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Tax: Fundamentals in Advance of Reform (Testimony of Robert J. Carroll Before the Senate Committee on Finance), United States Senate

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Chairman Baucus, Senator Grassley, Distinguished Members of the Committee.

Thank you for the opportunity to appear before you today to discuss tax reform. The Tax Foundation, now in its 71st year, is a non-profit, non-partisan research group whose mission is to educate taxpayers about sound tax policy.

The economic sluggishness we read about each day has prompted many suggestions of short-term economic fixes, but tax reform remains one of the most important long-term economic challenges. Tax reform offers significant opportunities to promote a growing economy by removing or minimizing the many ways in which our tax system interferes with economic decision making and create in its place a tax system where household and business decisions are based more on economic merit than on an array of complex and difficult to understand tax rules.

Today, the U.S. tax system remains a complicated web of tax rules that impose substantial compliance and economic costs on the economy. The number of special tax provisions with complex phase-ins and phase-outs continues to grow. These provisions may be well intentioned, but they increase compliance burdens, narrow the tax base and require higher tax rates to raise a given amount of revenue. Moreover, despite becoming a poster child for tax reform, the alternative minimum tax (AMT) remains a significant feature of the income tax. While the Congress continues to limit the AMT's grasp with temporary one-year patches, the growth in the size and scope of this parallel tax system will make these temporary fixes increasingly difficult from a budgetary perspective.

The compliance costs of the income tax system are substantial. According to the Internal Revenue Service (IRS), the compliance burden of the income tax system is about $140 billion annually. Moreover, the complexity has driven most taxpayers to use paid preparers or tax software: Today roughly only one of every eight taxpayers prepares their *own* tax returns.

In addition to the compliance burden, the tax system also interferes with household and business decisions in economically important ways. For households, for example, the income tax affects the decisions of how much to work, save, invest, give to charity, and borrow when purchasing a home. For businesses, it affects their decisions about how much to invest, where to invest internationally, the source of funds for investment (e.g., debt, equity), whether to invest in the corporate or non-corporate form, and how to distribute profits. A more tax neutral environment would mean that households and business would make decisions more based on economic merit rather than their tax treatment. Eliminating or reducing the various ways the tax system distorts economic decisions can produce substantial economic benefits. For example, estimates of how much larger the economy could be in the long-term with dramatic reform – nearly 9 percent – are suggestive of the large economic costs associated with the current tax system. In today's 14 trillion economy, this economic gain would translate into an additional $1.3 trillion in economic output.

In evaluating how to go about reforming our tax system it is useful to start with a set of objectives. It is easy enough to agree on a broad set of principles such as a tax system that is simple, fair and pro-growth. But, as we begin to scratch the surface, to dig more deeply, a more complex and fundamental set of issues need be addressed. For example, should the tax system focus on taxing income or consumption, what constitutes a fair distribution of the tax burden, and to what extent should citizens be relieved of having to remit taxes to the government at all? Also, to what extent does the United States need to consider its place in the world economy? Considering the possible answers to these questions provides a starting point for tax reform.

Taxing Income or Consumption?

The key difference between a tax system that taxes income versus one that taxes consumption is that a consumption-based tax does not tax the return to saving and investment, while an income tax does. Taxing the return to saving and investment results in less capital formation, which gives workers less capital with which to work, thereby reducing labor productivity. Lower labor productivity translates into lower living standards than would otherwise occur. These are the key relationships – investment, capital formation, labor productivity and living standards –which proponents of consumption taxes point to.

There are numerous ways of moving towards a tax system based more on taxing consumption. A national retail sales tax is perhaps the most obvious form of a consumption tax. But the European-style value-added taxes are also equivalently taxes on consumption with remittance of tax at the business level rather than by consumers. The so-called X-tax is another approach that more closely resembles the general structure of the current tax system by retaining a tax imposed at both the business and individual levels. In contrast to the current system, however, this approach would allow all investment to be written-off immediately and the individual level tax would only apply to compensation. While each of these approaches differ substantially in form, they would all transform the current tax to one that no longer taxes the return to saving and investment.

In large part because of the negative economic consequences of taxing the return to saving and investment, the current U.S. tax system already deviates from income tax principles in important ways. Although the current U.S. income tax system is nominally called an income tax, it is very much a hybrid income-consumption tax. Tax-preferred savings accounts, such as IRA's and 401(k)'s, remove the tax on the return to saving within these accounts. Accelerated depreciation, provided primarily for equipment, reduces the effective tax rate on the return to investment. Some estimates suggest that roughly 30 to 35 percent of U.S. household financial assets effectively receive consumption tax treatment.

