TAX FOUNDATION

SPECIAL BRIEF

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The Contract with America and Tax Reform

House Ways & Means Committee Testimony

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The following testimony was presented by Dr. Foster before the House Ways & Means Committee on January 11, 1995.

Mr. Chairman and Members of the Committee, my name is J.D. Foster and I am the Executive Director and Chief Economist of the Tax Foundation. It is an honor for me to appear before your committee today on behalf of the Tax Foundation to discuss the "Contract with America" and the direction of tax policy.

The Tax Foundation is a non-profit, nonpartisan research and public education organization that has been monitoring fiscal policy at all levels of government since 1937. We have approximately 600 members, consisting of large and small corporate and non-corporate businesses, charitable foundations, and individuals. Our business membership covers practically every region of the country and every industry category.

In the recent election, the American people, as interpreted by the press and this Congress, expressed a clear preference for lower taxes and less government.

I would like to emphasize to the Committee that the Tax Foundation is not a "grassroots" organization, a trade association, or a lobbying organization. We do not take positions on specific legislation or legislative proposals. Our goal is to explain as precisely and clearly as we can the current state of fiscal policy and the consequences of particular legislation in the light of the tax principles delineated before, so that you, the policy makers, may make informed decisions.

When it was established in the late 1930s, the Tax Foundation's founding fathers set out certain principles of taxation which the Tax Foundation would promote and which would guide our analysis of tax proposals. According to these principles, a good tax system should:

- Be as simple as possible — complexity makes accurate tax compliance needlessly expensive and diminishes the public's willingness to comply with the law;

- Not be retroactive — taxpayers must have confidence in the law as it exists entering into a transaction;

- Raise revenue, not micromanage the economy with subsidies and penalties;

- Not be continually rewritten — frequent change lessens citizen understanding of the tax code and complicates long-term economic planning; and,

- Be implemented recognizing the competitive nature of the world economy.

In the recent election the American people, as interpreted by the press and this Congress, expressed a clear preference for lower taxes and less government. One does not have to look far to find an explanation. Every year the Tax Foundation produces an analysis we call Tax Freedom Day. Imagine every dollar you earn going to pay federal, state, and local taxes beginning January 1. Tax Freedom Day is the day when the average taxpayer's tax bill is paid off for the year, when the taxpayer is free to keep the money he or she earns.

In 1994, Tax Freedom Day fell on May 5, tying 1981 with the latest Tax Freedom Day in U.S. history. In 1989, Tax Freedom Day fell on May 4. In 1964, after President Kennedy's tax cuts, Tax Freedom Day fell on April 13, nearly three weeks earlier.

Tax Cuts and the Bigger Picture

There are many economic problems facing the country that demand our attention. Many of these problems were discussed in great detail and clarity by the President's Entitlement Commission. Among these problems, I would emphasize that:

- Our rate of national saving is very low and constitutes a serious threat to long-term prosperity;

- Our rate of private investment is probably insufficient to create sustained growth in high-wage jobs; and

- The federal deficit, while less of a problem today than just a few years ago, is projected to grow rapidly in the coming years unless corrective action is taken.

Another problem related to all of the above is the anemic growth in productivity. Whether your main concern is wage growth, job growth, international competitiveness, or the economic futures we leave to our children, it all boils down to increasing productivity.

Productivity, measured as output per hour of all persons in the nonfarm business sector, grew at about 2.4% between 1959 and 1969, slowed to 1.3% from 1969 to 1979, and slowed further to 1.2% between 1979 and 1993 (and even this may be artificially high due to the surge in productivity experienced during the recent recession). This general pattern has been repeated in most of the major industrialized nations.

Tax policy is one of many influences on our economy. Even a perfect tax policy on economic efficiency grounds will not guarantee prosperity if we make enough other mistakes. Nevertheless, tax policy can contribute to higher productivity growth in many ways, most of which can be summed up by simply getting out of the way. Tax policy can best contribute to higher productivity by getting the tax disincentives out of saving, investing, business formation, and risk taking.

