S. HRG. 112–290

COULD TAX REFORM BOOST BUSINESS INVESTMENT AND JOB CREATION?

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

NOVEMBER 17, 2011

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

71–698 WASHINGTON : 2012

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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CONTENTS

COULD TAX REFORM BOOST BUSINESS INVESTMENT AND JOB CREATION?

THURSDAY, NOVEMBER 17, 2011

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 10:07 a.m. in Room 216 of the Hart Senate Office Building, the Honorable Kevin Brady, Vice Chairman, presiding.

Senators present: Casey, DeMint, and Coats.

Representatives present: Brady, Campbell, Duffy, and Mulvaney.

Staff present: Gail Cohen, Will Hansen, Colleen Healy, Jesse Hervitz, Brian Phillips, and Ted Boll.

OPENING STATEMENT OF HON. KEVIN BRADY, VICE CHAIRMAN, A U.S. REPRESENTATIVE FROM TEXAS

Vice Chairman Brady. Good morning everyone. On behalf of Senator Casey and myself, I want to welcome you to this morning's hearing on "Could Tax Reform Boost Business Investment and Job Creation?" Senator Casey will be with us in a few moments. We are joined by Congressman Mulvaney.

There is no question that President Obama inherited a poor economy, but after three years his policies have made it worse. The massive stimulus failed to jumpstart the economy and restore consumer confidence as he promised.

In fact, today there are 1.3 million fewer payroll jobs in America than when the first stimulus began. And now, 25 million Americans can't find a full-time job or any work at all. Hardworking taxpayers have paid a steep price in this Obama economy.

After exploding America's national debt in his first round of stimulus, the President now is out campaigning to raise income taxes on hardworking, successful Americans and local small business owners to pay for yet a second round of stimulus spending aimed at jobs in the government sector.

It is a basic principle of economics that if you want less of something, "tax it more"; and if you want more of something, "tax it less" or not at all. Common sense tells us that Washington taking more of what investors earn will only reduce investment in new jobs, research and expansion.

History proves that it's business investment in new buildings, equipment, and software that drives jobs along Main Street. One glance at the chart behind me, if you take a look at the chart here, which tracks business investment and private-sector job creation

for the past 40 years in America, it clearly shows that job creation in America will not rebound unless private investment rebounds.

While government spending in America is still above the level when the recession began, it is jobs and real business investment that have not recovered to their pre-recession levels more than two full years after the recession officially ended.

Putting Americans back to work—not taking more from small businesses and successful professionals—is the most effective way to grow federal revenues. Instead of increasing marginal tax rates, how about permanently lowering marginal rates to encourage business to invest and hire more workers? Or how about creating a 21st Century tax code based on flatter rates and a territorial tax regime like our global competitors?

Why not consider a transparent, straight-forward retail sales tax that replaces the income, business, payroll, gift, and death taxes and finally eliminates much of the complexity, burden, and special interest provisions that comprise our current mess of tax laws.

If lower rates, for example, were accompanied by the removal of many of the complicated provisions that have been added to the tax code—often because marginal rates are so high—we would kick-start investment and jobs creation by the private sector while naturally generating additional tax revenue to lower future federal budget deficits. A consumption-based tax could do the same.

Consider our high corporate tax rate and the requirement that U.S. companies pay that high rate when bringing home profits that were earned and taxed overseas. We should lower or remove that tax gate to allow an estimated $1 trillion in stranded profits overseas to flow back into America to fund new jobs, research, buildings, and expansions. It is a free-market stimulus that does not cost federal money—but rather, generates it.

Many of my Democratic colleagues charge that lowering tax rates would favor the "rich." But nearly half of American families already pay no federal income tax and the top one percent of wage earners already shoulder nearly 40 percent of the income tax burden—the top 10 percent over 70 percent.

America already has one of the most progressive tax codes in the world, and now the highest corporate tax rate among our global competitors. How much more should Washington take?

As for job creation, capital income is subject to multiple layers of taxation in the form of corporate income, dividend, and estate taxes. Business taxation is inordinately complex and imposes economic distortions and compliance costs that have no offsetting benefit to society whatsoever.

Yet, history proves that lowering the marginal tax rate on capital income increases business investment. In turn, more investment creates new private sector jobs. More investment means higher real wages for American workers. This happened in the 1960s and the 1980s and can happen again.

A common myth has arisen surrounding the so-called Buffett rule. But an analysis by my Joint Economic Committee staff of IRS taxpayer data prove President Obama's campaign assertions to be untrue: high-income Americans on average pay income tax rates three times higher than the middle class, more than 60 percent of their income is ordinary income not passive investment income,

and the 400 highest income earners in America are not the same people year to year, but a constantly changing set of taxpaying Americans.

That last point is important. For 17 years—from 1992 to 2008—the 400 highest income returns each year were comprised of 6,800 returns in total representing 3,672 different taxpayers. Of these taxpayers, only one-quarter appeared more than once, and only 15 percent appeared twice.

In any given year, on average about 39 percent of the top 400 adjusted gross income returns were filed by taxpayers that are not in any of the other 16 years—not any. Only 4 of the more than 3,000 taxpayers made the top 400 all 17 years.

That is because America is the land of opportunity. Anyone, anywhere, regardless of your birth or your station in life, you can earn your way into the wealthiest taxpayers in the Nation.

Mr. President, what is so wrong with that? Why are you intent on dividing our Nation, pitting one American against another because of their success?

Americans who work hard and play by the rules want productive jobs and a fair shot at success. They do not want handouts, bailouts, stimulus, or temporary make-work jobs. They understand that paying taxes is part of citizenship.

Americans should be able to find a good job and be able to make some contributions to the cost of the Federal Government. But for American workers to win in the global economy, American entrepreneurs must risk their capital to create the tools that American workers need to succeed.

If Washington is intent on growing the government rather than growing the economy and insists on taxing those hardworking taxpayers who supply the opportunities and the jobs at high rates, in the end it is the American workers who will be worse off.

Today we have before us witnesses who are advocates of major tax reforms designed to generate revenue for the Federal Government with a minimum of economic interference and allowances for very low-income families. What both ideas share is a commitment to reduce the after-tax cost to making job-creating, income-producing investments here in the United States. And that is what the American economy needs to kick-start the engine of job creation.

I look forward to hearing the testimony of the witnesses today. Let me introduce our panel:

Stephen J. Entin is currently President and Executive Director of the Institute for Research on the Economics of Taxation, a pro-free market economic public policy research organization based here in Washington. He advised the National Commission on Economic Growth and Tax Reform, the Kemp Commission; assisted in the drafting of the Commission's report, and was the author of several of its support documents. He is a former Deputy Assistant Secretary for Economic Policy at Treasury. He joined the Treasury Department in 1981 with the incoming Reagan Administration, and participated in the preparation of economic forecasts in the President's budgets, the development of the 1981 tax cuts, including the Tax Indexing Provision that keeps tax rates from rising due to inflation. He has a great deal of other experience in a wide variety of areas.

Mr. Entin, thank you for joining us. He is a graduate, by the way of Dartmouth College and received his graduate training in economics at the University of Chicago.

Dr. Chad Stone is the Chief Economist at the Center on Budget and Policy Priorities, where he specializes in the economic analysis of budget and policy issues. Dr. Stone was the Acting Executive Director with the Joint Economic Committee in 2007. Before that, he was staff director and chief economist for the Democratic staff of the Committee from 2002 to 2006. He held the position of chief economist for the Senate Budget Committee in 2001 to 2002. Previously he had served on the President's Council of Economic Advisers as senior economist, and chief economist from 1996 to 2001.

His other Congressional experience includes serving as chief economist to the House Science Committee. Dr. Stone has also worked at the Federal Trade Commission, the FCC, the OMB, and was a senior researcher with the Urban Institute, and co-authored the book entitled ECONOMIC POLICY IN THE REAGAN YEARS. He earned his Ph.D. in economics at Yale University.

Dr. Stone, thank you for joining us.

Dan Mastromarco was founder of the Argus Group, a public policy law and economic consulting firm for more than 16 years. He is a partner in the Mastromarco firm based in Michigan. He has counseled clients ranging from Fortune 500 companies to not-for-profit organizations on tax, trade, and labor issues.

In his Washington career he served as counsel to the U.S. Senate's Permanent Subcommittee on Investigations under the Chairmanship of Senator Roth. He also served as Assistant Chief Counsel for Tax Policy with the U.S. Small Business Administration. He was a special U.S. trial attorney with the Department of Justice in the Tax Division. He also worked as the Director of the Trade and Tax Division of the Jefferson Group, then one of the largest public affairs firms in Washington.

He has written extensively about tax reform, publishing more than 100 articles in a wide variety of outlets from law reviews to The Wall Street Journal. His latest book, entitled THE SECRET CHAMBER OR THE PUBLIC SQUARE: How Washington Makes Tax Policy, was published by the Heritage Foundation as a constructive critique of the tax policymaking process, particularly the process of revenue estimating and distributional analysis.

He attended Albion College where he earned his BA, Georgetown University Law Center, and the London School of Economics.

Welcome, Dan.

Mr. Seth Hanlon is Director of the Fiscal Reform for the Doing What Works Project at American Progress. His work focuses on increasing the efficiency and transparency of tax expenditures in the federal budget, and on tax issues generally.

Prior to joining CAP, he practiced law as an associate with the Washington, D.C., firm of Kaplan & Drysdale, where he focused on tax issues facing individuals, corporations, and nonprofit organizations.

Before law school, he served on Capitol Hill for more than five years as a legislative and press aide to Representative Harold Ford, Jr., and Marty Meehan of Massachusetts.

Mr. Hanlon also worked at the Initiative for a Competitive Inner City in Boston. There he was part of a team that partnered with *Inc.* magazine to launch the inaugural Inner City 100, a list of the fastest growing companies located in inner cities.

Mr. Hanlon received his bachelor's degree in history and literature from Harvard, and his J.D. from Yale Law School.

Gentlemen, thank you very much for joining us today. We have reserved five minutes for opening comments. We will submit your entire testimony for the record.

Mr. Entin, you are recognized.

[The prepared statement of Representative Brady appears in the Submissions for the Record on page 30.]

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

Mr. Entin. Thank you, Mr. Brady, and thank you Members of the Committee:

Prior to Treasury I was on the staff here for five years, so it is a little like coming home, except this building was not built when I was working here.

I thank you for the opportunity to testify today on tax changes that would generate investment and growth for the economy while being affordable for the federal budget.

The growth-in-jobs element in this exercise is critical. If we look only at the federal budget effects of tax proposals and forget about the economic consequences, we will miss what is most important: the public welfare—and we will get the budget numbers wrong.

To summarize, taxes affect the economy by altering incentives to work, save, and invest—not by handing out money to spend, or taking it away. Forget anything you have heard about Keynesian multipliers and the need to stimulate spending.

The income tax is heavily biased against saving and investment. True tax reform would remove the biases not just between industries but between saving and investment versus consumption. That is absolutely key to restoring growth.

The amount of capital—plant, equipment, and buildings—is highly sensitive to its tax treatment. Higher tax rates on capital shrink the capital stock, shrink the productivity of labor, reduce employment output, and income. The burden of higher taxes on capital formation falls largely on labor in the form of lower wages and hours worked.

The definition of the tax base—the income that we tax—is at least as important as the tax rate. Overstating business income by under-counting investment expenses leads to less investment and lower wages.

Trading away legitimate costs of production for a broader tax base may mean higher tax rates at the margin, even if the statutory rate is cut. That is what happened in the Tax Reform Act of 1986, which was bad for growth and should not be a model for any current reform effort.

We should not repeat the Tax Reform Act of 1986, which tried to perfect the broad-based income tax by supposedly evening out treatment among industries. Rather, we should adopt a different

tax base that is more neutral in its treatment of saving and investment relative to consumption. That is a much broader shift.

Mindless base-broadening is simply not the answer to our deficit problem. Expensing is the right approach to measuring the cost of investment. The current expensing provision if made permanent would boost GDP by 2.7 percent and would more than repay its static revenue cost. It is the most efficient way to encourage additional investment.

A 25 percent corporate rate would raise GDP by about 2.3 percent, almost as much as the expensing provision. It would cost more—about $25 billion more—in static terms, and require more offsets to make up the difference, if you go by static scoring.

But the corporate rate cut, too, would more than recover its revenue over time by raising wages and employment. Do not swap expensing for lower corporate rates. Do both. You do not have to choose. Neither costs you any revenue over time.

Expensing favors capital-intensive manufacturing and rapidly growing businesses, and corrects a mismeasurement of income that penalized them relative to other industries in the past. A corporate rate cut is preferred by businesses with intellectual property instead of physical property, and by established slower growing businesses that want higher returns on capital that they've already bought. They also get the benefit of expensing as they replace that old capital over time.

You can satisfy both by keeping expensing and, if necessary, phase in the corporate rate cuts to reduce the static revenue score. It is better to do a dynamic score and cut the rate faster. If the Joint Tax Committee is not able to provide a dynamic score, get one from a major academic and modeling outfit and use that. The budget rules permit that.

Increasing double taxation of corporate income by raising tax rates on capital gains and dividends to 20 percent, for example, would cut GDP by about 1.2 percent and would wipe out the expected revenue gain. In addition, realizations would collapse as they did after the 1986 Act and you would get less revenue out of the existing gains because people simply wouldn't take them.

Raising the two top tax rates back to 36 and 39.6 would cut GDP by about half a percent and lose about 40 percent of the expected revenue.

I have to say, with some regret, that the Bowles-Simpson Commission Proposal, and the Wyden-Coats bill, were not examined for their effects on the service price of capital. That's the required pretax return on capital needed to pay its taxes, cover the costs, and leave a normal return to the investor.

The proposals did not cut tax rates enough to offset the longer tax depreciation lives and the higher tax rates on capital gains and dividends, and they would both reduce GDP significantly.

It is important that any tax reform proposal promote growth because, as I explained in the testimony, we are at about 12 percent below trend GDP, and that plus the added spending we did in the vain attempt to get out of the stagnation is responsible for well over half the deficit.

Every tax bill that you consider should be examined for its effect on the service price of capital. If the Joint Committee of Taxation

and the Congressional Budget Office can't do that right now, again, go outside and get an outside estimate. They should always report that calculation to you when you're considering a bill.

If you cut the service price, you are going to get more investment and jobs. If you raise it, you are going to get less. And you really ought to know what you are doing to your constituents before you hold that final vote.

Thank you, very much.

[The prepared statement of Mr. Stephen J. Entin appears in the Submissions for the Record on page 32.]

Vice Chairman Brady. Thank you, Mr. Entin.

Dr. Stone.

STATEMENT OF DR. CHAD STONE, CHIEF ECONOMIST, CENTER ON BUDGET AND POLICY PRIORITIES, WASHINGTON, DC

Dr. Stone. Thank you, Vice Chairman Brady, and other Members of the Committee:

I guess I should say: And now for something completely different.

My bottom line is that tax reform is unlikely to be an effective tool for speeding up economic growth in the short run. Tax reform could be a useful tool for enhancing growth in the long run, but only in the context of a sound, overall program for achieving long-term fiscal stabilization, and not if it is used as an excuse to avoid the revenue increases that must necessarily be a part of any credible, sustainable deficit reduction plan.

In my testimony I have a chart that illustrates the distinction I want to make between the short run and the long run. I'm sorry we don't have a chart, but it is figure one in my written testimony, which shows the growth path of the economy if we were producing at full employment with full utilization of our existing capacity, and the actual GDP.

We know that the economy is in a deep hole and growing very slowly. That is why we have 9 percent unemployment.

So I want to distinguish between policies that would move the actual GDP line in the chart and policies that would move the potential GDP line in the chart.

So talking about the short run, the most compelling explanation to most economists for why we have a 9 percent unemployment rate, tame inflationary expectations, and a large output gap, is the textbook one: weak aggregate demand.

Businesses are not able to sell all the goods and services they are capable of producing right now. Putting more customers in their stores, and giving those customers more money to spend is a far better way to encourage businesses to expand and hire more workers than giving a tax break when their stores are still half empty.

Measures the President has proposed, like extending Federal Emergency Unemployment Insurance, extending and expanding the Payroll Tax holiday, relatively quick-acting infrastructure investments like repairing schools, and help to relieve pressure on state and local governments so they won't lay off more teachers, police, and fire fighters, are the policies that are likely to be most effective at getting the economy back on its feet and operating at full capacity, because they operate on the demand side and they don't

make long-term deficit problems materially worse because they are temporary.

Policies like corporate tax reform, and cutting top marginal rates for individuals, add to the budget deficit without generating much new spending in an economy with a huge output gap, high unemployment, and too much idle productive capacity, because they operate on the supply side. And right now we have plenty of potential supply, but not enough actual demand.

Looking at the long run, policies to move the blue line—this is where tax reform can come in. The longer term question is: What are the best policies for raising the economy's capacity to produce goods and services?

Here are my key points: Tax rates in the range we're talking about as part of a credible and sustainable debt stabilization plan are less harmful to growth than budget deficits of the kind we are projecting in the absence of such a plan. Reducing deficits in fact is a more potent way to increase long-term growth than cutting taxes, and revenue-neutral tax reform is not good enough because we need to raise revenue. With all due respect, supply-side fantasies and dynamic scoring pipe dreams won't cut it. That does not mean we should not embrace the enduring principle of tax reform that a broader tax base allows rates to be lower than a narrower tax base.

But we also have to ensure we have enough revenue to pay for the things we want government to do, ranging from national defense to an adequate safety net.

The debate should be about what we want government to do and how we should pay for it. Setting arbitrary limits on spending or revenue does not advance that debate.

I want to touch briefly on a couple of other topics. The first is the repatriation of foreign earnings. We tried a repatriation tax holiday in 2004 and it did not work. There were no effective mechanisms to ensure that repatriated earnings would be used for their intended purposes of investment in the United States, and just as economic and finance theory would predict the earnings multi-national companies brought back under the tax holiday ended up being returned to shareholders largely through stock repurchases.

There is scant evidence of any new investment having been generated. And indeed, many of the firms that repatriated large sums during the holiday actually laid off workers subsequently. Doing the same thing again—which is what CBO and other analysts and the Joint Committee on Taxation has scored—would add to the budget deficit without doing much, if anything, for the jobs deficit. The 2004 model is not a good model.

On small businesses and the question of higher marginal tax rates: Unlike large corporations, which are for the most part flush with cash, small businesses appear to still face difficulty financing expansion. That may justify short-term measures that target job creation in small businesses that would respond to such an incentive, but it does not justify costly and poorly targeted measures like keeping the current very low top marginal tax rates from expiring as scheduled.

Three quick points: The number of truly small businesses that would be affected by the top marginal tax rates is greatly exaggerated in most discussions of the issue.

Second, in many cases the effective tax rate on small business income is likely to be zero or negative regardless of reasonable changes in marginal tax rates because of the valuable array of tax subsidies that small businesses receive. Finally, the justification for those subsidies should be examined more carefully. The best recent research indicates that it is important to distinguish between young firms, start-ups, which are the main source of job creation and dynamism in the small business sector and other more established small businesses.

Thank you, and I look forward to discussing these issues further.

[The prepared statement of Dr. Chad Stone appears in the Submissions for the Record on page 52.]

Vice Chairman Brady. Dr. Stone, thank you.

Mr. Mastromarco.

STATEMENT OF MR. DAN R. MASTROMARCO, PRINCIPAL, THE ARGUS GROUP, ARLINGTON, VA

Mr. Mastromarco. Yes, Mr. Chairman, thank you.

You know, there is an old adage that if we could line up all the economists end to end on Pennsylvania Avenue and make them hold hands, they still would not reach a conclusion.

[Laughter.]

And I think you can say that that is true when you juxtapose the testimony today of Drs. Stone and Entin. But in reality, they should sing with the harmony of chorus girls when they are asked about the principles that should guide tax reform.

Economists ought to tell you an optimal tax regime imposes minimum costs for maximum voluntary compliance. But that is not what we do. We waste $431 billion in compliance only to endure a tax gap that is equally large and growing. That is the dollar value of all the finished goods and services in the State of Virginia, and 41 other states—resources unavailable for payroll, plant, or equipment.

The IRS embroils Americans in 72,000 litigation actions, 7 of 10 involving small firms, only to enforce a system that is apparently so confusing not even the Treasury Secretary, or two former Members of the Ways and Means Committee, can fully understand it.

Economists say an optimal system applies low marginal rates on a base neutral toward savings and investment. That is what Dr. Entin said is so important. But that is not what we do.

Our corporations pay a national statutory marginal rate of 35 percent on that chart. That is the highest in all of the OECD countries; a dubious distinction. These rates impose efficiency costs, according to the GAO, of as high as $728 billion. And if Dr. Stone has a problem with that analysis, he should talk to the Government Accountability Office about that.

After all, that explains why our 9,000 code sections of gibberish have been cobbled together by America's finest lobbyists, not America's finest economists.

Economists tell you an optimal system would not favor imports over exports, or discourage repatriation of profits. But that is not what we do.

The U.S. is alone in applying punishing rates—the highest in the OECD, and 50 percent higher than the average OECD rate at 23 percent—to domestic and foreign earnings alike, and in refusing to adopt a border-adjustable tax system. 33 of 34 OECD countries impose an average border-adjustable VAT of 18.5 percent. It is as if Congress is urging global producers: invest in overseas plants and facilities. Hire those foreign workers. And then market your products back to the American consumer who is punished for saving and rewarded for consumption.

Don't take my word for it. Look to the World Bank. They rate us the 124th worst nation for total tax cost, behind the Russian Federation.

Mr. Chairman, the FairTax, which replaces income and payroll taxes with a single-stage consumption tax, addresses these infirmities. It eliminates an estimated 90 percent in compliance cost, relieving individuals and nonretail businesses from filing returns or paying taxes. It would impose the lowest marginal rates on the broadest base of any plan that does not tax income more than once.

Laurence Kotlikoff estimates that this increases capital stock over the century by 96 percent, 44 percent by 2030, increasing real wages by 17 percent over that same period rather than the projected decline of 8 percent.

It would transform the U.S. from one of the least to the most tax-favored jurisdictions for business, meeting the challenges of border-adjustable regimes by exempting foreign consumption of U.S. goods from taxation, while imposing the FairTax on foreign goods consumed here just as we do on domestic goods—complete neutrality.

A zero marginal rate on productive income is better than a territorial tax because it issues our competitor nations an ultimatum: Reduce your tax rate on savings and investment, or lose that investment to America. And that sparks global tax competition.

By not taking the fruits of our labor until consumed, the FairTax gives taxpayers control over their tax obligation, which in turn lubricates upward mobility—what Chairman Brady was talking about earlier—and it proves we do not need to trade growth for equity.

Now I know I am running out of time, but with—with permission, I will just take a few more seconds of the Committee's time?

Vice Chairman Brady. If we may, Mr. Mastromarco, because we want to stay within the five-minute limit, I will ask you a question if you want to make a point to finish up.

Mr. Mastromarco. Very well.

[The prepared statement of Mr. Dan R. Mastromarco appears in the Submissions for the Record on page 64.]

Vice Chairman Brady. So, Mr. Hanlon, you are recognized.

STATEMENT OF MR. SETH HANLON, DIRECTOR OF FISCAL REFORM, DOING WHAT WORKS, CENTER FOR AMERICAN PROGRESS, WASHINGTON, DC

Mr. Hanlon. Thank you, Vice Chairman Brady, Chairman Casey, and the Members of the Committee:

Thank you for the opportunity to testify. It is a privilege to be here. This morning I will focus on four points that I discuss at greater length in my statement for the record.

First, tax reform, if done right, has the potential to improve economic growth over the long term, but it is not a solution to the urgent jobs crisis we face today and therefore should not come at the exclusion of immediate measures to boost demand and create jobs.

In this regard, I would associate myself with Dr. Stone's analysis.

Second, one of the most important things tax reform can do to boost long-term growth prospects is to adequately fund our needs as a country—including investments that will keep us competitive. Under any realistic fiscal scenario, that will require substantially more revenue than our current tax code raises.

For the last three years, federal revenues were less than 15 percent of GDP, the lowest since 1950. And if we maintain current tax policies, revenues will average just 17.7 percent of GDP over the next decade, not nearly enough to prevent continued deficits even under the house-passed budget, which brings federal spending down to about 20 percent by the end of the decade only by shifting health care costs onto seniors and dramatically reducing the public investments that are needed for long-term growth.

Recognizing these realities, all of the major bipartisan proposals to reduce the deficit—Bowles-Simpson, the Bipartisan Policy Center, the Gang of Six—raise revenues to 20 percent of GDP or higher.

With revenues at that level, the U.S. would still be a very low tax country. We now have the fifth lowest revenues among the more than 30 countries in the OECD, one-quarter less than the OECD average.

In the current fiscal context, tax reform cannot just be revenue neutral; it has to raise revenues.

Third, tax reform should not shift more of the tax burden onto middle class and low-income Americans who have experienced almost none of the real income gains in recent years, which is why we should let the Bush tax cuts expire for top income earners. There is little reason to believe that requiring the highest-income 2 percent of Americans to pay the modestly higher tax rates that they paid only a short time ago would slow economic growth.

Lest we forget, business investment, job growth, and real income growth were all stronger under the post-1993 tax code. 18 million private sector jobs were created in 6 years after 1993, compared to job growth of just 4.7 million in the corresponding period after the first Bush tax cuts were enacted, which does not even count job losses from the recession. And small businesses created jobs more than twice as fast.

That is not the only reason to doubt that small businesses will be harmed. About 97 percent of them are not in the brackets that would see any change. And 92 percent of the total benefit of extending the high-end tax cuts would go to high-income people who are not small business employers.

My fourth and final point is that the corporate tax code is in need of reform. But Congress should not finance corporate tax cuts either with regressive tax increases or additional debt. We often

hear that the U.S. has the second-highest statutory corporate tax rate among major economies, pending what Japan does, which is true. But given the wide variety of tax preferences and loopholes that exist in the code, effective rates are the better measure.

In a recent analysis of 280 public company financial statements by Citizens for Tax Justice and the Institute for Taxation and Economic Policy, it was found that these large U.S. corporations paid an average effective rate of 18.5 percent over 2008 to 2010, just over half of the statutory rate.

We also often hear that the U.S's corporate tax system is a drag on our multi-national corporations' ability to compete in global markets. Again, however, corporate financial statements tell a different story.

Researchers studying the effective rates of the 100 largest U.S. companies and 100 largest EU companies over the last decade found that the American companies paid lower income taxes on average than the European rivals. And a 2007 Treasury Department report also found that the average tax rate of U.S. corporations was below the OECD average. The U.S. raised 2.2 percent of its GDP in corporate taxes—well below the OECD average of 3.4 percent.

And so an accurate picture of the corporate tax burden in the U.S. leads to the conclusion that fiscally responsible tax reform should raise revenue from the corporate income tax by broadening its base, and at the very least be revenue neutral.

Thank you again for this opportunity and I look forward to your questions.

[The prepared statement of Mr. Seth Hanlon appears in the Submissions for the Record on page 91.]

Vice Chairman Brady. Thank you, Mr. Hanlon. We are joined by the Chairman of the Joint Economic Committee, Senator Casey. He is recognized for his opening statement.

Chairman Casey. Mr. Vice Chairman, thank you very much.

I want to make two points.

First of all, when people across the country—no matter where you are from—when they look at Washington, they have said two things to us. Number one is they want us to create jobs and deal with deficits and debt. That is the substantive message.

But they also want us to work together and come up with bipartisan solutions. What they want to see in the context of that is what we are doing today: Having what we will have, and I can tell by the opening statements, it is plainly evident that we will have a good, robust debate about tax policy, and that is good. People like that. What they do not like is when we do kind of the usual name-calling in Washington.

So this is a very constructive process that we are undertaking today. I think when we talk about the basics of this agreement, number one is there is broad agreement in this room and across the country that we need tax reform, and a lot of it. Whether we get that or not in the next couple of weeks remains to be seen, but I think that is at least one thing we can all agree on.

Secondly, what concerns me about some of the ideas that have been and will be presented today is what are the effects on at least two basic priorities? Number one is: What will happen to the middle class? And what will happen to deficit and debt?

I think they are two basic concerns that I have. But I think the Vice Chairman has done a very good job of gathering us together and getting some very smart folks to help us better understand what our challenges are and what some of those solutions can be. So I really appreciate the work that he has done to make this hearing possible.

Thanks, very much.

Vice Chairman Brady. Mr. Chairman, thank you.

We will begin the questioning.

Mr. Entin, thank you—this is a comment more than a question—thanks for making the point that the goal of tax reform is not simply broadening the base, or the effect on demand, but ought to be measured by the incentives to invest. Because that drives job creation consistently in this country.

Mr. Mastromarco, the FairTax seeks to replace a number of taxes—the personal income tax, the corporate tax, payroll taxes, gift and death taxes—with a single-stage retail sales tax.

Since the title of this hearing is "Can Tax Reform Boost Business Investment and Job Creation?" can you talk a moment about what you believe will be the impact on our economy as a result of the FairTax and who would be impacted by the change to that system?

Mr. Mastromarco. [Inaudible].

Vice Chairman Brady. If you could hit your microphone and make sure that it is on.

Mr. Mastromarco. The FairTax would unleash significant growth. In a way we can think of the FairTax is as being a Roth and a regular IRA all combined, where the earnings are not taxed. Think about investment in business—it is both pre-payroll and pre-income tax—where then the business can grow with its earnings tax-free. The business can then be sold tax-free. What it does it go back to a theory of Dr. Irving Fisher many years ago that income really is not income until it is consumed. The FairTax does not tax productive income.

And so let me show a chart, if I may, that we have that was done by Beacon Hill Institute. The FairTax, Chairman Brady, is a proposal that has been the most researched plan, I venture to say, in the history of the United States—certainly one of the most popular plans. These are the economic effects according to David Tuerck of the Beacon Hill Institute. Real GDP grows in all of the years—year five, year one, year ten; jobs increase; investment grows, and wages rise.

The chart that you looked at earlier showed that wages increased as a result of capital investment. Here capital stock grows and that is what increases wages. Farmers are not more efficient today than they were at the turn of the Century because they work harder hours, longer hours; they are more efficient because they have tractors, and capital to work with. And this capital comes in the form of investment, and it comes in the form of intellectual capital.

What the FairTax does is relieve the tax on that capital entirely.

