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Statement of

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A Blueprint for Tax Reform and Health Reform*

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Chairman Baucus, Ranking Member Grassley, and members of the committee: Thank you for inviting me to testify on tax reform.

It is a great honor to speak to you on this topic. The last great tax reform effort lured me to Washington away from academia to work for the Treasury Department in 1985. I remember when Chairman Packwood rescued reform from the abyss with his “27-percent solution”—a top rate so low it caught the public’s attention and sustained momentum for what became the Tax Reform Act of 1986. The creativity and bipartisanship of this committee were key elements in the success of the 1986 Act.

In the mid-1980s, the tax system desperately needed fixing. Tax shelters were rampant, with investment decisions often motivated solely by the tax savings they could produce, rather than their underlying economics, which were often dubious. The public had lost confidence in the fairness of the tax system.

If anything, the need for tax reform is even greater now for at least four reasons. First, under current law most of the tax cuts enacted since 2000 are set to expire at the end of 2010 and the code will revert to that of 2000. In theory, this will trigger what tax cut advocates are already calling the largest tax increase in history, but extending the tax cuts seems fiscally reckless. Second, the baby boomers are beginning to retire and the costs of providing their Social Security and medical care will strain available federal revenues. Third, under current law, the reach of the individual alternative minimum tax (AMT), a pointlessly complicated and unfair element of the current code, is scheduled to mushroom, hitting 32 million taxpayers by 2010, up from 4 million in 2007. Were that to happen the middle class would scream in protest, but making up for the hundreds of billions of dollars in revenue that the AMT is projected to produce will be a huge challenge. Finally, there is growing public dissatisfaction with our federal tax system which is complex, riddled with loopholes, and widely perceived to be unfair. It is hard to see how these challenges can be tackled without a major tax reform.

Although tax reform is always a long shot, there are reasons for optimism. Politicians in both parties—and even current presidential candidates—understand that the current situation is unsustainable. A new president who had campaigned on a platform of working in a bipartisan way to advance objectives that matter to both parties may be willing to stake political capital on advancing tax reform. And the fact that both sides acknowledge that this is a “change election” bodes well for the next president’s willingness to take political risks.

A successful tax reform should be designed to address the concerns of members in both parties. The reformed system will have to maintain progressivity, raise enough revenues to finance the government, and, if the Democrat wins the White House in November, dovetail with plans to provide universal access to health insurance. The tax system should be easy for taxpayers to understand and comply with, and it should be perceived as fair. Tax reform should enhance economic growth compared with the current system, which means lower income tax rates, fewer distortionary loopholes and tax preferences, and lower taxes on the returns to saving and investment. And it should include a credible mechanism to limit the rate of growth of federal spending.

I outline a plan that meets all of those criteria. In brief, it would combine a value-added tax (VAT) dedicated to pay for a new universal health insurance voucher with a vastly simplified and much flatter income tax. With a new financing source for health care, income tax rates could be cut sharply—the top rates could be cut to 25 percent or less. The health care voucher would also offset the inherent regressivity of a VAT, since the voucher would be worth more than the VAT tax paid by most households. Moreover, with the VAT rate (and the price of goods and services) tied to health care spending, the public would have a vested interest in reining in the growth of health care costs. That is, the financing mechanism would help control the fastest growing component of federal spending.

The simplified income tax would be designed so that most taxpayers would not have to file income tax returns. Tax incentives for working and child-related subsidies would be replaced with simplified refundable tax credits along the lines suggested by Michael Graetz (2008). And the alternative minimum tax would be eliminated.

And the plan would also bolster the solvency of social security and eliminate the Medicare payroll tax.

In my testimony, I will discuss in more detail the reasons why tax reform must happen and the prerequisites for successful tax reform, and outline the nature of such a plan.

I. Action-Forcing Events

Memos to policymakers that require a decision lead off with an “action-forcing event”—a reason why a decision has to be made. This is a key part of the memo, because decisions carry risks and politicians don’t want to make them unless they must.

The action-forcing events that could lead to tax reform include the following:

- the expiration of most of the tax cuts enacted since 2001 at the end of 2010;
- the explosive path of the AMT;
- a likely budget crunch coming within the next 10 years if the tax cuts are extended and the AMT reformed or repealed;
- the retirement of the baby boomers and rapidly growing health care costs that threaten the nation with insolvency if not addressed; and
- a host of related factors, including the complexity and inefficiency of the income tax, concerns about rising economic inequality, and calls to use the tax system to mitigate it, and the large fraction of households that pay no income tax.

A. Expiration of Bush tax cuts

Almost all of the tax cuts enacted in 2001 and 2003 expire at the end of 2010. They include lower marginal income tax rates (the top rate was cut from 39.6 to 35 percent); a doubling of the child tax credit and a new refundable portion for households with earn-

ings over \$12,060 (in 2008); phasing out of the estate tax and its repeal for one year in 2010; marriage penalty relief; and lower tax rates on capital gains and dividends.¹

It seems unlikely that Congress will simply let the tax cuts expire as scheduled. For one thing, the potential behavioral responses to the one-year estate tax holiday are too ghoulish to contemplate.

But extending all of the tax cuts would be costly—reducing tax revenues from 2008 to 2018 by almost \$2.3 trillion according to the Congressional Budget Office (2008). (See table 1.) The benefits from extending all of the tax cuts would disproportionately accrue to households with high incomes. (See table 2.) With Democrats likely to retain at least one house of Congress, these factors make it unlikely that the tax cuts will simply be extended as a package.

Nonetheless, all the presidential candidates have agreed to make the “middle class tax cuts” permanent. And all have promised significant other tax cuts.

The candidates have also all pledged to be fiscally responsible, although they have left somewhat vague how this fiscal responsibility should be measured. Senators Obama and Clinton have promised to abide by Pay-As-You-Go (PAYGO) rules that would require new tax cuts to be offset by tax increases. If PAYGO is measured relative to a current-law baseline (assuming the tax cuts expire at the end of 2010 and the AMT remains in place), this pledge could severely limit their ability to extend any tax cuts, enact new ones, or advance spending priorities. Senator McCain has said that he’d cut spending, although he would have to cut spending to levels last seen in the Eisenhower administration to achieve budget balance if all of his tax cuts were enacted—a long shot, to say the least (Burman and Leiserson 2008).

B. AMT

The individual AMT is the poster child for pointless complexity in the tax system, but its theoretical revenue-raising potential makes it extremely difficult to reform or repeal. Originally intended to ensure that rich people paid at least some tax, the AMT has morphed into an incomprehensible shadow tax system, poorly suited to its original purpose (Burman 2007). The largest AMT “preference item” (generally, deductions allowed under the regular income tax but disallowed under the AMT) is the deduction for state and local income and property taxes—hardly most people’s conception of a tax shelter. Personal exemptions are the second largest item.

The AMT’s biggest defect is that, unlike the regular income tax, its parameters are not indexed for inflation. So every year more and more people become potentially subject to the tax. President Bush’s tax cuts, which lowered regular income taxes but only offered a

¹ The 2001 act also increased contribution limits to defined contribution pension plans and IRAs and created a new nonrefundable tax credit for lower-income savers (along with other pension revisions). The Pension Protection Act of 2006 made those provisions permanent.

temporary fix for the AMT, also roughly doubled the number of taxpayers potentially subject to the AMT through 2010.

Congress has prevented the AMT from affecting too many taxpayers by a series of temporary fixes, but the last one expired at the end of 2007, and they get more expensive every year.

Under current law, more than 26 million people are scheduled to owe AMT in 2008. (See figure 1.) If the Bush tax cuts are extended, the number will explode to over 50 million (or about half of taxpayers) by 2017.

The AMT will in principle bring in an enormous amount of revenue over the next 10 years—\$800 billion if the Bush tax cuts expire on schedule and twice that much if they are extended. (See figure 2.) Of course, that revenue bonanza won't materialize because it would mean more and more middle-income taxpayers would become subject to the tax over time. But the fiction of the AMT as a revenue machine masks the size of our budget problems. Given that any revenue-neutral AMT reform would create many winners and losers, it is not clear how it could happen except as part of a major tax reform.

C. Short-term budget challenges

If the Bush tax cuts were allowed to expire on schedule and the AMT took its course, our short-term fiscal situation could be very good. According to the Congressional Budget Office (CBO), tax revenues would increase continuously as a share of GDP. (See figure 3.) Indeed, the CBO projects a budget surplus from 2012 to 2018 under current law (assuming modest spending growth).

However, if the tax cuts, the AMT patch (which basically amounts to indexing the AMT for inflation), and other perpetually expiring provisions, such as the research and experimentation tax credit, are all extended, tax receipts would decline as a percentage of GDP through 2013 and remain below their historical norms through the budget period. Including additional interest on the national debt, these tax-cut extensions would add up to almost \$4.9 trillion, more than offsetting the modest budget surplus in the baseline. (See table 1.) There would be substantial and growing deficits, exceeding \$600 billion in 2017, or 2.8 percent of GDP. Under this scenario, the national debt would be \$4.6 trillion higher in 2018 than it is now.

D. Retirement of baby boomers and long-term budget problems

We might take solace in the fact that a deficit-to-GDP ratio of 2.8 percent would not be unprecedented. The deficit-to-GDP ratio averaged 4.3 percent from 1982 to 1993 (Kogan and Aron-Dine 2006). However, Kogan and Aron-Dine note that this was the “*only period in the history of the United States* in which the government consistently ran large deficits—i.e., increased the debt-to-GDP ratio—during a time of peace and prosperity” (p. 2, emphasis in the original text).

There is an even more pressing concern about rising debt now. In the 1980s, the baby boomers' peak earning years were still ahead of them. Now they are entering retirement. Moreover, medical care costs—and the cost of federal health care programs for the elderly—have risen much faster than the economy, and are expected to continue to do so absent a major change in policy. Rising health care costs and the demographic surge threaten to create enormous long-term budget challenges. CBO projects that if health care expenditures continue to grow at roughly their historical rate, the three main programs for the elderly—Social Security, Medicare, and Medicaid (which pays for nursing home care) will together cost 18.1 percent of GDP in 2050. (See figure 4.) That is, those three entitlement programs would consume all federal revenues if tax collections remain at historic levels.

If other spending continues at historical levels and revenues do not increase, CBO projects that the national debt could reach nearly three times GDP by mid-century and balloon to more than eight times GDP by 2080. (See figure 5.) By comparison, the debt-to-GDP ratio was barely over one after World War II, and policies enacted thereafter tamed the debt through the 1950s and 1960s.

As bleak as these long-term projections are, they are in at least one sense wildly optimistic: they assume that the economy will continue to grow at historic rates. However, with such an explosion of public debt, the ability and willingness of foreigners and U.S. investors to hold U.S. government debt would quickly be exhausted. Interest rates would increase, raising debt service costs (exacerbating budget deficits) and stifling investment, home sales, and purchases of consumer durables. The economy would grind to a halt.

