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ECONOMIC CONSEQUENCES OF THE WYDEN-COATS TAX PLAN

Introduction

In February 2010, Senators Ron Wyden (D-OR) and Judd Gregg (R-NH) introduced the "Bipartisan Tax Fairness and Simplification Act of 2010" (S. 3018). The proposed legislation was reintroduced in April 2011, with small revisions, by Senators Wyden and Daniel Coats (R-IN) as the "Bipartisan Tax Fairness and Simplification Act of 2011" (S. 727). (Senator Gregg did not run for reelection in 2010.)

Wyden-Gregg, now Wyden-Coats, would revamp the individual and corporate income taxes. The authors' goals are to make the income tax system simpler, fairer, and less distortionary, and more transparent than it currently is, while causing less damage to economic growth than would complete repeal of the Bush tax cuts. To collect as much revenue as does the current system, the proposal includes a number of changes that the authors characterize as loophole closers.

Unfortunately, the plan accepts the notion that a broad based income tax is the ideal tax system, and seeks to make the income tax system more all-inclusive. The income tax is highly biased against saving and investment relative to consumption, with many instances of double taxation and overstatement of income. Many provisions of the current tax system are designed to reduce those biases, and create a more neutral, accurate, and unbiased tax base. These include pension and retirement plans, accelerated depreciation and expensing, and lower tax rates on capital gains and dividends. Such provisions are regarded by income tax advocates as "loopholes" or tax expenditures, but they are the norm under a uniform, neutral cash flow or consumed income tax.

Mistakenly assuming that a broader tax income tax base must be a better tax base, Wyden-Coats would worsen the tax treatment of saving and investment in a manner very much at odds with good economic policy. It moves in the opposite direction of what would constitute real tax reform, which would be some form of saving-consumption neutral tax. (These issues are discussed more fully following the economic modeling results.)

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Wyden-Coats would raise taxes substantially on capital income. Capital formation is highly sensitive to tax treatment. The capital stock would shrink as a result of the tax changes. The lower capital stock would reduce wages and employment. After-tax incomes would fall across the board. Wyden-Coats would reduce gross domestic product (GDP) and labor income by about 4.3 percent from current policy levels, reduce the private business sector stock of plant and equipment by more than 12% (about $3.5 trillion), and cost the Treasury a great deal of revenue. The chief culprits are the plan's perverse treatment of capital gains and dividends, depreciation, and the interest expense deduction. These are not "loopholes" to be closed. They are offsets to the anti-saving bias in the income tax system.

Chief Provisions of the Wyden-Coats Bill

The Wyden-Coats proposal has several highly visible and attractive provisions that would reduce taxes. It would replace the current six individual income tax brackets of 10%, 15%, 25%, 28%, 33%, and 35% (15%, 28%, 31%, 36%, and 39.6% if the Bush cuts expire) with three brackets of 15%, 25%, and 35%. It would raise the standard deduction to approximately 2.5 times what it is now, to $15,000 for singles and $30,000 for coupes filing jointly. This change would encourage more people, especially those with lower incomes, to claim the standard deduction instead of itemized deductions. It would also remove many people from the income tax rolls. Wyden-Coats would eliminate the alternative minimum tax (AMT).

For simplification, Wyden-Coats would replace the three existing types of individual retirement accounts (IRAs) with one type similar to the current Roth IRA (contributions not deductible but returns not taxed), subject to a yearly maximum of $5,000 (indexed for inflation). It would consolidate several tax credits and deductions for education expenses into a single credit. It would also create a new nondeductible American Dream Account, with a maximum yearly contribution of $2,000 (indexed for inflation), whose proceeds could be used for any purpose.

The plan would make permanent the Bush increases in the earned income tax credit (EITC), the dependent care credit, and the child credit. It would also make permanent the Bush provisions that eliminated the income-based phase-outs of personal exemptions and itemized deductions.

At the business level, Wyden-Coats would replace the graduated corporate income tax schedule, which taxes most corporate income at a 35% rate, with a flat tax rate of 24% on all corporate income. Another provision in the plan would permit small businesses with gross receipts below $1 million to expense (write off immediately) depreciable assets and inventories.

Wyden-Coats contains numerous revenue raisers, many of them highly technical. Because the list is long, only some are mentioned here.

The most prominent take-back at the individual level is that the 15% top tax rate on qualifying capital gains and dividends would be replaced by a 35% exclusion, with the remainder taxed as ordinary income, leading to an effective tax top rate of 22.75%.

Interest on municipal bonds issued in the future would no longer be tax exempt but would qualify for a 25% nonrefundable tax credit. The itemized deduction for miscellaneous expenses would be abolished. The tax exemption for a certain amount of the foreign earned income of U.S. citizens and residents living abroad would also be eliminated.

Alleging that the current consumer price index (CPI) overstates inflation, the plan would substitute what is known as a chained CPI when adjusting tax parameters for inflation in the future, affecting the indexation of the individual income tax, among other features of the tax system. (If the current CPI index is a little "rich", it merely acts to offset a small fraction of the "real" bracket creep due to productivity and income gains, which is a valuable protection for taxpayers. Government should not grow automatically as the population gets richer without a vote in Congress.)

At the corporate level, Wyden-Coats would deny businesses an increasing share of their interest expense deduction as the inflation rate rises, restricting the deduction to the "real" interest rate. Lenders, though, would continue to be taxed on the full amount of interest they receive, including the inflation-related portion.

