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on
Supporting Broad-Based Economic Growth and Fiscal Responsibility
through a Fairer Tax Code

Madame Chairman and Members of the Committee, I am Jane Gravelle, a Senior Specialist in Economic Policy at the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss tax reform.

In this testimony, several topics are addressed. The first is the effects on GDP of a tax increase to reduce the deficit. The next addresses the expected effects of a revenue neutral tax reform. The following sections discuss overall individual and corporate tax reform design, base-broadening provisions outside of tax expenditures (including so-called "loopholes"), and concerns about timing provisions that raise revenue in the short run but not in the long run.

Tax Increases to Reduce the Deficit

As the economy begins to approach full employment, a major issue confronting policy-makers is how to reduce the deficit to address an unsustainable debt.[1] Despite the slowing of medical cost growth, the increasing share of the elderly in our population means that programs that serve these groups (Social Security and especially Medicare) will grow as a share of output if current service levels continue. The expected growth in spending on these programs has long been recognized, but has yet to be fully addressed either with program cutbacks or additional revenues. Growth in the debt is also due to an expected increase in interest rates and interest payments as the economy recovers, which is exacerbated by the additional debt accumulated during the recession and recovery.

Without either reducing spending or increasing taxes, the debt will continue to grow relative to GDP. The Congressional Budget Office (CBO) has estimated that the cost of closing the fiscal gap (stabilizing the debt to GDP ratio at 73%) through 2038 would require an ongoing reduction in the deficit by 0.9% of GDP ($150 billion); to return the debt to its pre-recession level of 38% of GDP would require a reduction of 2.1% of GDP ($360 billion currently).[2]

Tax reform and base broadening provide an opportunity to raise revenue that could be used to reduce the deficit, as well as an opportunity to finance rate reduction or alternatively, more desirable tax reductions.

There may be some concern about the effect of tax increases on economic growth. However, the evidence suggests that supply side effects of tax changes are uncertain in

[1] During recession and recovery, reducing the deficit can be contractionary; the policy prescription in a recession is to increase spending and/or cut taxes. An unsustainable debt is one that grows as a percentage of GDP.
[2] CBO, *The 2013Long-Term Budget Outlook*
http://www.cbo.gov/sites/default/files/cbofiles/attachments/44521-LTBO2013_0.pdf

direction, although small in magnitude. In any case, over time, decreases in the deficit are expected to lead to increased output through less crowding out of private investment. Based on standard labor supply and savings elasticities, an across-the- board income tax rate increase that closed half the fiscal gap referenced earlier ($75 billion, or 0.45% of GDP) would cause output to fall, via supply side effects, by slightly over 0.1% in the short run and, at the maximum, less than 0.4% in the long run.[3] These numbers are not growth rates but changes in levels, so they reflect a change in output compared to previous levels. With an economy growing at 2.2% typically, the short run effect is the equivalent of a one-time increase in output equal to two weeks of normal growth, and the long run effect is the equivalent of two months.

These estimates are similar to those based on a 2006 study of a tax rate reduction by the Joint Committee on Taxation, although their long run supply side effect (measured at 30 years) was a gain in output of about 0.5% of GDP. However, the JCT study also accounted for crowding out of private investment and found that growth would be reduced in the long run. That is, the effect of crowding out would more than offset supply side effects. Based on their projections, a tax increase equal to 0.45% of output would increase GDP by 0.5% in the long run (30 years).[4] While the supply side effect stabilizes fairly quickly (growth effects from deficit reduction through increases in individual

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[3] See CRS Report R43381, *Dynamic Scoring for Tax Legislation: A Review of Models*, by Jane G. Gravelle. The estimate was for a tax change equal to 5% of output, so the results were scaled back.

[4] The JCT study was for a $500 billion tax cut over four years beginning in 2005, which based on projections at that time was 0.33% of GDP. The results were scaled up. They were also a weighted average of individual rate cut and corporate rate cut effects based on revenue shares. See CBO, The Budget and Economic Outlook: Fiscal Years 2005 to 2014 January 2004, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/49xx/doc4985/01-26-budgetoutlook-entirereport.pdf.. The slightly larger long run effects in the JCT study may reflect, in part, a substitution from housing to business capital which increases gross domestic product but not necessarily net product because of depreciation differences. Replacement investment is required to maintain the capital stock, so a net product comparison provides better information about well-being.

income tax rates would overcome the supply side effects in about ten years) the effects from reductions in crowding out continue indefinitely. Thus, increasing taxes to reduce the debt is expected to contribute to positive economic growth.