Of course, this is a perfect illustration of Stein's Law, "If something cannot go on forever, it will stop" (Stein 1997). The only ways to avoid the budget catastrophe are to raise taxes, reduce spending, increase the rate of growth of the economy, or some combination of the three. In my view, that creates an imperative for a tax system that can raise more revenues without taking an undue toll on economic growth combined with restraint on the growth of entitlement spending.

E. Other factors

1. The income tax is a mess

The AMT is but one indicator of the complexity and inefficiency of the income tax. For the past several decades, it has become the instrument of choice for advancing a host of social and economic goals. The deductions, credits, phase-ins, and phase-outs aimed at advancing these objectives are often ineffective (Steuerle 2004). Moreover, public perceptions about the income tax have changed. Americans once thought the income tax was the fairest tax. Now they perceive it as the least fair levy (Slemrod and Bakija 2004). This has prompted support for radical revisions, such as the flat tax and the national retail sales tax (called the FairTax by its supporters).

The corporate income tax draws special scorn. American companies face among the highest rates in the developed world, and yet the revenue yield from the tax is small by comparison with our trading partners. And, of course, a host of loopholes combined with high marginal tax rates creates both incentive and opportunity for tax sheltering. The corporate tax with its high rates and narrow base cries out for tax reform.

2. Concerns about rising economic inequality

Since the 1970s, the income distribution has been growing steadily less equal. Explanations include the growth of information technology, which substitutes for less skilled labor and raises the rewards to the most highly skilled (Autor, Levy, and Murnane 2003); globalization (Goldin and Margo 1992); the decline in such institutions as labor unions (Levy and Temin 2007); and the emergence of a winner-take-all society in which top performers earn many multiples of the income of those who perform almost as well (Dew-Becker and Gordon 2005). It is likely that all of these factors will persist. For that reason, some have called for more progressivity as an antidote to rising economic inequality (McMahon 2004; Burman et al. 2007).

This view, however, is far from universal. Penner (2003), for example, argues that the tax system is highly progressive when properly measured and the current level of progressivity is broadly consistent with public attitudes.

Bartels (2005) reported survey evidence that most voters (52 percent) thought that rich people paid less tax than they should, 44 percent thought that poor people paid too much, and only 8 percent thought the poor should pay more. About 46 percent reported that they thought they were overtaxed, although 48 percent thought they paid about the right amount. (Only 3 percent thought they paid too little.)

However, Bartels (2005) also reports that most of the people who thought the rich should pay more opposed the highly progressive estate tax. Slemrod (2006) reported evidence from the same survey that indicated that most people who say they favor more progressivity also favor the flat tax, which would be much less progressive than the current income tax.

This suggests that taxpayers are confused about the tax system and alternative policies. It might mean that if they understood the tax system, they would favor more progressivity. Or it might also mean that if they were better informed, they would be happy with the current level of tax progressivity or even favor a less progressive tax system.

3. Large fraction of households that do not pay income tax

Finally, there is a growing chorus of complaints, primarily but not exclusively from conservative quarters, about the large fraction of households that do not owe income tax. The Tax Policy Center estimated that, in 2007, more than 30 percent of tax units (households)

were in the zero marginal tax bracket or did not file.² Almost 40 percent of tax units owe no income tax after tax credits.³

The concern is that households who do not owe income tax perceive government to be free and thus will always support new programs, even if they have very little value. Put differently, they have no stake in reducing spending.

II. Requirements for Reform

Experience with the Tax Reform Act of 1986 (TRA) suggests that tax reform requires presidential leadership, bipartisan participation, and a lot of luck.⁴ The president would need to decide early that tax reform is a top priority. The Tax Reform Act of 1986, signed in August, started in January 1984, when President Reagan instructed the Treasury Department to produce a plan for release after the election (U.S. Treasury 1984). This suggests that for tax reform to be completed by the end of 2010 (because of the expiration of the Bush tax cuts), it would have to be a high priority from the day the next president takes office. Given that all of the candidates have promised to make health reform a priority, tax reform would have to be designed in such a way that it would dovetail with health reform, rather than compete for resources and attention.

Why would the president invest scarce political capital in a risky tax reform? First, of course, are the policy imperatives outlined in the previous section, which the president might find compelling. Second, political commentators of all stripes agree that this year's election will produce a mandate for change. The president might decide that there would be political rewards if he or she successfully tamed the income tax and put the nation on a more secure fiscal footing, especially if tax reform were combined with credible restraints on spending.

A second requirement for success is bipartisan investment in the process. If it were seen as a Democratic or Republican initiative, the other party could easily attack the president for the inevitable losers that would arise from any rationalization of the current tax system—especially if revenue increases were part of the package. In 1986, a Republican president, Ronald Reagan, worked successfully with the Democratic leadership of the House as well as the Republicans who controlled the Senate to bring TRA to a successful conclusion (Birnbaum and Murray 1987).

In fact, members of both parties recognize that we are on an unsustainable fiscal path and probably understand that spending cuts alone will not produce fiscal balance. The *Analytical Perspectives* volume of President Bush's FY 2009 Budget had virtually the same grim projection of the effect of extending current policies as produced by CBO (2007),

² Source: <http://www.taxpolicycenter.org/T07-0086>. Note that they do pay other federal taxes. We estimate that households at every income level owe at least some tax when you combine payroll, income, excise, and estate taxes.

³ Source: <http://www.taxpolicycenter.org/t04-0102>.

⁴ Birnbaum and Murray (1987) chronicle the story of TRA. In addition to presidential leadership and bipartisanship, they describe a number of occasions when TRA appeared to be dead, but something happened at just the right time to get the process back on track.

although the Budget implied that spending cuts alone would suffice to solve the problem. Republican economist Bruce Bartlett (2006) concluded that tax increases are inevitable and urged his colleagues to consider tax options that would be less injurious to growth than simply increasing income tax rates.

A requirement for bipartisan participation (and ultimate success) is that the process would have to address the major concerns of both parties. This means, on the Democratic side, it would have to be equitable, help low- and middle-income households, and guarantee enough revenues to finance an adequate level of government. As noted, if the Democratic candidate wins, tax reform has to be consistent with a program to provide universal access to health insurance.

To win Republican support, tax reform would have to be combined with a credible process to slow the growth of spending. Since entitlement spending accounts for a large and growing portion of spending, control of entitlements must be an integral part of the package. In addition, the reformed tax system should address concerns about the growing number of households that do not pay income tax. And a reform proposal should improve the economy. This means that income tax rate cuts need to be part of the package, as they were in 1986.

A final factor key to success in 1986 was a big increase in corporate income taxes (primarily through repeal of the investment tax credit and scaling back of accelerated depreciation). Although economists understand that corporate taxes are ultimately paid by people (investors, workers, and consumers), most Americans were apparently convinced that they would not pay the tax. At one point, corporate CEOs of large companies that would pay much higher taxes as a result of TRA lined up to support the plan because they, personally, would pay much lower income taxes (Birnbaum and Murray 1987). This was one of the pivotal moments and helped lead to TRA's passage.

A large corporate tax increase is probably not in the cards this time. There is no investment tax credit or highly accelerated depreciation to repeal or scale back and, if anything, there is pressure to reduce corporate taxes. However, it might be possible to introduce a new revenue source that is relatively palatable and widely accepted in the rest of the world—the VAT.

III. A Possible Reform

An approach that might meet all of the constraints above would be a combination of a VAT dedicated to paying for health care, similar to the proposal of Emanuel and Fuchs (2007); individual and corporate income tax cuts, including lower rates, a broader base, and elimination of the AMT; revenues sufficient to achieve budget balance over the short- and longer-terms; and a credible process to control spending, especially on entitlement programs. The package as a whole would also have to be designed to maintain or enhance progressivity.

A. The Health VAT

A cornerstone of the package is a VAT dedicated to pay for all federal medical expenditures, including a new voucher to provide universal access to health insurance. A VAT is a tax on consumption, similar to sales taxes levied by states, except that it is collected in stages from each business that contributes to the production and sale of consumer goods.⁵ It is universal in the rest of the industrialized world and generally thought to be relatively easy to administer and for businesses to comply with. Emmanuel and Fuchs (2007) estimate that a VAT rate of approximately 15 percent could pay for the fully phased in voucher program.

Two main complaints have been leveled at the VAT. One is that it would be a money machine and fuel the growth of government. A second is that it is regressive since lower-income households spend a much larger share of their incomes than higher-income households.

1. Health VAT and government spending

A VAT dedicated to paying for health care, including the new voucher, would seem to address both of these criticisms. The VAT would be reflected in retail prices and the VAT rate would have to increase over time if health care spending continues to grow faster than the economy.⁶ Since everyone would pay the VAT, the higher rate could build widespread support for effective measures to control health care costs. Moreover, the lowest-income 40 percent of households would have a stake in controlling government spending, addressing one of the conservatives' major complaints about the current system.

The overall effect of the program on federal spending will depend on the nature of the health care voucher. Emanuel and Fuchs (2007) propose that the voucher pay for health care provided through a program like the Federal Employees Health Benefits Program. They argue that the voucher could squeeze waste out of the system because the federal government would have the market power to require that providers control costs (and presumably would be combined with other reforms that would reduce ineffective care). There is also evidence that much of the variation in health care costs is not related to differences in health status or quality (Congressional Budget Office 2008b). By tying the basic voucher amount to age, gender, and health status, but not regional variation in prices, pressure would be put on providers to conform their standards of care to the best practices.⁷

⁵ See Yin (2006) for discussion of types of VAT and why it is superior on administrative grounds to a national retail sales tax, which several Republican presidential candidates (most notably Governor Huckabee) have endorsed.

⁶ One of the concerns about the VAT is that it is an invisible component of product prices. This concern might be mitigated by urging or requiring retailers to break out the VAT on sales receipts.

⁷ Even if this works, there would be issues during a transitional period if providers cannot immediately adapt.

Given that most working-age people and their families get health insurance through employers, there would be advantages to designing the voucher so that it could be used in concert with employer-sponsored insurance (ESI), especially for large employers that can provide such insurance relatively cheaply. One option would be to allow the voucher to be transferred to an employer that offers ESI either purchased directly or purchased through the publicly sponsored pool. To minimize adverse selection (employers with healthier-than-average workforces opting out of the public program), the voucher could be set at less than 100 percent of the cost per worker in the public pool.

A possible way to limit spending and improve the chance for bipartisan consensus would be to make the voucher pay for a high-deductible health insurance plan. Jonathan Gruber and Martin Feldstein (1995) proposed a universal voucher tied to plans with a deductible that varied with income. There are serious administrative issues to implementing this (or any means-tested health entitlement), but it could offset the prime complaint about high-deductible plans. The deductible could be set very low for households with low incomes and very high for those with incomes high enough to afford the higher risk. Alternatively, the high deductible plan could be combined with health savings accounts, as under current tax law, and the government could pay for all or part of the deductible for lower-income families.

