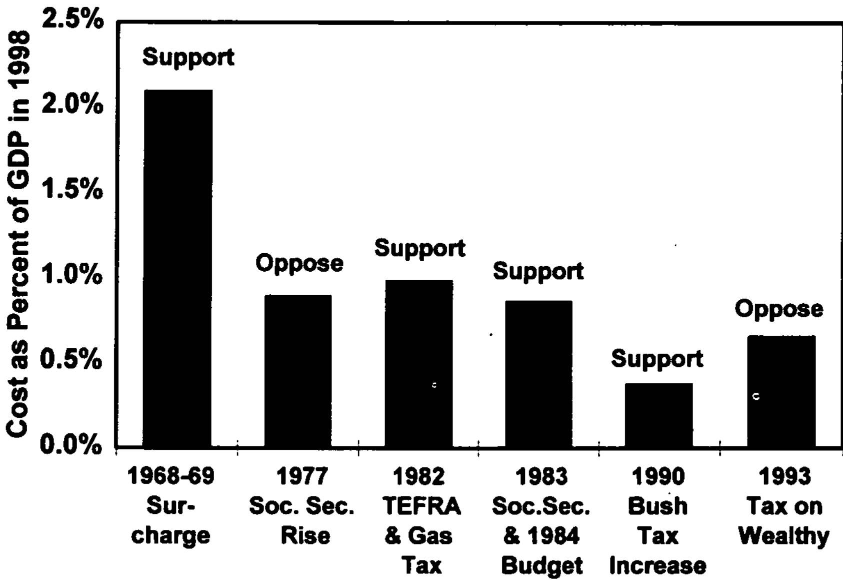

Reagan Tax Cut Caused High Real Long Rates, Massive Recession
20-Year Treasury Rates, Percent
8.0
6.0
4.0
2.0
0.0
-2.0
Real 20-Year T-Bond Rate (left scale)
Unemployment Rate (right scale)
Details Announced
Tax Cut Enacted
Reagan Elected
11.0
10.0
9.0
8.0
7.0
6.0
5.0
Unemployment Rate
1979
1980
1981
1982
Quarters

Bob Dole on Supply-Side Economics:

"I never was in that camp, if you go back and look at the record. I used to tell the story that someone told me -- a good-news-bad-news joke. The good news was a busload of supply-siders went over the cliff. The bad news was there were three empty seats.

"I'm a traditional Republican who believes you ought to restrain spending if you're going to cut taxes. I don't think you can just cut taxes alone and get gain without pain."

Larry King Live, Nov. 4, 1992



Source: Wall Street Journal, Feb. 16, 1996

"I BELIEVE IN ACTION!"

THE ECONOMIC IMPACT OF TAXING CONSUMPTION

by

Dale W. Jorgenson

INTRODUCTION AND SUMMARY

In this testimony I consider the economic impact of substituting a tax on consumption for corporate and individual income taxes at federal, state, and local levels, beginning January 1, 1996. I limit my analysis to a revenue neutral tax substitution–one that would leave government revenues unchanged. Finally, I focus on the impact of fundamental tax reform on economic growth, leaving progressivity of the resulting combination of taxes and government expenditures to be determined by adjustment of expenditures. I have summarized my conclusions in a series of eight charts appended to the text of this prepared statement. These were generated by simulating future U.S. economic growth with and without the change in tax policy. Further details are provided in an Appendix to this statement.

1. The revenue neutral substitution of a consumption tax for existing income taxes at both federal and state and local levels would have an immediate and powerful impact on the level of economic activity. The first chart shows that U.S. gross domestic product (GDP) would increase initially by about thirteen percent; this increase would gradually decline to around nine percent.

2. The imposition of a consumption tax would produce in a sharply higher tax rate on consumer goods and services. The second chart shows that the consumption tax rate required for replacing existing revenues from individual and corporate income taxes at both federal and state and local levels would be around fifteen

percent. This would gradually rise over time, ultimately reaching twenty-one percent.

3. As a consequence of the total transformation of the tax system, individuals would sharply curtail consumption of both goods and leisure. This would produce a dramatic jump in saving and a substantial rise in labor supply. These increases would subside only very gradually over time.

4. Taxation of consumption would induce a radical shift away from consumption toward investment. The third chart shows that real investment would leap upward by eighty percent! The fourth chart shows that real consumption would initially decline by around five percent, but consumption would grow rapidly and overtake the level under the income tax within two years.

5. Since producers would no longer pay taxes on profits or other forms of income from capital and workers would no longer pay taxes on wages, prices received by producers, shown in the fifth chart, would fall by an average of twenty percent. The sixth chart shows that industry outputs would rise by an average of twenty percent with substantial relative gains for investment goods producers.

6. In the long run producers' prices, shown in the seventh chart, would fall by more than twenty-five percent relative to prices under an income tax. The shift toward investment and away from consumption would redistribute economic activity among industries. The eighth chart shows that output would increase in all industries, but the rise in production of investment goods would be greatest.

IMPLEMENTATION OF A CONSUMPTION TAX

In *Hearings on Replacing the Federal Income Tax,* held by the Committee on Ways and Means last June, testimony focused on alternative methods for implementing a consumption-base value added tax. This is economic jargon for a consumption tax, where value added is the sum of capital and labor incomes and subtracting investment from value added would produce a consumption tax base. An alternative and equivalent definition of this tax base is the difference between business receipts and purchases from other businesses, including investment goods. A third definition of the tax base is the total of retail sales to consumers.

The three principal methods for implementation of a value added tax correspond to the three definitions of consumption as the tax base:

1. The invoice and credit method. Business invoices would include a credit against tax liabilities for value added taxes paid on goods and services received. This method is used in Canada and Europe. In Canada and many other countries the value added tax replaced an earlier and more complex system of retail and wholesale sales taxes. From the point of view of tax administration the invoice and credit method has the advantage that both purchases and sales generate records of the tax credits. The invoice and credit method would require substantial modification of collection procedures, but decades of experience have ironed out many of the bugs.[1]

2. The subtraction method. Business purchases from other businesses, including investment goods, would be subtracted from business receipts, including proceeds from the sale of assets. This could be implemented within the framework of the existing tax system by integrating individual and corporate income taxes, as proposed by

1. The advantages and disadvantages of the invoice and credit method for implementing the value added tax are discussed by the U.S. Treasury (1984).

the U.S. Treasury (1992), and treating all businesses as partnerships or "sub-chapter S" corporations. The second step would be to allow expensing of investment in the year it is undertaken. Enforcement problems could be reduced by drastically simplifying the tax rules,[2] but the principal method of enforcement, auditing of taxpayer records by the Internal Revenue Service, would remain.

3. National retail sales tax. Like existing state sales taxes, a national retail sales tax would be collected by retail establishments, including service providers and developers for residential real estate for sale to owner-occupiers. This would also require a new system for tax administration, possibly sub-contracting the actual collection to existing state agencies. The Internal Revenue Service could be reduced to an agency that would sub-contract collections. Alternatively, the IRS could be abolished and a new agency created for this purpose.[3] Enforcement procedures could be limited to those used by the states.

All three alternative methods for implementing a consumption tax could be based on the same definition of the tax base. This greatly simplifies the tax economist's task, since the economic impact would be the same for all three approaches. This leaves important issues to be resolved by other tax professionals, including, especially, tax lawyers who would write the legislation and the implementing regulations and tax accountants who would translate the laws and regulations into accounting practice and advise economic decision-makers about their implications.

2. A subtraction method value added tax has been proposed by Ranking Minority Member Sam Gibbons of the Committee on Ways and Ways. If no business receipts were excluded and no deductions and tax credits were permitted, the tax return could be reduced to the now familiar postcard size, as in the Flat Tax proposal of Majority Leader Dick Armey and Senator Richard Shelby (1995). Economists will recognize the Flat Tax proposal as a variant of the consumption-base value added tax proposed by Robert Hall and Alvin Rabushka (1995).

3. A national retail sales tax has been proposed by Chairman Bill Archer of the Committee on Ways and Means and Senator Richard Lugar.

From the economic point of view the definition of consumption is straightforward; a useful and commonly accepted point of departure is Personal Consumption Expenditures (PCE) as defined in the U.S. national income and product accounts. However, the taxation of services poses important administrative problems reviewed in a U.S. Treasury (1984) monograph on the value added tax. First, PCE includes the rental equivalent value of the services of owner-occupied housing, but does not include the services of consumers' durables. Both are substantial in magnitude, but could be taxed by the "prepayment method" described by the Hon. David Bradford (1986). In this approach taxes on services would be prepaid by including investment rather than consumption in the tax base.

The prepayment of taxes on services of owner-occupied housing would remove an important political obstacle to substitution of a consumption tax for existing income taxes. At the time the substitution takes place all owner-occupiers would be treated as having prepaid all future taxes on the services of their dwellings. This is equivalent to excluding not only mortgage interest from the tax base, but also returns to equity, which might be taxed upon the sale of residence with no corresponding purchase of residential property of equal or greater value. Of course, this presumes that home owners would refinance to take advantage of the altered tax treatment of mortgage lenders.

It is essential to include housing and consumers' durables in the tax base in order to reap the substantial economic benefits of putting household and business capital onto the same footing.[4] This raises politically sensitive issues and it is important to be clear about the implications of prepayment as the debate proceeds. Under the prepayment method purchases of consumers' durables by households for their own use would be subject to tax. These would include automobiles, appliances,

4. See, for example, my testimony before the Committee on Ways and Means of June 6, 1995.

home furnishings, and so on. In addition, new construction of owner-occupied housing would be subject to tax, as would sales of existing renter-occupied housing to owner-occupiers. Together with the exclusion of the rental values of existing owner-occupied housing, this would maintain the asset values for housing.

Other purchases of services that would be especially problematical under a consumption tax include services provided by nonprofit institutions, such as schools and colleges, hospitals, and religious and eleemosynary institutions. The traditional, tax-favored status of these forms of consumption would be defended tenaciously by recipients of the services and even more tenaciously by the providers. The argument can be made that educational services represent investment in human capital rather than consumption.

Finally, any definition of a consumption tax base will have to distinguish between consumption for personal and business purposes. On-going disputes over home offices, business-provided automobiles, equipment, and clothing, and business-related lodging, entertainment and meals would continue to plague tax officials, the entertainment and hospitality industries, and holders of expense accounts. In short, substitution of a consumption tax for the federal income tax system would not eliminate all the practical issues that arise from the necessity of distinguishing between business and personal activities in defining consumption. However, these issues are common to both income and consumption taxes.

CONCLUSION

Under any one of the three approaches to implementation of a value added tax, substitution of a consumption tax for existing individual and corporate income taxes would be the most drastic change in federal tax policy since the introduction of the income tax in 1913. It is not surprising that the economic impact summarized above

would be truly staggering in magnitude. It is easy to foresee that as Americans become more fully apprised of the manifold ramifications of fundamental tax reform that Gucci Gulch[5] will be transformed into the political equivalent of the Grand Canyon.

The coming debate over tax reform is a both a challenge and an opportunity for economists. It is a challenge because the impact of fundamental tax reform would involve almost every aspect of economic life. Economists who have spent their lives pre-occupied by the latest debating points in journals read only by other economists will suddenly find that the fine points that dominate scholarly discussions will be subjected to the refiner's fire of public scrutiny.

The debate will be an opportunity for economists because economic research has generated a wealth of information about the impacts of tax policy. Provided that the economic debate can be properly focused, economists and policy makers will learn a great deal about the U.S. economy and its potential for achieving a higher level of performance. I am personally very gratified that the Joint Committee on Taxation under the leadership of Chief of Staff Kenneth Kies has taken the initiative in channeling the professional discussion. In my remaining testimony I will outline my own recommendations for the initial ground rules.

The first issue in the debate will be the economic impact of the federal deficit. Nearly two decades of economic disputation over this issue has failed to produce any resolution. No doubt the dispute will continue well into the next century and preoccupy the next generation of fiscal economists, as it has the previous generation. An effective rhetorical device for insulating the discussion of fundamental tax reform from the budget debate is to limit consideration to revenue neutral proposals. This

5. Few readers of this testimony will be unaware of this colloquial expression for the corridor outside the hearing room of the Committee on Ways and Means. The expression appeared in the title of the definitive account of the Tax Reform Act of 1986 by Jeffrey H. Birnbaum and Alan S. Murray (1987).

device was critical to the eventual enactment of the Tax Reform Act of 1986 and is, I believe, essential to progress in fundamental tax reform.

The second issue to be debated is fiscal federalism or the role of state and local governments. Since state and local income taxes usually employ the same tax bases as the corresponding federal taxes, it is reasonable to assume that substitution of consumption for income taxes at the federal level would be followed by similar substitutions at the state and local level. Since an important advantage of a fundamental tax reform is the possibility, at least at the outset, of radically simplifying tax rules, it does not make much sense to assume that existing rules would continue to govern state and local taxes, even if the federal income tax were abolished.

The third issue that will surface in the tax reform debate is progressivity of the tax system. Fiscal economists of varying persuasions can agree that progressivity or the lack of it can be used to characterize all of government activity, not only taxes but also expenditures. I believe that a case can be made that policies to achieve progressivity can and should be limited to the expenditure side of the government budget. This initial policy stance would immeasurably simplify the debate over the economic impact of fundamental tax reform.

The central issue in evaluating the economic impact of fundamental tax reform is its impact on economic growth. A serious barrier to focusing attention on growth is that the main apparatus for policy evaluation employed by both the Congress and the Administration consists of distributional tables for policy impacts. So far as I am aware, the methodology I have employed in preparing this testimony–comparing time paths of U.S. economic growth with and without a change in tax policy–has never been used by either the Joint Tax Committee or the Office of Tax Analysis of the U.S. Treasury. Public discussion of tax reform will be crippled until this analytical gap is overcome.

APPENDIX

The simulations of U.S. economic growth summarized in the charts appended to this testimony are based on an intertemporal equilibrium model of the U.S. economy that I have constructed with Peter J. Wilcoxen. The details of the model and more than a dozen applications are summarized in our survey paper, "Energy, the Environment, and Economic Growth," published in 1993. The model has been continuously revised and updated since it was first published in 1990 and Version Nine is now available. This new version of the model incorporates the detailed representation of the U.S. tax structure I have published with Kun-Young Yun in our 1991 book, TAX REFORM AND THE COST OF CAPITAL.