Effects on the Overall Economy in a Revenue Neutral Tax Reform

In a revenue neutral tax reform, it is crucial to recognize that the behavioral response cannot be measured solely by statutory rate changes. The effective marginal tax rate determines this behavioral response and changes in the income base that change the share of income taxed at the margin also affect the marginal effective tax rate. For example, disallowing the deduction for state and local income taxes increases the tax burden at the margin. It is possible for base broadening provisions to raise effective marginal tax rates more than enough to offset the effects of a cut in statutory tax rates, leading to a contraction rather than an expansion in output.[5] For example, although reducing accelerated depreciation in exchange for a corporate rate cut may be a desirable policy, if the exchange is revenue neutral the cost of capital will increase because a corporate rate cut bestows a windfall gain on the return to existing capital. Economists studying the Tax Reform Act of 1986, which lowered tax rates and broadened the base, concluded that there was little real effect on the economy.[6]

This analysis suggests that pursuing base broadening because revenues can be used to lower statutory tax rates with the objective of spurring economic growth is unlikely to achieve its goals.

[5] See CRS Report R43381, *Dynamic Scoring for Tax Legislation: A Review of Models*, by Jane G. Gravelle.
[6] This conclusion is one that is reached with respect to the Tax Reform Act of 1986 which broadened the base and cut tax rates by Alan Auerbach and Joel Slemrod, "The Economic Effects of the Tax Reform Act of 1986, *Journal of Economic Literature*, Vol. 35, June 1997, pp. 589-632.

Designing a Tax Reform

Although base broadening simply to permit rate reduction is unlikely to achieve a growth objective, this type of tax reform can potentially improve fairness, efficiency and simplicity. Fairness may reflect issues of vertical distribution (how taxpayers at different income levels are treated) and horizontal distribution (equal treatment of similarly situated taxpayers). Tax reform can eliminate or limit existing tax benefits, but might also add or expand provisions. The Tax Reform Act of 1986, for example, included measures to reduce the numbers of low income individuals on the tax rolls and to expand the earned income credit (EIC).

The topic of tax reform is vast, and can only be addressed in a limited way in this testimony. These comments are based on related CRS reports and on tax reform proposals in the Congress and by the Administration, including the comprehensive tax reform proposals by Chairman Camp[7] and in the Wyden-Coats-Begich bill (S.727 from the 112th Congress), the discussion draft proposals from the Senate Finance Committee,[8] the Obama Administration's budget proposals,[9] the recent proposal by Senators Murray, Reed, and Brown, [10] and the House Budget Committee Resolution.[11]

[7] Documents describing the provisions of this proposal, and providing distributional, revenue, and macroeconomic analysis by the JCT can be found on their website, documents JCX-12-14 through JCX-22-14, at https://www.jct.gov/.

[8] Senate Finance Committee Tax Reform Discussion Drafts, http://www.finance.senate.gov/newsroom/chairman/release/?id=4f681789-343a-401c-a752-516028838040.

[9] The tax proposals in the budget are discussed in the greatest detail in the Treasury Green Book, *General Explanations of the Administration's FY2015 Revenue Proposals*, March 2014. http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf

[10]Senator Patty Murray introduces the 21st Century Workers Tax Cut Act, March 26, 2014 .http://www.murray.senate.gov/public/index.cfm/newsreleases?ID=469512e4-8bbe-407f-9de4-b8e7369ca753

[11] The Path to Prosperity, at http://budget.house.gov/uploadedfiles/fy15_blueprint.pdf.

Individual Income Tax Reform: General Issues

Significant base broadening of the individual income tax is challenging because, although individual tax expenditures are large relative to individual income tax revenues (allowing rate reductions of 43% if all could be eliminated), many tax expenditures are unlikely to be altered.[12] In most cases, they are viewed as serving an important purpose, are important for distributional reasons, are technically difficult to change, or are broadly used by the public and quite popular. This study[13] suggested that although tax expenditures are 80% of individual income tax revenue, base broadening was unlikely to yield more than 6% to 9% of individual income tax revenue. The Camp proposal's revenue raisers listed under individual income tax account to 7.4% of individual income tax revenues by 2023. If two provisions that would not gain permanent revenue were omitted, the revenue raisers would be 5.9% of revenues. This amount is not adequate to fund large tax rate reductions, although if used to raise revenue, would largely close the fiscal gap.

