Statement of

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Tax Reform to Encourage Growth, Reduce the Deficit, and Promote Fairness

Mr. Chairman, Members of the Committee, thank you for the opportunity to testify. My name is Dan Mitchell. I am a Senior Fellow at the Cato Institute. The views I'll be expressing today are my own.

The internal revenue code is needlessly punitive and complex. Some of its major flaws are:

1. High tax rates – Marginal tax rates on additional increments of productive activity are too high, discouraging people from productive behavior.

2. Biased treatment of income that is saved and invested – Because of the capital gains tax, the corporate income tax, the double tax on dividends, and the death tax, there is pervasive double taxation on capital, causing very high effective marginal tax rates.

3. Distorting loopholes – Many provisions of the internal revenue code are explicitly designed to encourage economically irrational choices.

4. Worldwide application – The United States have the world's most onerous tax system for international activity.

5. Corruption – While in most cases technically legal, the common practice of swapping favorable tax policies for political support is corrosive.

6. Complexity – Nearly 100 years of tax changes have produced 72,000 pages of law and accompanying regulation.

Tax reform has the potential to reduce, or perhaps even eliminate, these problems. But it also could make them worse. To ensure the best possible outcome, lawmakers should be guided by these principles.

A. Tax rates should be as low as possible – Taxes are a price, and it doesn't make sense to impose a high price of work and entrepreneurship.

B. The tax system should not discriminate against capital formation – Since every economic theory, even Marxism and socialism, holds that saving and investment is a key to long-run growth and higher living standards, it doesn't make sense to impose extra-high tax rates on capital.

C. Government should not tilt the playing field with preferences or penalties – Luring people into making economically inefficient choices makes the economy less productive.

D. Territorial taxation – This is the good-fences-makes-good-neighbors approach to tax policy. Disputes with other nations become trivial if each nation is in charge of taxing economic activity inside its borders.

The ideal system, based on the above principles, is a low-rate, consumption-base, loophole-free tax.

The best-known tax meeting these criteria is the flat tax, as developed by Professors Hall and Rabushka at Stanford University's Hoover Institution.

But the value-added tax is also satisfies these principles – assuming it is replacement rather than add-on tax. And a national sales tax also shares these theoretical qualities.

All of these tax regimes have different collection points, but the tax base is identical. All economic activity is taxed, but only one time and at a low rate.

If lawmakers want to improve growth, particularly in a competitive global economy, where labor and capital can cross borders in search of pro-growth fiscal policy, they should seek to reform the tax system so it fulfills these principles.

Economists will not agree on how much additional growth such a system will generate, but they generally will agree that a low-rate, consumption-base, loophole-free tax is the way to minimize the damage caused by taxation.

Tax reform and the deficit

No discussion of taxation is complete without also looking at the spending side of the fiscal ledger.

Simply stated, it is very difficult to maintain a tax system that is conducive to growth if the burden of government spending is on an upward trajectory.

Sweden is a good example. On a per-Krona-raised basis, Sweden has a very good tax system. But since that tax system is designed to collect about 50 percent of the economy's output every year, the overall impact of the tax system is punitive and helps to explain why Sweden, which used to be one of the five richest nations in the world back when the welfare state first began, has suffered several decades of mediocre growth.

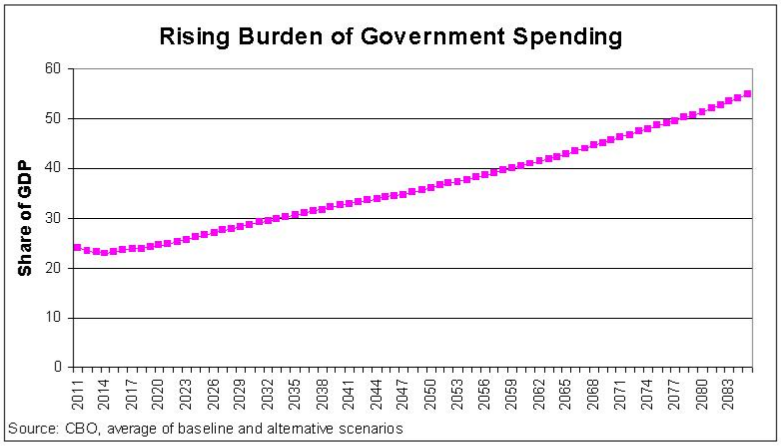
In places such as Hong Kong and Singapore, by contrast, it is difficult to have a bad system because the burden of government is much smaller – about 20 percent of economic output. This is one of the reasons why Hong Kong has a flat tax and Singapore's so-called progressive system has a top tax rate of just 20 percent. And neither jurisdiction imposes double taxation on capital gains or dividends, and neither has a death tax or wealth tax.

Unfortunately, the burden of government spending jumped significantly in the United States during the Bush-Obama years, and the long-run projections – to be blunt – indicate that the United States will become another Greece.

But the important thing to understand is that more than 100 percent of the problem is on the spending side of the fiscal ledger.

How can something be more than 100 percent of the problem? It's in the numbers.

The burden of spending is supposed to climb dramatically because of a combination of entitlement programs and demographics. This chart shows CBO's long-run estimate of federal spending as a share of GDP, based on taking an average of the baseline and alternative fiscal scenarios.

