



SPECIAL BRIEF

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Tax Rate Reduction in 1998 *House Ways & Means Committee Testimony*

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Mr. Chairman, Mr. Rangel, Members of the Committee, it is with great pleasure that I appear before this Committee to testify to the importance of focusing on tax rates as the centerpiece of any tax reduction program in 1998.

I am the Executive Director and Chief Economist of the Tax Foundation. The Tax Foundation is a 60-year old non-profit, non-partisan research institution. Our mission is a simple one: To provide accurate and timely information on matters of federal, state, and local fiscal policy so that policymakers may

previously urged by White House officials and others against a change in policy predicated on surpluses is well-taken, it is perfectly appropriate for this Committee to consider what actions it might want to take should a surplus arrive earlier than expected. Further, as this happy prospect of surpluses is the product of extraordinary growth in tax receipts, there is a certain simple logic to using the surpluses for tax relief.

Another reason to consider tax relief is simply that taxes are now at their highest levels in our nation's history. Last year, Tax Freedom Day arrived on May 9, the latest day ever. Tax Freedom Day is a simple representation of the total federal, state, and local tax burden. If all of the average taxpayer's income goes to pay his taxes beginning on January 1st, then Tax Freedom Day is the day his annual fiscal debt to society is marked "Paid In Full." Tax Freedom Day 1998 is almost certain to fall even later in the calendar.

It's also important to remember that this increased tax burden is occurring despite last year's historic tax cut. Why is that? Because last year's tax cuts were slight indeed compared to the revenues produced by a strong economy.

Which Taxes to Cut

There are, therefore, very good reasons to consider tax reductions at this time. In establishing a tax cut program, I believe the Committee should take a couple pages from the tax reform debates. The number one tax policy lesson from these debates is the great imperative to get the tax base right. Economic distortions due to taxation are minimized

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make better policy.

Mr. Chairman, we have good reason today to discuss tax reduction. We have an economy that is yielding tax revenues far in excess of official expectations of only a few months ago. This enormous revenue stream has created the possibility of budget surpluses in the near or very near future. While the caution

when the definition of the tax base is correct. On the other hand, whatever the tax rate, economic distortions grow with each error in the tax base. These distortions are important because they sap the economy of some of its growth potential.

A second lesson from the tax reform debates is the importance of tax simplification both economically and politically. Complexity in the tax code is wasteful and it is wrong. If there is anything about tax reform about which there is a general consensus, it is this — the current tax system is too complex. Perhaps if the Members of the Committee were required to do their own taxes as a condition for sitting on this Committee, then the proliferation of complex tax changes would cease.

Of course, tax reform is not the issue here, today. But the lessons remain the same. In an ideal world the Committee's focus ought to be

to effect tax policy changes that simplify the system and that move the federal income tax in the direction of a proper definition of taxable income. That would mean, for example, increasing as far as possible the ability of taxpayers to exclude capital income from taxation, eliminating that abomination of federal tax policy known as the Alternative Minimum Tax, and integrating the personal and corporate income taxes.

To the extent reality impinges on this ideal world, as it must in a democracy, I would urge the Committee to eschew narrow, targeted tax changes in favor of reducing marginal tax rates. Whatever distortions exist in the federal income tax, and they are many, they are given greater effect the higher are the marginal tax rates to which taxpayers are subjected. Conversely, reducing tax rates reduces virtually all the distortions created by

Figure 1
New Tax Instructions for Taxpayers with Capital Gains and Losses:

