



THE JAMES A. BAKER III INSTITUTE FOR PUBLIC POLICY  
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Testimony before the Committee on Ways and Means  
United States House of Representatives  
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Chairman Rangel, Ranking Member McCrery, and other members of the Committee, it is an honor to testify before the Ways and Means Committee on the economic issues that are confronting the nation. Let me start by stating that these are my views and should not be construed as representing the views of the James A. Baker III Institute for Public Policy, Rice University or any other organization.

#### **I. STATE OF THE ECONOMY**

The U.S. economy continues to grow at a solid pace and the U.S. unemployment rate is at or near the full employment rate. The Beige Book, published by the Federal Reserve on January 17, 2007, generally reported that labor market conditions are improving and that some businesses are having difficulty filling job openings. It also reported that while monetary wages are growing at a modest pace, compensation in the form of benefits is increasing rapidly, especially for health care. The Beige Book reports were also generally positive for services and manufacturing activity, excluding residential construction. Activity in commercial real estate, nonresidential construction, energy production and exploration, and mining was strong. An encouraging note is that some of the latest data on home sales and consumer attitudes on home buying suggest that the residential housing market may be nearing the end of the correction for the unsustainable surge in housing construction in 2004 and 2005. U.S. business profits continue to rebound from the corporate scandals in the late 1990s, the 2001 terrorist attacks in the U.S., the effects of hurricanes Katrina and Rita on production, and the recession of 2001. Moreover, larger-than-expected revenue growth from individual and corporate income taxes led the Congressional Budget Office to reduce its estimate of the 2006 deficit.

In spite of all this, the nation must confront several challenges to maintain a robust level of economic growth. The most important of these challenges is the enormous budget pressures associated with the projected increase in entitlement spending which threaten to undermine the strength of the economy. Additionally, the trend toward globalization presents other challenges such as promoting labor productivity growth, encouraging innovation and entrepreneurialism, and increasing the economic security of U.S. workers. I believe that in addressing these challenges it is imperative that U.S. fiscal

policies support long-term economic growth, and ensure that U.S. businesses remain competitive at home and abroad.

## **II. FISCAL POLICY: WHERE TO GO FROM HERE**

Reform of Social Security and Medicare should be at the forefront of any policy discussion since these are the heart of the budget problems facing the nation. The cost of these programs is projected to rapidly increase for two main reasons: the changing demographics of the U.S. population and rapidly rising medical costs. These changes will have major implications for tax and spending policies in the U.S. for years to come. Regarding this, Federal Reserve Chairman Bernanke recently testified that “to some extent, strong economic growth can help to mitigate budgetary pressures, and all else being equal, fiscal policies that are supportive of economic growth would be beneficial.”

The Congressional Budget Office (CBO) projects that tax revenues will be 18.3 percent of GDP in 2006, which is up from 17.5 percent of GDP in 2005. From 1962 to 2005, revenues were 18.2 percent of GDP. Over the next 10 years, the CBO projects that revenues will increase steadily as a percentage of GDP, and that by 2016 revenues will be \$4.2 trillion, or 19.8 percent of GDP. Under current tax law, including the scheduled expiration of the 2001 and 2003 tax cuts, the CBO projects that revenues will increase to 23.7 percent of GDP by 2050. This increase would result from a one-time tax increase in 2010 related to the expiration of the 2001 and 2003 tax cuts, and a steady increase in tax rates as real and nominal income growth shifts taxpayers into higher tax brackets and onto the Alternative Minimum Tax (AMT).

As a share of GDP, personal income taxes are 8.1 percent, corporate taxes are 2.6 percent, social insurance taxes are 6.4 percent, and other revenues are 1.3 percent. Over the next 10 years, personal income taxes are projected to increase from 8.1 to 10.5 percent of GDP. As discussed above, this increase in personal income taxes results from the expiration of the temporary tax provisions passed in 2001 and 2003, including the higher exemption amount under the AMT. Reforming the AMT will be necessary to keep the ratio of federal tax revenue to GDP from increasing far above historical levels. Under current law, in which all of the 2001 and 2003 tax cuts expire by 2011, the CBO projects that over 20 million taxpayers will pay \$60 billion more in taxes because of the AMT in 2014, and even more than that will be required to calculate their taxes under the AMT to see if they are affected. By comparison, in 2003, approximately 3 million taxpayers were subject to the AMT. The number of taxpayers and the increase in taxes will continue to increase over time if no changes are made to the AMT. Corporate income taxes are projected to decrease steadily from 2.6 to 1.7 percent of GDP over the next 10 years as a result of slower growth in corporate profits. Social insurance taxes are projected to remain close to 6.3 percent of GDP over the next 10 years.