For all forms of business, the plan would repeal the section 199 manufacturing deduction, a reduction of taxable income of 9 percent. This deduction effectively reduces the top corporate tax rate to 31.85% for corporate businesses that qualify, with corresponding reductions in marginal tax rates for non-corporate manufacturing businesses.

Wyden-Coats would significantly limit the cost recovery provisions for capital outlays. It would limit expensing of investment to businesses with gross receipts less than $1 million. Businesses with gross receipts exceeding $1 million would be required to use much longer depreciation periods for equipment than under current law, somewhat longer periods for structures, and much slower rates of write-off within those periods for equipment and structures.

Wyden-Coats would reintroduce a per country limitation in computing foreign tax credits, and it would restrict the foreign taxes for which large oil and gas companies could claim foreign tax credits. Wyden-Coats also includes many provisions to shrink the "tax gap", such as heavier penalties for filing incorrect information returns.

Estimating the Economic and Budget Effects of the Plan

This paper provides quantitative estimates of how the main features of Wyden-Coats would affect capital formation, employment, output, and tax collections relative to what would occur under

current tax levels. That is the relevant comparison to determine whether the bill would make economic conditions better or worse than at present. The paper does not measure the effects versus what would occur under full repeal of the Bush tax cuts, which is unlikely to occur.

The study utilizes a macroeconomic model driven by the impact of marginal tax rate changes on incentives to work, save, and invest. The incentives approach is consistent with how labor and capital markets and the production process operate in the real world. It is also consistent with the analytical methods taught in business schools to the people who decide how much and what type of capital to create. To examine interactions between the individual income tax and the overall economy, this study incorporates into the model an individual income tax calculator developed and made available by Gary Robbins of the Heritage Foundation Center for Data Analysis.[1]

The model simulations compare economic activity under the tax system now in force to what economic activity would be like if the main parts of Wyden-Coats were law and the economy had already fully adjusted to them. (The estimates do not show the year-by-year changes in economic activity during the several years that the adjustment to the new tax system would require.) The baseline includes current income tax rates and brackets, personal exemptions and standard deduction, corporate tax rate, and current depreciation rules including the 100% expensing for equipment that will be in force in 2011. The income, GDP, and budget levels in the model are set for 2008, the last year for which full GDP and IRS data were available when this project began.

To better understand how the various parts of Wyden-Coats would influence the economy, this study offers estimates for a series of cases. The first case models the proposed new individual rate brackets and standard deduction. Subsequent cases add successively more of the plan's features. The last case includes all the elements of Wyden-Coats that are modeled in this study and shows their combined effects. The differences between one model simulation and the next indicate the additional economic and revenue effects of the added provisions.

Some of the more narrowly targeted tax increases, such as the increased taxation of foreign source income and the repeal of certain oil and gas tax provisions, are not modeled. Adding them would result in lower levels of GDP, capital formation, employment, and wages than in the results displayed below. Also note that this study does not measure tax paperwork costs. Hence, it does not estimate the gains from the tax simplification provisions in Wyden-Coats, including consolidating IRAs, consolidating education accounts, and abolishing the AMT. Nor does the study factor in the added compliance costs due to the bill's tightening of tax reporting requirements.

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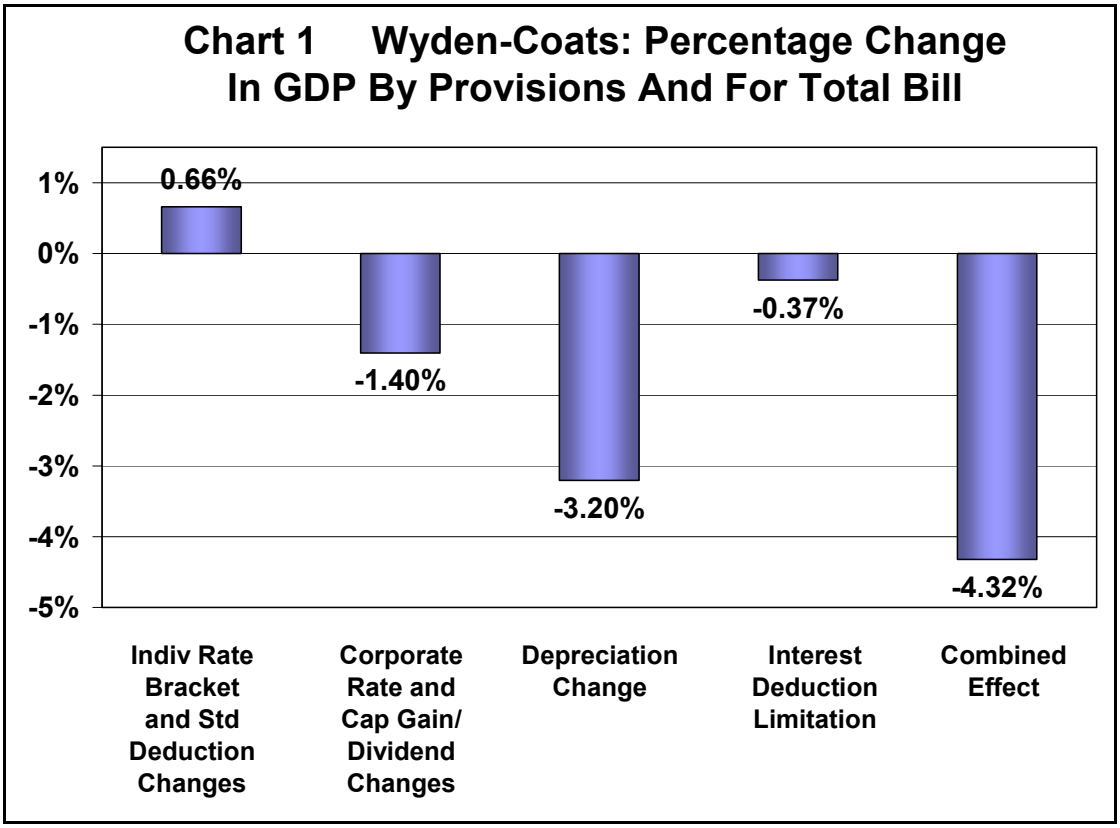
[1] For a fuller description of the model, see Stephen J. Entin, "Economic Consequences Of The Tax Policies Of The Kennedy And Johnson Administrations," *IRET Policy Bulletin*, No. 99, September 6, 2011, Appendix, available at http://iret.org/pub/BLTN-99.PDF.

