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PROGRESSIVITY AND THE FEDERAL TAX CODE

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PROGRESSIVITY AND THE FEDERAL TAX CODE

TUESDAY, JULY 15, 1986

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

The committee met, pursuant to notice, at 10 a.m., in room 2359, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representative Obey.

Also present: Steve Quick, Don Terry, and Chris Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. Let me simply say that this week we are going to see the beginning of a conference between the Senate and the House on tax reform legislation. And whichever way it goes, it will be a historic act on the part of the Congress.

There's no question that either the Senate or the House bill will provide a greater degree of horizontal equity than does the existing Tax Code. I think both bills represent a significant reversal of the 1981 decision to cut corporate taxes more steeply than individual taxes. And there's no doubt that the public wants both of those changes to occur.

But I think there's another change being contemplated, especially in the Senate bill, which is certainly at least debatable. And that is a question which in my mind ought to be looked at much more clearly because this is the last chance we'll have to do so. It's a question of the degree to which progressivity will be written out of the existing Tax Code.

Much has been written about the Senate bill in terms of its reduction of individual tax rates. It has been advertised as cutting individual tax rates. It has been advertised as having two rates—15 percent and 27 percent. But if you look at the details of that proposal, you could, I think, fairly conclude that there has been a significant amount of false advertising going on with that piece of legislation.

I would simply make two points. From the information I've seen, I think it's fair to conclude that the Senate proposal at this point would result in about 30 percent of all households with taxable income between $20,000 and $75,000 actually experiencing the joys of paying higher taxes in 1988 than they're paying today. And it is possible, given the timing of certain of the provisions in that legislation, for a majority of households in that category to actually experience a tax increase for 1987.

Second, the Senate bill has not two brackets, but four. For a family of four, on an income of zero to $13,000, roughly, there is no tax. There's a 15-percent marginal tax rate on income between $13,000 and $42,000. Between $42,000 and $75,000, there's a 27-percent tax rate. On income between $75,000 and $185,000, there is a 32-percent tax rate, as this chart indicates, because of the surcharge provision in the Senate bill.

But then, quaintly, the Senate bill drops the rate for income above $185,000 back down to 27 percent.

I guess what that means is that the fellow who drives a Chevy will be taxed at a 15-percent rate. The fellow who drives an Olds will be taxed at a 27-percent rate. The person who drives a Cadillac will be taxed at a 32-percent rate. And the person who drives a Rolls will be taxed at 27 percent.

I didn't know that we were in the business of subsidizing income for people in those categories, but I guess the Senate bill suggests that we give them a little encouragement.

In light of that gift to the superrich, which we have in the Senate proposal, I think it's legitimate to ask two questions. Would we really prefer to allow that provision to continue, or would it be better to use the potential revenue associated with that drop from the 32-percent rate for the very well off to 27 percent for the extremely well off, to reduce taxes for people on the lower end of the scale by an additional small degree or, given the fact that even OMB this morning is admitting that the deficit for this year is going to be larger than had been expected, would it be appropriate to continue that gift to the superrich in light of the fact that the deficit appears to be growing beyond expectations?

I have heard estimates that suggest, for instance, that even if Congress lives up to every pledge it made when it passed the budget resolution in terms of reducing spending, that we will still fall somewhere between $15 and $17 billion short in revenues expected because of the slowdown in the economy.

So I think those two questions—or I think the quaint Senate provision on that tax gift to the superrich ought to be considered in the light of those other questions. And we have two witnesses here today who I think can help us put in some focus what our choices are.

We have, first of all, on the assumption that the people who are going to be taxed ought to be consulted about what their preferences are before we make a final judgment on this score, we have Mr. Burns Roper. And we also have with us Mr. Alan Blinder, who, I think, given his testimony before various committees over the past 3 or 4 years, has become synonymous with intellectually defensible tax reform.

And I guess what I would like to do, Mr. Roper, is begin with you and have you lay out for us some of the interesting results that you found in the poll you conducted recently about public attitudes about tax reform.

We're happy to have you with us.

STATEMENT OF BURNS W. ROPER, CHAIRMAN, ROPER ORGANIZATION

Mr. ROPER. Thank you, Mr. Chairman.

I was asked here today because of two public opinion surveys the Roper Organization has recently completed on public attitudes toward our tax system, and specifically, toward tax reform. I'm flattered to be invited and pleased to tell you what these surveys found.

Let me start with the more comprehensive of the two surveys. This was a survey commissioned, but not designed, by H&R Block. This was the fourth survey in a series Block has undertaken to determine how the American public feels about our Federal tax system, what changes they would favor and what changes they would oppose. Each of the four surveys has been made public in its entirety. Each of the four has been conducted only after initial exploratory conversations with experts who are concerned with tax policy, both in and out of government.

Interviewing on this year's study took place on a face-to-face basis with a representative nationwide sample of 1,500 adults during the period from April 12 to 19, when the whole question of taxes was fresh in the public's mind.

More important than the actual dates are what existed by way of tax reform legislation and proposals at the time interviewing took place. The House Ways and Means Committee bill had been approved by the full House when interviewing started. No action had been taken, nor was any specific proposal being considered by the Senate Finance Committee, as of the date interviewing ended.

I mention this by way of noting that any specific bill the public was reacting to in this study had to be the House bill. There was no Senate bill, or even a proposed Senate bill.

We asked the American public which of a list of things the words "tax reform" mean to them. Of the six meanings we suggested, the easy winner was "that the income tax system would be revised to make it fairer to everyone, the poor, the rich, and the middle class." Forty-six percent said that was what tax reform meant to them.