Vice Chairman Brady. Thank you. And can you address for a moment the revenue-neutral issue? We sometimes see all sorts of numbers fly around about what their tax is from a revenue-neutral standpoint. Can you address that?

Mr. Mastromarco. I will address that. And I appreciate that question.

I think it is a very large question, because it opens the door to a criticism of the way in which revenue-estimating and analysis is done in this country. You know, the raison d'etre of tax reform is supposed to be economic growth, real wages; the things we are talking about today.

And yet, when the Joint Tax Committee comes up with their estimates such as the rate of the FairTax, we close our eyes to the economic growth. We say we do not want to hear this. We want to just look at the static estimates.

We do not know whether the Joint Tax Committee has analyzed the FairTax because the Joint Tax Committee operates with secrecy that rivals the CIA.

They should be disclosing to you their spreadsheets. They should say: Here is how we came up with it. We are scientists. We believe in our answer. We came up with the right answer, so we can accept the criticism of it. That is the way the Joint Tax Committee should function. And the Joint Tax Committee should not function by simply giving you a static estimate as if all tax cuts and increases are created equal, which they most certainly are not.

Vice Chairman Brady. May I ask—and we are closing out on time—but is the 23 percent rate in the FairTax revenue neutral?

Mr. Mastromarco. It is, sir. As a matter of fact, if the FairTax had been adopted last year, we would have $267 billion more dollars in our federal coffers than we do today.

Vice Chairman Brady. Thank you, sir.

Chairman Casey.

Chairman Casey. Thanks very much.

Dr. Stone, I wanted to start my questioning with a very basic question to you. How do you evaluate the proposal that was enunciated just a moment ago in terms of the analysis presented by the chart? What is your assessment of that proposal?

Dr. Stone. Well, the FairTax proposal is——

Chairman Casey. Oh, the mike. Yes.

Dr. Stone. The FairTax proposal is a version of a consumption tax. There are all kinds of consumption taxes: a value-added tax, a consumption tax like the FairTax—but we know the characteristics. They tend to be regressive compared with the current system.

I know the FairTax proposal has something to address what is going on at the bottom. But in terms of economic efficiency, you mentioned Dr. Kotlikoff, there are economists who looked at the efficiency of moving to a consumption tax. And what you learn is that almost all of the efficiency gains come as a result of taxing existing capital: people who have saved, already paid income taxes on the money they saved. They have to pay again when they consume.

And so in that situation what you do is you decide you had better work harder and you better invest more. It is like a natural disaster that knocks down a building. You have lost wealth, but you work harder to repair that wealth and you save more. That is where almost all the efficiency gains come from is the taxation of old existing capital in the FairTax proposal.

There is also a question of transition. You can have lots of transition rules to avoid those problems, but that takes away most of the efficiency gains.

Chairman Casey. I started in my statement with a concern about the impact on the middle class. Can you assess that?

Dr. Stone. The FairTax proposal does attempt to deal with folks at the very bottom, but like all consumption taxes very high income individuals get a much bigger break than the middle class. And so it would shift benefits towards—it has unattractive distributional characteristics if you think that a lot more after-tax income going to the very top of the distribution is not a good idea. The middle class gets hurt compared with the rich.

Chairman Casey. I wanted to ask as well, and I know we have limited time, there is a 2010 analysis by the Citizens for Tax Justice. Corporate taxpayers and corporate tax dodgers in the calendar year 2010, manufacturers paid 23.2 percent of their profits in taxes compared with 2.2 percent for IT companies, and 5.2 percent for telecom companies.

On average, the tax rate for the companies in their study was 17.5 percent.

Is anyone on the panel familiar with this data? Give me your assessment of those differentials.

Mr. Hanlon. Sure, I can jump in. I mean, Citizens for Tax Justice and ITEP have been doing this kind of analysis for basically 30 years. Actually one of their reports was one of the impetuses behind the 1986 Tax Reform Act when President Reagan read and saw the number of companies that were not paying—profitable companies that were not paying federal income taxes and said they have to do something about this.

So it is an analysis of only profitable companies. They screen out the ones that are not profitable. And it looks at their overall effective rate. And I think you had mentioned those—you know, it was very interesting, the disparities among industries, and in particular manufacturing being a 23 percent rate.

I think another thing that is masked in the way they do it is that there is also a differential between domestic manufacturing and foreign manufacturing, which I think is another distortion created by the tax code, and an important one, that we have to address.

So I think, you know, overall as you may——

Chairman Casey. Are you talking about the manufacturing being adversely impacted?

Mr. Hanlon. Right, the domestic manufacturing.

So I think the study on the whole survey undermines the notion that corporations are over-taxed in general compared to other countries, and certainly would lead to the conclusion that we need a base-broadening that levels the playing field among competing industries.

Chairman Casey. I know I am out of time but, Mr. Mastromarco, I know you will get rebuttal time.

Mr. Mastromarco. No, I appreciate the opportunity. I do not know whether Dr. Stone has actually had the opportunity to read the FairTax, but it is the only plan that completely untaxes the poor. Through its rebate mechanism it makes sure that no one pays their FairTax to meet the sustenance in life.

The amount that is at the poverty level is completely untaxed. That is not what we do today. Under the Earned Income Tax Credit, for example, in order to escape poverty we impose some of the highest marginal rates on those individuals. And that keeps them in that position. It is very bad.

In terms of equity, here is what the data of Dr. Kotlikoff showed when he looked at 42 family sets and ran his simulation model. He said that the lifetime average effective rates would decrease for lower-income taxpayers 86 percent over what it is today, and 42 percent for upper income folks. In other words, these are highly progressive results. And his study shows that the welfare gains are equally progressive.

Twenty-seven percent of the welfare gains go to low income individuals. Eleven percent go to the middle income, and five percent to the upper income.

Here is the problem, Mr. Chairman. We assume here——

Chairman Casey. I did not mean to give you this time. Can you hold that so we can move——

Mr. Mastromarco. Absolutely.

Chairman Casey. Can you hold that?

Mr. Mastromarco. Yes.

Chairman Casey. Thank you.

Vice Chairman Brady. Thank you very much.

Mr. Mulvaney.

Mr. Mulvaney. Thank you, Mr. Vice Chairman.

Mr. Mastromarco, I appreciated your comments at the outset about how all too often it is difficult to get economists to agree between various groups. I am always stunned at the number of times they do not seem to be able to agree with themselves.

Since we have been up here today I have heard now that tax reform will not create jobs, but in the next breath folks will extol the payroll tax cut, which is designed supposedly to do exactly that.

I have heard that we are seeking to increase aggregate demand, and in the next breath suggesting that the Bush/Obama tax cuts expire, which unequivocally will have the exact opposite impact on aggregate demand.

What is more frustrating is the number of economists who seem completely able to ignore the real world. It is like we have moved away from Adam Smith's worth, his beautiful insight into the real world, and human nature, and what actually existed outside of these walls, to Samuelson's text which I read in college which was—I always wondered if the guy actually ever wandered outside of a classroom.

And what it leads us to is a situation where today still some of you are arguing that infrastructure spending is the best way to spur adequate demand—despite the fact that we have tried that and it did not work; that you are still here today, gentlemen, some of you, pushing for an extension to things like Unemployment Benefits and extension to the payroll tax cuts when we already have unequivocal evidence that it did not work.

And I am just wondering if we have not learned anything from this most expensive economics lesson that anybody has ever received? We spent $800 billion to try to put exactly what you—Mr. Hanlon and Dr. Stone especially—have extolled here today, and the

only possible conclusion you can come to in the real world is that it did not work. But that is my comment, and here is my question:

Dr. Stone, you mentioned something I want to come back and talk to a little bit, which is about the base, broadening the tax base. And here I am talking about not the size of the income that we have available to tax, but the number of people who are actually participating in that tax base.

One of the numbers you hear a lot is that half of the folks in the country who make money, who earn money, do not pay the income tax. I am just wondering if you think that is fair, or needs to be changed?

Dr. Stone. I am not sure that the statistic is fair. The high figure that you cite is for a particular period. It is lower in years when the economy is not so weak.

But more importantly, people do pay federal taxes. Most people do pay federal taxes. They pay payroll taxes, and they pay income taxes. And to simply focus on the income tax is to miss the fact that people are paying taxes.

Mr. Mulvaney. But the payroll tax, I've always—since I got my first check when I was 14 or 15 years old, you know, my Dad laid out to me, this is the income tax, and then this is FICA. And what that is is that is Social Security—isn't that a segregated fund, supposed to be at least in theory? When you pay payroll taxes, you are paying for what people perceive to be their own benefits in the future, their Social Security, their Medicare. They are not paying for defense, USDA food safety, they're not paying for the FAA, they're not paying for the FBI. Correct?

Dr. Stone. The FICA tax is—is—goes into the Social Security Trust Fund, but revenues are all mixed together, and spending is all mixed together. It is not as though it is completely segregated.

It says, this—it is an indication of promises to pay future benefits.

Mr. Mulvaney. No, I understand that we raid the Trust Fund. I understand how that works, and that we buy nontradeable public debt. I understand all that. But the point of the matter is, if you are only paying payroll tax you are not paying for national defense, are you?

Dr. Stone. You're

Mr. Mulvaney. I'm what? I'm right?

[Laughter.]

Dr. Stone. It's more complicated than that. Nobody's dollar is going to national defense versus going to paying for Medicaid. It is all one pot.

Mr. Mulvaney. Do you think everybody should pay something towards national defense? Everybody in the country?

Dr. Stone. I think the people should pay taxes in proportion to their ability to pay, and receive benefits in proportion to their—to what they—to how they benefit.

Mr. Mulvaney. I've heard that before. I heard that before. I read that someplace. It's called: From those according to their abilities to those according to their needs, isn't it?

Dr. Stone. It's—It's about—it's about the system that we have had in the United States for a long time of a progressive tax and benefit system. That's what we have.

Mr. Mulvaney. Thank you, sir.
Thank you, Mr. Chairman.
Vice Chairman Brady. Mr. Duffy.
[Pause.]
Excuse me, Senator, you are recognized.
Senator Coats. Thank you. I have got a little bit of a time constraint, so I appreciate the yielding of the time.

First of all, thank you for your testimony. A lot of very interesting questions have been raised. I happened to co-sponsor a bill, a bipartisan bill, along with Senator Wyden, and it was really crafted by Senator Wyden and Senator Gregg over about a three-year period of time.

I got the baton handed off to me when Senator Gregg retired from service. I have worked with Senator Wyden tweaking some of the provisions of the plan. What we have both said—what he said with Senator Gregg and what he and I are saying today is, this is not the be-all and end-all of tax reform. These are some ideas and some thoughts based on some basic principles that have been invented over about a three-year period of time by a number of organizations, and we still leave the door wide open for suggestions for improvement, or even major changes to it if we can find adequate substitutes that better lead us toward the goals that we all are trying to reach with tax reform.

Clearly there is a growing consensus that we need this reform and need it badly. And I am hopeful that that consensus will lead to actual reform, and obviously we want to do it the right way.

In the limitation of time, let me just focus on one aspect of the Wyden-Coats provision. That is, addressing the corporate tax rate, which was mentioned and was on the chart.

We see that as a strong impediment to the competitiveness in a global economy. There is a difference of opinion as to how much of an impediment it is, but there is pretty much a consensus that we do not need to be at the top of the 36 OECD countries in tax rate. And then being at least at the average level would be a benefit to the United States.

And so ours brings it down to 24, but we are looking for ways to actually bring it down to 21 or 22. And we do that by eliminating a lot of the exclusions, exemptions, subsidies, and so forth that has been said by the panel, some of the more effective lobbyists have been able to insert into the tax code through—actually the Congress did—but through some effective lobbying by some corporations than others.

Now I met with and talked to a lot of heads of multi-national companies. Almost exclusively I have heard two things. One, well, our company does not have a problem with that because we have been able to use the X, Y, Z subsidies, credits, et cetera, et cetera, and that brings our rate down to a level where we are competitive.

And others say, you know, this is very unfair because those who have more—who have been successful with the tax-writing committees get a break at the expense of the others. And many have said to me: Look, if you could get us down into the low to mid 20s, I don't care what exemptions I have, or what breaks I will take, I will take that over having to go through the process of continuing

to work to save my subsidies, save my credit, save my exclusion, or get a new one, or whatever.

So I would just love to get rid of all that effort, all that time, all that cost, all that uncertainty, just give me a rate where I am competitive with my competitors.

Any problems with that goal in mind? And if any of you have examined our particular legislation, any comments you could provide for us, that would be helpful and would be appreciated.

Mr. Entin. Senator, a good friend of mine who in fact used to intern with us, was one of the staff people who worked with Senator Gregg on this bill, and I asked him as he was putting it together: Are you checking the rate cuts versus the offsets? And Joint Tax was not providing decent information.

In two areas there is a problem with the bill. First, the increase in taxes on capital gains and dividends is not a good idea.

Second, they really——

Senator Coats. I happen to agree with that, even though it is my own bill.

Mr. Entin. Okay. But Joint Tax gave you estimates and notions on depreciation that really were extraordinarily harmful and wrong. You have been put back to asset lives that Kennedy used, but not the double-declining balance that he used, so you have the worst tax treatment on depreciation of capital since the Eisenhower Administration.

Some industries do not care about that. If you have nothing but, for example, royalties and software, perhaps without any big manufacturing costs, that will not bother you, you prefer a lower tax rate. But if you have got manufacturing equipment and other capital intensive industries, that will cause a great deal of trouble.

We tried to measure the relative effects of these changes, and in our model it comes out very badly.

One of the points that you need to note is that you will have of course in your bill an elimination of the domestic production or manufacturing credit which already lowers the corporate rate to some extent for those companies, and that means that the rate cut you are apparently giving is not as big as it appears to be.

So the depreciation then weighs very heavily against what is in fact not quite a big-enough corporate rate cut. If you can get the corporate tax rate down to the very low 20s, or 19, with that depreciation schedule you might make up for it. But I think you are going to have a great deal of trouble getting a lower service price of capital in the structure that you have.

I also think that if you have a revenue problem, and cannot keep the expensing, you can still keep the depreciation allowances just as valuable by switching to a neutral cost recovery system. Keep the longer asset lives, but pay an interest rate, a respectable one like a long-term return on capital of about 3 percent plus inflation on the unused balances going forward.

The present value would be the same as expensing, but it would give you enough time to get all the added capital into place before you actually had to have the bigger depreciation writeoffs over time. This mismeasurement of the cost of investment in the bill is causing it real problems.

Now there are many other subsidies to the corporate sector that can and should be closed to lower the rate, and in that general framework I would agree. But when you have these specific provisions which hit at the service price of capital, it does not come out quite right.

Senator Coats. Well thank you for that. I take that as a constructive suggestion. I guess what I would ask of you is that you have the individual who wrote that who now works for you issue a mea culpa and send me details of what you just said, and we will go to work on it.

[Laughter.]

Mr. Entin. He was an intern 20 years ago, but I will get in touch with him again.

[Laughter.]

Senator Coats. Your suggestion is very helpful. My time is up. Thank you.

Vice Chairman Brady. Senator, thank you. And now, Mr. Duffy.

Mr. Duffy. Thank you, Mr. Chairman. And I appreciate the panel coming in today.

If you look at what has changed over the last 50 years, is it fair to say that as we look at the global marketplace we compete with China, India, Mexico, Vietnam, Brazil, Canada, at a far greater rate today than we even did 10 years ago? Or more than 40 years ago? Is that correct?

Mr. Entin. Yes.

Mr. Duffy. Would you all say that capital is pretty free-flowing? It goes to the best home possible? Right? I mean it is kind of like as we look at our own spending habits, Wal-Mart has become successful because people want their dollar to go as far as possible, right? They go to Wal-Mart instead of maybe another store that does not provide the best value?

[Panelists nod in the affirmative.]

Is capital kind of the same way? It goes to the best place? Am I right on that?

[Panelists nod in the affirmative.]

You are shaking your heads "yes."

Mr. Entin. Yes.

Mr. Duffy. And so if we look at raising taxes in America, doesn't that make us less competitive on this global stage? I mean, is it not as good a home for capital as some of the other OECD countries that were put up in the chart?

Mr. Entin. Yes.

Mr. Duffy. Okay. I guess, I don't know if you guys looked at Switzerland, Ireland, Germany, Canada, Chile. Are those countries, Mr. Stone, is there a movement within those countries to create economic growth by raising their tax rates right now?

Dr. Stone. There is not, although right now their short-term economic problems are so great that the question of attracting investment is less important to them than getting their budgets in order and worrying about high unemployment.

On the question of capital mobility, yes, capital is mobile, and yes, we are competing with more people. But there is an awful lot of considerations that go into whether it is worthwhile to be pro-

ducing in, you mentioned Vietnam, versus producing in Pennsylvania or in Texas. And there's a lot more considerations.

The United States still enjoys many advantages of producing right here in the United States. Capital is not flying all the way out. And capital is not quite as mobile as we all nodded our heads to. There are some limitations.

Mr. Duffy. And maybe your thinking is different than I do, but when I am talking to business leaders they all tell me it is not the only consideration. They look at the American workforce, its productivity, its intelligence, but they also look at the tax code.

Do they tell you something different than what they are telling me?

Dr. Stone. No, no. I am saying all these things figure in.

Mr. Duffy. Right. And so isn't it fair to say, if you guys are advocating raising taxes, you are too advocating for a less competitive American economy?

Mr. Hanlon. So I think, you know, we need to balance the fiscal priorities. You mentioned that one of the factors in our competitiveness is our workforce, and certainly other factors are infrastructure and the strength of the consumer base in the United States.

And so I think we need to balance, you know, the concern about statutory rates with the need to fund the investments that are going to maintain our competitiveness. In particular, if we think about workforce, education, investing in our infrastructure, and I think those things are indispensable to long-term economic growth and competitiveness.

Mr. Duffy. And I might not have the right number for this, but we are sitting at about a $98 trillion in unfunded liabilities? Is that roughly the right number? Anyone?

Dr. Stone. That is the number I have heard. We have large deficits in the future, yes.

Mr. Duffy. Do you think we can tax our way out of these unfunded liabilities? Or at some point do we have to say:

What promises have we made? If you look at the expansive growth of government, at some point, instead of going we have to tax more to meet the obligations, should we not at some point say we have too many obligations? We have to cut back. We have to scale back. Instead of adding, you know, more onto the unfunded liabilities this country has.

Mr. Stone.

Dr. Stone. Our long-term budget deficit problem—unfunded liabilities is one measure. It is a little bit of a shaky measure. But there is no question that we have big budget deficits in the future.

It is almost exclusively driven by rising health care costs. Health care costs are rising faster than other costs in the economy, faster than GDP, and that is happening not just in the government programs but it is happening in the private programs as well.

If we find a way to get a handle on those costs, our budget deficit problem down the road becomes much more manageable. It is not about Social Security being out of control. It is not about discretionary spending being out of control. It is——

Mr. Duffy. One quick question before I have to turn it over. Am I correct that there is not an historic correlation between tax rates and revenue as a percentage of GDP? The actual correlation of rev-

enue to the federal coffers will actually correlate with GDP growth? So the basic point is, if you grow your economy so too do you grow revenues to the federal coffers, as opposed to raising taxes, doesn't necessarily bring in the growth that would be projected?

Dr. Stone. Well, we did in the 1990s have a very strong economy, raised a lot of revenue, brought the budget deficit down, produced surpluses, and then we gave it away.

Mr. Duffy. My time is up, and I hope we will have a second round and I will yield back.

Vice Chairman Brady. Thank you, Mr. Duffy. I would point out that from 1981 to 2001 we actually lowered the size of our Federal Government from about 23 percent of the economy to 18 percent and during that period grew about 37 million jobs. So there is no—in the private sector, predominantly, so there is no question there is a correlation between the size of government and job growth.

Mr. Campbell.

Mr. Campbell. Thank you, Mr. Chairman.

And to Mr. Mastromarco's opening comment about economists holding hands, I agree with some of what each of you said, and disagree with what some of each of you said. So I guess I am in that same camp.

But Mr. Hanlon, first for you. You mentioned about repealing the Bush tax cuts for higher income individuals. Okay, let's assume we do that. It's done. It's all done. That does not come close to closing the deficit. So are there other tax increases that you believe we ought to have?

Mr. Hanlon. Sure. No, I agree. It is certainly a first step, and it is not the only thing. And I would think, just in response to the questions before, I mean there is no doubt we need to do things on both the spending and the revenue side. I mean, I am not advocating for only raising taxes, and particularly health care. We need to get health care costs systemwide under control.

And so—but in terms of what else we can do to raise revenues beyond that, I think we do need to do that. I think the best way is to broaden the tax base and look at the tax expenditure budget. In particular, tax expenditures that provide a greater benefit for high income people because of what is called the upside-down effect, that people who pay higher marginal rates benefit more from the various incentives that are in the tax code.

There is a proposal to——

Mr. Campbell. Sorry, no, what I'm getting at is, there is a lot of rhetoric around this town these days about taxes on high-income individuals, but even if you do that it still is not that big an amount of money relative to the problem.

So my question is—and you have said there ought to be some stuff on the spending side as well. I understand that. But let's say we do whatever for high-income, raise the rate to whatever, do whatever you think ought to be there, do you also believe that as a part of this that there should be tax increases on—or reductions in tax expenditures, whatever, on people who are not high-income, or not?

Mr. Hanlon. So have a—we developed a plan called the—it's called "Budgeting for Growth and Prosperity," and it is basically a,

it was the challenge to basically balance the budget over a 20- 25-year time frame. And we tried to do that by avoiding tax increases on middle class people.

I mean, I think one way—you know, something we need is to put a price on carbon emissions, which solves two problems. I think you definitely want to protect low-income people from that. But that is another potential revenue source that can help in the long term.

Mr. Campbell. But that obviously hits middle class taxpayers.

Mr. Hanlon. Sure, it could, depending on how you structure it; yes.

Mr. Campbell. Okay. All right, Mr. Mastromarco, FairTax. One of the things you did not mention in this argument, one of the arguments that a lot of FairTax people say is we can get rid of the IRS. There has to be a whole lot less enforcement, et cetera.

My concern has always been, if you take—and I do not know what number of a FairTax you have, but I have heard 23 percent or something. Let's just take that. I am from California. You add to our 10 percent sales tax, state sales tax. You are now up to 33 percent effectively consumption tax.

The incentive to avoid that tax and to take transactions and things underground would be enormous. And I have always thought that one of the problems with the FairTax is that it would be the opposite. You would actually need a much more intrusive enforcement mechanism than currently exists on the income tax.

What are your thoughts on that?

Mr. Mastromarco. Right. I really couldn't disagree more with that statement. And this is from somebody who has experience both as a tax practitioner and also has worked in tax——

Mr. Campbell. And by the way, I am a CPA and did tax returns for a living, and have a Masters in Taxation.

Mr. Mastromarco. So we should be kindred spirits on this.

Mr. Campbell. We should be. But like you say, joining hands and don't agree.

Mr. Mastromarco. Well, but part of it is defining the problems. That's the beginning, you know, and that's the good thing about what this Committee is doing, is to ask the right questions that lead to the right answers.

The good news is tax reform is coming. The bad news is, it is undefined.

There has been a lot of good work that Ms. Nina Olson, the National Tax Payer Advocate, has done, and through various reports, concerning what causes the tax gap; what causes this massive tax gap? Is it under-reporting.

What are the influences that deal with evasion? The first thing you have to understand, Congressman, is that the tax gap is really four different elements:

Honest taxpayers;

Confused taxpayers;

Game players; and

Evaders.

Under the FairTax, you pretty much eliminate the game players and the confused. I mean, it reduces the 9,000 code sections into how much did you sell the consumers? That is a pretty basic, easy

question. So it divides the line between evaders, game players, and those with excuses, pretty well.

All right, so then we look to evaders. What influences that? The number of taxpayers, they diminish by about 90 percent. 85 percent of the consumption taxes are paid by about 15 percent of the retailers. The opportunities they have for evasion in the code diminish. I could drop the code on the floor, you could too, and we could tell people how to avoid the taxes on any page. This is a very simple plan.

Third, marginal rates—and that is where you were focusing on—marginal rates; marginal rates under the FairTax are the lowest of any conceivable plan that could be developed. The base is twice that taxable income—23 percent—as opposed to 15.3 percent payroll taxes under the current system, plus. Let's take a taxpayer at 28 percent; that's 43 percent.

So if you're going to rob a bank, the question is: Do you rob the one with gold? Or do you rob the one with iron ore?

Mr. Campbell. Yes. And I think the Chairman is saying my time is up, so this will be a continuing discussion. But my concern is that you turn—it is like prohibition. You turn a lot of honest people into dishonest people because of the size of the benefit of becoming someone who does not pay taxes. But my time is over. Thank you, Mr. Chairman.

Vice Chairman Brady. Thank you, Mr. Campbell. We normally conclude at the end of the first round, but let me quickly offer the chance for a follow-up question from any of the members here on the panel.

Mr. Duffy.

Mr. Duffy. If I could just quickly. Mr. Hanlon, I think you indicated you would support a carbon tax? Is that right?

Mr. Hanlon. Some kind of price on carbon emissions.

Mr. Duffy. Is that so we would have a cleaner environment and less carbon emissions?

Mr. Hanlon. Yes.

Mr. Duffy. Okay. And you would admit that if you tax carbon, you get less of it? Less carbon emission, right?

Mr. Hanlon. Sure.

Mr. Duffy. And we tax cigarettes, as well, because we want people to smoke less, too, right?

Mr. Hanlon. Um-hmm.

Mr. Duffy. And so if we extend this argument out, if you tax income, if you tax capital, you will get less of that, as well? Right?

Mr. Hanlon. I see where you're going. I mean, certainly——

Mr. Duffy. Why does it work for carbon and it does not apply to every other principle we have talked about today?

Mr. Hanlon. Well it does apply, but you need to look at, you know, for example—we've talked about savings a lot, but we need to look at our national savings rate. And when we——

Mr. Duffy. But I think the point is, when we talk about taxes, I think you made the exact point. You tax carbon because you want less of it. You want to tax income, you want to tax capital, and you are going to get less of it. And if you look at the issues in the country today, it is an issue about the economy and jobs.

We want to see investment in America. We want to see expansion in America which will in the end lead to economic growth, and job creation. But here you sit here and advocate for greater taxes, and we will get less of that when we increase taxes. And that is my concern with the two of your positions, Mr. Stone and Mr. Hanlon.

I know that you guys have probably followed what we have done in the House. We have tried to, in our budget, make a proposal for tax reform where we are going to take the top rate from 35 to 25 percent and do away with quite a few of the loopholes, make it fairer, flatter, simpler. We're not quite where Mr. Mastromarco is with a FairTax, but we are going in that direction.

Would you all agree that that is a better system? Was anyone opposed to what we were trying to do in our budget with tax reform?

Dr. Stone. Sure. I'll be the devil's advocate here.

Mr. Duffy. I thought you would be.

Dr. Stone. The problem is that when we talk only about the problems with marginal tax rates affecting activities that we value, there are also government activities that only government can do—defense, some kinds of infrastructure—for the size of government that we need. And the problem that we have with most of the proposals in the House is that they just set the level way too low for the revenue that they are trying to raise relative to what is realistic in our political system, what is realistic in terms of our aging population and our needs.

And so if you—the principle is fine. It is just that the level of spending and revenue does not seem as though it will work.

Mr. Duffy. Mr. Entin.

Mr. Entin. If you get the tax base right, you are going to get some added growth. Then the needs may go down. If you get the tax base right, people will see the full cost of government instead of having it hidden here and there. And they might not want as much government.

You don't know what you need until you get things right. So that needs to be done.

Second, the burden tables that people talk about—this tax falls on this person, this tax falls on that person are misleading. If the tax is changing the size of the economy and the level of wages, it is bound to be shifted to the middle class. If you do something that depresses wages, they are going to be hurt even if it is not on the burden table.

The burden tables are nonsense. They do not take the effect on the economy into account.

Mr. Duffy. Right.

Mr. Entin. The tax expenditure list is a problem. In the late Bush Administration, right up through the 2009 budget, they had a chapter on tax expenditures. That is required. But in those years, they put in the tax expenditures as they would appear under the so-called broad-based income tax, and then another set of tax expenditures as they would appear under a neutral tax system. And most of the major tax expenditures simply vanished because under a neutral tax system they are not tax expenditures, they are the right treatment. All pension plans under a consumed income tax—where you put down your income, subtract your saving, and pay

tax on what is left, and when you withdraw from a pension you add it to your income—are the norm. But they are viewed as a big tax expenditure under the income tax. That misperception goes away under the consumption base.

The same is true as you go down through all the major tax expenditures, even in the housing sector. OMB got that one wrong. They messed that up. Under current law, even housing is treated correctly as it would be under a consumption tax base.

When you look at tax expenditures as they are commonly presented, you get a bad idea for tax reform because you are going to start raising taxes on capital. Capital responds more to taxes than labor. I am not an advocate of higher tax rates. But if I had to choose one thing in the Bush plan to let go, I would say let the two top rates go up. They hit CEOs. They hit high-paid attorneys. They hit high-paid athletes. They hit entertainers. And they also hit some entrepreneurs. But give the entrepreneurs expensing in exchange on a permanent basis and they will be held harmless.

If you want a lot of revenue, you are going to have to tax middle class workers. But if you tax them on consumption instead of income, at least they will be free to save and invest and try and get out from under it and have a decent retirement. Watch your base. That is more important than almost anything else.

Mr. Duffy. And it is fair to say that is why we went from not just millionaires and billionaires, as the President talked about, he actually went to those who made $200,000, $250,000 because that is where the money is at. The lower you go, the more people you hit.

Mr. Mastromarco. Yes. But you will not just hit them. There will be less capital formation, and then everybody will have a lower wage, including all the way down the income scale.

Mr. Duffy. Absolutely. I yield back. But I appreciate the panel coming in. I think it is a great discussion, seeing a couple of different sides of you and everyone sitting nicely and engaging. I appreciate you guys.

Mr. Campbell. Holding hands.

Mr. Duffy. Holding hands, yes.

Vice Chairman Brady. Well I want to follow up on that. I want to thank our witnesses for being here today. You know, some experts believe the 1800s was the British Century. 1900s was the American Century. And this is the China Century. I am not convinced we need to cede the strongest economy in the world to our Asian competitor.