Chart 1 summarizes the impact it is estimated that Wyden-Coats and various parts of the bill would have on GDP. The four cases that follow discuss these and other model results more fully.



Case 1. New Individual Rates and Rate Brackets, Increased Standard Deduction, and Elimination of the Individual AMT

The high-profile changes in this case, taken alone, would lead to more capital formation, higher employment, and greater output, but would sacrifice some government revenue.

The key estimates are presented in Table 1. Gross domestic product (GDP) would rise by $95 billion annually (0.66%) and private business output would be $73 billion higher annually (0.73%). The explanation is that the tax changes, especially the new rate brackets, would lower marginal tax rates, which would lead to increased supplies of labor and capital inputs and, in turn, expand production.

Table 1
Case 1. New Individual Rates and Rate Brackets, Increased Standard Deduction, and Elimination of the Individual AMT

	Old Law	Wyden-Coats	Difference	% Diff
Gross domestic product ($ billions)	$14,441.4	$14,536.8	$95.4	0.66%
Private business output (less indirect taxes plus	$9,946.7	$10,019.4	$72.7	0.73%
Compensation of employees	$6,415.8	$6,462.7	$46.9	0.73%
Gross capital income	$3,530.9	$3,556.7	$25.8	0.73%
Private Business Stocks	$27,607.6	$27,900.8	$293.2	1.06%
Wage rate $/hr	$33.37	$33.43	$0.1	0.16%
Private business hours of work (billions)	192.244	193.348	$1.1	0.57%
Total government receipts ($billions)	$4,091.4	$4,070.7	-$20.7	-0.51%
Federal	$2,502.7	$2,469.5	-$33.2	-1.33%
State & local	$2,036.5	$2,049.0	$12.5	0.62%
Total Federal expenditures	$3,224.5	$3,226.5	$2.0	0.06%
Federal surplus (+) or deficit (-)	-$721.8	-$757.1	-$35.3	4.89%
Individual income tax				
Federal marginal tax rates on AGI	22.8%	21.6%	-1.2%	-5.2%
Federal marginal tax rates on wages	21.7%	20.5%	-1.2%	-5.5%
Federal marginal tax rates on dividends	12.3%	11.7%	-0.6%	-5.0%
Federal marginal tax rates on interest income	23.4%	22.2%	-1.2%	-5.3%
Federal marginal tax rates on business income	27.4%	27.2%	-0.2%	-0.8%
Federal marginal tax rates on long-term capital gains	13.5%	14.0%	0.5%	3.6%
Weighted average service price				
Corporate	14.2%	14.2%	-0.1%	-0.4%
Noncorporate	12.1%	12.0%	0.0%	-0.2%
All business	13.5%	13.4%	0.0%	-0.3%
Federal budget effects				% of static
Revenues			$ Billions	tax change
"Static" federal revenue gain (+) or loss (-)			-$54.1	100%
"Dynamic" federal tax reflow from economic changes			$20.9	-39%
Net federal tax change after dynamic effects			-$33.2	61%
Federal outlay change if federal pay tracks private wages			$2.0	-4%
Change in federal surplus (- is larger deficit, smaller			-$35.3	65%

Source: Estimates calculated using model

As can be seen in the table, individual marginal tax rates would decline on most types of income. For example, the federal marginal tax rate on wages would drop by 1.2 percentage points (5.5%). The service price of capital (sometimes called the hurdle rate), is the minimum before-tax return needed in order that an investment be attractive, and it would fall by 0.3%, on average. (The service price of capital is the return required to compensate the investor for the time value of money, depreciation, inflation, risk, and taxes.) Capital formation is highly sensitive to the after-tax return on investment. With the more favorable tax climate, private business capital stocks would increase over several years by $293 billion (1.1%). The tax changes would allow workers to keep more of their earnings and the larger capital stock would lift worker productivity. As a result, work hours in the private sector would increase about 0.6% and hourly before-tax wages would rise about 0.2%.

The changes modeled in this case would, however, cost the government money. If it is assumed that the lower marginal tax rates have no effect whatsoever on overall economic activity, it is estimated that federal revenues would fall by $54 billion. This is what is known as a static revenue estimate. However, the model predicts that, in fact, the tax changes would lift investment, employment, and output, and it is estimated that the rise in economic activity would generate $21 billion of new revenue. When this positive revenue reflow is netted against the static loss, in what is known as a dynamic revenue estimate, the model predicts that the lower rates, higher standard deduction, and ending of the AMT would produce a net federal revenue loss of $33 billion.