Our model of U.S. economic growth is disaggregated to the thirty-five industries listed in the final four charts in my testimony. In addition, the model distinguishes among 1344 types of households, disaggregated by family size, age and gender of household head, region of residence, race, and urban versus rural location. The model is built around sub-models of investment and saving based on rational expectations. The price of investment goods in every period is based on expectations of future capital service prices and discount rates that are fulfilled by the solution of the model.

In order to analyze the economic impact of changes in tax policy, we simulate the growth of the U.S. economy with and without changes in these policies. The first and most difficult step is to generate a simulation based on current tax policy. We call this the *base case*. We then produce an alternative simulation based on a consumption tax. This represents the *alternative case*. Finally, we compare the base case with the alternative case in order to assess the effects of the substitution of a consumption tax for the existing income tax system.

The most difficult part of tax policy evaluation is to project U.S. economic growth under the existing tax system. For this purpose I have introduced the characteristic features of U.S. tax law into the cost of capital, distinguishing among assets employed in three different legal forms of organization–households and nonprofit institutions, noncorporate business, and corporations. Income from corporate business is subject to the corporate income tax, while distributions to households are subject to the individual income tax. Income from unincorporated businesses–partnerships and sole proprietorships–are taxed only at the individual level, while income from equity in household assets is not subject to the income tax.

REFERENCES

Armey, Dick, "The Freedom and Fairness Restoration Act," Washington, D.C., 104th Congress, First Session, 1995.

Birnbaum, Jeffrey H., and Alan S. Murray, *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform*, New York, Random House, 1987.

Bradford, David, *Untangling the Income Tax*, Cambridge, Harvard University Press, 1986.

Committee and Ways and Means, *Hearings on Replacing the Federal Income Tax*, U.S. House of Representatives, 104th Congress, First Session, 1996.

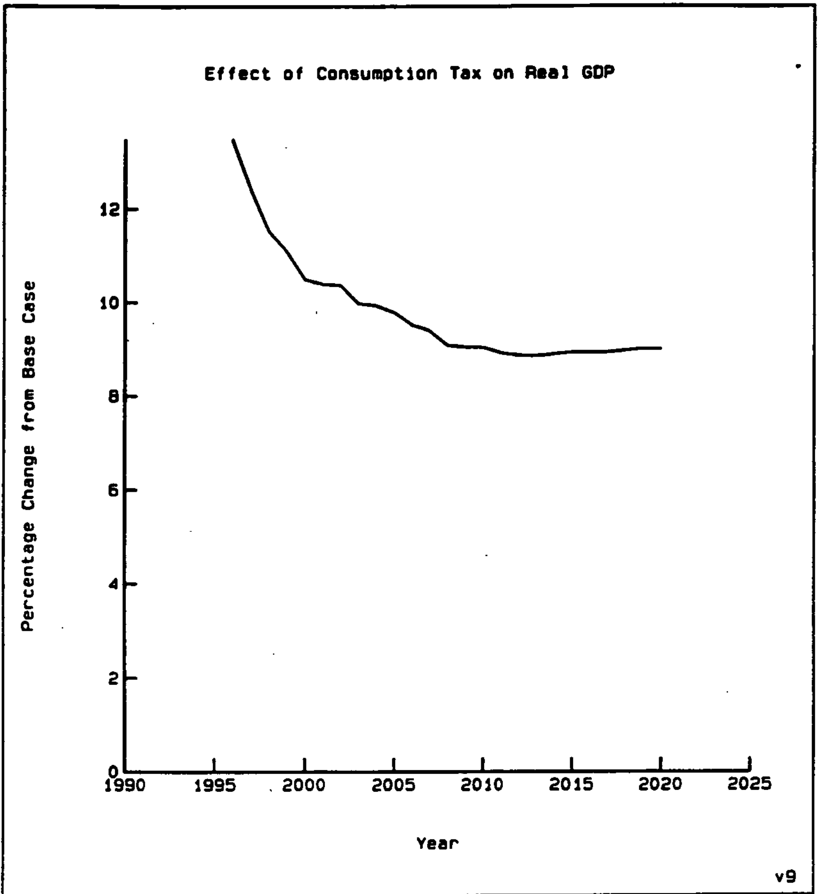
Hall, Robert E., and Alvin Rabushka, *The Flat Tax*, 2nd ed., Stanford, The Hoover Institution, 1995.

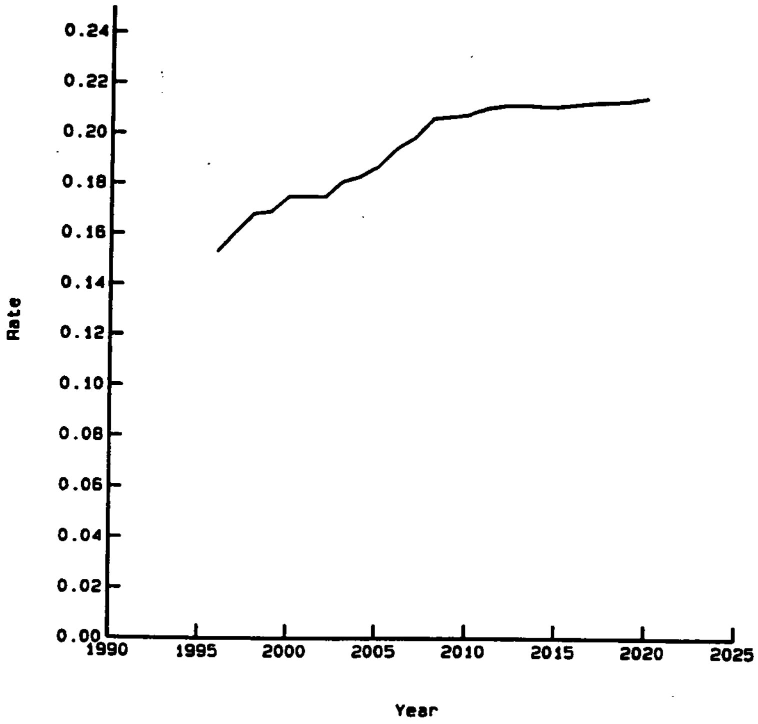
Jorgenson, Dale W., and Peter J. Wilcoxen, "Energy, the Environment, and Economic Growth," in A. V. Kneese and J. Sweeney (eds.), *Handbook of Natural Resource and Energy Economics*, Amsterdam, North-Holland, 1993.

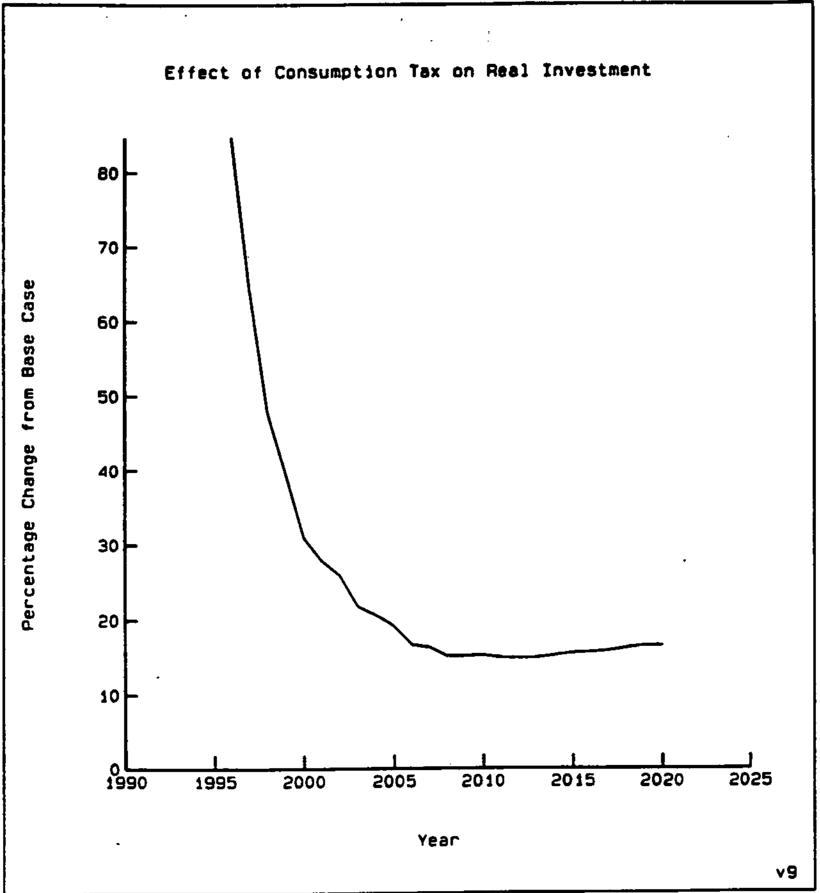
Jorgenson, Dale W., and Kun-Young Yun, *Tax Reform and the Cost of Capital*, New York, Oxford University Press, 1991.

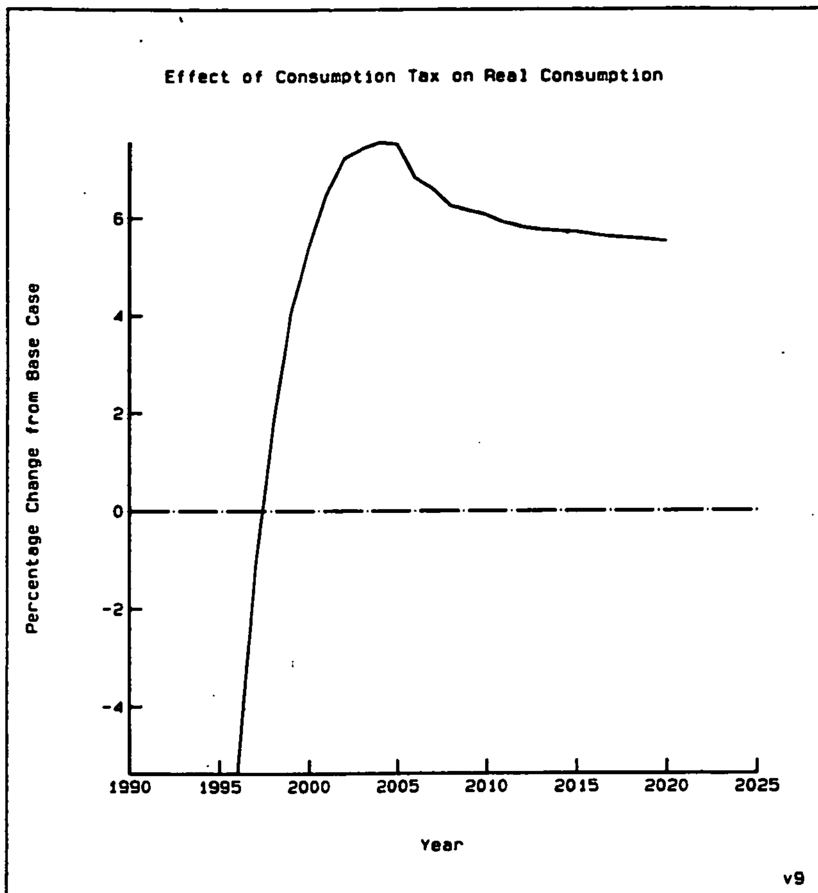
U.S. Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, Washington, U.S. Government Printing Office, 1984.

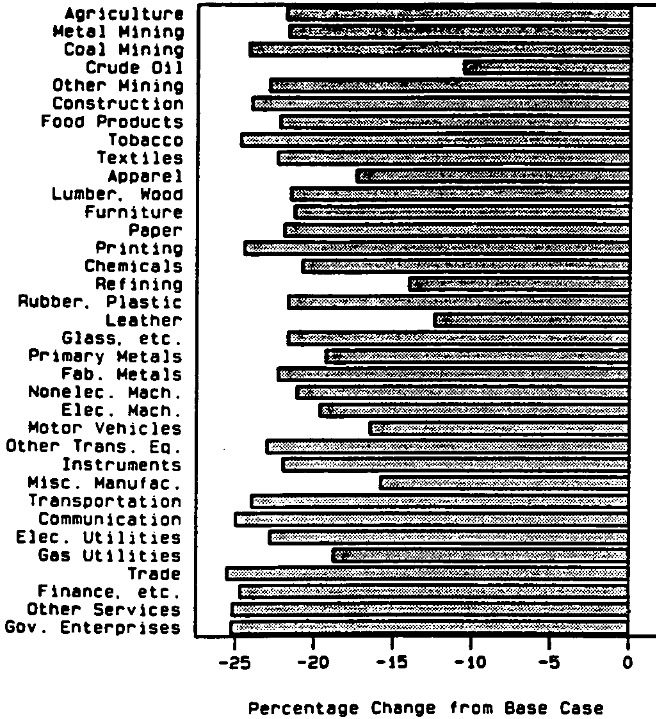
_____, *Taxing Business Income Once*, Washington, U.S. Government Printing Office, 1992.