A Tax Cut Checklist

In many ways, the current prospect of cutting taxes is extraordinary. And it would be an extraordinary shame if the exercise were completed in such a way that it ignored some of our long-term economic problems. Thus, I would like to offer a simple 5-point checklist for choosing among the tax cuts under consideration.

1) The tax cut package should not increase the budget deficit.

2) Tax cuts for individuals should not be paid for by raising taxes on businesses.

3) Tax cuts for low- and middle-income taxpayers, however defined, should not be paid for by raising taxes on the rest of our citizens.

4) Whatever tax cuts are enacted, they should not make the tax system more complicated than it already is. [Complicating changes in tax law impose their own costs on the taxpayer in time and energy spent trying to comply with the changes. It would be a great shame if the taxpayer's tax burden were reduced while his compliance burden were increased.]

5) Whatever tax cuts are enacted, even though passed relatively quickly, should not be chosen to meet short-term political goals but should instead be designed to address the needs of a long-term policy consistent with sustained economic growth. The current spate of proposed cuts should be developed as a near-term down-payment on a long-term program of fundamental tax reform.

Taxes, Choices and Prosperity

Everyday, each of us faces choices: should we go out to dinner or eat in tonight; should we buy a fancy new car or go with something more moderately priced; should we do our own taxes or pay somebody to do them for us; should we take a vacation or save the money for a rainy day; should we work this weekend or play golf; should we work at all or should we stay home and raise a family?

Each of these choices is made based on a variety of factors, one of which is almost always the relative costs of the alternatives. If I dine at home, then I have to buy the groceries, cook the food, and clean up. If I go out, then somebody else will do the work, but it might cost twice as much. If I buy the moderately priced car, then I may have enough left over for a nice vacation this year. Each set of opportunities carries a price, and so we speak of the price of one choice relative to the price of the choices foregone.

Virtually every tax affects some group of relative prices. Some of these effects are relatively easy to predict. For example, a new 5 cent per gallon tax on gasoline is probably going to raise the price of gasoline by about 5 cents relative to the price of most everything else. Other effects are much harder to predict. For example, it is very difficult to know who actually pays the corporate income tax in the sense of suffering a reduction in after-tax income.

The individual income tax is often not too difficult to diagnose. We know, for example, that as the marginal tax rate on earning income rises, individuals will choose to work less where possible because the relative price of labor to leisure has gone up. We also know that income tax is imposed on income from saving, thereby creating a disincentive to save.

The Power of Little Changes

It is sometimes hard to understand intuitively how small changes can affect economic incentives. After all, if you need to buy gas to drive to work, you are probably going to buy the gas whether it costs $1 or $2, so you will almost certainly buy it at $1.05.

The individual income tax is often not too difficult to diagnose. We know that as the marginal tax rate on earning income rises, individuals will choose to work less where possible because the relative price of labor to leisure has gone up.

Over time, however, changing relative prices can have profound effects on behavior. For example, at $2 a gallon for gasoline you may be inclined to buy a more fuel-efficient car next time, or you may move closer to work, join a car pool, or take mass transit.

Most of the time most people willing to buy a product at one price will still buy it if it costs just a bit more. That does not mean, however, that small changes in price do not affect individual choices. Why else is the Sunday paper filled with advertisements and coupons offering a few cents off on this product or that? Why else do retailers advertise their sales? When you drove to work this morning, whether you were listening to Christian radio or Howard Stern, there's a good chance you heard the local automobile dealerships advertising the "biggest sale of the year" two weeks into 1995.

Advertising a sale works because there are always consumers who are wavering between choices and who will respond to a new price differential. To be sure, most consumers will not be swayed by a small change in price. But those consumers who are wavering between their choices, those consumers who are on the margin, will respond and may respond strongly.

What holds true for buying cars also holds true for the choice to save and invest income rather than to consume it, and for working more or working less. Marginal tax rates, that is, those rates that apply to the next dollar of income or the next dollar of expenditure, can have powerful effects on the choices individuals make.

The Tax Foundation performed an analysis of marginal tax rates in June, 1994, some of which is presented in the table below, which demonstrates the extraordinary bias in the tax code against saving. The table presents the total effective marginal tax rates on different types of income after accounting for the tax increases of 1993.