To put this in perspective, it is useful to ask how much additional GDP the nation gains for every $1 the government loses in revenue. The GDP gain is $1.76 for each dollar of the estimated static federal revenue loss and $2.87 compared to each dollar of the estimated dynamic federal revenue loss. The gains are not larger because the higher standard deduction, which raises the amount of income exempt from tax, produces only a small drop in marginal tax rates compared to its revenue cost.

As modest as the gains are, they suggest that the public would be well-served by lowering taxes and government spending. Looking at the dynamic estimate, the trade-off implies that unless a dollar of government spending brings benefits of at least $2.87, it is not worth doing; the tax reduction would best be paid for by reducing the size of government, rather than raising other taxes. If one adds in the money that taxpayers keep as the a result of the tax cuts, the changes become even more attractive. In the dynamic case, the last dollar of government spending is not worth its costs in terms of lost GDP and lost after-tax income unless it generates benefits of at least $3.87.

Case 2. Case 1, Plus Raise the Top Tax Rate on Capital Gains and Dividends to 22.75%, Cut the Corporate Tax Rate to 24%, and End the Manufacturing Tax Credit

The additional tax changes in the corporate tax rate and the treatment of capital gains and dividends modeled in this case would worsen the picture for GDP, income, and capital formation, and would end up losing revenue for the government.

Case 2 builds on the lower individual rates, higher standard deduction, and AMT repeal of Case 1 by adding the proposed 24% corporate tax rate. This case also begins recognizing some of Wyden-Coat's offsetting revenue raisers. The manufacturer's tax deduction is eliminated. This loss would partially offset manufacturers' gains from the 24% corporate tax, although they would still see a rate reduction compared to current law.

More significantly, the 15% maximum tax rates on dividends and capital gains would be replaced by excluding 35% of qualifying dividends and capital gains from tax but taxing the rest as ordinary income. These changes would produce a top effective tax rate of 22.75% on qualified dividends and capital gains, which is 7.75 percentage points (51.2%) above the current top rate of 15% on qualified dividends and long term capital gains. As shown in Table 2, the income-weighted marginal federal tax rates on capital gains and dividends climb by 35% and 58%, respectively. This higher tax on shareholders further offsets the reduction in the corporate level tax rate on corporate sector income.

On a net basis, the model finds that the expansionary effects of the lower corporate and non-corporate business tax rates are outweighed by the heavier capital gains and dividend taxes and the loss of the manufacturers' deduction. The service price of capital (the required before-tax hurdle rate of return at which an investment is just worth undertaking), increases by 2.1% relative to current law. (For comparison, the service price had fallen 0.3% in Case 1.)

The key estimates are presented in Table 2. The combined reforms modeled in Case 2 would reduce GDP by $107 billion annually (-0.74%) and cut private business output by $72 billion (-0.73%). The desired stock of private-sector capital would fall by $765 billion (2.8%) compared to the baseline. The marginal tax rate on labor income would fall about as much as in Case 1, but the smaller capital stock would reduce labor productivity, and reduced labor productivity would lead to lower before-tax wages in line with the fall in GDP. On net, however, after-tax wages and work hours could rise for taxpayers with $10,000 to $50,000 in AGI, but after-tax incomes would fall for households below and above those levels. Because capital inputs used in production would drop substantially and labor inputs would rise only slightly, GDP would fall.

In a static revenue estimate (based on the false assumption that tax changes never affect aggregate economic activity), the capital gains and dividend rate hikes appear to be potent revenue raisers. Tax collections are still down because of the other tax cuts (now including the 24% corporate rate), but the estimated static federal revenue loss of $29 billion is considerably smaller than the estimated static revenue loss in Case 1. Dynamic analysis, however, reveals a different story. The induced decline in GDP costs an estimated $23 billion of potential tax revenues (compared to a gain in revenue of $21 billion in the previous case). Added to the static loss, there is an estimated dynamic federal revenue loss of $52 billion, larger than the dynamic revenue loss in Case 1.

Table 2
Case 2. Case 1, Plus Raise the Top Tax Rate on Capital Gains and Dividends to 22.75%, Cut the Corporate Tax Rate to 24%, and End the Manufacturing Tax Credit

	Old Law	Wyden-Coats	Difference	% Diff
Gross domestic product ($ billions)	$14,441.4	$14,334.0	-$107.4	-0.74%
Private business output (less indirect taxes plus subsidies)	$9,946.7	$9,874.3	-$72.4	-0.73%
Compensation of employees	$6,415.8	$6,369.1	-$46.7	-0.73%
Gross capital income	$3,530.9	$3,505.2	-$25.7	-0.73%
Private Business Stocks	$27,607.6	$26,843.1	-$764.5	-2.77%
Wage rate $/hr	$33.37	$33.03	-$0.3	-1.02%
Private business hours of work (billions)	192.244	192.818	$0.6	0.30%
Total government receipts ($billions)	$4,091.4	$4,022.5	-$69.0	-1.69%
Federal	$2,502.7	$2,450.6	-$52.1	-2.08%
State & local	$2,036.5	$2,019.6	-$16.9	-0.83%
Total Federal expenditures	$3,224.5	$3,219.0	-$5.5	-0.17%
Federal surplus (+) or deficit (-)	-$721.8	-$768.4	-$46.6	6.45%
Individual income tax				
Federal marginal tax rates on AGI	22.8%	21.6%	-1.2%	-5.1%
Federal marginal tax rates on wages	21.7%	20.4%	-1.3%	-6.1%
Federal marginal tax rates on dividends	12.3%	19.4%	7.1%	57.8%
Federal marginal tax rates on interest income	23.4%	22.8%	-0.6%	-2.5%
Federal marginal tax rates on business income	27.4%	27.2%	-0.2%	-0.8%
Federal marginal tax rates on long-term capital gains	13.5%	18.2%	4.7%	35.1%
Weighted average service price				
Corporate	14.2%	14.6%	0.4%	3.0%
Noncorporate	12.1%	12.0%	0.0%	-0.1%
All business	13.5%	13.8%	0.3%	2.1%
Federal budget effects				% of static
Revenues			$ Billions	tax change
"Static" federal revenue gain (+) or loss (-)			-$29.4	100%
"Dynamic" federal tax reflow from economic changes			-$22.7	77%
Net federal tax change after dynamic effects			-$52.1	177%
Federal outlay change if federal pay tracks private wages			-$5.5	19%
Change in federal surplus (- is larger deficit, smaller surplus)			-$46.6	158%

