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THE IMPACT ON INDIVIDUALS AND FAMILIES OF REPLACING THE FEDERAL INCOME TAX

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

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THE IMPACT ON INDIVIDUALS AND FAMILIES OF REPLACING THE FEDERAL INCOME TAX

TUESDAY, APRIL 15, 1997

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 10:08 a.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721
April 8, 1997
No. FC–6

Archer Announces Hearing on the Impact on Individuals and Families of Replacing the Federal Income Tax

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on the impact on individuals and families on replacing the Federal Income Tax. The hearing will take place on Tuesday, April 15, 1997, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

Oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

In the 104th Congress, the Committee held five days of hearings on problems caused by the current Federal income tax system and proposals to replace the Federal income tax. The Committee then began to examine how the proposed replacement systems would affect specific segments of society and the economy, holding hearings on the impact of replacing the income tax on small businesses, State and local governments, tax-exempt entities, international competitiveness, domestic manufacturing, energy and natural resources.

In announcing the next hearing, Chairman Archer stated: Two years ago, this Committee began a careful examination of how we could replace--in its entirety--our current income tax system. Now the Committee picks up on where it left off last year. Following this hearing, the Committee will continue to examine the impact of proposed alternatives, including the effects on employee benefits and retirement and personal savings incentives; home ownership and real estate generally; agriculture; retail sales; financial services; service industries; and health care." Dates for hearings on these topics will be announced in future advisories.

FOCUS OF THE HEARING:

The focus of this hearing will be on the impact on individuals and families of replacing the Federal income tax with one or more of the proposed alternative tax systems. The basic alternatives are an income tax (with one or more rates); a flat tax (such as the one introduced by House Majority Leader Dick Armey); a national sales tax (such as the one introduced by Reps. Schaefer and Tauzin); a value added tax (both invoice-credit and subtraction methods); and an income tax system with an unlimited savings deduction (such as the USA tax system introduced by Senator Domenici and former Senator Nunn). The witnesses should assume that any new tax system would replace, on a deficit-neutral basis, the individual income tax, the corporate income tax, and estate and gift taxes.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement and a 3.5-inch diskette in WordPerfect or ASCII format, with their address and date of hearing noted, by the close of business, Tuesday, April 29, 1997, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments. At the same time written statements are submitted to the Committee, witnesses are now requested to submit their statements on a 3.5-inch diskette in WordPerfect or ASCII format.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS__MEANS/'.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–225–1904 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman ARCHER. The Committee will come to order. Today I'm pleased to continue our series of hearings on alternative tax systems for structural reform of our current income tax. Over the past 2 years, the Committee has heard expert testimony on the shortcomings of the current income tax and the impact of proposed alternative tax systems on various sectors of our economy.

We covered a lot of ground in the 104th Congress, but we still have much work ahead of us. Today, April 15, is a fitting day to

examine the impact of fundamental tax reform on individuals and families.

As most people by now in this country know, I continue to do my own income tax, so I understand first hand the frustrations of millions of taxpayers as they struggle to figure out their income tax forms.

That's why it's so important that Congress respond when public sentiment about our tax system turns critically negative. If our income tax is perceived as unfair, inefficient and complex, it's time to reevaluate how we fund government. Without public confidence in our tax system and the administration of pertinent laws, our system of voluntary compliance cannot survive.

I've come to the conclusion that the Tax Code is so broken that it can't be fixed. I don't think better management at the IRS will do the trick, and I don't think minor reforms of the Tax Code will work. Instead, I believe we need to fundamentally overhaul and simplify the Federal Tax Code.

The current code is unfair, riddled with loopholes, excessively complicated, overly intrusive and antigrowth. We can and we must do better. I think we should pull the income tax out by its roots and throw it away so that it never grows back, and remove the Federal tax collector, the IRS, from any direct contact with every individual American citizen, that is, to get the IRS completely and totally out of the lives of every individual American.

I favor replacing the income tax with a tax on consumption that is fairer and simpler and more conducive to economic growth.

Our witnesses today will address the many key questions about how families and individuals fare under current law, and whether alternative tax proposals may improve or worsen their lives.

I'm also extremely pleased that our Majority Leader, and my very close friend, Dick Armey, has joined us today to discuss the merits of his bill, H.R. 1040.

I am now pleased to yield to Barbara Kennelly, the Acting Ranking Democrat on the Committee for any comments she might like to make.

Ms. KENNELLY. Thank you, Mr. Chairman. Good morning. This morning, the Committee is scheduled to hear testimony on the possibility of reforming the income tax and the impact on families. We would do well to recall that for all the complexity of the Code, the majority of all individual filers are in the 15 percent tax bracket, or pay no income tax at all.

First and foremost, any serious tax reform proposal should do no harm, and not leave these American families any worse off than they are today. It would be a cruel hoax to tell citizens a flat tax is possible, and not highlight the loss of a progressive tax system or the transition costs involved.

The second tax reform test ought to be deficit neutrality, or at least not increasing the deficit. There are those who would advocate a flat tax, which the Treasury Department projects would lose on average $138 billion annually. When the Federal budget deficit has come down in each of the last 4 years, such an approach borders on the irresponsible if this loss of progress is not factored in.

This Committee has a longstanding interest in tax fairness and simplicity. After careful thought and thousands of hours of work,

we enacted the Tax Reform Act of 1986 which reduced taxes on individuals by $280 billion over 5 years, and took 6 million low-income families off the income tax rolls. The country is certainly very different economically than it was then, we have to admit today that we are dealing in a truly global economy.

And so I would say, yes, it is time to conduct another thorough review. However, we would do well to recall that the largest deductions are home mortgage, state and local taxes, and charitable contributions, and that the largest exclusions, employer provided health and pension benefits, dwarf the largest deductions.

Taken together, these items account for the bulk of tax preferences in dollar terms. The Members, Democrat and Republican, House and Senate, were well unwilling to tackle these items in 1985 and 1986.

I do not see any reason to believe that any legislation that would reach the President's desk in 1997 or 1998 would be any different.

In the absence of such action, fundamental reform is unlikely in this session. I, however, feel that we should continue to look for possible doable tax reform, and obviously listening to the Chairman's remarks, I agree with him on simplicity.

It is also agreed that the 1986 Tax Reform Act, while dropping people from the rolls, also made business taxation even more complicated with the Alternate Minimum Tax, AMT, and passive loss changes. We should learn from these actions.

Having said that, I would welcome proposals to simplify the Internal Revenue Code, correct errors or rid the Code of outdated, unworkable provisions. In that vein, I am hopeful that the witnesses before us today will offer us constructive suggestions to do just that.

Thank you, Mr. Chairman, and, I, too, welcome the Majority Leader who is appearing before us, and who is so active in this question. Thank you.

Chairman ARCHER. Thank, you, Ms. Kennelly.

[The opening statement of Mr. Ramstad follows:]

Opening Statement of Hon. Jim Ramstad

Mr. Chairman, thank you for your continued leadership in exploring fundamental reform of our deeply flawed tax system.

Last year this committee had the opportunity to examine the impact of replacing our current system on several segments of society—from local governments, to large and small businesses, to tax-exempt organizations. But no group is more fundamental to our nation's well being than the one we are highlighting today—individual Americans and their families.

Providing relief to American families is what major tax reform should be all about.

Our current system hurts families by being overly complex, costing billions of dollars and billions of hours to comply. Our current system also hurts families by creating disincentives to work, save and invest for their futures.

Replacing our present tax system could mean a much lower tax burden for American families, allowing them to keep more of what they earn. Tax reform could also help us reach our economic potential, which would mean more jobs and a better standard of living for American families.

Again, Mr. Chairman, thank you for this opportunity to examine how American taxpayers and their families could be affected by fundamental tax reform.

Chairman ARCHER. I would like to invite our honored Majority Leader to take the witness chair, and to tell him that the reception will be warm here, in spite of our minor differences on this issue, and welcome to the Committee.

Without objection your entire printed statement will be put into the record, and you may summarize in any way that you see fit verbally, and you may proceed.

STATEMENT OF HON. RICHARD K. ARMEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS, AND MAJORITY LEADER, HOUSE OF REPRESENTATIVES

Mr. ARMEY. Thank you, Mr. Chairman. First of all let me thank you for holding these hearings. You alluded to our minor differences, and I would say, Mr. Chairman, they are minor. I think on the big things you and I are in perfect agreement.

We do find ourselves in agreement with the proposition that the current Tax Code is no longer acceptable to the American people. That proposition gets increasingly more verified each time we take a poll on the matter.

I first engaged this subject in January 1994 when I became convinced that the American people were fed up with the Tax Code, and would not tolerate a continued Tax Code of this type very much longer.