Part of that competitiveness and retaining that is a tax code for the 21st Century, that makes us competitive, that rewards that investment, that boosts our economy. Today we heard both pros and cons on how best to do that, but I think the lawmakers today who believe this is perhaps, along with getting our financial house in order, the strongest reform and change we can make to keep the world's largest economy are right. This is critical to get the broad range of debate about this. I want to thank our witnesses for being here today, and your insights on the various areas. I want to thank our lawmakers for taking time again to focus on the most important issue before us in the economy. And with that, the hearing is adjourned.

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[Whereupon, at 11:21 a.m., the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

Joint Economic Committee
Republicans Representative Kevin Brady, *Vice Chairman*

NEWS RELEASE

For Immediate Release
November 17, 2011

Press Release #112-14
Contact: Al Felzenberg
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STATEMENT OF VICE CHAIRMAN KEVIN BRADY

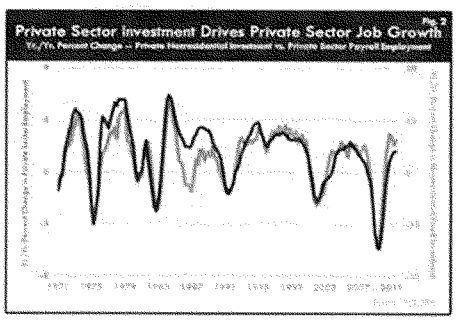
Could Tax Reform Boost Business Investment and Job Creation?

Washington, DC – There is no question that President Obama inherited a poor economy, but after three years his policies have made it worse. The massive stimulus failed to jumpstart the economy and restore consumer confidence as he promised. In fact, today there are 1.3 million fewer payroll jobs in America than when the first stimulus began. Now, 25 million Americans can't find a full-time job or any work at all. Hardworking taxpayers have paid a steep price in this Obama economy.

After exploding America's national debt in his first round of stimulus, the President now is out campaigning to raise income taxes on hardworking, successful Americans and local small business owners to pay for yet a second round of stimulus spending aimed at jobs in the government sector.

It's a basic principle of economics that if you want less of something "tax it more" and if you want more of something "tax it less" or not at all. Common sense tells us that Washington taking more of what investors earn will only reduce investment in new jobs, research, and expansions.

History proves that it's business investment in new buildings, equipment, and software that drives jobs along Main Street. One glance at the chart behind me – which tracks business investment and private-sector job creation for the past 40 years in America – clearly shows that job creation in America will not rebound unless private investment rebounds. While government spending in America is still above the level when the recession began, it is jobs and real business investment that have not recovered to their pre-recession levels more than two full years after the recession officially ended.



Putting Americans back to work - not taking more from small businesses and successful professionals - is the most effective way to grow federal revenues. Instead of increasing marginal tax rates, how about permanently lowering marginal rates to encourage business to invest and hire more workers? Or how about creating a 21st century tax code based on flatter rates and a territorial tax regime like our global competitors? Why not consider a transparent, straight forward retail sales tax that replaces the income, business, payroll, gift and death taxes and finally eliminates much of the complexity, burden and special interest provisions that comprise our current mess of tax laws.

If lower rates, for example, were accompanied by the removal of many of the complicated provisions that have been added to the tax code—often because marginal rates are so high—we would kick-start investment and job creation by the private sector while naturally generating additional tax revenue to lower future federal budget deficits. A consumption-based tax would do the same.

(OVER)

Consider our high corporate tax rate and the requirement that U.S. companies pay that high rate when bringing home profits that were earned and taxed overseas. We should lower or remove that tax gate to allow an estimated $1 trillion in stranded profits overseas to flow back into America to fund new jobs, research, buildings, and expansions. It's a free-market stimulus that doesn't cost federal money – but rather generates it.

Many of my Democratic colleagues charge that lowering tax rates would favor the "rich." But nearly half of American families already pay no federal income tax and the top one percent of wage earners already shoulder nearly 40% of the income tax burden – the top ten percent over 70%. America already has one of the most progressive tax codes in the world and now the highest corporate tax rate among our global competitors. How much more should Washington take?

As for job creation, capital income is subject to multiple layers of taxation in the form of corporate income, dividend, and estate taxes. Business taxation is inordinately complex and imposes economic distortions and compliance costs that have no offsetting benefit to society whatsoever.

Yet, history proves that lowering the marginal tax rate on capital income increases business investment. In turn, more investment creates new private sector jobs. More investment means higher real wages for American workers. This happened in the 1960s and the 1980s and can happen again.

A common myth has arisen surrounding the so-called Buffett rule. But an analysis by my Joint Economic Committee staff of IRS taxpayer data prove President Obama's campaign assertions to be untrue: high-income Americans on average pay income tax rates three times higher than the middle class, more than 60 percent of their income is ordinary income not passive investment income, and the 400 highest income earners in America are not the same people year to year but a constantly changing set of taxpaying Americans.

That last point is important. For seventeen years – from 1992 to 2008 – the 400 highest income returns each year were comprised of 6,800 returns in total representing 3,672 different taxpayers. Of these taxpayers only one-quarter appeared more than once and only 15% appeared twice. In any given year, on average, about 39 percent of the top 400 adjusted gross income returns were filed by taxpayers that are not in any of the other 16 years – not any. Only four of the more than 3,000 taxpayers made the top 400 all 17 years.

That's because America is the land of opportunity. Anyone, anywhere, regardless of your birth or your station in life can earn your way into the wealthiest taxpayers in the nation. Mr. President, what's so wrong with that? Why are you intent on dividing our nation, pitting one American against another because of their success?

Americans who work hard and play by the rules want productive jobs and a fair shot at success. They do not want handouts, bailouts, stimulus or temporary make-work jobs. They understand that paying taxes is part of citizenship.

Americans should be able to find a good job and be able to make some contribution to the cost of the federal government. But for American workers to win in the global economy, American entrepreneurs must risk their capital to create the tools that American workers need to succeed.

If Washington is intent on growing the government rather than growing the economy and insists on taxing those hardworking taxpayers who supply the opportunities and the jobs at high rates, in the end it is American workers who will be worse off.

Today we have before us witnesses who are advocates of major tax reforms designed to generate revenue for the federal government with a minimum of economic interference and allowances for very low income families. What both ideas share is a commitment to reduce the after-tax cost to make job-creating, income-producing investments in the United States. And that is what the American economy needs to kick-start the engine of job creation.

I look forward to hearing the testimony of today's witnesses.

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Institute For Research On The Economics Of Taxation (IRET)

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

before the

Joint Economic Committee
hearing on
Tax Reform Options: What Changes Would Generate the Greatest Growth for the Money

November 17, 2011

Chairman Casey, Vice Chairman Brady, and Members of the Committee, my name is Stephen J. Entin. I am President of the Institute for Research on the Economics of Taxation. Thank you for the opportunity to testify today on the subject of tax changes that would generate the greatest growth for the economy while being affordable for the federal budget.

I hope to address two issues in the hearing title. First, how do various tax changes affect the economy, people's employment opportunities, capital formation, and incomes? Second, what are the consequences for the federal budget of various types of tax changes? If we look only at the federal budget effects of tax proposals, and forget about the economic consequences, we will miss what is most important — the public welfare — and we will get the budget numbers wrong.

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Let me state some important conclusions up front:

- Taxes affect the economy by altering incentives to work, save, and invest, not by handing out money to spend or taking it away.

- The income tax is heavily biased against saving and investment.

- The burden of higher taxes on capital formation falls largely on labor in the form of lower wages and hours worked.

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

- Keeping the current treatment of gains and dividends while cutting the corporate tax rate would raise GDP, employment, and wages. It would increase, not decrease, federal revenue over time.

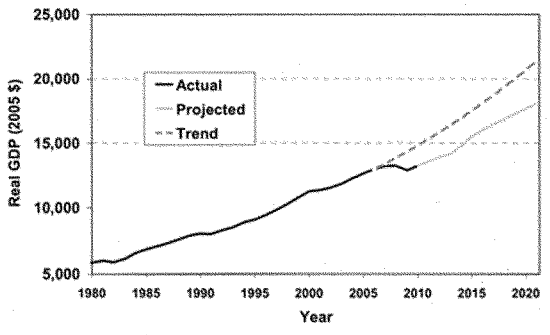
- The definition of the tax base (taxable income) is at least as important as the tax rate. Overstating business income by undercounting investment expenses (depreciation) leads to less investment and lower wages. Expensing is the right approach, and gains revenue over time.

- We should not repeat the Tax Reform Act of 1986, which tried to perfect the "broad-based income tax"; rather, we should adopt a different tax base that is more neutral in its treatment of saving and investment relative to consumption.

- Higher marginal tax rates on any group, especially those already paying the highest rates, would reduce GDP and income across the board, not just for the people paying the initial tax bill.

It is important that any tax reform promote economic growth, because lack of growth is the source of lower incomes, higher unemployment, and much of the current deficit. Chart 1 projects the GDP as if it had continued beyond 2006 at the trend rate of real growth since 1950. We are now some 12 percent below

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



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

that level, due to the recession and the financial industry debacle. CBO does not envision a recovery to that trend line in its forecast under current policy. That is a shame, because the lower levels of GDP mean lower levels of income and employment for all. CBO assumes reductions in unemployment largely by assuming workers become discouraged and leave the labor force. There is more at stake than the federal budget. As for the budget, the shortfall is responsible for about 40 percent of the deficit. The jump in spending as a share of GDP since the recession adds about 13 percent more. With those two issues resolved, the deficit would be a more manageable 4 percent of GDP instead of nearer 8.5 percent.

Current tax system is biased against saving and investment.

Federal and state tax systems hit income that is saved harder than income used for consumption. At the federal level there are at least four layers of possible tax on income that is saved.

1) Income is taxed when first earned (the initial layer of tax). If one uses the after-tax income to buy food, clothing, or a television, one can generally eat, stay warm, and enjoy the entertainment with no additional federal tax (except for a few federal excise taxes).

2) But if one buys a bond or stock or invests in a small business with that after-tax income there is another layer of personal income tax on the stream of interest, dividends, profits or capital gains received on the saving (which is a tax on the "enjoyment" that one "buys" when one saves). The added layer of tax on these purchased income streams is the ***basic income tax bias against saving***.

3) If the saving is in corporate stock, there is also the corporate tax to be paid before any distribution to the shareholder, or any reinvestment of retained after-tax earnings to increase the value of the business. (Whether the after-tax corporate income is paid as a dividend, or reinvested to raise the value of the business, which creates a capital gain, corporate income is taxed twice — ***the double taxation of corporate income***.)

4) If a modest amount is left at death (beyond an exempt amount that is barely enough to keep a couple in an assisted living facility for a decade), it is taxed again by ***the estate and gift tax***.

An additional problem is that depreciation understates costs, overstates income, and effectively raises the tax rate on investment returns. Depreciation makes businesses wait to claim part of the cost of their investment. The delay reduces the value of the write-offs due to the time value of money and inflation.

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

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

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

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

- Step 4: Eliminate the estate tax.

- Step 5: Move to a territorial tax system.

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

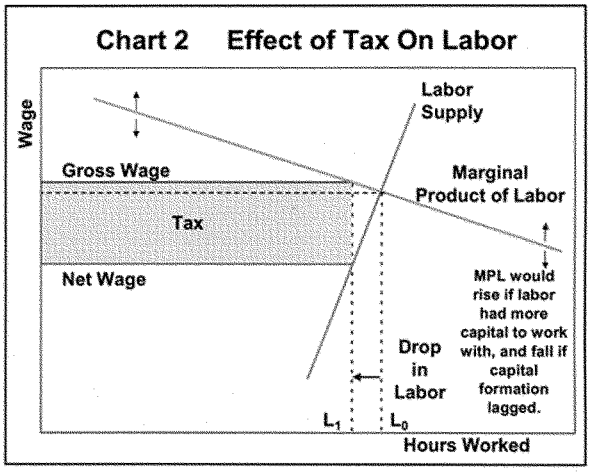
There are several less-biased, more growth-friendly tax alternatives, such as the cash flow in the Report of the tax President's Panel on Tax Reform — the Bush panel — or the Flat Tax, various versions of the USA Tax, or the Bradford "X" tax, or the straightforward inflow-outflow tax developed by Norman Ture (available at http://iret.org/pub/ inflow_ outflow.pdf). Real tax reform would move toward one of these systems. Other saving consumption neutral tax systems include the VAT and the national sales tax. These are somewhat less visible to the taxpayer, and are more of a change from the current system, but are equally less damaging to growth and income.

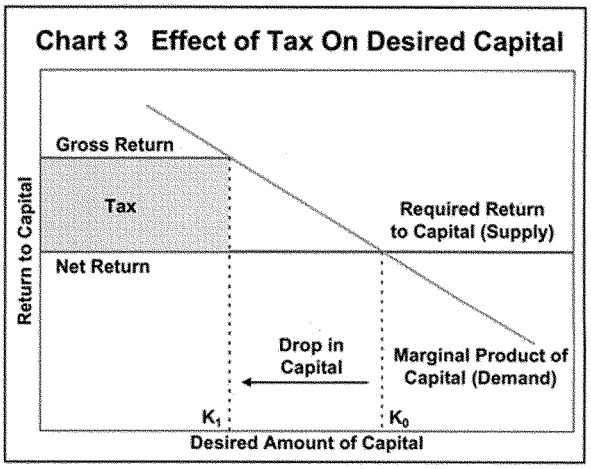
How taxes affect the economy: Effects of marginal income tax rates on labor and capital.

Taxes at the margin on incremental labor and capital force up the cost of labor and capital, and reduce the quantity offered and employed. The supply of labor is not very elastic. Consequently, much of any tax imposed on labor is borne by the workers. (See Chart 2.) Most people must work to have a satisfactory income, and many must conform their hours of work to the requirements of their employers. Moving across national borders is less of an option for labor than for capital. (Workers have some choices — to take or reject overtime, to contribute a second family earner to the labor force, how long to vacation, and when to retire.)

The quantity of capital is more sensitive to taxes than is the quantity of labor. When a tax is imposed on capital, the quantity of capital employed falls until the rate of return rises to cover the

tax, leaving the after-tax return about where it was before the tax. The tax is largely shifted to users of capital and those who work with it. (See Chart 3.) Capital is easily reproduced (elastic supply) and it takes a large change in the quantity to make much of a change in its rate of return. As for people's willingness to finance capital formation, people can always consume instead of save, or invest abroad instead of in the United States, if the rate of return on saving and investment is driven down by rising taxes.





The size of the capital stock and the level of investment depend on the service price of capital. The service price is the before-tax rate of return that an investment must earn to pay the taxes owed, cover its cost (depreciation), and yield a normal after-tax return to its owner. A tax increase on capital income raises the service price, and renders impractical any investment projects that cannot meet the higher service price. A tax reduction on capital income lowers the service price, and makes additional investment projects possible.

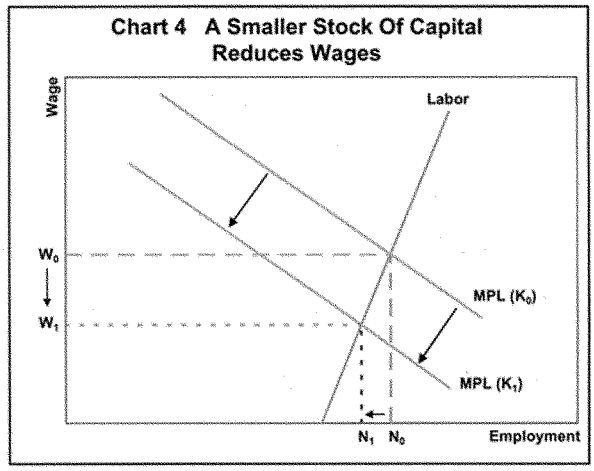
Each percentage point reduction in the service price of capital increases the capital stock over time by about 1.5%. The resulting increase in the productivity of labor increases the demand for

labor, and raises the total wage bill by a roughly similar percent. Private sector GDP rises by about 1.5%, with about two-thirds going to labor income and about one-third going to capital income, pre-tax. Various layers of government take a bit over 30% of the increase in income as taxes, a revenue gain of about $40 billion to $50 billion a year. Increases in the service price have the opposite effect on incomes and tax revenues. Failure to account for the changes in GDP and incomes, particularly labor incomes, seriously distorts the estimated revenue consequence of changes in taxation of capital.

Every tax bill relating to capital income and cost recovery that Congress considers should be examined for its effect on the service price of capital. The Joint Committee on Taxation, in conjunction with the Congressional Budget Office, should develop or borrow the software to conduct that calculation, and report the result to the Finance and Ways and Means Committees along with the (static) revenue estimate. If the bill increases the service price, it will reduce investment and GDP, which will reduce or eliminate the expected revenue from the provision. If the bill lowers the service price, it will raise GDP, which will provide some revenue reflow. If you are comparing two tax provisions, and one raises the service price more than the other relative to the amount of revenue expected to be raised, then that bill will do more economic damage, per dollar of revenue raised, than the other.

The tax treatment of capital hurts labor.

The more there is of any one type of factor, the higher will be the productivity and incomes of the other factors that work with it and gain from its presence. A tax that reduces the quantity of capital lowers the productivity of labor, the demand for labor, and the wages of labor. Labor thus bears much of the burden of the tax on capital. (See Chart 4.) Because capital is more sensitive to taxation than labor, a tax on capital will have a relatively large adverse impact on the quantity of capital, which will then cause a relatively large drop in the marginal product and compensation of labor.



Consider a small trucking company with five vehicles. Suppose that the rules for depreciating trucks for tax purposes change, with the government demanding that the trucks be written off over five years instead of three. The owner has had enough business to run four trucks flat out, and a fifth part time. He is barely breaking

even on the fifth truck under old law. It is now time to replace one of the trucks. Under the new tax regime, it does not quite pay to maintain the fifth truck. The owner decides not to replace it, and his income is only slightly affected. But what happens to the wages of the fifth truck driver? If he is laid off, who bears the burden of the tax increase on the capital?

The differences in the elasticities of supply and demand for labor and capital suggest that there is an economic advantage to moving away from the so-called broad-based income tax, which taxes income used for saving and capital formation *more heavily* than income used for consumption, to various taxes that are saving-consumption neutral.

Several studies in the economic literature illustrate that a zero tax rate on capital income would raise the after-tax income of labor, in present value terms, even if labor must pick up the tab for the lost tax revenue.[1] Productivity and wages would be higher (Chart 4 in reverse), leaving workers with higher gross wages and more after-tax income.

Simulating tax increases on upper income taxpayers.

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

I have run five potential variations of the pending tax increases on upper income taxpayers through a simple model of the economy and a tax calculator geared to 2008 income levels.[2] The results are displayed in Tables 1 and 2. The model is driven by the effect of the tax changes on marginal tax rates on labor income and on the service price of capital. Raising the top tax rates on capital gains and dividends would have a very significant effect on GDP, enough to eliminate any projected revenue gains. Raising the tax rates in the top two tax brackets would also have a significant effect, although not as great as an increase in capital gains and dividend taxation. The top rate increases would lose about 40 percent of the anticipated revenue.

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

This tax increase on wages, interest, and non-corporate business income would knock half a percent off private sector output and labor income across the board (not just in the upper tax brackets), and cut a percent off the capital stock. The service price rises primarily for non-corporate businesses. (See Table 1). The reduced income and economic activity would reduce federal revenue

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

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

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

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

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

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

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

from all types of taxes by about 40% of the expected static revenue gain. The loss of GDP and the tax payment to the government would cost the public $4 for each $1 collected in tax. Government spending funded in this manner must be worth a great deal more than its apparent budget cost of $1 to justify the outlay. The marginal tax rate increase on non-corporate business income is particularly high. (See Table 2.)

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

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

The 15% top tax rate on capital gains and dividends is a step toward fundamental tax reform. It may be thought of as mitigating the double taxation of corporate income. Alternatively, it may be viewed as offsetting some of the basic income tax bias against saving, in effect extending to more saving about half of the tax relief given under Roth IRAs.

The tax on capital gains is a double tax even for the non-corporate sector. The current value of a share of stock or a non-corporate business is the present (discounted) value of its future after-tax earnings. If for any reason (reinvested earnings, discovery of a better mousetrap, etc.) future earnings are expected to rise, the current value of the business or price of the stock will rise. If the future income does rise, that added income will be taxed when earned. To also tax the associated increase in the present value of the business is to double tax the future income.

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

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

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

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

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

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

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

Payroll taxes, the personal exemption, and the standard deduction.

The current and proposed temporary payroll tax holidays should have a minor effect on GDP because business investment is slow and the demand for labor is weak. Even if the payroll tax were reduced permanently, it would have limited effect on the GDP because the supply of labor is rather inelastic. Increases in the personal exemption and standard deduction have limited effect on marginal tax rates and GDP. They lower the tax on additional income only if they drop a taxpayer from one tax bracket to another, or off the tax rolls entirely. None of these tax reductions boost "demand" and consumption spending in the aggregate because the government has had to borrow additional money to cover the reduction in revenue, reducing other private sector spending. There are no initial or first order Keynesian demand effects from a tax cut or government spending increase. There are no magic "multipliers". Demand rises only if output and income rise first due to increased productive activity incentivized by higher expected after-tax returns to labor and capital.

Table 3 shows three additional model runs (Cases 6-8), a 2% and 4.1% reduction in the payroll tax, and a 10% increase in the personal exemptions and the standard deduction. The payroll tax cuts return only about 13% of their static revenue cost through economic growth. The exemption

Table 3
EFFECT OF CUTTING PAYROLL TAXES AND RAISING PERSONAL EXEMPTION AND STANDARD DEDUCTION ON GDP, CAPITAL STOCK, LABOR INCOME, SERVICE PRICE, AND FEDERAL REVENUE
(Effects and revenue estimates are modeled at 2008 income levels.)

Tax options	6*	7*	8*
GDP	0.64%	1.31%	0.10%
Private sector GDP	0.73%	1.49%	0.11%
Capital stock	0.67%	1.40%	0.15%
Wages	-0.03%	-0.04%	0.02%
Hours worked	0.75%	1.54%	0.10%
Million jobs	1.06	2.15	0.14
Service price			
Corporate	0.06%	0.09%	-0.02%
Non-corporate	0.05%	0.11%	-0.08%
Total	0.06%	0.09%	-0.04%
Static revenue ($ billions)	$147.2	-$301.7	-$14.0
Dynamic revenue ($ billions)	$127.2	-$262.4	-$10.7
% revenue regained from economic change	13.6%	13.0%	23.9%
GDP gain per $ of net revenue loss	$0.73	$0.72	$1.40
Cost of $1 of govt. spending	$1.73	$1.72	$2.40

* Tax options:
6: Cut payroll tax 2% (reflects 2011 reduction)
7: Cut payroll tax 4.1% (reflects recent proposal)
8: Raise personal exemption and standard deduction 10%

and deduction change returns about 24%. The GDP increases are quite small, especially compared to the high static and dynamic revenue costs of reducing taxes in this manner. For example, the 4.1% payroll tax cut, (Case 7) costs $302 billion on a static basis (at 2008 income levels) and raises GDP by 1.3%, regaining 13% of the revenue, leaving a dynamic cost of $262 billion. Compare that to a static cost of only $38 billion for keeping the 15% caps on the tax rate on capital gains and dividends instead of letting them rise to 20%, which generates nearly the same additional GDP, but which returns all of the revenue on a dynamic basis after economic growth (Case 2).

Table 4
EFFECT OF EXPENSING FOR EQUIPMENT AND CUTTING THE CORPORATE TAX RATE ON GDP, CAPITAL STOCK, LABOR INCOME, SERVICE PRICE, AND FEDERAL REVENUE
(Effects and revenue estimates are modeled at 2008 income levels.)

Tax options	9*	10*	11*	12*
GDP	2.71%	2.33%	2.26%	2.05%
Private sector GDP	2.81%	2.41%	2.34%	2.13%
Capital stock	7.64%	6.54%	6.34%	5.75%
Wages	2.29%	1.97%	1.91%	1.74%
Hours worked	0.51%	0.44%	0.42%	0.38%
Million jobs	0.71	0.61	0.59	0.54
Service price				
Corporate	-5.56%	-5.58%	-5.58%	-4.94%
Non-corporate	-1.94%	0.17%	0.17%	0.15%
Total	-4.49%	-3.87%	-3.87%	-3.43%
Static revenue ($ billions)	-34.2	-20.2	-51.6	-46.5
Dynamic revenue ($ billions)	48.7	51.3	19.1	17.7
% revenue regained from economic change	243%	353%	137%	138%
GDP gain per $ of net revenue loss	n.a.**	n.a.**	n.a.**	n.a.**
Cost of $1 of govt. spending	n.a.**	n.a.**	n.a.**	n.a.**

* Tax options:
9: 100% expensing of equipment for all businesses
10: 100% expensing of equipment for corporate sector only
11: cut corporate tax rate to 25%
12: cut corporate tax rate to 26% to approx. domestic production credit

** Tax rate decrease raises GDP to the point of gaining revenue.

Expensing and corporate tax rate reduction

Table 4 displays the effect of altering expensing and the corporate tax rate.

- Case 9: The current provision for 100% expensing of equipment would raise GDP by 2.71% over time, if made permanent. Its static revenue cost of $34 billion would be converted to a dynamic revenue gain of $49 billion, a 243% reflow of revenue (at 2008 income levels). It focuses the tax reduction on newly acquired capital equipment, and is of particular interest to new or rapidly growing businesses. Eventually, all capital is replaced, so even established businesses gain as their stock of equipment rolls over.

• Case 10: The corporate sector's share of the expensing provision would boost GDP by 2.33%, or about 86% of the total expensing provision. Its static cost is $20 billion. Growth returns about $71 billion, or 353% of the static cost, for a net gain of $51 billion.

• Case 11: A reduction in the corporate tax rate to 25% would generate a 2.26% rise in GDP, about the same as the corporate expensing provision. It would have a higher static cost, about $52 billion, generate a similar $71 billion dollar reflow, or 137% of the static cost, and net the government a gain of $19 billion. The higher static cost is due to the application of the lower corporate tax rate to returns on existing capital as well as new capital. This approach favors established or slow growing businesses, or those with more investment in structures than equipment.

• Case 12: Part of the current corporate tax rate is offset by the manufacturer's deduction which reduces the effective top rate to 32.85% on eligible production. We approximate the effect of the cutting the corporate tax rate but eliminating the manufacturers' deduction in partial exchange by modeling a rate cut to 26% (instead of 25%). GDP would rise 2.05%, with a static cost of $47 billion and a dynamic gain of $18 billion.

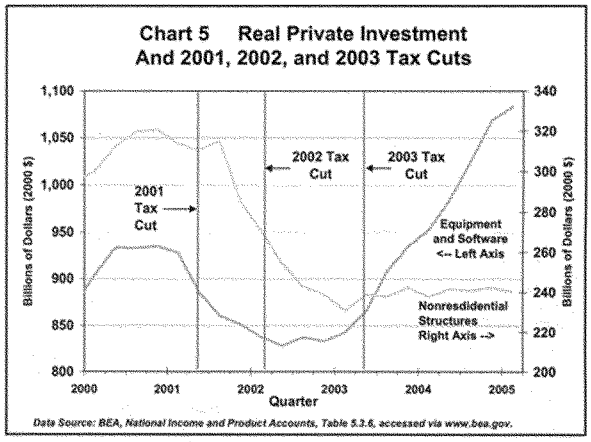
Giving up corporate expensing in exchange for a lower corporate tax rate in the range shown would yield similar GDP effects, but cost more revenue. It might please established businesses in the short run, but would not be as focused on rapid growth. The trade should not be necessary, because neither provision costs revenue after growth effects are considered. If Congress insists on relying solely on static revenue estimates, a lower short term revenue impact might be had by phasing in the corporate rate cut. If expensing must be altered, it could be replaced by a "neutral cost recovery system" in which the deferred portions of the depreciation write-off are augmented each year by an appropriate interest rate, such as inflation plus the long term real return on capital of about 3%. The present value of the deductible business cost for the investment would be preserved at 100 cents on the dollar.

Response of the economy to changes in the service price.

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

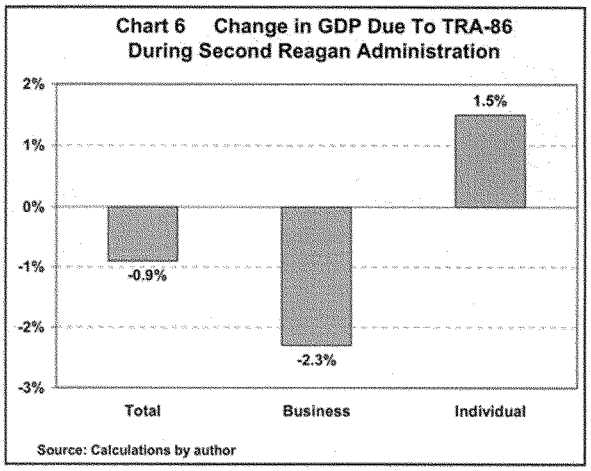
Chart 5 tracks the effect of the 2001 and 2003 tax cuts on GDP. There was a very slow "jobless recovery" from the 2000-2001 recession in the first two years after the 2001 tax reduction. The marginal rate cuts were phased in so slowly that there was little initial incentive effect. It was not until the 2003 tax cut that there were significant incentives for saving and investment. In that year, the capital gains and dividend tax rates were reduced to 15%; expensing, introduced in 2002 at 30% of equipment spending, was boosted to 50% of equipment outlays; and the rest of the

marginal tax rate cuts were brought forward. Estate tax relief helped too. After 2003, investment in equipment rose rapidly, and job growth accelerated.



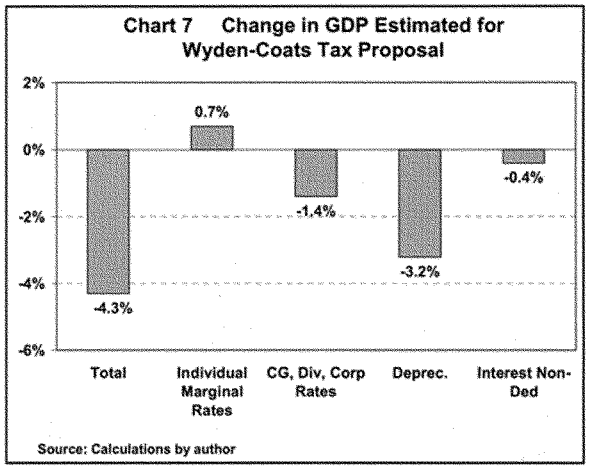
The Tax Reform Act of 1986 (TRA86)

TRA86 raised the net tax at the margin on capital and reduced it for labor. On balance, it slightly reduced potential output. (Chart 6.) The bill would have been a modest positive for the economy if Congress had followed the Treasury reform plan as submitted, but it did not. Treasury had recommended indexation of depreciation allowances for inflation. That would have helped to reduce slightly the required service price or "hurdle rate of return" that capital must earn in order to be a feasible investment, in spite of longer assets lives and repeal of the investment tax credit under the bill. Congress dropped the indexing provision, and the hurdle rate went up, discouraging investment.