Finally, the plan might include process reforms designed to limit the growth of entitlement programs. Penner and Steuerle (2005) propose caps and triggers for automatic cuts in entitlements that they claim would take those programs off auto-pilot. They also propose a super-majority requirement for the enactment of large new entitlement programs. However, enactment of these options might be delayed until policymakers see how well the automatic spending constraint built into the health VAT and voucher work.

2. Health VAT and progressivity

The new health care voucher paid for by the VAT would be most valuable to low- and middle-income households who either do not currently have health insurance or for whom the cost of health insurance is a very large portion of their incomes. Currently, health insurance averages more than 10 percent of compensation for employees who get it at work (Eibner, Kapur, and Marquis 2007). It is a larger percentage for those with lower incomes. Thus, the new health benefit will be worth far more than the additional tax paid through the VAT. For high-income people, in contrast, health insurance is only a fraction of income. The VAT will cost much more than the value of the new benefit.

Overall, distributional targets can be met by coordinating the income-tax changes with the VAT and the health voucher. A special consideration is that low-income people who currently qualify for free health care through Medicaid or the children's health insurance program, SCHIP, will receive less benefit from the voucher. Since food stamps are indexed for food price inflation and the refundable EITC is indexed to overall inflation, part of any effect of the VAT on prices would automatically be offset, but additional subsidies will be necessary for those with very low incomes.

3. VAT and seniors

A well-known feature of a VAT is that it is a tax on old capital. This especially affects older people, since they get relatively little benefit from the tax-exemption for new saving under the VAT while everything they buy becomes more expensive. Although this is probably a political disadvantage, seniors get so much more back in Social Security and medical care than they paid in, it makes sense to charge those who are able to pay for part of those costs. It is also important to note that those whose income comes mostly from Social Security would be relatively unaffected since those benefits are indexed to inflation.⁸

4. VAT and economic efficiency

The VAT is a relatively efficient revenue source. Since it taxes consumption rather than income, it does not discourage saving as does the income tax.

The biggest efficiency gain, though, could come from reductions in income tax rates. The VAT will cover the cost of current health care programs, offsetting federal spending on Medicaid, veterans' health programs, and the portion of Medicare paid out of general revenues. Although part of Medicare spending is covered by premiums and payroll taxes, more than \$200 billion in FY 2009 will be financed with general revenues (Congressional Budget Office 2008a). Federal spending on Medicaid and other federal health programs adds another \$240 billion. All told, the income tax would have to finance about \$450 billion less in health spending than it does at present.

In addition, there would no longer be a tax exclusion for employer-sponsored insurance (ESI), a \$169 billion income tax expenditure in 2008. Other potentially superfluous tax subsidies total about \$12 billion. Thus, the income tax base would become substantially larger. As a result, with the VAT covering health care costs, tax rates could be cut by about a third across the board with no effect on the deficit.⁹ And that is even before considering the additional revenues that could arise from base broadening.

With lower tax rates, the tax reform could also eliminate the differential between capital gains and other income (as in 1986), which would reduce the incentive and ability of individuals to engage in tax sheltering. More generally, the lower top rate would reduce the incentive for tax avoidance and evasion of all sorts.

⁸ Burman, Gravelle, and Rohaly (2005) found that households over 65 were less affected by a VAT than younger ones, because Social Security benefits are indexed.

⁹ CBO projects that individual and corporate income tax revenues will total \$1,696 billion in FY 2009. After repeal of the ESI exclusion and other health insurance tax expenditures, tax revenues would be about \$1,876 billion. Total general revenue financed federal spending on health care is about \$628 billion (including the tax expenditures). Thus, income tax revenues could be cut by 628/1,876, or 33.5 percent, with no net effect on the deficit. These calculations ignore behavioral responses, which are ambiguous. Eliminating the ESI exclusion might encourage some taxpayers to find other ways to shelter wages from tax. On the other hand, lower marginal tax rates would reduce the incentive for tax avoidance, generating a positive revenue feedback.

5. Payroll tax cut

Since health care for the elderly would be financed through the VAT, the Medicare portion of payroll taxes (1.45 percent on employers and employees) would no longer be necessary. Moreover, elimination of the ESI exclusion would significantly increase contributions to Social Security, substantially bolstering its finances. On the other hand, to the extent that the VAT translates into higher prices, the Social Security trust fund would tend to be devalued. But higher prices would also devalue U.S. debt, so, on balance, the federal government's balance sheet could improve. Part or all of those savings could be transferred to Social Security, if necessary. Over the long term, the Social Security trust fund will be much stronger because more of wages are included in the Social Security tax base.

6. Effect on states

If the federal government takes over states' obligations for Medicaid, states will avoid an enormous and growing financial obligation. The federal government could ask states to pay a larger portion of other programs they currently share with the federal government. Alternatively, the federal government might forgive the states their current obligations for care for patients who are eligible for both Medicare and Medicaid—a \$56 billion obligation in 2008—but require a state contribution toward the voucher equal to their states' other Medicaid spending. Even in this case, states' financial exposure would be substantially lower than under current law. The states' windfall might make them less resistant to sensible tax reforms, such as repealing the deductibility of state and local taxes and scaling back or eliminating the use of tax-exempt bonds, both of which are extremely inefficient subsidies.

B. Income and estate tax reform

The income tax reforms would reflect the traditional recipe: broad base (that is, fewer loopholes and deductions) and lower rates. The AMT would be eliminated. As noted, financing health care with the VAT would allow for significantly lower top marginal tax rates, even while eliminating the AMT. All of this would be accomplished while maintaining or enhancing the overall progressivity of the tax system (including the benefits from the new health care voucher). Simplicity would be achieved by relieving most taxpayers of filing requirements, and vastly simplifying filing for others.

There are several models that have some similarities to this plan. William Gale (2008) recently proposed a tax reform including integration of the corporate and individual income taxes for new investment and a VAT sufficient to raise 4 to 5 percent of GDP. Gale would eliminate the AMT (conditional on the AMT's anti-tax shelter provisions being incorporated into the tax code); eliminate many individual and corporate tax breaks; improve enforcement; simplify and consolidate tax breaks for education, retirement, and families; provide a new tax credit against payroll taxes on the first \$5,000 of earnings; and introduce return-free filing for many taxpayers.

Michael Graetz (2008) has also proposed a VAT, but would use the revenues generated to exempt families with incomes below \$100,000 (\$50,000 for singles) from income tax. Under Graetz's scheme, the income tax would return to its origins as a tax on those with very high incomes. He would cut top individual and corporate income tax rates and would retain some variant of the refundable child tax credit and earned income tax credit to prevent low-income families from suffering a tax increase. Of course, this would require income assessment for such families, so it is not so different from Gale's proposal to simplify the tax system enough so that many low- and middle-income families do not have to file (their income tax is determined by exact withholding).

As Graetz (2008) notes, the exact details of the tax reform will be determined by the political process. Indeed, specifying too many details in advance might doom any tax reform plan to failure. TRA was successful in part because President Reagan gave very parsimonious instructions to his tax reformers: cut top tax rates and preserve a subsidy for homeownership. Everything else was on the table and negotiated with Congress (Birnbau and Murray 1987).

A drawback of both the Graetz and the Gale plans is that they do not deal with health reform, meaning that either proposal would not be taken seriously in a Democratic administration until after health reform is completed (which could take a long time). Also, an add-on VAT that is not tied to health care might fuel conservatives' concerns that it would be a money machine that could spur the growth of government. And Graetz's plan would aggravate conservatives who complain that 40 percent of Americans owe no income tax. Under Graetz's plan, it would be closer to 90 percent.

Here is a rough outline of the nature of an income tax reform I believe could capture the best features of the Graetz and Gale plans while addressing bipartisan concerns. The goal would be to enable a return-free filing system for most households, which would require substantial simplification and flattening of the income tax. It is a more sweeping proposal than Gale's, which raises political issues as more sacred cows are jettisoned, but it would make simplicity a much higher priority than previous tax reforms have.

There would be two individual income tax rates—say, 15 and 25 percent (although the actual rates would depend on revenue and distributional targets), and the corporate tax rate would be set equal to the top individual income tax rate (so corporations do not become a tax shelter). Personal exemptions and the standard deduction would be eliminated. Itemized deductions would also become historical artifacts, as proposed by President Bush's tax reform panel. The mortgage interest deduction would be replaced by a flat 15 percent refundable tax credit paid directly to lenders. The deduction for charitable contributions would similarly be replaced by a 15 percent matching grant paid directly to qualifying nonprofits. (The U.K. does this now.) In each case, the match rate could be revised as part of congressional negotiations. Alternatively, taxpayers in the 25 percent tax bracket could be allowed to elect the deduction instead of the credit.¹⁰ Education tax

¹⁰ This would involve minor additional complexity. It could be implemented by allowing taxpayers to elect a full deduction and adding credits already received to taxes due. For taxpayers who use software or paid preparers, as most higher-income taxpayers do, the additional complexity would be imperceptible.

incentives should be replaced with an expansion of Pell grants and subsidized student loans. The deductibility for state and local taxes would be eliminated. (State governments could use their savings from the elimination of Medicaid to cut income and sales tax rates and increase their share of education financing, allowing local governments to cut property taxes, offsetting the effect of the lost tax deductions.)

Either traditional IRAs or Roth IRAs would be eliminated, as would nondeductible IRAs, which would simplify taxpayers' choices and accounting. The simplest option would be to retain only Roth IRAs, which feature nondeductible contributions and tax-free retirement withdrawals, eliminating all tax accounting requirements. The drawback of Roth IRAs is that they represent potentially large future reductions in the income tax base, since balances in these accounts are entirely tax-free so long as they are held until retirement, no matter how large they grow. Substantial growth in Roth IRAs could exacerbate our long-term budget challenges. In addition, rollover IRAs would need to be retained for balances in traditional 401(k) plans. But accounting for traditional IRAs would be more complicated.¹¹

The savers credit should be converted into a refundable tax credit payable directly to the financial institution. The IRS would send taxpayers a certificate in May or June of each year indicating their eligibility and credit rate based on information returns for those who do not have to file and tax returns for those who do, which would be used by the financial institution to claim the credit.

The child tax credit, the child-related portion of the earned income tax credit, the adoption tax credit, and the child and dependent care tax credit would be replaced by a \$2,000 per child fully refundable tax credit. (Again, the exact amount would be determined based on revenue and distributional targets.) The work subsidy in the EITC would be replaced with a 30 percent fully refundable payroll tax credit on the first \$10,000 of earnings for each adult worker.¹² This may seem extremely generous, but the 15 percent income tax bracket starts on the first dollar of earnings, so the net subsidy compared with current law would be modest.

The eligibility criteria for these new credits would be much simpler than the current child tax credit and EITC since the new credits would not phase out with income or depend so much on living arrangements. (For example, it would not matter which parent claimed a child for the tax credit so long as only one did—something easily verifiable by tax authorities.) The child tax credit amount could also be designed to offset the tax increase due to the VAT for very low income families that currently get free health insurance

¹¹ Contributions to traditional IRAs could be matched with a federal match, as for charitable contributions, with the option of deductibility for those in the 25 percent tax bracket. Withdrawals would be subject to a 15 percent withholding tax (plus a penalty tax for early withdrawals). This would be final withholding for most taxpayers. Higher-bracket taxpayers would have to include distributions in income and would be able to claim a credit for withholding tax paid. Rollover Roth IRAs would also need to be preserved for rollovers from Roth 401(k) accounts.