The tax rate increases scheduled under current law are almost certainly not consistent with fiscal policy that would support economic growth. While taxes are necessary to raise revenue to pay for government operations, they impose an economic cost by distorting individual decisions regarding how much to work, how much to invest in training and education, how much to save, the allocation of saving across assets, and tax avoidance opportunities. Distortions are also related to tax complexity and the

haphazard pattern of marginal tax rates created by the interplay of statutory tax rates, eligibility requirements, phase-ins, and phase-outs.

### **A. Disincentives to Work**

The empirical evidence on the responsiveness of hours worked to the after-tax wage rate generally ranges from nil to a small but significant effect. This ambiguity arises from two offsetting effects: (1) that higher marginal tax rates reduce the incentive to work at the margin; and (2) that higher taxes reduce disposable income, and therefore, individuals must work more to finance a given level of consumption. However, individuals make other labor supply decisions that may also be affected by taxes such as whether or not they should participate in the labor force, how much to invest in training and education, and how hard they should work. Currently, there is no consensus view on the magnitude of the effect of wage taxes on all of these labor supply decisions. Some observers argue that such responses are sensitive to wage tax rates and therefore wage taxes have a significant impact on long run economic growth. By contrast, others argue that the effects of wage taxes for primary workers are small or negligible, while recognizing that the labor supply of secondary earners is more responsive to wage tax changes. In addition, reported taxable income of high income taxpayers is responsive to changes in tax rates over time.

### **B. Disincentives to Save and Invest**

The disincentive to save and invest that is inherent under an income tax system is perhaps its most costly distortion. An income-based tax is levied on capital and labor income, regardless of whether the income is saved or consumed. Thus an income tax system penalizes future consumption. There is substantial evidence that reducing the taxation of capital income could increase saving, investment, productivity, and national output in the long run. In addition, the allocation of saving across different asset types is influenced by the haphazard pattern of tax rates on different types of assets. The distortions that are caused by this differing tax treatment are as large as distortions that would be associated with a several percentage point increase in overall capital income tax rates, indicating the importance of eliminating differential capital income taxes.

### **C. Economic Costs of Tax Complexity**

A compelling argument for tax reform is the need to simplify the incredibly complex current tax system. The complexity of the current tax system imposes substantial costs on taxpayers in the form of time and money spent to understand and comply with the tax law. The President's Advisory Panel on Tax Reform estimates that individual taxpayers spend 3.5 billion hours doing their taxes (an average of 26 hours each) and about \$100 billion on tax preparation and compliance. In addition, businesses spend about 3 billion hours and \$40 billion. The cost of complying with the tax system can be particularly burdensome for taxpayers that claim the Earned Income Tax Credit (EITC), that must pay the Alternative Minimum Tax (AMT), and for small businesses. The panel reported that almost 75 percent of taxpayers that claimed the EITC or paid the AMT used a tax preparer. The panel reported that 45 percent of taxpayers with tax liability will be subject to the AMT by 2015, indicating that financial costs of tax complexity are likely to rise over time under current law. In addition, the complexity of

the current tax system creates the opportunity for some taxpayers to avoid or evade taxes and thus perpetuates the notion that the tax system is unfair. Since the tax reform of 1986, Congress has enacted more than 15,000 changes in the Tax Code (p. 16). This includes a number of provisions that are temporary, and set to expire in 2010 such as the tax rate for ordinary income, the child tax credit, the lower tax on dividends and capital gains, and the repeal of the Estate and Gift Tax. The high costs of tax compliance are increased by the volatile nature of the tax code, which creates more uncertainty and complexity for both businesses and families.

#### **D. International Competitiveness and the Corporate Income Tax**

Proposals for reform of the corporate income tax are drawing more attention as globalization and declining corporate tax rates around the world have drastically changed the competitive environment facing U.S. multinational firms. Moreover, the increase in multinational firms and globalization has substantially increased complexity associated with taxing cross-border corporate income. The U.S. corporate income tax, which taxes all repatriated and “foreign source” income after allowing for a limited credit for foreign taxes paid, is riddled with potential tax avoidance and evasion schemes that reduce corporate taxes and create costly economic distortions in the production and distribution of corporate products. However, evaluating proposals to reform the corporate income tax is a daunting task as we must account for the effect of corporate income taxes on a number of important corporate decisions such as the location of tangible and intangible capital, income repatriation, the location of income for tax purposes, financial decisions, incentives to export, incentives to lower foreign tax burdens, and foreign country tax treatment of U.S. corporations.