In second place was "that the income tax system would be tightened up so that tax loopholes that work to the advantage of some people would be eliminated." That is what tax reform meant to 29 percent of the sample. The other four meanings we suggested were "also rans."

On the subject of loopholes, people do not regard the rather widespread, common deductions such as mortgage interest, charitable contributions, and IRA contributions as loopholes. These are seen as reasonable deductions. Hence, loopholes have to be the exotic deductions and shelters that most people probably couldn't even describe.

It seems clear from these data that the public's focus is fairness. But what does fairness mean? We get a clue from another question in the survey which asked whether each of a number of types of people pay too much, too little, or about the right amount in Federal income taxes. Fifty-three percent said low-income families pay too much. Only 4 percent said they pay too little. The results were almost identical for middle-income families; 62 percent said too much, 4 percent too little.

By contrast, 77 percent felt high-income families pay too little and only 7 percent feel they pay too much.

Similarly, 78 percent feel large business corporations pay too little and only 6 percent feel they pay too much.

Another question that deals with fairness is one in which we pointed out that some years back the top tax bracket was 90 percent, then it was lowered to 70 percent and now it is 50 percent, with a proposal to lower it to 35 percent. People were then asked whether they thought such a move was a good idea or a bad idea. Only 1 in 5 saw it as a good idea; 2 in 3 viewed it as a bad idea.

We then asked about a hypothetical family of four at each of five different annual income levels. At each income level, we asked whether the family should pay more in taxes than they do now or should pay less than they do now or whether their taxes should be left just as they are.

I think it's easiest to assimilate these results if I read you the percentages at each income level who said that that family's tax should be increased.

At the $12,000 income level, 1 percent said their taxes should be increased. At the $25,000 level, 3 percent said increased. At $50,000, it was 23 percent. At $100,000, it was 56 percent. And at the $200,000 level, 73 percent said their taxes should be increased.

Now let me read you the percentages at each of these same levels who said their taxes should be decreased.

At the $12,000 level, 55 percent said their taxes should be lowered and another 18 percent volunteered the opinion that a family with a $12,000 income should pay no taxes at all, even though the question did not specifically mention this as an option.

This means, then, that 73 percent of the American public think that families of four with $12,000 incomes should have their taxes either lowered or eliminated. Forty-two percent think such families with $25,000 incomes should have their taxes lowered. Only 14 percent would lower the taxes of the $50,000 a year family. That figure drops to 8 percent at the $100,000 level and to 5 percent at the $200,000 level.

At the two extremes, $12,000 annual income and $200,000 annual income, the results to this question are almost mirror images of each other. At the $12,000 level, 73 percent of the American public would either reduce or eliminate a family's taxes. Only 1 percent would increase them.

At the $200,000 level, 73 percent of the American public would increase taxes, only 5 percent would reduce them.

These results show quite clearly that the public wants a more progressive tax system, not a simplified, flatter tax system. Tax reform to the American public means fairness and their perception of fairness is more progressive, not less progressive.

We asked people whether they generally favored or opposed "the tax reform proposals before Congress." As I said earlier, at the time interviewing actually took place, the only "tax proposals before Congress" were the House-approved bill. The public favored the proposals before Congress at that time by a 43- to 30-percent margin with the balance undecided.

We then asked people what they thought the effect of the tax proposals before Congress would be on various kinds of groups' taxes. Rightly or wrongly, people clearly thought taxes would go down for low-income people, that they would go up for high-income people, and they would go up for business.

So to summarize some of the principal findings of this H&R Block sponsored study, tax reform to the American public means fairness and plugging loopholes. This, in turn, means a more progressive tax system, not a flatter tax system.

Let me turn now to the second of the two studies we conducted on the subject of tax reform. This second study was conducted for the Cable News Network and U.S. News & World Report. It was less intensive a survey than the Block study, but it had the virtue that it was conducted immediately after the Senate Finance Committee approved the Senate Finance Committee reform bill by a 20-to-0 vote, whereas the H&R Block study was conducted prior to any suggestion of a Senate bill.

Because this U.S. News and Cable News Network survey was a telephone survey that dealt with several different subjects and not just taxes, it attempted to wrap up public attitudes toward the Senate Finance Committee bill in one big, fat question. To assess the results this survey produced about the Senate Finance Committee bill, one must know the actual question asked to judge its fairness or unfairness and to judge its completeness or incompleteness.

Let me read it:

> The Senate Finance Committee has just passed a sweeping tax reform bill. Please bear with me a minute while I describe it. The bill simplifies individual income taxes and sharply lowers the maximum tax rates—from 50 percent now to 27 percent in the new bill. At the same time, a number of deductions people are accustomed to are eliminated to make these lower tax rates possible. You would no longer be able to deduct from your taxable income the money you put into an IRA, if you have any other pension plan; you could not deduct State and local sales taxes; you could not deduct interest you pay on installment loans, car loans, and credit card balances; and capital gains would be taxed like any other income. The net effect of the lower tax rates, but with fewer deductions, would be a tax that is about the same or slightly less for most people than they now pay. From what you know of the new tax bill, would you like to see Congress pass it, or would you rather they stick to the present tax laws?

In response to this question, 50 percent of the sample said stick to the present tax laws; only 33 percent said pass the new Senate bill. Of those who expressed an opinion, sentiment was 3 to 2 against the Finance Committee bill.