¹² Although the amounts are different because the scope of my proposal is much broader, the idea of replacing the EITC and child tax credit with fully refundable work and child tax credits is similar to a proposal made by Forman, Carasso, and Saleem (2005).

through Medicaid or SCHIP, since they almost all have children and their expenditures subject to VAT are likely to be relatively small.¹³

Workers with earnings and family incomes below certain thresholds would not be required to file a W-4 withholding form. Their employers would withhold income tax at a 15 percent rate. Interest, dividends, and withdrawals from traditional pensions, 401(k) plans, and IRAs would be subject to 15 percent withholding as well. For most taxpayers, this would be final withholding, requiring no additional accounting on tax returns. Other conforming changes, such as eliminating the deduction for alimony and child support payments for donors and taxation of such payments to recipients, would also facilitate the return-free system. For most taxpayers, this simplification would produce the same overall tax burden as under current law, but it would result in higher tax in the case where the donor was in the top bracket and the recipient was not.

Up to \$1,000 of capital gains (again, the amount is an example) would be exempt from tax every year. All other capital gains would be taxable as ordinary income.¹⁴ To reach bipartisan consensus, providing a tax break on long-term capital gains may be necessary. As noted, a rate differential between capital gains and other income creates enormous opportunities for tax sheltering, but some view it as important to encourage investment, reduce lock-in (the incentive to delay sales of assets to avoid the tax), and offset the double-taxation of corporate income.¹⁵ If capital gains (and dividends) are to be taxed at lower rates, the simplest way would be via an exclusion rather than the alternate rate structure that exists currently. For example, 60 percent of long-term capital gains and qualified dividends could be included in taxable income, creating a maximum effective tax rate of 15 percent (60 percent of 25 percent).

Under this plan, taxpayers in the 15 percent bracket would not have to file income tax returns unless they had a large capital gain or some other unusual tax situation. The only complexity would be how to convey the refundable tax credits. Graetz (2008) suggests that it could either be done through payroll adjustments by employers (as the advance EITC is done now) or through a debit card—an ATM card that would have the value of refundable credits based on earnings and number of children each year.

The estate tax is obviously fraught with controversy (Graetz and Shapiro 2005), but a reasonable compromise would be to extend the 2009 exemption of \$3.5 million and top tax rate of 45 percent. This would exempt all but very wealthy estates from the tax and might defuse the issue politically. The estate tax could also be simplified, for example by allowing surviving spouses to carry over any unused estate tax exemption from the first spouse to die. This would effectively grant an automatic \$7 million exemption for cou-

¹³ Under the parameters specified above, a one-earner couple with two children earning \$10,000 would get about the same refund, net of VAT, as under current law. Higher income couples would pay more tax, but presumably benefit more (on average) from the new health voucher.

¹⁴ One issue is whether corporate income taxes should be integrated to eliminate double taxation. While this change would be desirable in principle, full integration is relatively rare in the rest of the world and may be hard for voters to comprehend. Given the significant reduction in individual and corporate income tax rates, the economic gains would also be smaller than they would be under the current system.

¹⁵ See Burman (1997) for a discussion of the issues.

ples, which would significantly simplify tax planning for many couples. A more sweeping reform would be to convert the estate tax to an inheritance tax as described in Batchelder (2007).

Obviously many details are left out of this short sketch. Gale (2008) discusses individual and corporate income tax simplification, base broadeners, and compliance initiatives in more detail. There would also surely be significant administrative issues in setting up the new credits. In addition, some of the proposals are probably not politically feasible, and there would inevitably be a great deal of redistribution compared with current law. But the role of the political process is to vet the political and policy issues and balance them out. The key is for the president and congressional leaders to commit to keep the process moving toward the broad goals agreed to at the outset.

C. Other issues

There are many options to improve the income tax system that could be paired with the health VAT. For example, the income tax reforms outlined here could be replaced by those suggested by Michael Graetz (2008) or William Gale (2008) with relatively minor modifications. Senator Ron Wyden (D-OR) and Congressman Rahm Emanuel (D-IL) have proposed the Fair Flat Tax Act of 2007 (S. 1111), which would simplify tax filing and reduce the number of tax brackets, while recognizing that certain tax breaks are sacrosanct. If paired with the health VAT, the top individual and corporate income tax rates in that plan could be reduced from the proposed 35 percent to 25 percent or less (although refundable tax credits would need to be adjusted for low-income households currently receiving free health care that would be disadvantaged by the VAT).

A practical issue is sequencing of the major reforms proposed here, which include income tax reform, a new tax for the United States (a VAT), and health reform. It is probably an understatement to say that it is unlikely that Congress could accomplish all of this in one term. One option would be to extend some of the Bush tax cuts and index the AMT for inflation through 2012 (or some other fixed but not too distant date). In principle, the components of the reform outlined here could be enacted in stages. The challenge would be sequencing the pieces so that momentum for reform is not derailed along the way.

I applaud the committee for taking on the incredibly important task of tax reform. Obviously, it will not be easy, and I suspect I have only scratched the surface of the challenges you face. But nobody thought TRA would happen in 1986, and it did. The bipartisanship, creativity, and tenacity of Democrats and Republicans on this committee played a key part in making it happen. I hope that you can repeat and improve on that accomplishment.

That concludes my testimony. I am happy to answer any questions.

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Table 1. Effect of Extending Tax Cuts on Receipts and Deficit, Fiscal Years 2008-2018

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Total, 2009- 2018
Baseline receipts	2,654	2,817	2,907	3,182	3,442	3,585	3,763	3,941	4,131	4,334	4,548	36,649
Percent of GDP	18.7	19.0	18.6	19.3	19.9	19.9	20.0	20.0	20.1	20.2	20.3	19.8
Extend tax cuts	0	-3	-6	-147	-254	-281	-292	-304	-316	-329	-344	-2,277
Index AMT	-6	-75	-76	-71	-42	-49	-58	-68	-80	-94	-110	-724
Interaction	0	0	0	-18	-61	-69	-76	-83	-90	-97	-105	-598
Other expiring provisions	-6	-14	-22	-31	-38	-44	-49	-53	-58	-63	-67	-438
Receipts after tax cuts	2,661	2,744	2,822	2,934	3,067	3,161	3,308	3,453	3,608	3,771	3,941	32,631
Percent of GDP	18.7	18.5	18.1	17.8	17.8	17.5	17.5	17.5	17.6	17.6	17.6	17.6
Baseline surplus or deficit	-219	-198	-241	-117	87	61	96	117	95	151	223	274
minus tax cuts	-12	-92	-104	-267	-395	-443	-475	-508	-543	-583	-626	-4,038
additional interest on debt	0	-2	-7	-17	-34	-56	-81	-109	-140	-175	-213	-835
Surplus or deficit after tax cuts	-231	-293	-352	-401	-342	-439	-460	-500	-589	-607	-617	-4,600
Percent of GDP	-1.6	-2.0	-2.3	-2.4	-2.0	-2.4	-2.4	-2.5	-2.9	-2.8	-2.8	-2.5

Source: Congressional Budget Office; *The Budget and Economic Outlook: Fiscal Years 2008 to 2018*, January 2008.
http://www.cbo.gov/ftpdocs/89xx/doc8917/01-23-2008_BudgetOutlook.pdf

Table 2. Distribution in 2011 of Benefits from Extending Bush Tax Cuts set to Expire in 2010

Cash Income Percentile	Percent of After-Tax Income	Share of Tax Cut (Percent)	Average Tax Cut in Dollars
Lowest Quintile	0.4	0.5	41
Second Quintile	2.1	5.3	456
Middle Quintile	2.3	9.7	828
Fourth Quintile	2.2	15.3	1,309
Top Quintile	3.5	68.9	5,904
All	2.9	100.0	1,713
Addendum			
Top 10 Percent	4.0	56.5	9,673
Top 5 Percent	4.7	48.7	16,686
Top 1 Percent	6.7	37.4	64,154
Top 0.5 Percent	7.3	31.6	108,227
Top 0.1 Percent	7.8	18.9	323,621

Source: Tax Policy Center, Table T06-0284.

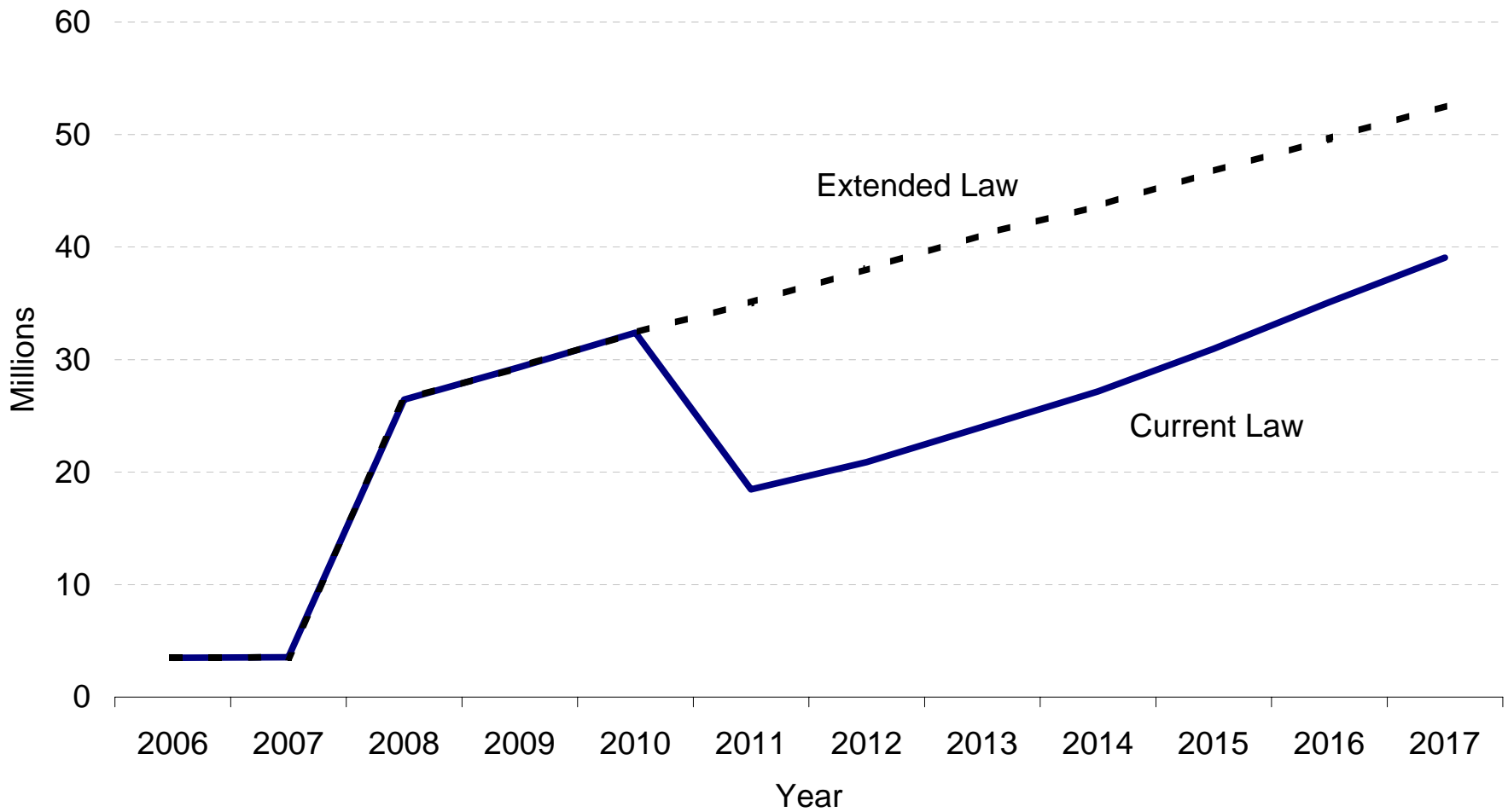
Notes: (1) Calendar year. Baseline is pre-EGTRRA law. Tax cuts include individual income and estate tax provisions in EGTRRA, JCWA, JGTRRA, WFTRA, AJCA, TIPRA, and PPA.