I should tell you, looking at some of the reasons why I found that they are fed up with it, the first is its complexity. And I was laughing at myself this morning. Mr. Chairman, my mother, who had only a high school education, spent most of her time, most of the years when I was a youngster at home, doing taxes for people throughout the community—individual taxes, taxes often for farmers and small businesses.

And in those days she was able, even with a high school education, to help people do their taxes, and they would then feel that they had some opportunity for things to come out right.

Today we find that the Tax Code is so complex that in a recent poll of IRS agents, the agents themselves answered only 78 percent of the questions correctly. The people that are mandated to enforce the Code can't get it right. This is a new story.

But here's my latest iteration of that story, Mr. Chairman.As you know, I have a Ph.D. in economics. I've been studying these sorts of things all my life, and I, too, do my own taxes. My own taxes are somewhat simple. I am not a wealthy person. And one would think that I could do my taxes.

I have here today my tax refund check—$400 less than what I thought it would be when I sent my forms in to the IRS. I meticulously worked my way through the 1040 form, and the instructions. I thought I had covered all my bases. I filed my taxes a month and a half ago, and just 2 days ago I received a notification from the IRS that I had failed to decrease the value of my itemized deductions relative to my adjusted gross income, and they were making the adjustment on my behalf, and that I would get my refund check at some amount.

I can't imagine having to go to heaven some day and face my mother and explain how I could make a mistake like that, especially when she's sure to remind me that that requirement in the Tax Code was put into effect during a period of time in which I was a Member of Congress. My only plea can be, Well, Mom, I didn't vote for it.

But at any rate, this shows me, I think, on a daily basis, the complexity is too much. We have all kinds of statistics on that which you'll find in my statement.

Seventy percent of people recently polled said they want a new Tax Code. Only one out of ten people said that they felt the current Tax Code could be repaired.

Taxes as we have them today are too high. There's no doubt about it. And, quite frankly, we believe that you can lower people's taxes and still retain the aggregate earnings.

Taxes are not neutral, and they do hinder economic opportunity. Taxes undermine good government. Now, I started studying this in January 1994. At that time, the unrest among the public had been consolidated primarily and almost singularly into an organization called Citizens for an Alternative Tax System. Mr. Chairman, you know them as principal advocates of a national sales tax.

I, naturally, in 1994 began to study the sales tax as an alternative to the existing Tax Code. And I felt frustrated in my efforts to respond in that way. At that point I rediscovered the work of Professors Hall and Rabushka, and began to restudy the flat tax, and as you know, I settled on the flat tax as a solution.

The problem is simple: the current Tax Code will not work. It is no longer acceptable to the American people. The solution is to replace it, and replace it altogether.

Why the flat tax? You get the simplicity that we're looking for, you get fairness, in that everybody's treated the same as everybody else. You will get an encouraged growth rate, because we end the double taxation of savings and investment that you have under the current Tax Code, and virtually everybody who has studied the flat tax is in agreement on that.

There will be lower taxes. There is a de facto progressivity that's due to the generous family allowance that for a family of four is $33,800. This means that if you earn $25,000 you owe no tax. A family of four earning $50,000 will pay only 6 percent of its income in taxes, and a family earning $200,000 would pay 14 percent.

The flat tax is profamily in many ways, not the least of which, it relieves the family of the burden of just dealing with this complexity which if you do your own taxes you know can be a difficult thing.

It is an honest way to tax. I have to tell you, Mr. Chairman, I believe that in the end all taxes are paid by people, and all taxes are paid out of current income. And the flat tax, as a direct, honest income tax, accepts that proposition.

We are told by even the Federal Reserve Bank of Kansas City that the flat tax will lower interest rates by as much as 25 percent, and nobody that has examined the flat tax disputes that it will lower interest rates. The only dispute is in the estimators view of how much.

And let me just say very quickly that I believe very profoundly that in a flat tax world, charitable giving will go up because I think charitable giving is first a function of what charity is in your heart, and second, a function of what you have to give.

And in a flat tax world, where more people have better jobs, with more promotions and more take-home pay, they will give more. That is what happened in the eighties, where the tax value of charitable deductions went down, charitable deductions more than doubled, and charitable deductions to faith-based institutions more than tripled.

Those are my comments, Mr. Chairman, and I'll be happy to answer any questions.

[The prepared statement follows:]

Statement of Representative Dick Armey

Mr. Chairman, I appreciate you affording me the opportunity to testify before the committee today on the subject of tax reform. I would also like to commend you for holding these hearings and focusing attention on the need to end the tax code and the IRS as we know it.

THE TAX CODE IS BROKEN

As you have stated so many times yourself, Mr. Chairman, our current tax system is broken and needs to be scrapped and replaced with a system that is fair, simple and honest. The current tax code is complex; unfair; inhibits saving, investment and job creation; imposes a heavy burden on families; and undermines the integrity of the democratic process. It must go.

I'd like to focus my remarks today on the effect government taxation has had on America's families. Unfortunately, during the past few decades the tax system has become more complex, less fair, more destructive to the economy, and, in the process, more of a burden on American families.

Complex

The complexity of the tax system is incomparably worse than when I was growing up. When I was a child, during tax season my mother prepared tax returns for farmers and other small businessmen in Cando, North Dakota. Though she only had an eighth grade education, she was able to prepare tax returns and feel comfortable that they were correct.

Today, even the best-trained tax attorney must question his ability to accurately complete a tax return. During the past forty years, the tax code has grown mind-numbingly complex. The number of words in the income tax code has increased more than four-fold to 800,000. There are more than 6,000 pages of accompanying tax regulations for the income tax.

Each year Americans devote 5.4 billion hours complying with the tax code, which is more time than it takes to build every car, truck and van built in the United States. The IRS sends out more than 8 billion pages of forms and instructions which, if laid end to end, would circle the earth 28 times.

In my own family we have experienced the costs of complexity. Like so many other American families, time we spend searching for receipts and studying tax law could be spent with our children.

Unfair

The main reason the tax code is complex, of course, is the proliferation of deductions, credits and other special preferences in the law. Because of these loopholes, taxpayers with similar incomes can pay vastly different amounts in taxes. This uneven treatment of taxpayers is fundamentally unfair and is at odds with the American value of equality before the law.

According to a recent poll by Luntz Research, three-quarters of Americans believe it is common for taxpayers with similar incomes to pay vastly different amounts in taxes. Perhaps this is why more than two-thirds support a fundamental overhaul of the tax system.

Heavy Taxes

The American people are beleaguered by the highest tax burden in American history. Taxes represent a larger share of the economy than ever before. As a result,

American families now pay more in taxes than they spend on food, clothing and shelter combined.

According to the Tax Foundation, in 1955 the typical family paid about 27 percent of its income in total taxes. Today, the typical family pays about 38 percent of its income in taxes—a 40 percent increase in the tax burden.

The Tax Foundation data reveal the key truth to why so many families feel as though two incomes are needed to do what one income accomplished a generation ago. While per capita income has doubled in the past generation, a majority of the higher income families have earned has gone to pay taxes.

Since 1955, 52 percent of the growth in wages for the typical single-earner family has gone to the government. For a two-earner family, 59 percent of the growth in wages has gone to pay higher taxes. The fact is, the second earner today works not to support the family, but to support the government.

But the tax code's anti-family bias doesn't stop there. The code often places a stiff cost on marriage through the so-called marriage penalty, under which people getting married face a tax increase. In addition, for years the value of the personal exemption, which includes the exemption for children, fell as inflation slowly but, over time, dramatically diminished the value of the personal exemption.

As you know, Mr. Chairman, most of the growth in the tax burden has come from higher payroll taxes and higher taxes at the state and local level. The only good news for families came in 1981. Were it not for President Reagan's 25 percent reduction in income tax rates and indexing of personal exemptions and the tax brackets to inflation, Americans would be paying significantly more in taxes than they do today.

Hinders Economic Opportunity

While the economy has been generally healthy, it is not growing at its potential because of a tax policy that is biased against work, saving, investment and entrepreneurial activity. In fact, recent growth has sparked fears of inflation. When Alan Greenspan raised interest rates last month, he was indicting our current tax code, which prevents our economy from sustaining robust growth levels. By placing multiple layers on saving, the tax code reduces the amount of investments in new machines and technology that make American workers more efficient and competitive. By favoring certain economic activities over others, the tax code distorts financial decisions and reduces economic efficiency.