Some illustrations highlight the difficulty associated with using individual income tax expenditures to raise revenues capable of financing substantial rate reductions. About 30% of individual tax expenditures are associated with savings incentives; many who wish to reform taxes would not wish to disturb these provisions. Provisions such as the deduction for extraordinary medical expenses provide relief for those with large medical expenses and less ability to pay, a provision that may be justified on equity grounds. Some provisions might be justified on both equity and efficiency grounds. For example,

[12] See CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford, which examines the top 20 individual income tax expenditures, which account for 90% of the total.
[13] Ibid.

the earned income credit (EIC) is a major part of the income support system, but has also been found to encourage labor supply.[14] The exclusion of capital gains on owner-occupied housing prevents this tax from being a barrier to labor mobility and also helps to equalize the treatment of those whose health or financial circumstances require them to sell their home and those who can retain their home until death. Some income is received in kind and may be technically difficult to tax (such as defined benefit pensions, employer health plans, and Medicare benefits).

It is particularly difficult to find base broadening provisions that offset large rate reductions for high income taxpayers, such as the reduction to 25% that some have proposed, without shifting some of the burden to the middle class. The fully specified reforms (the Camp proposal and S. 727) had a top rate of 35%. In the Tax Reform Act of 1986, the lowering of top rates was combined with taxing capital gains at ordinary rates and restrictions on tax shelters. The latter is not available as a revenue raiser, and the former, under current scoring, gains relatively little revenue due to assumed realization responses.[15] No other provision is as concentrated among top earners as lower rates on capital gains.[16]

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[14] See Nada Eissa and Hilary W. Hoynes, "Behavioral Responses to Taxes: The EITC and Labor Supply," in *Tax Policy and the Economy* (Chicago: University of Chicago Press, 2006), pp. 73-110 for a review of the evidence and for their own estimates.

[15] It would be appropriate to use static revenue effects to measure burden and estimates incorporating realizations responses for revenue estimates. However, raising taxes on capital gains solely for the purpose achieving more uniform distribution without gaining revenue may not be desirable. At the same time, a survey of research suggests that the capital gains realization responses used by the JCT may be too large. See CRS Report R41364, *Capital Gains Tax Options: Behavioral Responses and Revenues* by Jane G. Gravelle.

[16] Another capital gains provision is the exclusion of gains at death, but that proposal has been historically rejected. Other provisions that tend to be concentrated in higher income levels are tax exempt bond interest and lower rates on dividends. See CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford, Table 5, for progressivity indices for major tax expenditures..

Corporate Tax Reform

Corporate tax expenditures are much smaller relative to corporate tax revenues than individual tax expenditures are relative to individual income tax revenues. Setting aside the tax treatment of foreign source income, eliminating all corporate tax expenditures is estimated to allow a steady-state, revenue-neutral reduction of the corporate tax rate to 29.5%, or about a 15% reduction.[17] If deferral of foreign source income were also eliminated, the rate could be reduced to 27%, or a 23% reduction. While it may be more feasible to revise corporate tax expenditures than individual income tax expenditures, there are in most cases some issues about the desirability of these changes. For example, exchanging accelerated depreciation for rate reduction might be desirable for more neutral taxation of equipment and structures, but it will increase the cost of capital.

The current environment for tax reform is dramatically different for corporate tax revisions compared to the Tax Reform Act of 1986. The 12-percentage-point rate reduction from 46% to 34% was offset by the repeal of the investment tax credit.[18] Today, there is no investment credit and returning to the alternative depreciation system that defines the tax expenditure for accelerated depreciation would permit a reduction of only 2.2 percentage points.[19]

There is one area in which revenue increases may be used for revenue gain without increasing the cost of capital in the United States, which is to increase the tax on

[17] See CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle.
[18] The corporate rate cut cost $116 billion over five years while the repeal of the investment credit raised $119 billion. There was also a slowdown in depreciation, but it accounted for only $8 billion. See JCT, *General Explanation of the Tax Reform Act of 1986*, May 4, 1987.
[19] See CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle. The calculation is for depreciation claimed by corporations (not including unincorporated business) and in the steady state.

income earned abroad. One option for increasing taxes on income earned abroad is to repeal the deferral of foreign source income. Much of that deferred foreign income may be income that should be taxed in the United States under arms-length pricing and has been artificially shifted to low tax countries through techniques such as transfer pricing and leveraging (borrowing in high tax countries). Eliminating deferral, according to JCT estimates, would raise about $50 billion in 2014,[20] although the Treasury estimates are about $72 billion.[21] There is some disagreement about the direction which should be taken with respect to international tax reform, with some preferring moving towards a territorial tax where foreign source income would not be taxed and some preferring an elimination of deferral. Others might opt for something in between (such as taxing income abroad at a lower rate). All of these would address concerns about firms retaining funds abroad. Most conventional economic analysis supports a worldwide tax without deferral on economic efficiency grounds, because it tends to equate most closely the tax burden on income from capital invested at home and aboard.[22]