Quite frankly, I was very surprised by these results. When I wrote that question, I thought that the last thing people heard before being asked the question itself would be all that they took into account in answering the question. By that I mean the sentence that said:

> The net effect of the lowered tax rates but with fewer deductions would be a tax that is about the same or slightly less for most people than they now pay.

Now, knowing the results to this question on the one hand and knowing what the Block study found, I think it is clear that people got a very different picture of the Senate Finance Committee bill from what I had expected. Instead of favoring the bill because their taxes would be the same or lowered, it now seems to me clear that their reaction was, "I'm supposed to give up my IRA deduction, my sales tax deduction, and my installment interest deductions so that the fat cats can have their tax rates cut almost in half, while my taxes remain either unchanged or only slightly lowered."

Incidentally, the other polls I have seen, and specifically, the NBC-Wall Street Journal poll, pretty much validate our findings. The NBC-Wall Street Journal poll approached the subject somewhat differently, but got confirmatory results.

In their poll, they described the essential elements of the Senate and House bills, but without identifying them as the Senate and House bills. They asked a seemingly theoretical question about deep cuts in tax rates, but with very few deductions versus lesser cuts in tax rates but with more deductions. The respondents they interviewed favored the lesser cuts with more deductions by a 54- to 35-percent margin over the deep cuts with few deductions.

There's one final point I'd like to make.

To some, these results may seem to say simply, don't tax you, don't tax me, tax that fellow behind the tree. There is undoubtedly some of that. But I do not regard that as the main message. People are concerned with fairness, fairness as they perceive it.

If it were simply a matter of tax someone else, one might expect the more affluent segment of our society to want to raise taxes on lower income people and lower taxes on higher income people.

Let us look for a moment not at the entire American public, as we have been, but at those people with annual incomes of $35,000 or more, roughly the upper quartile of the Nation's population. Let's look at how this group answered about the family of four at each of five different income levels.

Only 1 percent of this upscale group would raise taxes for the $12,000 family. Sixty-nine percent would lower or eliminate their taxes. Only 1 percent of this group would raise the taxes of the $25,000 family. Forty-seven percent would lower them.

When it comes to the $50,000 family, which is roughly where most of this upper income group is, or presumably expect to be some day, more say taxes should be lowered than raised. But far more significantly, a clear majority of 61 percent says taxes on the $50,000 family should be left as they are. When it comes to the $100,000 family, sentiment reverses. Forty-five percent of the most prosperous quartile say taxes should be raised on the $100,000 family. Only 14 percent say lowered.

As far as the $200,000 family is concerned, it's still more lopsided. Seventy percent of those earning $35,000 or more/say taxes should be raised for the $200,000 family. Only 5 percent say they should be lowered.

If opinion were purely of a self-interest nature, people would not overwhelmingly favor lowering taxes at income levels below theirs, favor leaving taxes as they are at their own income levels, and favor raising them at the higher levels they aspire to.

In this statement, I've gone very light on the documentation for the points I've made, for everything I have referred to is documented in the H&R Block report which all Members of Congress have already received.

To conclude and summarize, as well as repeat myself, our two surveys and all of the others I have seen that bear on the issue of progressive versus flat tax, say that the public wants a more progressive tax system, not a less progressive tax system, in order to achieve greater fairness.

Thank you.

Representative OBEY. Thank you very much, Mr. Roper.

Mr. Blinder, please proceed.

STATEMENT OF ALAN S. BLINDER, GORDON S. RENTSCHLER MEMORIAL PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY

Mr. BLINDER. Thank you, Mr. Chairman.

I'd particularly like to thank you for inviting me to testify here today on the eve, if that's the right word, of the very important conference that is coming up. If the American people are lucky, at the end of this we'll have a better bill than either the House bill or the Senate bill now offers. If we're unlucky, the obvious will happen.

One of the issues that's sure to arise, and the one that you asked me to address here today, is the appropriate degree of progressivity in the bracket structure, and in particular, the concern of some Members of the House and Senate and, from what we've just heard, the concern of a preponderant majority of public opinion that the rates in these bills, and especially in the Senate bill, are not sufficiently progressive.

I'd like to begin with a distinction that somehow seems to have been lost in the entire tax reform debate, which is that in deciding how to reform the income tax, there are two very different issues to be faced. The first, and the one that economists generally identify with tax reform, is deciding on a definition of income for tax purposes. That is to say, drawing up lists of items that are going to be totally or partially excluded, deductions, tax credits, and the like.

The fundamental objective of tax reform, as we all know, is to pare down this list as much as possible, and especially to make it more rational. That is to say, to broaden the tax base.

In making decisions like that, the guiding principles are, as Mr. Roper was just saying, fairness, which in this context means mainly horizontal equity rather than vertical equity. I'll come back to vertical equity shortly. Second, simplicity. And third, the one that economists worry about most but everyone else worries about least, economic efficiency. That is to say, a desire to have a less intrusive tax system that distorts the allocation of resources less.

Now a tax system that is more neutral—that is to say, a tax system that imposes equal marginal rates of taxation on different types of income—will generally contribute to each of these three goals. It will make the tax system simpler, more efficient and normally would contribute to horizontal equity. And because of that greater tax neutrality has always been one of the basic goals of tax reformers.

But there's a second question which is really logically distinct: deciding on the system of bracket rates to apply to whatever definition of income we settle upon. The guiding principle here is really quite different than those used in defining the base. The rate structure that we select ought to reflect society's ethical judgments about what constitutes ability to pay and what constitutes distributive justice, which are issues on which economists claim no particular expertise—but politicians do, as well they should.

