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Exploring the Effects of a Flat Federal Income Tax For the District of Columbia

Statement of Stephen J. Entin
President & Executive Director
Institute for Research on the Economics of Taxation

to the
Senate Committee on Appropriations
Subcommittee on the District of Columbia

Hearing on
The Potential Effects of a Flat Federal Income Tax
in the District of Columbia

March 8, 2006

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to testify on the economic advantages of fundamental tax reform. The Subcommittee is to be commended for exploring the gains that reform could bring to workers and savers at all income levels, and in all corners of the nation.

Fundamental tax reform is about creating a tax system that is simpler and more conducive to economic growth than the current income tax. Simplicity alone is not enough. For example – "Line one: Put down your income. Line two: Send it in." – is as simple a system as one can get, but it is not conducive to economic growth. Economic growth means defining income correctly to get the tax base right, and taxing it in a uniform, non-distorting manner.

What is the tax base?

The broad-based income tax. The comprehensive or broad-based income tax in use today taxes most income as it is received, including income used for saving, and taxes the returns on saving as soon as they accrue (except for capital gains, which can be deferred until realized). Such taxes fall more heavily on income used for saving than for consumption.[1] The tax bias against saving is made worse by imposing an add-on corporate tax and transfer (estate and gift) taxes. Long write-off periods for depreciable assets further discourage investment.[2] These taxes impose high economic costs, including reduced productivity, wages, and incomes across the board.

Neutral taxes. Neutral taxes are those that treat all economic activity alike. In particular, they do not discourage those who produce the most with steeply graduated tax rates, and they are not biased against saving and investment in favor of consumption. Neutral tax systems (sometimes called consumption-based taxes) include the saving-deferred tax[3], the national retail sales tax, the value added tax (VAT)[4], the returns-exempt Flat Tax[5], or some combination. To put saving and

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[1] Income is ordinarily taxed when earned. If the income is used for consumption, there is generally no further federal tax (except for a few selective excises). One can buy a loaf of bread and eat it, or buy a television and watch a stream of programming, and there is no further federal tax. If it is used for saving, however, the returns on the saving (the streams of interest, dividends, capital gains, or profits of non-corporate businesses) are taxed. This is the basic income tax bias against saving. If used to buy corporate stock, the returns are also subject to the corporate tax before being paid as a dividend or reinvested to raise the value of the company (leading to a capital gain). This is a third layer of tax on saving. The estate tax is a fourth layer of tax on income that is saved. Even if the inherited saving was done in a tax deferred pension (offsetting the basic bias), it will be subject to the heirs' income tax, so the transfer taxes are always an extra layer of tax on saving. See Appendix for further discussion.

[2] Depreciation forces businesses to delay claiming the costs of their investments in depreciable assets. The long write-off periods reduce the value of the capital consumption allowances by ignoring inflation and the time value of money. The allowances fall short of the real cost of the assets, overstating real profits and raising effective tax rates. Capital formation is discouraged, and productivity and wages are reduced. The correct tax treatment would be "expensing", that is, writing off the cost of investment assets immediately, in the year they are made. Expensing would correctly account for the real cost of investment, reducing the excess tax burden on capital and expanding investment and wages. See Appendix for a discussion of the service price of capital.

[3] A tax on income less net saving, in which all saving is tax deferred in the manner that current law allows for limited amounts of saving in an ordinary IRA, 401(k), or pension. This type of tax is also called an inflow-outflow tax, a consumed income tax, an individual cash flow tax, or an expenditure tax.

[4] Value added tax, including European style credit invoice method VATs, goods and services taxes or GSTs (as in Canada and Australia), or subtraction method VATs (also called business transfer taxes in the United States, such as is proposed in the USA Tax).

[5] A returns exempt tax does not allow a deduction for or deferral of current saving, which must be done on an after-tax basis, but it does not subsequently tax the returns on that after-tax saving. It is the method used for Roth IRAs, and is how individual savers are treated in the Hall-Rabushka or Armey-Shelby Flat Tax.

consumption on an equal footing, a tax system must impose the same tax, in present value, on income used for immediate consumption and on income saved for future consumption. To do so, neutral taxes either defer taxes on income saved (as with a pension or regular IRA) and tax the subsequent withdrawals of principal and earnings, or tax the income up front but eliminate taxes on the returns (as with a Roth IRA). Neutral systems do not have add-on layers of tax at the corporate level, either taxing the returns on corporate assets at the business level or the shareholder level, but not both. There is no estate or gift tax. Capital outlays are expensed immediately, rather than depreciated over time.

Benefits of neutral taxes

A saving-consumption neutral tax with a flat rate would serve every type of economic actor better than the current income tax system, which includes the graduated comprehensive personal income tax, the corporate income tax, and the estate and gift taxes. If the United States were to replace its personal and corporate income taxes with a saving-consumption neutral tax, and eliminate the estate and gift taxes, the country would experience a sharp reduction in the service price of capital, and a major increase in capital investment. Productivity, wages, and employment would increase. If the basic tax rate were kept low, there would be a further labor force response. All told, there would be something over a ten percent increase in national output and national income within about seven to ten years.

For a middle income family of four earning about $50,000, that would mean a roughly $5,000 increase in annual income, before tax (and about $3,500 after tax). Allowing for a percent a year in real income growth over a working lifetime due to technological change, that initial 10 income percent differential would be enough to allow the family to live in a $350,000 house instead of a $200,000 house, or to pay to send a child to a good college, or to retire with greater security. With a "static" revenue-neutral tax restructuring, there would be a significant positive revenue feedback for federal, state, and local tax authorities, reducing budget pressures. Alternatively, the revenue feedback could be used to further lower tax rates on labor and capital income. These are non-negligible real benefits that we are simply throwing away by having a tax system that is unnecessarily harsh on saving and investment.

What is meant by a "flat tax"?

<u>The European "flat taxes" on an income base.</u> Several Eastern European countries have adopted so-called "flat" income taxes. They apply a single tax rate (hence "flat" tax) to personal income, corporate income, and payroll or sales. These taxes are non-neutral, and are "flat" only in the sense that they have one tax rate, imposed several times. Saving is taxed twice compared to consumption, and corporate income is taxed a third time. These systems are partial, but not fundamental, tax reform. They improve simplicity and reduce compliance costs, but do not maximize growth and income.