According to a study by Jane Gravelle, an economist with the Congressional Research Service, and Larry Kotlikoff, an economist at Boston University, the corporate income tax costs the economy more in lost production than it raises in revenue for the Treasury. Dale Jorgenson, the chairman of the Economics Department at Harvard University, found that each extra dollar the government raises in revenue through the current system costs the economy $1.39.

Undermines Good Government

In 1956, then Senator John F. Kennedy said, "The lobbyists who speak for the various economic, commercial and other functional interests of this country serve a very useful purpose and have assumed an important role in the legislative process." Today, the lobbying industry is more than three times as large as it was when John Kennedy was President.

But as the government has grown and tax burdens and tax favoritism has proliferated, the lobbying industry has flourished. Today, the lobbying industry is the largest private sector employer in Washington. One out of every six private sector workers—62,072 people—work in the lobbying industry.

The lobbying industry generates $8.4 billion in revenue each year, making it larger than the entire economies of 57 countries. Data from the Clerk of the House show that more lobbyists work on taxes than any other issue. The lobbying industry is no longer as innocuous as in John Kennedy's day. As tax favoritism has increased, so has the number and influence of lobbyists. As I have said many times before, it is not healthy for our economy or our democracy that so much talent, energy and resources are diverted toward securing special consideration under the tax system.

THE FLAT TAX SOLUTION

Last month I introduced with Senator Shelby H.R. 1040, which would scrap the entire income tax code and replace it with a flat-rate income tax that treats all Americans the same. This plan would simplify the tax code, promote economic opportunity, and restore fairness and integrity to the tax system. The flat rate would be phased-in over a three-year period, with a 20 percent rate for the first two years and a 17 percent rate for subsequent years.

Individuals and businesses would pay the same rate. The plan eliminates all deductions and credits. The only income not subject to tax would be a generous personal exemption that every American would receive. For a family of four, the first $33,800 in income would be exempt from tax. There are no breaks for special interests. No loopholes for powerful lobbies. Just a simple tax system that treats every American the same.

WHAT A FLAT TAX MEANS FOR AMERICA

Simplicity

The flat tax replaces the current income tax code, with its maze of exemptions, loopholes, and targeted breaks, with a system so simple Americans could file their taxes on a postcard-size form. The Tax Foundation estimates that a flat tax would reduce compliance costs by 94 percent, saving taxpayers more than $100 billion in compliance costs each year.

Fairness

The flat tax will restore fairness to tax law by treating everyone the same. No matter how much money you make, what kind of business you're in, whether or not you have a lobbyist in Washington, you will be taxed at the same rate as every other taxpayer.

Prosperity

Because the flat tax treats all economic activity equally, it will promote greater economic efficiency and increased prosperity. When saving is no longer taxed twice, people will save and invest more, leading to higher productivity and greater take-home pay. When marginal tax rates are lower, people will work more, start more businesses and devote fewer resources to tax avoidance and evasion. And because tax rules will be uniform, people will base their financial decisions on common-sense economics, not arcane tax law.

As you know, Mr. Chairman, the Joint Committee on Taxation hosted a conference in January at which a broad group of economists forecasted the results of tax reform proposals. Every economist who attended reported that a flat tax would result in a larger economy. Economists affiliated with the Brookings Institution, Federal Reserve, CBO, Coopers & Lybrand, DRI/McGraw-Hill, Harvard University and others all found that a flat tax would lead to higher living standards. The unanimous finding of such a diverse group of economists shows that there is virtually no debate as to whether the flat tax would increase economic growth, but only by how much.

According to one study by a former chief economist for Congress' Joint Committee on Taxation, under the flat tax the economy would be 5.7 percent larger after five years than under the current system. That translates into $522 billion in higher output, or $3,000 in higher income for the typical family of four. Michael Boskin, a former chairman of the Council of Economic Advisors, estimates that the flat tax would increase the size of the economy by ten percent.

Lower Taxes

According to data by the U.S. Treasury Department, the bill would cut taxes by about $30 billion in the first year of enactment. When the rate is reduced to 17 percent in the third year of the proposal, there would be significant further tax reduction. The bill is carefully designed, however, to safeguard taxpayers against higher deficits. Rigid spending caps are included in the plan. Coupled with the additional economic growth the flat tax will spur, the tight spending controls will ensure that the budget reaches balance by 2002.

Progressivity

Under the flat tax, the more you earn, the more you pay. In fact, because of the high family exemption, the more a taxpayer earns, the greater the share of his income he pays in tax. A family of four earning $25,000 would owe no tax under the proposal. A family of four earning $50,000 would pay only six percent of its income in income taxes, while a family earning $200,000 would pay 14 percent.

Pro-Family

The flat tax eliminates the marriage penalty and nearly doubles the deduction for dependent children. By ending the multiple taxation of saving, the flat tax provides all Americans with the tax equivalent of an unlimited IRA. This will make it easier for families to save for a home, a family vacation, a college education for their children, or for their retirement years.

Pro-Taxpayer

The flat tax trusts average Americans by giving them the freedom to make their own economic decisions. In addition, the flat tax includes a special safeguard against higher taxes. It requires a three-fifths supermajority vote of Congress to raise the tax rate, lower the family allowance or add loopholes.

Honesty

By eliminating itemized deductions and special breaks, the flat tax would have a chilling effect on special-interest lobbying and transform the political culture in Washington. Under a simple, transparent system that taxes all income one time at one rate—and requires a supermajority vote to add a loophole—there will be far fewer lobbyists than under today's system. Instead of being divided into numerous special-interest groups, the flat tax will make every American equal under the tax code with a shared interest in lower rates and continued fairness.

Lower Interest Rates

According to a study by an economist at the Federal Reserve Bank of Kansas City, published in the Kansas City Federal Reserve's Economic Review, the flat tax would reduce interest rates by 25 percent, or about two percentage points. Lower interest rates under the flat tax will not only reduce the costs of student, car and credit card loans, they will also offset the loss of the home mortgage interest deduction. According to reports by the Congressional Research Service and the Tax Foundation, the flat tax will have no meaningful effect on home values.

Consider how a sharp reduction in interest rates would affect the average family that earns $50,000 and deducts $5,000 in mortgage interest. The home mortgage deduction saves this family $750 in taxes, where a 25 percent drop in interest rates saves it $1,250 in lower interest payments. That family is $500 better off under the flat tax with lower interest rates—even without the home mortgage interest deduction (and not counting the higher personal exemptions).

More to Give

As incomes rise under the flat tax, so too will donations to America's charities. Over the past several decades, increases in giving have closely tracked increases in personal income. This trend continued during the 1980s when, even as the tax value of the deduction declined and fewer taxpayers were able to take the charitable deduction, charitable giving increased. Because incomes will increase significantly under the flat tax, giving will rise in the long run as well, even without the charitable deduction.

I believe the flat tax would represent a tremendous step forward for American families. It would simplify the tax system, saving taxpayers countless hours and resources, freeing up time and money to meet more important family needs. A flat tax would also lead to increased prosperity and higher wages. Coupled with a tax cut, the higher incomes under the flat tax would significantly increase the take-home pay, allowing parents to meet the important needs of their family.

Perhaps most importantly, a flat tax would be true to our values. A tax system under which every American is treated the same and special-interest provisions are removed would do a lot to increase the American public's faith in their government.

Chairman ARCHER. Thank you, Mr. Majority Leader. Have you done your income tax for this year?

Mr. ARMEY. Yes, I have.

Chairman ARCHER. Because I was going to volunteer to help you work through the work table on how you lose your itemized deductions, in the event you needed any consultation or help.

Mr. ARMEY. Well, I'm going to go back and review that part, because I certainly don't want to suffer this embarrassment next year.

Chairman ARCHER. It's so typical of what we have in the Tax Code today, you're given something with one hand and it's taken away with the other hand. And we see that over and over in the Code.

You and I both agree that we need to do that. We need to do something about that and change it.

Could you tell the Committee what the maximum tax rate would be under your flat tax proposal?

Mr. ARMEY. If we were to implement the flat tax today, Mr. Chairman, we would start with a 20-percent rate. We would hold that rate for 2 years, and on the third year it would be lowered to 17 percent.

We believe that gives the growth effect of the flat tax time to work its way into the economy and allows us to move to the 17 percent and stay there indefinitely.

Chairman ARCHER. Do you have revenue estimates on your proposal? Will a 20-percent rate in the first 2 years duplicate the revenue from the current code?

Mr. ARMEY. I believe the 20-percent rate, given the family allowance at the level we have it, gets us within $30 billion of current revenue.

Chairman ARCHER. $30 billion?

Mr. ARMEY. $30 billion.

Chairman ARCHER. Per year. Because the comments that were made by Ms. Kennelly early on were that you would lose $138 billion in the first year.