Two general directions are commonly suggested for corporate tax reform. The first would include some form of integration of the corporate and individual income taxes to ensure that all income is taxed once, with much recent attention devoted to plans that would accomplish this at the individual level (reducing dividend and capital gains tax rates), rather than the business level (reducing the corporate tax rate or allowing deductions or exemptions for dividend payments to shareholders). A second approach would introduce a new consumption-based tax to replace the current federal income tax system which is a hybrid tax that has both income tax and consumption tax elements, including the corporate income tax. Given the ever-increasing importance of globalization, especially cross-country flows of both goods and mobile capital, reforming the corporate income tax to maintain the competitiveness of U.S. business is a critical issue that deserves careful consideration. Note also that lowering individual taxation rather than business taxation is problematic in terms of attracting foreign capital.

#### **E. Tax Reform**

Our federal tax system is unnecessarily complicated and burdens millions of taxpayers and businesses who must comply with its many convoluted provisions. It hampers U.S. business from competing in an increasingly integrated global marketplace. It is riddled with loopholes, haphazard provisions, and often undermines our perception of fairness. Most importantly, it is often counterproductive in terms of promoting economic growth. In short, the current federal tax system is in need of a comprehensive overhaul. All of the issues discussed above could be addressed by a

well-designed tax reform plan that created a simple, fair and pro-growth federal tax system. The 2005 report of the President's Advisory Panel on Federal Income Tax proposed two alternatives: (1) a reformed and integrated income tax (the "Simplified Income Tax"), and (2) a consumption-based system supplemented with an "add-on" layer of capital income taxation at the individual level (the "Growth and Investment Tax") that is broadly similar to the dual income tax. The panel also discussed at length a true consumption-based tax – its "Progressive Consumption Tax" (PCT) option – although the panel ultimately decided against recommending this approach. Reforming the federal tax system would require tough economic choices that would require presidential leadership and ample bipartisanship to achieve a viable reform option.

#### **F. The Importance of Comparing Alternative Tax Policies**

A useful example of comparing the growth effects of alternative tax proposals is provided in a report by the Office of Tax Analysis (OTA) published in July 2006 that examines the dynamic effects of the president's proposal to permanently extend a variety of tax provisions enacted in 2001 and 2003. The report provides information on the macroeconomic effects of the various tax provisions, similar to an analysis by the Joint Committee on Taxation (2005), as well as the aggregate macroeconomic effect of all the provisions. This information allows for a comparison of the macroeconomic effects of various policies and, if used appropriately, could prove useful in determining tax policy changes that would support economic growth. For example, the OTA report analyzes the following three groups of provisions:

- Extension of lower capital gains and dividend tax rates;
- Extension of lower ordinary income bracket rates for the 25, 28, 33, and 35 percent brackets and an extension of the repeal of personal exemptions and itemized deductions; and,
- Extension of the increase in the child credit from \$500 to \$1,000 per child, the increased standard deduction and bracket width for joint filers, and the 10 percent rate bracket.

Table 1 shows that lowering capital gains and dividend taxes increased gross national product (GNP) by 0.3 to 0.4 percent in the long run, depending on the assumed fiscal offset. This increase in GNP occurs because lower effective tax rates on capital income increased saving and investment. In fact, permanently extending the dividend and capital gains tax cuts increased real GNP in the long run for all of the options considered in the OTA analysis. However, as noted by OTA, changes in a variety of simplifying assumptions underlying the economic model used in this report could strengthen or weaken these results. This includes assumptions about the economic effects of dividend taxes and a variety of other economic distortions that are not included in the model.

For the base case parameter values, Table 1 shows that permanently extending the cuts in the top four ordinary income tax brackets increases real GNP by 0.0 to 0.7 percent in the long run, depending on the assumed fiscal offset. By comparison, permanently

extending the increase in the child credit, the increase in the standard deduction and bracket width for joint filers, and the 10 percent rate bracket reduces real GNP by 0.4 to 1.2 percent, depending on the assumed fiscal offset. These provisions are inframarginal changes for most taxpayers and thus would not increase the incentive to work or save.

Purely from an efficiency perspective, a permanent reduction in dividend and capital gains tax rates has the most positive effect on the economy in most of the cases that were examined by OTA. In addition, lowering the four highest ordinary income tax rates increased GNP more than the permanent extension of the increase in the child credit, the marriage tax relief, and the 10 percent bracket. However, efficiency is not the only important factor in determining fiscal policy—fairness and simplicity in administration and compliance are also factors that should be considered.