The Hall-Rabushka-Armey-Shelby Flat Tax on a consumed-income base. The Hall-Rabushka and Armey-Shelby "Flat Taxes" impose a single tax rate on a nearly neutral consumed-income base. They eliminate most tax biases against saving and investment and the corporate form. They are largely saving-consumption neutral because capital investment is expensed and corporate income is taxed only once at the business level and not again at the shareholder level. They tax capital income at the source, with many deductions eliminated for simplicity. However, some deductions needed to measure income accurately are eliminated for simplicity. Some call this part of the tax's "flatness", but this feature can place some income on the wrong person's tax form, as by ignoring transfers, or may misstate income by ignoring certain business and education costs, including payments for state and local government services and education.

Other neutral consumed-income or cash-flow taxes. A consumed-income or consumption-based tax retains only those deductions needed to define income correctly (as revenue less the cost of earning revenue), and allocates the income for tax purposes to those who get to spend it by means of appropriate treatment of transfer payments. These systems include the consumed-income tax (revenue less saving = consumption spending), national retail sales tax (consumption spending), or VAT (consumption spending). All include expensing of investment outlays; exempt tuition and training; deduct (or exclude) state and local taxes (or outlays) for education, transfers to the poor, and services to businesses; and correctly handle transfers such as charitable contributions, gifts, or alimony as income of the recipient.

The various consumed-income or H-R style neutral taxes combine simplification with the biggest potential for income growth. These are fundamental tax reforms worthy of the name. The economic benefits are well-known, and it is long past time that one of them was adopted. In recent years, each time we have moved in the direction of a neutral, pro-growth tax system, the economy has responded with more jobs and rising output. The tax reductions of 2001, as amended in 2003, with lower marginal tax rates, reduced double taxation of corporate income via the 15% rate caps on dividends and capital gains, and repeal of the estate and gift taxes, are steps in the right direction. We could achieve fundamental reform nationwide in stages, making these rate reductions permanent, enlarging the amounts of saving eligible for neutral treatment in IRAs and pensions, and shortening asset lives. Later, we could more completely integrate the individual and corporate taxes.

A Flat Tax for the District of Columbia?

The question here today is what benefits might be had from enacting a voluntary saving-consumption neutral tax, specifically, a variant of the Hall-Rabushka "Flat Tax", for the District of Columbia, as an example for the nation. Individuals could volunteer to give up certain deductions in exchange for lower marginal tax rates and less onerous tax treatment of saving and investment. Such a demonstration would be feasible if some modifications are made to allow the tax to apply only to residents of the District (or to any state or region), rather than to the nation as a whole.

Benefits for the District and the cost to the Treasury. A Flat Tax, or some variant, if enacted for the District, would lower the cost of capital for firms investing here. It would reduce, in some manner, the tax imposed on savers living in or lending to the District. Investment and employment would increase. Some of the increase would be investment attracted from over the borders from Maryland and Virginia. Some would represent a rise in national economic activity.

The District has relatively few large manufacturing businesses, in part due to its limited geographical area. It is likely to remain a place where human capital and labor intensive service jobs dominate (law firms, hospitals, schools, restaurants). Much of the investment might take the form of residential rental units. Some savers would find the District more attractive than their current states of residence for tax purposes, and might move here. Property values would be bid up. Additional residential construction should lower rents regionally, although the impact on specific neighborhoods within and without the District could vary. District income tax and property tax revenues would rise.

In scoring the budget cost of a Flat Tax proposal, the Treasury and the Joint Tax Committee of the Congress will not assume any gains in national economic output, because they are wedded to a static scoring method. The revenue estimators will not show the gains in wages for District residents, which will distort the distribution of the tax reductions across income classes. If they are being truly static, they would calculate the revenue change by looking only at the proposal's effect on current residents, without assuming many more people will move into the District to take advantage of the tax change. If the estimators wish to be antagonistic to the idea, they will omit the economic gains but assume a large influx of people into the District in search of lower tax rates on their capital and salary income.

A voluntary application. The proposal would make the Flat Tax voluntary. That is possible to some degree, but there would have to be some areas of coordination between employers and employees, and between borrowers and lenders.

For example, under the Flat Tax (and VAT), borrowers are not allowed to deduct interest, but lenders do not have to pay tax on interest received. Mortgages would carry the current after-tax interest rate, instead of the higher pre-tax rate we see today, and borrowers and lenders would be in the same net position, after-tax, as they are now. But if a homeowner or business borrower opted out of the Flat Tax, but its lender opted in, the interest income might escape tax entirely. There would have to be a requirement for each loan to be treated alike by the borrower and the lender. For example, financial firms might be allowed to offer homeowners either a taxable or a non-taxable mortgage, with both sides treating the interest on that particular loan alike.

Also under the Flat Tax, businesses are not allowed to deduct fringe benefits, including health insurance premiums. In return, these are not taxable on the workers' tax forms, and they get a lower tax rate on their cash wages. If workers participate, but businesses opt not to participate, some fringe benefits might continue to escape tax entirely. Workers might get reduced tax rates without the "base broadening" that is meant to offset the revenue loss and make the tax system more neutral and efficient. If this aspect of the Flat Tax is retained, it would affect the revenue estimate. Workers and their bosses might have to opt in or opt out jointly to make the system work smoothly.

Regional considerations in designing the proposal

Even with adjustments to the voluntary feature of the proposal, imposing a Flat Tax on a region within the country raises a number of administrative, enforcement, and compliance issues.

All the major neutral tax systems are internally consistent applied nationwide. All specify consistent choices and definitions for income that crosses the national border. Similar care would be needed to preserve consistency if such taxes were to be implemented on a regional or state basis.

The Hall Rabushka and other saving-consumption "neutral" taxes are really quite similar, falling on roughly the same amount of consumed income each year, with the main difference among them being the point of collection. Because of this difference, two of the systems would not be suitable for use in a sub-region of the country, such as the District of Columbia. The retail sales tax could be avoided by driving to Maryland or Virginia to shop. A "destination" type VAT (imposed on imports, rebated on exports) would require customs sheds at the bridges and border-crossing roads. An "origin-type" VAT (imposed on wages and capital income of residents) could be adapted to regional use. So could the Hall-Rabushka "Flat Tax" or the consumed income tax, with appropriate modifications.

Residency requirements. It would be necessary to make rules relating to part time residents. The federal tax system would need to include the same sort of rules as states impose when people move in or out of their jurisdiction during the year. Presumably, the part-time District residents would be under one system for part of the year, and another for the remainder.