A second relevant factor in fixing the rate structure is the disincentive effects of high marginal tax rates. Here economists do claim some expertise.

Now in thinking about how we should apportion the tax burden, it is the average, not the marginal, rates of tax on different people that matter. Even if the tax rate structure was strictly flat—that is, if it had only one bracket rate, which the Senate bill certainly does not—it could still be quite progressive if it allowed a big enough exemption.

My first point is that these two decisions are logically distinct. Once we decide how to broaden the base—and the House and Senate, of course, reached different decisions on that—we can then apply rates that are steeply progressive, mildly progressive, or not progressive at all, depending on how we weigh the welfare of the lower, middle, and upper income classes, and how we appraise the incentive effects of high tax rates.

That neat, logical distinction between the two groups of decisions, however, was never made in the tax reform debate because the two decisions are not politically separable. And that's because any decision we make about either the base or the bracket rates affects the tax burdens that particular groups of people bear, and Members of Congress are keenly interested in that, as well they should be.

Nonetheless, I think it useful to remember, especially at this stage, that the two decisions really are logically separable. There is nothing inconsistent, for example, with taking the Senate's broader personal income tax base—broader relative to the House and to the current code, that is—and applying more graduated rates to that base so as to shift some of the tax burden higher up on the income distribution.

Supply-side rhetoric notwithstanding, no economic miracle should be expected from the Senate's 32-percent top marginal rate rather than the 35 percent that the President originally insisted on or the 38 percent that's in the House's bill. After all, we didn't witness any miracle in 1981 when we cut the marginal rate on top earners far more than we're talking about doing now.

The current tax reform system starts from a tax system, the one that we have now, that looks very progressive if you simply look at the tax form, but really isn't. A family of four is entitled to roughly $8,000 of tax-free income if it claims the standard deduction, and thereafter, marginal rates escalate from 11 percent up to 50 percent. So just looking at that, you might think we have a very progressive tax system.

But a great deal of that progressivity, I'm afraid, is mythical. Progressivity has slipped badly at the top of the income distribution due mainly to the erosion of the tax base. Scores of tax loopholes make taxable income an ever poorer indicator of true economic income as we go up the income ladder.

We've all heard, for example, of the lurid tales of millionaires who, quite legally, don't pay any tax at all. More systematically, the Joint Taxation Committee estimated that 44 percent of the taxpayers with total true income above $200,000 paid an average tax rate that was below 20 percent. And fully two-thirds of this well-off group paid an average tax rate below 30 percent, irrespective of what the tax table said they were supposed to pay.

So we now have a system of putatively high tax rates on the rich which we don't actually expect them to pay. I, for one, find that basically fraudulent and would greatly prefer a system that had a less progressive rate structure, but one that we actually made people pay.

Progressivity has slipped at the bottom of the income distribution for a very different reason—mainly the erosion of the real value of the personal exemption and the standard deduction. You can think of the erosion since the 1981 Tax Act, but it is more relevant to think of the erosion since the 1950's. The exemption and standard deduction have been falling in real terms, with occasional reversals, since the 1950's. In fact, even the personal exemption that's in the House and Senate bills will not restore the real value of the exemptions to what it was in 1955. It leaves it lower in real terms.

The result of this inflationary erosion has been to pull more and more poor and near-poor families into the income tax system precisely at the time when their payroll tax burdens were escalating dramatically.

Frankly, I've always been much more concerned with progressivity at the bottom of the income distribution than at the top.

Now if we turn to the two competing bills, we find that each broadens the tax base and lowers the tax rates, the marginal rates that is. But the Senate bill does far more broadening of the personal tax base, while the House bill concentrates on the corporate tax base.

The House's personal income tax brackets are graduated, though not as steeply as those in the current law, while the Senate's have the odd structure to which you've already referred and to which I will return.

What do the two bills do to the distribution of the tax burden?

Well, in the lower half, roughly, of the income distribution, the overriding feature is certainly that each bill raises the zero bracket amount from about $8,000 for a family of four taking the standard deduction to about $13,000. And because of that, either of these two bills is far more progressive at the bottom than what we have now. I consider this easing of tax burdens on the poor and the near-poor one of the really great achievements of both tax bills. And it would be a shame, indeed, if bickering about any other aspect of progressivity were allowed to interfere with it in any way. It certainly doesn't look like that's going to happen in the conference.

For most of the rest of tax returns—just to pick rough numbers, say, family incomes of between $30,000 and $80,000, which get you most of the rest of Americans, but not the well off—the Senate's implied average returns on taxable income are systematically lower than the House's. But that's somewhat misleading because the Senate's definition of taxable income is a good deal broader than the House's, especially in its denial of many deductions, some of which were mentioned already.

In addition, the Senate's bill has a broader definition of income, which includes 100 percent of capital gains in income, which disallows passive losses on partnerships—which I think is very important—and which limits immediate deductions for IRA's—which are heavily used in this income tax bracket and are not very heavily used in the income brackets below $30,000.

Now there seems to be some political concern that people at the lower end of this income range—say $30,000 to $40,000, or something like that—are treated shabbily by the Senate bill relative to the House bill. And if that's deemed a problem, a suggestion I'll make shortly would rectify it rather easily.

Now I come to the rich. To compare what the two bills do at the top of the income distribution, we must distinguish between the moderately rich—say, incomes from $80,000 to $200,000—and the extremely rich—say, incomes above $200,000—for the Senate bill is relatively tough on the former, but remarkably solicitous of the latter.