(2) Tax units with negative cash income are excluded from the lowest quintile but are included in the totals. For a description of cash income, see <http://www.taxpolicycenter.org/TaxModel/income.cfm>

(3) Includes both filing and non-filing units. Tax units that are dependents of other taxpayers are excluded from the analysis.

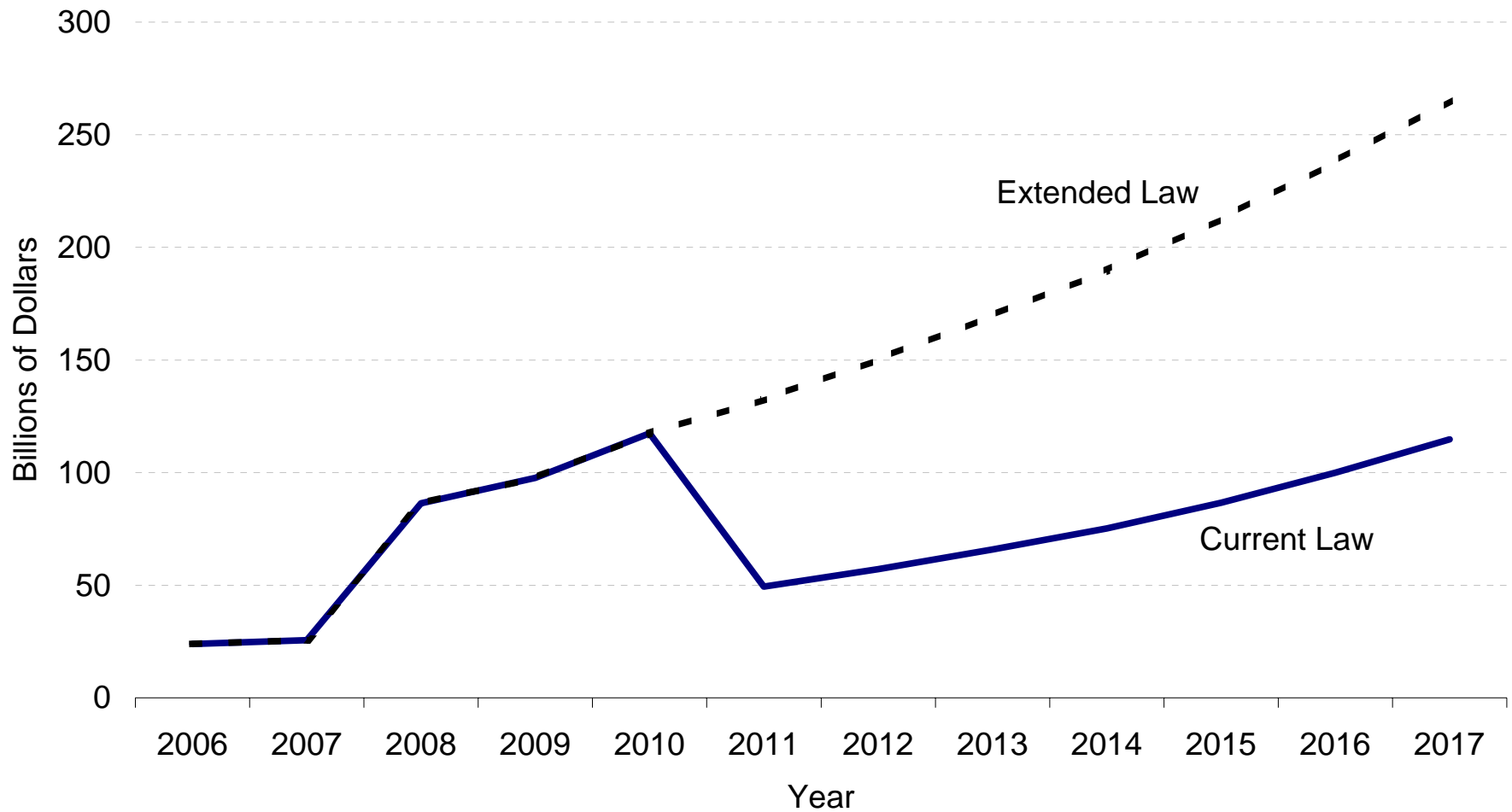
(4) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

**Figure 1. Number of AMT Taxpayers, 2006-17,
With and Without Extension of Bush Tax Cuts**



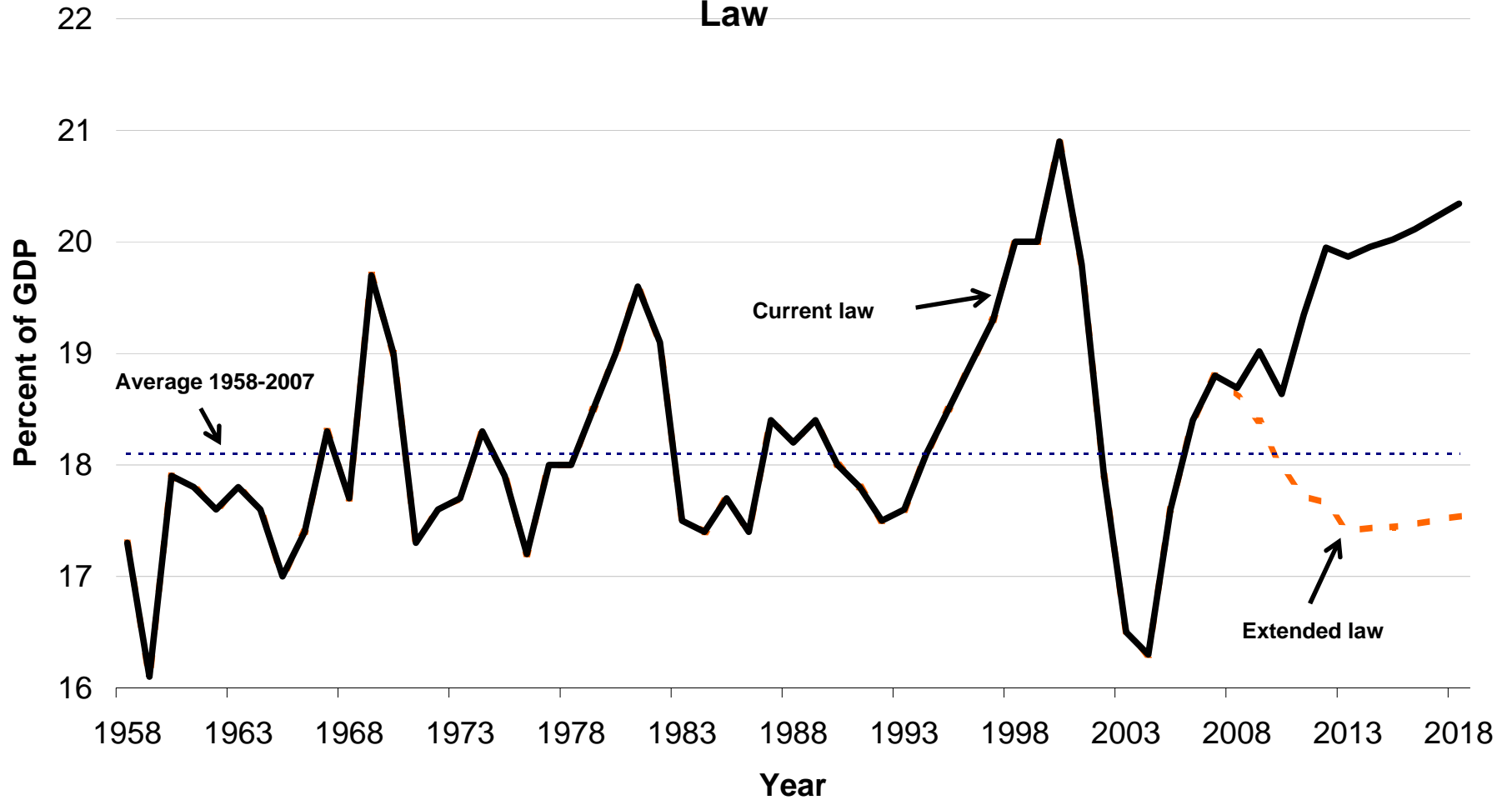
Source: Tax Policy Center, www.taxpolicycenter.org/T08-0043