The IRS would have to determine the validity of claims to residency status. If state practice is a guide, there would need to be requirements for people to be physically present for a number of days to qualify for the favored tax status. As a Federal tax example, under changes enacted in 2004, the IRS is currently adding a modest days-per-year residency requirement to narrow eligibility for the federal income tax relief granted to residents of the U.S. Virgin Islands under section 936. Some sort of residency requirement would be needed for the District tax.

Treatment of capital income. Saving-consumption neutral taxes either defer tax on income that is put into saving (as in a regular IRA or pension) and tax withdrawals from saving, or they tax income up front and exempt the returns (interest, dividends, or capital gains, as with a Roth IRA or municipal bond). Businesses expense outlays instead of depreciating them. If these features were retained in the District tax, then rules would be needed to define their application to individuals and businesses.

Individuals under a regional tax. Individuals willing to give up some of their existing deductions could be offered a lower tax rate. High income, high saving individuals who have otherwise maxed out on their pension IRA and 401(k) contributions would find the District an attractive place to live, at least for tax purposes, because they would receive some form of pension treatment on more of their saving. The legislation setting up the District tax would have to define that treatment clearly.

For example, under the returns-exempt method of the Hall-Rabushka tax, what would happen if people have lived and saved in the District, and later move out? Would they lose the exemption on the returns on the saving they did while living in the District? Some people would not save as much as the Flat Tax would ordinarily encourage them to do if this string were attached.

If, alternatively, the deferral of saving method applied, then people would get universal IRA treatment of saving contributions for years in which they live in the District, but not for years they live outside. If they move out of the District, would they have to pay tax immediately on such accounts, or only when they withdraw the money? Would the inside build-up continue to be tax-deferred until withdrawal, or become taxable annually? Saving would be higher if the accounts were to retain their saving-deferred treatment until withdrawal. Either approach is administrable, but the legislation would have to set the rule.

Businesses under a regional tax. A small business owner living and working in the District would presumably get to expense his District business outlays, and would pay tax on all returns. For a corporate or non-corporate business that operates in many states and the District, presumably only its investments placed in service in the District would be expensed.

In the Hall-Rabushka Flat Tax, corporate income is taxed at the business level, and is not taxed again at the shareholders' level. The legislation would have to specify whether the District income of corporations paid as a dividend is to be exempt only for District residents or for shareholders nationwide. To realize the full economic effect, it should be nationwide. To determine how much of a capital gain stemming from reinvested after-tax District business income should be tax free, a "deemed dividend" (a notice allowing shareholders to raise the tax basis of their shares by the reinvested District income) could be adopted. Again, the legislation would have to specify if that were to apply only to shareholders who live in the District, or to all shareholders.

Under the Hall-Rabushka tax plan, financial transactions are not taxed. Interest is non-deductible by the borrower, and not taxable to the lender.[6] If the tax system is only applied in the District, there would have to be rules governing the treatment of interest paid and received by

[6] Under Hall-Rabushka, special rules were suggested for taxing financial firms whose income is earned from the spread between interest earned and interest paid. Such rules appear to be difficult to design and implement. Consequently, under the Armey Flat Tax, banks and other financial institutions would be taxed as under current law, but with expensing.

a business with multi-state operations. Presumably, a multi-state business could deduct interest on loans taken to invest in Kansas but not on loans taken to invest in the District. Presumably, interest earned by a District-based lender on loans made to out-of-District borrowers would be taxable. Money is fungible. We have international interest allocation rules now to deal with firms that borrow and invest globally. Similar rules would be needed within the country to handle the different tax system for the District.

In a consumed-income tax, there is no corporate tax. Instead, corporate income is taxed when shareholders receive dividends or sell assets without reinvesting. If this method were chosen, each company would have to break its income into two parts, that which is District income, free of the federal corporate income tax, and that which is non-District income, taxable under the federal corporate tax. Dividends paid would then be taxable to the shareholders (wherever they reside). Non-corporate business income would appear on the owners' tax forms. Interest payments would be deductible, and interest received would be taxable, as under current law, for small business owners.

Conclusion

The benefits of shifting to a saving-consumption neutral tax system would be large and would be distributed across most of the population. It is long past the time for adopting such a system.

The country could move to such a system on a nationwide basis, step by step. Alternatively, it could proceed region by region. The latter is doable, but more difficult. Having one federal tax system for most of the country and another federal tax system for a single state or region would potentially create administrative and enforcement issues for the government and compliance problems for individual and business taxpayers that would have to be carefully addressed in writing the legislation and the regulations.

Ideally, Congress would work toward a reformed tax for the whole country step by step as budget conditions allow. If a region by region approach is adopted, it might be administratively easier to use the saving-deferred method rather than the returns-exempt method of neutral taxation. If the Hall-Rabushka approach is adopted, it would be best to modify it so as not to eliminate deductions for charitable contributions and state and local taxes.

Appendix:
Economic Benefits of Extending the Fifteen Percent Tax Rate on Dividends and Capital Gains and the Other Pro-Growth Elements of the 2001 and 2003 Tax Acts, and of Enacting Further Reforms

Several provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001, as amended by the Jobs and Growth Tax Relief Reconciliation Act of 2003, helped to end the recession by turning around a severe slump in investment. Three key provisions either have expired, or soon will expire, if not extended by the Congress. The 15% top tax rates on dividends and capital gains, enacted in 2003, will expire at the end of 2008. The marginal income tax rate cuts enacted in 2001, and accelerated to full effect in 2003, will expire at the end of 2010. The 50% expensing provision in the 2003 Act was billed as a temporary jump start for investment and the recovery, and was allowed to expire at the end of 2004.

The expected future tax treatment of saving and investment affects saving and investment being done today. Allowing the remaining investment-related provisions to expire would jeopardize the economic recovery. Extending them now, rather than waiting until the last minute, would reduce uncertainty as to whether the more favorable tax treatment will be available for investments whose lives extend beyond the sunset dates of the tax provisions. Immediate extension would boost investment spending, employment, and wages starting now, not three to five years down the road.