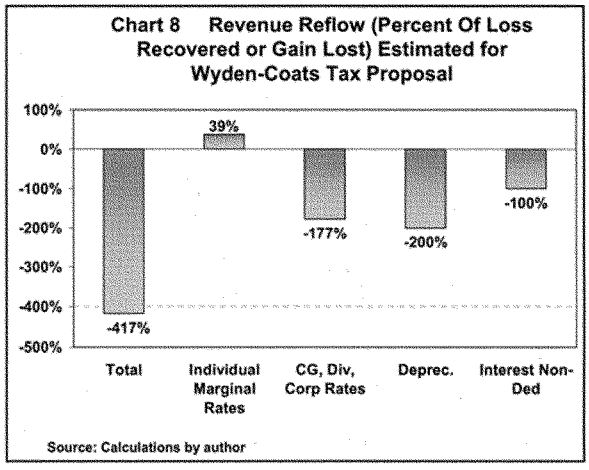
TRA86 cut the corporate rate 12 points from 46% to 34%, but offset about half that reduction by eliminating provisions that were already mitigating some of the corporate tax at the margin (loophole and preference closings). TRA86 cut the top individual tax rates from 50% to 28%, with a 33% rate bubble to recapture the benefits of rates below 28%. These cuts lowered the top tax rate on dividends to 28% or 33%. However, TRA86 also raised the top tax rates on capital gains from 20% to 28% or 33%. TRA86 raised taxes on capital in other

ways. It eliminated the investment tax credit. It switched from ACRS (accelerated cost recovery system) to MACRS (modified ACRS), with longer asset lives, especially for long lived structures, which went from 31.5 years to 39 years. Passive loss rules were tightened on real estate, and upper income taxpayers were limited in their access to IRAs. TRA86 is not a good model for creating a pro-growth fundamental tax reform. It moved away from a neutral tax base toward a more-inclusive and more anti-investment version of the broad-based income tax.



Wyden-Coats

The Wyden-Coats bill (formerly Wyden-Gregg) and the Bowles-Simpson Commission emulate TRA86. They would cut tax rates on businesses in exchange for higher tax rates on capital gains and dividends, and much slower tax depreciation of plant, equipment, and structures. They are heavier on the penalties and lighter on the rate reductions than TRA86, and would do even more damage to GDP and employment. They cut taxes where the growth benefits are small, and on balance raise taxes where the adverse effects are large.



Wyden-Coats, in particular, would revert to asset lives of the old Guidelines system from 1961, but make them even worse with straight line depreciation instead of double declining balance. The bill would raise the tax on capital gains and

dividends from a maximum of 15% to 22.75%. Expensing would end for large firms doing most of the nation's investment. Businesses would not be allowed a deduction for the inflation portion of their interest costs, but lenders would be taxed on the full amount of interest received. The bill would increase the standard deduction to 2.5 times its current level. The top individual rate would remain at 35%. The graduated corporate tax rates with a top rate of 35% would be replaced by a flat 24% rate. The depreciation changes and the higher tax rates on capital gains and dividends would make the bill a strong negative for the economy, in spite of the rate cuts and enlarged standard deduction. The service price would soar 11%. The ultimate drop in GDP would be 4.32%. A static revenue increase of $33 billion would turn into a revenue loss of $105 billion. (Charts 7 and 8.)

Response of capital gains realizations to higher tax rates.

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

Table 5 is from the Department of the Treasury, Office of Tax Analysis. It displays the amount of capital gains realized and the tax paid in dollars, the average effective tax rate, realized gains as a percent of GDP, and the maximum tax rate on long-term gains from 1954 to 2007. The numbers cover all types of capital gains, including those on real estate, corporate stock, non-corporate businesses, bonds, and other assets. The maximum rate includes adjustments for exclusions, surcharges, the minimum tax and alternative minimum tax, and the phase-out of itemized deductions as income rises. These are features of the tax code that have been in place at various times.

There have been four major reductions and two major increases in the capital gains tax rate since 1968.

The Johnson surtax and increases in the Minimum Tax under Nixon and Ford raised the top tax rate on long term gains from 25% in 1967 to nearly 40%. Realizations fell from over 3% of GDP in 1967-69 to about 2% of GDP in 1974-78. The Steiger Amendment The Steiger Amendment lowered the top tax rate most commonly found on long term capital gains in mid- 1978, from just under 40% to 28%. It eliminated capital gains as a preference item under the minimum tax and created a 60% exclusion of long term gains from taxable income. Realizations were 2.20% of GDP in 1978, and rose by about a fourth to between 2.58% and 2.86% of GDP in 1979-1981. The Economic Recovery Tax Act of 1981 reduced the top rate to 20% in the spring of that year. Realizations were 2.77% of GDP in 1982, rising to 3.47% in 1983 and 4.08% in 1985.

The longest and most interesting change occurred following the Tax Reform Act of 1986, which raised the top capital gains tax rate from 20% back to 28%. The rate hike was effective January 1, 1987. To beat the 1987 rate hike, asset holders realized a large amount of capital gains

Table 5
Capital Gains and Taxes Paid on Capital Gains
for Returns with Positive Net Capital Gains, 1954-2005
(dollar amounts in millions)

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

Department of the Treasury
Office of Tax Analysis

January 14, 2010

1/ Preliminary estimate, subject to revision.

in the last months of 1986. Realizations surged from 4.08% of GDP in 1985 to 7.36% in 1986. There was a subsequent drop in realizations in 1987, to 3.13% of GDP.

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

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

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

Competitiveness

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

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

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

Conclusion

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

Tax cuts that reduce the biases in the income tax against saving and investment give the most "bang for the buck". These include expensing or some form of neutral cost recovery for depreciable assets, followed by cuts in the corporate tax rate and elimination of the estate tax. These cuts would not cost revenue after growth effects are factored in. Reductions in the top tax rates for individuals rank next. About 40% of their revenue loss would be recovered. Far less growth and revenue reflow is achieved by increases in personal exemptions or the standard deduction, or cuts in the payroll tax.

Endnotes

1. Martin Feldstein, "Incidence of a Capital Income Tax in a Growing Economy with Variable Savings Rates," *The Review of Economic Studies*, 41(4), 1974, pp. 505-513. Christophe Chamley, "Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives," *Econometrica*, 54, May 1986, pp. 607-22. Kenneth L. Judd, "Redistributive Taxation in a Simple Perfect Foresight Model," *Journal of Public Economics*, 28, October 1985, pp. 59-83. Also, see Kenneth L. Judd, "A Dynamic Theory of Factor Taxation," *American Economic Review*, 77, May 1987, pp. 42-48; H. Greg Mankiw, "The Savers-Spenders Theory of Fiscal Policy," *American Economic Review*, 90(2), 2000, pp. 120-125; and Casey B. Mulligan, "Capital Tax Incidence: First Impressions from the Time Series," NBER Working Paper 9374, National Bureau of Economic Research, Cambridge, MA, December 2002. Andrew Atkeson, V.V. Chari, and Patrick J. Kehoe, "Taxing Capital Income: A Bad Idea," *Federal Reserve Bank of Minneapolis Quarterly Review*, Vol. 23, No. 3, Summer 1999, pp. 3-17.

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

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November 17, 2011

TESTIMONY OF CHAD STONE
CHIEF ECONOMIST, CENTER ON BUDGET AND POLICY PRIORITIES

Before the
Joint Economic Committee
United States Congress

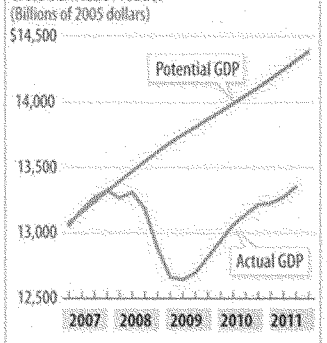
Hearing on "Could Tax Reform Boost Business Investment and Job Creation"

Chairman Casey, Vice Chairman Brady, and other members of the Committee, thank you for the opportunity to testify before this committee, which has been special to me since I first worked on the JEC staff in 1989. In my testimony, I want to make one overarching point about the question raised by the title of this hearing, "Could tax reform boost business investment and job creation?" and a couple of other specific points about repatriation of foreign earnings and small businesses.

A Framework for Analysis

My overarching point is that in framing the question "could tax reform boost business investment and job creation," it is critically important to distinguish between policies likely to boost investment, economic activity, and job creation in the short term and policies likely to increase the economy's potential for sustainable long-term growth with broadly shared prosperity. The distinction can be illustrated with the help of Figure 1, which shows the current gap between the quantity of goods and services actually being produced (actual GDP) and the quantity that could be produced if the available workforce were fully employed and the country's businesses were operating at their full productive capacity (potential GDP).

FIGURE 1:
Economy Operating Well Below Full Capacity



Sources: Bureau of Economic Analysis and Congressional Budget Office

As the red line for actual GDP shows, the economy fell into a deep hole in the Great Recession of late 2007-2009. It started to come back following enactment of the American Recovery and Reinvestment Act of 2009 (ARRA), but growth has to be substantially faster than we have seen so far to close the gap and get the economy back on its long-run sustainable growth path (the blue line).

In evaluating the impact of tax reform we need to distinguish between two questions 1) would it be effective at stimulating economic growth in the short-term and erasing the output gap and jobs deficit (i.e., how would it affect the red line?) and 2) would it be effective at increasing the long-run capacity of the economy to produce goods and services (i.e., how would it affect the blue line?).

My reading of the economic evidence is that tax reform is unlikely to be an effective tool for speeding up economic growth in the short run. Tax reform *could* be a useful tool for enhancing growth in the longer run, but only in the context of a sound overall program for achieving long-term fiscal stabilization and not if it is used as an excuse to avoid the revenue increases that must necessarily be a part of any credible, sustainable deficit-reduction plan.

The Short-Term Problem: Inadequate Demand

With a huge output gap, high unemployment, and too much idle productive capacity, job #1 for policymakers should be jobs — putting people back to work and getting businesses back to operating at full capacity. Corporate tax reform, cutting top marginal tax rates, or reducing taxes on business income — none of these has anywhere near the short-term demand-creating, job-creating bang-for-the-buck of measures like those the President has proposed: extending federal emergency unemployment insurance, extending and expanding the payroll tax holiday, relatively quick acting infrastructure investments like repairing schools, and help to relieve pressure on state and local governments to lay off teachers, police, and firefighters.

Congressional Budget Office Director Douglas Elmendorf provided new CBO estimates of the impact of different policies for increasing economic growth and employment in 2012 and 2013 in testimony before the Senate Budget Committee, November 15, 2011.[1] Policies like increasing aid to the unemployed, reducing payroll taxes, and increasing aid to state governments ranked considerably higher in terms of both GDP and jobs generated per dollar of total budgetary cost ("bang-for-the-buck") than keeping the Bush income tax rates in 2013 rather than letting them expire as scheduled and business tax cuts that merely pad companies' bottom lines.

Almost by definition, excess unemployment and idle productive capacity mean the economy is suffering from inadequate aggregate demand for goods and services. I know there are some economists out there with models saying that all of the increase in unemployment since 2007 represents a structural mismatch between workers' skills and employers' needs or the sudden desire of large numbers of workers to take time off, but the most compelling explanation to most economists for why we have a 9 percent unemployment rate, tame inflationary expectations, and a large output gap is the textbook one: weak aggregate demand. Businesses are not able to sell all the goods and services they are capable of producing. Right now, putting more customers in their stores and giving those customers more money to spend is a far better way to encourage businesses to expand and hire more workers than giving them a tax break. After all, their stores are still half empty, and businesses are not going to produce more than they expect to sell.

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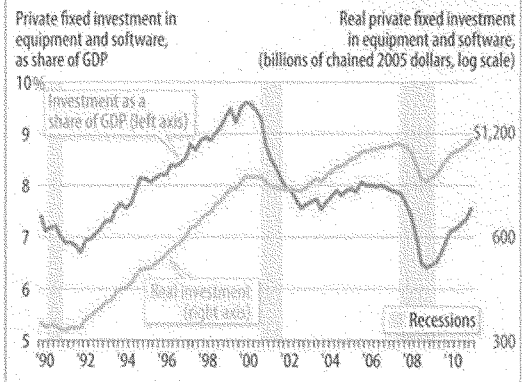
[1] Douglas Elmendorf, "Policies for Increasing Economic Growth and Employment in 2012 and 2013," Congressional Budget Office, testimony before the Senate Budget Committee, November 15, 2011: http://www.cbo.gov/ftpdocs/124xx/doc12437/11-15-Outlook_Stimulus_Testimony.pdf

The pattern of overall business investment in recent years is obscured by the boom and bust in business structures (new factories, plants, office buildings, stores, etc.). However, business investment in equipment and software has been solid so far in this expansion. As shown in Figure 2, such investment fell sharply in the recession but has since grown faster than GDP (as evidenced by the rise in equipment and software investment as a share of GDP). This investment growth has been far better in the early stages of this recovery, for example, than in the comparable stage of the recovery from the 2001 recession, although we are not quite back to 2007 levels as a share of GDP, much less the levels achieved in the 1990s.

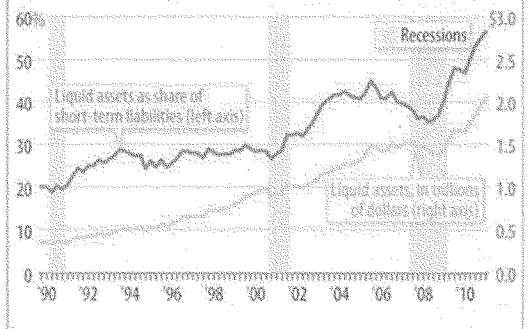
FIGURE 2:
Equipment and Software Investment Growing Faster Than GDP



Sources: Bureau of Economic Analysis and National Bureau of Economic Research

As Figure 3 shows, businesses are building up cash reserves relative to their short-term liabilities, as they did in the early stages of the previous two recessions while there was still excess unemployment and uncertainty about when sales would begin to pick up. Once it was clear a recovery was underway, cash reserves leveled off as a share of short-term liabilities. The magnitude of the current cash stockpiling is unprecedented, but the phenomenon is familiar. Firms are making profits, but as the current recovery struggles to gain traction, surveys show that firms continue to worry about weak economic growth and sluggish sales and so are building up cash until things pick up.

FIGURE 3:
Companies Are Flush With Cash



Sources: Federal Reserve and National Bureau of Economic Research

While the the cash reserves shown in Figure 3 are mostly held by large corporations, surveys of small businesses show a similar phenomenon. In National Federation of Business surveys of what concerns small business the most, taxes and regulation register at about the same level in both good economic times and bad, but weak sales quickly became the number one concern in the Great Recession and remain the number one concern of small businesses today.

To summarize, the major factor holding back investment and job creation in the current economy is weak sales due to inadequate aggregate demand and slow economic growth. Policies that increase aggregate *demand* are the best short-term policies for creating a more favorable environment for investment and job creation, and tax reform policies typically operate on the *supply* side of the equation. Measures like those in the President's American Jobs Act are likely to be much more effective at boosting aggregate demand and closing the jobs deficit — without adding to the long-term budget deficit, because they are temporary.

The Longer-Term Goal: Achieving Fiscal Stabilization and Promoting Shared Prosperity

Turning to the longer term, the question is how would tax reform affect the economy's potential to produce goods and services and its long-term growth path? This question needs to be addressed in the context of how we achieve long-term fiscal stabilization, which is critical to ensuring strong long-term growth and shared prosperity. In our judgment it is not possible to produce a credible, sustainable, long-term fiscal stabilization plan without acknowledging the need for more revenues.

As my colleague Kathy Ruffing showed in a recent paper,[2] revenue increases were a part of every major deficit-reduction package in the 1980s and 1990s until the Balanced Budget Act of 1997. In several cases — notably in 1982 and 1984 (where they offset a portion of President Reagan's large tax cuts of 1981) — they dominated the package. In several other cases — 1987, 1990, and 1993 — they contributed from one-third to more than one-half of the total savings (including the debt-service savings), and a larger share of the *policy* savings (i.e., if the debt service savings are set to the side rather than counted as a spending cut).

A key aim of fiscal sustainability is a stable or declining ratio of debt to GDP. To stabilize that ratio, we need to get deficits in the medium term down to about 3 percent of GDP. But under current policies, the deficit will be about 4 percent to 5 percent of GDP for the next decade even after the economy recovers and after we have phased down operations in Iraq and Afghanistan. So we need to cut the deficit by 1 percent to 2 percent of GDP in the coming decade — an amount that rivals the biggest deficit-reduction efforts of the past. Meanwhile, the nation faces a graying population and continued demands on government in the areas of defense, homeland security, veterans' care, infrastructure, and other needs; the amount of deficit reduction for future decades will need to be larger.

Given the size of that challenge, and the need to phase in any entitlement changes gradually, the next round of deficit reduction must include substantial revenue increases. Plans that rely on spending cuts alone do not acknowledge the changing realities of the U.S. economy and U.S. society or the preferences of the American people as revealed in poll after poll.

The tax reform mantra is: we can broaden the base, which will allow us to lower the rates, without any adverse effect on revenue. That's not good enough in the current budget situation, because we need to raise revenue. The fact that tax reform is not a panacea for our budget problems does not mean, however, that we should abandon the principle that *if we have enough revenue* to fund the size and role of government we want to have, broadening the tax base allows us to have

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[2] Kathy Ruffing, "The Composition of Past Deficit-Reduction Packages — and Lessons for the Next One," Center on Budget and Policy Priorities, November 14, 2011: http://www.cbpp.org/files/11-14-11bud2.pdf

lower tax rates. It means that we still have to make tough choices about taxes and spending. Taking a hard look at spending that occurs through the tax code —"tax expenditures," which are defined as revenue losses attributable to provisions of the tax code that provide special benefits to particular taxpayers or groups of taxpayers — should definitely be on the table.

A key point to keep in mind when discussing tax reform in the context of fiscal stabilization and long-term growth is that deficit reduction is much more critical to long-term growth (once the economy is back closer to full employment) than reducing taxes. As my colleague Paul Van de Water discussed in a recent paper,[3] even if revenue-neutral tax reform might produce some small economic growth benefits, it would be far more economically beneficial to use the additional revenues gained from limiting tax preferences to reduce budget deficits rather than cut marginal tax rates. When the economy is operating near or at its capacity, federal budget deficits reduce total saving in the economy, crowd out capital investment, and reduce the economy's potential rate of growth. Most economists believe that the adverse effect of higher deficits dominates the effect of higher tax rates.

For example, the Congressional Budget Office finds that permanent extension of the 2001 and 2003 tax cuts and AMT relief would *reduce* output in the long run if the extension is deficit-financed. Conversely, reducing the deficit once the economy is stronger will spur economic growth even if it requires higher tax rates. In other words, putting a dollar of budget savings into deficit reduction would do more to boost the economy's capacity to produce goods and services (potential GDP) than using that dollar to cut marginal tax rates, and any hit to the economy's capacity to produce goods and services from raising a dollar of taxes would be more than offset by the gain from reducing the deficit by a dollar.

In summary, in the longer run, the goal is to achieve the maximum sustainable growth rate in potential GDP. That comes from capital investment (including investment in infrastructure), investment in people in order to produce a well-trained, well-educated, adaptable workforce, and technological progress. Tax rates in the range we are talking about as part of a credible and sustainable debt stabilization plan are less harmful to growth than budget deficits of the kind we are projecting in the absence of such a plan. It's hard to be serious about long-term deficit reduction without recognizing that revenues have to be part of the solution. Supply side fantasies and dynamic scoring pipedreams won't cut it. So it makes sense to embrace an enduring principle of tax reform — that a broader tax base allows rates to be lower than a narrower tax base, but we also have to ensure we have enough revenue to pay for the things we want government to do — ranging from national defense to an adequate safety net. The debate should be about what we want government to do and how should we pay for it, not what can we squeeze into some arbitrarily determined limit on how much revenue we are willing to collect.

Other Observations

In the remainder of my testimony, I would like to touch on a couple of specific topics: the repatriation of foreign earnings and the impact of increases in the top marginal tax rate on small businesses.

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[3] Paul Van de Water, "Supercommittee Should Reject 'Dynamic Scoring': Estimates Are Uncertain and Subject to Manipulation," Center on Budget and Policy Priorities, October 18, 2011: http://www.cbpp.org/files/10-18-11bud.pdf

The Perils of Another Repatriation Tax Holiday

In 2004 policymakers were seduced by the idea that giving U.S. multinational companies a window in which they could repatriate overseas profits and pay a greatly reduced U.S. corporate income tax on those profits would be a boon to U.S. investment and job creation. But researchers have found scant evidence that the 2004 repatriation legislation produced such effects. Instead of expanding their operations and creating more jobs, most companies appear to have used their tax-favored repatriated income to pay dividends or buy back stock.

Studies by academic researchers, the Congressional Research Service (CRS), and others have found no convincing evidence that the 2004 holiday had any of the promised positive economic effects.[4] To the contrary, there is strong evidence that firms primarily used the repatriated earnings to benefit owners and shareholders, and that the restrictions Congress imposed on the use of the repatriated earnings — aiming to ensure that firms invested them in the United States — proved ineffective. In fact, many of the firms that repatriated large sums during the holiday actually laid off workers.

With most companies likely to be affected by a repatriation tax holiday flush with cash and enjoying ready access to capital markets, there is every reason to expect that the results from a second tax holiday would be at least as disappointing as those from the failed 2004 legislation. In its analysis of recent repatriation proposals, Goldman Sachs concluded, "The short-term economic benefits of such a policy would likely be minimal."[5] Goldman Sachs explained, "we would not expect a significant change in corporate hiring or investment plans: most firms with large amounts of overseas profits are likely to have adequate access to financing, so the availability of cash on hand is unlikely to be a constraint on investment at the present time." In its latest analysis of policies under consideration for boosting economic activity and jobs, the Congressional Budget Office ranks a repatriation tax holiday like that enacted in 2004 dead last in effectiveness and estimates that it would have minimal impact.[6]

The Joint Committee on Taxation (JCT) estimates that a proposal like the 2004 proposal would reduce revenues over the next 10 years by almost $80 billion, even though about $700 billion would be repatriated and tax revenues would be higher in the window opened by a temporary tax holiday. Without the legislation, some of these earnings would have been repatriated at a higher rate later in the 10-year budget period covered by the estimate or outside the budget window. More significantly, enactment of a second repatriation holiday in less than a decade would create the expectation that more such holidays will occur in the future. That would give companies an incentive to shift the location of future investments abroad to escape higher U.S. tax rates on earnings with the expectation that those earnings will be repatriated in the *next* tax holiday.

In the JCT estimate, during the first three years, revenues would be higher as the large volume of repatriation dominates the lower tax rate. Subsequently, however, the proposal would lose an even

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[4] Chuck Marr, Brian Highsmith, and Chye-Ching Huang, "Repatriation Tax Holiday Would Increase Deficits and Push Investment Overseas," Center on Budget and Policy Priorities, October 12, 2011. http://www.cbpp.org/cms/index.cfm?fa=view&id=3593

[5] Alec Phillips, "U.S. Daily: Profit Repatriation Tax Holiday: Still an Uphill Climb," Goldman Sachs, October 5, 2011

[6] Elmendorf, November 15, 2011.

larger amount of revenue because the earnings that would have been repatriated at a higher rate were already repatriated during the window and because the increased investment abroad induced by the expectation of further holidays generates more tax-sheltered earnings abroad and less taxable earnings in the United States.

A policy that would do little to stimulate investment in the current weak economy but would lose tax revenue in the future when deficit reduction should be kicking in doesn't make sense. That is why Mark Zandi, Chief Economist of Moody's Analytics, has urged lawmakers not to regard repatriation as a stimulus measure but rather to consider it in the broader context of corporate tax reform.[7] I would reiterate, however, that many proposals for corporate tax reform would likely further diminish the shrinking amount of revenue coming from the corporate income tax, which would make it harder to achieve our deficit reduction goals.

I believe the best policy is not to enact a second repatriation tax holiday. But if the momentum behind such legislation seems unstoppable, I would certainly encourage Congress to try to limit the uses to which repatriated earnings can be put better than they did last time.

Small Businesses

The claim that raising marginal tax rates at the top of the income distribution would severely harm small businesses has little factual basis. The most basic reason is that few small business owners pay taxes at the top rates. According to a recent Treasury analysis, when you look at a definition of small business that captures what people usually mean by the term, only 2.5 percent of small business owners who are taxed at the individual rather than corporate rates are in the top two income-tax brackets.[8] In addition, the best research on small firms as job creators indicates that it is important to distinguish between young firms (startups), which are the main source of job creation in the small business sector, and other more established small businesses.

With respect to the impact of taxes on small businesses, Tax Policy Center co-Director William Gale has noted that "the effective tax rate on small business income is likely to be zero or negative, regardless of small changes in the marginal tax rates," because of the valuable array of tax subsidies that small businesses receive.[9] As CRS notes, the subsidies with the broadest reach include:

> "the taxation of small firms as pass through entities, the graduated rate structure for the corporate income tax, the expensing allowance for equipment …, the exemption of some small corporations

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[7] Response by Mark Zandi at Senate Budget Committee hearing on "Policy Prescriptions for the Economy," September 15, 2011

[8] Matthew Knittel, Susan Nelson, Jason DeBacker et al., "Methodology to Identify Small Businesses and Their Owners," Treasury Department Office of Tax Analysis, August 2011: http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf

[9] The Congressional Research Service has found that "current federal tax law contains a number of provisions bestowing preferential treatment on small firms." Gary Geunther, "Small Business Tax Benefits: Overview and Economic Rationales", Congressional Research Service, revised September 18, 2007, p. 3.

from the corporate alternative minimum tax, cash basis accounting, and the exclusion from taxation of capital gains on the sale or disposition of certain small business stock."[10]

The imagined impact of high marginal tax rates on small businesses is a weak justification for extending the current top two rates or for shielding very high-income individuals from making a significant contribution to deficit reduction.

Policymakers have justified channeling a large volume of tax breaks to small businesses, primarily on the assumptions that small businesses are the primary creators of jobs and that tax policy strongly affects small business job creation. Both assumptions bear closer examination. The claim that small businesses are the primary creator of jobs is based on research conducted in the 1980s; as CRS notes, "more recent research has revealed some methodological deficiencies in these original studies and suggests that small businesses contribute only slightly more jobs than other firms relative to their employment share. Moreover, this differential is not due to hiring by existing small firms, but rather to start-ups, which tend to be small."[11]

Similarly, a 2010 National Bureau of Economic Research study finds no systematic relationship between firm size and job growth after controlling for firms' age.[12] This indicates that it is particularly important to distinguish between young businesses (startups), which the study finds "contribute substantially to both gross and net job creation," and other small businesses.[13]

The evidence that tax rates strongly affect small business growth and job creation is also thin. Only one study exists that directly addresses the question of whether cutting the marginal tax rates of small business owners leads to increased hiring in existing firms. That study, by Douglas Holtz-Eakin and others, finds a statistically significant increase in small business hiring following the deep cuts in tax rates from the 1986 tax reform.[14] But CRS notes that the study may overstate the extent to which high-income entrepreneurs respond to tax changes. CRS also cautions that "given only one study, it is premature to conclude that raising taxes of the owner would decrease hiring in existing firms."[15]

Unlike large corporations, which are, for the most part, flush with cash, small businesses appear to still face difficulty financing expansions. That may justify short-term measures that target job creation in small businesses, but it does not justify a costly and poorly targeted measures like keeping the current very low top marginal tax rates from expiring as scheduled.