1994 Effective Marginal Income Tax Rates by Type of Income

Type of Income	Total	Federal	State
Wages	27.5%	22.8%	4.7%
Interest	34.5%	29.7%	4.8%
Business	38.2%	32.9%	5.3%
Dividends	42.1%	36.8%	5.3%

These figures indicate, for example, that an individual considering whether to invest an extra dollar in corporate equity must pay 42 cents in total tax for every $1.00 earned. When potential investors consider whether to spend a dollar on consumption or to invest it, it should come as no surprise that individuals so frequently choose consumption.

While all modern taxes distort individuals' decisions, not all tax cuts reduce these distortions equally. Some tax cuts can have a profound effect on how much individuals save, how much they invest, and how much they are willing to work. Others will have very little effect at all. It's all a question of rates: statutory tax rates, average tax rates, and marginal tax rates.

Consider a typical American family. The

Census Bureau reports that the median income of a two-earner family in 1994 was $53,354. According to a Tax Foundation analysis done in November of last year, this family faced an average federal income tax rate of 10.4 percent and a marginal federal income tax rate of 28 percent.

Now consider two alternative tax plans, the first of which would increase the personal exemption for all taxpayers by $2,000; the second would allow taxpayers to contribute $2,000 to an Individual Retirement Account (IRA) and reduce their taxable income by $2,000.

The first plan would reduce the family's average tax rate on all income to 9.4 percent; it would not affect the family's marginal tax rate on either wage income or savings. Consequently, this plan would not reduce the tax disincentive to work since another dollar of labor income still faces a marginal tax rate of 28 percent. Nor would this plan reduce the tax disincentive to save since the tax reduction occurs whether the taxpayer saves or not.

Now consider the second plan whereby taxpayers are allowed to contribute $2,000 in pre-tax income to an IRA. Like the first plan, this plan does not reduce the marginal tax rate on labor. However, this plan does reduce the tax disincentive to save because the tax reduction is linked directly with the amount of saving that occurs through the IRA.

IRAs increase private saving because they reduce the tax burden on saved income, thus lowering the price of saving relative to consumption. That IRAs tend to increase private saving is certain; the amount of the increase, however, is certainly open to debate.

There was a time not long ago when tax policy discussions took place almost entirely in terms of economic incentives, marginal tax rates, and long-term goals. These concepts, which reached a height of popularity in the debate leading up to the 1986 Tax Reform Act, have since been overtaken by revenue estimates and tax fairness.

Whatever one's opinions about the 1986 Tax Reform Act, the motivations of the Congress and the President were right on target. Whatever tax cuts are passed in the coming few months would most benefit the nation if they adhere to those same motivations, if not necessarily the same types of results, such as reducing the disincentives to working, saving, and investing.

Near-Term Objectives and Long-Term Reforms

One statement on which virtually everyone agrees is that the current federal income tax system is too complicated, too expensive to operate and comply with, and far too much of a burden on the economy. The question is, what should be done about it?

The Majority Leader, Congressman Dick Armey (R-TX), has a tax reform plan built around the concept of a flat tax which seemed to be picking up steam before the November election, and which must now be assumed to have been given a big boost by that election.

Senators Domenici (R-NM) and Nunn (D-GA) have their own detailed tax reform plan that is expected to be introduced in the next few weeks. These plans are sufficiently similar — they both emphasize simplification and the elimination of the multiple taxation of saving — and have drawn enough support from diverse quarters, that it may be safe to assume that they represent the starting point for the coming tax reform debate.

As the Committee considers various options for cutting taxes in the near term, it will save itself and the taxpayers unnecessary hardship if it keeps in mind the direction tax reform is likely to follow. If you believe that the Armey/Domenici-Nunn approach is the path we are likely to follow, or if you believe that lower marginal tax rates and a simpler income tax is where we should be heading, then some elements of the Contract with America are very likely to be consistent with future tax reform efforts. Capital gains relief, neutral cost recovery, and the improved IRA called the American Dream Savings Account are all likely to be consistent with future tax reform.