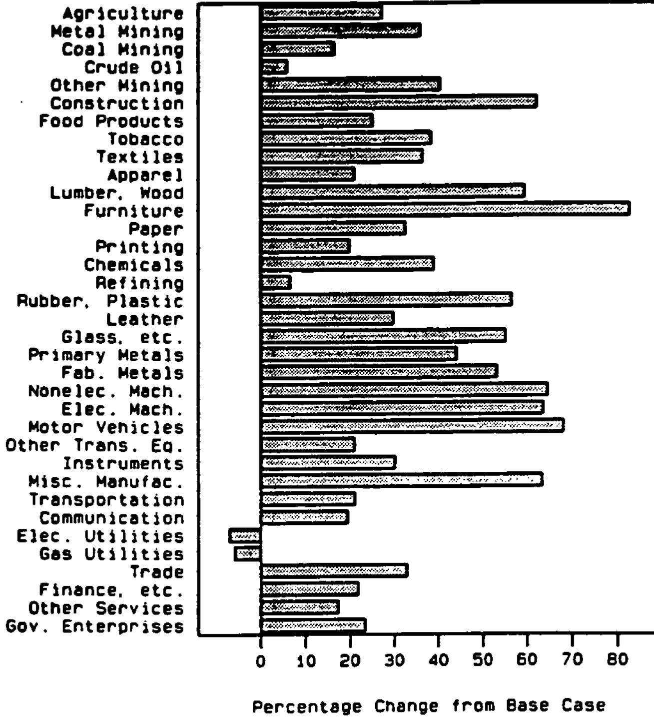

Effect of Consumption Tax on Real GDP
Percentage Change from Base Case
0
2
4
6
8
10
12
1990
1995
2000
2005
2010
2015
2020
2025
Year
v9

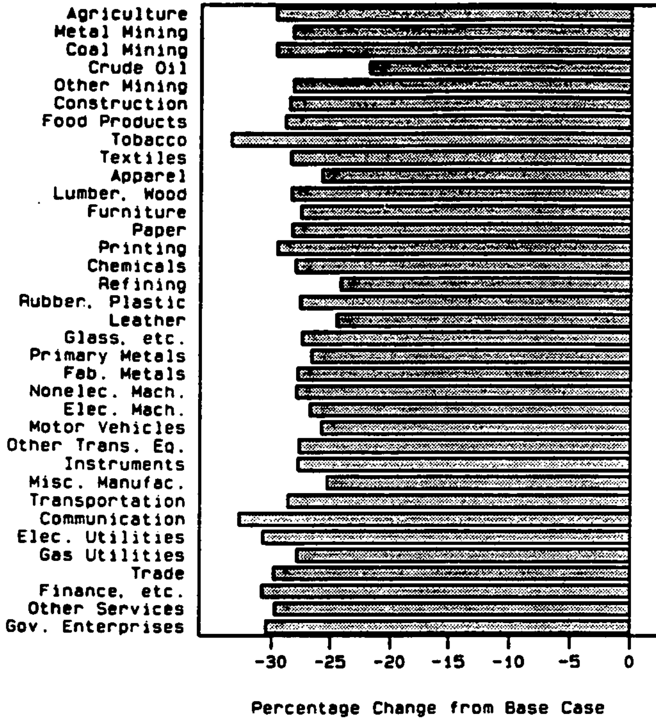

Consumption Tax Rate
Rate
0.24
0.22
0.20
0.18
0.16
0.14
0.12
0.10
0.08
0.06
0.04
0.02
0.00
1990
1995
2000
2005
2010
2015
2020
2025
Year
v9

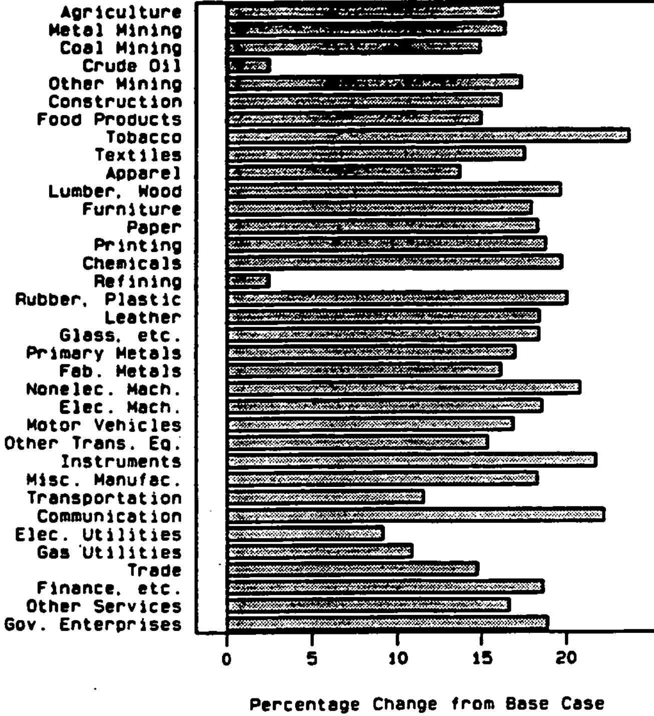

Effect of Consumption Tax on Real Investment
Percentage Change from Base Case
80
70
60
50
40
30
20
10
0
1990
1995
2000
2005
2010
2015
2020
2025
Year
v9


Effect of Consumption Tax on Real Consumption
Percentage Change from Base Case
6
4
2
0
-2
-4
1990
1995
2000
2005
2010
2015
2020
2025
Year
v9


Effect of a Consumption Tax on Producer Prices in 1996
Agriculture
Metal Mining
Coal Mining
Crude Oil
Other Mining
Construction
Food Products
Tobacco
Textiles
Apparel
Lumber, Wood
Furniture
Paper
Printing
Chemicals
Refining
Rubber, Plastic
Leather
Glass, etc.
Primary Metals
Fab. Metals
Nonelec. Mach.
Elec. Mach.
Motor Vehicles
Other Trans. Eq.
Instruments
Misc. Manufac.
Transportation
Communication
Elec. Utilities
Gas Utilities
Trade
Finance, etc.
Other Services
Gov. Enterprises
-25
-20
-15
-10
-5
0
Percentage Change from Base Case
v9


Effect of a Consumption Tax on Industry Output in 1996
Agriculture
Metal Mining
Coal Mining
Crude Oil
Other Mining
Construction
Food Products
Tobacco
Textiles
Apparel
Lumber, Wood
Furniture
Paper
Printing
Chemicals
Refining
Rubber, Plastic
Leather
Glass, etc.
Primary Metals
Fab. Metals
Nonelec. Mach.
Elec. Mach.
Motor Vehicles
Other Trans. Eq.
Instruments
Misc. Manufac.
Transportation
Communication
Elec. Utilities
Gas Utilities
Trade
Finance, etc.
Other Services
Gov. Enterprises
0 10 20 30 40 50 60 70 80
Percentage Change from Base Case
v9


Effect of a Consumption Tax on Producer Prices in 2020
Agriculture
Metal Mining
Coal Mining
Crude Oil
Other Mining
Construction
Food Products
Tobacco
Textiles
Apparel
Lumber, Wood
Furniture
Paper
Printing
Chemicals
Refining
Rubber, Plastic
Leather
Glass, etc.
Primary Metals
Fab. Metals
Nonelec. Mach.
Elec. Mach.
Motor Vehicles
Other Trans. Eq.
Instruments
Misc. Manufac.
Transportation
Communication
Elec. Utilities
Gas Utilities
Trade
Finance, etc.
Other Services
Gov. Enterprises
-30
-25
-20
-15
-10
-5
0
Percentage Change from Base Case
v9


Effect of a Consumption Tax on Industry Output in 2020
Agriculture
Metal Mining
Coal Mining
Crude Oil
Other Mining
Construction
Food Products
Tobacco
Textiles
Apparel
Lumber, Wood
Furniture
Paper
Printing
Chemicals
Refining
Rubber, Plastic
Leather
Glass, etc.
Primary Metals
Fab. Metals
Nonelec. Mach.
Elec. Mach.
Motor Vehicles
Other Trans. Eq.
Instruments
Misc. Manufac.
Transportation
Communication
Elec. Utilities
Gas Utilities
Trade
Finance, etc.
Other Services
Gov. Enterprises
0
5
10
15
20
Percentage Change from Base Case
v9

11

The Economic Impact of Fundamental Tax Reform

DALE W. JORGENSON

Introduction

Tax policy for saving and investment is critical for stimulating U.S. economic growth because investment is the most important source of growth. To achieve a more satisfactory growth performance, the tax burden on investment must be reduced substantially. This could be achieved by fundamental tax reforms like the flat tax, proposed by Congressman Dick Armey, or the USA (unlimited savings allowance) Tax, proposed by Senators Sam Nunn and Pete Domenici. These tax proposals would have the effect of shifting the base for taxation at the federal level from income to consumption, while preserving the existing administrative structure of the income tax. An alternative approach for shifting the federal tax base to consumption would be to adopt a value-added tax, like that employed in Europe and Japan. A consumption-based value-added tax would eliminate investment from the tax base. The system for value-added taxation common in Europe is based on allowing credit for the value-added tax already paid on business purchases of goods and services. Adoption of this system for the United States would require a new structure for tax administration, based on auditing sales and purchases of all businesses.

A third approach to consumption taxation is a retail sales tax like that employed by many state governments and some local governments in the United States. The existing administrative structure established by state governments could be employed for federal retail sales tax collections, possibly by having these

collections done by existing state agencies but financed by the federal government. To exclude investment from the federal sales tax base, such a tax would have to be levied only on purchases by final consumers—households and institutions—and not on purchases by businesses.

Current consumption tax proposals are based on well-tested economic ideas and could serve as an appropriate starting point for fundamental tax reform. An important advantage of the Armey flat tax and the Nunn-Domenici USA Tax proposals is that the resulting consumption tax systems would be administered in much the same way as the present income tax system. The traditional objection to a consumption tax is that it would be regressive rather than progressive, falling disproportionately on low-income taxpayers. Both the flat tax and the USA Tax would achieve progressivity by means of a system of personal exemptions.

The Tax Reform Act of 1986 is the most recent fundamental tax reform in the United States. This landmark legislation preserved income as the tax base for the federal revenue system. However, the federal income tax was substantially reformed by eliminating special tax provisions for a number of specific types of investment, such as the investment tax credit for investment in equipment. These reforms removed important barriers to the efficient allocation of capital. In this chapter I show that the 1986 tax act created nearly one trillion dollars in new opportunities for economic growth!

Although recognizing the significant achievements of the 1986 tax act, I show that this legislation fell far short of exploiting the available opportunities for stimulating U.S. economic growth through tax reform. Changing the tax base from income to consumption would have generated more than two trillion dollars in opportunities for economic growth! I conclude that adopting consumption as the tax base would have *doubled* the benefits from fundamental tax reform. Ironically, a consumption tax was explicitly considered and rejected in the debate that preceded the 1986 tax legislation.

In a 1977 study, *Blueprints for Tax Reform*, the U.S. Treasury had proposed two alternative approaches for shifting the federal tax base from income to consumption. The first of these is a value-added tax, like that employed in Europe and Japan. The second would eliminate investment from the tax base by permitting taxpayers to treat investment expenditures as a tax deduction like that for any other business expense. Because investment would be excluded from the tax base, all other deductions from capital income, such as deductions for interest expenses, would be eliminated. However, these approaches to tax reform were considered and rejected by the U.S. Treasury in a 1984 report that initiated the debate leading to the 1986 tax act.

Neutral cost recovery, recently passed by the House of Representatives as Title II of the Job Creation and Wage Enhancement Act of 1995, is an important step toward reviving the Treasury proposals of 1977. This system for recovering capital cost would provide depreciation deductions with the same present value

as immediate "expensing" of investment. These deductions would be based on the recovery of capital cost over the lifetime of an asset, as under current law. However, the deductions would be increased annually to allow a return on capital of 3.5 percent a year and compensate for inflation. At a discount rate of 3.5 percent, these deductions would have the same present value as an immediate write-off of capital outlays.

Neutral cost recovery, like the Treasury proposal of 1977, would eliminate investment from the tax base. To complete the shift in the tax base to consumption, however, it would be necessary to eliminate other deductions from capital income at the same time, including deductions for interest expenses. Otherwise, the U.S. Treasury would be in the position of providing subsidies through tax deductions for taxpayers who choose to finance investment through debt rather than equity. These subsidies could stimulate a revival of the tax shelter industry that flourished before the Tax Reform Act of 1986.

The recovery of capital costs should be regarded as one component of a tax system based on consumption rather than income. Shifting the federal tax base from income to consumption, as recommended in *Blueprints*, would require deductions equivalent to expensing of investment. However, other deductions from capital income would have to be eliminated at the same time. Adoption of a consumption tax would create important new opportunities for U.S economic growth.

The 1986 Tax Reform

I will support my conclusions by first reviewing the achievements of the 1986 tax reform.[1] I have presented simulations of future U.S. economic growth under alternative tax policies in table 1. These simulations show that the economic impact of the 1986 tax reform was positive and substantial at rates of inflation prevailing at the time. As the rate of inflation has declined these benefits have grown substantially, reflecting the fact that capital cost recovery deductions under the 1986 legislation were not indexed for inflation. These deductions decline in present value as the rate of inflation increases.

More specifically, I have compared growth opportunities available to the U.S. economy under the 1986 tax act with those available under the preexisting 1985 tax law and two tax reform proposals advanced by the Treasury in 1984 and the president in 1985. The benchmark for comparison is the 1985 tax law at a 6 percent inflation rate. Table 1 presents the difference between growth opportunities under alternative tax reforms with those resulting from no change in tax policy and an unchanged rate of inflation. It is important to be explicit about the role of inflation because the 1985 tax law and the 1986 tax act omitted important

Table 1 Growth Opportunities Created by the 1986 Tax Reform (in billions of 1987 dollars)

Rate of Inflation (%)	*Revenue Adjustment*	*1985 Tax Law*	*Treasury Proposal*	*President's Proposal*	*1986 Tax Act*
0	Lump-sum tax	$724.0	$1,489.6	$1,691.4	$1,561.8
	Labor income tax	478.2	1,468.8	1,642.4	1,565.0
	Sales tax	400.3	1,452.9	1,614.6	1,558.7
	Individual income tax	374.5	1,456.1	1,619.1	1,563.1
6	Lump-sum tax	0.0	1,907.6	2,452.2	448.4
	Labor income tax	0.0	1,711.4	2,170.4	746.9
	Sales tax	0.0	1,600.1	2,104.9	901.2
	Individual income tax	0.0	1,595.8	2,007.9	999.4
10	Lump-sum tax	−477.1	2,060.4	3,015.6	−200.8
	Labor income tax	−333.7	1,791.6	2,584.7	267.3
	Sales tax	−285.2	1,623.5	2,356.4	517.0
	Individual income tax	−221.9	1,604.8	2,353.1	748.6

NOTE: In 1987, the national wealth (beginning of the year) was $15,920.2 billion dollars.

provisions for indexing the tax structure for inflation included in the Treasury proposal and the president's proposal.

In comparing U.S. economic growth under alternative tax policies I require that all changes in tax policy be revenue neutral, that is, revenue and expenditure of the government are the same as in the base case given by the tax law of 1985. This requires adjusting tax revenues to maintain the budgetary position of the government. A hypothetical "lump-sum" tax or subsidy does not add to tax-induced distortions of private decisions and serves as a standard for comparison among alternative tax policies. I also consider three alternative methods for adjusting government revenues. These involve proportional changes in taxes on labor income, sales taxes on investment and consumption goods, and taxes on income from both capital and labor.