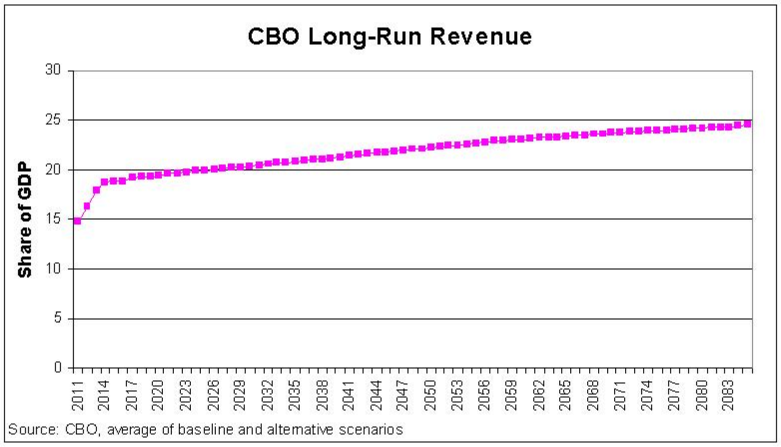


For the post-WWII era, federal spending averaged about 20 percent of GDP. And when Bill Clinton left office, the burden of spending was down to 18.2 percent of economic output.

Rapid spending increases during the Bush-Obama years have dramatically expanded the size of the federal government, up to about 24 percent of GDP. And the federal budget will consume more than 50 percent in the future if policy is left on autopilot.

Now let's look at the same numbers, but for revenue. During the post-WWII era, federal revenues averaged about 18 percent of GDP. They are temporarily below that amount because of the very tepid and weak economic expansion. But even with that weak recovery, revenues are supposed to be above average by the end of the decade.

What's most remarkable, however, is that CBO projects that federal revenues will climb significantly in coming decades, largely because of real bracket creep.



Source: CBO, average of baseline and alternative scenarios

And since revenues are climbing well above the long-run average, it is quite fair to say that more than 100 percent of the long-run fiscal problem is that spending is climbing even faster.

This is why tax reform should not be a revenue-raising exercise – especially since economic growth is very important for sound fiscal policy. These numbers, taken from the CBO sensitivity tables, show how even tiny changes in economic growth can have a substantial impact on revenue.

How Selected Economic Changes Might Affect CBO's Baseline Budget Projections

(Billions of dollars)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total 2013-2017	Total 2013-2022
	Growth Rate of Real GDP Is 0.1 Percentage Point Lower per Year												
Change in Revenues	-1	-4	-8	-13	-18	-23	-29	-35	-42	-49	-57	-66	-278
Change in Outlays													
Mandatory spending	*	*	*	*	*	*	*	*	*	-1	-1	*	-2
Debt service	*	*	*	*	1	2	3	5	7	9	12	3	39
Total	*	*	*	*	1	2	3	4	6	9	11	3	36
Change in the Deficit[a]	-1	-4	-8	-13	-19	-25	-32	-39	-48	-58	-68	-69	-314

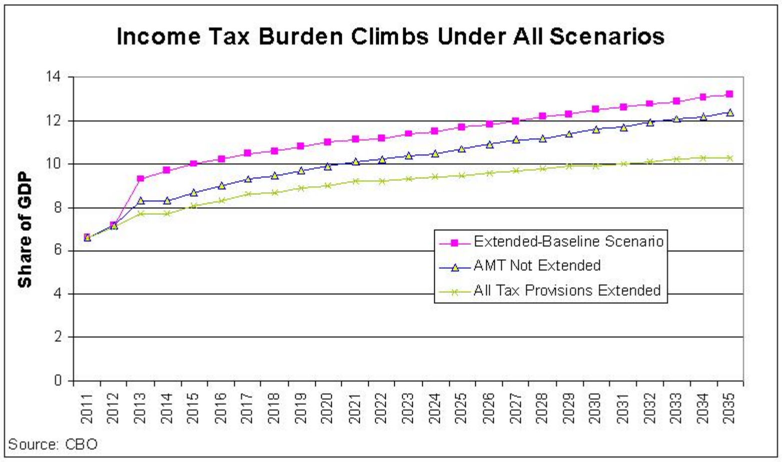
Tax reform and fairness

Like beauty, fairness is in the eye of the beholder.

Proponents of tax reform generally define fairness as a system that treats everyone equally, which is why the flat tax is appealing.

But there are others who want the tax code to impose harsher burdens on those who produce more output.

I'll make two points. First, the income tax burden is expected to rise in coming decades, even if the 2001/2003 tax cuts are made permanent. These numbers from the CBO long-run outlook show that income tax receipts will rise to record levels.



Second, there is a big difference between tax rates and tax collections. Here's some data from the IRS's annual Statistics of Income Bulletins.

These numbers show taxpayers, taxable income, and tax rates in 1980, when the top rate was 70 percent, and the same data for 1988, when the top rate was 28 percent.

1980 Taxes Paid on Income Over $200 Thousand

	1980 Returns	1980 Taxable Income	1980 Income Tax Paid
$200k - $500k	99,971	$22,696,007	$11,089,114
$500k -$1 Mill	12,397	$6,512,424	$3,613,195
$1 Mill-plus	4,389	$7,013,225	$4,301,111
Total	116,757	$36,221,656	$19,003,420

1988 Taxes Paid on Income Over $200 Thousand

	1988 Returns	1988 Taxable income	1988 Income Tax Paid
$200k - $500k	547,239	$134,655,949	$38,446,620
$500k -$1 Mill	114,562	$67,552,225	$19,040,602
$1 Mill-plus	61,896	$150,744,777	$42,254,821
Total	723,697	$352,952,951	$99,742,043

This is remarkable evidence for the so-called Laffer Curve. The IRS got five times as much money at a 28 percent rate as it did at the 70 percent rate.

Obviously, there were many other factors besides lower tax rates that contributed to this huge surge in taxable income and tax revenues, but it certainly appears that reasonable tax rates are more effective at generate revenue than confiscatory tax rates.

Thank you very much. I will be happy to answer questions.