On the other hand, however well intentioned, it is less likely that the child tax credit and the adoption tax credit, if enacted in the tax cuts of today, will survive the tax reform of tomorrow because they complicate the tax code without offering any offsetting benefits in terms of marginal tax rate reduction.

Tax Relief and Deficit Reduction

The federal budget deficit remains a very serious problem despite a series of large tax increases. Some have argued that we should take advantage of the current willingness of the Congress and the American people to cut federal spending and use those cuts to reduce the deficit. Others have argued that there should be a division of the spending cuts between tax relief and deficit reduction. Anyone concerned about the federal deficit should take heart in the current exercise, and not merely because of the general agreement that the bill should be paid for in full.

Most recent tax bills have raised taxes based on highly suspect revenue estimating procedures. (I do not mean at all to impugn the professionalism of the revenue estimators at either the Joint Tax Committee or the Treasury Department; but the fact is even the best navigator will get lost if the compass is faulty.) If the tax bill that emerges from this exercise includes tax increases on some to pay for the tax reductions on others, then it, too, will fail to achieve the expected revenues and we face the possibility of increasing the budget deficit.

Spending cuts, in contrast, are far easier for the Congress to guarantee because it is not a question of one group or another responding in predictable ways to tax increases; the Congress merely has to forego spending the money as enforced by lower spending limits. With tax increases, therefore, the economy must behave as predicted to achieve the expected revenues; with spending cuts, the Congress must merely act on its own decisions.

Just as tax increases generally raise less, (and sometimes much less), revenue than forecast by the estimators, tax cuts rarely cost the Treasury as much in tax revenues as the estimators expect. Of course, in each case the amount of error will depend on the nature of the tax reduction. Estimates of the revenues lost from increasing the personal exemption or establishing child tax credits are likely to be reasonably accurate because little economic activity will be affected.

In contrast, the Social Security earnings limit increase, the American Dream Savings Account, capital gains relief, the increase in the amount of capital purchases that a small business may expense, even the proposed estate tax relief, all may cost less than estimated because they will each stimulate economic activity, thereby increasing federal revenues from a variety of sources.

Revenue Estimates and Collections

The revenue estimating process is one of the most poorly understood and poorly reported aspects of the tax debate. Without going into an extended discussion of static versus dynamic revenue estimates, two examples should demonstrate why a tax bill using spending cuts to pay for tax cuts that improve economic incentives will actually reduce the budget deficit through the non-inflationary stimulative effects of the tax cuts.

The Capital Gains Exclusion

The capital gains exclusion in the Contract with America is similar to previous proposals that the Congress has considered. Four dominant revenue effects will follow from such a proposal: an exclusion effect, a realizations effect, a price effect, and a growth effect. Of these four, the current estimating procedures account for the exclusion and realization effects with great precision and detail, and ignore the price and growth effects altogether.

A capital gain arises when an asset is sold that has appreciated since its time of purchase, that is, when the capital gain is realized. Of the four effects, the exclusion effect is the easiest to understand and to measure. Quite simply, given a level of net capital gains realizations, a 50 percent exclusion would reduce by half the amount of realizations subject to tax.

In a given year, taxpayers own a certain body of assets which have appreciated in price. From this pool of appreciated assets they will sell a certain dollar amount on which will arise a certain dollar amount of taxable capital gains. For each taxpayer, the decision to sell an asset may be the product of many factors, one of which is the tax on capital gain that may be owed. Clearly, the higher the rate of tax the less disposed the taxpayer will be to sell a tax-bearing asset. The effect of a capital gain exclusion is to reduce the effective rate of tax, and thereby reduce the disincentive to sell the asset. Consequently, all else held equal, a capital gains exclusion will increase the rate of capital gains realizations.

Few issues in tax policy have been so thoroughly researched empirically as the change in capital gains realizations following a change in the effective tax rate. And, despite the differences in their estimates, the Treasury Department and the Joint Tax Committee actually use very similar estimates of taxpayer response so that the difference in their estimates is statistically meaningless, even though the difference in dollar terms may be quite large.