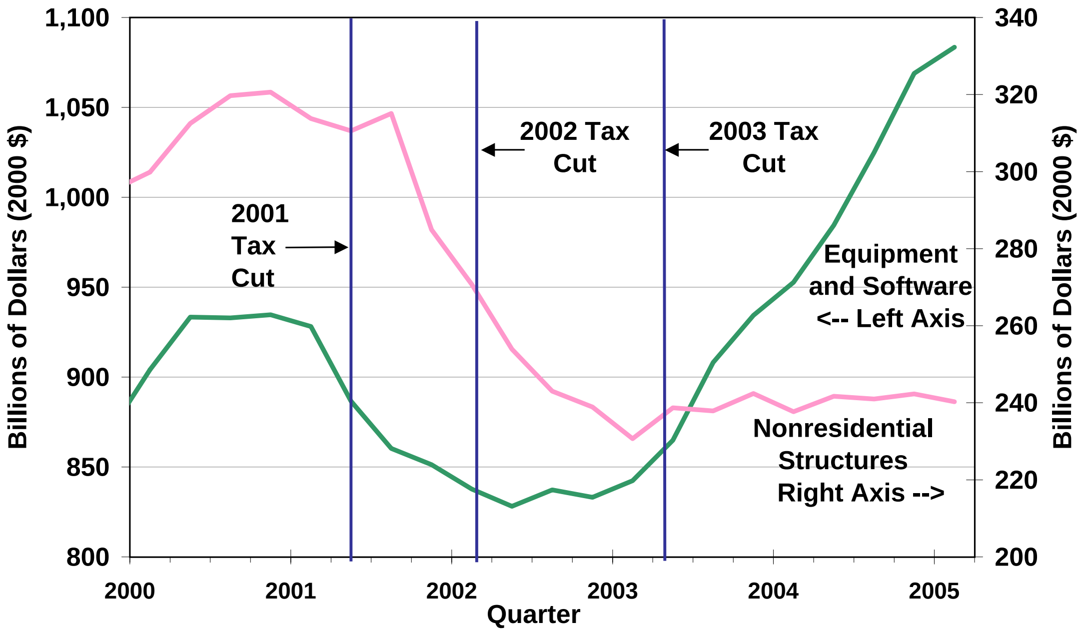
All of these provisions are consistent with proposals for a fundamental reform of the tax system. Full reform would go even further in reducing tax biases against saving and investment, and the economic gains from a fundamental reform would be correspondingly larger.

Recent swings in the economy have mirrored swings in investment.

The main cause of the 2001 recession was a sharp drop in investment. The decline in spending on equipment and software, and in non-residential structures, is shown in Chart 1. The chart also shows the response of investment to subsequent tax changes.

The 2001 Tax Act cut passed the Congress on May 26, 2001, but investment spending continued to slip for the rest of the year. That tax reduction did very little to encourage additional investment spending in the short run, giving out money mainly for social policies that are not related to economic growth. The bill's marginal tax rate reductions on small business owners, corporate shareholders, and other savers, which would have reduced the service price of capital and encouraged investment, were largely deferred until later years, with only half a percentage point effective in 2001. There was nothing else in the bill that directly lowered the cost of business investment.

Chart 1 Real Private Investment
And 2001, 2002, and 2003 Tax Cuts



Data Source: BEA, National Income and Product Accounts, Table 5.3.6, accessed via www.bea.gov.

The early stages of the economic recovery in 2002 were weak because investment remained weak. The Jobs Creation and Worker Assistance Act of 2002 was signed into law on March 9, 2002. It contained a special 30% "bonus expensing" provision for investment in equipment and software (but not for most structures). Also, the second half-point step in the phased income tax rate reduction became effective in 2002. Investment in equipment and software (but not structures) began to recover, modestly, over the next four quarters.

The 2003 Tax Act was signed into law on May 28, 2003. It upped the special expensing provision to 50%, directly cutting the cost of equipment and software (but not most structures) for corporate and non-corporate businesses. More importantly, it also brought forward to 2003 the remaining 2 to 3.6 percentage points marginal income tax rate reductions on small business owners, shareholders, and savers scheduled for 2004 and 2006. Most importantly, for taxpayers in the top four brackets, it cut the top tax rates on dividends and capital gains from 20% to 15% through 2008. For taxpayers in the 10% and 15% brackets, the rates were set at 5% through 2007, and zero in 2008.

Investment in equipment and software shot up almost at once. Investment in non-residential structures, which was helped by the capital gains, dividend, and marginal tax rate cuts, but got no direct depreciation relief, abruptly stopped its decline and rose by a slight amount. Investment and growth remained strong throughout 2004. Employment and wage growth advanced. The expensing provision expired at the end of 2004. Investment growth seems to have slowed a bit since.

The tax cuts lowered the service price of capital. Failure to extend them would raise the service price and reduce GDP.

The size of the capital stock and the level of investment depend on the service price of capital. The service price is the rate of return that an investment must earn to pay the taxes owed, cover its cost (depreciation), and yield a normal after-tax return to its owner. A tax increase on capital income raises the service price, and renders impractical any investment projects that cannot meet the higher service price. A tax reduction on capital income lowers the service price, and makes additional investment projects possible.

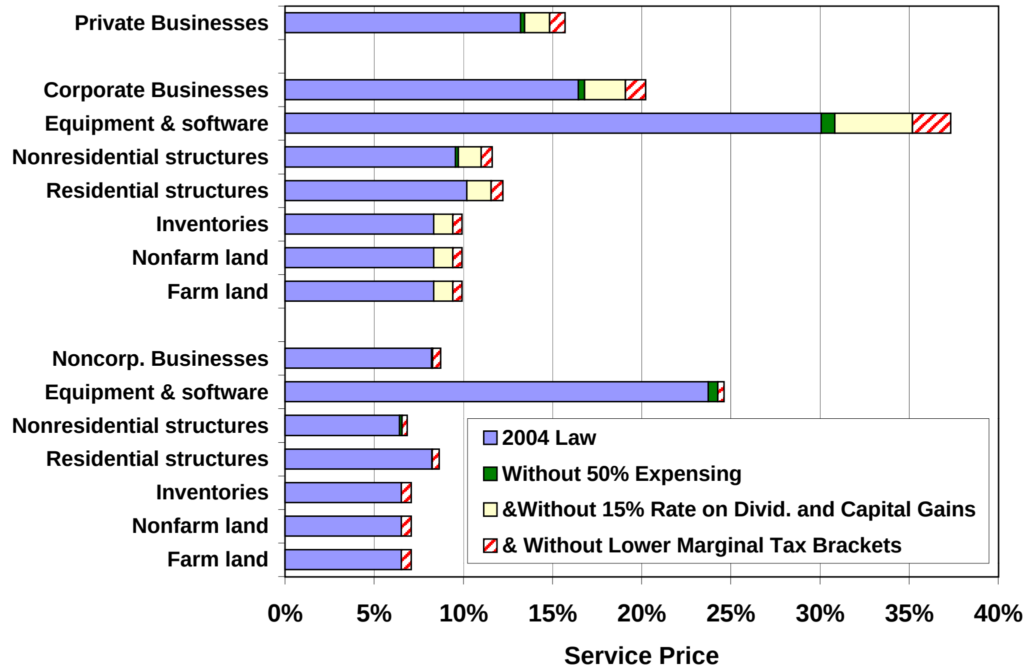
Chart 2 and Table 1 show the service prices of various types of capital (equipment and software, structures, inventory, land) in the corporate and non-corporate sectors under 2004 law, with all three investment-related tax provisions in place. They also show the higher service prices that would result from their expirations, first of the expensing provision, then the 15% tax cap (corporate sector only), and then the marginal rate reductions. The numbers are for the private business sector, which is about 80% of GDP. The corporate sector is about 56%, and the non-corporate private sector about 24% of GDP.