**Figure 2. AMT Revenue, 2006-17,
With and Without Extension of Bush Tax Cuts**



Source: Tax Policy Center, www.taxpolicycenter.org/T08-0043

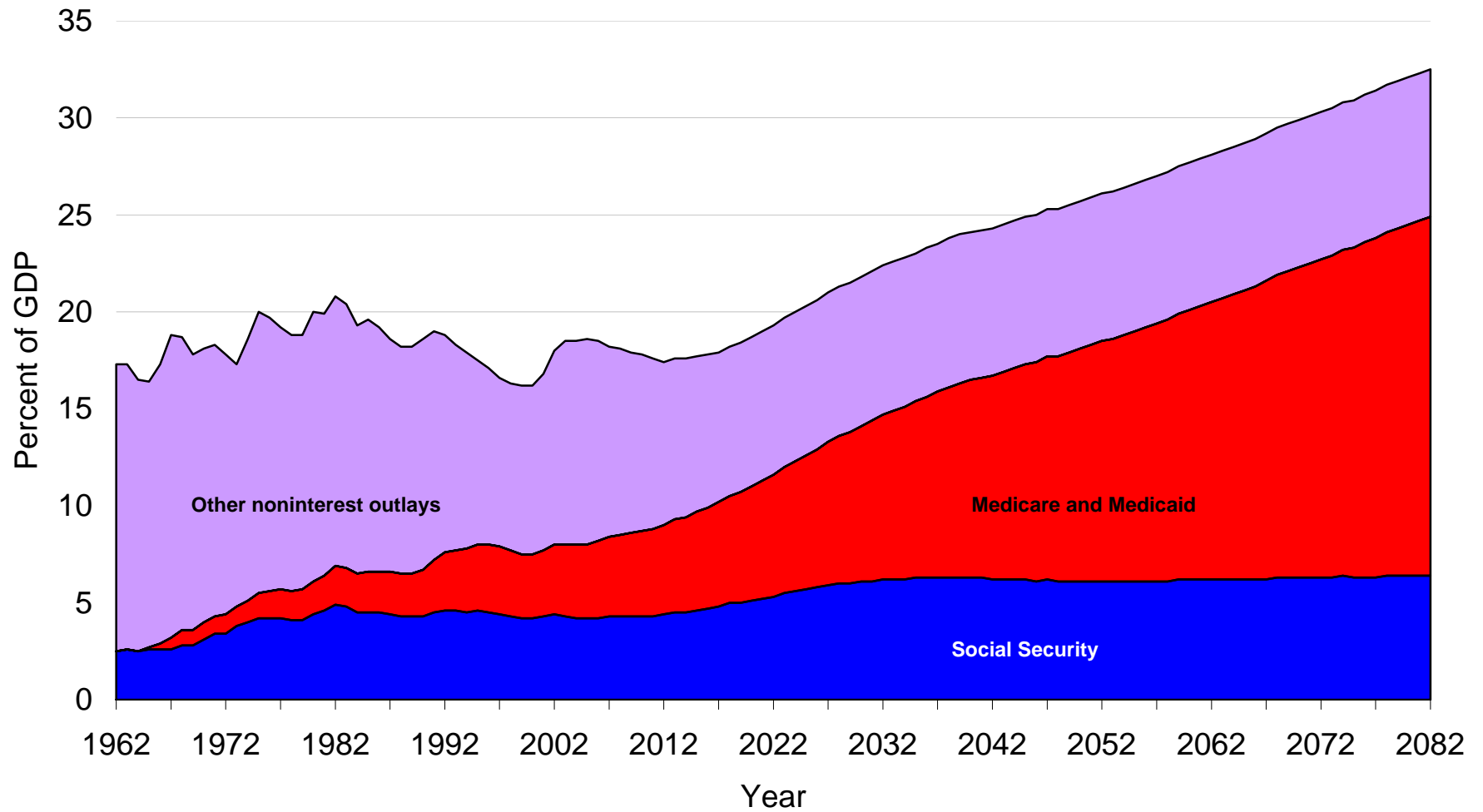
Figure 3. Historical and Projected Receipts: Current vs. Extended Law



Source: CBO Budget Outlook, 2008-2018, and Tax Policy Center

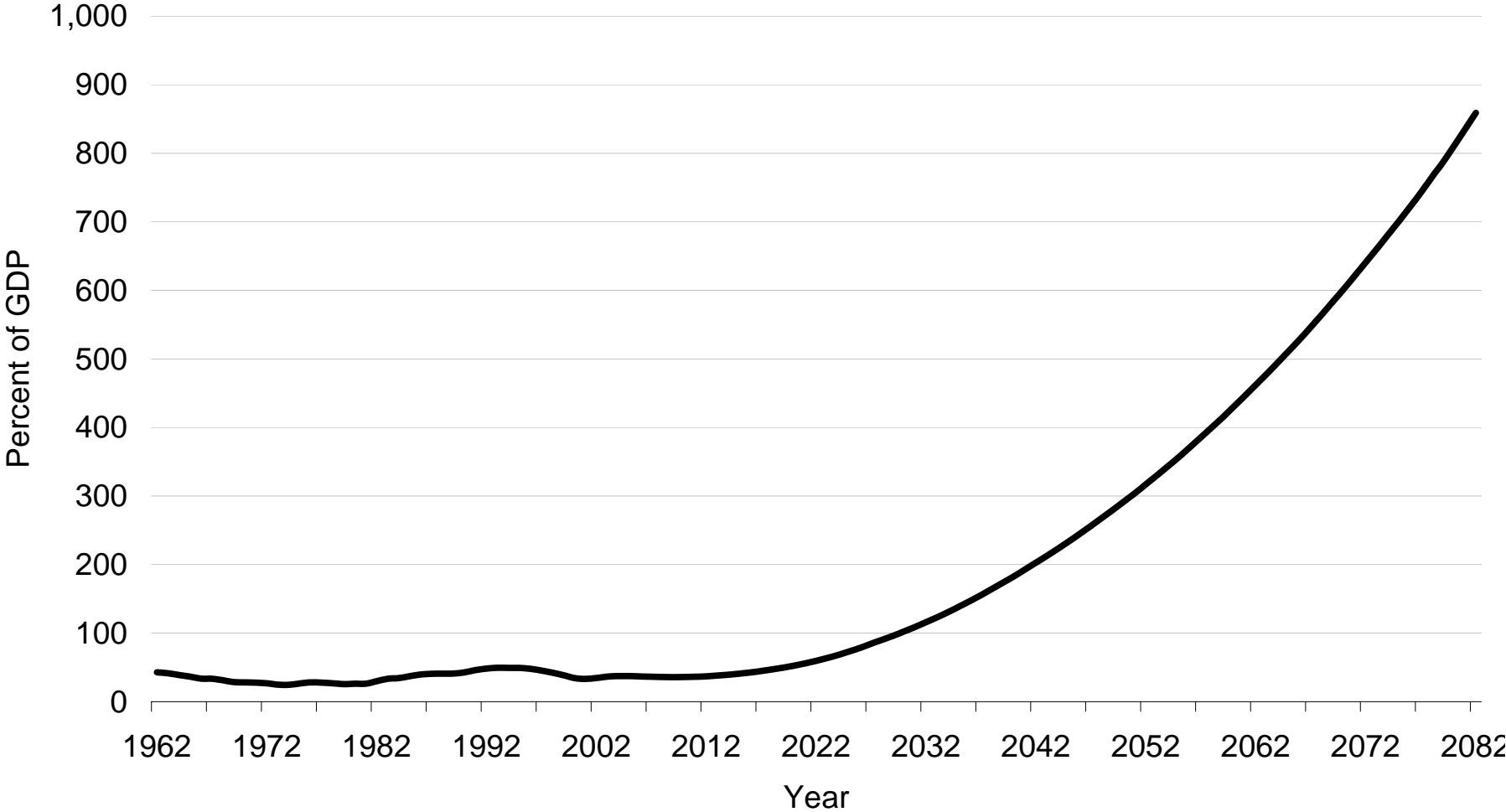
Note: extended law assumes extension of Bush tax cuts, AMT indexing, and other expiring provisions.

Figure 4. CBO Long-Term Spending Projections



Source: Congressional Budget Office (2007).

**Figure 5. Debt Held by the Public, 1962-2082,
Assuming Current Policies and Health Spending Trends Continue**



Source: Congressional Budget Office (2007).

May 20, 2008

Dr. Leonard Burman
Director, Tax Policy Center
Urban Institute
2100 M Street, NW
Washington, DC 20037

Dear Dr. Burman:

Thank you for your testimony before the United States Senate Committee on Finance on Tuesday, May 13, 2008. Included in this letter are written questions for the record from Committee Members. Please review these questions expeditiously and provide answers, in writing, to Ryan Abraham at the Senate Committee on Finance, 219 Dirksen Senate Office Building, Washington, DC, 20510, by June 20, 2008. Please also provide your answers via e-mail to Ryan_Abraham@finance-dem.senate.gov and include each question with the answer.

Thank you for your prompt attention to this matter. If you have any questions regarding this letter, please contact Ryan Abraham at 202-224-4515.

Sincerely,

Max Baucus
Chairman

**United States Senate Committee on Finance Hearing
Tax: Cracking the Code – Tax Reform for Individuals
May 13, 2008**

Questions Submitted for the Record

Questions for Dr. Burman:

Senator Baucus

1. Should simplification be the goal of individual tax reform? If so, what's the best way to simplify the system?

Simplification should be a goal, although not the only one. The others are fairness, efficiency, and revenues adequate to finance government operations. However, simplification often gets short shrift in tax legislation; that is unfortunate and can even undermine other goals. Complexity creates opportunities for tax avoidance and evasion, which are inefficient and reduce revenues. Also, taxpayers tend to view an overly complex tax system as unfair because they suspect that others are getting more than their fair share of tax breaks.

The tax system may be simplified by adopting a broad measure of income and minimizing the number of deductions and tax credits. To the extent that deductions and credits are warranted, it is simplest to make them available to everyone without complicated phase-ins and phase-outs. Phase-outs are often motivated by concerns about fairness or revenue, but those objectives could be achieved more simply by adjusting the tax schedule. If credits must be phased out, it would be best to combine and apply a single phaseout rate—e.g., 5 percent. That would be simpler and also avoid the very high—and inefficient—marginal effective tax rates that multiple phase-outs may create.

Hidden tax surcharges, like the personal exemption phase-out and the phase-out of itemized deductions, are especially hard to justify. It would be much better to simply eliminate them and raise tax rates to compensate. Similarly, the individual alternative minimum tax, as you have noted, is unfair and complex. It would be better to adjust tax rates to achieve the same level of revenues and progressivity and eliminate this alternative levy. The taxation of long-term capital gains and qualifying dividends is also pointlessly complex. A large part of Schedule D (taxation of gains and qualifying dividends) and Form 6251 (AMT) are devoted to taxing gains and dividends at lower rates. It would be far simpler to exclude a portion of capital gains and dividends from tax, as was done before 1987. For example, 50 percent of long-term capital gains and qualifying dividends could be included in AGI, making the effective top rate 17.5 percent. This would be a far, far simpler calculation.

It would be best to avoid multiple tax subsidies for the same activity. For example, college students and their families are now eligible for the Hope credit, lifetime learning

credit, and deduction for higher education expenses, all subject to slightly different eligibility requirements and phase-outs. Choosing the best option is extremely complex. It would be much simpler to combine the credits and eliminate the deduction.

President Bush's tax reform panel made a number of proposals that would simplify the tax system, including some innovative accounting simplifications for small businesses, simpler taxation of social security benefits, and a slightly simpler replacement for the EITC. It would also have eliminated the AMT on a revenue-neutral basis.

Finally, sufficient simplification could make possible a system under which most taxpayers would not have to file tax returns. This is done in the UK and is theoretically feasible here. The proposal I outline in my testimony would, I argue, allow a return-free system for most tax filers.