Mr. ARMEY. My bill, as I've written it, does not score that way. I know a lot of people have raised their eyebrows about the $30 billion, but I have to tell you, Mr. Chairman, if I were to endorse revenue neutrality I would be endorsing spending at its current levels, and I believe spending must come down anyway, so the flat tax as I've written it would provide further incentive for that.

And we have written in there spending caps to see to it that we would not worsen the deficit.

Chairman ARCHER. I have just one last question. In the event that your proposal were considered by this Committee, and in the event that a majority on the Committee believed that it would be appropriate to add some limited number of deductions, like charitable contributions, or home mortgage interest, would you be able to support such a bill, as a final package?

Mr. ARMEY. One would never want to turn their back on it altogether. I would resist that. I believe that the way you get simplicity and you make it stick is that you eliminate the whole playing field for special exemptions and itemized deductions.

Once you've done that, then you've broken the Code. If you put in the homeowners' deduction, you've got now in place the first best reason to add charitable deductions. Once you have that in place, you've got two good first best reasons to do something, you're back in the same game.

If the Committee were to report a bill to the floor that reinstated in the new flat Tax Code these deductions—they would obviously have to adjust the rates to compensate for the revenue loss that would attend that—and I would petition the Rules Committee for the opportunity to offer an amendment in the form of a substitute that would give me a chance to have a vote on the flat tax written as I wrote it.

Chairman ARCHER. Well, you have just confirmed what you and I have privately talked about and confirmed my respect for you, in

that you believe that this should be a pure flat tax, and not be dolled up with any kind of additional deductions, no matter how appealing, nor be extended to tax dividends, interests, or what we might call unearned income. And I greatly respect you for that.

Mr. ARMEY. Let me just say, Mr. Chairman, that I developed this model while making a trip to New Hampshire, not as a candidate last year, where having read their license plates, I decided to say the motto is Stay Flat or Die. But if you want tax reform to stick, you better stick with it.

Chairman ARCHER. Ms. Kennelly.

Ms. KENNELLY. Thank you, Mr. Chairman. And I salute your mother for doing those tax returns. I think, though, probably the fact that she got a good high school education had as much to do with it as the simplicity of the Tax Code, and that's something we'd like to get back to.

Mr. Armey, I'm still interested in the $138 billion figure, because I know that last year we had a lot of trouble getting the cuts we were looking for to balance the budget. I think we have to be realistic.

I respect both of your opinions—the Chairman and the Majority Leader. But I have to say to you, though, that the American people have to understand very, very much up front that they could lose their home mortgage deduction and they have structured their finances based on that. They could lose other deductions, and that's why we have to make sure that the public understands.

But I am very interested in the charitable deduction. I come from a town, Hartford, that used to be well off. It's now on the list of the poorest cities in the United States of America, and I have met with people in the charitable world.

And they deal with the goodness of people's hearts constantly. As you mentioned, that's how people give to charity. But I have to tell you something, Mr. Majority Leader, a lot of it has had to do with the Tax Code.

And I would like you to explain once more what you just said, that when the tax rates go down the giving doubled, is that what you said?

Mr. ARMEY. Let me just relate, I believe the $138 billion figure you have comes from someone who scored me at 17 percent in the first year. I'm at 20 percent in the first year.

Ms. KENNELLY. Somebody at Treasury.

Mr. ARMEY. The home mortgage deduction is a worry to people, and what I have done, and people have done it by as many as 180,000 hits on the flat tax home page in a single month, when people try the current Tax Code with their home mortgage deduction and try the new Tax Code without it, more often than not they'll say I'd rather change.

In fact, I think in a recent poll, 54 percent of new mortgage holders said that for the other advantages they would get in a flat tax, they would happily give up their home mortgage deduction. That, I think, is quite manageable by education.

Now, the charitable thing, I think you have to rely on the empirical observation and some common sense. First of all, no intelligent, rational person is going to be willing to give $100 in order to gain a $33 reduction in their taxes.

So clearly they're not making charitable contributions for the tax advantage. They make the contribution out of their belief in the purpose at hand, and how much money they have available.

What we saw in the eighties, when the tax value of a charitable contribution was cut to one third of its prior level, we saw that in fact charitable contributions doubled nationwide in the eighties, and tripled for faith-based organizations.

Faith-based charities, I think, are perhaps more often more reliant on the smaller denomination gifts of low-income people and clearly as they had more they gave more.

Ms. KENNELLY. Mr. Majority Leader, I still think the jury is out on that mortgage interest question, and we're going to have to be discussing this more, but you and I both know that we don't have a simplified tax system yet. And no, someone doesn't give $100 to get $33. But when someone earns $50 million and they would rather give to a charitable institution than give to the government, other things come into play.

And so that's another area I think we have to continue to look at. I'm not arguing with you that the system is not too complicated. It's much too complicated. It's antiquated. So I'm not here saying we don't need tax simplification, we don't need more tax fairness. I just want to make sure that the American people know what they're getting into when they give up a progressive tax system.

Mr. ARMEY. I agree. They should. That's why I wrote the book. That's why I put it on the home page.

Ms. KENNELLY. I bought it.

Mr. ARMEY. And that's why I invite people, try it for yourself.

Ms. KENNELLY. Thank you, Mr. Chairman.

Chairman ARCHER. Thank you. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman. Thank you, Mr. Armey for your comments and the proposals you've put forward, because it does give us some interesting data to talk about.

My area of concern is that of small business, and how small businesses may be affected by either the consumption tax or by the flat tax. What have you determined or what have your studies shown a small business with profits between $75,000 and $150,000, how would they be affected? That seems to be a major concern of small businesses.

Mr. ARMEY. Mr. Collins, the first reaction I have is that under the flat tax we would expense inventory and capital expenditures. So obviously the simplicity of the Code shows up right away for a small business.

I have not worked out anything in particular, but the long and the short of it is that they would take any legitimate, necessary business expense, deduct that from gross earnings, and then pay the flat rate on the net earnings of the business, while they expense capital and inventory.

At this point, that's the best answer I can give you. I can't resist saying, by contrast, the small business organization in a flat tax world is not asked to be the tax collector for the State as a retailer, and they would hold no responsibility for any taxes other than their own, as opposed to a national sales tax, where they would be asked to collect taxes on behalf of the government.

Mr. COLLINS. But in contrast, a lot of small businesses do collect consumption tax on behalf of State government or local government. So that would be just adding one more entity line to the collection there.

But on the small business, and the difference seems to be, the concern is between the graduated tax rates on the smaller profits, versus the competitive edge that larger business may have with the flat tax. Now they will have the same flat tax rate as the larger business.

Mr. ARMEY. They would have the same rate. And obviously their business expenses are enumerated, but whether you're a small business or a large business, you must get to net earnings, and then you pay the same rate as anybody else.

The object of the flat tax is to tax each dollar earned in the country in a tax year irrespective of its source at exactly the same rate as every other dollar that's earned.

Mr. COLLINS. In the area of small business—and I've been in small business—I'm still a small business man. I've had some type of small business for 35 years. I know I don't look that old. But I have.

But, you know, with the incentives that are there for the small investor to take a risk, and with the graduated tax rates and then of course the competitive edge that a lot of people with the resources and wherewithal that are in bigger businesses trying to compete with, I have some concern, too, that the flat rate may impose a higher or larger tax liability on small business.

Now, one thing I do like is your loss carry forward, because I've suffered some of those years when I had some loss carry forward that would not have been beneficial to me.

Now, under the individual taxpayer under the flat tax, what are your deductions there?

Mr. ARMEY. Well, let me just again remind you that any time you have high marginal rates you punish success and you discourage people from growing. The rates being the same, people would have all the incentive in the world to grow.

If you file the flat tax as an individual, it's a very simple calculation. You take your personal or your family exemption. For a family of four it's $33,800. You deduct that from your gross earnings, you get then your adjusted gross earnings, you apply the flat rate of 17 percent times that. In two simple calculations you're out of there and you go on, and you don't need to have all of the IRS records to find out what your brother-in-law is paying. All you have to know is the size of his income, and the size of his family, and you can calculate his taxes, and know that he's paying the same as you, and therefore you feel like there's justice in the world.

Mr. COLLINS. Well, I can appreciate the simplicity. I am concerned that there may be a higher tax liability on small business, and that's one of the areas that I really want to focus in on.

I'm filing today. This is the first time. I told my brother, who is my CPA, that we're making history this year. I am actually filing on time. I will be sick at midnight tonight, but I'm still filing.

Mr. ARMEY. Well, I appreciate that, and you know, in the old days when you first started your business, it was easier to file on time.