The tax changes of 2003 boosted investment and GDP by lowering the service prices of various types of capital to the 2004 levels shown. For the whole private sector, the reduction was 2.5 percentage points, from 15.7% to 13.2%. The biggest reduction was in the corporate sector (a drop of 3.7 points, from 20.2% to 16.5%), where the largest cut was on equipment and software (7.2 points, from 37.3% to 30.1%). All three of the investment-related tax provisions, including the 15% tax rate on dividends, applied to the corporate sector. The non-corporate sector benefitted mainly from the individual marginal income tax rate reductions and the expensing provision. The service price in the non-corporate sector, which fell from 8.7% to 8.2%, is far lower than in the double-taxed corporate sector.

The biggest reduction in the corporate service price on equipment and software (over 4 points) was due to the 15% rate cap on dividends and capital gains, which reduced the double taxation of corporate income. Next in size was the marginal tax rate reductions on shareholders (about 2 points), then the expensing provision (under 1 point). In the non-corporate sector, on all assets together, the marginal tax rate reductions had the bigger impact, with expensing larger for equipment and software.

Allowing the expensing provision to expire eliminated about 8 percent of the cut in the service price available in 2004. Allowing the 15% rate cap on dividends and capital gains to lapse would eliminate about 56% of the cut in the service price. Allowing the marginal tax rate reductions to expire would end the remaining 36%.

Chart 2 Service Price Of Private Business Capital



Data Source: Gary Robbins, Heritage Center for Data Analysis

Table 1 Service Price of Private Business Capital

	2004 Law	Without 50% Expensing	Without 15% Rate on Dividends and Capital Gains	Without Lower Marginal Tax Brackets
Private Businesses	**0.132**	**0.134**	**0.148**	**0.157**
Corporate Businesses	**0.165**	**0.168**	**0.191**	**0.202**
Equipment & software	0.301	0.308	0.352	0.373
Nonresidential structures	0.096	0.097	0.110	0.116
Residential structures	0.102	0.102	0.115	0.122
Inventories	0.083	0.083	0.094	0.099
Nonfarm land	0.083	0.083	0.094	0.099
Farm land	0.083	0.083	0.094	0.099
Noncorporate Businesses	**0.082**	**0.083**		**0.087**
Equipment & software	0.237	0.243		0.246
Nonresidential structures	0.064	0.066		0.069
Residential structures	0.082	0.082		0.086
Inventories	0.065	0.065		0.071
Nonfarm land	0.065	0.065		0.071
Farm land	0.065	0.065		0.071

Data Source: Gary Robbins, Heritage Center for Data Analysis

Each percentage point reduction in the service price of capital increases the capital stock over time by about 1.5%. The resulting increase in the productivity of labor increases the demand for labor, and raises the total wage bill by a roughly similar percent. Private sector GDP rises by about 1.5%, with about two-thirds going to labor income and about one-third going to capital income, pre-tax. Various layers of government take a bit over 30% of the increase in income as taxes, a revenue gain of about $40 billion to $50 billion a year. Increases in the service price have the opposite effect on incomes and tax revenues. Failure to account for the changes in GDP and incomes, particularly labor incomes, seriously distorts the estimated revenue consequence of changes in taxation of capital.

Every tax bill relating to capital income and cost recovery that Congress considers should be examined for its effect on the service price of capital. The Joint Committee on Taxation, in conjunction with the Congressional Budget Office, should develop or borrow the software to conduct that calculation, and report the result to the Finance and Ways and Means Committees along with the (static) revenue estimate. If the bill increases the service price, it will reduce investment and GDP, which will reduce or eliminate the expected revenue from the provision. If the bill lowers the service price, it will raise GDP, which will provide some revenue reflow. If you are comparing two tax provisions, and one raises the service price more than the other relative to the amount of revenue expected to be raised, then that bill will do more economic damage, per dollar of revenue raised, than the other.

Current tax system is biased against saving and investment.

The 15% top tax rate on capital gains and dividends is a step toward fundamental tax reform. It may be thought of as mitigating the double taxation of corporate income. Alternatively, it may be viewed as offsetting some of the basic income tax bias against saving, in effect extending to more saving about half of the tax relief given under Roth IRAs.

Federal and state tax systems hit income that is saved harder than income used for consumption. At the federal level there are at least four layers of possible tax on income that is saved.

1) Income is taxed when first earned (the initial layer of tax). If one uses the after-tax income to buy food, clothing, or a television, one can generally eat, stay warm, and enjoy the entertainment with no additional federal tax (except for a few federal excise taxes).

2) But if one buys a bond or stock or invests in a small business with that after-tax income there is another layer of personal income tax on the stream of interest, dividends, profits or capital gains received on the saving (which is a tax on the "enjoyment" that one "buys" when one saves). The added layer of tax on these purchased income streams is the ***basic income tax bias against saving***.

3) If the saving is in corporate stock, there is also the corporate tax to be paid before any distribution to the shareholder, or any reinvestment of retained after-tax earnings to increase the

value of the business. (Whether the after-tax corporate income is paid as a dividend, or reinvested to raise the value of the business, which creates a capital gain, corporate income is taxed twice ***— the double taxation of corporate income***.)