Table 1 presents estimates of the growth opportunities created or destroyed by alternative tax reform packages; all estimates are in billions of 1987 dollars. Let me first be precise about the meaning of the term *growth opportunities.* The objective of government policy, including tax policy, is to enhance the standard of living of U.S. consumers now and in the future. The concept of growth opportunities is a summary measure of the present value of future increases in the standard of living. It represents the willingness of the present generation of taxpayers to pay for a change in tax policy that will affect their own standard of living and that of future generations of taxpayers.[7]

Turning to the impact of the 1986 tax act, we see that this fundamental tax reform produces a sizable gain in opportunities for future U.S. economic growth. For the revenue adjustments based on proportional changes in tax rates, these gains range from 746.9 billion 1987 dollars to $999.4 billion, or nearly *one trillion dollars!* There are important differences between results for a hypothetical "lump-sum" tax adjustment and adjustments based on changes in tax rates. However, the results do not depend significantly on which of the tax rates is used in maintaining revenue neutrality.

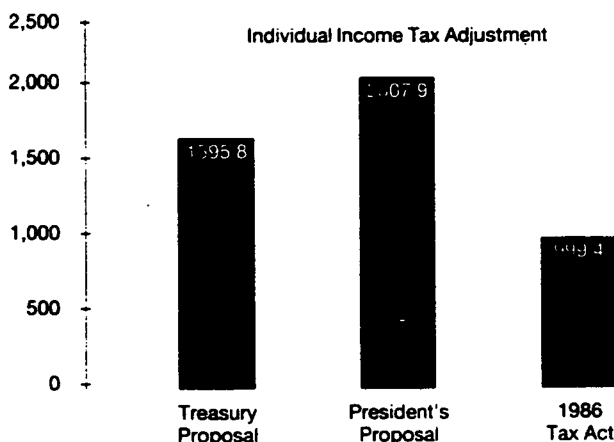
Although the Tax Reform Act of 1986 obviously generated substantial growth opportunities for the U.S. economy, the Treasury and the president's proposals would have done substantially more to enhance economic growth. For tax adjustments based on changes in tax rates to maintain revenue neutrality, the Treasury proposal would have produced growth opportunities ranging from 1,595.8 billion 1987 dollars to $1,711.4 billion. The president's proposal would have produced gains ranging from 2,007.9 billion 1987 dollars to $2,170.4 billion, or more than *double* the gains from the 1986 tax act! Nonetheless, tax policy makers should recognize the 1986 reform as a giant step in the right direction.

The estimates presented in the first column of table 1 also make it possible to isolate the effects of changes in inflation with no change in tax policy. The 1985 tax law, like the Tax Reform Act of 1986, was not completely indexed for inflation so that the tax burden increases with the inflation rate. By contrast the Treasury proposal and the president's proposal involved indexing the tax structure for inflation. With no change in tax law the results presented in table 1 show that an increase in the inflation rate from 6 to 10 percent would have imposed a loss on the economy in the range of 221.9–333.7 billion 1987 dollars. Reducing the inflation rate to zero would have produced a gain in the range of $374.5–$478.2 billion.

If we compare the Treasury and the president's proposals with the 1986 tax act at a 6 percent inflation rate in chart 1, we find that these proposals would have produced much greater gains in growth opportunities. Gains from the president's proposal would have been more than double those of the 1986 tax act, and gains from the Treasury proposal would have been 50 percent higher. However, at a zero inflation rate the two proposals and the actual 1986 tax legislation would have had similar economic impacts, resulting in gains in growth opportunities of one and a half trillion dollars. Under the 1986 tax act the gains shrink with increased inflation, but these gains actually grow with increased inflation under the two alternative proposals.

In summary, the Tax Reform Act of 1986 created almost one trillion dollars in growth opportunities for the U.S. economy. This demonstrates the potential contribution to growth from fundamental tax reform. As the inflation rate has gradually subsided, these growth opportunities have steadily increased. At a zero rate of inflation the impact of the 1986 tax act on U.S. economic growth would

Chart 1 Growth Opportunities Created by the 1986 Tax Reform



have been closely comparable to that of the Treasury proposal or the president's proposal. However, the 1986 tax act did not incorporate provisions from these proposals that would have largely insulated the U.S. tax structure from the impact of inflation.

Fundamental Tax Reform

In this section I consider the economic impact of a shift in the tax base for the federal revenue system from consumption to income. I also consider a number of alternative tax reforms. As in the previous seciton, I use the 1985 tax law with a 6 percent inflation rate as a benchmark. These alternative reforms focus on tax distortions induced by differences in the tax treatment of income from corporate, noncorporate, and household sectors and short-lived and long-lived assets. In the parlance of the 1986 tax debate, these are different ways of "leveling the playing field." As before, I achieve revenue neutrality for each proposal by adjusting tax rates to preserve the balance between revenues and expenditures.

Initially, I will focus attention on the seventh line in table 2. This is the consumption tax scheme proposed in the Treasury's 1977 *Blueprints for Tax Reform* and now embodied in the Armey flat tax and the Nunn-Domenici USA Tax proposals. Under these proposals the tax base for the federal tax system would be shifted from income to consumption by excluding investment from the tax base. In the business sector this would be achieved through deductions for in-

Table 2 Growth Opportunities Created by Leveling the Playing Field under the 1985 Law (in billions of 1987 dollars)

	Lump-Sum Tax Adjustment	*Labor Income Tax Adjustment*	*Sales Tax Adjustment*	*Individual Income Tax Adjustment*
Within sector interasset distortion	$ 443.9	$ 248.1	$ 168.7	70.2
Intersector distortion: C and NC sectors	−93.3	−416.7	−523.8	−715.5
Intersector distortion: All sectors	2,262.6	2,159.9	2,118.6	2,067.7
No tax distortion: C and NC sectors, all assets	326.4	69.2	−29.1	−169.7
No tax distortion: All sectors, all assets	2,663.7	2,603.9	2,572.4	2,547.2
Corporate tax integration	1,313.1	493.4	238.1	−274.5
Consumption tax rules (zero effective tax rates)	3,859.9	2,045.4	1,749.3	2,045.4
Consumption tax rules (zero effective tax rates; no sales tax on investment goods)	4,128.1	1,988.0	1,722.1	1,988.0

vestment outlays like those for any other business expenses. The eighth line of table 2 is a more thoroughgoing version of this scheme that would eliminate sales taxes on investment as well.

The introduction of consumption tax rules for capital cost recovery in 1986 would have generated growth opportunities of more than *two trillion dollars*. This fundamental tax reform would have doubled the gains in U.S. economic growth that resulted from the 1986 tax act. This is the consequence of leveling the playing field among all economic sectors—households, noncorporate businesses, and corporations. At the same time income from different types of assets—plant, equipment, inventories, and land—would be treated symmetrically under the tax law. The tax treatment of income from all assets employed in the U.S. economy would be completely neutral under consumption tax rules like those proposed in *Blueprints*.

The first line of table 2 is a hypothetical tax reform that would eliminate differences in the tax treatment of different assets but would leave the existing tax distortions due to differences in the tax treatment of corporate, noncorporate, and household capital income unaffected. The second line would remove distortions between corporate and noncorporate business but would not alter the treatment of income from household assets, such as owner-occupied residential housing. The third line extends this treatment to the household sector.

The fourth line would level the playing field among assets in corporate and noncorporate sectors, while the fifth would extend this treatment to the house-

hold sector as well. The sixth would reduce taxation on corporate assets to those of noncorporate assets through "corporate tax integration," as proposed by the Treasury's 1992 report *Taxing Business Income Once*. Equalizing the treatment of income from assets in business and household sectors would create the greatest opportunities for U.S. economic growth, as indicated in the simulations summarized in the third and fifth lines of table 2.

An important advantage of consumption tax rules is that income from capital employed in the household sector, such as owner-occupied residential housing, would be treated symmetrically with income from capital employed by corporate and noncorporate businesses. An alternative approach to equalizing the treatment of all forms of capital income would be to try to include income from owner-occupied residential housing in the federal tax base. However, this would require such politically unpalatable measures as reducing or totally eliminating popular tax deductions for home mortgage interest and state and local property taxes.

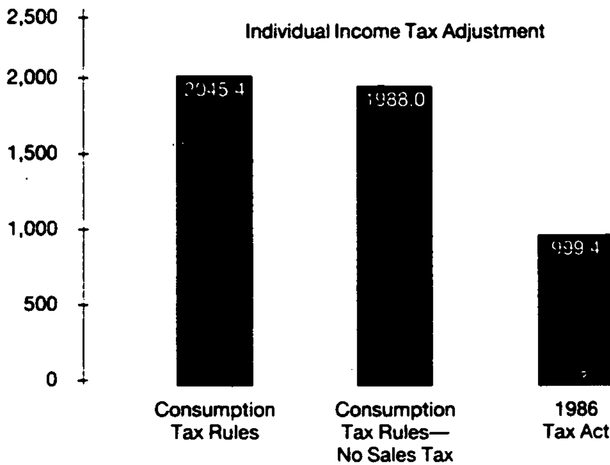
As a practical matter, the inclusion of income from the services of owner-occupied residential housing in the tax base for income would he highly problematic. Although owner-occupied residential housing is an investment from an economic point of view, the services of this housing are part of both consumption and income. A possible approach to the taxation of this part of income would be to treat each owner occupier as a business owning a residence. This approach would involve an "imputation" for the rental value of housing as part of taxable income. European experience[5] shows that this approach is nearly impossible to implement.

A second approach to the taxation of income from owner-occupied housing would be to exclude the value of new residential construction from investment by disallowing a deduction for the purchase of a home along with all other housing-related deductions, such as home mortgage interest and state and local property taxes. In the Armey flat tax proposal the appeal of a low flat rate of taxation would help to offset the political consequences of eliminating these popular deductions.

A third approach to taxation of housing, employed in the Nunn-Domenici USA Tax proposal, represents a compromise between the existing income tax treatment and a full-scale consumption tax treatment. In this approach the current tax treatment of owner-occupied housing would be retained, while business income would be treated under consumption tax rules. This would nearly equalize the tax burdens on the household sector and the business sector. An important advantage of this compromise between income and consumption taxation would be to avoid complex transition rules for owner-occupied housing already in existence at the time of fundamental tax reform.

In summary, the principal conclusions that emerge from comparison of all

Chart 2 Growth Opportunities Created by a Consumption Tax



eight hypothetical reform proposals are illustrated in chart two. The most important opportunities for future growth of the U.S. economy would be created by the adoption of consumption tax rules for capital income. This would make it possible to reduce business taxes at both corporate and individual levels substantially. If this approach to tax reform had been adopted in 1986, the gains would have been equivalent to almost two trillion dollars, or *double* the gains resulting from the 1986 tax act.

Directions for Future Tax Reform

The purpose of the simulations of U.S. economic growth described in the preceding section is to compare actual tax reform proposals with the Tax Reform Act of 1986. The current tax structure retains many of the features that resulted from the 1986 reform. However, important changes in tax policy were incorporated in the Budget Enforcement Act of 1990 under President Bush and President Clinton's Omnibus Budget Reconciliation Act of 1993. Both of these budget agreements raised tax rates for upper-income tax payers, increasing the reliance on capital income taxes relative to those on labor income. These changes have created important new opportunities for generating economic growth through fundamental tax reform.

I next provide a more precise assessment of opportunities to contribute to the future growth of the U.S. economy through tax reform.[4] For this purpose I link tax-induced losses in economic efficiency directly to U.S. economic growth. I use a nondistorting tax system as a benchmark in measuring the loss in efficiency from taxation. In this tax system all revenue is raised by purely hypothetical lump-sum taxes that do not distort private decisions and involve no efficiency loss. By focusing on differences in losses among alternative tax programs, I am able to identify promising avenues for future tax reform.

My first conclusion is that the loss in efficiency imposed on the U.S. economy by the current tax system is very large. The efficiency loss is equivalent to 18 percent of government tax revenue. Each dollar of tax revenue costs the private sector a dollar of forgone investment or consumption and an additional loss in growth opportunities of eighteen cents. I refer to this estimate as the *average excess burden*, defined as the gain in efficiency that would result from replacing the whole U.S. tax system by a nondistorting system. Let me hasten to emphasize that this replacement is purely hypothetical.

The concept of efficiency loss most relevant to tax reform is the *marginal excess burden*. The marginal excess burden of the U.S. tax system is defined in terms of the efficiency loss *per dollar* for the final dollar of revenue raised. The marginal excess burden enables me to quantify one of the most familiar propositions in tax policy analysis. Because efficiency losses rise as tax burdens increase, the marginal cost of raising tax revenue is much greater than the average cost. I estimate that the marginal efficiency loss is 39.1 cents per dollar of revenue, more than double the average loss.

Most important, large differences in marginal excess burdens among different tax programs remain. For example, the marginal cost of raising a dollar through taxes on capital income at the individual level is 111.7 cents, while the cost of raising a dollar from labor income taxes is only 37.6 cents. For every dollar of tax revenue transferred from capital income to labor income, the U.S. economy *gains* 64.1 cents in future growth opportunities. This transfer would be revenue neutral and thus in perfect conformity to the Clinton budget plan of 1993. This provides a clear indication of important potential gains in future U.S. economic growth through tax reform.

I next describe the efficiency costs of various parts of the U.S. tax system in greater detail. For this purpose, I analyze the growth of the U.S. economy under reductions of tax rates for the following nine components of the U.S. tax system: (1) the corporate income tax, (2) capital income taxes at the individual level, including taxes levied on noncorporate capital income and taxes on individual capital income originating in the corporate sector, (3) property taxes on corporate, noncorporate, and household assets, (4) capital income taxes at both corporate and individual levels, (5) labor income taxes, (6) capital and labor income

taxes, (7) the individual income tax, (8) sales taxes on consumption and investment goods, and (9) all taxes.

Table 3 presents the average and marginal efficiency costs of all components of the U.S. tax system under the Tax Reform Act of 1986. The marginal efficiency costs of the whole U.S. tax system in the ninth panel of table 3 show that the marginal efficiency cost at rates prevailing under the 1986 tax act was .391, meaning that the loss in efficiency for each dollar of tax revenue raised was 39.1 cents. However, the average efficiency cost for the whole tax system was .180; thus replacing all taxes by a nondistorting tax would have increased opportunities for economic growth by an average of 18 cents per dollar of tax revenue.