2. How can the tax system be made fairer?

Reducing the number of targeted tax breaks and deductions, as suggested above, would result in fewer disparities in the taxation of taxpayers who have similar incomes. (That is, it would improve horizontal equity.) As noted, it would also improve perceptions of fairness, which I think are probably as important. In my view, the tax system should also be progressive, collecting the highest share of income from those most able to pay, although others clearly differ on the ideal level of progressivity. The tax cuts enacted since 2001 have made the tax system much less progressive. This is especially unfortunate in light of the increasing inequality in pre-tax incomes. By broadening the tax base (in particular, trimming or eliminating tax breaks that primarily benefit high-income people) and adjusting tax rates, the tax system could reduce disparities in after-tax income.

As I note in my testimony, distributional goals may also be advanced through spending programs. For example, if the government provided a voucher to pay for health care, low- and middle-class working people would be much better off than they are currently, because the uninsured would gain health insurance and those who currently have insurance would have more income available for other purposes. As I argue in my testimony, if a health care entitlement were paired with a value added tax (VAT), the combination could be both fairer and more efficient than the current system.

3. How can the system be made more efficient?

The traditional recipe for efficiency is a broad base and low rates. A broad base is more efficient because the tax system does less to distort choices among economic activities. Lower rates reduce the economic cost of any tax system. Switching from a tax based on income to a tax based on consumption would probably also produce some economic gains by reducing the tax bias against saving (although the gains are often overstated by advocates).

The trade-off is that flatter rates and shifting the tax base to consumption make the tax system less fair. A revenue-neutral, flat-rate consumption tax would produce huge tax cuts for high-income people and large tax increases on those with more modest incomes. My testimony outlines a compromise that would be much more efficient than the current system, by relying more on consumption taxes and lowering rates, while preserving or enhancing progressivity.

4. What are some of the negatives of doing what you suggest to meet the goals of simplification, fairness, and efficiency?

As noted, there are often trade-offs between efficiency and fairness. Simplification could result in less precise measurement of income (which could create new opportunities for tax avoidance) and limit the ability to target tax provisions. Also, tax reform can create significant transition issues. For example, the mortgage interest deduction is poorly targeted—mostly benefiting those with high incomes who least need help—and probably does little or nothing to advance homeownership, but eliminating it would likely reduce housing values and would impose significant burdens on current homeowners. And, as you are acutely aware, the losers from any major tax reform create a huge political hurdle to meaningful change.

5. What type of transition would be required to implement this system?

To the extent that you decide to eliminate or scale back tax breaks, you may wish to “grandfather”—for a limited time—those who are currently eligible and to phase in changes to avoid large effects on asset values. The drawback of grandfathering is the potential for lock-in: asset owners would have a strong disincentive to sell since the grandfathered benefit would not transfer to a buyer. Making grandfather provisions temporary mitigates that problem.

6. How would your proposal affect small businesses? Would there be an increased burden?

As noted, the president’s tax reform panel proposed significantly simplified accounting for small businesses. Although that is not explicitly a part of my proposal, it would be worthy of consideration. My proposal would lower maximum marginal tax rates, which would help many businesses.

Firms of all sizes would have to collect the VAT, a new tax in the US but common throughout the world. A VAT would impose some compliance burden, but would be much simpler to comply with than the income tax. Also, under the credit-invoice VAT used in most OECD countries, small businesses could be exempted with little cost in terms of lost revenue or economic efficiency.

The most significant change, though, would be the voucher for health care, which would be a huge benefit for small businesses. They face much higher premiums for health insurance than large firms, and run an enormous risk of even higher premiums if an

employee gets a serious illness. Furthermore, since small businesses often have lower-wage workforces than large firms, they find it harder to offer health insurance (since the employees cannot afford the lower wages necessary to offset premium costs). This puts smaller firms at a disadvantage in hiring compared with large firms.

7. What would be the IRS's role? What are some administrative issues with adopting your proposal?

In my proposal, I suggest that most filers would not have to file income tax returns. Income tax would be paid through exact withholding. The IRS would have to significantly improve its IT systems to enable matching of withholding to individual income taxpayers in real time. Currently, for example, the IRS does not even receive W-2 information from the Social Security Administration until well after the tax filing season, and while the IRS does receive information returns for some forms of asset income, there is generally no withholding on non-wage income.

Beyond that, the income tax would be simpler to administer than it is currently, with many fewer deductions and credits and many fewer returns filed by taxpayers. An added complication would be the need for the IRS to administer refundable credits for working and children. Although simplifying the complicated eligibility criteria for the EITC and child tax credit would make that task easier, more households would be eligible for the new credits.

The IRS would also have to administer a new VAT. That is not particularly difficult, but it would require additional IRS resources.

8. Is repeal of the AMT a viable option? If so, how can Congress get this done?

Yes. The challenge is making up the lost revenue. The best way to eliminate the AMT would be as part of tax reform, and virtually all serious tax reform proposals would eliminate the AMT. There are also incremental options. I outlined a number of them in my testimony before this committee on June 27, 2007. One option, similar to a proposal made by Ways and Means Committee Chairman, Charles Rangel, would be to replace the AMT with a 4-percent surtax on incomes above \$200,000. This is by no means an ideal solution, but it would be much, much simpler than the current AMT and it would be progressive, shifting more of the burden on very high-income people who were the AMT's original target. And many taxpayers who would pay the surtax would owe less tax than they would under the AMT. My 2007 testimony outlined a number of other revenue-neutral incremental options.

Of course, if the AMT were easy to fix, you would have done it years ago as it has almost no constituency. Like fundamental tax reform, revenue-neutral AMT repeal would create winners and losers, and thus generate political opposition.

And repealing the AMT without making up the lost revenue would create a huge fiscal hole—more than \$1 trillion over the next decade—and would also be highly regressive—another large tax cut for relatively well off families.

9. If repeal is not viable, what can be done to stop this tax from applying to middle income taxpayers?

Bill Gale lists a number of reform options for the AMT in his answers to these questions, which would all be improvements over current law and fiscally responsible.

10. How do we replace the lost revenue?

See answers to previous two questions.

11. Dr. Burman, you recommend creating a VAT to pay for healthcare. How would the health VAT work?

Congress would dedicate revenue from the VAT to cover all health care expenses that are currently financed out of general revenues as well as the cost of a new health care voucher. A value added tax is a kind of consumption tax—like state retail sales taxes—that is collected in stages from all producers and retailers. There are two main variants. A “subtraction method” VAT is basically a cash flow tax. Businesses subtract the cost of goods sold from gross revenues and pay tax at the VAT rate—say 10 percent—on the difference. If the tax is collected at every stage of production, it is equivalent to a 10-percent (or whatever the rate is) tax on the value of the good sold at retail. Under a “credit invoice” VAT, producers owe tax on the entire sales price, but they may claim a credit for gross taxes paid by their suppliers, as verified by a tax invoice. This also adds up to a 10-percent tax on the final value of the goods sold. The credit-invoice VAT is thought to be largely self-enforcing since retailers and other businesses want to receive the invoice showing that the VAT had been paid by their suppliers. Otherwise, they have to pay the tax avoided by suppliers themselves. A subtraction method VAT offers more opportunities for evasion. (The least enforceable type of consumption tax is a retail sales tax. Since there is only one point of collection, the tax can be completely evaded if the retailer does not pay the tax.)

Under either form of VAT, the tax applies to imports and is rebated on exports. Many countries use such border-tax adjustment, which complies with international trade rules.

Dedicating a VAT to cover health care expenses would allow substantial reduction in income tax rates because the income tax would no longer need to finance the federal portion of Medicaid, Medicare, and S-CHIP and the income and payroll tax bases would expand substantially if the employer payroll tax exclusion for health insurance were eliminated. In addition, since the VAT rate would be tied to health care costs, there might be more political support for measures aimed at reducing the rate of growth of

health spending, mitigating a substantial threat to long-term federal finances. And the VAT is a more efficient revenue source than the income tax.

12. One thing you state is that the government would have to control spending. Would this be overall or just for the spending relating to the VAT?

The government needs to control spending overall, but the fastest growing source of spending by far is health care. Indeed, it could be argued that some kinds of federal spending, such as for infrastructure (roads, bridges, dams, mass transit, etc.) should increase. Creating a dedicated revenue source to cover health spending would reduce the squeeze on other essential priorities that is coming if healthcare costs continue to rise faster than the economy and we rely almost entirely on income and payroll taxes.

13. Please explain in more detail, the effect of the VAT on seniors.

Absent transition relief, senior citizens would see a reduction in the real value of their savings if a VAT translates into higher prices for goods and services. As a group, older people would be slightly less burdened by a VAT than younger people because a large share of seniors' income comes from Social Security, which is indexed for inflation. However, wealthy seniors would experience a substantial tax increase. The effect on middle-income seniors could be entirely or partially offset by a temporarily higher standard deduction for the elderly or a refundable tax credit. Any such tax relief, however, should phase out over time because future elderly will have benefited from the new health care voucher (as well as the fact that the VAT is more friendly to saving than an income tax).

14. Please explain how the VAT would work with the rest of the tax system.

This is a good question. As noted above, a VAT works well in the rest of the world, but most other countries don't have state or regional sales taxes. States are concerned that a VAT would complicate compliance with sales taxes, but many state tax experts think those concerns are overblown. A VAT is less complex than many other taxes that currently apply to businesses, especially federal and state corporate income taxes.

Stanford economist, Charles McLure, who served in President Reagan's Treasury Department in the mid-1980s, is organizing a major conference on the practical issues related to administering a VAT in the US scheduled for February 2009. We should know more about this issue after McLure and his colleagues (including me) complete their work.

15. Senator Grassley asked Mr. Entin about bracket creep. What is bracket creep? Does bracket creep exist? If so, was it more of a problem prior to the 2001 and 2003 tax cuts?

I concur with Bill Gale's response.

16. What would be the revenue effects of making the 2001 and 2003 tax cuts permanent? What would be the revenue effects of making permanent the lower tax rate for capital gains and dividends?

I concur with Bill Gale's response.

17. What has been the economic result of lowering the tax rate for capital gains and dividends?

As Bill Gale noted, the economic effect of tax cuts depends on how the lost revenue is made up. The issue is more complex in the case of capital gains and dividends. Lower tax rates on capital gains have mixed effects on the economy. On the one hand, they reduce the incentive of investors to hold onto assets to avoid the tax and they might encourage risk-taking and entrepreneurship. However, as I conclude in my book, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed*, all of these effects are likely to be much smaller than tax cut advocates believe. In addition, the lower tax rates on gains and dividends reduce the double taxation of corporate income, but lower tax rates are a very blunt instrument to accomplish what economists call corporate tax integration. The lower rates apply whether or not the firm pays any corporate income tax. And capital gains tax breaks apply to much more than corporate stock.

Moreover, low tax rates on capital gains are notorious for fueling tax shelters. A wealthy person who can arrange to convert \$10 million from ordinary income (e.g., wages) into capital gains stands to save \$2 million in tax. My guess is that the lower tax rate on dividends could also be used to shelter income, but less is known about that. Tax shelter schemes are always economically inefficient. And, of course, the benefits of low tax rates on gains and dividends fall disproportionately on very high-income taxpayers.