The adoption of efficient, fair, and simple tax and spending policies is critical given the fiscal gap facing the nation, which has been estimated to be as high as \$98 trillion in present value terms.

### **III. TRENDS IN HOUSEHOLD INCOME**

Promoting labor productivity growth is crucial to increasing living standards since real wages increase with productivity in the long run. The growth of productivity is determined by technological changes that increase the amount of goods and services that can be produced with a given level of capital and labor, increases in the capital to labor ratio, and increases in human capital. Thus, policies that are likely to promote productivity growth include encouraging innovation and entrepreneurial ventures, lower taxes on capital income, and increasing investment in human capital. Recently, labor productivity growth has been roughly 3 percent annually or higher from 2002 to 2005. However, an anomaly is that monetary wages have not been increasing at a similar pace. Recent increases in non monetary compensation in the form of benefits may explain a part of this trend. Other factors also affect real wages by changing labor supply and demand, such as immigration and competition from abroad. Wages are the largest source of household income for most families in the U.S. Figure 1 shows the growth in household income for different income percentiles over time. It illustrates two concerns that are the topic of much recent discussion in academic, political, and policy circles: the widening gap between high- and low-income households over time and the slow recovery of household income from 2001 to 2005.

Figure 1 shows that the widening gap between high- and low-income households accelerated in the 1980s and 1990s. There are many potential explanations for the widening of the income gap between high- and low-income households including: an inflow of less-skilled immigrants, international trade, technological change, transfers of production activities to foreign countries, a reduction in the quality of education, the decline of labor unions, and deregulation. Immigration of less-skilled workers into the U.S. is an important factor that reduces growth in wages of less-skilled workers. It is important to note that immigration reforms that would reduce the negative impacts of immigration on the wages of less-skilled workers would potentially increase the prices of other goods and services and perhaps limit wage increases for higher-skilled workers. In addition, anecdotal evidence and several economic studies support the view that outsourcing is also a potential factor in some of the recent decrease in the demand for



less-skilled (and even some skilled) workers. However, it is not likely to explain fully the widening income gap between more- and less-skilled workers. Technological change also plays a role as many technological improvements have increased the demand for skilled labor relative to unskilled labor and therefore have resulted in larger wage growth for more-skilled workers. In any case, there does not seem to be a simple policy solution to the widening gap between more- and less-skilled workers. Moreover, it is not at all clear that the U.S. can reverse the trend toward increased globalization or that we would be better off if we did.

I do not believe that drastically increasing taxes on the rich would be a desirable or effective means of attempting to reverse the effects of increased competition from foreign workers on the widening gap in household incomes. Most importantly, this would decrease the incentives to work and invest, and may be detrimental to U.S. economic growth. Moreover, given the progressivity of the current federal income tax system, it is not clear that such a policy would be supported politically. In 2003, the top one percent of taxpayers ranked by adjusted gross income (AGI) paid 34.3 percent of all personal income taxes. The top five percent of taxpayers paid 54.4 percent of all personal income taxes. Taxpayers that ranked in the top 50 percent of taxpayers paid 96.5 percent of all personal income taxes in 2003. In fact, the top 50 percent of taxpayers have paid more than 95 percent of all personal income taxes in every year since 1993. The President's Advisory Panel on Federal Tax Reform estimated in 2006 that the bottom 50 percent of tax filers would have a negative average tax rate and that over 30 percent of tax filers would have no tax liability or receive a refund. In addition, 15 million households would not be required to file an income tax form. This implies that over 40 percent of families would have no liability or received a refund.

However, this does not imply that nothing should be done. Increased competition from abroad threatens the security of many workers in the U.S. as businesses struggle to compete with low-cost foreign producers for customers and capital. This has created a situation of increasing financial insecurity for many U.S. citizens. At the same time, this process reduces prices for goods and services that U.S. residents consume and thus increases the well being of many U.S. residents. While competition and production efficiency are necessary for long run growth and increased economic well being worldwide, the shifting economic landscape that leads to a more global world economy is certain to increase insecurity and reduce the well being of some U.S. workers during the transition phase. Thus, policymakers and U.S. businesses will face the chore of ensuring that U.S. workers have the opportunity to adapt in this ever-changing environment by engaging in education and training to learn new skills. The role of tax policy should be to ensure that U.S. businesses remain competitive. For example, reforming the corporate tax system to reduce the burden of capital income taxation and costs of tax compliance is imperative to maintaining the competitiveness of U.S. businesses. In addition, transforming the role of unemployment taxes and the benefits and training that U.S. workers receive in spells of unemployment may also be an important course of action to help U.S. workers cope with increased competition from abroad.