In addition, we ought to remember that the owners of capital—that is to say, wealthy people—probably pay most of the corporate income tax, although there's some doubt about that. And there's a substantial difference between the House and Senate bills on corporate taxes, with the House putting a bigger burden on corporations.

As you've already noted, the Senate bill has been and continues to be falsely advertised as having only two rates—15 and 27 percent. And it seems, that no matter how many people point that out, the newspapers every day carry a story about how wonderful it is that the highest rate in the Senate bill is 27 percent. Unfortunately, no matter how many times that is said, it isn't true. It doesn't matter if every newspaper in the country says it. The highest tax bracket in the Senate bill is at least 32 percent, and can, indeed, go higher because the second part of the phaseout, the part that phases out the personal exemption, depends on how many exemptions you have. And for families with incomes in the relevant bracket and with more than four exemptions, the top marginal rate, is, in fact, higher than 32 percent.

It's an interesting question, by the way, which is only tangentially related to progressivity, as to why the Senate wants to put the highest marginal tax rate on the biggest families. But I won't speculate on that.

The result of this is what you see on the chart: that the Senate's bracket structure, even if you leave out the zero bracket, is not a two-bracket structure, but a four-bracket structure that bumps up to 32 percent, possibly goes even higher for a few families, and then comes back down to 27 percent.

This ungainly bracket structure puts the highest marginal rates on the moderately rich rather than on the truly rich, which is a sharp departure from historical practice. To my knowledge, we've never done that before, going right back to the beginning of the income tax.

At a minimum, that seems an odd way to set tax brackets and I'd like to know the reasons for it other than what I think really is the reason, which is concealing the fact that the top rate is really 32 percent, not 27 percent.

Going beyond esthetic considerations, it strikes many people, as it struck you, as unfair to place a higher marginal rate on a family with two working professionals—this is the sort of person that will fall into this high bracket rate—than on a multimillionaire, an inequity, by the way, which is componded by the fact that the professional couple can take their allowable deductions only against the lower 27-percent rate, even though their income will be taxed at the 32-percent marginal rate.

More to the point of progressivity, however, is the fact that this gerrymandered bracket structure effectively ends all progressivity in the extreme upper tail of the income distribution.

Under the Senate's bracket structure, a family of four will reach the 26-percent average—not marginal, but average—tax rate at a taxable income of $161,450. Beyond that point, the average tax rate will creep up at a snail's pace and never get above 27 percent, even for someone who earns $20, $30, $50 million in a year.

So, essentially, we have almost, though not literally, a completely flat average tax structure beyond about $161,000 a year.

The resulting tax savings of that flat structure for the very rich are tremendous. They approximate 5 percent of income, which, when you're talking about seven-figure incomes, is a huge sum of money.

Now, as I indicated before, I'm far more concerned with progressivity at the bottom than at the top. And this problem that I'm alluding to now is really of very small importance relative to the concern with the people at the bottom.

Nonetheless, there is enough egalitarian left in me—and it does seem, from the poll results, enough egalitarianism left in the American people—to be somewhat offended by these huge giveaways to the extremely rich, especially in view of the fact that they were the big winners from the 1981 tax cuts. And, again, we should remember that in addition to this, the Senate bill puts lower taxes on corporations than does the House bill. And it's likely that those corporate taxes fall most heavily on the wealthy.

So I take it, then, that there are two main distributional concerns with the Senate bill. First, that it doesn't give a big enough tax break to families in the $30,000 to $40,000 range, or something like that, and second, that it's too generous to the very rich.

If that's so, there's a simple way to ameliorate both problems at once without raising the highest bracket rate in the Senate bill. And that would simply be by taking the 32-percent rate that is now the highest marginal rate in the Senate bill and simply lining it out so it applies to all taxable income above $75,000, rather than dropping back to 27 percent for the very rich.

As I indicated a moment ago, that would raise the average tax rate on millionaires from roughly 27 percent to roughly 32 percent. It would thereby free up some revenue that could be used to help moderate-income people, the people that many Members of Congress want to help.

One possible way to do this, the way I advocated in the current issue of Business Week, would be to take the revenue gained by lining out the 32-percent rate and use it to move the upper end of the 15-percent bracket further up the income distribution. Instead of ending at $29,300, it would then end somewhere between $30,000 and $31,000 of taxable income.

Another use for that revenue would be to lower the 15-percent bracket rate a bit, though there we couldn't do very much because we're not talking about that much revenue. Or we could raise the standard deduction a bit higher; but, again, we couldn't do much because we're not talking about a great deal of revenue.

A rough estimate, I think, of how much revenue we're talking about is something in the neighborhood of $3 to $4 billion a year added revenue by lining out the 32-percent bracket.

Now, in addition to increasing progressivity, this suggestion has several side benefits. By eliminating the phaseout provisions in the Senate, it would simplify the tax forms. It would end the anomaly of taxing income at 32 percent while we allow deductions at only 27 percent. And it would eliminate the incentive for very rich people to bunch income in good years in order to take advantage of the 27-percent rate—which is exactly the opposite incentive that a progressive tax system gives you. And finally, and I think not unimportantly, it would be a lot more honest about what marginal tax rates really are. I count that as a plus.

Now one obvious objection to this proposal is that it would increase the taxation of capital gains under the Senate's plan to treat capital gains just like ordinary income, which, by the way, is an idea I heartily applaud.

Under the Senate bill, gains that are received by the very rich would be taxed at only a 27-percent range, while gains that are received by the moderately rich would be taxed at a 32-percent rate.