The marginal efficiency cost of sales taxes given in the eighth panel of table 3 was .262 after the reform, while the cost of property taxes given in the third panel was .176. By contrast, the marginal efficiency cost of all income taxes given in the sixth panel of table 3 was .497. The efficiency losses were 49.7 cents per dollar of income tax revenue, only 17.6 cents per dollar of property tax revenue, and only 26.2 cents per dollar of sales tax revenue. A substantial increase in efficiency could have been realized by reducing income tax rates and increasing the rates of sales and property taxes. We conclude that the Tax Reform Act of 1986 did not successfully overcome the excessive reliance of the U.S. tax system on income taxes.

The structure of the income tax itself is completely out of balance with marginal efficiency costs of labor income taxes at .376, individual capital income taxes at 1.017, and corporate income taxes at .448. Substantial gains in efficiency could have been realized by further reductions in marginal tax rates on individual and corporate taxes on capital income, even at the expense of increases in marginal tax rates on labor income. Considerable gains in growth opportunities for the U.S. economy could have resulted from reduced reliance on individual income taxes on capital income and more reliance on corporate income taxes.

Second, within the income tax there is excessive reliance on taxes on capital income at the individual level. Finally, existing taxes on capital income put excessive burdens on individuals, relative to corporations. Taxes on capital income at both corporate and individual levels are too burdensome, relative to taxes on labor income. Every dollar transferred to labor income taxes from capital income taxes at the individual level costs the U.S. economy 64.1 cents in lost growth opportunities. Reversing the direction of the 1986 reform by raising marginal rates for high-income taxpayers has greatly increased the tax burden on capital income. This will be enormously costly in terms of opportunities for reviving the growth of the U.S. economy. These conclusions are summarized in chart 3.

In summary, the best way to create new growth opportunities for the U.S. economy would be to reduce the top rates of taxation at the individual level, not to increase these rates. This could be financed by cutting back on tax expenditure

26–726 0 - 96 - 5

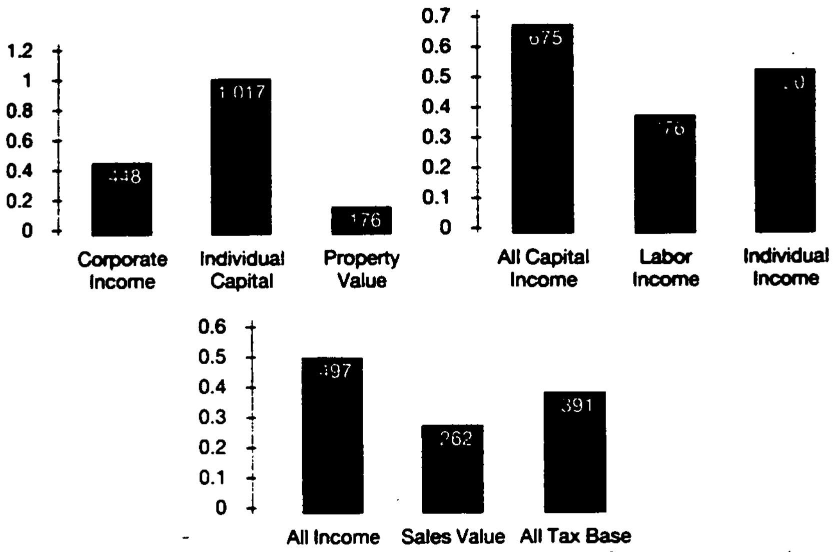
Table 3 Efficiency Costs of U.S. Tax Revenues after the Tax Reform Act of 1986

		REDUCTION IN TAX RATES (%)										
		5	10	20	30	40	50	60	70	80	90	100
Corporate income	MEC[a]	.448	.435	.418	.397	.379	.363	.348	.334	.322	.310	.301
	AEC[b]	.448	.442	.431	.421	.412	.404	.397	.391	.384	.379	.374
Individual capital income	MEC	1.017	.989	.951	.904	.853	.812	.767	.727	.688	.650	.613
	AEC	1.017	1.003	.977	.953	.928	.906	.884	.863	.842	.822	.803
Property value	MEC	.176	.174	.171	.168	.164	.160	.157	.153	.149	.145	.142
	AEC	.176	.175	.173	.171	.169	.168	.166	.164	.162	.160	.158
All capital income	MEC	.675	.650	.616	.573	.533	.498	.466	.435	.407	.382	.359
	AEC	.675	.663	.640	.619	.600	.582	.566	.551	.537	.524	.512
Labor income	MEC	.376	.358	.333	.303	.276	.253	.237	.216	.201	.190	.183
	AEC	.376	.367	.350	.334	.320	.307	.296	.285	.275	.266	.259
1 + 2 + 5 = 4 + 5	MEC	.497	.462	.414	.355	.301	.254	.212	.175	.142	.114	.091
	AEC	.497	.480	.448	.418	.391	.366	.343	.323	.304	.287	.271
Individual income	MEC	.520	.490	.449	.396	.349	.305	.265	.229	.196	.167	.140
	AEC	.520	.505	.477	.451	.426	.403	.381	.361	.342	.325	.308
Sales value	MEC	.262	.259	.254	.249	.242	.236	.230	.224	.218	.211	.205
	AEC	.262	.261	.257	.254	.251	.248	.245	.242	.239	.236	.232
All tax bases	MEC	.391	.356	.308	.249	.197	.151	.113	.082	.063	.048	.040
	AEC	.391	.374	.342	.312	.285	.260	.238	.220	.204	.190	.180

[a] marginal efficiency cost

[b] average efficiency cost

Chart 3 Efficiency Costs of U.S. Tax Revenues (%)



programs such as deductions for mortgage interest and state and local property taxes. President Bush's Budget Enforcement Act of 1990 and the Clinton Omnibus Budget Reconciliation Act of 1993 have substantially increased taxes on capital income at the individual level. A growth-oriented tax policy requires reinforcing the basic thrust of the Tax Reform Act of 1986 by reducing differences in the marginal excess burdens imposed by different parts of the U.S. tax system.

Conclusion

My first overall conclusion is that increases in tax rates for upper-income taxpayers in 1990 and 1993 have nullified many of the growth opportunities for the U.S. economy created by the Tax Reform Act of 1986. It is important to underline this conclusion because the recent emphasis on "soaking the rich" has increased reliance on capital income taxes relative to those on labor income. This will be enormously costly in terms of future consumption for growth of the U.S. economy. Future tax reforms should strengthen rather than weaken the basic thrust of the Tax Reform Act of 1986.

Second, neutral cost recovery is an important contribution to the debate over

tax reform. This tax proposal would introduce provisions for recovery of capital costs that are equivalent to the expensing of investment expenditures required under consumption tax rules. However, neutral cost recovery must be combined with other tax reforms, such as the elimination of deductions for interest expenses, to enhance the neutrality of the federal tax system. Achieving neutrality in the taxation of income from all assets in the U.S. economy is the most important goal for future tax reform.

Finally, changing the federal tax base from income to consumption is an idea whose time has come. This change will create important new opportunities for growth in the standard of living of all Americans. The traditional objections to consumption as a base for taxation on grounds of fairness have been successfully addressed in the Armey flat tax and the Nunn-Domenici USA Tax proposals. These proposals would create substantial new growth opportunities for the U.S. economy. Both are based on well-established economic ideas and could serve as a point of departure for tax reform legislation.

Notes

1. This review is based on my paper "Tax Reform and U.S. Economic Growth," with Kun-Young Yun. The paper provides a more detailed appraisal of the Tax Reform Act of 1986.

2. Further details are given in my paper with Yun, "The Excess Burden of Taxation."

3. This experience is reviewed in my book with Ralph Landau, *Tax Reform and the Cost of Capital: An International Comparison.*

4. Here I draw on a second paper, "The Excess Burden of U.S. Taxation," that I have published with Yun.

References

Armey, Dick. "The Freedom and Fairness Restoration Act." Washington, D.C., 103d Congress, 2d Session, 1994.

Jorgenson, Dale W., and Ralph Landau, eds. *Tax Reform and the Cost of Capital: An International Comparison.* Washington, D.C.: Brookings Institution, 1993.

Jorgenson, Dale W., and Kun-Young Yun. "Tax Reform and U.S. Economic Growth." *Journal of Political Economy* 98, no. 5, part 2 (October 1990): 151–93.

———. "The Excess Burden of U.S. Taxation." *Journal of Accounting, Auditing, and Finance* 6, no. 4 (fall 1991): 487–509.

Nunn, Sam, and Pete Domenici. "The USA Tax System." Alliance USA, Washington, D.C., 1994.

Smith, Nick. "Neutral Cost Recovery Act of 1995." Washington, D.C., 104th Congress, 1st Session, 1995.

U.S. Deaprtment of the Treasury. *Blueprints for Tax Reform*. Washington, D.C.: U.S. Government Printing Office, 1977.

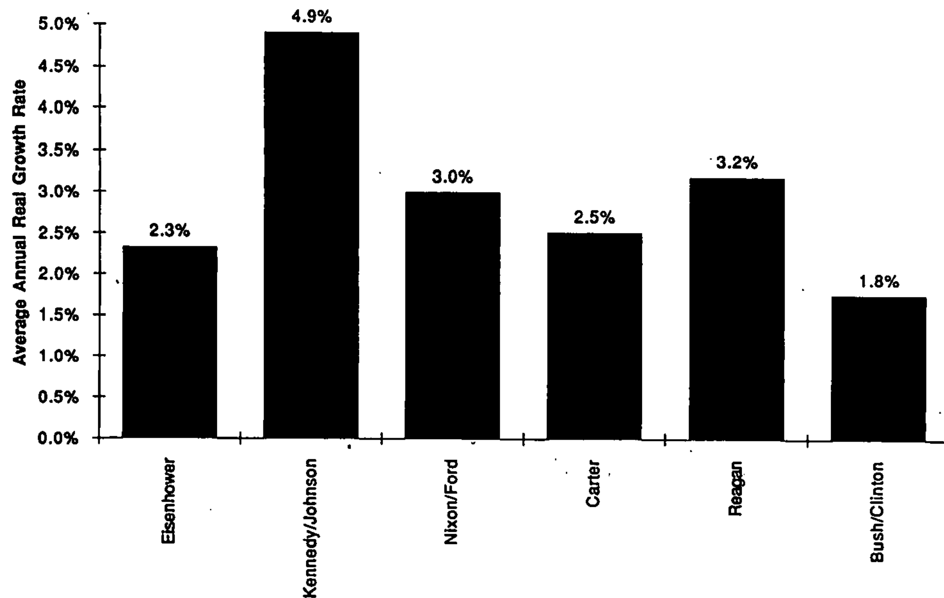
——. *Tax Reform for Fairness, Simplicity, and Economic Growth*. Washington, D.C.: U.S. Government Printing Office, 1984.

——. *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*. Washington, D.C.: U.S. Government Printing Office, 1985.

——. *Taxing Business Income Once*. Washington, D.C.: U.S. Government Printing Office, 1992.

BC/fig/GDPCW2

Average Annual Real Economic Growth*



*Refers to new Commerce Department chain-weighted GDP measure.

The 1980s Vs. The 1990s

	Reagan 1981-89	Bush Clinton 1989-95
GDP Growth (Chain Weighted)	3.2%	1.8%
Real Median Household Income*		
% Change	+11%	-5%
$ Change	$4,000	-$2,100
Annual Job Growth	2.0%	1.1%
Annual Jobs Created (Thousands)	2,120	1,300
Manufacturing Jobs (Thousands)	-800	-1,200
Productivity Rate	1.4%	1.1%
Personal Savings Rate	6.5%	5.0%
Net Investment Rate	5.3%	3.8%
Average Budget Deficit		
Billions of 1995 Dollars	$242	$248
% GDP	4.4%	3.9%

* Income data is through 1994.

Source: Institute for Policy Innovation, Lewisville, TX, 1996.

REAGAN TAX CUTS VERSUS BUSH-CLINTON TAX HIKES

OVERALL REAL REVENUE GROWTH

After Reagan Tax Cuts	Revenue	Growth	After Bush-Clinton Tax Hikes	Revenue	Growth
1982	738		1990	914	
1983	684	-7.3	1991	895	-2.1
1984	730	6.7	1992	895	0.0
1985	777	6.4	1993	922	3.7
1986	790	1.7	1994	982	6.5
1987	854	8.1	1995	1,034	5.3
1988	877	2.7	1996	1,064	2.9*
1989	916	4.4	1997	1,082	1.7*
Total		24.1%			18.5%

Congressional Budget Office, March 1996 revenue forecast.

December 15, 1995

RESTRUCTURING THE FEDERAL TAX SYSTEM

Economic Policy Bulletin No. 65

by Norman B. Ture

- The existing federal tax system fails every test of an acceptable tax system for a free society. First and foremost, it fails to perform the basic function of taxation: to tell the public what they must pay for the services they want government to provide.

- We have a tax system that no one believes is fair. For those who favor a redistributive tax policy, the ethical justification appears to be that the rich are rich only because they've deprived the poor. There is no factual or analytical basis for this notion.

- One of the acid tests of the acceptability of a tax system is that it imposes the lowest possible costs of compliance, administration, and enforcement. The existing tax system fails this test miserably.

- Minimizing tax-induced distortions of the free market's operations is a hallmark of acceptable taxation. The existing tax system is a hodgepodge of provisions that grossly interfere with efficient market operations. Perhaps the worst distortion is the effect of the income tax in raising the cost of saving and investment relative to the cost of current consumption.

- Creating a new federal tax system to replace the system now in place should be guided by fundamental principles and should avoid the ad hoc approach that has characterized past reform efforts.

- Taxes should be paid directly by *real* people on whom the burden of all taxes ultimately rests. Taxes on corporations should be minimized.

- Taxes should be designed so that people are acutely aware of paying them.

- If taxes are to be effective in telling people what they pay for government, everyone except the truly destitute should be required to pay.

- Because all taxes are paid out of income, the new tax system must correctly define income for tax purposes. The correct concept is the common sense definition: all of one's revenues less all of the costs one incurred to produce those revenues.

Institute for Research on the Economics of Taxation

IRET is a non-profit, tax exempt 501 (c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote economic growth and efficient operation of the free market economy.