There is general agreement that, regardless of the tax regime, there are significant problems with artificial profit shifting.[23] For example, the Obama Administration's budget proposal projects revenue gains by 2024 equal to 7% of corporate revenues to deal with perceived abuses in the international system.[24] Chairman Camp's proposal would address some of these issues, while also moving to a territorial system that exempts

[20] JCT, Estimates Of Federal Tax Expenditures For Fiscal Years 2012-2017,JCS-1-13, February 1, 2013, p.30, https://www.jct.gov/publications.html?func=startdown&id=4503.
[21] U.S. Budget, *Analytical Perspectives*, p 205, . http://www.gpo.gov/fdsys/pkg/BUDGET-2015-PER/pdf/BUDGET-2015-PER.pdf
[22] See CRS Report RL34115, *Reform of International Taxation: Alternatives*, and CRS Report R42624, *Moving to a Territorial Tax: Options and Challenges*, by Jane Gravelle.
[23] See CRS Report R40623, *Tax Havens: International Tax Evasion and Avoidance*, by Jane G. Gravelle.
[24] Revenues in these and other examples are from CBO, *The Budget and Economic Outlook: Fiscal Years 2005 to 2014 January 2004*, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/49xx/doc4985/01-26-budgetoutlook-entirereport.pdf.

dividends from foreign subsidiaries, projected to lose about 4% of corporate revenue, outside of the transitory one-time repatriation revenue (see discussion below).

Adding to Tax Benefits: The EIC Expansion and Second Earner Deduction

A proposal has been made by Senate Budget Committee Chairman Murray and co-sponsors, The 21st Century Workers Tax Cut, to expand the EIC for those without children and to allow a 20% deduction for second earners. These provisions would be financed in part by currently taxing income earned abroad in tax havens. An expansion of the EIC for these low income individuals without children is also contained in other proposals, including the Obama Administration's budget outline.

The EIC expansions for singles and married couples without children would contribute to horizontal equity. Currently these benefits are very small and phase out at very low incomes. A study that examined how fundamental elements of the tax code treated families of different sizes with the same ability to pay (that is, incomes adjusted for family size) indicated that the clearest change in the tax code to increase horizontal equity, or equal treatment of equals, is expanding the EIC for families without children.[25]

From 1981 until its repeal as part of the Tax Reform Act of 1986, the tax code had a second earner deduction. This type of provision can be justified, compared to general rate reductions, on efficiency grounds. Secondary earners (typically married women) have a larger labor supply response to wages than primary earners, although this differential has been narrowing in recent years. They also tend to face higher taxes when deciding whether to participate in the labor market than most other workers, because their

[25] Jane Gravelle and Jennifer Gravelle, "Horizontal Equity and Family Tax Treatment: The Orphan Child of Tax Policy," *National Tax Journal*, Vol. 59, September 2006, pp. 631-649. This issue is also discussed in CRS Report RL33755, *Federal Income Tax Treatment of the Family*, by Jane G. Gravelle.

tax rate begins at the rate on the last dollar of income earned by their spouse. There is also an equity argument for the second earner deduction because, compared to one-worker couples, two earner couples do not get the benefit of implicit, but untaxed, labor by the stay-at-home spouse. However, single individuals are taxed more heavily than married couples, and the deduction would increase that difference.

Other Tax Provisions, Including "Loopholes"

Some provisions that might be considered for base broadening might not fall in the tax expenditures list, either because they were not considered departures from a normal system or because they are unintended (one might say "loopholes.). A judgment is made in identifying tax expenditures about whether a provision is a departure from a "normal" tax system. There are several examples of base broadening provisions among the various tax reform proposals that do not fall into the tax expenditure list, such as disallowing deductions for moving expenses, capitalizing advertising costs, extending the amortization period for acquired intangibles, restricting interest deductions that reflect inflation, and disallowing deductions for alimony. These provisions are reminders that tax expenditure lists do not exhaust possibilities for base broadening, although there is a strong justification for deducting alimony payments.[26]

Also of interest are tax provisions not identified in the tax expenditure list, or subsumed in other provisions, that might be considered "loopholes." What distinguishes a provision as a loophole is not precise, but it often means either an unintended consequence or an apparent anomaly. For example, part of the revenue loss from deferral,

[26] When a couple divorces, they lose the income splitting benefits of marriage; deducting alimony (and taxing it to the recipient) helps to offset that loss. Divorce decrees are also based on the current tax treatment.

to the extent that it arises from profit shifting, would be considered a loophole. Other foreign related provisions may be viewed as loopholes (such as allowing foreign tax credits for payments that are essentially royalties on oil and mineral extraction). There may be more agreement on addressing a provision regarded as a loophole, than one that is a tax expenditure.