Source: Estimates calculated using model

Isolating the difference of the added provisions by comparing Cases 1 and 2, we see that the higher taxes on capital income turn a $95 billion (0.66%) GDP increase into a $107 billion (-0.73%) GDP loss, a difference of -$202 billion (-1.40%) in GDP, with $1,058 less capital formation. The higher capital taxes by themselves yield an apparent federal revenue gain of $24.7 billion in static terms (the static loss in case 2 is only $29.4 billion instead of $54.1 billion in case 1). However, in dynamic terms, the capital taxes reduce the revenue reflow from economic changes by $43.6 billion (a drop of $22.7 billion instead of a gain of $20.9 billion); they lose 177% of their anticipated static revenue due to the weaker economy, and end up being net revenue losers.

Case 3. Case 2, Plus Reversion to Longer Asset Lives and the End of Accelerated Depreciation

An obscure but extremely important revenue offset in Wyden-Coats is a provision that would slash the present value of tax depreciation allowances by doing away with the current MACRS depreciation schedules and replacing them with both straight line depreciation and longer asset lives. Although the bill would modify IRS Code Section 179 so that businesses with gross receipts of less than $1 million could expense their depreciable asset purchases, this fundamental change in investment tax treatment would have severe adverse effects because larger businesses do most of the investment in this country. The small business exception would do little to mitigate the damage.

The key estimates are presented in Table 3. The combined reforms modeled in Case 3 would reduce GDP by $570 billion annually (-3.95%) and cut private business output by $403 billion (-4.05%). Labor income would fall by a similar percent. Whether measured pre-tax or after-tax, workers' incomes would suffer at all income levels. The desired stock of private-sector capital would fall by $3,086 billion (11.18%) compared to the baseline.

Depreciation forces businesses to string out deducting the cost of plant, equipment, and buildings over many tax years, even though the costs were incurred at the time of purchase. Delaying the deduction of the costs reduces the present value of the write-offs, as they lose value to the time value of money and inflation. It raises the apparent profit early in the lives of the assets, and is, in effect, an interest free loan to the government. Complete and immediate expensing (100% write-off) is the ideal, accurate measure of business costs. The further from expensing the tax rules stray, the more that profits and taxes are overstated. Accelerated depreciation is not a "loophole" in a tax system that is neutral in its treatment of income used for saving versus income used for consumption. Rather, it is the norm, and anything short of full expensing is an anti-saving, anti-investment distortion.

The Kennedy tax cuts of 1962 switched from Bulletin F tax lives to the newer Guidelines system, which had shorter asset lives and permitted double declining balance (accelerated) write-offs. Subsequent changes included the change to ADR in 1971, ACRS/MACRS in the Reagan years, and 50% and later 100% expensing for equipment in recent years. These changes have raised the allowances for the purchase of capital assets to be more in line with the full cost of the assets. In some periods, an investment tax credit for equipment had impacts similar to the current expensing provision.

Table 3
Case 3. Case 2, Plus Reversion to Longer Asset Lives and the End of Accelerated Depreciation

	Old Law	Wyden-Coats	Difference	% Diff
Gross domestic product ($ billions)	$14,441.4	$13,871.6	-$569.8	-3.95%
Private business output (less indirect taxes plus subsidies)	$9,946.7	$9,544.0	-$402.8	-4.05%
Compensation of employees	$6,415.8	$6,156.0	-$259.8	-4.05%
Gross capital income	$3,530.9	$3,387.9	-$143.0	-4.05%
Private Business Stocks	$27,607.6	$24,521.9	-$3,085.6	-11.18%
Wage rate $/hr	$33.37	$32.12	-$1.2	-3.74%
Private business hours of work (billions)	192.244	191.628	-$0.6	-0.32%
Total government receipts ($billions)	$4,091.4	$3,918.3	-$173.1	-4.23%
Federal	$2,502.7	$2,398.2	-$104.5	-4.17%
State & local	$2,036.5	$1,967.8	-$68.7	-3.37%
Total Federal expenditures	$3,224.5	$3,201.7	-$22.8	-0.71%
Federal surplus (+) or deficit (-)	-$721.8	-$803.4	-$81.6	11.31%
Individual income tax				
Federal marginal tax rates on AGI	22.8%	21.4%	-1.4%	-6.0%
Federal marginal tax rates on wages	21.7%	20.0%	-1.7%	-8.0%
Federal marginal tax rates on dividends	12.3%	19.3%	7.0%	57.2%
Federal marginal tax rates on interest income	23.4%	22.6%	-0.8%	-3.5%
Federal marginal tax rates on business income	27.4%	27.4%	0.0%	-0.2%
Federal marginal tax rates on long-term capital gains	13.5%	18.1%	4.7%	34.5%
Weighted average service price				
Corporate	14.2%	15.6%	1.4%	10.0%
Noncorporate	12.1%	12.5%	0.4%	3.4%
All business	13.5%	14.6%	1.1%	8.0%
Federal budget effects				% of static
Revenues			$ Billions	tax change
"Static" federal revenue gain (+) or loss (-)			$22.2	100%
"Dynamic" federal tax reflow from economic changes			-$126.7	-570%
Net federal tax change after dynamic effects			-$104.5	-470%
Federal outlay change if federal pay tracks private wages			-$22.8	-103%
Change in federal surplus (- is larger deficit, smaller surplus)			-$81.6	-368%

Source: Estimates calculated using model

Over time, these changes encouraged additional capital formation, and are responsible for much of the gains over time in productivity, wages, and living standards.