1300 19th Street, N.W., Suite 240 • Washington, D.C. 20036 • (202) 463-1400 • FAX: (202) 463-6199

- True tax fairness, based on the long-standing basic principle that every person should stand equally before the law, calls for imposing the same marginal rate on every person's income.
- To eliminate the tax bias against saving and investment, the multiple layers of income taxes on saving and investment in existing law must be eliminated.
- The new tax system must minimize costs of compliance, administration, and enforcement. Basing the income tax on the correct concept of income for tax purposes will itself eliminate much of the complexity that gives rise to the extraordinary compliance and enforcement costs under the existing system.

POLICY BULLETIN

December 15, 1995
No. 65

RESTRUCTURING THE FEDERAL TAX SYSTEM

Introduction

A growing consensus in the tax policy community is that the existing federal income taxes must be drastically overhauled, if not, indeed, entirely discarded. Numerous proposals to replace these taxes have surfaced in the last two years; although differing in important respects, all of these proposals seek the same objective: to achieve a tax system that less impedes economic growth, that is fairer, and that is far less complex, less costly to comply with and to enforce than the existing income taxes.

> *The existing federal tax system ... fails to perform the basic function of taxation for a free society: to tell the public what they must pay for the services they ask government to provide.*

This objective is certainly appropriate, but in itself offers little guidance for the design of a new tax structure. To this end, federal policy makers need to spell out and to be guided by the basic tax principles and criteria on which tax restructuring efforts should be based. These principles and criteria are those that have been developed to meet the requirements of a free society whose economic activities are directed primarily by the operations of free market system. The ad hoc approach that has characterized most past tax reform efforts is virtually certain to fail to provide much improvement over the existing tax structure.

Deficiencies of the Existing Tax System

Hiding the cost of government

The existing federal tax system fails every test of an acceptable tax system for a free society. For one thing, it fails to perform the basic function of taxation for a free society: to tell the public what they must pay for the services they ask government to provide. If we don't know what government costs us, we will ask for more and more of it. But government services and activities aren't free. To provide those services and activities, government takes resources that would otherwise be available to households to improve their living standards and to businesses to produce the products and services we would seek in the market place. In the process, government drives up the cost and reduces the quantity of goods and services available in the private sector.

Institute for Research on the Economics of Taxation

IRET is a non-profit, tax exempt 501 (c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote economic growth and efficient operation of the free market economy.

1300 19th Street, N.W., Suite 240 • Washington, D.C. 20036 • (202) 463-1400 • FAX: (202) 463-6199

Page 2

The existing federal tax system falls far short of telling us what we pay for our government. Who among us knows how much corporate income tax he or she pays, one way or another? Does anyone have even a ballpark estimate of what he or she paid in federal excise taxes last year? Ask your friends how much payroll tax was deducted from their gross wages or salaries last year; indeed, ask yourself how much you paid in payroll taxes last year. Do you know, as you read this, how much federal income tax you paid last year or are likely to pay this year? Everyone in a self-governing, self-reliant society should be able to answer these questions and to decide whether the amount and character of the government they're getting is worth what they're paying for it. The existing tax system fails this test. Because it does and because we don't insist that government limit its outlays to what we are willing to pay in taxes, we get too much government at too high a cost. This excess government costs us the more valuable products and services we would otherwise have. The result is that we have a smaller economy that grows more slowly than otherwise.

We need a tax system that does a vastly better job than the one we now have of telling us what government costs. This is reason enough to scrap the existing system and enact a tax system that performs this core function adequately.

Imposing tax burdens unfairly

We have a tax system that virtually no one believes is fair. The popular view, embraced by most policy makers, is that fairness should be judged in terms of the share of the total tax that is paid by people at various income levels. According to this view, fairness calls for imposing tax burdens that are disproportionately greater the higher is one's income or wealth. Many of those who assert the tax system is unfair base that judgment on the belief that the "rich" don't pay their "fair share" of the total tax burden. Few, if any, of those who hold this view, however, identify what fraction of the total tax burden they think is the fair share for the rich to bear.

INCOME AND INCOME TAXES, 1993
(Dollar amounts in billions)

	All taxpayers	Top 10%	Bottom 50%
Adjusted gross income	$3,775.6	$1,474.8	$563.3
Share of income	100%	39.1%	14.9%
Income tax	$500.7	$294.4	$24.1
Share of tax	100%	58.8%	4.8%
Tax rate	13.3%	20.0%	4.3%

Source: Internal Revenue Service

In the taxable year 1993, the top 10 percent of the income earners, people who accounted for 39 percent of the nation's adjusted gross income in 1993, paid a disproportionate share -- almost 59 percent -- of the total individual income tax revenues collected by the federal government. Their effective tax rate was 20 percent of their income. The bottom 50 percent of income earners had almost 15

percent of total adjusted gross income but paid only 4.8 percent of the total individual income tax that year. Their income taxes were 4.3 percent of their income, only slightly more than a fifth the effective rate paid by the top 10 percent of income earners.

What do these data tell us about the fairness of the federal individual income tax? On what basis might one assert that fairness requires that the top ten percent of income recipients should pay more than 58.8 percent of the total income tax or that it would be unfair to decrease their share to, say, 55 percent?

This approach to tax fairness derives from the notion that the tax system should be used to redistribute income and wealth from the affluent to the poor. The redistributive thrust of this fairness standard is without solid basis in analysis or in ethics. Changing the income-level distribution of income and wealth is not an appropriate function of government nor in a free market economy is it a function that government tax and spending policies can effectively perform. Redistributive tax policies impel market adjustments that substantially offset changes in after-tax incomes sought by those policies, while limiting gains in output and income for the society as a whole.

For some who favor a redistributive tax policy, the ... ethical justification is that the rich people are rich only because they've deprived the poor. There is ... no factual basis for this notion.

For some who favor a redistributive tax policy, the implicit if not explicit ethical justification is that the rich people are rich only because they've deprived the poor. There is, however, no factual basis for this notion. In fact, the rewards people receive for active participation in the free market economy closely match what each person has contributed to aggregate output. Moreover, those rewards are not earned at other people's expense. Indeed, the contrary is true; the efforts one makes to increase one's productivity and earning capacity virtually always benefit others as well. The free-market economy is not a zero-sum game in which one person's gains are obtained at another person's expense. What one does to enhance one's income-producing ability is sure to provide expanded economic opportunities for others.

Nor does a redistributive tax system reflect a nation's charitable character. There is no element of charity in taxes which are, by their very nature, involuntary exactions, no matter the uses to which the tax revenues are put. Charity is a personal, not a collectivized, function.

A far more meaningful way of looking at tax fairness is to call to mind one of the oldest, most basic principles on which this nation was founded. Throughout our history we have insisted that everyone in this society should stand equally before the law, that no personal attribute should

either give a person a legal advantage or disadvantage in dealing with fellow citizens. Applying that principle in the field of taxation leads us to a superior standard of fairness: if the government is to tax income, everyone should be exposed to the same rate of tax on his or her income.

Against this standard, upward-graduated income tax rates should be seen as the utmost in unfairness. As one of the major features of a redistributive tax policy, such a system of tax rates asserts that the more productive one is, the more one contributes to society's well being, the greater is the rate of tax one should pay on any additional income one produces. Constructive tax restructuring must be based on critical rethinking about fairness and embody a fairness standard that respects personal achievement.

<u>Excessively complicated</u>

One of the acid tests of the acceptability of a tax system is that it imposes the lowest possible costs of compliance, administration, and enforcement. The existing tax system is totally unacceptable on these grounds. Every element of that tax system is extremely complicated, requiring an enormous number of man hours and hundreds of billions of dollars of manpower, machine, and paper costs.

One of the acid tests of the acceptability of a tax system is that it imposes the lowest possible costs of compliance, administration, and enforcement. The existing tax system is totally unacceptable on these grounds.

The statutory provisions encoded in our tax laws are the source of this costly complexity. The complexity of the tax laws inevitably results in harsh and complex rules and regulations imposed to ensure compliance with those laws, and enforcement of those rules and regulations in turn generates arbitrary, often cruelly harsh procedures by the tax administrators -- the Internal Revenue Service (IRS). The history of the contemporary tax system, in particular, that of the income tax, provides a laboratory example of the process of making the tax laws more and more costly to comply with, to administer, and to enforce. Virtually every tax bill enacted in recent years has increased the law's complexity in efforts to reach every last dime of what tax policy makers believe should be taxable income. The consequence has been huge increases in taxpayers' compliance costs and in the IRS budgets for administration and enforcement personnel.

This process has also led to enforcement procedures that increasingly invade our property rights; the IRS can and does seize the property of people it deems to have evaded paying the taxes they owe without first going to court. No government agency should have the power to confiscate one's property without a finding by a court of violation of the law.

We tend to overlook the fact that we pay for these enormous compliance, administration, and enforcement burdens by giving up products and services that we would otherwise produce to satisfy our current consumption demands and to add to our capacity to produce more products and services in the future. We pay for the complexity of our tax laws by suffering lower living standards today and less gain in those standards over time than we would otherwise be able to achieve.

It should be abundantly clear that simplification of the tax laws and reducing compliance, administration, and enforcement costs lie beyond so-called tax "reform." Since the adoption of the 16th Amendment of the Constitution, the federal income tax has been reformed and reformed. Each reform has produced more and more statutes that have made the tax laws more and more complex and have led inexorably to more and more rules and regulations that have exponentially increased costs of compliance, administration, and enforcement.

The classic case of reform gone wildly astray is the Tax Reform Act of 1986. That legislation simplified compliance only for the several million people it dropped from the income tax rolls; it hugely increased complexity and compliance costs for virtually all business-income taxpayers and for individual taxpayers receiving income as returns on their saving and investment.

Tax restructuring, that is, producing an entirely new tax system, not mere tax reform, that is, modification of existing tax laws, is needed if tax simplification is to be achieved. The focus of efforts to reduce compliance, administration, and enforcement costs must be on the underlying tax laws, not on the misbehavior of some Internal Revenue Service agents. Realization of real economies in these respects requires replacing existing taxes with a tax system that is guided by the basic principles discussed below.

Distortionary and biased against saving and investment

A tax system acceptable to a free society should to the least possible extent disrupt the operations of the market system. Every tax ever designed has the effect of raising the cost of what is taxed compared to the costs of other things. Because every tax has this "excise" effect, every tax changes the signals the market system would otherwise give us about the costs of alternative uses of the resources we have at our disposal. Every tax, therefore, changes the incentives each of us would otherwise confront concerning the most efficient use of our talents, energies, other production capabilities, and time. In the aggregate, the nation winds up with a less satisfying, as well as a smaller, basket of products and services than it would otherwise have available. Minimizing tax-induced distortions of the free market's operations, therefore, is a hallmark of acceptable taxation.

Regrettably, the existing tax system is a hodgepodge of tax provisions, each with its own excise effects that grossly interfere with efficient market operation. For one thing, our income

taxes severely increase the cost of saving out of our current income compared with using that income for current consumption. Saving is the way in which each of us can add to our future earning power; relying on taxes that make saving more costly impairs the ability of each of us to attain a more prosperous future, to provide a financial cushion against economic misfortunes, and to ensure our families' economic well being. And in the aggregate, this punitive treatment of saving imposes on us a smaller and less dynamic economy than we would otherwise enjoy.

> ***[T]he existing tax system is a hodgepodge of tax provisions ... that grossly interfere with efficient market operation ... A visitor from another planet would conclude from examining our tax structure that we believe saving to be a sinful activity to be taxed out of existence.***

A visitor from another planet would conclude from examining our tax structure that we believe saving to be a sinful activity to be taxed out of existence. The existing income tax not only taxes the income we save, it also taxes the income produced by the investment of that saving. In contrast, the income tax falls on the income we use for current consumption but doesn't fall as well on the consumption outlays and the services and the enjoyment they provide.

Moreover, if we commit our saving to buying shares in a corporate business, the income that business produces for us is separately taxed under the corporate income tax; if distributed to us, those dividends are taxed to us again under the individual income tax. If instead the business retains and reinvests those after-corporate-income-tax earnings and the market value of our shares goes up to reflect the business's increase in earning power, that increase in value will also be taxed if and when we sell the shares.

If, notwithstanding these tax barriers to our saving and investing, we accumulate even a modest amount of assets during our lifetime, that accumulated saving becomes subject to extremely heavy transfer -- estate and gift -- taxes when transferred by gift or at death.

And paralleling this piling of federal tax after federal tax onto our saving and the income it produces, many of our states impose the same sort of taxes on the same income, the same saving, the same returns on that saving, and the same estates transferred by gift or at death, as well as some taxes, e.g., property taxes, imposed only by the states and their subdivisions. Our friend from outer space would shake its head in utter amazement.

Our income taxes also include features that distort our choices about how we save, where we invest, and the types of capital into which we direct our saving. In a few cases, such tax provisions are subsidies that lower the cost of the saving and investment relative to what these costs would be in a tax-free world. For the most part, however, these distortions are produced

by tax provisions that differentially penalize saving and investment compared with consumption uses of income.

The existing income tax also exerts a severe bias against innovative, high-risk entrepreneurial activity compared with business-as-usual activities. Economic progress depends critically on the willingness of people to undertake cutting-edge enterprises and on their ability to attract saving to finance the creations of such enterprises and their growth. By their very nature, such business ventures tend to be much riskier – to face much larger possibilities of losses – than established businesses pursuing more conventional activities. The riskier is the investment or business, the greater has to be the reward to justify the undertaking. With graduated rates, the income tax takes a bigger and bigger bite out of the these rewards the more successful is the investment or business venture. The existing income tax also imposes limits on the current deductibility of business losses and those from the sale of capital assets. In combination, these features slant the income tax severely in favor of the nonventuresome and against the highly innovative business, and increase the risks and the costs confronting the entrepreneur.

In these and many other ways the existing tax system erects barriers to economic progress. It is a testimonial to the vigor and strength of American workers and businesses and to the free market system that the nation has made continuing and substantial advances, despite the obstacles thrown up by our long-standing anti-growth tax policies. The goal of tax restructuring should be to replace the existing income taxes with a tax system that will unleash the growth impulses in American households and businesses.

A Tax System For a Dynamic, Free America

Creating a new federal tax system to replace the unacceptable system now in place must be guided by fundamental principles, rather than by the ad hoc approach that has characterized past reform efforts. The core objectives of tax restructuring are (1) to achieve a tax structure that effectively performs the basic function of taxation in a free society and (2) does so with the least adverse effects on the growth-generating activities of households and businesses.