Proponents of moving further towards a consumption tax anticipate that by further reducing the tax on the return to saving and investment, the additional capital formation will eventually result in a larger economic pie. Estimates of very far reaching reforms that broadly include all consumption in the tax base and replace the progressive tax rate schedule with a flat tax rate suggest that, in the long-run, the overall size of the economy would be 9 percent larger.[1] Even the more modest and perhaps more politically plausible reforms recommended in 2005 by the President's Advisory Panel for Federal Tax Reform suggest substantial positive economic gains with an in increase in the overall size of the economy in the long-run by roughly 2.5 percent to 3.0 percent.[2]

What Constitutes A Fair Distribution of the Tax Burden?

One of the criticisms of moving the income-consumption tax pendulum further towards a consumption tax base is the widely-held view that consumption taxes are regressive. The reasoning behind this view is that savings is held disproportionately by higher-income taxpayers, so removing the tax on the return to saving and investment will disproportionately benefit those that hold these assets. This view, however, misses several key points.

First, it presumes that taxes on the return to saving and investment are borne by owners of capital. The proponents of consumptions taxes, however, have stressed the economic benefit that removing or reducing the tax on the return to saving and investment can have on capital formation, labor productivity and living standards. Underlying this linkage is the notion that the tax on the return to saving and investment is borne primarily by labor, not capital. That is, taxes on saving and investment are reflected primarily in lower real wages, not lower returns to capital, in the long run.

Importantly, recent research helps support this view. Drawing on the international experience over the past several decades researchers have examined the relationship between corporate income taxes and wages.[3] Generally, this research has found that those countries that have reduced their corporate taxes the most have experienced the largest increases in real manufacturing wages and are suggestive that workers, not owners of capital, bear a substantial portion of the corporate tax.

Second, this view does not recognize that many types of consumption taxes exempt from tax only a portion, but the economically important part, of the tax on the return to saving and investment. The tax on the portion of the return needed to make the investment – the so-called "normal" return or "opportunity cost" of capital – is removed under many types of consumption taxes, while the return in excess of the normal return – the so-called "super" normal or "infra-marginal" return – continues to be taxed. This is important because some estimates suggest that super normal returns

[1]Altig, David, Alan Auerbach, Laurence Kotlikoff, Kent Smetters and Jan Walliser, "Simulating Fundamental Tax Reform in the United States." *American Economic Review* Vol. 91(2001): 574-595.

[2] Carroll, Robert, John Diamond, Craig Johnson and James Mackie III, "A Summary of the Dynamic Analysis of the Tax Reform Options Prepared for the President's Advisory Panel on Federal Tax Reform," Report of the U.S. Department of the Treasury, Office of Tax Policy, May 2006.

[3]For a recent review of this research see: William Gentry, "A Review of the Evidence on the Incidence of the Corporate Income Tax," OTA Working Paper 101, U.S. Department of the Treasury, Office of Tax Analysis, December 2007.

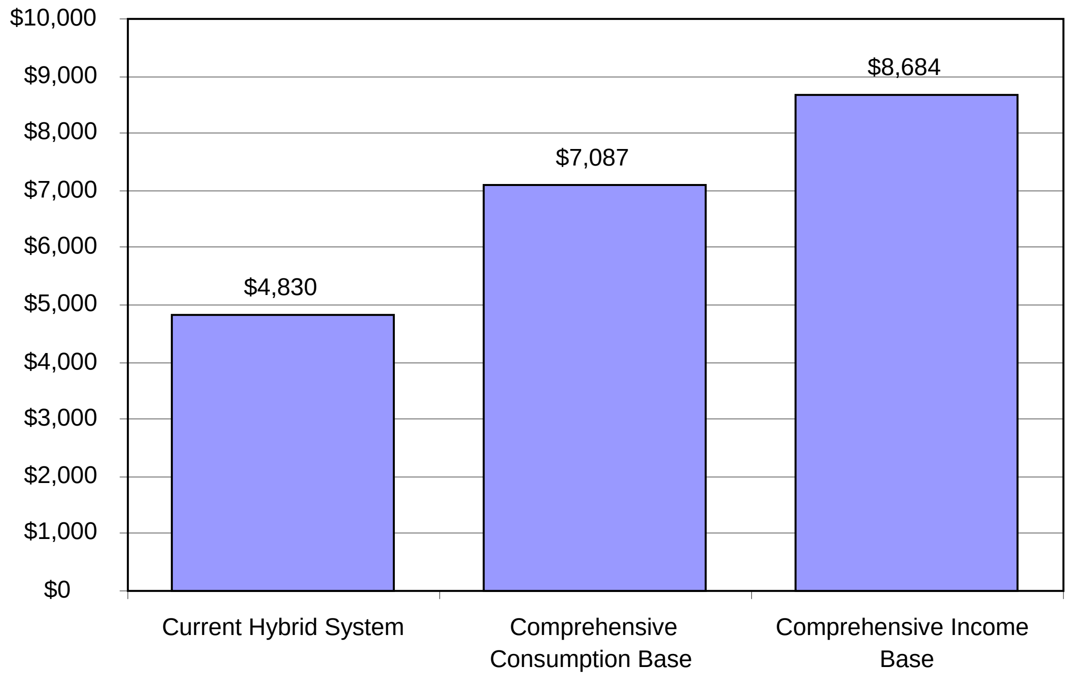
may well represent a substantial portion of the total return to investment and would be taxed under both an income and consumption tax.[4] This suggests that consumption taxes may not be as regressive as some have suggested.

