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Testimony before the Senate Budget Committee

February 2, 2011

## The Budgetary Case for Fundamental Tax Reform

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Thank you Mr. Chairman and members of this committee for the opportunity to be here today to discuss the long term budgetary situation and the need for fundamental tax reform in order to put the country on the path to long term fiscal stability. The link between tax reform and our fiscal future comes down to one simple observation. A look at the current income based tax system suggests that we are getting as much blood from the stone as can be reasonably expected. The economic cost of additional revenue under this system is extremely high. To the extent additional revenue is needed in the future, the economic cost of collecting it through higher rates in the context of the current system is prohibitive.

Moreover, there is a widespread body of consensus among economists in both parties that fundamental reform would significantly increase tax revenue. A survey of the economics literature by Kevin Hassett and Alan Auerbach finds that a revenue neutral switch to a more sensible tax regime would add between 5 and 10 percent to U.S. GDP over a decade<sup>1</sup>. Thirty years ago Larry Summers estimated that such a switch would generate an 18 percent gain in output<sup>2</sup> and more recently Dale Jorgenson estimated a 19 percent increase in national wealth from such a switch<sup>3</sup>. Suffice it to say that an economy that is 10 percent larger can produce at least 10 percent more tax revenue without increasing tax rates or burden.

While some commentators have focused on the concept of a “revenue maximizing” tax rate, I believe this is beside the point. Focus on a revenue maximizing rate presumes all you care

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<sup>1</sup> Alan J. Auerbach and Kevin A. Hassett, “Toward Fundamental Tax Reform,” AEI Press, 2005, 6.

<sup>2</sup> Summers, Lawrence H, “Capital Taxation and Accumulation in a Life Cycle Growth Model,” American Economic Review, American Economic Association, 1981 vol. 71(4), pages 533-44, September.

<sup>3</sup> Dale W. Jorgenson, “Efficient Taxation of Income,” Harvard Magazine, March-April 2003.

about is tax revenue, not what is really important, the cost to society of raising that revenue. Two factors combine to make the cost of raising additional revenue through higher rates on the existing base a very expensive proposition for the economy. First, we know, and have known at least since the time of Adam Smith, that higher tax rates shrink the tax base on which they are imposed. This stems from straightforward economic theory since taxes either tend to raise the cost of production and/or the cost of purchasing the good in question. When labor or capital income is taxed the attractiveness of working, saving, investing, or taking risks is directly impacted.

Second, we know from basic economic theory that the excess burden of a tax – the cost to the taxpayer above and beyond the check that he must write to the government to pay the tax – rises with the square of the tax rate. So for example, the excess burden of a 20 percent tax is four times the burden of a 10 percent tax; the burden of a 50 percent tax is 25 times as much as a 10 percent tax. This excess burden is an economic concept that measures how much worse off taxpayers are because their decisions are distorted by taxes. So as tax rates rise not only does the additional revenue rise less than proportionately to the rise in the rate because the tax base shrinks, the burden of the tax rises much faster than in proportion to the rate.

Consider a very real world example. At present, the all-in marginal rate on entrepreneurial income is roughly 40 percent, depending on the precise situation of the taxpayer. The recently passed health bill will raise that by between 0.9 and 3.8 points and an expiration of the 2001 and 2003 cuts will add another 5.8 points to the rate, making the rate roughly 50 percent. Based on my work on tax changes in the 1980s, a 10 point rise in the rate from 40 percent to 50 percent would cut the base of affected taxpayers by about 10 percent<sup>4</sup>. At the most

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<sup>4</sup> Lawrence B. Lindsey, "Individual taxpayer response to tax cuts: 1982-1984: With implications for the revenue maximizing tax rate," *Journal of Public Economics*, 1987, p. 173-206.

simple level, a 40 percent tax on a one dollar base would produce 40 cents in revenue, but if the rate went up to 50, the one dollar base would drop to 90 cents, of which the government would take half, producing 45 cents in revenue.

Note that this is the estimated response at the top income tax rate. But the same responsiveness to the tax rate exists throughout the tax code. Greg Mankiw and Matthew Weinzierl estimated that a change in labor income taxes across the board would change revenue by only 83 percent of what a static model would predict while the same figure would be just 50 percent for across the board changes in capital income<sup>5</sup>. Adjusted for tax rates, these estimates are quite similar to the ones I just discussed.

In addition, we need to consider the excess burden of the tax. This adds an extra cost in economic well being above and beyond the revenue collected and rises roughly 3 and half cents on each dollar in the existing tax base. Put the two together, and the economic burden to the taxpayer rises by about 8 and a half cents – 5 cents in the form of extra revenue the government collects and 3 and a half cents because the tax distorts his decision making in a way that makes him less well off. Stated plainly, the taxpayer suffers a loss in economic well being that is almost twice as much as the extra revenue the governor collects.

The effect gets even worse as rates rise further. At a 60 percent tax rate the base would shrink still further – to just 77 percent of its size at 40 percent, meaning the government would collect just 1.6 cents more in revenue than at a 50 percent rate. Meanwhile the excess burden rises a further 4 cents. This means that for each additional dollar collected by the government, the taxpayer is made about four dollars worse off. There is a clear lesson here: a high tax rate

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<sup>5</sup> N. Gregory Mankiw and Matthew Weinzierl, "Dynamic Scoring: A Back-of-the-Envelope Guide," *Journal of Public Economics*, 2006 (90): 1415-1433

that might still raise revenue for the government is by no means an economically optimal rate from the point of view of society.