Telling us what we must pay for government

As discussed earlier, the core function of taxation in a free society like ours is to tell the people what price they must pay for the activities and services they want the government to provide. To perform this function effectively, the tax system must have certain essential attributes. One of these is that taxes must be visible to the people who pay them. If we aren't aware of paying a tax or of how much we pay, clearly the tax isn't telling us anything about what we must pay for government.

To satisfy this requirement, the nation should rely on taxes that are paid directly by the *real* people on whom their burden rests. This means that we should minimize the use of taxes on

corporations. The burden of those taxes, borne initially by the people who own the corporations' shares, ultimately is imposed as well on people as employees, in the form of fewer job opportunities, lower productivity, and lower real wages, and by people as consumers. In the final analysis, it is people, not corporations, that pay the tax. Notwithstanding that only real people pay corporate taxes, few of them are aware of the fact that they shoulder this burden. Such taxes, therefore, fail to perform the basic function of taxes, in addition to erecting barriers to employment and economic growth.

The new tax system should rely principally on taxes we are acutely conscious of paying. Many of the taxes that real people pay directly nonetheless escape their awareness. Whatever taxes may be included in a restructured tax system, we should insist that they are levied in a way that makes those who pay them keenly aware of doing so.

All taxes are paid out of income ... The correct concept of income is the common sense definition: all of one's revenues less the full amount of the costs one necessarily incurs to produce those revenues.

A tax system that performs the core tax function effectively will require the largest possible number of people in the society to pay something in taxes. Responsibility for paying for government and for deciding how much of what kind of government we want should be shared by all of us, excluding only those of us who are truly destitute. One of the most important determinants of whether a tax system is acceptable is whether it is levied on as many of us as possible.

Defining income correctly

All taxes are paid out of income. An acceptable tax system for a free and progressive society recognizes this fact and the corresponding necessity to define income correctly for tax purposes. ~~All taxes are paid out of income ...~~ The correct concept of income is the common sense definition: all of one's revenues less the full amount of the costs one necessarily incurs to produce those revenues. ~~The correct concept of income is the common sense definition: all of one's revenues less the full amount of the costs one necessarily incurs to produce those revenues.~~ This real world view leaves no room for differentiating on the basis of where the revenues came from and what type of costs were incurred or who earned the income. Moreover, this concept of income dictates that costs of generating revenues are taken fully into account when they are incurred, not spread over time in a mistaken effort to match their timing with the timing of receipts. Accordingly, the amount a business spends for machinery, for raw materials, for additions to its inventory, for the labor services it employs, etc., should be deducted in full when

the expenditures are made. All such outlays, in other words, should be expensed instead of capitalized and written off over a period of years, as under existing law.

Interest paid on borrowing by businesses or individuals should be deductible, and the interest received should be taxable to the lender. This guideline should apply in the case of mortgages on one's residence, as well as in the case of non-mortgage borrowing.

Only income over which one retains control should be treated as one's income for tax purposes. You should not include in your taxable income other taxes you have paid, either to the federal government or to another taxing jurisdiction. It is a basic tax principle that you shouldn't pay tax on taxes. Neither should you include in your taxable income amounts such as alimony, child support, or damages that a court of law has ruled you must pay to someone else. Moreover, if you give some of your income to some one else, you should exclude that amount from your income and the other person should include it in his or hers.

Application of this principle requires the deductibility of charitable contributions. When you make a charitable contribution, you relinquish control over that amount of your income and assign it to someone else. You should, therefore, be able to deduct any such contribution. The recipient would take the contribution into its income but is likely to spend what it receives on deductible research, wages, and other costs it incurs in carrying out its charitable activities, including the donations and gifts it makes to its beneficiaries. All of these payments would be deducted by the charitable organization and included in the income of the recipients, some of whom will be too poor to owe tax.

The same basic principles dictate that if the income is yours to use as you choose, it should be included in your taxable income and you should pay the tax due on it. The tax visibility, tax consciousness requirement for a tax that does its core job of telling us what we must pay for government rules out having someone else make the tax payment on your income. Proposals to exclude from your taxable income the interest, dividends, or other income you earn on your investments and to deny the corporations making these payments a deduction for such payments are clearly at odds with tax visibility and tax consciousness.

<u>Treating everyone equally and fairly under the tax law</u>

The acceptable tax for a free America must satisfy the public's tests of fairness. It is widely assumed that the American people are convinced that tax fairness means using the tax system to redistribute income and wealth from the well-to-do to the poor, but there is little if any factual basis for this assumption. It is doubtful that people of modest means would agree that it is fair to tax them at a higher rate than their next-door neighbors whose income is somewhat less. This mistaken income-redistribution notion of fairness can only be foisted on the public by comparing the extraordinarily wealthy with the tragically poor, comparisons that have no operational relevance in the design of a tax system.

The appropriate fairness standard should take account of the facts of economic life in a free market economy. With very few exceptions, the income a person receives closely matches what that person has contributed to the economy's total output and income. Rich people are rich because they are more productive than people who are less rich, not because they've deprived poorer people of the income or wealth they've earned. Imposing a higher rate of tax on a person the greater that person's productivity satisfies no meaningful criterion of public policy. Indeed, taxing away a larger share of the income of the rich to transfer income to the less rich or the poor is utterly unfair.

True tax fairness calls for imposing the same marginal rate of tax on every person's income.

True tax fairness calls for imposing the same marginal rate of tax on every person's income. To insure that no significant amount of tax is imposed on the truly destitute, some personal exemption or standard deduction should be provided to create a zero-rate bracket of income. On income in excess of that zero-bracket amount, however, the same tax rate should apply.

A system conducive to saving and growth

The new tax system should to the least possible extent distort the incentives that are cast up by the operation of the free market price system. Of particular importance, taxes should not raise the cost of using our income to save and invest in order to have more income than otherwise in the future, compared with the cost of consumption uses of income. Similarly, taxes should not increase the cost of saving in one way compared to another or of investing one's saving in a particular form of capital compared to another or in one form of business organization compared to any other.

[T]he multiple layers of income taxes on saving and investment that characterize existing law must be eliminated.

To achieve this result, so important to pursuit of the nation's growth objective, the multiple layers of income taxes on saving and investment that characterize existing law must be eliminated. There are two basic, equivalent ways of achieving this result. One approach is to exclude from taxable income the amount saved out of one's current income and to include in taxable income all of the returns realized on that saving. In this case, the returns would include the full amount of the proceeds from the sale of the assets in which the saving is invested. The

alternative approach is to include the current income you save in your taxable income and to exclude from taxable income any and all returns that saving provides. Each of these approaches is exactly the same in terms of eliminating the extra tax on income that is saved. Each has some practical advantages and drawbacks, but the first conforms more closely than the latter with the principle that the costs of producing revenues should be deducted in the year in which the costs are incurred.

Graduated tax rates have the effect of making it more and more costly to earn additional income, whether by saving or by increasing one's personal effort, the more productive a person has been.

Under either approach, capital gains as such would vanish as a tax issue. This is obvious in the case of the second approach, since *none* of the proceeds from the disposition of one's assets would be subject to tax. In the first approach, because the purchase of the assets would be expensed, i.e., excluded from taxable income, the assets would have no basis for tax purposes, and all of the sales proceeds would be properly included in taxable income. Since asset purchases would be deductible, reinvestment of the sales proceeds would provide rollover treatment -- deferral of tax -- until the assets were liquidated to finance consumption spending. To exclude the proceeds from the sale of the assets from taxable income or to subject these proceeds to a lower rate of tax would go beyond providing equal tax burdens on income that is saved and income that is consumed and would subsidize saving.

Much of the complexity in the existing tax system, giving rise to its extraordinary manpower and dollar costs of compliance and enforcement, is the result of legislative efforts to differentiate tax liabilities on the basis of attributes, characteristics, and activities of taxpayers that should not be considered relevant for tax purposes ... The [new] tax system would be virtually free of these complexities, hence would entail much lower compliance and enforcement costs.

The same anti-distortion criterion dictates that only a single statutory tax rate should be imposed. Graduated tax rates have the effect of making it more and more costly to earn additional income, whether by saving or by increasing one's personal effort, the more productive a person has been. With graduated tax rates, the greater is one's income, the greater is the amount of consumption or leisure the person must give up to earn an additional dollar of after-tax

income. There is no principle or social policy goal that validates such a bizarre result. An acceptable tax system, one that minimizes tax obstacles to economic progress, will impose its liabilities at a single marginal tax rate.

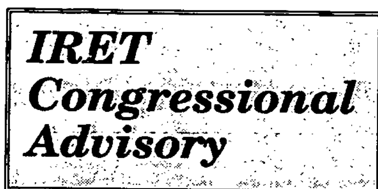
No one tax structure may be uniquely qualified to meet the goals of a fairer, simpler, less growth-obstructing tax system ... Nevertheless, the prospects for finding the right mix of provisions are bright.

The new tax system should seek to minimize costs of compliance, administration, and enforcement. Much of the complexity in the existing tax system, giving rise to its extraordinary manpower and dollar costs of compliance and enforcement, is the result of legislative efforts to differentiate tax liabilities on the basis of attributes, characteristics, and activities of taxpayers that should not be considered relevant for tax purposes. In addition, statutory provisions governing depreciation and other capital recovery, capital gains and losses, and income obtained from foreign business operations and investments, among others, are the source of much complexity, compliance, and enforcement costs. The tax system meeting the standards presented above would be virtually free of these complexities, hence would entail much lower compliance and enforcement costs.

Conclusion

No one tax structure may be uniquely qualified to meet the goals of a fairer, simpler, less growth-obstructing tax system. Each of the tax restructuring proposals that have been advanced in the last few years has much to commend it in terms of the principles and attributes presented in this discussion. By the same token, however, each of the proposed new tax systems fails to meet one or more of the standards against which an acceptable tax system for the next century should be evaluated. Nevertheless, the prospects for finding the right mix of provisions are bright. There is every reason to believe that a new tax system, guided by the principles and standards discussed above, will help to achieve the goals of individual freedom and responsibility, greater and more sustained economic progress, and effective constraint on the growth and composition of government activity to which the nation aspires.

Norman B. Ture
IRET President



June 14, 1995 No. 46

IMPACT OF THE FLAT TAX ON TAX EXEMPT BONDS

There has been some concern expressed by traders of tax exempt securities, brokers, and bondholders over the potential impact of major tax restructuring proposals on the tax exempt bond market. In particular, there is concern over the effect of such proposal on the market value of existing tax exempt bonds and on the interest cost facing state and local governments in the future. We conclude that these concerns are unfounded, and that pro-saving tax reform would raise returns to all savers and strengthen state and local government finances.

Most of the major tax restructuring proposals currently being circulated seek to correct the current income tax bias against income used for saving and investment. In the process, some of them would eliminate the difference in tax treatment between currently taxable and currently tax exempt securities.

The "flat tax" (such as the Armey-Shelby proposal) would effectively extend current tax exempt bond treatment to currently taxable bonds, and to other types of saving instruments, in a modified income tax context. Replacement of the income tax with either a national sales tax (such as proposed by Senator Lugar and Representative Archer) or a VAT would also erase the tax distinction between taxable and tax exempt bonds.

By contrast, the saving exempt income tax, as drafted by Senators Domenici and Nunn, would create a deduction for purchases of private sector securities to improve their treatment versus income used for consumption, but would preserve the tax treatment differential between private sector debt and state and local government debt by effectively doubling up on the tax deduction for state and local issues.[1]

Tax exempt bond dealers and financial writers have linked relative price weakness in the tax exempt bond market to prospects of enactment of the flat tax, and suggest that the flat tax would hurt the tax exempt bond market. For example, a recent column in Forbes magazine claims that tax exempt bonds would become less attractive.[2]

Has the prospect of the flat tax (or a national sales tax) depressed prices in the tax exempt bond market? Has this injured holders of existing tax exempt bonds? Would a federal flat tax system injure state, county, and local governments in the future?

<u>There may be other reasons for relative price weakness in the tax exempt bond market.</u>

Prospects for significant tax reform are better now than in many years. However, other tax and budget changes, and changing economic conditions, may also be affecting the tax exempt bond market.

- <u>Taxes.</u> The House passed tax bill provides significant reduction in capital gains taxes and the present value equivalent of first year write-off (expensing) of outlays on plant, equipment, and structures. These reforms may be watered down, but steps in this direction would boost returns on equities and divert saving from bonds to equities. Enhanced depreciation would also improve the ability of businesses to service debt, reducing risk premiums on taxable securities. It is difficult to calculate the net effect on debt versus equities, but there would be a relative reduction in risk of taxable versus tax exempt bonds.

- <u>Federal spending.</u> Federal spending cuts would certainly benefit the economy as a whole, and would reduce the threat of tax increases that might add to the tax premium in interest rates and that might impair the ability of the private sector to service its debt. However, the spending cuts may include a reduction in federal transfer payments to the states and the transfer of

Institute for Research on the Economics of Taxation

IRET is a non-profit, tax exempt 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote economic growth and efficient operation of the free market economy.
1300 19th Street, N.W., Suite 240, Washington, D.C. 20036 • (202) 463-1400 • FAX (202) 463-6199

responsibility for spending programs to state and local governments with only limited funding by federal block grants, suggesting that state and local governments might have to borrow more in the future or that they might be facing more budget pressures. It is possible, therefore, that the House and Senate Budget Resolutions could lead to a strengthening of the price of federal or private debt relative to state and local government debt. These concerns might well be over-blown. Reduced federal spending and a stronger private economy would raise the tax base of state and local governments and strengthen their finances.

- Inflation. A few months ago, inflation expectations appeared to be rising. Bond prices may have been depressed by such fears. More recently, there has been less talk of inflation, bond prices have rallied, and long term interest rates have pulled back. Inflation results in an inflation premium in interest rates. That inflation premium is larger for taxable bonds because the premium is taxable. A reduction in inflation expectations would probably result in a larger drop in interest rates and a stronger rally in the taxable bond market than the tax exempt bond market.

If flat tax talk has depressed tax exempt bond prices, the effect on current bondholders will be temporary. Furthermore, they can benefit from higher interest income on reinvested principal and interest.