Wyden-Coats reverts to asset lives similar to the Kennedy Guideline lives, but with less generous straight line depreciation instead of double declining balance. In one fell swoop, it more than erases fifty years of improvement in depreciation allowances. The treatment is worse than under the Guidelines for equipment and non-residential buildings, and worse even than the old Bulletin F rules for residential buildings. That is, the present value of the write-offs falls even further below the full up-front cost of acquiring the assets, further overstating business income and effectively raising the tax rate on the investment. This is horrible tax policy, and bound to discourage investment in the United States compared to other nations.

Table 3 shows the service price of capital (minimum required pre-tax rate for an investment to be attractive) would be 8.0% higher than under current law, on average. This would lead to a sharp reduction in the desired stock of capital. The large loss of capital would hurt labor productivity, with the result that hourly labor compensation would fall 3.7% and work hours would decrease 0.3%. (The supply of labor inputs is much less responsive than the supply of capital inputs to changes in its after-tax reward.) The smaller capital stock and reduced labor force would result in the predicted decline in GDP.

If one assumes counterfactually that none of the tax changes affects GDP or other economic aggregates, the changes in Wyden-Coats modeled up to this point appear to boost government revenues, producing an estimated static federal revenue gain of $22 billion. Unfortunately, the tax-induced decline in output generates a negative federal tax reflow of $127 billion. When the negative reflow is combined with the static gain, the net result is an estimated dynamic revenue loss of $104.5 billion. Another way to express this is that for every $1 of apparent federal revenue gain in the static estimate, actual federal revenue would fall nearly $5 and GDP would plunge by over $25, based on the dynamic estimate.

Compared to Case 2, the depreciation changes by themselves lower GDP by $462 billion, and private business output by $330 billion. The capital stock falls by $2,321 more than in Case 2. Instead of adding $51.6 billion to revenue (static) compared to Case 2, the depreciation changes alone reduce revenue $52.4 billion (a $104 billion swing due to additional GDP loss). The deprecation provision loses 200% of its expected static gain to the economic damage it causes. Like the higher capital gains and dividend taxes examined in Case 2, it is one of those few tax increases that turns into a net revenue loser.

Case 4. Case 3, Plus Restriction on Deductibility of Corporate Interest Costs

This case adds another important, but easily overlooked, revenue offset proposed by Wyden-Coats: corporate borrowers would be denied the portion of their interest costs assumed to be

due to inflation. Lenders, however, would still pay tax on the full amount of interest they receive. For example, if it is assumed that expected inflation raises the market interest rate from 6% to 8%, this provision of the bill would prevent corporations from deducting 25% of their interest costs. Based on the bill's disallowance formula, companies would lose an increasing portion of their interest deductions as the inflation rate rose, which would aggravate the tax system's tendency to force taxpayers to pay real taxes on phantom income during periods of inflation. The disallowance would vary over time based on fluctuations in inflation, but a reasonable assumption used here for modeling purposes is that the disallowance would average 25%.

The rationale for this provision is a perversion of an earlier Treasury analysis. Treasury has described various methods for dealing with inflation in the tax system, including adjustments in tax brackets, tax thresholds, and depreciation allowances to prevent changes in inflation from having a major effect on real tax liabilities and revenue.

Interest is another area affected by inflation, but in a different manner. Current rules allow a full deduction for interest by the borrower, including the inflation component of the interest rate, and tax all the interest received by the lender, including the inflation component. Alternatively, one could adjust the tax rules for inflation to allow the borrower only to deduct the real component of the interest rate, and tax the lender only on the real component received. When inflation is correctly anticipated, credit markets take inflation into account in setting interest rates, so either method is acceptable. There are windfall gains and losses if inflation rates change unexpectedly, but only in the short run until rates adjust and old securities roll over, and the gains and losses tend to cancel out across borrowers and lenders with no major impact on tax collections.

The Wyden-Coats approach ends this symmetry between borrowers and lenders, and ends the neutrality between taxpayers and the Treasury, in favor of the Treasury. It takes half of one method for borrowers, and half of the other method for lenders. It is worse than a gimmick; it is very harmful to the economy, to investors, and the work force.

The estimates here follow the same pattern as in Case 3, but with added damage. As shown in Table 4, the model estimates that the service price of capital would average 8.8% higher than under current law, which would cause a tax-induced decrease in the capital stock of $3,349 billion (-12.1%). Less capital and lower labor productivity would cause the wage rate would fall by 4.1% and hours worked by 0.4%. With much less capital and somewhat less labor supplied as inputs in the production of goods and services, the model estimates that GDP would be $624 billion lower than under current law (a 4.3% drop) and private business output would be $441 lower (a 4.4% drop). Those declines are, respectively, $54 billion and $39 billion more than in Case 3.