Chairman ARCHER. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman. And thank you, Mr. Armey, for your testimony and also for the fact that you've been leading the charge with our Chairman on this whole issue of restructuring the Tax Code.

I'm interested in hearing your opinion on whether or not tax policy should have any affect on social policy. You know, our code obviously plays a large role in the development of social policy, everywhere from tax credits for low-income housing to myriad deductions, for home mortgage, charitable and life insurance and everything else.

Let me ask you specifically, though, there's a lot of momentum right now on the Senate side in terms of some of the sin taxes, and also trying to affect the way some of the cigarette companies are targeting our children, and especially women.

I mean, it's deplorable what I see Philip Morris doing right now in a campaign to go after the younger females in an ad campaign. I really struggle with it, and I really am frustrated.

I am not of the opinion right now though that the way to effect change is through tax policy, but a lot of people are jumping on that band wagon. How do you feel about the social policy aspect?

Mr. ARMEY. Well, as often I do, I take my instruction from Milton Friedman who once made the observation that once you set the rate everything else is social policy. I believe that the object of a Tax Code should be to raise that necessary revenue for the government in that manner which is the least meddlesome against the freedom of individuals.

I do not believe you ought to use the Tax Code in order to try to direct human action and human behavior in one way or another. Now, when you get down to the so called sin tax doctrine, that is, of course, a very heavy decision that carries with it a tone of morality, and often plays against some of our very heartfelt concerns, such as children and cigarette consumption, and so forth.

But in the end, we have discovered that the States and other areas tend to levy higher excise taxes in these areas of consumption precisely because they are price inelastic, that the principal motivation for the consumption is so compelling that they are hardly mitigated against by pecuniary influences.

So insofar as you say, for example, we're going to raise revenue and decrease smoking, you can't do both. It's going to be one or the other. And we have found that in many of these areas, there's just a lack of responsiveness.

Now there may be, and certainly must be things to address there, but I don't think that you—should I say, compromise the integrity of your Tax Code with respect to the question of neutrality in order to fulfill social objectives that might otherwise in fact be better fulfilled with other measures.

Mr. CHRISTENSEN. Thank you. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Jefferson.

Mr. JEFFERSON. Thank you, Mr. Chairman. Good morning, Mr. Armey. I want to ask you a question that I've run across in some of the studies that I have been provided which suggests that a totally flat rate, although it simplifies the Code, would involve a sub-

stantial shift of the tax burden from those in the highest income tax brackets to lower and middle income tax payers.

The flat rate would raise the share of taxes paid by low- and middle-income tax families, and sharply reduce the share of taxes paid by the wealthy. And the reason for it is that for those people who are characterized as the working poor, this eliminates the Earned Income Tax Credit or EITC.

Now, I recognize that you have a higher floor where your taxation would start, but still above the limit that you're dealing with, that presents something of a problem. Is your limit now $33,000?

Mr. ARMEY. $33,800 for a family of four.

Mr. JEFFERSON. OK. The other is with respect to the effect on Federal Insurance Contributions Act, FICA, on employer paid health policies, and on other employee benefits that an employer may now exempt. Am I correct in thinking there may be a problem with this shifting, or do you have another answer for it?

Mr. ARMEY. Any time you're examining any change in the Tax Code, the redistribution charts are always the most difficult thing to measure out. You can say that anybody today who files a standard deduction, irrespective of the size of their family and the number of dependents, is going to be better off in a flat tax world than they are in today's world by virtue of the lower rate and the higher relative family exemption.

Many people at the low-income bracket would find their loss of earned income tax credit compensated for by that gain. Insofar as they're not compensated, then if you're engaging in a program of income maintenance for the low income, we think that should be transferred to the spending side of the ledger, not to the taxing side of the ledger. It's just a value judgment we make.

We know that as many as 10 million low-income families, or low-income individuals will be taken off the tax rolls in the flat tax world by the analysis that's been made of it. And, finally, what we've seen is, for example, Ross Perot last year who only paid 9 percent of his income in taxes, under the flat tax he would pay 17 percent of his income.

If, in fact, as it is generally alleged, loopholes and exemptions are things that are most advantageous to the wealthy, then, of course, a Tax Code that eliminates them should have its greater impact on the wealthy. I believe the flat tax as I've written it is at least as fair as the current Tax Code relative to the question of progressivity, and I believe it is clearly more fair relative to a more widely held view of fairness, that fairness is when everyone is treated the same as everyone else.

And so I am perfectly willing to advance the flat tax as I've written it, on the fairness question, with great confidence that it holds up under scrutiny by individuals.

Mr. JEFFERSON. It appears that there is some question about it, because most of the loopholes, things we characterize as loopholes are really enjoyed by taxpayers who are not in the upper brackets, as it turns out.

Let me ask you one other thing, if I might. On the issue of shifting the way we characterize income, there's been a problem under previous codes that when you have a class of income that has a lower tax rate, or no tax rate, and it can be characterized from the

type of income that has a higher rate to that which has a lower. That's when the escaping of the tax liability takes place.

If you have a system where you have no income tax on capital gains, no capital gains tax, and no tax in a few other areas, but that taxes everything that comes in wages and salaries, won't that be a powerful incentive to mischaracterize or to recharacterize the title you put on the income source to avoid paying tax altogether? Won't we have more tax avoidance problems under something like that?

Mr. ARMEY. Frankly just quite the contrary. Since the rate applies the same to every dollar irrespective of the source, there would be no reason to say I got it from this source versus that source. What we do with capital gains taxation is very important. We do not double tax that income.

That income right now is doubled taxed at a very prejudicial rate. We would collect the taxes on capital earnings at the source in the same way as they are collected at their source now.

And I can give you a quick illustration. I have been filing my taxes with the IRS every year of my life since I was 16. I have never in all those years written a check to the IRS. The reason being my taxes were collected at the source, they were held on my account by the IRS, and at the end of the year I filed in such a way as to clean up my account with them, and they gave me, sometimes grudgingly, a refund of that extra money with no credit for interest earned during the time they were holding what is my savings.

Now, we're doing the same thing with investment earnings. We'll collect the tax at its source. We'll make the remittance at its source, but we won't ask you to suffer taxation on that same earnings a second time.

Mr. JEFFERSON. Thank you, Mr. Chairman.

Chairman ARCHER. Thank you. Dick, I understand that you've got an 11 o'clock appointment. Is that correct?

Mr. ARMEY. I imagine. I don't know.

Chairman ARCHER. Could you take two more questions before you have to leave?

Mr. ARMEY. Yes, I could.

Chairman ARCHER. Ms. Dunn.

Mr. ARMEY. As long as they're not too tough.

Ms. DUNN. I'll give you a couple of easy ones, Mr. Leader. Thank you, Mr. Chairman. I'm interested on behalf of the taxpayers in my district, and as a small business owner and the owner of a small family business in several areas.

And I am wondering if you could briefly tell us the effect of the flat tax, your flat tax with regards to what happens to the IRS, and estate taxes and savings.

Mr. ARMEY. The IRS, I think—there's been an analysis. I forget where it was done—that as much as 94 percent of the current compliance costs with the IRS would be eliminated under the flat tax. I would guess—and I know I've heard the Speaker talk about a goal of reducing the size of the IRS by 60 percent. I would guess the flat tax would more than fulfill that goal.

Now, obviously, you will always have an enforcement agency any time you have a Tax Code. The question is, if you have a minimal

code and a civilized code, can you have a minimal and a civilized IRS? I think you can accomplish that with a flat tax.

Ms. DUNN. And estate tax, and savings.

Mr. ARMEY. Under the flat tax, there is no estate tax. Again, we're trying to end double taxation. You should collect every dollar, gather every dollar into the tax base, tax it once in the year it's earned, and it should never be taxed the second time.

Savings, again, you paid taxes on your earnings in this year, you save them in any multiple number of ways, and you would not be taxed on that a second time.

Ms. DUNN. Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Portman.

Mr. PORTMAN. Just a quick question, Mr. Leader. First, thank you for being here today, and thank you for testifying before the Commission to Restructure the IRS. That was very helpful to us.

We spent, as you know, about the last year looking into the problems at the Internal Revenue Service, and there is a consensus now, I think it's fair to say, among our 17 Commissioners, including Senator Kerry and myself, who are the cochairs, that until you simplify the Tax Code, you're really not going to be able to ultimately improve the IRS in the way all of us would like to see.

As long as you have the current Tax Code, it will be very difficult to administer it. That being said, there are things we should do with the IRS to make it work better, and we appreciate your testimony on that, and your giving us some pointers on simplification.