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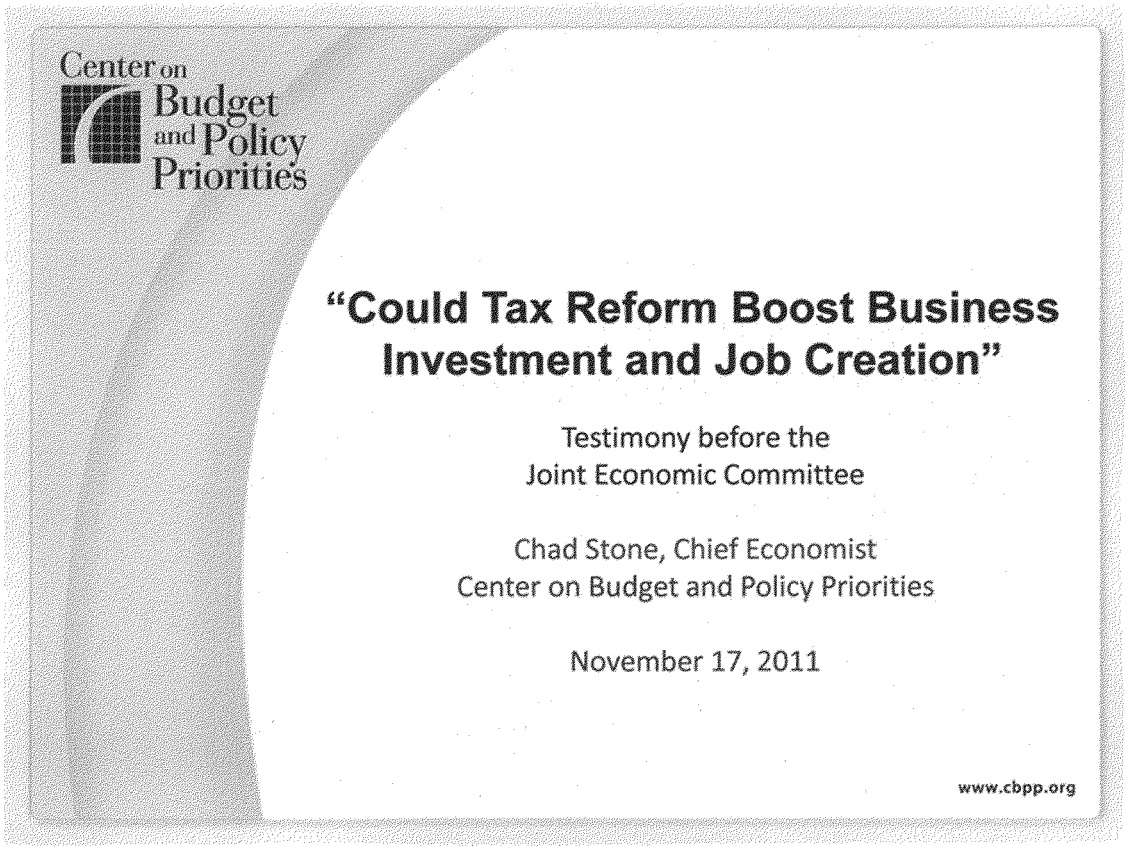
[10]Gary Geunther, "Small Business Tax Benefits: Overview and Economic Rationales", Congressional Research Service, revised September 18, 2007, p. (i).
[11]Jane Gravelle, "Small Business and the Expiration of the 2001 Tax Rate Reductions: Economic Issues," Congressional Research Service, September 3, 2010: http://assets.opencrs.com/rpts/R41392_20100903.pdf

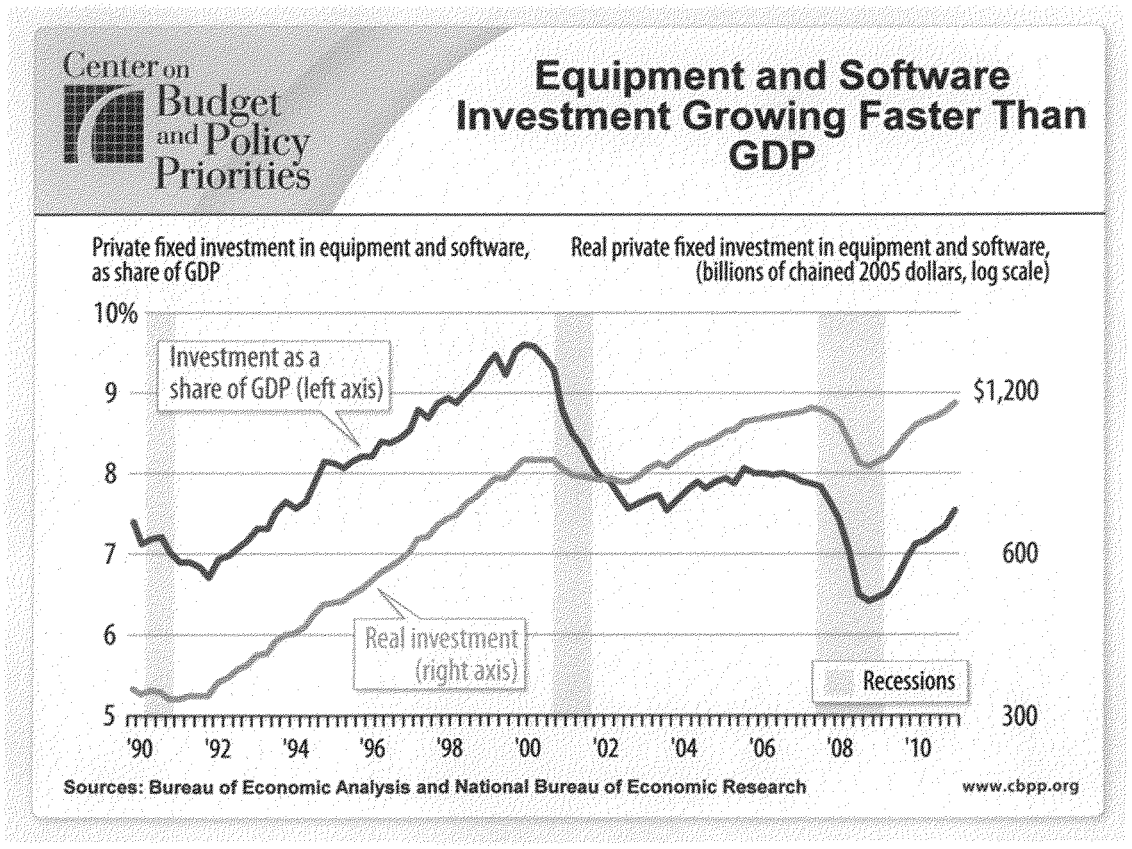
[12] John Haltiwanger, Ron Jarmin and Javier Miranda, "Who Creates Jobs? Small vs. Large vs. Young," NBER working paper, August 2010: http://papers.nber.org/papers/w16300

[13] Haltiwanger et al, August 2010, pg. 30

[14] Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, "Entrepreneurs, Income Taxes, and Investment," Chapter 13 in *Does Atlas Shrug?* edited by Joel B. Slemrod, Russell Sage Foundation, 2000.

[15]Gravelle, September 3, 2010





Testimony of Dan R. Mastromarco

Before the Joint Committee on Economics

on

How U.S. Tax Policy Affects Business Investment and Job Creation

November 17, 2011

Dear Mr. Chairman and Members of the Committee:

Let me begin with an observation leading to a compliment. My observation? The debate over America's tax system is not about one problem. It is about a bundle of competing problems searching out competing solutions. Although all Americans share a fervent disdain for the tax system, they do so for many reasons. Before policymakers can make true progress in discussing the effectiveness of various alternatives in achieving reform goals, therefore, they must first agree upon the common issues reform is meant to address. Stated another way, they must decide "what are the central problems with our current system?" before they can intelligently ask "how well the ideas for reform address those problems?".

My compliment? The Committee insightfully titled this hearing "*How* American Tax Policy Affects U.S. Businesses." Shrift was doubtless given to titling it "*Whether* U.S. Tax Policy Affects Business." U.S. Tax policy affects, and unfortunately disaffects business, in ways well beyond the tax expenditures purposely designed to affect that result.[1] In short, our tax regime influences business from the cradle to the grave: whether or not to start a business, what business to start, how to organize it, where to locate it (here or abroad), how to fund and run the business, when and how to expand it, when to hire, when to terminate it and how to unwind it.

Over the course of the last 25 years, I have seen how tax policy affects business from many angles: as a practitioner, an advocate, a federal prosecutor, an adjunct professor, an author of treatises and a book on the policy process, and as a Congressional counsel. And from these differing perspectives, I cannot help but see the discouragement of many economists whose voices of reason are ignored; not so much because they are discordant, but because they are drowned out by the deafening din of lobbyists. Our tax system has in a nutshell devolved into an unholy trinity of lobbyists, industry seeking relative advantage and Members who seek campaign contributions, all of whom would sacrifice at the altar of a public auction our national prosperity for relative advantage.

The good news is that Tax reform is coming. It is a tide that if resisted by this Congress will be passed by their replacement. But the bad news is that the direction of tax reform remains to this day uncertain. What will reform look like? What are the criteria by which reform will be adjudged? Will reform be accomplished in name only, to leave to another generation the ultimate fix when the economy has worsened?

Understanding how we have gone astray is as easy as hearing the central chorus of economists. They will tell you that the critical maladies of our current system are three-fold:

- its complexity, prolixity and crushing compliance costs;
- its high marginal rates which trample productive income, stifle growth, job creation and wages;
- an anachronistic international tax system that is self-flagellating.

And many will tell you, as I will today, that the solution to this crisis is a consumption tax that makes the taxes we pay visible, ensures all Americans are stakeholders, is neutral as to savings and investment, lowers marginal rates, reduces compliance costs and removes the anti-competitive nature of our non-border adjustable extraterritorial tax system. The best of these is the FairTax, which stands in such stark

[1] 1974 Congressional Budget and Impoundment Control Act (PL 93-344).

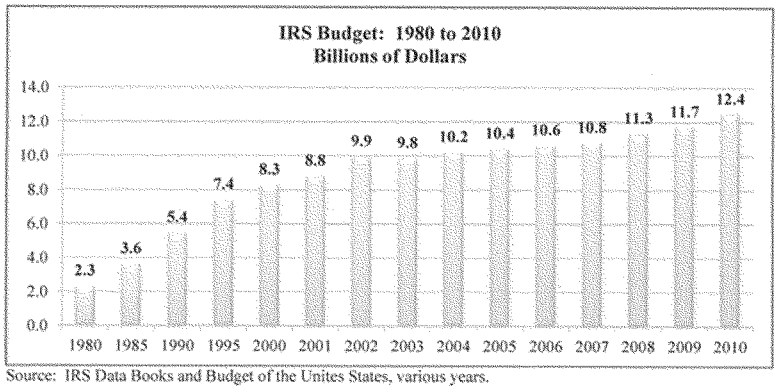
contrast to the *causus male* of our current system that it illuminates the path this Nation must take to regain the trajectory of our prosperity.

I. The Maladies: Three Ways Our Tax System Hurts Business

A. Compliance Costs Impose a Crushing Weight on Business.-- As we think about the ways (and degree to which) the U.S. tax regime adversely affects business, it is helpful to see the issue as a cluster of *antibiosis maladies*. In case one missed that, *antibiosis* is the opposite of *symbiosis*. What it means is that each factor combines to *worsen* the negative contribution of the other. Complexity begets costs, begets loopholes, begets evasion, begets high rates, begets more lobbying for loopholes, which begets more evasion, which begets a perception of unfairness, which begets even higher rates, more evasion, more economic inefficiency, and so on.

Understanding the tax regimes harmful effects begins with the compliance costs it imposes. Visualize the 1967 movie, Cool Hand Luke. Then imagine the taxpayer personified by Paul Newman as he complains about breaking rocks and moving them back and forth from one pile to another for no apparent reason in the prison yard. When Newman approaches expiration, the response of the guard is "What we've got here is... failure to communicate." This is a scenario lived and relived by small firms in every day. The gravity of the problem has been heard by this very Committee several times.[2]

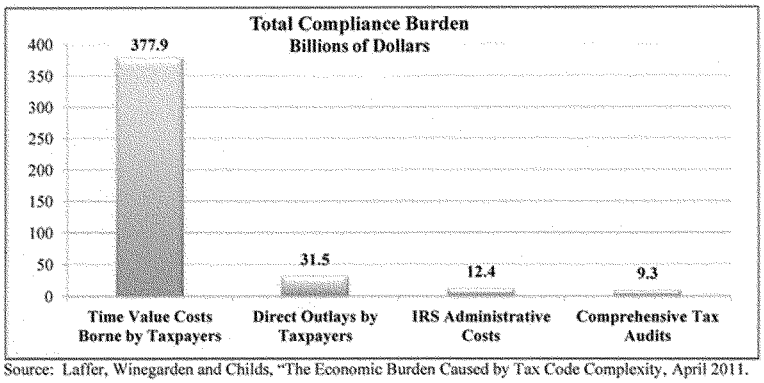
One aspect of compliance costs is administrative costs. The IRS directly employs about one hundred thousand employees. The IRS budget is about $12.4 billion[3], which has grown by 323% since the Tax Reform Act of 1986 in order to, among other things, handle 1.7 billion pieces of paper annually. All told, Americans spend more on IRS enforcement than they do to administer the nation's environmental, labor or other laws combined.



Source: IRS Data Books and Budget of the Unites States, various years.

[2] Joint Economic Committee, Report #109-353, Report on the 2005 Economic Report of the President, Nov., 2005.
[3] The Internal Revenue Service Data Book, 2010, Table 28.

But these *administrative* costs are themselves negligible when compared to the broader federal mandate thrust upon the IRS's "customers." These are the *compliance* costs, borne by businesses and individuals in their efforts to calculate, substantiate and pay the taxes owed.



Source: Laffer, Winegarden and Childs, "The Economic Burden Caused by Tax Code Complexity, April 2011.

While the economic burden occasioned by compliance has been estimated many ways by many researchers, with a correspondingly large range of values, the most recent credible study shows that U.S. taxpayers waste as much as $431.1 billion annually on tax compliance. If this figure is near correct, it means that we pay about 30 percent of total income taxes collected, just to … well … pay those taxes.[4] Of the 431.1 billion, 88% is the time value costs borne by taxpayers: $161.7 billion by businesses and $216.2 billion by individuals.

How much is $431.1 billion? It is more than the dollar value of *all* the finished goods and services produced in the states of Virginia ($427.7 billion), North Carolina ($407.4 billion), and Georgia ($404.6 billion); in fact, more than the GDP of 42 of the 50 states. It is more than the GDP of 171 other nations.[5] It represents more workers than employed by Wal-Mart Stores, United Parcel Service, McDonald's, International Business Machines, and Citigroup combined.

The drivers of these costs are several-fold. Costs are increased by the complexity of the law, by the numbers of taxpayers, and by the taxable events they incur.

The legendary complexity of our tax system is part of a protean trend that has accelerated over a century with the nearly perennial enactment of new tax legislation (4,428 changes to the tax code in just the last decade). In 2010 alone there were 579 changes, more than one per day.[6] The continuous tinkering with

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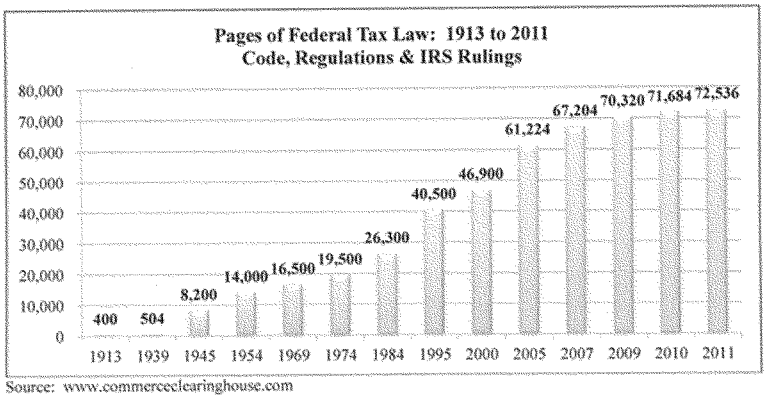
[4] Laffer, Winegarden, and Childs, "The Economic Burden Caused by Tax Code Complexity, April, 2011.

[5] "List of Countries by GDP (nominal)." 2010 estimates. Wikimedia Foundation, Inc. Nov. 11, 2011. http://en.wikipedia.org/wiki/List_of_countries_by_GDP_(nominal).

[6] Taxpayer Advocate Service, 2010 Annual Report to Congress, "The Time for Tax Reform is Now," Dec. 31, 2010, p. 4. The IRS's own centers established to help people prepare their tax returns show the complexity. According to the Taxpayer Advocate Service, the IRS received 110 million calls in each of the last two fiscal years; 25 percent of which the IRS was

the tax code has resulted in tripling the length of the tax code, now a mind-boggling 3.8 million words.[7] As shown graphically above, the combined federal income tax code, regulations, and IRS rulings have exploded from 14,000 pages in 1954 to 72,536 pages by 2011 – an increase of 518 percent. Consider as well the sheer volume of returns: 236.5 million in 2010 (excludes informational returns).



Source: www.commerceclearinghouse.com

Who pays these costs? Not surprisingly, small firms disproportionately absorb the lion's share of the $161.7 billion in fixed costs that stem from paperwork and record keeping, tracking wages, and interpreting the law – costs they cannot passed along. In 2007, researchers at the IRS estimated the total costs of complying with the income tax for businesses of varying sizes.[8] They found that the cost of compliance consumed from 15 to 18 percent of revenues for very small businesses—those with receipts of $50,000 to $100,000. For businesses with receipts between $100,000 and $500,000, that ratio fell to about 5 percent. For businesses with receipts between $500,000 and $1 million, it was about 2 percent. And for businesses with receipts greater than $1 million, it was only 0.5 percent.

What effect do these costs have on business? Dollars wasted on compliance are directed away from hiring, reinvestment, plant or equipment, R&D and other productive activity; all to fund an industry of tax attorneys, accountants and financial planners that produce nothing that adds to our economic well-being. The estimate of $431.1 billion in tax compliance costs does not include any of the behavioral changes that misallocate resources from their most economically efficient uses toward their most tax-efficient uses. Nor do these compliance costs measure the lost economic opportunities due to the uncertainty created by our complex tax code.[9] Indeed, increases in business uncertainty are associated with prolonged declines in economic activity.[10]

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unable to answer. In addition to the telephone calls, the IRS must process more than 11 million pieces of taxpayer correspondence annually.

[7] *Ibid.*

[8] Donald B Marron, "Tax Policy and Small Business,' Testimony before the Subcommittee on Select Revenue Measures, House Ways and Means Committee, March 3, 2011 citing research by DeLuca, et.al., "Estimates of U.S. Federal Income Tax Compliance for Small Businesses." Paper presented at the 2007 National Tax Association meetings, Columbus, OH.

[9] Adbiweli M. Ali, "Political Instability, Policy Uncertainty and Economic Growth: An Empirical Investigation," Atlantic

There is also collateral damage not always measurable in currency. Our system is so complex the IRS does not understand it[11] (we could say the same for the tax-writers). One survey found that only 58% of the public agree that the IRS and its staff are experienced and knowledgeable, while 37% do not. The findings are the same for perceived trustworthiness (59% versus 38%, respectively).[12] Even Warren Buffet, with the most sophisticated tax advisers money can buy is in a years'-long dispute over its federal tax bills.[13] But the complexity does not prevent the income tax from being collected with a heavy hand. In 2010, our government embroiled its citizens in more than 71,696 litigation actions, with 7 of 10 involving small firms. Taxpayers sustained more than 3.6 million levies. That same year, the IRS assessed 37,055,841 Americans $28.1 billion in civil penalties (27.1 million penalties for the individual income tax alone). The corporate income tax required the issuance of 1,145,931 penalties and the employment tax had 7,838,423 penalties issued to businesses with employees. The IRS data on civil penalties also shows that13% of these penalties (representing 36% of the penalty amounts) were ultimately abated.

We can see just how broken our system is when compliance costs and complexity are seen as a function of the rate of compliance itself. To understand the relationship between compliance costs and compliance, consider how we may be able to achieve an acceptable compliance rate, even with a tax system – such as a poll tax – if we were only willing to impose enough penalties at a high rate, take away civil liberties, require enough substantiation, or provide enough resources for detection. Reducing the interrelationship between compliance and enforcement to a very simple balancing act, we might, therefore express this interrelationship as a goal: our goal would be to minimize one function (compliance costs) at the same time we maximize another (the voluntary compliance rate).

But today, despite these onerous compliance costs, as much as one-fifth of all income taxes owed are not actually paid. The U.S. tax gap is a major, continuing and growing problem, notwithstanding a much larger IRS, more burdensome information reporting requirements, increasingly stiff and numerous penalties. In 2001, the IRS estimated that the gross tax gap—the difference between taxes owed and taxes paid on time—was $345 billion. Adjusting the 2001 "tax gap" estimate to tax revenues for 2006 yields a gross tax gap estimate of $432 billion.[14] Further escalation of compliance costs may actually spawn further noncompliance.[15] An estimated 18 million wage-earning Americans have dropped out of

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Economic Journal, March, 2001.

[10] Bachmann, *et al.*, Uncertainty and Economic Activity: Evidence from Business Survey Data, NBER Working Paper No. 16143, June 2010.

[11] In 1989, one out of three callers got incorrect answers. GAO accepts IRS testing that says in 1992 the IRS gave the right answer to taxpayer questions 88 percent of the time. The IRS's own centers labor hard to help people prepare their tax returns; however, even the IRS gave incorrect answers – or no answer at all – to 43 percent of the questions asked by Treasury Department investigators posing as taxpayers. The investigators concluded that half a million taxpayers may have been given wrong information between July and December 2002.

[12] Benno Torgler, *Tax Compliance and Tax Morale: A Theoretical and Empirical Analysis*. Massachusetts: Edward Elgar Publishing, Inc., 2007.

[13] According to Berkshire Hathaway's own annual report — see Note 15 on pp. 54-56.

[14] John O'Hare, Managing Principal, Quantria Strategies, LLC, an economic and tax policy consulting firm, September, 2007.

[15] Willis, Lynda D., "Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap," U.S. General Accounting Office, Testimony Before the National Commission on Restructuring the Internal Revenue Service, GAO/T-GGD-97-35, January 9, 1997. Higher compliance costs can reduce voluntary compliance at a certain level. As the GAO has stated, "...some of the

the income tax system entirely as "non-filers." Non-filers alone accounted for $30 billion of the tax gap in 2001, up nearly 300 percent since 1992.

The *antibiosis* continues because complexity breeds complexity as a target rich area for lobbyists. In this year's State of the Union address,[16] President Obama said:

> *Over the years, a parade of lobbyists has rigged the tax code to benefit particular companies and industries. Those with accountants or lawyers to work the system can end up paying no taxes at all. But all the rest are hit with one of the highest corporate tax rates in the world. It makes no sense, and it has to change. . . . So tonight, I'm asking Democrats and Republicans to simplify the system. Get rid of the loopholes. Level the playing field. And use the savings to lower the corporate tax rate for the first time in 25 years—without adding to our deficit.*

But that was just before he proposed small firms be given a tax credit for hiring veterans, which of course they already do. Who could possibly be against small business and veterans?

Compliance costs impose dead weight. Complexity introduces unfairness. Both contribute to the tax gap. And as the tax gap increases, because taxpayers are not paying what the law requires, further compliance costs are imposed. Honest businesses pay in several ways: they pay higher taxes because non-compliers evade or avoid them, they pay higher compliance costs to ensure the low level of compliance that currently occurs, and they pay again when the complexity stimulates more lobbying, more loopholes that result in higher rates that weight down investment and our national prosperity. And the beat goes on . . . .

B. The Anti-Growth Effects of Punishing Productive Enterprise

High Marginal Rates and Triple Taxation of Savings and Investment Stifle Job Creation, Reduce Real Wages and National Prosperity.-- To cite a general economic proposition and its corollary: no form of taxes have a benign effect on the economy; but not all forms of tax regimes inflict the same degree of harm. There is a consensus in the economics profession that given a certain level of taxation, the two most important factors affecting investment, savings, output and real incomes are (1) the level of marginal tax rates and (2) the degree to which the tax base penalizes savings, investment and productive activity.

What is emblematic of a good tax system? An optimal tax regime imposes the lowest marginal tax rates that can be devised in order to raise a given level of taxes (which themselves should be low), in conjunction with a tax base that is neutral towards savings and investment (*i.e.*, does not favor consumption), is neutral across industries and international borders. Although there is spirited disagreement about how large the positive effects are of a system that lowers marginal rates or achieves such neutrality, no serious analyst would disagree with the salient effects. And more importantly, no serious analysis would find that the U.S. is going in the right direction.

How High Are the U.S. Tax Rates?-- When the media, pundits and politicians use the term "tax rate," they often neglect to explain what they mean. When economists refer to the *national statutory rate* they

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'tax gap' may not be collectible at an acceptable cost. Such collection might require either more intrusive record keeping or reporting than the public is willing to accept or more resources than IRS can commit."

[16] Speech given to Congress on January 25, 2011.

always mean the government's tax rate imposed by law and assessed on income/profits, and they typically mean the top statutory marginal rate. This is very different from the effective tax rate, which is the total tax paid as a percentage of total income earned, and which accounts for all brackets, deductions, credits, depreciation, and preferences in the tax code and is a function of what the entity actually pays in taxes.

In the U.S., corporations that earn profits of more than $18.3 million are taxed at an outstanding top statutory marginal rate of 35 percent.[17] The statutory combined rate adds to this state and local tax rates (on average 4.2 percent), yielding a 39.2 percent statutory combined rate. Owners of S corporations, partnerships and sole-proprietorships based on the current budget proposal pay a *national statutory rate* of 39.6 percent (not including payroll taxes) on income over $383,350. But that same taxpayer pays 10 percent on income up to $8,600, and 15 percent on income up to $34,900, etc. Depending on deductions, a taxpayer might pay a relatively modest average tax on total earnings, yet nonetheless face a 39.6 percent marginal tax on any activities that could push income higher—such as extra effort, education, entrepreneurship, or investment. The chart below shows where the U.S. ranks among developed countries when considering corporate rates.

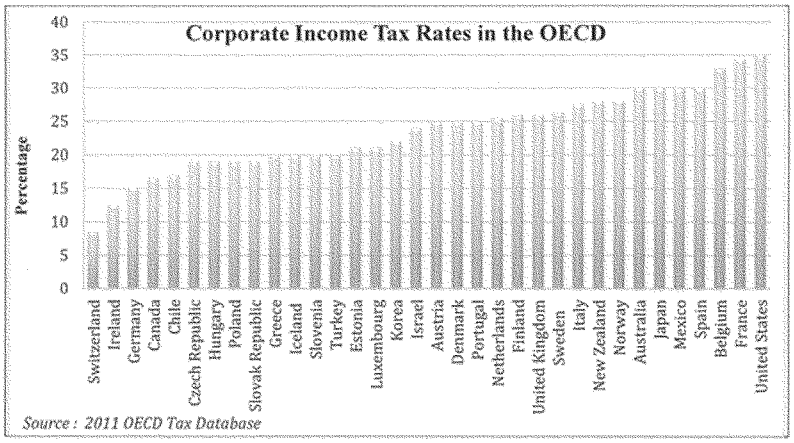
2010 Corporate Tax Rates, U.S. vs. OECD Countries

	U.S.	*OECD Average*	*U.S. Rank*
National Statutory Rate	35.0%	23.4%	34th out of 34
Statutory Combined Rate	39.2%	25.1%	33rd out of 34
Effective Rate	29.0%	20.5%	33rd out of 34

In short, the U.S. has the dubious distinction of sporting a national statutory rate of 35 percent and a statutory combined rate of 39.2 percent, compared with average OECD rates of 23.4 percent and 25.1 percent, respectively. For tax policy considerations, marginal decisions (such as extra effort or investment) depend mainly on marginal incentives (extra income, after taxes). For this reason, it is the marginal rate that has the greatest negative effect on the economy.

Mercatus Center Senior Research Fellow Veronique de Rugy has done excellent work in charting corporate income tax rates. According to her findings, the U.S. has the highest national statutory corporate tax rate in the OECD. In 2011, national statutory corporate tax rates among the thirty-four members of the OECD will range from 8.5 percent in Switzerland to 35 percent in the U.S. When sub-national taxes are added, the U.S. has the second-highest statutory combined corporate tax rate – 39.2 percent – after Japan's rate of 39.5 percent. Marginal tax rates became the central theme of a revolution in economic policy that swept the globe during the last two decades of the twentieth century, with more than fifty nations significantly reducing their highest marginal tax rates.

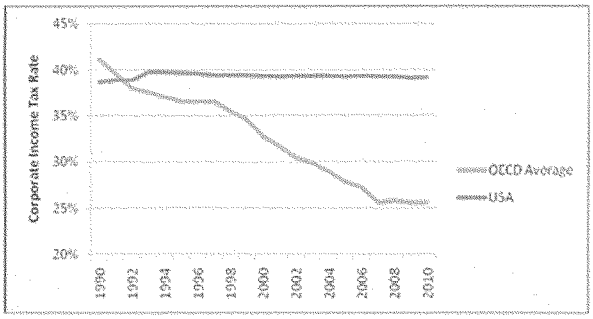
[17] According to the 2008 SOI, there were 1.8 million C Corporations for that year, 4.05M S Corporations, 3.14M Partnerships (LLCs, LLPs, LP's, et cet), and 22M sole-proprietorships.



According to World Bank rankings, the U.S.' relative ranking on the "total tax cost" imposed on businesses has gone from bad to worse, falling from 118th in 2010 to 124th in 2011. The total tax cost expressed as a percent of before-tax profits is 46.8%.[18] The U.S. effective corporate tax rate on new investment was 34.6 percent in 2010, which was the highest rate in the OECD and the fifth-highest rate among 83 countries. The average OECD rate was 18.6 percent, and the average rate for 83 countries was 17.7 percent.[19]

How did we arrive at this point? We arrived here because Congress would rather trade influence in doling out special interests tax breaks that reduce the tax base and raise marginal rates than hear the chorus of economists. In 1990, the Organization for Economic Co-operation and Development (OECD) average statutory combined corporate tax rate was 41.1 percent, higher than the U.S.' rate of 38.7 percent. But while other nations have been racing over the past few decades to slash corporate tax rates to welcome multinational corporations, the U.S. has stagnated. Japan is the only country with a higher combined corporate tax rate than the U.S., and it plans to reduce its statutory combined rate by roughly 5 percent in the near future.

[18] The World Bank, Paying Taxes in 2011: The Global Picture, Table 4.
[19] Chen, D. and Mintz, J. "New Estimates of Effective Corporate Tax Rates on Business Investment." Tax and Budget Bulletin, No. 64, February 2011.



Lowering marginal tax rates is part of a revolution in economic policy that swept the globe during the last two decades of the twentieth century. More than fifty nations significantly reduced their highest marginal tax rates on individual income. The U.S. sat on the sidelines.

And the U.S. income tax remains a model for *what not to do* in more ways than just through high marginal rates. By double, triple, and even quadruple taxation, our system inhibits economic performance and wage growth by creating a significant bias against saving and investment in favor of leisure and consumption. Track an investment. Initially, wage and salary income are taxed when earned. Then, if wages and salaries are saved or invested, the resulting earnings are taxed again and again and sometimes again still. All income derived from investment is taxed. If an income-producing asset, such as a stock or bond, equipment or real estate, is sold for more than it was purchased, the increase in the value of the capital investment – the capital gain – is taxed.[20] Corporate income (including capital gains) is taxed at the corporate level and again when it is paid to shareholders as dividends. Intercorporate dividends are also often subject to tax, creating yet another level of taxation. When the taxpayer dies, the estate and gift tax may tax his or her investments one final time. If what we tax we get less of, then we have sought to punish savings, investment, and entrepreneurial activity.