Under the proposal I just made, most gains would be taxed at a 32-percent rate. But to soften the blow on capital gains, I would also propose that Congress do what was always the logical thing to do, and which Treasury I proposed that it do, which is index the tax treatment of capital gains. By the way, I was happy to see as I came down on the train this morning that indexing was advocated in the Wall Street Journal's editorial this morning. Indexing is not a left-right issue, I think since taxation of capital gains is sure to be a contentious issue in the conference, and since it's intimately tied up with the issue of setting the top bracket rate, I'd like to say a few words in defense of this proposal.

First of all, I think altogether too much has been made of the fact that the House's 22-percent top rate on gains is lower than the Senate's 27-percent top rate on gains.

Yes, it's certainly true that higher tax rates on gains will weaken incentives to invest in risky assets. But that will not doom capitalism in America, and neither would a tax rate of 32 percent on capital gains.

Arguments for preferential treatment of gains ring hollow these days, especially when set against the likelihood, and I think it's a strong likelihood, that the tax preference for capital gains is the source of more complexity and more tax shelter activity than any other provision in the Tax Code.

I want to review these arguments briefly and dispose of them quickly, because it's not difficult.

It used to be said that a lower tax rate for capital gains is necessary because gains tend to be bunched in large lots and would therefore be overtaxed in a progressive tax system. Well, the right solution to that problem was always income averaging, not giving a preference to gains. But the problem itself mostly disappeared in 1981, when all the upper tax brackets were collapsed into a single

50-percent bracket, and it will grow smaller still under the much flatter tax schedules now being contemplated by the Congress.

The second excuse for capital gains preference was inflation, which, under current law, levies taxes on illusory gains that are merely adjustments to a rise in price level. The correct solution here is what I just mentioned—indexing—not a preferential tax rate that is independent of the holding period and independent of the inflation rate.

Nowadays, with inflation much lower, one hears more unashamedly the argument that we simply must subsidize risky investments, and especially venture capital, for the good of the Republic. While the argument may be forthright and honest, it's not very persuasive. First of all, venture capital is but a small fraction of the assets that now get this privileged capital gains treatment. Speculative gains in the stock market, for example, are far, far larger.

Second, although the lower capital gains rates that have been in effect since 1978 may well have contributed to the resurgence of venture capital since then, the Nation's productivity performance has nonetheless been abysmal. It's enough to make a skeptic wonder whether subsidizing all that venture capital was such a good idea in the first place.

And finally, a 5-percentage point gap in the capital gains rate really isn't that momentous an event to a venture capitalist, anyway. I've attached to the testimony a table 1, the first column of which is meant to illustrate this last point. It takes a prototypical successful, and I underline "successful," venture capital investment—not all of them, of course, are successful—of $100,000 that in 10 years grows to $1 million. That implies, as you see on line 1, a rate of return before tax of 25.9 percent, which is a rate not unknown to venture capitalists when they succeed.

The current law puts a 20-percent tax on the $900,000 gain, leaving the capitalist $820,000 to keep, and lowers the implied rate of return to 23.4 percent.

You'll note, by the way, that that 23.4 percent on the second line is not 20 percent below the tax-free rate, even though the tax rate is putatively 20 percent. The reason for that is that capital gains enjoy the privilege of tax deferral. They're taxed not as they accrue, but only when you realize them at the end.

I want to point that out because the deferral privilege will remain even under the Senate's plan to tax gains like ordinary income. They will retain the benefit of deferral of the tax burden to the end, which is a very important benefit. And that's simply not an issue; it remains true under every proposal.

Now the House bill would raise the maximum tax rate on gains to 22 percent—that's line 3—and lowers the rate of return, therefore, by a miniscule amount. That seems to worry no one, nor should it.

The Senate bill's 27 percent capital gains rate would lower the rate of return by another seven-tenths of a percentage point to 22.4 percent—this is line 4—which, again, is nothing cataclysmic and I think helps explain why neither the administration nor Wall Street is very distressed about this impending increase in the capital gains rate.

Line 5 shows the implications of a 32-percent tax rate, which the Senate bill now imposes on some gains and my proposal would impose on most gains. That lowers the rate of return by another seven-tenths of a percentage point, which is why I said earlier that I don't think this would doom capitalism in America. Our market system is a bit more robust than that.

Finally, I've suggested that, both for fairness and for economic efficiency, we should tax only real capital gains; that is, the excess of capital gains over inflation. And the last line shows what that would mean at a 32-percent rate if the inflation rate was 4 percent over the 10-year holding period.

You see that you get a somewhat better rate of return than on line 5, though not quite as good as line 4. But the main point is that none of these differences are all that large. Venture capitalists, to be sure, have many more important things to worry about than a seven-tenths of a percentage point tax-induced charge in the rate of return.

I won't go over the rest of table 1. It simply makes similar comparisons for two very different sorts of investments, designed to show that indexing is much more important for those more modest investments than it is for venture capital, which has these fantastic rates of return.

Column 2 I call a typical good investment, which I define as an asset that appreciates at a 12-percent compound interest rate for 6 years and then is sold. On this good investment, a 32-percent tax rate on indexed gains—that's the bottom line, a 9.7-percent rate of return—turns out to be more generous than the Senate bill and almost as generous as the House bill.

And the last item, which I call a pure inflation hedge, is something that I mean to stand for money you might put away for retirement—an asset that simply grows 2 percent faster than inflation for 25 years and then is cashed in for retirement and the gains tax paid.