4) If a modest amount is left at death (beyond an exempt amount that is barely enough to keep a couple in an assisted living facility for a decade), it is taxed again by ***the estate and gift tax***.

Eliminating the estate and gift tax and the corporate tax would remove two layers of bias. Granting all saving the treatment given to pensions or IRAs, either by deferring tax on saving until the money is withdrawn for consumption (as in a regular IRA), or by taxing income before it is saved and not taxing the returns (as in a Roth IRA), would remove the basic bias. Saving-deferred taxes, the Flat Tax, VATs, and retail sales taxes are examples of saving-consumption neutral taxes.

The tax on capital gains is a double tax even for the non-corporate sector. The current value of a share of stock or a non-corporate business is the present (discounted) value of its future after-tax earnings. If for any reason (reinvested earnings, discovery of a better mousetrap, etc.) future earnings are expected to rise, the current value of the business or price of the stock will rise. If the future income does rise, that added income will be taxed when earned. To also tax the associated increase in the present value of the business is to double tax the future income.

Effects of marginal income tax rates on labor and capital.

Taxes on labor and capital income force up the cost of labor and capital, and reduce the quantity offered and employed. The supply of labor is not very elastic. Consequently, much of any tax imposed on labor is borne by the workers. [Chart 3.] Most people must work to have a satisfactory income, and many must conform their hours of work to the requirements of their employers. Moving across national borders is less of an option for labor than for capital. (Workers have some choices — to take or reject overtime, to contribute a second family earner to the labor force, how long to vacation, and when to retire.)

The quantity of capital is more sensitive to taxes than is the quantity of labor. When a tax is imposed on capital, the quantity of capital employed falls until the rate of return rises to cover the tax, leaving the after-tax return about where it was before the tax. The tax is largely shifted to users of capital and those who work with it. [Chart 4.] Capital is easily reproduced (elastic supply) and it takes a large change in the quantity to make a large change in its rate of return. As for people's willingness to finance capital formation, people can always consume instead of save, or invest abroad instead of in the United States, if the rate of return on saving and investment is driven down by rising taxes.

The differences in the elasticities of supply and demand for labor and capital suggest that there is an economic advantage to moving away from the so-called broad-based income tax, which

Chart 3 Effect of Tax On Labor

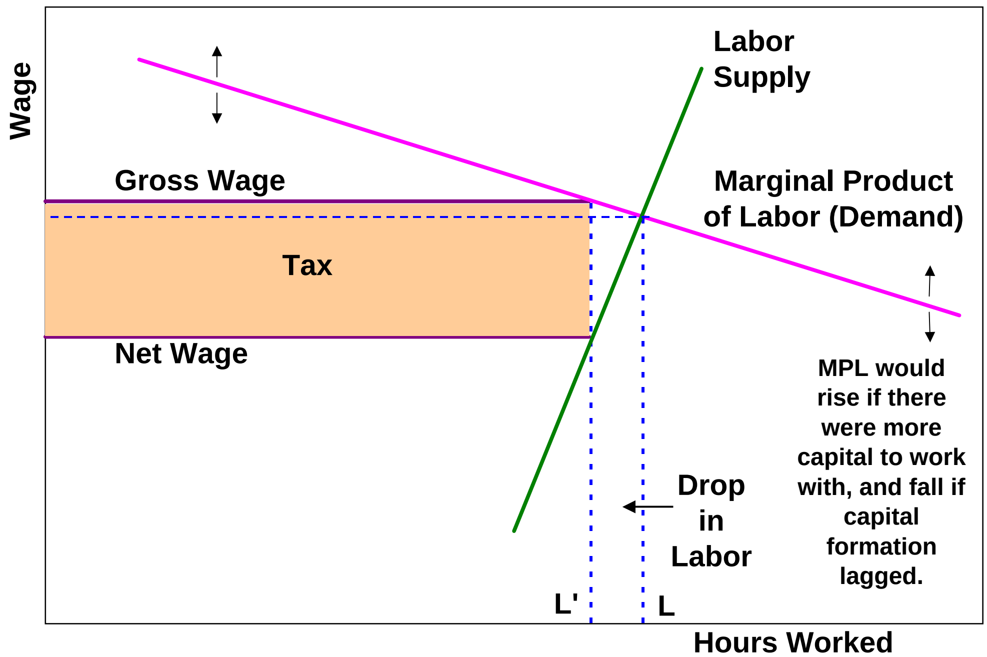
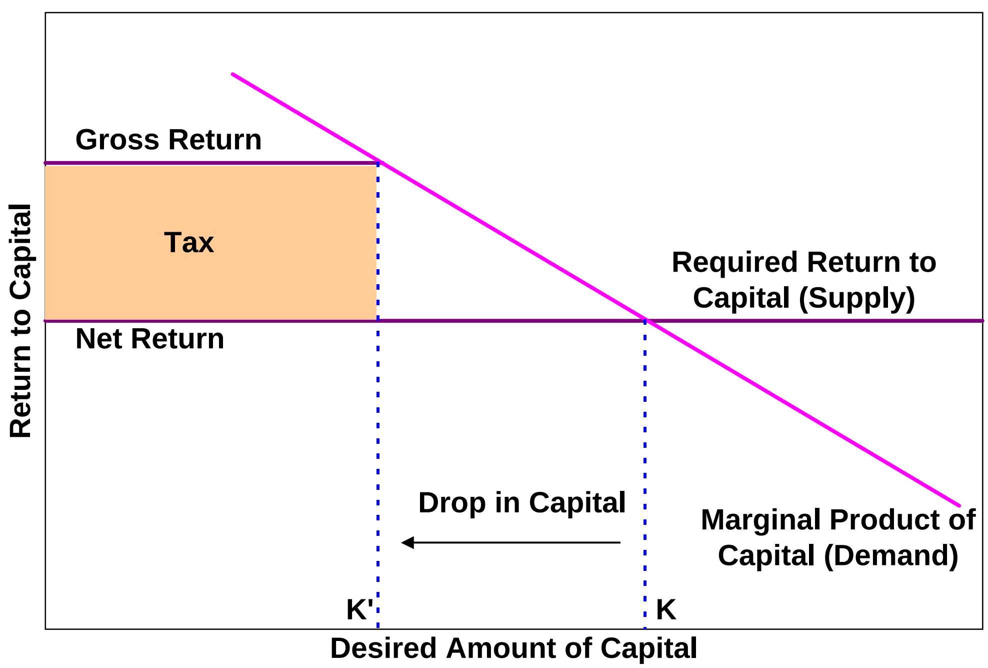


Chart 4 Effect of Tax On Desired Capital Stock



taxes income used for saving and capital formation *more heavily* than income used for consumption, to various taxes that are saving-consumption neutral.[7]

The tax treatment of capital hurts labor.