One of the concerns that we have focused on with this commission is the EITC, and the degree to which that causes problems of administration at the IRS. Of course, there's a good deal of fraud with the program as well. And in our interviews with over 300 online IRS employees, the EITC came up time and time again as a problematic part of what they have to do.

In response to the question of Mr. Jefferson, you talked about the fact that with a more generous exemption, up to, I think, $33,800, you wouldn't be having an EITC. There wouldn't be the process of taxpayers filing and receiving a refund.

But that doesn't pick up everybody among the working poor. And you mentioned on the spending side addressing it. Is your thought that the tax system might not be the best place to address some of those problems, but rather you'd do it in terms of new spending from Congress? How do you respond to that?

Mr. ARMEY. That is my thought. I mean, we're basically making a decision that we have certain levels of income, given certain family sizes and so forth, that are insufficient to achieve an acceptable level of living for that family, and that we want to supplement that family's income.

Now, there are two ways you can do that. You can either do it directly through the expenditure way, which I think is the more clear, direct and honest way to do it, or you can do it through the Tax Code. We tried that with the EITC, and I think one of the heartbreaking things about our effort to work that way is the fact that it's resulted in an enormous amount of fraud, and has driven up the compliance frustrations of the agency enormously.

But it's also fed a certain cynicism among the taxpayers. When, you know, people frankly don't need to read your tax forms, like

the IRS has been doing quite frankly illegitimately, but they know, the word goes through a community that somebody is getting away with something, and there's a resentment from that.

Either somebody resents it or they mimic it. And when those things happen I think that creates a cynicism throughout the country. We pride ourselves with the concept of a voluntary tax system. I think if you're going to have a system of voluntary compliance, people are going to have to believe it's simple, it's fair, it's honest, and nobody has an opportunity to game it.

And if I don't believe somebody else is doing it, then I will restrain myself from doing it. But once you allow that cynicism to creep in, I think you have a self-defeating process.

Mr. PORTMAN. Thank you. Thank you, Mr. Chairman.

Chairman ARCHER. Dick, one last question, and then we will release you. Mr. Hayworth.

Mr. HAYWORTH. I thank the Chairman, and the Leader. Thanks for coming by to see us today, and I appreciate this preview of the great debate that will take place in terms of tax reform.

You touched earlier on a subject of great concern to me, especially on April 15, in your response to the question from our colleague from Washington State, in terms of the flat tax and its impact on the IRS.

One of the stated goals of the new majority in Congress is to end the IRS as we know it. Indeed, Chairman Kasich of the Budget Committee this weekend on national television talked about abolishing the Internal Revenue Service as it exists today.

And while you offered a projection that seemed to align with the estimation of the Speaker, in terms of reducing the size of the Internal Revenue Service by some 60 percent, or perhaps in excess of that, one of the criticisms of the flat tax I am hearing is that perhaps it would not alter the role of the IRS enough in terms of its intrusive nature.

Indeed, some of the work done by Raymond Keating of the Center for Small Business Survival as reported in the Journal of the Foundation for Economic Education, talked about the institution of the income tax and how it has grown to this leviathan stature in our society.

What safeguards should we take if we end up with a flat tax to in fact make sure that the system does not grow back again at some future date for future generations?

Mr. ARMEY. I think it goes back, frankly, to the question asked earlier by Chairman Archer. It seems to me you have to write the flat tax with enormous discipline. I mean, make it as simple as you can make it. And I think we've done that. And then stick by your guns. Resist all the temptations.

Ninety-nine percent of all the enemies of the flat tax make their living in Washington, DC. A great many of them are tax lobbyists, and they make their living making it more complex.

And so somebody is going to have to be stubborn about this. I am stubborn about it, because I think you have to be.

Then you have to write in safeguards. For example, we said it takes a three fifths vote in either house to either raise the rate, reduce the family exemption, restore any itemized deductions, or create multiple rates.

Now, no Congress can completely protect America from a future Congress. But you can write in those safeguards that will make it as difficult as can be. And I think anybody, whether it be my plan or any other plan, that got enacted into law, you would have to have those safeguards in place.

Trust me on this: you can write a national sales tax, and if you don't have that discipline, vigilance, it, too, can grow into the same kind of horrible monstrosity that we have today.

Any Tax Code can grow that way unless you put in the discipline at its outset, and then the safeguards against easy change.

Mr. HAYWORTH. I thank the Leader. And that certainly points up the importance of today's vote later, when we talk about a two-thirds majority needed to increase taxes.

Again, thank you, Mr. Leader. And I thank the Chairman.

Mr. ARMEY. Thank you.

Chairman ARCHER. Thank you, Mr. Armey.

Mr. ARMEY. Thank you, Mr. Chairman.

Chairman ARCHER. I told you that you would have a warm reception, and I think that you have left unscathed.

Mr. ARMEY. I thought you were referring to the hot seat. I do appreciate it. Thank you all.

Chairman ARCHER. Our next witnesses are in a panel. Messrs. Steuerle, Hubbard, Dr. Asmus, Dr. Sullivan, Mr. Mitchell and Mr. Dannenfelser. If you could come to the witness table please.

Welcome, gentlemen. Most of you, I'm sure, are aware of the rules of the Committee, that we're going ask you to limit your oral testimony to 5 minutes, and the little lights there will tell you how you're proceeding.

The yellow light comes on, that means you have 1 minute left, and the red light means, as is always the case in our society, stop.

Your entire printed statements, without objection, will be inserted in the record. And we're most pleased to have you with us this morning, and, Mr. Steuerle, if you would lead off, we'd be pleased to receive your testimony. If you would each identify yourselves for the record, then you may get into your oral testimony.

Mr. Steuerle.

STATEMENT OF C. EUGENE STEUERLE, SENIOR FELLOW, URBAN INSTITUTE

Mr. STEUERLE. Good morning. Thank you, Mr. Chairman. My name is Gene Steuerle, and I'm a senior fellow at the Urban Institute here in Washington, DC.

When it comes to tax reform, family issues are often among the last to be considered. In practice, however, these issues often dominate the revenue adjustments that might be required in moving to any different type of system.

I should indicate, by the way, that my testimony deals primarily with family issues defined as those adjustments that are required according to such things as family size and the distribution of income and resources within the family.

Having served as economic coordinator of the Treasury's 1984 to 1986 tax reform effort, I can warn anyone trying to redesign tax reform that these types of family issues at times will drive the process, if for no other reason than that so much money is involved.

Now, many provisions of the current Federal income tax are specifically designed to take into account the economic circumstances of the family. My testimony deals with the dependency exemption, a child credit such as proposed by both political parties, but not enacted; the earned income credit; the child dependent care credit; the so-called kiddie tax; the standard deduction; the special rate schedule for heads of household; marital income splitting, and the treatment of alimony and child support.

All of these are the family type issues which I am going to try to deal with briefly. However, I will speak only to the first three of these issues, given the time constraint, and the rest of the issues are discussed in my testimony.

Over the 48-year period from 1948 to 1996, the dependency exemption has grown four fold. During that same period, however, per capita personal income has grown sixteen fold. As a consequence, the dependency exemption fell from about 42 percent of per capita personal income in 1948 to less than 11 percent by 1996.

The dependency exemption for 1996 would need to be set at about $10,000 for it to represent the same percentage of per capita income as it represented in 1948. If converted to a credit that offset taxes, the exemption would need to be about $1,500 per child.

This decline in the dependency exemption, along with increases in Social Security taxes, has increased the tax burden of families with children relative to almost all other taxpayers. It is one of the major reasons for consideration today of a child credit.

Now, a child credit is a possible alternative mechanism for delivering tax relief to families with dependent children. And although both political parties have proposed such child credits, none has been enacted to date.

Significant simplification gains are possible if tax relief for dependent children is provided through one mechanism rather than several. A credit mechanism that combined the benefits of an earned income credit and the dependency exemption could be coordinated better also with rules for phasing out welfare benefits.

Congress may also have a very unique opportunity today to link some unified child credit with a requirement that a credit is available only to families who purchase health insurance for their children. That is, in one combined effort, Congress could partially reverse the historic trend toward increasing the relative tax burden on families with children, could reduce dramatically the lack of health insurance among children and among some adults as well, and reduce some of the very high implicit tax rates on those who decide not to go on welfare in the first place.

Proponents of any type of tax reform have a major difficult issue to deal with when dealing with the earned income credit, some of which came up in the previous questions and answers. For example, it is impossible to remove many low-income families from filing returns as long as the earned income credit is designed in its current form.

For those who favor many types of consumption taxes, the earned income credit also affects dramatically the simplification gains they hope to achieve because the earned income credit is necessarily income based, that is, it's phased out for high income indi-

viduals on the basis of their income, not on the basis of their wages or consumption.