Finally, moving towards a consumption tax base and maintaining the progressivity of the tax system are not mutually exclusively objectives. Progressive tax rates and broadening the base in ways that limit the benefit of special tax provisions to higher-income taxpayers, while enhancing their benefit to lower-income taxpayers is one recipe for a distributionally balanced reform. As shown in Figure 1, the current tax base is roughly 55 percent of the size of a comprehensive income tax base and roughly 70 percent of the size of a comprehensive consumption tax base. In terms of revenue and their effect on the structure of the tax system, just a handful of the more than one hundred special tax provisions dominant: 1) the exclusion for employer-based health insurance, 2) the home mortgage deduction, 3) the charitable giving deduction, and 4) the state and local tax deduction. Limiting or redirecting the benefits of these provisions could satisfy the dual objective of minimizing their effect on economic decision making and more carefully focus their benefits on those with fewer resources.

Indeed, there is a significant cost associated with channeling tax benefits through targeted tax provisions: the higher tax rates imposed on all taxpayers. As an illustration, repeal of the roughly $100 billion annually in housing tax subsidies could finance an across-the-board reduction in tax rates of roughly 14 percent. Importantly, the economic cost of high tax rates grows more than proportionately as the tax rate increases; that is, high tax rates have a disproportionately high economic cost associated with them.

[4]Gentry, William M. and R. Glenn Hubbard, (1997) "Distributional Implications of Introducing a Broad-Based Consumption Tax," NBER Working Paper No. 5832, Cambridge, MA: National Bureau of Economic Research.

Figure 1
Various Exclusions, Deductions and Credits Reduce the Current Tax Base by More Than Half as Compared to a Comprehensive Income or Consumption Tax Base (2001
Billions



Source: *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System,* The President's Advisory Panel on Federal Tax Reform, November 2005, p.23

Removing Taxpayers from the Rolls a Means to Simplicity?

One measure that is sometimes used to gauge whether a reform is simpler is the extent by which it minimizes the interaction of taxpayers with the IRS or, in the extreme, removes them from the rolls altogether. Some reforms, for example, that would replace a significant portion of the income tax with some type of value-added tax could remove millions of households from the income tax system. These households would, in effect, continue to pay tax through the value-added tax when purchasing goods and services, but would not themselves remit tax to the federal government.

Alternatively, others have considered moving towards a return-free system whereby most taxpayers would have their taxes exactly withheld during the year by their employers and financial institutions. One potential advantage of this approach is that many of the special tax provisions would likely need to be eliminated in order to include a significant number of taxpayers in the return free system. That is, the return-free structure itself might help motivate reform towards a more streamlined tax code with fewer special provisions. Also, such a system might be less subject to change in the future because changes would involve increasing the number of taxpayers who would have to file separate returns and interact with the taxing authority.