In addition to foreign provisions that address loopholes and raise $35 billion by 2024, the President's budget outline includes four provisions it specifically identifies as "loophole closers," which in total would raise about $10 billion in revenue by 2024. One provision is carried interest, which allows partnership interests in connection with the performance of personal services (such as hedge-fund managers) to receive substantial amounts of income taxed as capital gains.[27] (A carried interest provision that excludes real estate is also included in the Camp draft.) The second is to change the provision that allows those who have inherited IRAs, and who are not spouses, to receive distributions over their lifetimes. Children who inherit IRAs from parents often have significantly longer lives than the parent's original expected lifetime. In addition, retention of earnings in the IRA were intended to cover the parent's retirement, not the child's. A third provision would put an aggregate limit on the benefits of retirement plans, where defined benefit, defined contribution, and IRA plans have separate limits and where large accumulations from multiple plans are possible.

A final provision proposed stems from what might be viewed as an anomaly, or inconsistency, in the tax law's treatment. The Affordable Care Act included an additional 3.8% tax (equal to the Medicare tax on earnings) on capital income (such as capital gains,

[27] See CRS Report RS22689, *Taxation of Hedge Fund and Private Equity Managers*, by Donald J. Marples for further discussion.

dividends, and interest) for certain high income individuals, and also increased the existing Medicare tax on wage income for high income earners from 2.9% to 3.8%. However, the legislation excluded active (although not passive) income of partners and shareholders of Subchapter S firms, the only income exempt from both taxes. The administration's proposal would address this provision by treating this income as wage income in the case of professional service businesses. Another, or additional, approach would be to apply the 3.8% tax to active income of partners and Subchapter S shareholders.

The budget proposal also has a mixed category, "revenue raisers and other loopholes," which includes some other items that might be considered "loopholes," such as more generous depreciation for general aviation aircraft than for commercial aircraft (the "corporate jet" provision), inventory accounting methods, like-kind exchanges and some narrow technical provisions. Some of these provisions are in the tax expenditure list. There are also a number of estate tax provisions that might be considered loopholes.

Transitory Revenue Gains and Permanent Losses

A final issue to be considered that has consequences for the budget deficit is the use of provisions that have transitory revenue gains to pay for permanent loss provisions. In the case of a tax reform that is revenue neutral over the ten-year budget window, using such provisions will contribute to future deficits and debt. If a tax reform that gains revenue does so by relying on transitory revenue gains, the gains may be smaller or disappear outside the budget window.

We only have to look to the past to see the problems with timing effects. The Tax Reform Act of 1986 (TRA) is often referred to as revenue neutral, raising approximately $120 billion in corporate revenue and losing $120 billion in individual revenue, all over five years. Yet, an estimated $68 billion of corporate increases were temporary tax increases which did not persist. (The largest single provision was the uniform capitalization rules.) In addition, there were an estimated $43 billion of transitory individual tax increases which accrued largely to high-income individuals, which suggest that not only was TRA not revenue neutral, it was also not distributionally neutral.[28]

Current and recent tax proposals have contained a number of these timing provisions. Some of them are unavoidably inter-twined with tax reform provisions while others are not.

Some of these provisions that raise more revenue in the short run than in the long run include slower cost recovery provisions (reducing accelerated depreciation, capitalizing items currently expensed such as research and development, and advertising), and eliminating LIFO inventory accounting. Other provisions include phasing in revenue losing provisions, shifting traditional retirement savings from those with an up-front deduction with taxes on distribution to a Roth form with neither a deduction or taxation of benefits (an approach that gains in the near term and loses in the future), temporarily suspending indexing provisions, and a one-time tax on existing accumulated earnings abroad as a transition to a territorial tax.

One way of limiting the potentially damaging effect of timing on the true cost revenue consequences of a proposal is to require that the JCT also provide estimates on a

[28] Jane G. Gravelle, "Equity Effects of the Tax Reform Act of 1986, " *The Journal of Economic Perspectives*, Vol. 6, No. 1 (Winter, 1992), pp. 27-44.

steady state basis (that is, assuming a provision had long been in place) and judge revenue neutrality with that yardstick. This estimating approach is currently used in measuring tax expenditures.