Part IV Tax Computation Using Maximum Capital Gains Rates		19
19	Enter your taxable income from Form 1040, line 38	19
20	Enter the smaller of line 16 or line 17	20
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21
22	Subtract line 21 from line 20. If zero or less, enter -0-	22
23	Combine lines 7 and 15. If zero or less, enter -0-	23
24	Enter the smaller of line 15 or line 23, but not less than zero	24
25	Enter your unrecaptured section 1250 gain, if any (see page D-4)	25
26	Add lines 24 and 25	26
27	Subtract line 26 from line 22. If zero or less, enter -0-	27
28	Subtract line 27 from line 19. If zero or less, enter -0-	28
29	Enter the smaller of line 19 or \$41,200 (\$24,650 if single; \$20,600 if married filing separately; \$33,050 if head of household)	29
30	Enter the smaller of line 28 or line 29	30
31	Subtract line 22 from line 19. If zero or less, enter -0-	31
32	Enter the larger of line 30 or line 31	32
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies	33
34	Enter the amount from line 29	34
35	Enter the amount from line 28	35
36	Subtract line 35 from line 34. If zero or less, enter -0-	36
37	Multiply line 36 by 10% (.10)	37
38	Enter the smaller of line 19 or line 27	38
39	Enter the amount from line 36	39
40	Subtract line 39 from line 38. If zero or less, enter -0-	40
41	Multiply line 40 by 20% (.20)	41
42	Enter the smaller of line 22 or line 25	42
43	Add lines 22 and 32	43
44	Enter the amount from line 19	44
45	Subtract line 44 from line 43. If zero or less, enter -0-	45
46	Subtract line 45 from line 42. If zero or less, enter -0-	46
47	Multiply line 46 by 25% (.25)	47
48	Enter the amount from line 19	48
49	Add lines 32, 36, 40, and 46	49
50	Subtract line 49 from line 48	50
51	Multiply line 50 by 28% (.28)	51
52	Add lines 33, 37, 41, 47, and 51	52
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies	53
54	Tax. Enter the smaller of line 52 or line 53 here and on Form 1040, line 39	54

the tax code that rob the economy of vitality and rob the American people of greater opportunity and prosperity.

This Committee is fully versed in the distortions to the economy created by the federal income tax and in the multitude of opportunities for greater prosperity lost as a result. Therefore, I will not discuss them in great detail. Instead, I will briefly enumerate the most important of these.

Income taxes imposed on wages and salaries reduce the incentive to work and, conversely, increase the incentive to take one's leisure. At very low tax rates, one's incentive to work is about equal to one's economic contribution to society. At low tax rates the price of leisure is high. At high marginal tax rates, one's return to work a few more hours drops rapidly and the price of leisure drops along with it. Reducing marginal tax rates directly reduces the disincentive to work.

This Committee has heard for years that the people of the United States save too little. Assuming this is true, the federal income tax must bear much of the blame. Despite the many slivers of tax relief available to some saving, current law continues to heap layer upon layer of tax on additional saving. In most cases, income is taxed as earned irrespective of what one does with it. If it is saved, it is likely to face multiple layers of additional tax in the form of taxes on interest, dividends, corporate income, capital gains, and estate taxes.

People respond to incentives and disincentives. Why do brokerage houses advertise their strong track records yielding value to investors if investors are not influenced by yields? Why would car companies advertise price reductions, year-end discounts, and low financing rates if they fail to elicit more sales? Why do supermarkets advertise their sales in the local papers? Because even reductions in the price of a can of soup or a bunch of bananas can alter consumer choices.

The tax code has a highly developed system of tax penalties to discourage taxpayers from cheating on their taxes. Why would we believe that monetary penalties would be effective in discouraging tax cheating, and yet not believe that monetary penalties would be effective in discouraging saving? Reducing marginal tax rates and thereby reducing the tax on saving directly reduces the disincentive to save.

To demonstrate how widespread would be the benefits of marginal tax rate reductions, consider:

- If a major concern is the tax burden on families generally, then rate reduction will help.

- If your concern is the marriage penalty, or even the single tax filer penalty, then rate reduction will help — without the complexity inherent in most solutions to this problem.

- If your goal is to encourage additional investment in plant and equipment, then rate reduction is your answer because it would reduce the cost of capital, particularly if the rate reduction is extended to the corporate income tax rates. Rate reduction reduces the tax on dividend and interest income and, if extended to capital gains, it can further reduce the tax burden on capital gains.