The addition of the partial interest expense disallowance boosts the apparent static revenue gain but slightly widens the dynamic revenue loss. The combined effect of the statutory rate cuts in Wyden-Coats, together with the bill's main revenue offsets, is an estimated static federal revenue gain

Table 4
Case 4. Case 3, Plus Restriction on Deductibility of Corporate Interest Costs

	Old Law	Wyden-Coats	Difference	% Diff
Gross domestic product ($ billions)	$14,441.4	$13,817.5	-$623.9	-4.32%
Private business output (less indirect taxes plus subsidies)	$9,946.7	$9,505.4	-$441.4	-4.44%
Compensation of employees	$6,415.8	$6,131.1	-$284.7	-4.44%
Gross capital income	$3,530.9	$3,374.2	-$156.7	-4.44%
Private Business Stocks	$27,607.6	$24,258.4	-$3,349.2	-12.13%
Wage rate $/hr	$33.37	$32.02	-$1.4	-4.06%
Private business hours of work (billions)	192.244	191.491	-$0.8	-0.39%
Total government receipts ($billions)	$4,091.4	$3,909.6	-$181.8	-4.44%
Federal	$2,502.7	$2,397.3	-$105.4	-4.21%
State & local	$2,036.5	$1,960.0	-$76.5	-3.75%
Total Federal expenditures	$3,224.5	$3,199.7	-$24.9	-0.77%
Federal surplus (+) or deficit (-)	-$721.8	-$802.3	-$80.5	11.15%
Individual income tax				
Federal marginal tax rates on AGI	22.8%	21.3%	-1.4%	-6.2%
Federal marginal tax rates on wages	21.7%	19.9%	-1.8%	-8.3%
Federal marginal tax rates on dividends	12.3%	19.3%	7.0%	57.1%
Federal marginal tax rates on interest income	23.4%	22.6%	-0.9%	-3.7%
Federal marginal tax rates on business income	27.4%	27.4%	-0.1%	-0.3%
Federal marginal tax rates on long-term capital gains	13.5%	18.1%	4.6%	34.4%
Weighted average service price				
Corporate	14.2%	15.8%	1.6%	11.0%
Noncorporate	12.1%	12.5%	0.4%	3.4%
All business	13.5%	14.7%	1.2%	8.8%
Federal budget effects				% of static
Revenues			$ Billions	tax change
"Static" federal revenue gain (+) or loss (-)			$33.2	100%
"Dynamic" federal tax reflow from economic changes			-$138.6	-417%
Net federal tax change after dynamic effects			-$105.4	-317%
Federal outlay change if federal pay tracks private wages			-$24.9	-75%
Change in federal surplus (- is larger deficit, smaller surplus)			-$80.5	-242%

Source: Estimates calculated using model

of $33.2 billion ($11 billion more than in the previous case). However, the smaller economy generates a negative federal tax reflow of $138.6 billion (about $12 billion more than in the previous case), with the result that federal tax collections fall by $105.4 billion, based on the dynamic revenue estimate (a billion more than in the previous case). The interest provision alone loses just over 100% of its apparent static revenue gain to the additional reduction it causes in GDP. For the whole Wyden-Coats tax package, every $1 of apparent federal revenue gain in the static estimate would lower dynamically estimated federal revenues by over $3 and GDP by almost $19.

Tax reform, the tax base, and tax expenditures

Fighting the deficit while improving the economy is not a simple task. Tax reform must be done right if it is to help the situation. It is important to understand two things. First, government spending does not increase employment and output; it crowds out private sector output, usually with a decrease in value to the public, and creates dead-weight losses from the taxes imposed to fund the spending. Second, "perfecting" the income tax by "broadening the base and lowering the rate" would hurt, not help, the economy in most instances; we need a more fundamental shift to a different tax base.

The current income tax system is heavily biased against saving and investment, and is seriously depressing output and income. There are several less-biased, more growth-friendly tax alternatives, such as the cash flow tax in the Report of the President's Panel on Tax Reform (the Bush panel), the Flat Tax, various versions of the USA Tax, the Bradford "X" tax, or the straightforward inflow-outflow tax developed by Norman Ture (on our web site at www.iret.org). Real tax reform would move toward one of these systems.[2] Wyden-Coats does not take that road.

The "broad-based" income tax hits income used for saving and investment repeatedly and more harshly than income used for consumption. Pay tax on your income (tax layer one) and consume the remainder, and there are few added federal taxes (other than alcohol, tobacco, and gasoline). But save your after-tax income (outside of limited pension and IRA options), and the profit, interest, dividends, or capital gains are taxed (tax layer two). Dividends and stock-related capital gains also face the corporate tax (tax layer three). For all businesses, corporate and non-corporate, investment expenses must be deducted over many years instead of when they are made (when expensing is not in force), overstating income, and creating a back-door increase in effective tax rates. Save too much, and you become subject to the estate tax (tax layer four).

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[2] A national retail sales tax and a VAT are equally "neutral" between consumption and investment. Both incorporate expensing and avoid multiple taxation of capital income. Their major drawback is that they tend to mask the cost of government from the taxpayer/voter, which is a bad policy in a democracy. It is also difficult to exclude the poorest citizens from these taxes except by exempting large amounts of "necessities", which drives up the rate on other items.

Real tax reform would end these biases and overstatements or double counting of capital income by taking a few key steps. They would fundamentally shift the tax base from "broad-based income" to "consumed income" or "cash flow".