For this sort of a very conservative asset, you see the rate of return after tax under indexing with a 32-percent rate as the bottom right-hand number: 5.5 percent. That is actually not only more generous than all the proposals now before the Congress, but is even more generous than current law, which would reduce the rate of return to 5.3 percent.

The point of these numbers is that whether a 32-percent rate applied to index capital gains represents an increase or a decrease in capital gains taxes compared to the House or the Senate bill depends on the sort of asset you have in mind. Indexing offers the greatest help for long-term conservative investments and the least help for short-term speculative investments. So we shouldn't think of the proposal as either raising or lowering capital gains taxes, but, rather, as rationalizing them.

I just want to close by expressing my opinion that the Senate bill, as it stands now, is a huge improvement over the Tax Code we now have. The Senate bill with the addition of some of the corporate loophole closings that are in the House bill would be a bigger improvement yet. More progressivity in the bracket structure would make the bill better yet. But I do think it's a secondary issue compared to the huge improvement in the efficiency and fairness of the tax system that we're likely to get, irrespective of the bracket structure.

Thank you, Mr. Chairman.

[The table referred to in Mr. Blinder's statement follows:]

TABLE 1.—RATES OF RETURN ON ALTERNATIVE ASSETS UNDER DIFFERENT CAPITAL GAINS TAXES

Tax treatment	Type of investment (percent)		
	Successful venture capital [1]	Typical good investment [2]	Pure inflation hedge [3]
1. No tax	25.9	12.0	6.0
2. Current law (20 percent tax)	23.4	10.1	5.3
3. House bill (22 percent tax)	23.1	9.9	5.2
4. Senate bill (27 percent rate)	22.4	9.4	5.0
5. Senate bill (32 percent rate)	21.7	8.8	4.8
6. Indexing (32 percent rate)	21.9	9.7	5.5

[1] $100,000 investment that increases to $1,000,000 in 10 years.
[2] Investment that appreciates at 12-percent compound rate for 6 years.
[3] Investment that appreciates 2 percentage points faster than the inflation rate (assumed to be 4 percent) for 25 years.

Representative OBEY. Thank you very much, Mr. Blinder.

I'm trying to find your statement, Mr. Roper.

I did not understand one set of numbers in your statement. You say that an annual family income of $12,000, families should pay more taxes, 1 percent, less taxes, 73 percent. Then you say, immediately below that, at a $12,000 level, 55 percent said their taxes should be lowered.

I didn't understand why that sentence is different than the two numbers you list. What am I missing?

Mr. ROPER. Because we asked in the question whether they should be raised, lowered, or left the same. We allowed for a volunteered answer. We did not suggest it to the respondents that they should be eliminated entirely. And 55 percent answered in the terms that we asked; namely, said lower it, but another 18 percent volunteered that they should pay no tax at all.

And when you add the 18 and the 55, you get 73.

Representative OBEY. OK. Easy enough. I should have seen that.

Mr. Blinder, what you're simply saying, then, is that you prefer eliminating as many deductions as possible to increase horizontal equity and broaden the base and simplify the tax structure. But you'd prefer to see the Senate bill improved by moving somewhat in the direction of the House bill in terms of taxation of corporations. You would prefer to see them raise that 27 percent for the superrich 32 percent, and use the revenue to reduce tax rates for those in the 15- and 27-percent brackets.

Mr. BLINDER. That's right.

Representative OBEY. Or you're saying the 15-percent bracket, or both?

Mr. BLINDER. Well, I think that there are a variety of choices in terms of where you could bestow the largesse that would result from raising the upper bracket rate. I mentioned a couple of possibilities. Raising the exemption would concentrate the benefits down at the bottom. I mentioned specifically extending the 15-percent bracket, which would help mostly the people at the lower end of that first 27-percent bracket. And there are a variety of other choices.

Representative OBEY. Mr. Roper, you indicated that the poll indicated a preference on the part of the public for some of the deductions in question. But based on your polling data, what do you think the public's response would be to the kind of changes suggested by Mr. Blinder?

Mr. ROPER. I find it very difficult to speculate on public opinion. I can measure it, but I find I'm wrong about 50 percent of the time in guessing what it will be.

Representative OBEY. Well, is there anything that is inconsistent in what Mr. Blinder is suggesting—is there anything that he's suggesting that is inconsistent with the preferences of the public that you laid out in your poll, with the possible exception of Mr. Blinder being willing to go further by way of eliminating specific deductions than the public seems to indicate in your data?

Mr. ROPER. With that exception, no, there's nothing inconsistent.

Representative OBEY. OK. Mr. Blinder, you indicated that your estimate—you said you weren't really sure how much rescinding that superrich gift would raise—but you estimated $3 to $4 billion.

My understanding is that while Brookings isn't sure, either, they are estimating somewhere between $8 and $10 billion that could be recouped.

Mr. BLINDER. Per year? I meant per year.

Representative OBEY. Yes.

Mr. BLINDER. You meant per year?

Representative OBEY. Yes.

Mr. BLINDER. I'm surprised at that.

Representative OBEY. I was, too, and I'm not certain that it was correct. The numbers certainly do slide around.

Mr. BLINDER. Excuse me. I would imagine the Joint Taxation Committee has a good estimate—no, they don't. I'm seeing that the answer is no.

They should have a good estimate of that.

Representative OBEY. Can you tell us, Is there any other period in history where we had tax rates that actually represented a lower marginal rate for those in the very highest bracket than had been applied to income groups below the top-level income?