Adam Smith broke with the existing mercantilist view of the well being of a nation in 1776 by arguing that it was not the revenue the state was collecting, but the overall well being of society, that determines the true wealth of a nation. Obviously governments must collect revenue. But it is hard to argue that society is really better off when the government is enriched by a dollar at the expense of two to four dollars for the citizens footing the bill. That is true even if those citizens are politically out of favor – such as the “rich” – which many seem to think should pay ever increasing amounts of taxes.

The high economic cost of the current tax system is the result of a number of factors. The first is complexity. Much of the tax code involves what amounts to judgment calls about what should be taxed and what should not. The reason is that we levy taxes on income and not on cash flow. There is an old saying that gained a lot of credence during the recent economic crises and accounting scandals of a decade ago – “Cash is a fact, income is an opinion.”

The accounting profession exists to tell the difference between the two, and has created a set of rules – Generally Accepted Accounting Principles, that by the way, aren’t even fixed in the opinion they render, but evolve over time. Then, the Securities and Exchange Commission has certain modifications to these GAAP rules that must be reported to shareholders and the public. Of course, none of these definitions bear much resemblance to a whole different set of opinions that the IRS has about what is income. Isn’t it at least a little bizarre that the government itself requires a business to keep several sets of books?

Even at the level of a very simple company like the one I now own, this complexity makes absolutely no sense. Let me give one simple example: health insurance contributions.

The health insurance payments I make to my employees are considered to be a business expense and therefore not part of my company's income, but the same premiums my company pays for me and my family under the same health insurance program are considered income to me. Now the income tax renders an opinion that these can be treated as an adjustment to my income for income tax purposes, but not for payroll tax purposes. Does anyone have an explanation why this piece of cash flow is considered income to some but not to others, and is considered income under some income based taxes but not under other income based taxes?

This complexity is the major cause of a second problem with the current income based tax system – what economists would call “horizontal inequality”. Some people are able to design their economic behavior in ways that minimizes tax liability while others do not. As a result, individuals with relatively similar incomes often pay quite different amounts and rates of tax. This is all very annoying to both taxpayers and to the country. The question is how to fix it. Some very high income people, Warren Buffet comes to mind, admit that their tax rates are quite low and feel that rich people like themselves should pay more and support raising tax rates as a result. According to news paper stories, Mr. Buffet pays about 16 percent of his income in taxes, about half what other entrepreneurs pay, even ones far less successful than he. But the way to fix this inequality is not to raise tax rates on those who are already paying twice the rate that Mr. Buffett is. It is to eliminate the “opinions” that define some of Mr. Buffett's income as exempt from tax or subject to lower rates.

The third major problem with our income based system is that it encourages economic activity to go abroad. An item that is manufactured in China but purchased in America has a cost structure that involves no U.S. income or payroll taxes on its labor content and virtually no U.S. corporate tax on the capital involved in the production. Of course China does have an

income tax, but it is quite low compared to ours. The Chinese Individual Income tax produces revenue equal to just 1.2 percent of GDP compared to roughly 7 percent in the United States. The largest component of the Chinese tax system is the Value Added Tax, which generates roughly one third of all Chinese tax revenue. But Value Added taxes are rebated on exports, so this tax does not apply. Conversely, an item built in America and then sold to China involves labor costs that pay both income and payroll taxes and capital costs that involve the whole panoply of U.S. taxation. When they arrive in China the import cost is subject to Chinese Value Added Tax. And this is not just the Chinese. Throughout Europe Value Added Taxation has increasingly replaced direct taxation on personal and corporate incomes over the last couple decades and under World Trade Organization rules it is perfectly legal for them to rebate the tax on exports and impose it on imports.

We complain a lot about the advantages the Chinese give themselves through manipulation of their exchange rate. At the same time we induce this massive self inflicted wound on ourselves in the form of our income based tax system. And whenever someone advocates raising rates within our current tax regime they are implicitly calling for these distortions to be larger and therefore for Chinese goods to become even more competitive here and our goods to become even less competitive overseas.

I do not believe that these fundamental problems with our tax structure can be adequately addressed by changes to our current income based tax system. Rate reductions within the current tax system have proved economically successful because the excess burden associated with current rates are so high that the economy naturally prospers when rates are cut and the benefits to the economy of those cuts have consistently exceeded the foregone revenue. But further revenue reduction is not possible given our current debt position.

America must move away from an income based system – where what is taxed is an opinion – to a cash based system based on the gross receipts of a business less those items the business has purchased on which it has already paid tax to another business. Such a tax system should not be an add-on to our current system. Adding yet another layer of complexity on top of what we already have would be among the worst ideas we could come up with. Instead, we need to replace all of our existing income-based tax concepts with a cash-based tax on net receipts. Congress should also define receipts in terms of a border-adjusted way so that goods we export should not be treated as receipts. Obviously goods imported from abroad, even those that find their way into other products, would not have already paid an American business receipts tax and so would not be available for such a deduction by the imported firm. Governments and non-profit entities could be given separate treatment so that only the labor component of their expense structure would be covered by tax. This would be necessary to level the playing field between economic activity in the for-profit business sector and similar activity outside it.

Problems of horizontal inequality would be minimized by having all receipts taxed once at a single source, regardless from where they were derived. Issues of vertical equality – making sure that the rate was higher for higher income individuals – could be accomplished with a two tier business receipts tax where the higher tier rate exempted employee compensation below a certain amount.

We certainly need to address our budgetary challenges. But, I do not believe that we can move forward tackling these issues with a tax system that imposes such high economic costs when rates are raised to produce additional revenue. Our tax system is limiting American prosperity through its needless complexity, horizontal inequities, and implicit subsidies of economic activity outside of our borders to produce goods and services consumed at home.

Fundamental reform is desperately needed. A switch to a cash-flow based tax such as a Business Receipts Tax or even a Value Added Tax would greatly facilitate our ability to address these issues.

Thank you and I would be happy to address your questions.