If flat tax talk has depressed tax exempt bond prices, the effect on current bondholders will be temporary. Furthermore, they can benefit from higher interest income on reinvested principal and interest.

If the demand for state and local government bonds were to fall on the anticipation of tax reform, their yields would have to rise, and existing bonds would fall in price. However, the bonds would pay full face value at maturity. Anyone holding tax exempt bonds to maturity would suffer no losses. In particular, investors who rely for spending money only on the interest from tax exempts, or who are receiving periodic returns of principal from bond funds, or who have a portfolio with staggered maturities such that some bonds are coming due each month or quarter, would not be inconvenienced. Indeed, they would be able to reinvest their principal returns at higher yields, and would have a gain in income, even before passage of the flat tax. (Income gains to savers after passage would be even higher, as noted below.)

The flat tax would not significantly alter the relative treatment of new issues of currently tax exempt and currently taxable types of debt instruments.

The flat tax would not worsen the tax treatment of state and local bonds. Savers currently lend to those governments on an after-tax basis, and there is no tax premium in the interest rate (no federal tax premium, and no state tax premium for own-state holders).

The interest rates on taxable bonds contain tax premiums. Bondholders are subject to federal income tax on interest they receive on their holdings of Federal debt, and to federal and state income taxes on interest they receive on their holdings of corporate debt. These tax burdens are reflected in higher interest rates on such securities than would occur if the bonds were tax exempt. On an after-tax risk-adjusted basis, their yields are little different from yields on tax exempt securities. If the taxable bonds were to be put on an after-tax basis, their pre-tax yields would fall but their after-tax yields would not change significantly, nor would they suddenly become a threat to state and local debt instruments.

- Assume for a moment that all borrowers and lenders are in the 35% federal tax bracket (and ignore state taxes). A state bond with a 6.5% coupon would be equivalent, after taxes, to a corporate bond with a 10% yield (ignoring risk differentials between government and private bonds). Both the buyer and the issuer of a corporate bond realize a 6.5% after-tax interest rate. The buyer of a corporate bond nets 6.5% after paying tax on the interest. The borrower gets to deduct interest paid, and only pays 6.5% after taxes. The gain from the tax exempt status of the state bond accrues to the state, not to the bondholder. In a competitive market, the bondholder would get the same after-tax yield from either type of bond, and the borrowers would face the same cost of borrowing.

- Under the flat tax, the corporate bond interest would be neither taxable to the lender nor tax deductible to the borrower. The tax premium would be removed from the interest rate, which would drop to 6.5%, leaving everyone in the same after-tax position as before. The state bond need not experience a change in interest rates to remain competitive.

- Interest rates on federal debt also include a tax premium. Removal of the tax on federal debt interest would result in a drop in interest rates on federal debt.

- Not everyone is in the same tax bracket, of course, so high bracket lenders tend to buy tax exempt securities while lower bracket lenders tend more toward the taxable bonds. However, the differences in after-tax yields are not great. (Again, most of the tax advantage is captured by the issuers, not the lenders.) In the event that the tax premiums were eliminated, the segmentation of the market would vanish and all lenders would consider buying all bonds. Current buyers of state and local bonds would put some corporate bonds in their portfolios; some buyers of corporate bonds would include state and municipal obligations in their portfolios. The net-of-tax interest rate changes needed to equalize the attractiveness of the various bonds would not be large.

- State and local debt would continue to enjoy the advantage of a tax exemption for own-state income taxes.

<u>If the flat tax were to pass, its primary effect would be to alter the relative treatment of equities vs. debt, not taxable debt vs. non-taxable debt.</u>

The Forbes magazine column claims that, relative to equities, the flat tax would make most bonds (the currently taxable types) more attractive (while municipal bonds, it claims, would become less attractive). The article asks, "If you can get 7.5% on Treasurys, free from all income tax, who needs the risks of the stock market? If relatively high quality junk bonds yield 10%, who needs to speculate in new issues?"[3]

The article has it exactly backwards. First of all, Treasurys and junk bonds would no longer yield 7.5% and 10%, respectively, but more like their current after-tax rates of (about) 4.9% and 6.5%, respectively (assuming a 35% tax rate).

Second, the current tax code double-taxes saving in interest bearing instruments, but triple-taxes (or worse) saving in equities. Income is taxed when it is first earned. If used for consumption, there is no further federal tax (a few excises aside). If, however, the income is saved, as in a bank account or by buying a bond, the saver also pays tax on the interest he or she receives. If the saving is invested in stock, there is the corporate tax on the earnings. In addition, however, if the after-tax corporate income is paid out, there is another tax on the dividends, and if the after-tax earnings are retained and reinvested, raising the stock price, there is a capital gains tax if the stock is sold. The flat tax puts debt and equity on an equal plane; it removes the single excess layer of tax on debt instruments, and the two excess layers of tax on equities. Tax neutrality would provide more relief, relative to current law, to equities than to debt, and would boost the stock market more than the bond market.

A shift to the flat tax would temporarily raise real after-tax rates of return on investment. Savers and lenders would profit from the change. Workers would benefit from higher investment.

<u>If a more nearly neutral tax system were implemented, the economy would strengthen and state and local government revenues would increase. Those governments would be better off, not worse off.</u>

State and local governments would have less need to borrow as the flat tax increased economic activity, incomes, property values, and state and local tax revenues. State and local governments would be better able to service debt, and have better credit ratings.

<u>A shift to the flat tax would temporarily raise real after-tax rates of return on investment. Savers and lenders would profit from the change. Workers would benefit from higher investment.</u>

The flat tax and the saving-exempt income tax would permit expensing (first year write-off) of investment in plant, equipment, and structures. A national sales tax, if confined to the retail level, would not tax purchases of plant and equipment. If these tax systems replace the current income tax, they would, initially, raise the real return on physical capital. The higher real returns on investment would be shared with lenders in the form of higher real after-tax interest rates.

State and local governments would see an improvement in their fiscal condition brought about by the expanding economy and the resulting higher tax base.

The economy would adjust to lower taxes and higher rates of return by adding additional plant, equipment, and structures in the private sector over several years. As the desired augmentation of the physical capital stock was gradually achieved, and rates of return on capital declined to normal, real after-tax interest rates would return to normal levels as well. (Witness the pattern in the early 1980s as reduced taxes on saving and investment led to faster growth, which later tapered off.)

During the expansion, savers would have higher income per dollar of assets, and on a permanent basis, would have more assets on which to earn income. Additional capital accumulation would raise productivity, wages, and employment permanently. State and local governments would see an improvement in their fiscal condition brought about by the expanding economy and the resulting higher tax base.

Stephen Entin
Resident Scholar

Endnotes

1. In the Domenici-Nunn proposal, income saved, including income used to purchase bonds, would be deducted from taxable income, and returns on saving, including bond interest, would generally be included in taxable income (unless reinvested). Exempting the amount saved while taxing the return is equivalent, over the life of the bond, to simply excluding the interest from tax, as with current tax exempt bonds. If only private sector bonds were allowed this deduction of principal, and state and local bond interest were not taxed, the two types of bonds would enjoy equivalent tax status. However, Domenici-Nunn would allow individual income taxpayers to deduct purchases of state and local government securities as well, while continuing to exempt the interest on such bonds from tax, effectively doubling up on the current tax exclusion for state and local bonds and retaining their current tax advantage vis-a-vis private sector issues. For financial intermediaries, however, the state and local bond interest would be included in the taxable income.

2. "Flat tax winners and losers", by Richard Lehmann, *Forbes*, May 22, 1995, p. 280.

3. *Ibid.*

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.

Handout for

Roundtable Discussion on

TAXES AND ECONOMIC GROWTH

before the Joint Economic Committee
June 10, 1996

William G. Gale
Senior Fellow
The Brookings Institution

SUMMARY OF MAIN FINDINGS

- A 15 percent across-the-board tax cut would have at best a (very) small positive effect on private saving, but would raise the deficit and therefore reduce national saving.

- Idealized versions of fundamental tax reform could raise output per person by about 10 percent over a 10-year horizon, but allowing for realistic aspects of the economy and for realistic policies reduces that effect to close to zero or below zero.

- Economic growth in the 1980s was robust, but was not due to the effects of tax reform on saving: the simple fact is that saving did not rise after the 1981 tax cuts. Rather, growth was due to cyclical factors, and increases in the employment/population ratio, the debt/GDP ratio and foreign capital inflows. None of these avenues are promising for growth in the 1990s.

William G. Gale

EFFECTS ON SAVING OF A 15 PERCENT ACROSS-THE-BOARD TAX CUT

Private Saving

–The current average effective tax rate on saving is about 30 percent.

This may seem low in light of a 35 percent statutory tax rate at the corporate level and a highest rate of 39.6 percent at the individual level, but the effective rate also accounts for the tax-deductibility of interest at the corporate level, the deferral of unrealized capital gains income, the virtual nontaxation of income from housing, and the fact that most personal saving occurs via tax-preferred vehicles like pensions and 401(k)s.

–A 15 percent tax cut would reduce the effective tax rate to 25.5 percent.

This would raise the after-tax return from its current level of about 70 cents on the dollar (1-30 cents) to 74.5 cents, an increase of about 6.4 percent.

–Applying Michael Boskin's well-known estimated saving elasticity of 0.4, this suggests a 2.6 percent increase in saving (=6.4*0.4).

This represents an increase in saving from about 5 percent of GDP to about 5.13 percent of GDP, or about a $10 billion increase in saving.

–A $10 billion increase in saving will not show up as any amount of measurable growth in a $7 trillion economy.

Public Saving (The Deficit)

–In the absence of any growth effects, revenues would fall (the deficit would rise) by about $120 billion: about $95 billion from the individual income tax, and $25 billion from the corporate income tax.

National Saving (Public plus private saving)

–National saving would fall, which would have an adverse impact on economic growth.

William G. Gale

EFFECTS OF FUNDAMENTAL TAX REFORM ON ECONOMIC GROWTH

Tax Plan	Estimated Impact on Output per Person after 2 years	10 years	Long Term
Comprehensive Consumption tax No adjustment costs to investment No personal exemptions No transition relief No deductions	6.8%	9.0%	9.7%
Comprehensive Consumption tax With adjustment costs to investment	4.5%	6.0%	8.9%
Armey Flat tax With adjustment costs to investment With personal exemptions	1.0%	2.3%	5.3%
Armey Flat tax With adjustment costs to investment With personal exemptions With transitional relief	-0.6%	0.3%	2.5%
Add deductions for.... Mortgage interest? Charitable contributions? State and local taxes? Health insurance? Payroll taxes?	Would reduce the impact further. (Adding these deductions would raise the required marginal tax rate by 7-10 percentage points.)		
Reduce the impact on saving due to the existence of pensions and precautionary saving	Would reduce the impact further. (Adding each factor reduces the initial impact on saving in the first 2 years by one-third.)		

Sources: First four rows: Alan J. Auerbach, "Tax Reform, Capital Allocation, Efficiency, and Growth," prepared for a Brookings conference on "Economic Effects of Fundamental Tax Reform," February 15-16, 1996. Fifth row: William G. Gale, "The Kemp Commission and The Future of Tax Reform," Tax Notes, February 5, 1996. Sixth row: Eric M. Engen and William G. Gale, "The Effects of Fundamental Tax Reform on Saving," prepared for a Brookings conference on "Economic Effects of Fundamental Tax Reform," February 15-16, 1996.

William G. Gale

TAXES AND ECONOMIC GROWTH IN THE 1980S

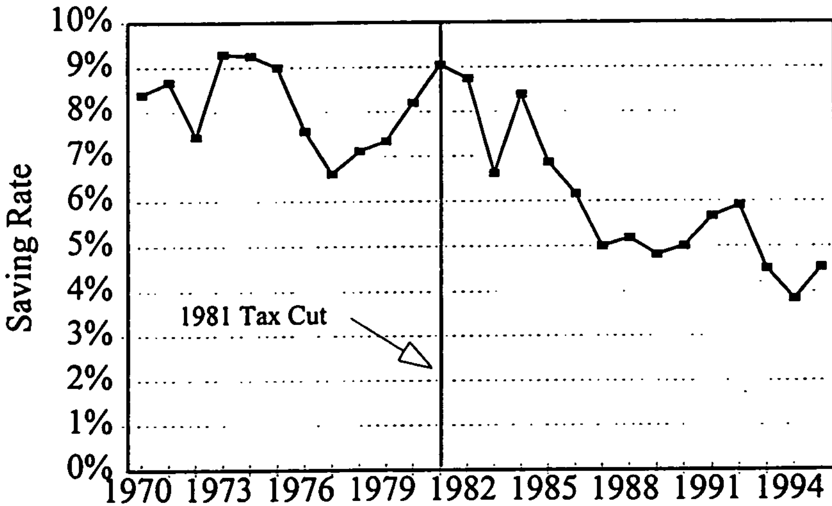
Standard Story:

Tax cuts in 1981 raised the growth rate from 1982-89 by spurring saving and investment.

Fact:

Despite the tax cuts in 1981, universal eligibility for IRAs, and high real interest rates, the personal saving rate did NOT rise after 1981.

Personal Saving Rates:



William G. Gale

Accounting for growth in the 1980s:

Factor	1982	1989	Current
Public Debt / GDP	29.5	43.2	57.4 (1995)
Capacity Utilization rate	72.8	83.2	82.0 (April, 1996)
Unemployment rate	9.7	5.3	5.6 (May, 1996)
Employment / Population	57.8	63.0	62.9 (1995)
Net international investment position / GDP	8.2	-1.4	-8.4 (1994)

Note: all variables are given in percentages

Lessons from the 1980s for the 1990s:

Growth in the 1980s was due in part to cyclical factors (the rise in capacity utilization and the drop in unemployment rates). There appears to be little room currently to raise growth through these channels.

Growth was also due to a historic increase in the employment/population ratio, due in part to changing roles of women in the labor force. Some of this trend was likely due to reductions in tax rates as well. But this ratio seems unlikely to rise by very much more today.

Growth was also due to an increase in the public debt/GDP ratio and a decline in the net international investment position of the U.S. Further increases in the former and reductions in the latter may not be the most desirable directions for policy to follow.

Growth in the 1980s was not due to tax-induced increases in saving for the simple reason that saving did not rise in the 1980s. Although the saving rate is lower today than in the early 1980s, there is no evidence to suggest that tax cuts would raise the saving rate.

O