- Step 1: Give all saving the same treatment received by pensions; either defer tax on saving and its returns until the money is withdrawn for consumption, or tax the saving up front and do not tax the earnings.

- Step 2: Adopt expensing instead of depreciation; alternatively, adjust the depreciation allowances for the time value of money (index unused portions by an appropriate discount rate) to preserve their present value.

- Step 3: Tax income in the corporate sector either at the level of the firm or at the level of the shareholder, but not both; that is, integrate the corporate and personal income taxes.

- Step 4: Eliminate the estate tax.

- Step 5: Move to a territorial tax system.

Many of the so-called loopholes in the current tax code are merely partial offsets to these tax biases against saving and investment, and steps in the direction of an ideal, saving-consumption neutral tax system. These include all the existing deferred saving and pension arrangements, accelerated depreciation and expensing, reduced tax rates on capital gains and dividends, and most offsets to the corporate income tax, including deferral of taxation of foreign source income. Unfortunately, Wyden-Coats attacks all but the saving arrangements and estate taxes.

The broad-based income tax was designed by its intellectual godfathers, Professors Robert Haig and Henry Simons, to redistribute income at the expense of thrift and production, not to foster economic growth. (Although even Haig and Simons thought the corporate tax on top of the personal tax was going too far.) Simons acknowledged that his tax proposals would dampen saving and reduce GDP. We do not need more of that. Perfecting the income tax by broadening the base by double or triple taxing the same income is not the answer to our tax problems.

There are, of course, a number of tax provisions that are true loopholes and do not belong in any tax system, including the neutral taxes. The largest example is the exclusion of employer-provided health insurance premiums from taxable income. Neither the premiums nor the insurance benefits are ever taxed. Tax credits in excess of the value of expensing of investment provide a subsidy for uneconomical activities, such as "green" energy programs; these are also loopholes.

The Analytical Perspectives volume of the, Budget of the United States, Fiscal Year 2009, has an expanded chapter on so-called "tax expenditures". The tax expenditure chapter usually lists only

those items that are departures from a comprehensive income tax in which multiple layers of tax on capital income are considered normal. In the last years of the Bush Administration, the chapter was expanded to note that there are far fewer tax expenditures if one measures them against the tax treatment that would be normal in a consumption-based or cash flow tax. In such a tax system, expensing is the norm, and any depreciation regime that falls short is a "negative tax expenditure". The corporate tax itself is a form of double taxation. It or the additional taxes on capital gains and dividends should be considered "negative tax expenditures". Unfortunately, the Obama Administration has dropped this expanded presentation of the tax expenditure issue. Failure to note the tax biases against saving and investment in the income tax, and branding offsets to those biases as "tax expenditures", interferes with the consideration of alternative tax systems that are less harmful to growth, and encourages tax reform plans that would damage the economy, such as Wyden-Coats.

Conclusion

The net effect of the Wyden-Coats bill would be a drop in GDP and labor income of more than 4.3%, and a reduction in the stock of private business capital of more than 12%. The economic benefits of lower tax rates in the bill are swamped by "base broadeners" that either overstate profit or increase the extent to which income from capital is subject to multiple layers of taxation. The key flaw is that the bill seeks to patch the broad-based income tax, which is biased against saving and investment, instead of moving in the direction of a more neutral tax system, such as a consumed income or cash flow tax.

Wyden-Coats has laudable goals. It seeks to simplify the income tax system and to lower existing tax barriers to economic efficiency and growth. Moreover, out of concern for the federal budget, the authors have tried to make their package revenue neutral by broadening the tax base.

This study finds that reducing individual and corporate tax rates as in the Wyden-Coats plan would be beneficial, but that other "base broadening" provisions in the bill relating to business activity would be damaging, and would dwarf the benefits of the bill's tax rate reductions. The most troublesome provisions are the switch to a very harsh system of depreciation, higher tax rates on capital gains and dividends, and elimination of a number of business deductions or deferrals that are designed to offset some of the double tax situations inherent in the income tax.

The major base broadeners in the proposed legislation would impair capital formation and reduce GDP relative to current tax levels. The revenue raisers give the illusion of functioning as intended in the static revenue estimates, with the static revenue numbers steadily improving as more of the base broadeners are included in the analysis. However, the dynamic estimates reveal that the base broadeners actually lose revenue because of negative tax reflows due to the economic damage they cause.

One lesson from the disappointing performance of the base broadeners in Wyden-Coats is that expanding the tax base is not necessarily desirable. Some loophole closers eliminate departures from a theoretically pure income tax. But the "pure" income tax is heavily biased against income used for saving and investment relative to income used for consumption. Many departures from the pure income tax treatment belong in the tax system either to moderate the income tax's growth-depressing bias against saving and investment or to counteract biases elsewhere in the tax system (as with drawn-out depreciation rules).

Moreover, some base broadeners, such as disallowing an increasing portion of business interest costs as inflation rises, would not close real loopholes but, instead, expand the tax base by understating expenses and, consequently, overstating income in a manner that would be poor tax policy even under an income tax. Further, because so many loopholes in the tax treatment of business activity were closed by the Tax Reform Act of 1986 and subsequent legislation, it is difficult to find genuine, sizable "loopholes" involving business activity that are still in the tax code. (Some politically favored activities, such as tax free premiums for employer-provided health insurance or "green" energy tax subsidies are indeed tax loopholes that are not justifiable on pure tax policy grounds under any tax system.)

A real tax reform would abandon the broad-based income tax in favor of a more growth-friendly tax system. Short of that, it would be best to pay for lower income tax rates by reducing government spending.

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