**Table 1**

**Macroeconomic Effects of Extending The 2001 and 2003 Tax Cuts with Base Case Parameter Values: Percentage Change from Initial Steady-State Values**

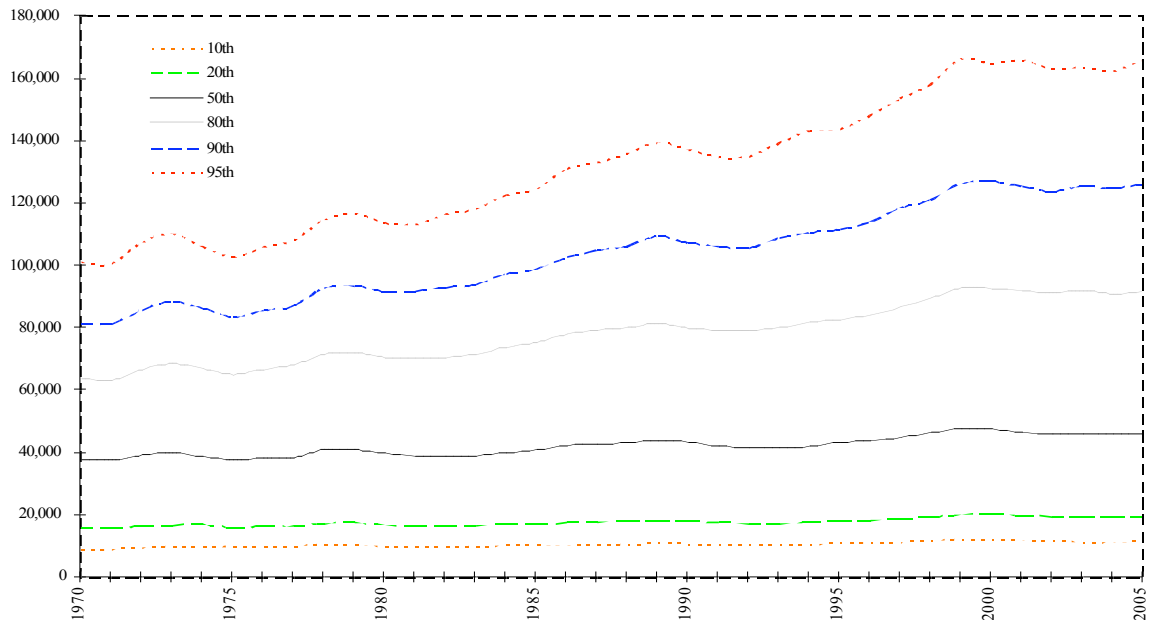
	(1)		(2)		(3)	
	Lower Dividends and Capital Gains		(1) Plus Lower Top 4 Ordinary Rates		(2) Plus Remaining Tax Cut Extensions	
	2011-2016	Long Run	2011-2016	Long Run	2011-2016	Long Run
<b>Base Simulation*</b>						
Financed by Decreasing Future Government Consumption						
Real GDP	0.1%	0.4%	0.7%	1.1%	0.5%	0.7%
Capital Stock	0.2%	1.2%	0.1%	2.3%	-0.3%	2.3%
Labor Supply	0.0%	-0.1%	0.7%	0.2%	0.5%	-0.3%
Consumption	0.1%	0.6%	1.1%	2.5%	1.3%	3.5%
Investment	0.5%	1.6%	-0.5%	2.6%	-3.0%	2.3%
Financed by Increasing Future Income Taxes						
Real GDP	0.2%	0.3%	0.9%	0.3%	0.8%	-0.9%
Capital Stock	0.3%	0.7%	0.6%	0.3%	0.6%	-1.8%
Labor Supply	0.1%	-0.1%	0.9%	0.0%	0.7%	-0.8%
Consumption	0.0%	0.1%	0.7%	0.4%	0.5%	-0.7%
Investment	1.1%	1.1%	2.1%	0.5%	1.8%	-2.0%

Department of the Treasury  
Office of Tax Analysis

\* Assumes the U.S. is a large open economy with a simple representation of limited international capital flows

Source: Reproduced from Office of Tax Analysis, U.S. Department of the Treasury, "A Dynamic Analysis of Permanent Extension of the President's Tax Relief," 2006.

**Household Income at Selected Percentiles: 1970 to 2005  
(In 2005 adjusted dollars)**



Data Source: U.S. Census Bureau, Current Population Reports, P60-231, *Income, Poverty, and Health Insurance Coverage in the United States: 2005*.