Mr. BLINDER. I don't believe that's the case. When I make a statement like that, I always have the lingering fear that there was a 6-month period in 1929 in which something funny happened to the tax bracket code. But without actually going through the laws of all the different years, from my recollection, I don't believe it has ever happened. We have always had marginal rates that either were the same as you went up the income scale or rose, I believe.

Representative OBEY. I share your confusion about why the Senate adopted that provision. In my State right now, we have a lot of froth about the advisability of establishing a lottery, and it's probably going to pass.

My understanding is that if you take a family at a $100,000 income level and let's say they won a $10,000 lottery, they would pay in taxes about $3,200 on that; whereas, a family making $300,000 would pay in taxes on that same $10,000 lottery $2,700.

I used the word "quaint" before. I can't think of any other word to use to describe it.

Let me ask one other question because I think both of you have provided statements that are pretty much self-evident.

The argument, and you mentioned this, but I'd like you to address it again—as you know, the argument which is always raised when people suggest that it is not necessarily essential to eliminate progressivity in order to have tax reform, the argument is always used that, well, if you do have progressivity, you will destroy the ability of the country to save and to develop funds for investment purposes.

So what's your response to that?

Mr. BLINDER. I think by now fewer and fewer people are making that argument because, in some significant degree, the changes in the Tax Code we made in 1981 were predicated on that belief. It wasn't the only reason for doing what we did. But fundamentally, the idea was that by cutting taxes on the very rich more than on anybody else and by lowering the tax burdens on corporations, especially the marginal tax burdens on corporate investments, that we would get a spurt of savings and investment, that the American people as a whole would save more and invest more.

There never was very strong a priori evidence to expect that. But economists who argued to the contrary in 1981 got very little hearing.

We've now had 5 years' experience. What we've seen in that 5 years' experience is, roughly speaking, that the fraction of GNP invested is more or less the same. It fluctuates with the business cycle a good deal. But a rough generalization is that America is investing just a little bit more, correcting for the business cycle than it was back in the early 1980's.

And it's actually saving less, rather than more. I'd hesitate to attribute the drop in savings to the tax changes, for there's nothing in the tax changes that you'd expect to lead to a lot less saving. But the important thing is that it's clear that savings rate has not risen despite IRA's, other special advantages for savings, the reduction in the marginal tax rate for top-bracket people from 70 percent to 50 percent, and also the far greater rates of return that people have been able to earn over the last few years on savings simply because real interest rates have been so much higher.

All of those things might have been expected to raise savings tremendously. They haven't. That's consistent with what I think was the best-informed guess that economists could have made, and did make, in 1981—which is that none of this would do much to the personal savings rate.

I think if you just turn that argument around now it says that if you reverse some of these changes—and, by the way, we're not really talking about reversing them; we're still talking about bringing down the top-bracket rate, not bringing it up, relative to what we have now. But to the extent that you reverse some of that, you ought not to expect any substantial impact on national savings.

Representative OBEY. One last question for you. Are you for—I mean, you indicate that you applaud the Senate's action on capital gains. You've also indicated that if they are going to make a change in it, that you'd suggest indexing, something which I've favored since 1970.

But which is your preferred position? If you had your druthers, would you be for the elimination, assuming that the conference were to do what you're talking about and straight line that 32-percent top bracket, would you be for, would you still be for the retention of the Senate provision or would you be for indexing at that point?

Mr. BLINDER. I don't understand the alternative. You mean 32-percent rate unindexed. I don't understand what are the two alternatives you're asking me about.

Representative OBEY. The alternatives would be to straight line the 32-percent bracket.

Mr. BLINDER. And apply it also to capital gains?

Representative OBEY. And retain the Senate position on capital gains or to index capital gains.

Mr. BLINDER. With what bracket structure?

Representative OBEY. With the new bracket structure that you're talking about.

Mr. BLINDER. With 32?

Representative OBEY. Thirty-two.

Mr. BLINDER. So the issue is 32 percent with or without indexing?

Representative OBEY. Yes.

Mr. BLINDER. With indexing. I would certainly favor with indexing, and always have—not quite since 1970, but for a long time.

Representative OBEY. All right. One last question for you, Mr. Roper.

Does your poll data indicate anything at all about the level of public awareness about the fact that a good many people in middle-income brackets are going to wind up paying more taxes in 1988?

Mr. ROPER. The earlier of the two studies which was before the Senate Finance Committee bill and after the House bill indicated that equal numbers of people thought that middle-income level taxes would stay the same or would go up. Those were the two dominant positions. As I remember, 34 percent thought they would stay the same and 34 percent thought they would go up.

Representative OBEY. Well, I found something very interesting in my district. I have not given a single public speech in the last 6 weeks, I think, on taxes back home. Two weeks ago, when I was home, I think there was virtually unanimous—of those who brought it up, and not many people did. They were talking about other things, such as the farm problem—but of people who brought it up, almost unanimous questioning was, gee whiz, do you think you can get the Senate bill that wanted it.

This last week I was home and I think there's been a significant change. I had the majority of people who raised it who were asking critical questions about the issue. Part of that was due to the IRA publicity, but a good deal was due to the progressivity question, which we've talked about here today.

So I don't know if that—it's not a scientific sample, but that was my experience back home.

Anything else either one of you would like to add?

[No response.]

Representative OBEY. All right. Thank you very much for coming. We appreciate it.

Mr. BLINDER. Thank you.

Mr. ROPER. Thank you.

[Whereupon, at 11:02 a.m., the committee adjourned, subject to the call of the Chair.]

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