The problem is not solved by making the issue of relief for low-income workers a problem for the welfare system, because those systems also contain implicit income taxes that require income reporting.

My testimony today had dealt with the many family sensitive issues that must be dealt with in major tax reform. Several of these issues affect large numbers of taxpayers and affects significant amounts of revenues. While certain types of reform efforts technically may be beyond an income tax, you really cannot bypass these family issues.

Thus, earned income credits and welfare programs have income phase outs that operate like income taxes, even in the presence of a consumption tax. And a consumption tax, or a value-added tax or retail sales tax that did not allow for a child care deduction, a decision would still have to be made as to whether child care expenses will be taxable as consumption services.

Some divorce settlements would have to be renegotiated under any major tax reform, even though they might be based on an allocation of tax benefits under former law.

Of all the issues I've raised, perhaps the largest and the most important are those that relate to the way the tax system adjusts for the presence of children through tax credits, dependent exemptions and the earned income credit.

Recent bipartisan support for child credits, and the push for tax reform create a unique opportunity to lessen the increasing reliance of our tax system on families with children, to expand significantly health insurance for children, and at the same time to reduce the extraordinarily high tax rates and marriage penalties on many low-income individuals. Thank you.

[The prepared statement follows:]

Statement of C. Eugene Steuerle, Senior Fellow, The Urban Institute

Any opinions expressed herein are solely the author's and should not be attributed to The Urban Institute, its officers or funders.

The family is the primary social structure in the United States for nurturing, raising and paying for the needs of children. Support for families, however, has long been an expressed policy goal of both major U.S. political parties. Whether U.S. tax policy—as opposed to expenditure policy—should be designed specifically to benefit families is an issue of legitimate debate. In a recent article with Professor Michael McIntyre of Wright State University, we subscribed to the traditional view that a personal tax system should be designed primarily to distribute tax burdens in a way that is fair to all individuals, irrespective of their family circumstances. At the same time we concluded that a tax system cannot be fair to individuals unless it takes into account the differences in ability to pay that result from the way that resources are shared within families of different sizes and types.

When it comes to tax reform, "family" issues are often among the last to be considered. In practice, however, these issues often dominate the revenue adjustments that might be required in moving to any different type of system. Having served as the Economic Coordinator for the Treasury Department's 1984 to 1986 tax reform effort, I can warn anyone trying to redesign the tax system that "family" issues at times will drive the process if for no other reason than that so much money is at stake. Congress' recent debate over a child credit demonstrates just how expensive changes here can be. One reason is that decisions over how to treat children or spouses in the tax Code typically involve millions, tens of millions, or even hundreds of millions of people. A change of $500 for 50 million taxpayers, for instance, might require that $25 billion in tax liabilities be shifted annually. By way of contrast, most other reform issues involve far smaller numbers of taxpayers.

Many provisions of the current federal income tax are specifically designed to take into account the economic circumstances of the family. Examples of some family-sensitive tax issues follow:

- the dependency exemption;
- a child credit (proposed by both major political parties, but not enacted);
- the earned income tax credit;
- the child and dependent care credit; the "kiddie" tax;
- the standard deduction and tax-free levels of income that vary in amount for different types of households;
- the special rate schedule for heads of households;
- marital income splitting and the rate schedule for single taxpayers; and
- the deduction for alimony payments and the nondeductibility of child support payments.

Obviously, all tax issues affect the family in some manner or another. For instance, the home mortgage interest deduction and the charitable contributions deduction affect families in different ways. However, I will confine my discussion today mainly to those issues where adjustments in tax burden are made according to the size of the family—in particular, the presence of children.

One major source of complication must be admitted up front. Current tax law includes several measures designed to benefit low-income families. Some of these measures are defended on tax policy grounds, whereas others are defended on spending policy grounds. A major objective of family taxation reform—indeed, one that has become unavoidable—should be to coordinate the tax measures that are designed to benefit low-income families with children with the various direct expenditure programs targeted at such families. Indeed, as I will demonstrate, tax administration often requires this coordination whether we desire it or not.

A. Dependency Exemption

The dependency exemption is a major mechanism for adjusting tax burdens for the costs of supporting children and is the only mechanism that provides tax benefits to all middle-income families with dependent children. The dependency exemption for 1996 was $2,550 per dependent child. Since 1987, it has been phased out for high-income taxpayers. For tax year 1994, taxpayers claimed a total of approximately 70 million dependency exemptions.

Few changes in federal income tax laws over the past four decades have had as far-reaching effects on the distribution of federal tax burdens as the shift in the relative tax burdens from taxpayers without dependent children to taxpayers with dependent children. The increase in relative tax burdens has been particularly marked for middle-income taxpayers with children.

The increase in relative burdens on families with dependent children did not occur because policymakers, after careful study, concluded that parents with dependent children were being taxed too lightly. Instead, it happened primarily because the chief mechanism for granting tax relief to families with dependent children—the dependency exemption—was not adjusted sufficiently to keep up with economic growth.

Over the 48-year period from 1948 to 1996, the dependency exemption has grown from $600 to $2,550—slightly more than a four-fold increase. During that same period, per capita personal income has grown from $1,425 to $23,882, which is more than a sixteen-fold increase. As a consequence of economic growth, the dependency exemption fell from about 42 percent of per capita personal income in 1948 to less than 11 percent by 1996.

The dependency exemption for 1996 would need to be set at approximately $10,000 for it to represent the same percentage of per capita income as it represented in 1948 (Figure 1). Simply to adjust the dependency exemption for post-1948 inflation would require that it be increased to nearly $4,000. If converted to a credit that offset taxes, the exemption would need to equal $1,500 or more per child to reduce taxes for the same proportion of income as in 1948.

This decline in the dependency exemption, along with increases in Social Security taxes, has increased the tax burden of families with children relative to almost all other taxpayers and is one of the major reasons today for the consideration of a child credit.

B. Tax Credit for Dependent Children (Child Credit)

A child dependency credit, generally referred to as a child credit, is a possible alternative mechanism for delivering tax relief to parents with dependent children. The credit might be a fixed amount per dependent child, or the amount of the credit might vary with family size. It could be fixed in amount at all income levels; some

would phase out at middle-or high-income levels, although phase outs by their very nature involve implicit rather than explicit tax rates. Although both political parties have proposed child credits, most major reform proposals do not deal with this issue.

Significant simplification gains are possible if tax relief to families with dependent children is provided through one mechanism that integrates the benefits of current law and any new benefits that policymakers are prepared to give to families with dependent children. Under current law, relief is now targeted at families with children through the dependency exemption and, for low-income families, through the earned income tax credit (EITC). Adding a third relief mechanism with a different set of eligibility rules appears needlessly complex. Nonetheless, rolling two and perhaps all three mechanisms into a single mechanism would require some changes in policy—for example, a uniform definition of "dependent" would probably be required. Such changes may create some additional winners and losers in order to achieve gains in administrative economy.

In tax theory, there is no strong case in favor of a credit over a deduction or vice-versa. Indeed, as a technical matter, for families of one size but different incomes, it is possible to develop a credit-based system that would replicate exactly an exemption-based system. Assuming the continuation of the EITC and the commitment of the nation to provide minimal levels of support to many low-income individuals, the use of a unified credit would seem to be the preferred approach. In addition, a credit mechanism that combined the benefits of the EITC and the dependency exemption could be coordinated better with various rules for phasing out welfare benefits than is possible under current law.

Finally, I have also suggested that Congress may have a unique opportunity today to link some unified child credit with a requirement that the credit is only available to families that purchase health insurance for their children. In one combined effort, Congress could partiality reverse the historical trend toward increasing the relative tax burden placed on families with children, reduce dramatically the lack of health insurance among children (and among some adults as well), and reduce some of the high implicit tax rates imposed on those who decide not to take welfare or who move off of welfare.

C. Earned Income Tax Credit

Current law provides low-income workers with a refundable tax credit—that is, besides reducing the tax liability for low-income families, the government sends a check to the taxpayer for any amount by which the allowable credit exceeds that taxpayer's liability for taxes payable on his or her income tax return. This earned income tax credit (EITC) provides significant benefits to low-income families with dependent children and more limited relief to other low-income individuals. Taxpayers with income over specified income thresholds are not eligible for the EITC.

The EITC began as a limited program in 1975 during the Ford administration and has been expanded several times since then, with large increases enacted in 1986, 1990, and 1993 and some modest adjustments in 1996. The 1993 additions were only scheduled to become fully effective in 1996. Most of the credits represent amounts refunded to households.