The more there is of any one type of factor, the higher will be the productivity and incomes of the other factors that work with it and gain from its presence. A tax that reduces the quantity of capital lowers the wages of labor. Labor thus bears much of the burden of the tax on capital. (See Chart 5.) Because capital is more sensitive to taxation than labor, a tax on capital will have a relatively large adverse impact on the quantity of capital, which will then cause a relatively large drop in the marginal product and compensation of labor.

Consider a small trucking company with five vehicles. Suppose that the rules for depreciating trucks for tax purposes change, with the government demanding that the trucks be written off over five years instead of three. The owner has had enough business to run four trucks flat out, and a fifth part time. He is barely breaking even on the fifth truck under old law. It is now time to replace one of the trucks. Under the new tax regime, it does not quite pay to maintain the fifth truck. The owner decides not to replace it, and his income is only slightly affected. But what happens to the wages of the fifth truck driver? If he is laid off, who bears the burden of the tax increase on the capital?

Several studies in the economic literature illustrate that a zero tax rate on capital income would raise the after-tax income of labor, in present value terms, even if labor must pick up the tab for the lost tax revenue.[8] Productivity and wages would be higher (Chart 4 in reverse), leaving workers with higher gross wages and more after-tax income.

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[7] For a further explanation of the biases against saving in the current income tax, see Stephen J. Entin, "Fixing the Saving Problem: How the Tax System Depresses Saving and What To Do About It," *IRET Policy Bulletin*, No. 85, August 6, 2001, p. 15 ff., Institute for Research on the Economics of Taxation, available at www.iret.org. Also see David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, second edition, revised (Arlington, VA: Tax Analysts, 1985).

[8] Martin Feldstein, "Incidence of a Capital Income Tax in a Growing Economy with Variable Savings Rates," *The Review of Economic Studies*, 41(4), 1974, pp. 505-513. Christophe Chamley, "Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives," *Econometrica*, 54, May 1986, pp. 607-22. Kenneth L. Judd, "Redistributive Taxation in a Simple Perfect Foresight Model," *Journal of Public Economics*, 28, October 1985, pp. 59-83. Also, see Kenneth L. Judd, "A Dynamic Theory of Factor Taxation," *American Economic Review*, 77, May 1987, pp. 42-48; H. Greg Mankiw, "The Savers-Spenders Theory of Fiscal Policy," *American Economic Review*, 90(2), 2000, pp. 120-125; and Casey B. Mulligan, "Capital Tax Incidence: First Impressions from the Time Series," NBER Working Paper 9374, National Bureau of Economic Research, Cambridge, MA, December 2002. Andrew Atkeson, V.V. Chari, and Patrick J. Kehoe, "Taxing Capital Income: A Bad Idea," *Federal Reserve Bank of Minneapolis Quarterly Review*, Vol. 23, No. 3, Summer 1999, pp. 3-17.

Chart 5 A Smaller Stock Of Capital Reduces Wages

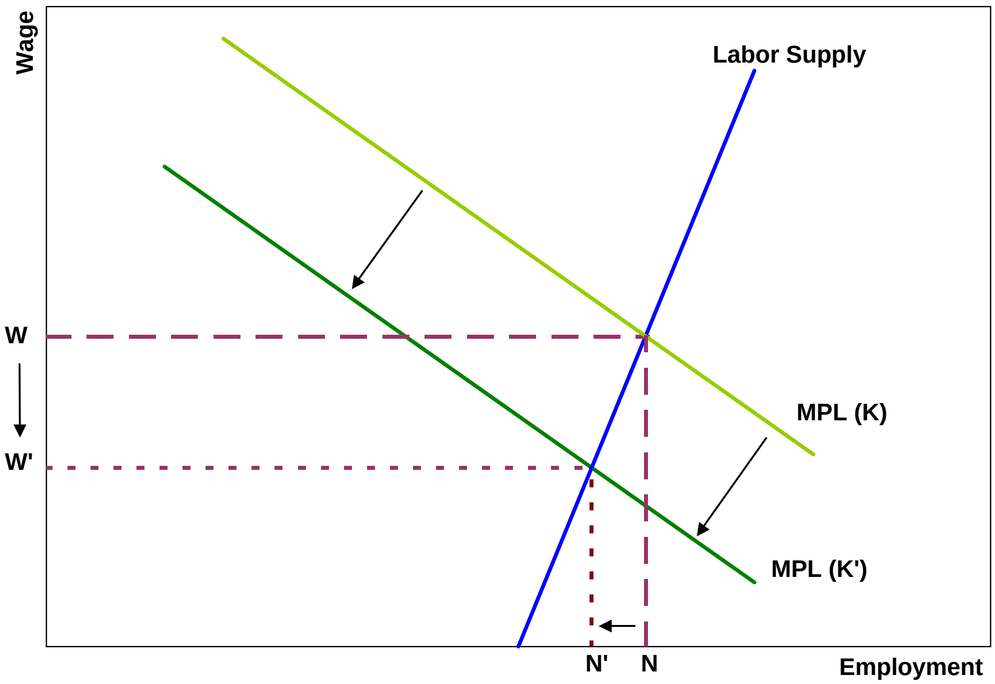
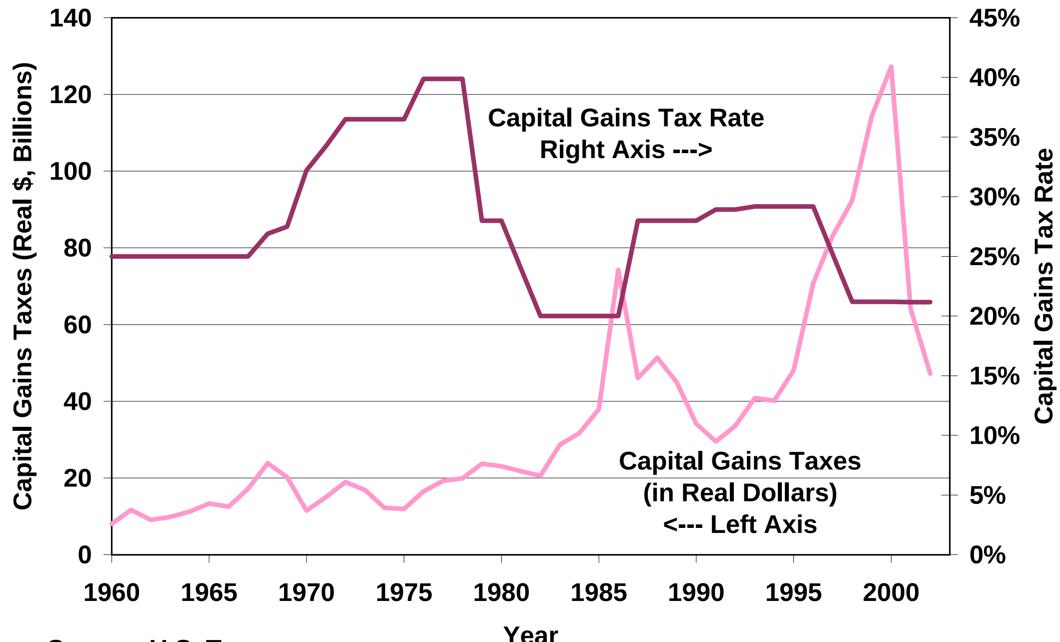