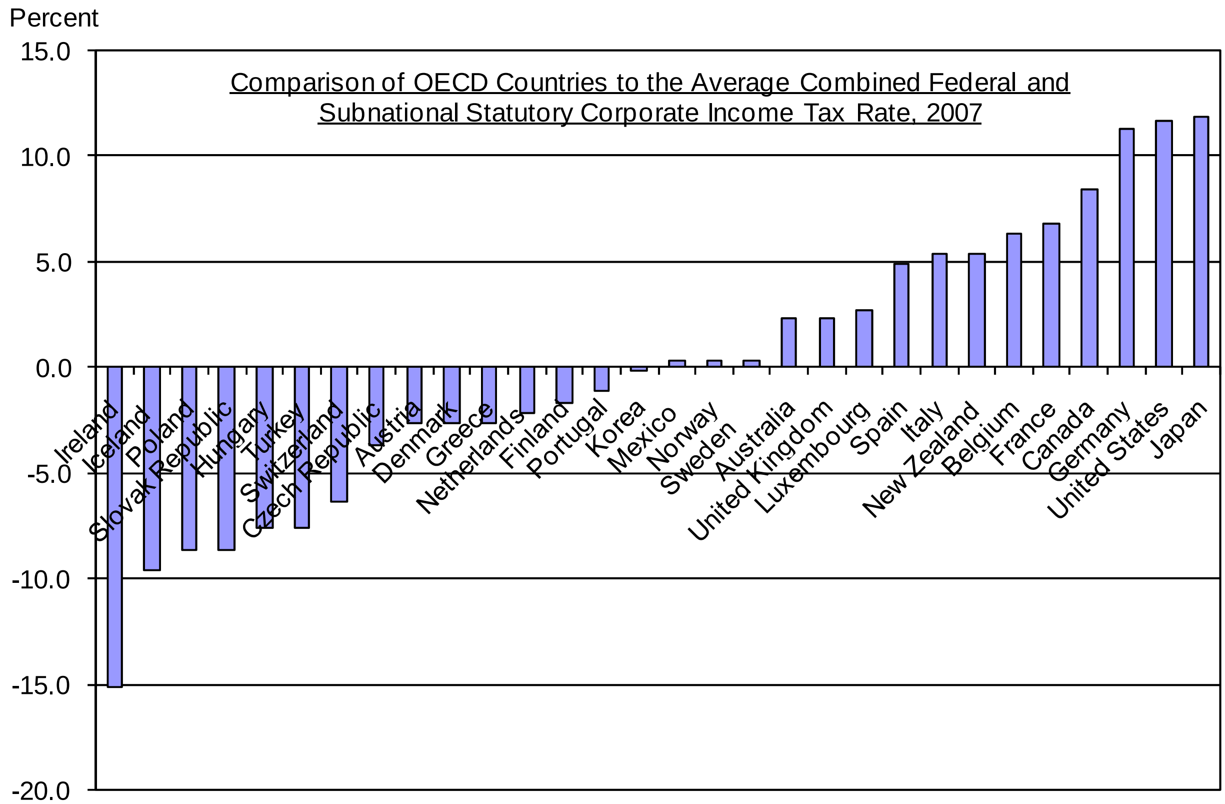
While these approaches may be well intentioned, reducing the interaction of households with the taxing authority could have more far reaching effects on the extent to which citizens have a stake in the government.

The U.S. Tax System in an Increasingly Global Marketplace

The ability of the United States to continue to attract investment and further increase living standards depends, in part, on how its business tax system compares to its major trading partners. While the United States economy was once characterized by its dominance in the world marketplace, it now operates in an increasingly open world economy where capital flows freely across borders.

The U.S. business tax system, however, may have fallen behind. During the past two decades the Unites States has gone from a country with a low statutory corporate tax rate to one with a high statutory corporate tax rate as compared to member nations in the Organisation for Economic Co-operation and Development (OECD). As shown in Figure 2 (see below), the U.S. now has the second highest combined federal-state corporate tax rate among OECD nations, exceeded only by Japan.

Chart 2: The United States has the Second Highest Statutory Corporate Tax Rate Among OECD Nations.



Source: Organisation for Economic Co-operation and Development www.oecd.org).

Moreover, the distance between the U.S. corporate tax rate and the lower corporate tax rates abroad is growing, further disadvantaging the United States as a place to invest. In just the past two months, at least six countries have announced plans to cut their corporate tax rates: Canada, Hong Kong, Korea, South Africa, Spain and Taiwan.

What is the effect of U.S. government inaction while other nations continue to reform their business tax systems? In a world of greater economic integration and increased trade and capital flows, a firm's decision about where to locate and expand its operations will be increasingly influenced by factors such as a country's statutory corporate tax rate and overall investment climate.

By standing still, the United States can expect to see reduced inflows of foreign capital and investment because the United States will be a less attractive place in which to invest, innovate and grow. U.S. firms will face a higher cost of capital than foreign firms, making it more difficult to compete in foreign markets. In the near-term, this would translate into slower economic growth, a slower advance in labor productivity, and less employment. The industries that are being hurt the most are those that manufacture or buy capital-intensive products.

The recent Treasury report, *Approaches to Reform of the U.S. Business Tax System for the 21st Century*, found that wholesale replacement of the U.S. corporate income tax with a consumption-based tax would increase economic output by between 2.0 percent and 2.5 percent in the long-run. Importantly, because this estimate does not fully capture the positive effects of free-flowing capital in a global setting, it is likely to be a conservative estimate of the potential benefits of reforming the U.S. business tax system.

A more disturbing possibility emerges as the disparity grows between corporate taxation in the United States and its trading partners: a slower pace of innovation in the United States. A key determinant of economic growth, innovation tends to take place where the investment climate is best.

Summary

Reforming the U.S. tax system poses significant political challenges, but offers the opportunity to rationalize many aspects of the tax system in a way that reduces the compliance burdens imposed on households and businesses and creates an environment for greater economic growth in a manner that is appropriately fair.

Thank you again, Mr. Chairman, Senator Grassley, and Members of the Committee for the opportunity to appear before you today.