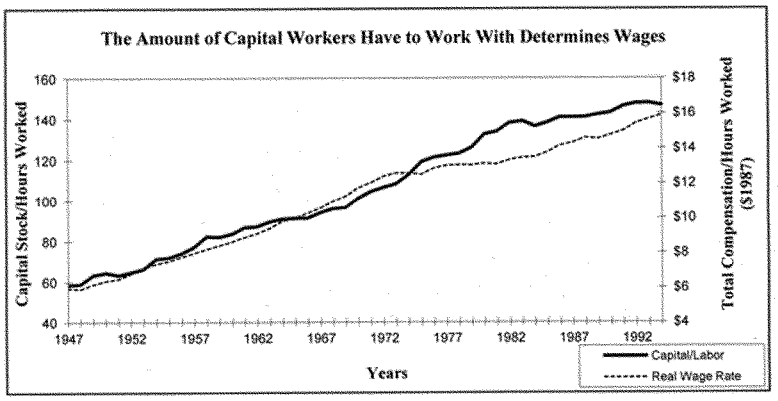
Why We Must Care: The Economic Effect.-- As bad as compliance costs are, estimates of efficiency losses of the federal tax system can dwarf compliance costs. Efficiency costs, deadweight loss, reduced output, excess burden (all terms for the same thing) occur when tax rules distort the decisions of individuals and businesses regarding work or leisure, savings and investment or consumption. By changing the relative value of highly taxed and lightly taxed activities, taxes alter decisions such as what to consume and how to invest. When taxpayers alter their behavior in response to tax rules, they often end up with a combination of savings, investment, or consumption and work, risk taking and leisure that they value less than the combination they would have preferred to make if decisions were freed of any tax influences. According to a GAO study, efficiency costs imposed on the economy on the order of magnitude of two to five percent of Gross Domestic Product (GDP).[21] Based on GDP of $14.551 trillion in 2010, efficiency costs can top $728 billion. In fact, the economic loss increases with the

[20] Thus, both the future income stream *and* its capitalization are taxed, constituting still another layer of multiple taxation.
[21] "Tax Policy: Summary of Estimates of the Costs of the Federal Tax System," U.S. Government Accountability Office Report No. GAO-05-878, August, 2005, p. 20.

square of the tax rate.[22] Similarly, the economic gain from reducing marginal tax rates increases at a more rapid rate than the reduction in the tax rate.

What are some of the ways in which high marginal rates and triplicative taxation of savings and investment create such distortions? As noted, they create an incentive to consume now rather than save for the future. Although market interest rates effectively pay people to defer consumption into the future (i.e., to save), because the tax wedge reduces those payments, people inevitably will choose less future consumption (saving) and more current consumption. This harms the economy because less saving results in less investment, less innovation, slower growth, and lower future living standards than would be enjoyed without a tax on saving. Future consumption is reduced by both the extra current consumption and the forgone returns that greater saving would otherwise have produced. Some of this loss is a deadweight loss to society; that is, a loss to some that benefits no one. Eliminating taxes on capital income would eliminate the tax wedge on saving, and total saving would be much closer to the optimal amount. The tax system would be "temporally" neutral in the sense that it would not affect the choice between current consumption and future consumption (saving).

Through this distortion and through confiscation of net profits from which investments are made, marginal tax rates and a biased tax base reduce capital formation and the savings and investment necessary to finance the higher levels of capital per worker that increase productivity, output, competitiveness, and material well-being. Investment is important to all wage earners because of the relationship that exists between real wage rates and the level of capital investment per worker, which is the most significant contributing factor to achieving higher real wages. A worker or farmer, for example, is more productive if he or she has more machinery and equipment to work with, particularly new equipment that incorporates the latest technological innovations. Higher productivity leads to



[22] More formally, the increases with the square of the tax rate. See almost any Price Theory textbook for a discussion of why. For a detailed and mathematically sophisticated discussion, see Auerbach, Alan J., and James R. Hines, "Taxation and Economic Efficiency," *Handbook of Public Economics*, Vol. 3, Chapter 21, sections 1-3. For a short summary, see Economic Report of the President, February 2005, Chapter 3, p. 71.

Source: Gary and Aldona Robbins, Institute for Policy Innovation.

higher real wages. Employers cannot pay workers higher wages than their productivity justifies without jeopardizing their businesses. Higher investment levels per hour worked explain as much as 97 percent of the increase in inflation-adjusted wages since 1948, as can be seen in the chart above.[23]

As consumption is to savings, theory suggests that an increase in the marginal income-tax rate makes leisure relatively less expensive. This tends to increase leisure relative to consumption and work. As this happens, GDP falls. The evidence from economic research indicates that high and increasing marginal tax rates have serious negative consequences on labor supply, as well as economic growth, and capital formation.[24] A decrease in marginal income-tax rates on labor income makes leisure relatively more expensive. Thus, leisure decreases and consumption increases, which increases labor input and GDP.[25]

Numerous studies have found that high marginal tax rates not only reduce people's willingness to work up to their potential, but to take entrepreneurial risks, and to create and expand a new business (ably surveyed by Karabegovic *et al.*[26](2004)). Personal income tax rates have a direct effect on small business profits, hiring, investment, and growth. Recent research by Carroll, *et al.*, measured the impact of marginal tax rate cuts under TRA86 on sole proprietor revenue growth.[27] They found that tax rate reductions had a "significant influence" on firm growth rates and concluded that a tax cut that raised taxpayers' after-tax share on marginal income (i.e. one minus the tax rate) by 10 percent would cause them to increase business revenues by 8.4 percent. Another paper by Carroll, *et al.*, examined changes in sole proprietor capital investment before and after TRA86. The authors found that "changes in marginal tax rates have a substantial impact on entrepreneurs' investment spending." For example, they found that a five-percentage point change in marginal tax rates would cause a 10-percent change in capital investment expenditures.

A third paper by the same authors examined the effect of personal income tax rates on sole proprietor hiring decisions.[28] They found that a tax cut that boosts after-tax income by 10 percent would raise a small business's likelihood of hiring by 12 percent. In summary, reductions in marginal income tax rates can be expected to have an expansionary impact on America's small business sector.[29]

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[23] Robbins, Gary and Aldona, *The Truth About Falling Wages*, Institute for Policy Innovation, Tax Action Analysis, Economic Scorecard, Third Quarter, 1995, p. 5.

[24] Federal Reserve Bank of Minneapolis senior adviser EDWARD PRESCOTT, co recipient of the 2004 Nobel Prize in economics, found that the "low labor supplies in Germany, France, and Italy are due to high [marginal] tax rates" (Prescott 2004, p. 7).

[25] Prescott attributes lower labor-force participation in some European countries almost entirely to higher marginal tax rates. Lower marginal income-tax rates, he suggests, would increase the labor supply and therefore total output in the process.

[26]Karabegović, Amelia, Economic Freedom of North America, Fraser Institute (Vancouver, B.C.), National Center for Policy Analysis (U.S.), 2004.

[27] Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen, "Personal Income Taxes and the Growth of Small Firms," Tax Policy and the Economy, Vol. 15, 2001.

[28]Carroll, et.al., "Taxes and Entrepreneurs' Use of Labor," Journal of Labor Economics, Vol. 18, No. 2, pp. 324-351, 1999.

[29] This is important because small businesses fill a unique role in the economic growth process. While many small businesses stay small, some will grow to become leaders in whole new industries. New firms often challenge existing firms with untried ideas and thereby generate greater competition and efficiency. Evidence suggests that small firms perform a disproportionately large share of radical innovations in the economy.

Lifetime family work effort and entrepreneurship are not the only things affected. Nobel laureate Robert Lucas emphasized the deleterious effect on economic growth of high tax rates on capital. Philip Trostel focused on the impact on Human Capital, finding that high marginal tax rates on labor income reduce the lifetime reward from investing time and money in education. There are evidently many channels through which high marginal tax rates may discourage additions to personal income, and thus also discourage marginal additions to national output (*i.e.,* economic growth). Countries in which the combined marginal impact of taxes and benefits is to punish success and reward indolence often face "capital flight" and a "brain drain." And finally, the U.S. tax code — high rates with a bounty of subsidies, shelters and special breaks — has made American multinationals world leaders in tax avoidance. Loopholes (the result of lobbying themselves) severely distort market behavior, influencing behavior based on tax preferences rather than economic choice.[30]

The bottom line is simply this. People react to tax incentives or tax increases for the same reason they react to price incentives or increases. Supply (of effort and investment) and demand (for government transfer payments) respond to marginal incentives. To increase income, people may have to study more, accept added risks and responsibilities, relocate, work late or take work home, tackle the dangers of starting a new business or investing in one, and so on. People earn more by producing more. Because it is easier to earn less than to earn more, marginal incentives matter. To the extent to which a country's tax system punishes added income with high marginal tax rates, it also punishes added output—that is, economic growth.

C. Our International System is Anachronistic.

The U.S. international tax system is today an embarrassing anachronism. When it was shiny and new in 1918 – the year President Woodrow Wilson donned his top hat to become the first president to leave North America -- we led the way in enacting a system where income taxes duly paid to a foreign country could be credited against U.S. income taxes. Ten years after that, in 1928, the League of Nations introduced draft model income tax treaties, based on this formulation.

Time has passed us by. As our tax code remains anchored in the past, developed at a time when the U.S. was more insular in trade and a dominant capital exporter, before the age of consumption taxes, the world economy and our role within it has transformed. Throughout the 1920s, the U.S. was running budget surpluses. Today, of course, the U.S. is a net debtor nation running huge budget deficits, and trade deficits with nearly every major partner is nearly every traded good. In the 1920s, we were a net creditor nation. While in 1961, the U.S. exported just under $21 billion ($159 billion real terms today) and imported approximately $14.5 billion in merchandise ($110 billion today), we exported $1.4 trillion of goods and services and imported $1.8 trillion from January to August of this year alone.[31] During the 1920s, federal revenues averaged about 4 percent of GDP. In recent history, from 1971 to 2010, revenues have averaged 18 percent of GDP. Technological improvements in communications and transportation, and the opening of formerly closed markets have created permanent interdependencies among nations that will exponentially increase this volume of trade and with it the need to get our international tax regime right with the times.

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[30] Donald Marron, Urban-Brookings Tax Policy Center, "Cutting Tax Preferences Is Key to Tax Reform and Deficit Reduction," Testimony before the Senate Committee on the Budget, February 2011.

[31] http://www.census.gov/foreign-trade/Press-Release/current_press_release/ft900.pdf

Our failure to evolve with the international economy has been succeeded only by our failure to keep pace with evolutions in its tax laws. Today, the U.S. is:

- in the minority in trying to tax its multinational corporations on their foreign earnings.
- virtually alone in imposing some of the highest tax rates in the world
- and virtually alone in failing to adopt a border-adjustable destination based consumption tax.

High Rates Diminish Foreign Investment and Discourage Repatriation.— How do these anachronisms perversely influence corporate decision-making and impede competitiveness? At the core of our international tax system, as most tax policy gurus know, is the principal of extraterritoriality. What this principal means in the context of outbound transactions is that the U.S. system will tax its individual residents and citizens, and corporations on their worldwide income under the rates specified in IRC section 1 and 11 (the individual and corporate rates), regardless of where that income is derived. U.S. taxpayers engaged in activities abroad generally compute taxable income in the same manner as U.S. taxpayer producing solely with the U.S. Because the norm of international juridical taxation, with the U.S. generally follows, cedes the primary taxing authority to the country or territorial connection (i.e., where the income is earned) and the residual taxing authority to the county of residence, the U.S. seeks to avoid double taxation by crediting any income taxes paid to the foreign country, against the income tax otherwise due in the U.S.[32] One of the largest exceptions to deferral is, of course, Subpart F, which was introduced in the Kennedy Administration in exchange for lowering rates, and is intended to discourage U.S. corporations from redirecting income outside the U.S. in order to avoid immediate U.S. taxation.

While the extraterritorial credit system is at least in theory straightforward -- by crediting the foreign taxes paid on the foreign income up to the rate of tax imposed on that income we seek to avoid taxing the same income twice -- it is ridiculously complex in application. That is because before one can determine what credit can apply, the U.S. resident, citizen or corporation must first determine where the income and deductions are sourced under an elaborate set of rules, modified further by treaty and the intercompany transfer pricing rules. One must determine whether and to what extent the foreign taxes are even creditable. One must then compute the direct and indirect credit (on dividends) by distributing the income within more than nine separate "baskets" for which the foreign tax credit is individually limited – enough baskets to turn any sane individual into a "basket" case. And neither least nor last, before determining the credit to which one is entitled, one must determine if deferral from a subsidiary must yield to any one of the separate rules under Subpart F pertaining to Controlled Foreign Corporations.

Because the U.S. is virtually alone in trying to tax its multinational corporations on their foreign earnings, it incentivizes companies to avoid those taxes indefinitely by keeping profits overseas. That in turn encourages companies to use accounting maneuvers to shift profits to low-tax countries and to invest profits offshore. However badly U.S. multinational corporations who earn money overseas want to bring that money back home to the U.S., our international tax system discourages, and some would say "penalizes" repatriation of foreign earnings by imposing a 35 percent residual U.S. tax at the time of

[32] A U.S. parent of a foreign subsidiary is generally not taxed on the earnings of the subsidiary until distributed at which time the credit is imputed. (IRC section 951-960.

repatriation. As a result, several high-profile U.S. multinational corporations are sitting on large piles of cash earned from foreign operations. Yet these same corporations are actually borrowing money rather than repatriating their offshore cash.

How much money is trapped offshore? U.S. multinational companies MNCs currently hold an estimated $1.4 trillion in foreign earnings overseas. About $581 billion in after-tax dividends will be distributed to U.S. shareholders, according to one recent study.[33] And that same study stated that spending could increase gross domestic product by $178 billion to $336 billion and will add 1.3 million to 2.5 million jobs if we were to offer a temporary reprieve from the repatriation tax, as well as boost U.S. tax revenues. About half of OECD nations do not have this problem because they have "territorial" tax systems.

Our extraterritorial income tax system affects U.S. entities and corporations in more ways than by frustrating their effort to repatriate earnings like their competitors based in lower taxed jurisdictions can do. That is, in a manner of speaking, just a symptom. The greater infirmity is that rate of the tax we impose makes the U.S. one of the least favorable locations to base international operations.

Again an understanding of the U.S. international tax system is critical. Broadly stated, nonresident alien individuals, unincorporated entities even corporations are taxed like U.S. taxpayers on most U.S. Business income. An individual is taxed when it is engaged in a trade or business on income effectively connected to that trade or business (IRC section 871(b). A foreign corporation is likely taxed under IRS section 11 on its taxable income effectively connected with the conduct of a U.S. trade or business (IRC section 882). But nonresident individuals are also subject to U.S. taxation on some types of recurring investment income. And a corporation who is conducting a trade or business may be also subject to the Branch Profits Tax.[34]

Paradoxically, despite having the highest national statutory rate, the U.S. raises less revenue from its corporate tax than do the other members of the OECD on average. In fact, federal corporate income taxes raise little revenue compared with other federal taxes; roughly comprising 11.6% of total federal tax revenues. At $191 billion, they were equal to 1.3 percent of the nation's gross domestic product.

The combination of high rates, worldwide taxation and a competitive global marketplace makes our corporate tax system extremely punishing. But it is the marginal tax rate -- the rate on the last dollar of income earned (which is very different from the average tax rate, which is the total tax paid as a percentage of total income earned) – that matters the most. The rate at which we tax decisions at the margin matters in at least two regards: (1) it discourages foreign corporations from locating their corporate offices or subsidiaries in the U.S. and in locating plants, facilities here for production purposes (i.e., it influences the location where capital is deployed), and (2) it encourages outsourcing of plants, facilities and production facilities of domestic multinationals to jurisdictions where the taxes imposed are less.[35]

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[33] "The Benefits for the U.S. Economy of a Temporary Tax Reduction on the Repatriation of Foreign Subsidiary Earnings," by Laura D'Andrea Tyson, Ph.D.; Kenneth Serwin, Ph.D.; Eric Drabkin, Ph.D. (October 13, 2011).

[34] The branch profits tax is an extra income tax imposed by the U.S. on foreign corporations that earn profit from their U.S. investments or U.S. business operations.

[35] Salvador Barrios (European Commission), Harry Huizinga* (Tilburg University and CEPR)

Border Adjustable Taxes Act as Unanswered Trade Subsidies.-- Add to this the fact most of our trading partners effectively rebate their taxes at the border and provide for themselves a powerful export trade subsidy and benefit for consumption of domestic goods that is unanswered by the U.S. It is a widely understood proposition that the U.S. should not target a particular trade deficit level, subsidize its exporters or impose tariffs on imports. The reason, established clearly in economic theory, is that doing so interferes with mutually beneficial transnational economic exchanges, to the disadvantage, in the aggregate, of both countries' economies. However, the U.S. government should not, as a matter of policy, accord a huge advantage to foreign companies competing in the U.S. market or impose a huge disadvantage on American producers and workers selling their goods and services in the U.S. and foreign markets. That has been the effect, however, of border adjustable VATs.

Consider this. The U.S. tax system imposes heavy income and payroll taxes on U.S. workers and businesses producing goods in the U.S. whether those goods are sold in the U.S. market or abroad. Recall U.S. corporate taxes are the about nine percentage points higher than the OECD average.[36] The U.S., however, imposes no corresponding tax burden on foreign goods sold in the U.S. market. Moreover, foreign VATs -- a major component of the revenue raised in most developed countries -- are rebated if foreign goods are exported to the U.S. market. This creates a large and artificial relative price advantage for foreign goods, in both the U.S. market and abroad.

The table below illustrates this point. American producers pay two sets of taxes when selling into foreign markets. Conversely, in U.S. markets, foreign goods bear no U.S. tax and the foreign value added tax is forgiven. Thus, a most manifest unfairness in the U.S. tax system is that it places U.S. producers – including businesses and workers in manufacturing, agriculture, mining, and forestry – at a large competitive disadvantage relative to their foreign competitors here and abroad. Our failure to counteract these border-adjusted taxes explicitly encourages consumption of foreign, goods. And it converts many of our nation's retailers into tax free trade zones for foreign produced goods.

Advantage for Foreign Producers

	Sold in U.S. market	Sold in foreign markets
U.S. production	Pays U.S. income and payroll taxes.	Pays U.S. income and payroll tax & foreign VATs.
Foreign production	Pays no U.S. income or payroll tax and no foreign VAT.	Pays foreign value-added tax.

The U.S. has adopted this self-destructive policy, in part, because of our entirely laudable commitment to free enterprise and our rejection of mercantilism. At least since WWII, American business and political leaders have viewed free trade as the basis for international peace and prosperity. As the dominant economic and military power, the U.S. led the movement to dismantle trade barriers, both by setting the example and by supporting a New World Order of international trade regulation (GATT and WTO), economic cooperation (OECD), and customs unions (such as the European Union and NAFTA).

Luc Laeven (International Monetary Fund and CEPR) and Gaëtan Nicodème (European Commission, CEB, CESifo and ECARES), International Taxation and Multinational Firm Location Decisions (April 2009). See also Claudio A. Agostini, "The Impact of State Corporate Taxes on FDI Location," *Public Finance Review 2007*; 35; 335.

[36] Edwards, Chris, "The U.S. Corporate Tax and the Global Economy," Cato Institute, September 2003.

According to the OECD, its members have reduced their average tariff rates from 40 percent at the end of World War II to 4 percent today. The average import duty on goods in the U.S. is currently 1.7 percent.

Today, the 29 of 30 OECD countries have enacted border-adjustable tax regimes. America stands nearly alone as the sole developed economy, which refuses to adopt a border-adjustable tax system. The European Union 15 has an average standard VAT of 19 percent, and the average OECD standard VAT is 18.5 percent. During the 1990s, Mexico and Canada increased composite rates to 15 percent from 10 percent and 7 percent, respectively, and China adopted a 17-percent VAT in 1994. As foreign governments have increased the VAT, they have also reduced effective corporate income taxes. Meanwhile, high U.S. corporate tax rates today coupled with our custom of taxing the foreign income of corporations based in the states causes the flight of corporations' headquarters to countries that exempt taxation of overseas income. In effect, the U.S. tax system is distorting the international marketplace and literally driving plants and good jobs out of this country at a devastating and unsustainable pace. There are, after all, only so many assets we can sell to foreigners before the entire financial system enters into a severe crisis.

Some economists mistakenly argue that if America adopted a border-adjusted tax system, *any* relative price change would be eliminated by an offsetting appreciation in the dollar. If the FairTax were implemented, for example, they hypothesize that the price change would be offset by a 23 percent immediate appreciation in the dollar. The appreciation in this case, they contend, would be caused by a reduction in U.S. demand for foreign currency to acquire (the now more expensive) foreign goods and an increase in foreign demand for U.S. currency to acquire (the now less expensive) U.S. goods. However, the arguments are dubious. The problem with that logic is that the demand for U.S. dollars is not limited to the traded-goods market. Nearly $90 trillion in U.S. assets owned by households and non-financial businesses are denominated in dollars. Financial institutions trade trillions of dollars in securities and currency each day based on expectations and guesses. Furthermore, the non-traded goods and services sector is also denominated in dollars and exceeds the traded-goods sector in size.[37] A study by Professor Jim Hausman of the Massachusetts Institute of Technology is helpful to understanding this problem.[38]

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[37] If, however, these economists are right and there is no increase in the competitiveness of U.S. goods because of a 23-percent increase in the price of the dollar (more or less precisely) relative to foreign currency, then that means the FairTax will have succeeded in increasing the wealth of the American people by something on the order of $20 trillion (23 percent of $90 trillion) relative to the rest of the world, an instantaneous increase nearly equal to the value of all the goods and services produced in the U.S. over two years. That would be reason enough to enact the FairTax. Unfortunately for American asset owners, it is impossible for the traded-goods sector to dominate the currency movements, since the dollar-asset markets are perhaps 100 times as large as the annual traded-goods market (net basis). See B. 100 and B. 102, Flow of Funds Accounts, U.S. of America, Fourth Quarter 2004, Federal Reserve System, for statistical information on asset markets.

[38] Professor Hausman found:

(1) That the existing disparity in treatment of corporate income taxes and VATs for purposes of border adjustment leads to extremely large economic distortions.

(2) That U.S. exporters typically bear both domestic income taxes and foreign VATs in selling abroad.

(3) That foreign exporters in countries relying largely on VATs typically receive a full rebate of such taxes upon export to the U.S., and are not subject to U.S. corporate income taxes.

(4) That this situation creates a very significant tax and cost disadvantage for U.S. producers in international trade with significant impact on investment decisions – leading to the location of major manufacturing and other production facilities in countries that benefit from current rules on the border adjustment of taxes.

(5) That elimination of the current disparity in WTO rules (by eliminating border adjustment for either direct or indirect taxes) would increase U.S. exports by 14 to 15 percent, or approximately $100 billion based upon 2004 import levels.

Border-adjustable taxes are, quite simply, the most powerful weapons foreign producers have against U.S. producers and workers. Our failure to adopt a destination-based consumption tax sends a clear message to American producers: Please, move your plants and facilities overseas, hire foreign workers, and then market your products back to the American consumers who are punished for saving and rewarded for overspending. It sends a clear signal to retailers: stock foreign inventory. It sends a clear signal to consumers: buy foreign products. The problem is that American industry and consumers are taking the Congress' tax policy advice. Market forces do work. And the burgeoning trade deficit is one of the consequences of our failure to confront this reality. The decimation of our domestic producer base results in job losses for America's middle class, lost opportunities for the young, suffering for the poor and a widening wealth gap.

II. The Medicine: Three Ways the FairTax Helps Businesses

As we lament the maladies of the current system, Congress has clear options. The best example of a tax regime that would permanently save compliance costs is the FairTax. The FairTax has been introduced in the House by Representative Rob Woodall as H.R. 25 and in the Senate as S. 13 by Senator Saxby Chambliss. The House bill now has 66 cosponsors, more than any other tax replacement plan in a century. The Senate bill has 8 cosponsors. Some are on this Committee.

The FairTax is an integrated tax replacement system that repeals all current taxes imposed by the Internal Revenue Code on income and wages, including personal, gift, estate, capital gains, alternative minimum, Social Security, Medicare, self-employment, and corporate taxes. In place of these taxes, the FairTax imposes a single-rate tax on the final retail sale of new goods and services used or consumed in the U.S. at the revenue-neutral rate of about 23 cents from every dollar spent.[39] The FairTax plan also amends the U.S. Constitution so that the income tax chapter of American taxation is closed forever.

To ensure the FairTax does not cascade, business-to-business transactions are not taxed under the FairTax. Intermediate goods and services are properly treated as inputs into goods and services sold at retail. Unlike the current system that taxes income multiple times and on an inconsistent basis, the FairTax taxes income only once, upon consumption.

A. The FairTax Would Reduce Compliance Costs More than Any Other Tax Replacement/Reform Proposal.

Compliance Costs Are Reduced an Estimated 90 Percent Under the FairTax.— The Tax Foundation, the oldest national tax research organization, has estimated that compliance costs would drop more than 90 percent under the FairTax.[40] No other plan that has been developed or could be developed would eliminate wasteful compliance costs quite like the FairTax. Consider that by imposing taxes at the cash register, the FairTax wholly exempts individuals from ever having to file a return. Since business-to-business transactions are fully exempt, businesses that serve other businesses will neither collect nor pay taxes. Retailers, most of which already collect state sales taxes (in the 45 states that have them) are provided an administrative credit compensating them for the costs of sales tax compliance. It reduces the more than 700 incomprehensible sections of the Internal Revenue Code to one simple question asked of retailers: How much did you sell to consumers?

[39] This is *a tax-inclusive* rate, the same means by which the income, payroll and capital gains taxes it replaces are measured.
[40] Hall, Arthur P., "Compliance Costs of Alternative Tax Systems," Tax Foundation, Testimony before the House Ways and Means Committee, June 6, 1995.

Examples of provisions in the tax law that cause great complexity but no longer exist under the FairTax include the uniform capitalization rules for inventory; the qualified plan rules that establish various top-heavy, non-discrimination, participation, vesting, and other rules for approximately a dozen different types of retirement savings accounts; the passive loss limitation rules; the alternative minimum tax; the qualified dividend rules (for determining whether the 15- percent rate applies to dividends); the different depreciation rules applicable for regular tax, AMT, and earnings and profits purposes; the complex rules governing whether mergers, acquisitions, and liquidations are tax free; and, in the international area, the separate basket limitations; income sourcing and expense allocation rules; controlled foreign corporation; branch profits tax, and passive foreign investment company rules.

The FairTax would be a much more efficient taxation system from the point of view of the administration, collection, and filing costs that it would bring about when compared to the administration, collection, and filing costs of the current tax system it replaces. Researchers have found the administrative costs of state sales tax vary as a percent of revenue received from between 0.4 and 1.0 percent, and average 0.7 percent of revenues received.[41] The compliance costs imposed on businesses from state sales taxes have been estimated to fall between 2.0 and 3.8 percent of revenues.[42] Based on similar methodology, researchers have estimated that the costs to comply with a national sales tax would be as low as 1.0 percent of collections, compared with the flat tax at 1.2 percent of collections and a consumed-income tax at 4.6 percent of collections.[43]

According to the IRS, historically about 12 percent of all C and S Corporation returns were filed by retail firms.[44] Retail trade accounts for about 12.9 percent of all business establishments in the U.S., according to the industry statistics as well. There are approximately 25 million business establishments in the U.S. FairTax.org estimates that, including retailers and service providers likely to sell to consumers, the number of businesses remitting the FairTax is, therefore, approximately 13 million firms. A study by Beacon Hill Institute, found that the FairTax saves $346.5 billion in administrative costs in 2005 when compared to the administrative costs of the current federal tax system it replaces. This implies a saving of $14.70 per $100 of the gross revenue the FairTax would collect.

Under the Fair Tax, certain transactional areas still require special rules. For example, the treatment of financial intermediation services, the treatment of mixed-use property, and transitional considerations will add some complexity. However, when fully operational, the main decisional juncture is reduced to the analysis under one current code section – section 162. Was a purchase an "ordinary and necessary" business expense? Any tax system that does not seek to tax business inputs (meaning any well-considered tax system) must make this essential distinction.

In summary, the savings from the reduction in taxpayers, the reduction in decisional points by simplicity, and the reduction in the events of taxation, are robust enough to ensure that even if any

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[41] Due, John F., and John L. Mikesell, *Sales Taxation, State and Local Structure and Administration*, Second edition, Washington, D.C.: Urban Institute Press, 1994.
[42] Research summarized by Cnossen. Cnossen, Sijbren, "Administrative and Compliance Costs of the VAT: A Review of the Evidence." *Tax Notes International*, Vol. 8, No. 25, June 20, 1994, pp. 1649-68.
[43] Hall, Arthur P., "Compliance Costs of Alternative Tax Systems," Tax Foundation Special Brief before the House Ways & Means Committee, June 1995.
[44] IRS Statistics of Income, Table 1.--2001, Corporation Income Tax Returns: Selected Balance Sheet, Income Statement, and Tax Items, by North American Industry Classification System (NAICS) Sector and by Asset Size.

additional spending were needed under the FairTax to hold avoidance and evasion to their current levels; this increased spending would never overcome the savings the FairTax brings when compared to the current taxation system. [45] The Laffer study on tax code complexity previously mentioned finds that over 10 years, an increase in our annual economic growth rate between 0.45 percent (the low-end estimate from a 50 percent reduction in tax complexity) and 0.9 percent (the high-end estimate from a 90 percent reduction in tax complexity) becomes significant. By the 10th year, per capita incomes would be $2,800 to $6,000 higher. So enacting the FairTax plan, which reduces compliance costs by 90 percent would create an increase in income growth and tax revenues more than double what would be expected with other tax reform plans that only bring about a 50 percent reduction in compliance costs. And this of course would inure to the advantage of business, particularly small business that again bears the lion's share of these costs.

Of course, higher economic growth by itself would raise tax revenues as well. The benefit from reduced tax complexity could significantly reduce our national debt. Due to enhanced economic growth, over the entire 10-year period, increased tax revenues at current tax rates are between $650 billion and $1.4 trillion in net present value terms[46].

The Ratio of Cost to Actual Compliance Would Greatly Improve.-- The twin advantages of simplicity and visibility produce another benefit: Greater enforceability with less intrusiveness. Recall that compliance costs are only the price to achieve compliance.

It is true that some people will evade taxes no matter what the governing tax system. The difficulty of enforcing the income tax (a tax based on a complicated legal concept of income, deductions, credits, exclusions, deferrals, exemptions, and allocations) will only worsen in the digital age without much more stringent and onerous regulation.