One effect that neither Treasury nor the Joint Tax Committee account for is the price effect of capital gains relief. An asset's price is determined by the discounted value of all after-tax proceeds from that asset. Clearly, for any asset inclined to increase in price, a lower capital gains tax will produce a higher asset price. Therefore, any reduction in the effective capital gains tax rate will surely produce a general increase in asset prices, thereby increasing the current pool of unrealized capital gains, thereby further increasing the dollar volume of capital gains realized in a given year and increasing the aggregate amount of capital gains tax paid.

Finally, capital gains relief is proposed because it is expected to reduce the tax disincentives to save and invest, ultimately producing stronger economic growth. While the degree to which a given capital gains proposal will have this beneficial effect is debatable, the existence of the effect itself is not. Nevertheless, the official estimates make no effort to include even the slightest growth effect in their calculations. Moreover, this effect would manifest itself not only in terms of higher subsequent capital gains tax receipts, but also as higher receipts from virtually every tax and fee imposed by the federal government.

Even if the combination of the exclusion and realization effects reduces federal receipts as the official estimates predict, when we add in the combination of the price and growth effects, then a 50 percent exclusion of taxable gains will almost certainly produce higher federal receipts in both the short run and the long.

The Social Security Earnings Limit

The Social Security earnings limit applies to taxpayers under 70 years of age and reduces their Social Security benefits by one dollar for every three dollars they earn over a specific threshold. The earnings limit, therefore, is the economic equivalent of a 33 percent income tax surcharge on those affected. Any raising of the earnings limit threshold or the benefit loss ratio reduces the effective tax disincentive facing the elderly who wish to continue to earn labor income. Such a change would also, in the first instance, increase the federal outlays for Social Security benefits, thereby increasing the budget deficit.

Raising the earnings limit would have other, revenue increasing effects, as well, which are not included in the official estimates. For example, if an elderly individual chooses to work more following the increase in the earnings limit, he or she will be subject to payroll tax on the earnings. Thus, while the amount of benefits paid increases, so, too, does total payroll tax receipts.

Also, the General Fund of the Treasury would receive an increase in individual income tax receipts as the elderly would likely have larger amounts of income subject to income tax. In fact, the elderly are likely to pay more of a wide variety of federal levies if they choose to work longer following the raising of the earnings limit. In combination, each of these effects may not cause the increase of the Social Security earnings limit to reduce the budget deficit on net, but they certainly would reduce the amount of the deficit increase relative to the official estimates.

The congressional leadership has indicated that it will accept the methodologies of the past for purposes of scoring the Contract with America's proposals and that the bill or bills will not be permitted to increase the federal budget deficit on that basis. Since the Contract will be revenue neutral on a static basis, and since many of the tax cuts will cost the Treasury less than the official static estimates indicate, it therefore follows that the federal deficit will be lower than it otherwise would have been following the enactment of this bill.

Conclusion

The Congress has embarked on a program of change in the role of government. Less is now perceived to be better than more. And yet, as in most things, some means of achieving the desired results are better than others. The 5-point checklist presented earlier, and again below, may be taken as a guide to these policy decisions:

- Deficit neutrality;
- Individual tax cuts without business tax increases;
- Eschewing the tax shuffle of cutting some individuals' taxes while raising other individuals' taxes;
- Avoiding complicating tax changes; and,
- Reducing the micromanagment of the economy through the tax code.

If the Congress follows this checklist, then whatever bill is sent to the President is very likely to achieve results every American can support.

Finally, if we really believe that the American people spoke in the past election in favor of less government and more freedom, then perhaps Tax Freedom Day provides a good measure of what is or should be accomplished. Tax Freedom Day in 1994 was May 5, tying 1981 with the latest day ever. Perhaps it would be useful if the Congress were to decide how many additional days of tax freedom the American people really want. Was the recent election a call for one more day of tax freedom? Two? A week?

And then, having decided how much additional tax freedom the American taxpayer wants, that then should be the guide to how far taxes and spending need to be cut.

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has been monitoring tax and fiscal activities at all levels of government since 1937.

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