18. Senator Grassley asked Mr. Entin about the gap in scoring between the Department of Treasury and the Joint Committee on Taxation in relation to the scoring for the 2001 and 2003 tax cuts. The estimates differ for the cost of making permanent the lower tax rate for capital gains. What are your thoughts on this issue?

I'm reluctant to second-guess the official revenue estimators. I know the estimators at both JCT and OTA and have been enormously impressed with their professionalism. Empirical estimates of the effects of capital gains taxes on sales of assets include a considerable amount of uncertainty. The estimates vary among different studies and there is a fairly large variance around each point estimate. I'd guess that the difference between the two organizations' estimates is not statistically significant and simply reflects different assumptions that are well within the bounds of our empirical knowledge.

19. During the hearing you stated that you favor a progressive tax system. What are some concerns that you have with a proportional tax system?

A proportional tax system would result in huge tax cuts for high-income taxpayers and large tax increases for others. Some flat-rate proposals include tax credits or “demogrants” to offset the increase in tax liability for those with very low incomes, but that means that the tax increase on middle-income households would have to be even larger. High income people have experienced enormous income gains in the past two decades (while incomes for everyone else have grown very slowly, if at all). I personally think that it is appropriate to expect high-income people to bear a disproportionate share of the tax burden.

I should stress, however, that this is my opinion. Economics does not tell us how progressive the tax system should be (unless one is willing to make strong assumptions about society’s values).

Senator Grassley

1. This question is for the panel. I know that in testimony, concerns have been raised about ‘cherrypicking’ – that is taking some reforms but not others. But as we all know, sometimes to get reforms we have to go one step at a time.

So, I would like your comments on that – are there reforms that can be moved independently or separately from other reforms? For example the New Family and Work Credits. And second, if there are reforms that can stand on their own, what would be your recommended priorities for action by this Committee? What should we be looking at first?

There are incremental reforms that could represent significant improvements in the tax code, although I believe that the tax system desperately needs more fundamental reform. The AMT could be repealed or reformed on a revenue neutral basis, as discussed above. The education credits could be consolidated. Lowering corporate tax rates and broadening the tax base on a revenue neutral basis, as proposed by Congressman Rangel, would improve economic efficiency. Replacing the alternative tax rate schedule on capital gains and dividends with a partial exclusion would be a significant simplification for those with such income. And the tax code could be made more progressive and raise more revenue by adjusting tax rates—although a more efficient option would be to eliminate deductions and preferences that primarily help high-income taxpayers.

If Congress is not going to tackle tax reform soon, something should be done about the estate tax, which is scheduled for repeal, but only for one year—2010. NYU law professor, Lily Batchelder, has argued that replacing the estate tax with an inheritance tax (paid by heirs rather than the estates of decedents) would be a significant improvement and I agree. Some fix should be enacted before the end of 2009 so we don’t read grim stories about deadly estate tax avoidance schemes to take advantage of the one-year estate tax holiday.

My top priorities would be to enhance progressivity, repeal the AMT, cut corporate tax rates, and adjust rates so as to balance the budget over the next five years or so. That is, I'd like to lessen the tax burdens on my children.

2. All of you agree the alternative minimum tax ("AMT") needs to be repealed or reformed. I don't think you'll find many of us behind the dais who will disagree with you. Where the panel differs and where we, on this side, differ with those on the other side, is whether a condition of AMT repeal or reform is replacement of revenue lost.

According to the CBO in its current budget outlook document, there are expiring spending provisions that will cost \$1.3 trillion. The expiring spending provisions, unlike expiring tax provisions, are not included in the CBO baseline and are not subject to pay-go. So, there's a double standard built into the system that favors continued spending and disfavors continuing tax relief.

I'd ask the panel how folks can hold the view that we must continue an unfair tax, like the AMT, by scoring the AMT patch, which is the will of the Congress, and not account for expiring entitlement spending? Doesn't that strike you, like it does me, as fundamentally unfair?

I'm puzzled by your comment about bias in the scoring rules. The rules were agreed to as part of a bipartisan process and included in the Budget Enforcement Act of 1990. Entitlement increases and new entitlement programs are never scored as temporary. That would be an obvious and illegitimate scoring gimmick. Similarly, the full cost of permanent repeal of the AMT should be scored as a revenue loss relative to the baseline.

On the philosophical question of whether, since the AMT would tax people who were never its intended target, AMT revenues should never have been counted on, there is a logical inconsistency. That argument had at least as much salience in 2001, when AMT revenues were counted on to mask the true cost of proposed tax cuts. What's more, if the baseline should exclude the AMT, then projections should have recognized that the nation's fiscal position was worse than advertised, which might have limited the tax cuts.

In 2001, legislators understood that the AMT would "take back" a significant portion of the tax cuts and therefore keep their estimated cost within the tax bill's \$1.35 trillion target. By 2010, the AMT will reclaim almost 28 percent of the individual income tax cuts, including more than 70 percent of the cut that would have gone to taxpayers making between \$200,000 and \$500,000.

Repeal of the AMT would be not only prohibitively expensive but also extremely regressive. TPC estimated in 2007 that nearly 96 percent of the tax benefits of AMT repeal would go to the top fifth of income earners and 80 percent would go to the top tenth. More than half would go to taxpayers with incomes greater than \$200,000. After-tax incomes of taxpayers with incomes between \$200,000 and \$500,000 would rise by 2.7 percent, or an average of nearly \$6,000. In contrast, taxpayers in the middle quintile

of the income distribution would receive less than 1 percent of the benefits and would see their after-tax income rise by an average of only \$5.

Senator Hatch

1. In citing the need for tax reform, two of you, Drs. Burman and Gale, indicated that one major factor is the need for more revenue because of the projected increases in entitlement program spending over the next decades. This question is for each of our witnesses. Should our goal be to make sure revenues match projected spending over the coming years, or should we focus on finding the optimum level of revenue that will keep our economy strong, growing and producing jobs, and then attempt to match our spending to that level of revenue?

These issues are completely intertwined. Taxes entail an economic cost, so if you are looking at taxes alone, you'd conclude that zero taxes are best for economic growth, but government provides benefits that we are willing to pay for. Government spending for national defense, education, the environment, national parks, research, infrastructure, courts, law enforcement, even Congress, may all produce high value and are worth paying for. Many people, including me, think that government also has a role in helping those who are less fortunate, and society seems to have agreed that government should provide income support and healthcare for the elderly and those with low incomes, especially children. The optimal tax and spending levels would be determined where the social benefit from the last (least productive) dollar spent by government equaled the cost (including efficiency costs) of the last dollar of revenue raised.

More fundamentally, we've tried the experiment of setting tax revenues below spending, and it hasn't worked out very well. I believe that requiring adequate taxes be raised to cover current spending serves as a brake on government since people do not like to pay taxes. If tax rates had increased to pay for the war, the new prescription drug entitlement program under Medicare, and other spending increases, Congress would have been under increased pressure to try to rein in spending. Cato Institute president, William Niskanen, has argued that deficit-financed spending gives people the misperception that government is available at a discount, which increases the demand for it.

And, even if low tax rates spur the economy in the short-term, the higher future tax rates needed to control ballooning public debt would more than offset any gains in growth. A constant (budget-balancing) tax rate would be better for growth in the long run than a low rate now and a high tax rate in the future.

2. As you all know, a big reason our tax code is so complex is that Congress has tried to accomplish many social and economic goals through its provisions. One more question for each of you. As we look to reforming the tax code, should we ideally focus exclusively on raising revenue and not try to meet other goals, no matter how worthy they might seem?

Again, the answer depends on the costs and benefits. Some tax subsidies probably produce so little value that they should be eliminated, but some produce high returns for society and are worth financing. Some of those may best be provided through the tax system. For example, the earned income tax credit, despite its flaws, is a relatively efficient way to reward work and augment income for low-income families and participation is high because there is no welfare stigma. Other programs might be advanced more effectively through direct spending programs than through tax expenditures. For example, the panoply of subsidies for higher education probably does little to help low- and moderate-income families pay for college. A better option might be to repeal the tax subsidies and use the revenue saved to expand Pell grants and subsidized student loans.

3. Dr. Burman, you mentioned in your testimony that almost 40 percent of households do not owe any income tax after the application of tax credits. Can you elaborate on the social and economic effects of this, and whether it is a good thing? In other words, should one of our goals be to even further reduce the number of the income tax rolls?

There are trade-offs. On the one hand, the tax system helps a lot of lower-income households who are struggling to make ends meet, and it is probably a more efficient mechanism for income support than other programs (and certainly less costly than most restrictions on trade or regulations of wages or prices). On the other hand, households that owe no income tax may perceive government to be a free good. This could increase the demand for government aid and services that are not worth their cost to society.

I try to address both the problems of disparities in income distribution and the incentive problem in my tax/health reform proposal. In my proposal, all households would be subject to income and consumption taxes on the margin and thus would have a stake in limiting the growth in government. In particular, the VAT rate would be tied to the fastest growing source of government spending—health care—so this would naturally build support for measures to limit the growth of such spending. Moreover, the new healthcare voucher would be worth far more than the additional tax owed by lower- and middle-income households, so the tax and transfer system overall would become more progressive.

Senator Smith

1. Some tax reform proposals, such as the 2005 report from the President's Advisory Panel on Tax Reform, have recommended that various defined contribution plans be streamlined into one plan. But some of these proposals have made no specific mention of, or provision for, employee stock ownership plans (ESOPs). ESOPs are among the most effective retirement savings plans available to American workers. Indeed, in 1996 and 1997, Congress enacted legislation to allow ESOPs to own Subchapter S businesses. This has led to significant retirement savings for many workers – now employee-owners – in these companies, including in my own home state. Would you share with me your views about how – as tax reform

moves forward – we can preserve and promote private ESOP-owned companies, and how we avoid making changes to tax laws that would inadvertently burden these structures?

I share Bill Gale's concern about the risk in ESOPs. Workers whose retirement savings is entirely invested in their own company face enormous risk if the company fails. They lose not only a job, which often entails a significant financial loss, but their largest financial asset. Workers who live in a company town may also experience a large reduction in the value of their home. Ideally, workers should diversify so that their wealth risk is not tied to their job market risk.

2. About three-quarters of small businesses are organized as pass through businesses, so they are paying their business tax at the individual level. What impact do you think raising the individual tax rate would have on small businesses?
 - a. Small businesses have been a large job creator over the past decade. Would higher individual tax rates potentially have a negative impact on this job creation?
 - b. What impact would higher individual rates have on the entrepreneurs who are thinking about starting a small business?

As I have noted, my preference is to broaden the base and keep marginal tax rates as low as possible while preserving progressivity. That said, most small businesses are taxed at relatively low rates because their owners have modest incomes, so the top rates have no effect on them. Also, high marginal income tax rates probably encourage entrepreneurship since entrepreneurs may earn low incomes for many years while they are building their companies. The economic cost of investing human capital (sacrificing earnings) is lower at a high tax rate than at a low one.