Analytics and empirical evidence suggests that the FairTax would increase voluntary compliance at the same time compliance costs are reduced. For example, much of the tax gap today is attributable to mistakes caused by the complexity of the law. Mistakes and confusion would be all but eliminated under a system that creates no exemptions, and dispenses with the complex issues present today. And the FairTax improves all the known factors that bear upon noncompliance, including reducing the rate and the number of focal points. The more than 60 years of practical experience in administering sales taxes at the state level supports the assertion that the FairTax would be administrable at higher compliance rates relative to administrative and compliance costs

Not only are the administrative and compliance costs of a sales tax much lower than an income tax per dollar of revenue received, the compliance rate is higher. A Minnesota study in the year 2000 compared input-output data to taxable sales and estimated how much tax should have been collected. The difference between estimated and actual collections was 9.9 percent. The sales tax gap was therefore an estimated 9.9 percent in Minnesota. This compares favorably to a federal tax compliance gap (and therefore a state income tax compliance gap) nearly double that amount, despite the imposition of much higher administrative and compliance costs. Overall, the noncompliance rate is from 15 percent to 16.6 percent of the true tax liability, according to the IRS, and that same rate of noncompliance can be

[45] Tuerck, David, Paul Bachman, and Alfonso Sanchez-Penalver, Tax Administration and Collection Costs: The FairTax vs. the Existing Federal Tax System, The Beacon Hill Institute at Suffolk University, Sept. 2007.
[46] Laffer, Winegarden, and Childs, "The Economic Burden Caused by Tax Code Complexity, April, 2011.

expected to apply to the state tax system that relies on the Federal enforcement apparatus. In the broadest aggregate, assuming the gap of $353 billion, gross noncompliance is about 18 percent of revenues.[47] The evidence at the state level suggests sales taxes – even those at the state level that are largely very complicated and which cascade – have twice the compliance rate of the income tax at a fraction of the cost.

To understand how a simple plan reduces the tax gap, policymakers must distinguish between two components of the tax gap: Fraud and non-fraud contributions. The tax gap is certainly comprised of taxes not voluntarily paid because the taxpayer violated a known legal duty (evasion), but it is also comprised of failures to pay that are unintentional, such as those caused by mathematical errors or confusion. The tax gap is at the same time a measure of the burden and frustration of taxpayers who want to comply but are tripped by tax code complexity and of willful tax cheating by a minority who want the benefits of government services without paying their fair share.[48]

The portion of the tax gap attributable to mistake and confusion is high, as high as 80 percent. Almost 40 percent of the public, according to the IRS, is out of compliance with the current tax system, some unintentionally due to its enormous complexity. The reasons for noncompliance are instructive as to the benefits of simplicity: (1) taxpayers lack the requisite knowledge of the tax law; (2) taxpayers interpret the law differently than the IRS –; (3) taxpayers lack record keeping sufficient to satisfy the IRS; and (4) taxpayers do their math wrong or they rely on professional return preparers who get it.[49] The largest percentage increase in the tax gap from 1981 to 1992 was attributable to math errors, a 212.3 percent increase.

Again, the GAO as well as others have indicated that the simpler the rules, the better. According to the GAO, "[t]his reflects the basic principle that the simpler the tax code, the more certain the results in applying it and the fewer the opportunities for disagreements over the 'fine points' of tax law."[50] The increased transparency of the FairTax system induces more compliance because it increases the likelihood that tax evasion is uncovered.

Even if we are looking at the portion of the tax gap attributable to fraud, the FairTax reduces the tax gap. To understand how it does so, policymakers need to look at the several factors that bear upon compliance: both fraud and non-fraud. An objective analysis of the FairTax demonstrates that it would have a much higher compliance rate than current law (i.e., substantially reducing the large current $312 to 353 billion "tax gap"[51]) – even with respect to those taxpayers who seek to intentionally violate a known legal duty – because it improves upon all known factors that improve compliance. For example, the FairTax reduces the number of tax filers by as much as 80 percent, as individuals are removed entirely from the tax system and because small firms account for only 14.9 percent of gross receipts by

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[47] The income tax gap of $353 billion/$1,952 trillion in collections for FY 2004.
[48] The IRS defines the tax gap as "the difference between the tax that taxpayers should pay and what they actually pay on a timely basis." The gap is broken down into three components by the IRS: Non-filing (failure to file a tax return), underreporting (understating income, overstating deductions) and underpayment (failure to fully pay reported taxes owed).
[49] The annual *Money* magazine survey in which 50 accountants prepare a hypothetical middle class couple's tax return and come up with at least 45 different answers each year is a major indication that our tax system is simply not administrable.
[50] Willis, supra.
[51] The difference between what taxpayers should pay and what they actually pay on a timely basis.

all retailers, wholesalers, and service providers.[52] More than 85 percent of the sales tax is collected by less than 15 percent of the retailers. Because compliance is inversely proportional to the marginal rate or the reward for being noncompliant,[53] and marginal tax rates are the lowest they can be under any sound tax system, cheaters profit less from cheating. In short, tax collectors focus enforcement resources on far fewer taxpayers, using consistent and vastly simpler forms, with far fewer opportunities to cheat, diminished incentives to do so, and a far greater chance of getting caught if they do.

B. The FairTax Would Unleash Economic Growth, Increase GDP, Real Wages, the Number of Jobs, Tax Revenue and Our National Prosperity

How does the FairTax address the problem of high marginal rates and double taxation of savings and investment? The short answer is that the FairTax has more positive impact than any other tax reform proposal because it has the lowest marginal tax rates of any plan, a tax base that is neutral toward savings and investment, reduces compliance costs and eliminates the bias against U.S. producers. It is difficult, therefore, to conceive of a plan that would have a more positive impact on the economy and the material well being of the American people than the FairTax.[54]

In the final analysis, the FairTax has the broadest overall base and the lowest marginal tax rates of any tax reform proposal being considered today and dramatically lower than the marginal tax rates under current law.

Kotlikoff's research finds that the current total effective federal marginal tax rates on labor supply appear to be either higher or much higher for almost all American households than they would be under the FairTax. The current system's marginal wage tax rate exceeded the FairTax's 23 percent marginal rate for all of the 42 single and married stylized households he considered.[55]

For some low- and middle-income households, the marginal tax on working under our current tax system is more than twice the 23 percent FairTax rate! Take, as an example, a middle-aged married couple earning $30,000 per year with two children. Given the level of their federal marginal tax bracket, their loss, at the margin, of the Earned Income Tax Credit from earning extra income, and their exposure to marginal FICA taxation, their current total marginal effective tax on earning an extra dollar is 47.6 percent!

Since the FairTax taxes consumption at the same rate no matter when it occurs, it imparts no incentive to consume now as opposed to later and, thus, no disincentive to save. In economic terms, the FairTax's marginal effective tax rate on saving is zero. In contrast, the existing federal tax system imposes very high marginal effective tax rates on saving. For the 42 households considered here, marginal effective tax rates on saving range from 22.6 percent to 54.2 percent.

In addition to imposing, in almost all cases, much lower marginal taxes on working and, in all cases, dramatically lower marginal taxes on saving, the FairTax imposes much lower average taxes on

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[52] IRS Statistics of Income, reported in "Impact on Small Business of Replacing the Federal Income Tax", Joint Committee on Taxation, April 23, 1996, JCS-3-96, pp. 109-127.

[53] Clotfelter, Charles T., "Tax Evasion and Tax Rates: An Analysis of Individual Returns," *The Review of Economics and Statistics*, Vol. 65, No. 3, 1983, pp. 363-373.

[54] In fact, only a head tax or per capita tax that requires each person to pay a set amount annually is more pro-growth because the marginal tax rate would be zero. Such a tax, however, would generally be regarded as unfair and is politically impossible to enact. Thus, no serious analyst has proposed it.

[55] Kotlikoff, Laurence J. and David Rapson, "Comparing Average and Marginal Tax Rates under the FairTax and the Current System of Federal Taxation," NBER Working Paper No. 12533, revised October 2006.

working-age households than does the current system. The FairTax broadens the tax base from what is now primarily a system of labor income taxation to a system that taxes, albeit indirectly, both labor income and existing wealth. By including existing wealth in the effective tax base, much of which is owned by rich and middle-class elderly households, the FairTax is able to tax labor income at a lower effective rate and, thereby, lower the average lifetime tax rates facing working-age Americans.

Below is a summary of three independent research studies on the economic impact of the FairTax plan by three different groups of economists utilizing three distinct modeling approaches. While the results vary, all three studies show that GDP growth is significantly higher than it would otherwise be if the current federal tax system remained in place. The FairTax plan would also improve wages and the economic well being of all Americans.

First, Arduin, Laffer and Moore Econometrics found that the economy fares much better under the FairTax (see table below). The economy as measured by GDP is 2.4 percent higher in the first year and 11.3 percent higher by the tenth year than it would otherwise be. Consumption increases by 2.4 percent more in the first year than it would be if the current system were to remain in place. The increase in consumption is fueled by the 1.7 percent increase in disposable (after tax) personal income that accompanies the rise in incomes from capital and labor once the FairTax is enacted. By the tenth year consumption increases by 11.7 percent over what it would be if the current tax system remained in place, and disposable income will be up by 11.8 percent.[56]

FairTax simulation model results

Cumulative growth over current system	Year 1	Year 2	Year 3	Year 4	Year 5	Year 10
Gross domestic product	2.4%	5.2%	7.0%	8.2%	9.0%	11.3%
Employment	3.5%	5.7%	7.0%	7.7%	8.2%	9.0%
Domestic investment	33.0%	35.4%	36.9%	38.0%	38.8%	41.2%
Income from employment (wages)	27.4%	31.8%	34.5%	36.4%	37.7%	41.2%
Consumption	2.4%	4.1%	5.8%	7.1%	8.1%	11.7%
Disposable personal income (adjusted for changes in the price level)	1.7%	4.5%	6.4%	7.7%	8.7%	11.8%

Units scaled 2004 GDP = 1.00. Capital and labor set to equal constant shares of 0.3 and 0.7, respectively.

Following the implementation of the FairTax plan, the higher take-home wage provides an immediate incentive for people to work more. During the first year, this will lead to total employment growth of 3.5 percent in excess of the baseline scenario, which continues to grow through year ten such that total employment is 9.0 percent above what it would have been under the baseline scenario. The impact on total labor income is even more pronounced, increasing due to both an increase in after-tax wages and an increase in the number of people working. Total labor income will rise 27.4 percent in the first year. By year ten, labor income will be over 41 percent higher than what it would have been under the baseline scenario.

[56] Arduin, Laffer & Moore Econometrics, "A Macroeconomic Analysis of the FairTax Proposal," Americans for Fair Taxation Research Monograph, July 2006.

In the second study, Laurence Kotlikoff found that switching to the FairTax (replaces all federal taxes on income with a single rate tax on final consumption) improves capital stock, which is dramatically higher in the long run under the FairTax than under the current tax system. Indeed, the capital stock in 2100 is 96.2 percent higher. While the expansion of the capital stock proceeds relatively slowly, it is noticeable even by 2010. In that year, the capital stock is 12.8 percent higher. By 2030, the capital stock is 43.7 percent higher than would otherwise have been the case.

The increased capital formation also leads to a rise in the real wage per unit of human capital. Rather than declining by 8.0 percent by the end of the century, the real wage now rises by 17.0 percent. This is a 25.0-percent difference in real worker remuneration. Again, the pace of the change is slow, but by 2030 real wages under the FairTax are 11.5 percent higher than they would otherwise have been. In transforming the economy's prospect from one of a capital shortage to one of capital deepening, the FairTax also reduces real interest rates, with the 2100 real interest rate ending up 160 basis points lower than under the current system.[57]

And the third study, by The Beacon Hill Institute, uses a dynamic computable general equilibrium (CGE) model to estimate the impact of the FairTax plan on the economy. Their main findings are:

- GDP is estimated to be 7.9 percent higher in the first year, 10.9% higher in year 10 and 10.3% higher in year 25 after enactment of the FairTax than what would otherwise be the case if the current system remained in place.
- Domestic investment is 74.5% higher, 75.9% higher and 65.2% higher in years 1, 10, and 25, respectively.
- The capital stock is 9.3% higher in year 5, 14.1% higher in year 10, and 17.3% higher in year 25.
- Real wages are 10.3%, 9.5%, and 9.2% higher in years 1, 10, and 25, respectively than would otherwise be the case.
- Consumption drops slightly in the first two years (0.6% and 0.8%), and then becomes 1.8% higher in year 5, 4.3% higher in year 10, and 6.0% higher in year 25.

The economic studies discussed above examine only the effects caused by the reduction in the user cost of capital and labor responsiveness to changes in marginal tax rates and do not examine microeconomic efficiencies gained from a more efficient allocation of scarce capital/labor resources, productivity gains from lower private tax compliance costs, or gains in competitiveness from moving to a destination-principle tax. They also generally make limiting assumptions about attracting investment from abroad.

Replacing federal income, payroll, and estate and gift taxes with the FairTax has a positive impact on the stock and bond markets as well. The value of corporate stock or a corporate bond is the present discounted value of the expected future income stream (net of tax) of the stock or bond. Thus, a stock's value or a bond's value is a function of two things: The expected future income from owning the asset and the interest rate. If a firm's expected future income stream increases, then the stock will increase in value. If a firm's expected future income stream goes down, then the stock price will fall. If the expected future income stream from a bond declines due, for example, to a heightened risk of default, then the price of the bond will fall. Changes in interest rates also dramatically affect the price of stocks and bonds.

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[57] Kotlikoff, Laurence J. and Sabine Jokisch, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," *National Tax Journal*, June 2007.

Similarly, lower interest rates mean that the present value of the future income that a corporation is expected to earn will increase. Thus, lower interest rates cause stock prices to rise. When interest rates rise, the present value of the corporation's future income declines and stock prices decline.

The FairTax causes nominal interest rates to fall. Interest rates will fall 25-35 percent under a consumption tax like the FairTax.[58] Rates will drop immediately and quickly toward the current tax-exempt rate. Investors will no longer need to receive a tax premium to achieve a particular after-tax rate of return. The impact of eliminating this "tax wedge" or tax premium on interest can be seen every day in the *Wall Street Journal*. Tax-exempt municipal bonds tend to yield about 30 percent less than taxable corporate bonds of similar term and risk.

C. The FairTax Would Introduce to the World the Most Internally Sound and Competitive Tax System

Effect on Direct Investment, Locational Decisions, and Repatriation.— Consider what would happen to the current international tax problems posed above if the FairTax were adopted beginning with the consequences of the U.S. being the world's largest national market with a zero marginal rate of tax on productive activity, investment and capital returns. Such a change would have profound relevance for both foreign direct investment and domestic locational choices.

The U.S. would become the most attractive jurisdiction in the world from which to export, attracting both foreign direct investment and domestic investment to base operations here. This, of course, satisfies the fundamental policy goal of those who are considering a territorial taxing regime for the U.S., as many countries have adopted: that goal is to ensure that a choice between headquartering a company in the U.S. or overseas would not be influenced through the application of high U.S. marginal tax rates to global income with no connection to the U.S. save the fact that the location of the headquarters of the company. The FairTax provides the equivalent of a territorial taxing regime because it does not tax foreign sourced income at all, and therefore cedes taxing jurisdiction to the country of income source.

But it improves upon this choice dramatically. The FairTax would not also encourage investment overseas as the territorial tax movement, by its own rationale, admits would occur. In fact, a zero rate of U.S. tax would give foreign jurisdictions two choices: Reduce their tax rate on savings and investment (which will stimulate global economic reform and growth) or lose investment to America. Companies now American in name only would repatriate investment and jobs back to our shores.

Adoption of the FairTax would also end the problem posed by deferral – which imposes a penalty for repatriating income earned overseas. Companies here now in name only would repatriate investment and jobs back to our shores without penalty, since the earnings of subsidiaries would not be taxed to the parent at all and the taxes paid to foreign nations would not be limited by the complex foreign tax credit rules. And since the U.S. would not tax foreign returns to capital (as it would not tax U.S. returns) the U.S. market for investment in stocks, in business, in real estate and otherwise would effectively become the world's largest tax haven for investment capital.

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[58] For an more detailed discussion of the impact a national sales tax would have on interest rates, see Golob, John E., "How Would Tax Reform Affect Financial Markets?," *Economic Review*, Federal Reserve Bank of Kansas City, Fourth Quarter, 1995. He estimates a 25-35 percent drop (p. 27). See also Feldstein, Martin, "The Effect of a Consumption Tax on the Rate of Interest," National Bureau of Economic Research, Working Paper No. 5397, December, 1995.

Answering the Problem Posed by Border-Adjustable Tax Subsidies.-- There are two ways tax-writers could confront the reality of global border-adjustable taxes: (1) encourage our trade representatives and trading partners to allow income taxes to be border-adjusted, or (2) adopt our own destination-based consumption tax. The first will never happen.

To get some sense of the Herculean task involved with the former tack, consider convincing the WTO's Member countries to eliminate the admittedly artificial distinction now drawn by the WTO between direct taxes (income taxes) and indirect taxes (consumption taxes) on which their trade subsidies depend. These are the same nations willing to sue in international courts to get the U.S. to abandon its relatively minor export incentive worth about $4 billion annually (the Foreign Sales Corporations) so as to preserve for themselves this unilateral advantage.

Even if such diplomacy were to miraculously prevail, eliminating the indirect/direct distinction would only countervail a sliver of the trade subsidy, and then only for exporters. If the direct/indirect distinction were fully eliminated, an export subsidy would only allow exporters to defer or exempt a portion of their *income tax,* when payroll taxes constitute about 36 percent of the gross collections by type of tax. And lest we forget, since America has record trade deficits, this does nothing to level the playing field on imports which continue to compete against domestic producers unfairly on our own soil.

The best alternative is to enact what the rest of the world has enacted – a destination-principle tax system (also known as a border-adjusted tax system) – that incorporates our entire tax burden. We need to move to a tax system that taxes all goods consumed in the U.S. alike, whether the goods are produced in the U.S. or abroad. We need to eliminate those aspects of the U.S. tax system that artificially place U.S. production at a competitive disadvantage compared to foreign production.

How would the FairTax accomplish this full-scale border adjustability? As an indirect tax, fully WTO-compliant, the FairTax would:

- repeal *all* upstream federal taxes now embedded in the product price of U.S. goods and eliminates any business-to-business taxes, including payroll taxes,
- completely exempt foreign consumption from taxation. Only goods and services for final retail sale in the U.S. are taxed, and
- impose the FairTax on foreign goods entering our shores for final consumption.

Recall the table above which showed the unfair application of foreign and U.S. taxes on exports and imports restively. In essence, under current law, foreign and U.S. taxes are doubly imposed on goods produced in the U.S., while imports that compete against U.S. produced goods are exempted from taxation. Now consider how under the FairTax, the table would look entirely neutral as to whether foreign or U.S. goods were consumed here or abroad.

The U.S. Tax System Under the FairTax

	Sold in U.S. market	**Sold in foreign markets**
U.S. production	Pays the FairTax.	Pays foreign value-added tax
Foreign production	Is exempted from the source country VAT, but pays *the FairTax*	Pays foreign value-added tax

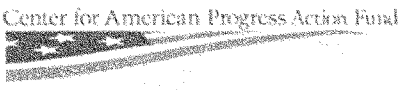
Only the FairTax can claim that under its regime, foreign manufactured goods and U.S. manufactured goods will pay the same tax when the goods are sold at retail. Only the FairTax can make the claim that U.S. businesses selling goods or services in foreign markets will be fully relieved of federal tax (including payroll taxes).

Conclusion

I conclude with an observation about tenor of discussion for fundamental tax reform. Many who lack an in-depth knowledge of the tax laws, their practical effect cling to an unfounded assumption that the Income Tax System is somewhat of an American inheritance – devolved from a celestial body as highest social engineering achievement of mankind. Perhaps this theory is bolstered by the ecosystem made dependent upon it, where lobbyists, Members and industry seeking relative advantage combine in that unholy trinity to conspire unwittingly against national prosperity. But to mainstream economists nothing could be farther from the truth.

Enabled by a political system that has literally sold each word, each deduction, each credit and each exemption to the highest bidder at a private auction, our tax system has been cobbled together by the finest lobbyists America can produce, not our nation's finest economists. The result has been predictable: our tax code has enshrined politics over sound policy, special interests over the interests of our national prosperity. And what is most troublesome, in this season of politics, it is justified by political advisers who see the merits in advancing trite distributional tests without defining fairness– even as the devastating effects of slower economic growth impact our national well-being. Must we be reminded, lower income Americans are the first to be fired when bad times come, and the last to be rehired when good times return.

The beneficiaries of this broken discourse are the new industry of American political divisiveness: the losers are the American people, whose prosperity is diminished. It is as if political leaders who would rather sow the seeds of divisiveness than accede true reform is essential to our national prosperity. To the extent your hearing examines what we are doing wrong, how a tax system can be least destructive, it is a breath of fresh air. To the extent you are able to move the monolith, to effectuate these recommendations, to define reform in a manner repeated by the chorus of economists, we applaud you. You will be living up the trust that the American people have given to you.



Testimony before the Joint Economic Committee hearing,
"Could Tax Reform Boost Business Investment and Job Creation?"

Seth Hanlon,
Director of Fiscal Reform, Center for American Progress Action Fund
November 17, 2011

Thank you, Chairman Casey, Vice-Chairman Brady, and the members of the committee for the chance to appear today to discuss tax reform and the economy.

There is wide agreement that the tax code is long overdue for reform. Our current tax code is inefficient, overly complex, and unfair in myriad ways. Our tax code is also failing at its most fundamental purpose, which is to raise sufficient revenue to meet our needs as a country in an equitable way. Fundamental tax reform—a reform that broadens the tax base and eliminates economic distortions—is important for promoting long-term economic growth.

That said, tax reform simply cannot address the central economic challenge facing the United States right now—the severe and prolonged jobs crisis, which is a product of the lack of demand in the economy. At a time of 9 percent unemployment and vast unused resources, Congress should be focused above all else on boosting demand, reducing unemployment, and putting our economy back on a path toward healthy economic growth.

And so my testimony today will summarize briefly the reasons why I believe that fundamental tax reform is an important priority, but one that should not derail immediate and fast-acting measures to address our most pressing challenge—putting people back to work. My testimony will then discuss some of the critical issues and principles in tax reform, including:

- The fiscal context for tax reform
- The need to avoid tax policies that would shift a greater share of the tax burden on middle-class families
- The need for business tax reform that encourages investment and job growth in the United States, levels the playing field among competing businesses, and ensures that companies pay their fair share

* *

I. The immediate economic challenge

The most immediate and fundamental challenge facing the economy today is the jobs crisis. More specifically, it is the $1 trillion hole in aggregate demand caused by the collapse of the housing bubble, the financial crisis, and continued mass unemployment.[1] The Great Recession is still taking its toll on the economy. The output gap—the difference between the economy's actual output and its capacity to produce at full employment—is still at about 6.7 percent of potential GDP, or nearly $1 trillion per year.[2] That gap has closed somewhat since the low point of the Great Recession, thanks in part to the American Recovery and Reinvestment Act and other policies, but the Congressional Budget Office projects it to remain at 5 percent below potential GDP through 2011, with an output gap persisting for several years to come and inflicting continued pain on workers.

The economy needs more aggregate demand to close the output gap and return people to work. CBO predicts that if we stay on the current policy path "a large amount of labor and capital resources [will] be unused for some time."[3] The fact that the economy is not performing at its potential is shown most dramatically and tragically in the fact that 14 million people remain unemployed, and long-term unemployment stands at record levels. The prolonged output gap means that business investments are not being made and worker skills are atrophying, which hurts our national economic competitiveness.

With excess capacity, businesses will be hesitant to hire and invest until they are confident there will be demand for their products and services. The most urgent problem is not a lack of capital, at least not for large businesses. The corporate sector has been enjoying strong profits and is flush with cash: Nonfinancial companies are holding more than $2 trillion in cash and liquid assets in the United States, according to the Federal Reserve.[4] The tax code is now strongly incentivizing business investment, with 100 percent expensing (full write-offs) of investments made this year. And despite the claims, "regulatory uncertainty" is not a real explanation for the lack of hiring.[5] Both the economic data and business owners themselves point to a lack of demand as the major obstacle to job creation and economic growth.[6]

Though it is not the subject of my testimony today, my colleagues at the Center for American Progress have identified the most promising ways to boost consumer and business demand and create private-sector jobs while investing in the future. They include: investing in infrastructure, aiding the housing market by reducing the flood of foreclosed homes, providing aid to the states to prevent further public sector layoffs, and supporting the energy-efficient retrofitting of homes and businesses.[7] Congress also cannot afford to *worsen* consumer demand by allowing the temporary payroll tax reductions and long-term unemployment assistance to expire. These ideas and others are encapsulated in the president's American Jobs Act, which many independent forecasters predict will create as many as 1.3-1.9 million jobs.[8]

In sum, tax reform is a worthy goal. Done right, it can improve long-term economic growth, especially if it is part of a long-term growth strategy that also makes important public investments and strengthens the middle class.[9] But it is not a response to the immediate and ongoing jobs crisis. And therefore discussions of tax reform should not be to the exclusion of immediate job creation measures like the American Jobs Act.

II. The context for tax reform: long-term fiscal challenges and growing inequality

a. The existing tax code does not raise adequate revenue to meet national needs under any realistic fiscal scenario.

Any tax reform effort will have to be considered against the backdrop of the long-term fiscal challenges facing the United States. Those challenges are undeniable. The United States was running deficits even at the peak of the business cycle in the mid-2000s. Since 2008, the recession and Congress's policy responses caused a sharp fall-off in revenues. The short-term fiscal situation has improved, with deficits as a share of GDP declining for fiscal year 2012 and projected to decline further over the next several years. However, the more serious challenges are in 2021 and beyond, as an aging population, rising health care costs (even if the rate of growth slows), responsibilities to the millions of new Iraq and Afghanistan veterans, a decaying infrastructure in need of rebuilding, and other ongoing national needs exert pressures on the budget. The United States will also have to pay a growing amount of interest on the debts incurred from the wars, the 2001-03 tax cuts, and the larger deficits caused by the recession.

The fact is that our current tax policies do not raise nearly enough revenue to stop the accumulation of debt, even in scenarios with draconian spending cuts. If we maintain our current tax policies, revenues will only reach 18.1 percent of GDP in 2021 and will average just 17.7 percent over the next decade.[10] That is not nearly enough to prevent continued deficits even under the House-passed budget, under which federal spending would decline to about 20 percent by the end of the decade. That budget would dramatically reduce public investments in education, infrastructure, and scientific research while tearing at the social safety net, including turning Medicare into an inadequate voucher program and slashing Medicaid.

In light of these realities, every major bipartisan effort to propose solutions for the nation's long-term fiscal challenges has found it necessary to rely on both spending reductions and substantial revenue increases that boost revenues to at least 20 percent of GDP, or significantly higher.[11] It should be noted that federal revenues averaged about 20 percent of GDP over the four-year period from FY 1998-FY 2001, when the budget was last in balance—and spending needs were much less then, with a smaller pre-9/11 military budget, a younger population, and lower health-care costs per capita.

The fact that our current tax code is inadequate to fund our national needs without accumulating more debt means that tax reform must contribute to solving our long-term fiscal challenges. In other words, it must be revenue-positive. If our tax code cannot be reformed to raise additional revenue, the resulting deficits will drive debt-to-GDP ratios to unsustainable levels, with negative repercussions for the United States economy over the long term.

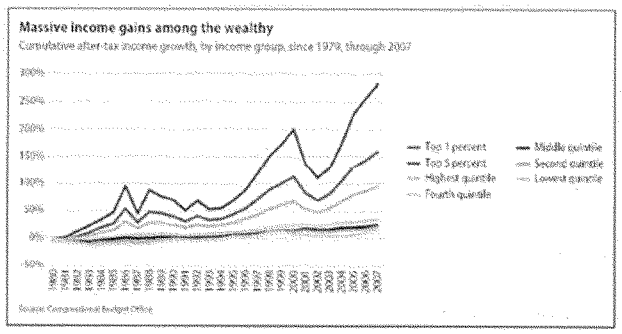
Many hold up the last major tax overhaul, the Tax Reform Act of 1986, as a model for today. TRA86 was ostensibly revenue neutral, achieving significant reductions in both corporate and individual tax rates in exchange for reductions in tax expenditures and loopholes. But today, our long-term budget challenges are much more severe than they were in 1986. And the large budget

deficits that persisted after 1986 were closed only through further deficit reduction efforts, including increases in the top marginal rates in 1990 and 1993.

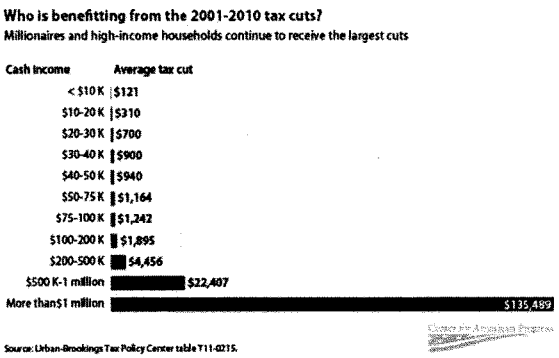
The good news is that unlike some European countries that also have long-term fiscal imbalances, the United States is a low-tax country. Federal receipts as a share of GDP were under 15 percent for the last three years—the lowest since 1950. The United States also raises comparatively little revenue by international standards: Total revenues in the United States were 26.9 percent of GDP from 2004-2008, nearly 25 percent lower than the average OECD country. Within the OECD, only Mexico, Chile, Turkey, and South Korea had lower taxes as a share of their economies. By comparison, revenues total 33 percent of GDP in Canada and 36 percent in Britain. The bottom line is that there is ample room to increase revenues. We are a low-tax country now and will remain a relatively low-tax country even if we balance the federal budget entirely with new revenue.

b. Tax reform must not exacerbate growing income inequality by shifting a greater share of the tax burden onto low-income Americans and the middle class.

Another important part of the context for tax reform is that income inequality has dramatically widened in recent decades. Top income earners, most dramatically the top 1 percent, have pulled apart from those in the middle and at the bottom. In recent years, the share of income accruing to the top 1 percent reached levels not seen since the 1920s.[12] At the same time, real incomes for the middle class have barely grown.