Chart 6 The Capital Gains Tax Rate And The Amount The Tax Collects Often Move In Opposite Directions



Source: U.S. Treasury

Budget impact.

The faster economic recovery since the 2003 Tax Act has improved the budget outlook. For fiscal year 2005, federal revenues ran 14.5%, or $274 billion, ahead of 2004 levels. The deficit for fiscal 2005 ran 22.9%, or $94 billion, below that of fiscal 2004. There have been large gains in taxes not withheld. These revenues are from non-corporate business income, bonuses and options, and capital gains and dividends. A large part of the improvement in FY 2005 receipts is due to higher capital gains realizations and higher dividend payments.

Dividend payments have risen sharply since the 2003 Act.[9] They would rise further if the 15% tax rate were made permanent. More companies are paying dividends. Many are raising dividends. More would do so if the rate reductions on their shareholders were made permanent. Added dividend payouts reduce the revenue loss from lowering the rate on dividends already being paid. Under their revenue estimating rules, the JCT and Treasury try to gauge the increase in dividends due to a tax rate cut. This will be new territory for them, however. Furthermore, they do not go on to calculate the reduction in the service price of capital and the resulting increases in investment, employment, and wages, and so they miss the higher tax revenues resulting from the higher incomes.

Treasury estimates for extending the 15% tax rate cap on dividends beyond 2008 include revenue gains of about half a billion a year from higher dividend payments in 2005-2008. Treasury is acknowledging that some firms have hesitated to raise dividends, or have limited the increases, due to uncertainty about how long the lower rate will last. Extension would boost payouts starting now, adding to short term revenue. Treasury shows losses in the out years from lowering the rates on dividends they assume would have been paid in their baseline. This loss is exaggerated by failure to take account of the economic impact on investment, employment, and wages.

The Treasury, the Congressional Budget Office, and the Joint Committee on Taxation underestimate swings in revenue from tax rate changes on capital gains. A tax rate reduction has three effects: an "unlocking" effect as people choose to realize ("take") more gains at low tax rates; a valuation effect, as the lower tax rate increases the market value of stocks and increases the quantity of gains available to be taken; and an economic effect, as the lower tax rate on capital reduces the service price of capital, and raises the desired capital stock, investment, employment, output, and taxable incomes.

Federal revenue estimators try to account for the unlocking effect under their revenue scoring rules, but they ignore the market effect (stock markets have risen since the 15% capital gains rate

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[9] See Daniel Clifton and Elizabeth Karas, "Two Years Later: Tax Cut Still Paying Dividends for American Shareholders", American Shareholders Association, Washington, DC, June 2005, pages 11-12, analyzing Standard and Poors 500 historical dividend data. Also Stephen Moore and Phil Kerpen, "Show Me the Money! Dividend Payouts after the Bush Tax Cut", CATO Institute Briefing Papers No. 88, Washington DC, October 11, 2004.

was enacted) and, most importantly, they ignore the economic effect of the reduction in the service price of capital. In addition, the unlocking effects have generally been larger than the estimators anticipated. Studies in the mid-1980s at Treasury suggested that the reductions in the capital gains tax rate from nearly 40% to 28% in 1979 and from 28% to 20% in 1981 have raised revenue.[10] By contrast, the capital gains rate hike, from 20% to 28%, enacted in 1986, was followed by a collapse in realizations. Long term gains as a share of GDP did not recover to 1985 levels for twelve years. [Chart 6.]

Extending the 15% top tax rate on dividends and capital gains now would be excellent insurance against renewed weakness in investment. It would lower the projected service price of capital, and would improve the economic outlook. The revenue consequences would be positive in the short run, and less negative than the static revenue projections from Treasury and the JCT in the long run. More importantly, the effect on the economy, wages, and employment would be sharply positive.

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[10] See the following Treasury Department Papers: the panel study in "Report to Congress on the Capital Gains Tax Reduction of 1978", Office of Tax Analysis, September, 1985; Michael R. Darby, Robert Gillingham, and John S. Greenlees, "The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time Series Evidence", Research Paper 8801, Office of the Assistant Secretary for Economic Policy, May 24, 1988; Gillingham, Greenlees, and Kimberly D. Zieschang, "New Estimates of Capital Gains Realization Behavior: Evidence from Pooled Cross-Section Data", OTA Paper 66, May 1989, and Gerald E. Auten, Leonard E. Burman, and William C. Randolph, "Estimation and Interpretation of Capital Gains Realization Behavior: Evidence from Panel Data", OTA Paper 67, May 1989, both from the Assistant Secretary for Tax Policy, Office of Tax Analysis; Gillingham and Greenlees, "Evaluating Recent Evidence on Capital Gains Realization Behavior", August 4, 1989; and "The Effect of Marginal Tax Rates on Capital Gains Revenue, Another Look at the Evidence", Research Paper 9003, Dec. 1, 1990, both from the Office of Economic Policy. Also see Gillingham, Greenlees, and Zieschang, "An Econometric Model of Capital Gains Realization Behavior", presented at the 65th Annual Conference of the Western Economic Association, July 1, 1990.