The 1997 tax bill was criticized, not entirely unfairly in my opinion, for being a hodgepodge of tax provisions. Many of the provisions, particularly as they relate to individual taxpayers, introduced enormous new complexities into the tax code. I have attached to my testimony the new rules appearing in this year's tax instructions for taxpayers with capital gains and losses (see *Figure 1*). These instructions are mind numbing. Indeed, perhaps the Committee could use these instructions as a simple test of the qualifications of any person seeking employment at the Joint Tax Committee: They must be able to explain this procedure, in English, after reading it through no more than ten times. I suggest few would pass the test.

I believe last year's tax bill was a tremendous victory for taxpayers. The tax cuts slowed, but did not halt, the tide of rising taxes and may have ushered in a new era of tax cutting. However, last year's tax bill also opened the Congress to real criticism for reasons beyond complexity. The bill created millions of winners, but it also created legions of the ignored. In appearance, at least, this was rent seeking at its worst. This is not a game I believe the Committee or the Congress should be playing.

The surest way to avoid a similar trap and yet to provide significant tax relief is by reducing tax rates. Tax rate reduction can be devised so that all taxpayers benefit, and not just a select and well-represented few. There are other important reasons to favor tax rate reduction:

- It is simple. A great many tax cut proposals would increase the tax complexity hurdle for those lucky taxpayers who would qualify.

- It's simplicity further enhances a public sense of its fairness. The Congress

would not be perceived as bestowing relief on a select few.

- It is very flexible. Through the lowering of rates and raising of bracket points, the Committee has a great ability to fine-tune the amount of relief, again without complex special rules and effective dates.

Many of the 1997 tax bill provisions ... introduced enormous new complexities into the tax code. I have attached to my testimony the new rules appearing in this year's tax instructions for taxpayers with capital gains and losses.... Perhaps the Committee could use these instructions as a simple test of the qualifications of any person seeking employment at the Joint Tax Committee: They must be able to explain this procedure, in English, after reading it through no more than ten times.

consequence for economic growth and one that specifically targeted certain beneficiaries to the exclusion of all others. This year these same groups are back fighting to eliminate the marriage tax penalty. The marriage tax penalty relates to the tax burden of some married couples relative to the tax they would owe if they were "single" filers. It is problematic. Yet for every four couples suffering from the penalty, there are five couples who pay less tax because of their joint filing status than they would had they filed single.

If the pro-family groups were fighting for a fairer tax code, they would address the marriage bonus families and the marriage tax penalized. To my knowledge, they are silent on the bonus, and so they stand self-indicted as purely special interests. Across-the-board rate cuts, in comparison, would benefit proportionately those subject to the marriage penalty, those subject to the marriage bonus, and all single tax filers.

Finally, some might argue that statutory tax rates have declined significantly over the past 17 years, and that further reductions are therefore not needed. If one opposes tax reductions generally, then this argument is at least defensible. However, if the question is not whether to cut taxes, but how, then this argument is without foundation. The high marginal tax rates of the past were found to be counter-productive and have been roundly repudiated. Today's rates have no basis in theory. They are the product of revenue requirements and politics. If the politics and revenue requirements permit tax reductions, then marginal tax rate cuts should be the Committee's primary goal.

- And it is easy to explain and therefore easily garners credibility and public support.

The case for making tax rate reduction a major component of any tax relief bill is so compelling it is worth considering why it might not be favored in some quarters.

One valid reason for emphasizing alternate tax cut proposals would be if the Committee were to choose to correct the tax base instead. As noted above, taxable income is badly defined under current law. Working towards an economically sound definition of taxable income should always be a policy goal of the first order.

A second source of opposition to across-the-board marginal tax rate cuts might arise from special interests who will fight to get a bigger piece of any tax cut pie for their own constituencies. Even when their objectives are sound, as is often the case, they put this Committee in the terrible position of playing Santa Claus to a select few. A good example of such a special interest is the "pro-family" groups whose efforts resulted last year in the child tax credit — an item of zero

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