As income inequality has continued to grow, and while middle-class incomes have stagnated, the tax rates paid by the well-off have plunged. Millionaires are now paying about one-quarter less in federal taxes as a share of their income as they were as recently as the mid-1990s.[13] The top 1 percent of Americans has experienced a similar reduction in taxes.[14] A principal cause of the lighter tax burden on the wealthy was the tax rate cuts enacted under President George W. Bush in 2001 and 2003: The average millionaire (whose incomes average $2.9 million) will pay $135,000 less this year because the 2001-03 tax cuts are still in effect, according to the nonpartisan Tax Policy Center.[15] The wealthy have also benefitted greatly from historically low rates on income from capital gains and dividends.[16]



The end result is a federal income tax code that is generally progressive, but less progressive than it used to be, and one in which many very wealthy people pay lower effective rates than people below them on the income scale. And of course the federal income tax is only one component of a larger tax system; other kinds of taxes, including payroll taxes and consumption taxes (e.g., excise taxes, state and local sales taxes) fall harder on those at the bottom than those at the top. Families in the middle of the income spectrum pay 9.4 percent of their incomes in federal payroll taxes on average, while the top one percent pays only 1.6 percent.[17] This is because the largest portion of federal payroll taxes only applies to a worker's first $106,800 in wages, and not to wages in excess of that amount or to investment income.

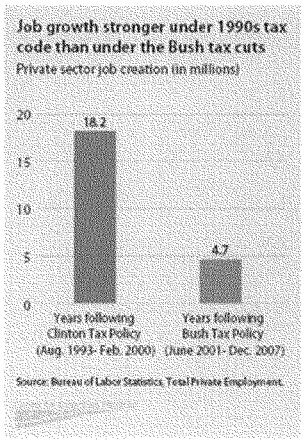
President Obama has said that one of the principles underlying tax reform should be the "Buffett rule." The "Buffett rule" is not a specific tax code rule, but the general principle that no millionaires should be paying lower taxes as a share of their income than middle-class families. The current tax code often violates this principle. For example, there are nearly 100,000 millionaires (about one in four) who pay a tax rate of less than 26.5 percent—more than 10.4 million Americans earning less than $100,000 pay.[18] Statistics like these undermine the sense of basic fairness that should undergird the tax code.

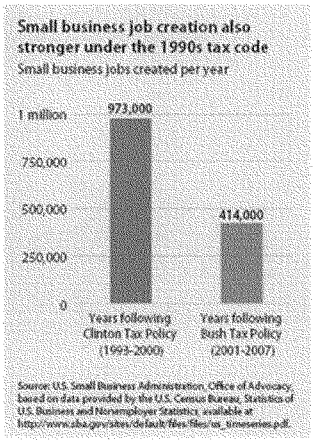
So in sum, we need additional revenues. And the group of Americans whose incomes have skyrocketed are now paying lower taxes than they were just a short time ago. These factors point toward allowing the Bush tax cuts on top-incomes to expire. Doing so would reduce the deficit over 10 years by about $800 billion—two-thirds of the way toward the amount of deficit reduction that the Joint Select Committee on Deficit Reduction is charged with finding.

It is often claimed that allowing the high-end Bush tax cuts to expire—which would simply reinstitute the top marginal tax rates that were in effect during the 1990s economic expansion—would stifle job creation and harm small businesses. It is even said that the very prospect that tax rates on the rich will return to 1990s levels—with the 33 percent bracket going to 36 percent and the 35 percent bracket going to 39.6 percent—is holding back hiring and business investment. Neither of these claims is true. Three facts underscore why.

The first is recent history. The expiration of the two top brackets would simply revert the top marginal tax rates to levels that were in effect from 1993-2001. The same claims about economic growth and the negative impact on small business were made in 1993, when the top marginal rate was raised from 31 percent to 39.6 percent, a much larger percent increase than is contemplated now. What followed, however, was a period of very strong economic growth and job growth, among both large and small employers. And the federal budget was balanced for the last four fiscal years the 1990s tax rates were in effect.

With higher tax rates on both ordinary income and capital gains in effect, business investment was stronger in the 1990s than in the period since the 2001-03 tax cuts.[19] Millions of jobs were created and real incomes grew across the income spectrum. About 18.2 million private-sector jobs were created in the six years after the top tax rate was raised to 39.6 percent in 1993, compared to only 4.7 million private-sector jobs created in the corresponding period after the 2001 Bush tax cuts, which does not even include job losses from the Great Recession.[20] Small businesses created jobs at a much faster rate when the Clinton-era tax code was in effect. Between 1993 and 2000 small businesses (those with fewer than 500 employees) added nearly a million jobs per year on average (973,000). But in the period after the Bush tax cuts were enacted in 2001 until the onset of the recession in 2007, small business job growth was less than twice as rapid (414,000 per year).[21]





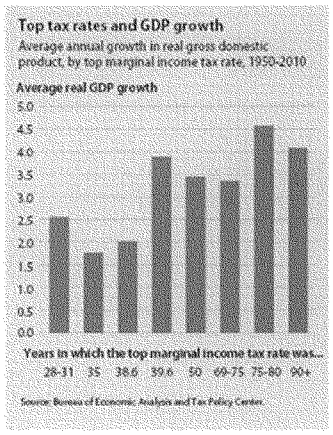
Also undermining the claim that small businesses will be harmed if the high-end Bush tax cuts expire on schedule is that only a very small percentage of small businesses owners are in the highest tax brackets. Only about 3 percent of small business owners are in the top two tax brackets.[22]

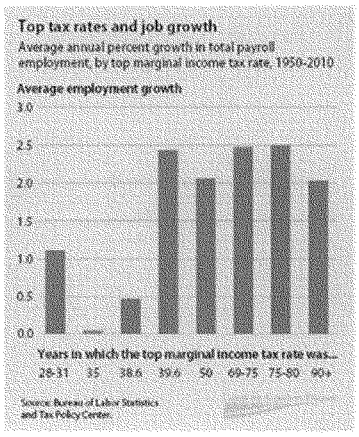
And finally, the portion of the benefit of extending the high-end tax cuts going to small business employers is very small. A new Treasury report reveals that fully 92 percent of the tax benefit

would go to corporate executives, investors, highly paid professionals, athletes, and other people who are not small business employers.[23]

Two other points should be emphasized. First, even those in the 33 and 35 percent brackets would continue to benefit by about $6,500 per year from extensions of the current *lower bracket* rates, which President Obama has proposed in each of his budgets. And they would only pay incrementally higher tax rates on dollars of income earned above the cutoffs for the top two brackets. A married business owner with $300,000 in total income and $250,000 in taxable income, for example, would pay only $243 more under the rate structure in the president's budget proposal than she is now—or less than 0.1 percent of her total income. A business owner with $600,000 in total income and $500,000 in taxable income would pay only about $10,000 more—or only 1.5 percent of his total income. It is difficult to believe that a business owner would respond to these modestly higher personal tax bills by cutting payroll or foregoing promising investments. It is even more difficult to believe that the very prospect of such modest tax increases taking effect in 2013 would be chilling business investment today. It should also be emphasized that because labor costs are deductible, the marginal personal tax rate of the owners of a business has no impact on the business's incentive to hire workers.

Top bracket rates of 36 and 39.6 percent are much lower than the top rates that existed for most of the history of the income tax, including the United States's strongest periods of economic growth. The historical evidence shows that marginal rates higher than current rates are perfectly consistent with robust economic growth. As my colleague Michael Linden has found, the United States has experienced stronger economic growth and faster job creation in periods when top marginal tax rates were much higher than the current 35 percent.[24]





In sum, there is little reason to believe that the expiration of the Bush-era marginal income tax rates on high-incomes will have a negative impact on economic growth or job creation. Rather, they will strengthen our economy's long-term prospects by contributing substantially to debt

reduction. The expiration of the top two marginal rates is an important first step toward a fair and fiscally responsible tax code.

III. Corporate and business tax reform

Finally, I would like to address the corporate and business tax reform—in particular the need for tax reform that encourages rather than discourages job growth in the United States, levels the playing field among competing businesses, and ensures that U.S. companies pay their fair share.

The corporate tax is an important component of our tax system. It is the third largest federal revenue source, behind individual income and payroll taxes. It also provides a needed backstop to the individual income tax, preventing tax sheltering in corporations and helping to maintain the progressivity of the income tax. However, the corporate tax is in need of reform. In President Obama's words, "Over the years, a parade of lobbyists has rigged the tax code to benefit particular companies and industries. Those with accountants or lawyers to work the system can end up paying no taxes at all. But all the rest are hit with one of the highest corporate tax rates in the world. It makes no sense, and it has to change."

The president is right that the corporate tax code favors some industries over others, distorting investment and thereby impeding economic growth over the long-term. The corporate tax code is ripe for reform.

a. The corporate tax burden in context

As with individual taxes, the discussion of corporate tax reform must take into account the fiscal challenges facing the United States. Corporate taxes once contributed about 30 percent of federal revenues in the 1950s, but they have steadily declined and in recent years have averaged only about 10 percent of federal revenues. Corporate taxes represent a smaller portion of GDP in the United States than in other major economies.[25] With the diminishing corporate tax, the United States has relied more heavily on other taxes, in particular payroll taxes on wages. Payroll taxes, which were about 12 percent of federal revenues during the 1950s, have reached 40 percent of revenues.[26] The increasing share of business activity being conducted via "passthrough" entities, including S corporations and LLCs is partly responsible for the decline in corporate tax revenues. But also responsible is the fact that corporations are paying lower tax rates on their profits than they did in the recent past.[27]

This is the case despite the fact that the United States's 35 percent statutory tax rate—the rate on the books—has not been lowered in 25 years and is now the second-highest in the OECD. But solely focusing on the statutory rate leads to misperceptions about the overall tax rate actually paid by corporations, because it ignores the wide variety of tax preferences and loopholes that exist in the code. Corporate "tax expenditures," the special exemptions, deductions, and credits that companies use to reduce their tax bill, total roughly $1.2 trillion over 10 years.[28] And not all features of the tax code reducing corporate effective rates appear on the official tax expenditure lists.

The better measure of the actual tax paid by corporations is their effective rates. And corporate effective rates are much lower than the statutory 35 percent rate. Recent studies have found that the effective rates of large U.S. corporations are in line with or actually lower than their foreign counterparts.

- In 2007, a Treasury Department survey found that by one measure, the average tax rate paid by U.S. corporations from 2000-2005 was 13.4 percent—below the OECD average of 16.1 percent.[29] As the Treasury report summarized, "The contrast between [the United States's] high statutory corporate income tax rate and low average corporate tax rate implies a relatively narrow corporate tax base, due to accelerated depreciation allowances, corporate tax preferences, and tax-planning incentives created by [the] high statutory rate."[30]

- A recent analysis of public company financial statements by Citizens for Tax Justice and the Institute for Taxation and Economic Policy (CTJ/ITEP) found that 280 of the largest U.S. corporations paid an average effective tax rate of 18.5 percent over 2008-2010—just over half of the statutory rate.[31]

- A recent study of the effective tax rate paid by the largest 100 U.S. companies and 100 largest European Union companies over the last decade found that the American companies paid lower income tax rates, on average, than their European rivals.[32]

- Other studies have found that corporate effective rates are closely in line with those in other large countries.[33]

Because their success is bound to the success of the overall U.S. economy, U.S. corporations have a strong stake in our country's fiscal sustainability and growth. They benefit greatly from U.S. government services, from law enforcement to product safety, to patent protection, to education and workforce development. Given these realities, the corporate sector should not be exempted from the process of deficit reduction. To take the corporate income tax off the deficit reduction table means that critical government services and public investments would face even deeper cuts, or that middle-class Americans would face a larger share of the tax burden. Neither alternative is desirable. The narrowness of the U.S. corporate tax base means that U.S. corporations can, on the whole, contribute a greater share of revenues. Accordingly, corporate tax reform should be at least revenue-neutral. Given the potential savings from broadening the corporate tax base, it should be possible to achieve deficit reduction from the corporate tax while still lowering the statutory rate.

b. International tax reform

The corporate tax code is replete with explicit subsidies and other preferences that cause economic distortions. One of the most significant distortions in the corporate code is its fundamental bias toward foreign investment over investment in the United States.

The debate over international taxes is often framed as a choice between "worldwide" and "territorial" tax systems. I would maintain that these labels obscure the more fundamental issues

of whether our tax system encourages investment and job creation in the United States and whether it protects our revenue base.

Despite the fact that the United States nominally has a "worldwide" tax system, foreign profits are taxed very differently than domestic profits. Because of the feature known as "deferral," U.S. multinationals can delay paying U.S. taxes on overseas profits indefinitely, whereas they pay taxes on domestic profits in the year they are earned. Overseas profits are taxed only when and if they are returned to the United States, as when they are paid out as dividends from overseas subsidiaries to U.S. parents. At that point corporations do not pay the U.S. corporate rate, but rather the difference between the U.S. corporate rate and the effective rate of foreign taxes they have paid. (This is because corporations are entitled to a credit for foreign taxes.)

Our current deferral system provides tax incentives for overseas investments. In fact, it encourages U.S. companies to make job-creating investments offshore even if similar investments in the United States (absent tax considerations) would be more profitable. As a result of "deferral" and other aspects of the U.S. international tax system, U.S. multinational corporations pay much lower tax rates on foreign investments than on domestic investments: In 2008, the Government Accountability Office, or GAO, found that corporations pay a 16.1 percent rate on foreign-source income (combining both the source country tax and the residual U.S. tax), and a 25.2 percent rate on U.S. source income.[34] In recent years, companies have become more adept at lowering the effective rate on foreign investments, and thus their overall effective tax rates, through complex tax strategies enabled by U.S. policy changes.[35] These strategies are only available to large multinationals.

The tax differential between foreign and domestic income not only puts a thumb on the scale in favor of offshore investment; it also creates enormous incentives for companies to use complex legal and accounting techniques to move income-producing assets to low-tax countries or tax havens, especially assets like valuable intellectual property that exist only on paper.[36] U.S. companies report their largest profits in small countries like the Netherlands, Luxembourg, and Bermuda—even though that is clearly not where the most real economic activity is taking place.[37] The U.S. Treasury, the Government Accountability Office, the Joint Committee on Taxation, and numerous independent researchers have published studies pointing to strong evidence of tax-motivated income shifting.[38] The resulting phenomenon has been called "stateless income" —profits that migrate to low-tax or no-tax jurisdictions, eroding the tax bases of the countries where the income is actually generated (*i.e.*, where the R&D is performed, the business decisions are made, where the customers are, and so on).

Corporate income shifting decimates the corporate revenue base, draining the United States of tens of billions of dollars in revenue every year. By one estimate, the U.S. government lost about $90 billion in revenue in 2008 from corporate income shifting—up from $60 billion in 2004.[39] To put that figure in perspective, the corporate income tax only raised an average of $300 billion per year during the 2004-08 timespan.

These two problems—the bias toward overseas investment and the erosion of the tax base due to income shifting—could be made worse if the United States moves in the direction of a "territorial" tax system without more fundamental reforms. Under a territorial system, overseas

profits would be tax-exempt, not just tax-deferred. The only remaining backstop against profit shifting, the tax upon repatriation, would be removed.

It is often said that the United States must move to a territorial system to maintain competitiveness with other countries that have adopted territorial taxation. But there is little evidence that U.S. firms' global competitiveness is actually being undermined by the existing deferral system, which (because of the combination of deferral and other aspects of the tax code) often allows them to pay lower taxes than they would under a properly functioning territorial system.[40] Of course, the competitiveness of a company is determined mostly by nontax factors; but to the extent taxes matter, the key figure is the company's relative effective tax rate. The most recent comprehensive survey of the effective tax rate paid by the largest 100 U.S. companies and 100 largest European Union companies over the last decade found that the American companies paid about the same or lower effective tax rates, on average, than their European rivals.[41]

As one of the authors of that study notes, the reason that EU companies have the same or higher effective rates is that EU countries have a broader tax base. Specifically, those countries have stronger antiabuse rules that deter the shifting of profits into tax havens.[42] Rather than moving headlong toward territoriality, the United States should address income shifting directly. A good place to start would be to enact a rule requiring current U.S. taxation of income reported in low-tax countries or tax-havens. Many countries with "territorial" tax systems already have such rules [43]

c. Leveling the playing field among business investment by reducing inefficient tax code subsidies

Finally, corporate tax reform provides an opportunity to level the playing field between businesses and reduce the economic distortions caused by special tax preferences. The tax code contains some $130 billion in annual tax expenditures benefitting businesses.[44] The approximately $100 billion for corporations represents a significant share (one-quarter to one-half) of all corporate tax revenues.

The relative generosity of these types of subsidies helps lead to vast differentials in the relative tax burdens of various industrial sectors. For example, according to financial statement research by New York University professor Aswath Damodaran, drug and biotechnology firms paid a small fraction of the statutory rate (effective rates of 4.5 and 5.6 percent, respectively); while heavy construction and trucking firms paid close to 35 percent (33.8 percent and 30.9 percent, respectively). Financial services firms paid 16.5 percent, while petroleum producers paid 11.3 percent.[45] The recent CTJ/ITEP analysis of corporate effective rates also found that corporate effective tax rates vary widely by industry: Financial firms, for example, paid 15.5 percent effective rates; miscellaneous manufacturing paid 23.1 percent; and engineering and construction paid 27.4 percent. CTJ/ITEP found that 56 percent of total tax subsidies went to four industries: financial, utilities, telecommunications, and oil, gas, and pipelines.[46]

By reducing unjustified preferences, Congress can level the playing field for competing investments. Removing tax-caused distortions can improve long-term economic growth; it can also reduce the deficit and potentially help pay for a corporate rate reduction.

To be sure, however, some business tax expenditures have economic justifications. The low-income housing tax credit, for example, helps address the dearth of affordable housing in many communities and cannot simply be eliminated. There is also a strong theoretical justification for the research tax credit, in that one firm's research and experimentation expenses may lead to innovations that benefit other firms and the broader economy. Congress should, however, conduct ongoing reviews of the credit's effectiveness in increasing innovative research above the levels that would exist in its absence. In general, Congress should apply the same level of scrutiny to these kinds of special tax breaks as it does to programs that spend taxpayer dollars directly. After all, as economists across the ideological spectrum recognize, tax "expenditures" are the economic equivalent of spending programs.[47]

In reviewing the tax expenditure budget, the critical question is not whether the sectors that receive special tax breaks support jobs or economic activity—of course they do—but whether there is a strong enough public policy reason to give them taxpayer subsidies not available to other businesses. A useful framework for evaluating special tax provisions is whether, if they were structured as direct-spending programs, they would make economic sense or represent the best use of taxpayer dollars.

The need to scrutinize the effectiveness of business tax expenditures highlights one final point: Tax reform is hard. Fiscally responsible reforms to corporate taxes are probably not possible without reforms to other aspects of the tax code, potentially affecting individuals and noncorporate businesses. Reform is extremely complex, and must be done right, which will take time.

* * *

That brings me back to my central point, which is that while tax reform has the potential to enhance our economy's growth prospects over the long-term, it should not distract Congress from the urgent jobs crisis facing America today.

Thank you once again for the opportunity to appear today.

[1] *See* Adam Hersh, *Misery is not an option: Economy needs more demand*, MarketWatch, July 29, 2011, http://www.marketwatch.com/story/misery-is-not-an-option-economy-needs-more-demand-2011-07-29?link=MW_story_latest_news.
[2] Congressional Budget Office, Detailed Economic Projections, CY 2011-2021; Actual Data, 1950-2009, http://cbo.gov/doc.cfm?index=12316.
[3] Statement of Congressional Budget Office Director Douglas Elmendorf, "Confronting the Nation's Fiscal Policy Challenges," before the Joint Select Committee on Deficit Reduction, Sept. 13, 2011, http://www.cbo.gov/ftpdocs/124xx/doc12413/09-13-FiscalPolicyChallenges.pdf.
[4] Ben Casselman & Justin Lahart, *Companies Shun Investment, Hoard Cash*, Wall St. Journal, Sept. 17, 2011.
[5] *See* Lawrence Mishel, *Regulatory Uncertainty: A Phony Explanation for Our Jobs Problem*, (Washington: Economic Policy Institute, Sept. 27, 2011); Kristina Costa & Michael Linden, *Five Canards About Job-Killing Regulations*, (Washington: Center for American Progress, Oct. 21, 2011, http://www.americanprogress.org/issues/2011/10/regulation_canards.html.
[6] Small business owners have identified "poor sales" as the single most important problem facing their businesses in recent surveys of small business owners conducted by the National Federation of Independent Businesses (NFIB). *See* Mishel, *Regulatory Uncertainty*, pp. 6-8.
[7] Michael Ettlinger et al, *Spurring Job Creation in the Private Sector*, (Washington: Center for American Progress, Aug. 26, 2011), http://www.americanprogressaction.org/issues/2011/08/private_sector_jobs.html.
[8] *See* Mark Zandi, *An Analysis of the Obama Jobs Plan*, Moody's Analytics, Sept. 9, 2011, http://www.economy.com/dismal/article_free.asp?cid=224641; Macroeconomic Advisers, American Jobs Act: A Significant Boost to GDP and Employment, Sept. 8, 2011, http://macroadvisers.blogspot.com/2011/09/american-jobs-act-significant-boost-to.html.
[9] The Center for American Progress recently proposed a comprehensive plan for balancing the budget, reforming the tax code, and promoting long-term growth. *See* Michael Ettlinger, Michael Linden & Seth Hanlon, *Budgeting for Growth and Prosperity* (Washington: Center for American Progress, May 2011), http://www.americanprogress.org/issues/2011/05/budgeting_for_growth.html. The plan was developed as part of the Solutions Initiative convened by the Peter G. Peterson Foundation.
[10] This scenario would extend all of the 2001-03 tax cuts, "patch" the AMT, and maintain all current "tax extenders." The current payroll tax holiday is not extended under this scenario.
[11] The co-chairs of the President's Commission on Fiscal Responsibility and Reform ("Bowles-Simpson") proposed to increase revenues to 20.5 percent of GDP by 2021; the Bipartisan Policy Center's Debt Reduction Task Force ("Rivlin-Domenici") raised revenues to 21.4 percent of GDP by 2021; and the rough outline from the Senate's "Gang of Six" would raise revenues to 19.9 percent of GDP by 2021. *See* Michael Linden, *Obama Plan Lighter on Taxes than Bipartisan Plans*, (Washington: Center for American Progress, Sept. 26, 2011), http://www.americanprogress.org/issues/2011/09/obama_plan_revenue.html).
[12] Thomas Picketty & Emmanuel Saez, *Income Inequality in the United States, 1913-1998*, Quarterly Journal of Economics, 118(1), 2003, 1-39 (and 2008 update), available at http://elsa.berkeley.edu/~saez/.
[13] Seth Hanlon, *Making More, Contributing Less* (Washington: Center for American Progress, Aug. 4, 2011), http://www.americanprogress.org/issues/2011/08/millionaire_tax_rates.html.
[14] Congressional Budget Office, *Average Federal Taxes by Income Group* (June 2010).
[15] Tax Policy Center, Table T11-0207. "Millionaires" are households with more than $1,000,000 in cash income.
[16] At 15 percent, the tax rate on long-term capital gains is the lowest since the 1930s; the 15 percent rate on qualified dividends is the lowest ever.
[17] Congressional Budget Office, *Average Federal Taxes by Income Group* (June 2010) (2007 figures). CBO attributes employer-side payroll taxes to workers.
[18] These figures include all federal taxes. *See* Thomas L. Hungerford, *An Analysis of the "Buffett Rule"* (Congressional Research Service, October 7, 2011); Sarah Ayres, *The Three Things You Need to Know About Millionaire Tax Rates* (Washington, Center for American Progress, Oct. 14, 2011), http://www.americanprogress.org/issues/2011/09/millionaire_fast_facts.html.
[19] *See* Michael Ettlinger & John Irons, *Take a Walk on the Supply Side* (Washington, Center for American Progress, Sept. 12, 2008), http://www.americanprogress.org/issues/2008/09/supply_side.html.
[20] Bureau of Labor Statistics, Total Private Employment (comparing August 1993 – February 2000; June 2001 – December 2007).

[21] U.S. Small Business Administration, Office of Advocacy, based on data provided by the U.S. Census Bureau, Statistics of U.S. Business and Nonemployer Statistics, available athttp://www.sba.gov/sites/default/files/files/us_timeseries.pdf.

[22] *See* Joint Committee on Taxation, *President Law and the President's Fiscal Year 2011 Budget Proposals Related to Selected Individual Income Tax Provisions Scheduled to Expire under the Sunset Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001* (JCT 36-10, July 14, 2010), p. 10; Urban-Brookings Tax Policy Center, Table T10-0186 (finding that only 2.5 percent of tax units reporting business income of any kind, and 3.2 percent of those reporting positive business income, would have fallen into the top two tax brackets in 2011 under President Obama's proposal to allow the 2001-03 tax cuts to expire for top earners).

[23] This figure was derived by economist Martin A. Sullivan (Tax Notes, Sept. 12, 2011) from recent Treasury data in Knittel et al, *Methodology to Identify Small Businesses and Their Owners*, Office of Tax Analysis, Technical Paper 4, Aug. 2011.

[24] Michael Linden, *The Myth of the Lower Marginal Rates* (Washington: Center for American Progress, June 20, 2011), http://www.americanprogress.org/issues/2011/06/marginal_tax_charticle.html; Linden, *Rich People's Taxes Have Little to Do with Job Creation* (Washington: Center for American Progress, June 27, 2011), http://www.americanprogress.org/issues/2011/06/marginal_tax_employment_charticle.html.

[25] U.S Dep't of Treasury, *Treasury Conference on Business Taxation and Global Competitiveness, Background Paper* (July 23, 2007), table 5.3, http://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf.

[26] OMB Historical Tables, table 2.2.

[27] Citizens for Tax Justice and the Institute for Taxation and Economic Policy have been analyzing the financial statements of the largest U.S. corporations since the early 1980s. The corporations included in their study paid an average effective tax rate of 14.1 percent in 1981-83, which rose to 26.5 percent shortly after the Tax Reform Act of 1986. In 1996-98 the average effective rate fell to 21.7 percent; and in 2002-03 it had fallen to 17.2 percent. The latest study, based on 280 profitable companies over the years 2008-10, found that the corporations paid an average effective rate of 18.5 percent. *See* Citizens for Tax Justice and the Institute for Taxation and Economic Policy, *Corporate Taxpayers & Corporate Tax Dodgers, 2008-10*, http://ctj.org/corporatetaxdodgers/, p. 9.

[28] *See* U.S Dep't of Treasury, *Treasury Conference on Business Taxation and Global Competitiveness, Background Paper* (July 23, 2007), table 2.1, http://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf.

[29] U.S Dep't of Treasury, *Treasury Conference on Business Taxation and Global Competitiveness, Background Paper* (July 23, 2007), table 5.3, http://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf. Using OECD data, the Treasury study divides corporate operating surplus by corporate remittances to derive a measure of average tax rates in each country.

[30] *Treasury Background Paper (2007)*, p. 43.

[31] The CTJ/ITEP analysis only included companies that reported profits in all three years.

[32] Reuven Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest U.S. and E.U. Multinationals* (draft of Oct. 24, 2011), available at http://ssrn.com/abstract=1949226.

[33] A summary of such studies is found in Jane Gravelle, *International Corporate Tax Rate Comparisons and Policy Implications* (Washington: Congressional Research Service, Mar. 31, 2011).

[34] Government Accountability Office, *U.S. Multinational Corporations: Effective Tax Rates Are Correlated with Where Income Is Reported* (GAO-08-950, Aug. 2008), http://www.gao.gov/new.items/d08950.pdf.

[35] Roseanne Altshuler & Harry Grubert, *The Three Parties in the Race to the Bottom: Host Governments, Home Governments, and Multinational Companies*, 7 Fla. Tax Rev. 154 (2005) (attributing the decline to tax planning strategies developed after the introduction of the U.S. Treasury's "check the box" regulations in 1997); Edward D. Kleinbard, *Stateless Income*, 11 Fla. Tax Rev. __ (2011) (forthcoming), pp. 33-57 (also discussing the enactment of IRC section 954(c)(6) in 2004).

[36] Several illustrative (anonymous) examples of these techniques are described in Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX 37-10, July 20, 2010).

[37] *See* Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, Tax Notes (March 30, 2011).

[38] Dep't of the Treasury, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (Nov. 2007); GAO (2008); Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX 37-10); Michael McDonald, *Income Shifting from Transfer Pricing: Further Evidence from Tax Return Data* (Dep't of Treasury, Office of Tax Analysis Technical Working Paper 2, July 2008); Statement of Martin A. Sullivan, "Transfer Pricing Issues in the Global Economy," before the

Committee on Ways and Means, U.S. House of Representatives, July 22, 2010; Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, Tax Notes (Mar. 28, 2011).

[39] Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, Tax Notes (March 30, 2011). Martin Sullivan cites $28 billion annually as a "lower bound" estimate. Sullivan, 7/22/10 testimony.

[40] J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 Emory L.J.79 (2009).

[41] Reuven Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest U.S. and E.U. Multinationals* (draft of Oct. 24, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1949226.

[42] Avi-Yonah & Lahav, p. 7.

[43] Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income* (JCX 33-11, May 20, 2011).

[44] President's Economic Recovery Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation* (Aug. 2010).

[45] Professor Damodaran's complete chart is available at http://www.stern.nyu.edu/~adamodar/pc/archives/dbtfund09.xls

[46] *See* Citizens for Tax Justice and the Institute for Taxation and Economic Policy, *Corporate Taxpayers & Corporate Tax Dodgers, 2008-10*, http://ctj.org/corporatetaxdodgers/, p. 8.

[47] Several economists and tax experts emphasized this point at a recent Senate Finance Committee hearing. Former Federal Reserve Board Chairman Alan Greenspan said: "Cuts in tax expenditures can be alternatively structured, and viewed, as cuts in outlays rather than a reduction in revenues. The deduction for interest on home mortgages, for example, could just as easily have been reconstituted as a subsidy payment to homeowners. Similarly, oil and gas depletion allowances could be restructured as subsidies to producers." President Ronald Reagan's chief economic advisor, Martin Feldstein, testified that when tax expenditures are reduced, "the economic effect is the same as any other reduction in government outlays." Edward Kleinbard, former director of Congress's Joint Committee on Taxation, explained that "deliberate Congressional subsidy programs baked into the tax code … are a form of government spending, not tax reductions." Senate Finance Committee Hearing, "Examining Whether There is a Role for Tax Reform in Comprehensive Deficit Reduction and U.S. Fiscal Policy," Sept. 13, 2011.