Historically, the EITC has been promoted as a useful mechanism for lowering income taxes and offsetting FICA (Social Security) taxes for low-income individuals with dependent children; for some it also offset the work disincentives associated with welfare. Both of these goals continue to be invoked to justify the EITC. Today, the EITC probably should be considered primarily as an extension of a combined welfare/tax system. That is, it has important tax and welfare features that to some extent are inseparable.

Proponents of many types of tax reform have many difficult issues to face with the EITC. For example, it is impossible to remove most low-income families from filing returns as long as the EITC is designed in its current fashion. For those who favor many types of consumption taxes, the EITC also affects the simplification gains that they hope to achieve by eliminating requirements to measure capital income for tax purposes. The EITC is necessarily income-based, unless high-income individuals with low wages or low levels of consumption are to be made eligible for the EITC. To administer the EITC, therefore, the tax authorities must obtain substantial information about the capital income of prospective recipients of the EITC. A similar constraint applies to welfare authorities administering Food Stamps, Supplemental Security Income, and other programs. The problem is not solved by making the issue of relief for low-income workers a problem for the welfare system. Those systems contain implicit income taxes that affect millions. Meanwhile, businesses, banks, and other institutions would still need to perform income reporting even if the main body of the income tax were converted to a consumption tax.

Revision of the EITC is likely to be a topic on the public agenda for some time, whatever the political fate of the major reform plans. The EITC has received political support from many sources, including, at various times, from the leadership of the two major political parties. In my view, it represents an intermediate step as the nation searches for a way to convert welfare into work support. It has been favored both because of the work incentives that it provides compared to welfare, as well as the relief that it delivers to low-income families. Some supporters have seen it as a politically viable alternative to an increase in the minimum wage. The EITC, however, has also received criticisms from a range of sources, partly because of problems with its implementation and partly because it is not well integrated with income-tested welfare programs. Congress and the IRS have attempted to deal with the problem of ineligible participants receiving the credit by reforming eligibility criteria and by checking more closely with taxpayers over the existence of dependents. Error rates, however, remain very high.

An additional problem in the EITC remains to be addressed: the ability of taxpayers to overdeclare income to receive higher credit amounts. This problem, which I have labeled the "superterranean economy" (as opposed to the underreporting of income in the subterrranean economy), does not require cheating. Two neighbors could baby-sit for each other and generate significant EITCs as a consequence.

Coordination of Tax Provisions with Implicit Taxes Embedded in Welfare Programs.

I recognize that your focus today is on tax reform, while a focus on family issues keeps pulling us toward discussion of transfer programs as well. For low and moderate income individuals, however, tax and transfer issues simply can no longer be separated. An important objective of public policy, whether characterized as tax policy or welfare policy, should be to substantially reduce the high marginal "tax" rates that low income individuals typically face when they attempt to enter the workforce or the effective tax rates that low income workers face simply by choosing never to go on welfare. A reduction in those rates presumably would discourage long-term dependence on welfare. It would also reduce the extent to which low-income workers perceive that they are being treated unfairly.

Figure 2 shows the combined tax rates derived from tax and welfare programs just before the enactment of welfare reform—although it is doubtful that these rates have changed much since then. In effect, welfare recipients who worked faced combined tax rates of 70 percent not just when they went to work at minimum wage but all the way up toward three times the minimum wage (the effective marginal rate on additional work is often even higher than this "average" rate on all earnings). At one to three times minimum wage for a full-time worker, few individuals receive much in what is commonly thought of as welfare: AFDC or its replacement, TANF (Temporary Assistance to Needy Families). The high tax rates at those income levels derive from federal income tax, phase out of the EITC, state income tax, phase out of housing benefits for those who receive them, phase out of Food Stamps, and phase out of eligibility for Medicaid. All phase outs, remember, basically take away benefits as income increases. Avoidance of such poverty traps should be an important, long-term, objective of any major tax reform.

In addition to the large tax rates on work, marriage penalties are enormous for low-income individuals. For a typical welfare recipient who married someone with a modest paying job, their combined income would fall by an additional 30 percent or so just from marriage alone. Many marriage penalties are caused by welfare, but some are in the tax code itself due to the earned income tax credit and the standard deduction. Thus, another potential advantage of a unified approach to tax and welfare issues is the opportunity provided for reducing marriage penalties. Although, as discussed later, there are also marriage penalties for higher income individuals due to the rate structure, but these are smaller relative to income than those faced by low income individuals.

Let me return briefly to how a child credit provides a means of linking together these concerns between the welfare system and the tax system. Just as a welfare payment operates as a refundable tax credit that is phased out as income increases, so also a child credit could be designed to be there when the welfare payment was no longer available. Once the credit is fully phased in, it can be allowed to remain constant throughout the low-and middle-income ranges, thereby avoiding the implicit taxes that result under current law from the phase-out of the EITC or welfare credits.

In effect, a child credit can be explicitly designed to reduce, although not eliminate, some of the poverty traps and marriage penalties faced by low income individuals. As far as I can tell, none of the major tax reform proposals on the national agenda attempt to address the poverty traps created by the interplay of tax and wel-

fare policies. Several of them attempt to replicate the distribution of taxes at low-income levels and simply to leave these issues to another time and place.

D. Child-Care Credit

Parents with one or more children under age 13 may claim a tax credit under current law for a portion of the expenses for child care and household services that they incur in pursuing gainful employment outside the home. The allowable credit is a percentage (30 percent at low-income levels, phased down to 20 percent) of qualifying expenses. Qualifying expenses are capped at $2,400 (one qualifying dependent) or at $4,800 (two or more qualifying dependents). In the case of a two-job married couple, the expenses eligible for the credit generally cannot exceed the income of the lower-earner spouse. Taxpayers claiming the credit must provide the Internal Revenue Service with the name, address, and taxpayer identification number of their provider.

A deduction for child-care expenses was introduced in 1954, during the Eisenhower administration, primarily as a mechanism for encouraging mothers on welfare to work outside the home. The deduction was capped at $600 and was phased out at rather low income levels. The allowance has been expanded several times and was converted into a credit in 1976. The child-care credit was claimed in 1995 by just over 6 million taxpayers for total credits of under $3 billion. For a taxpayer with adjusted gross income of $10,000 or less and two qualifying dependents, the maximum credit is $1,440. The maximum credit is $960 for parents with income of $30,000 or more.

The case for repeal on efficiency grounds is at best mixed. An initial and continuing purpose of a child-care allowance has been to mitigate the tax and welfare disincentives that some parents face in taking a job in the labor market. The efficiency problem arises if the tax system tries to be neutral between child care provided in the home and child care provided outside of the home. The current credit generally favors child care outside of the home for those with low and middle incomes, but favors child care in the home for taxpayers with above average incomes. Eliminating any adjustment for child care clearly would favor child care in the home, as can be seen most readily by examining the circumstances of a single parent who must obtain child care in order to work. Maintaining an adjustment, on the other hand, would cause some modest increase in the tax rate, which could have some efficiency costs.

The case for a child-care allowance on fairness grounds also is mixed. One argument for a child-care allowance is that it constitutes a legitimate cost of earning income and ought to be deductible in a tax system seeking to measure net income (or net consumption). Those arguing that child-care expenses constitute a business cost can show that the costs of child care are closely analogous to certain expenses, such as the costs of travel away from home, that are deductible as a cost of earning income. On the other hand, those costs are also analogous to certain other expenses, such as the cost of most types of personal clothing, that are not deductible, notwithstanding a close relationship to business. Because child-care costs arise from the quintessentially personal decision to have and raise children, a case for the deduction on business-expense grounds can never be conclusively made.

As a practical matter, I believe that some adjustment is appropriate but needs to be limited and kept simple. Nonetheless, any reform proposal that attempts to eliminate filing requirements cannot maintain a child care credit or deduction unless these could be channeled directly through employers.

E. Kiddie Tax

Under current law, as amended in 1986, children under the age of 14 are taxable on their unearned income at the marginal tax rate of their parents. This rule is popularly, if inexactly, referred to as the "kiddie tax." Its point is to prevent parents from avoiding the bite of the graduated rate structure by shifting investment income to their children. Its initial purpose was to simplify tax planning costs. Its adoption, indeed, did reduce the tax planning benefits obtaining from establishing certain family trusts, thereby reducing the complexity for the taxpayer and the tax authorities that is associated with such tax planning. Earned income—e.g., income that children earn from babysitting or delivering newspapers—is not subject to the kiddie tax rule. Nonetheless, in 1986 Congress went much further than the initial "kiddie tax" goals when it dramatically reduced or eliminated the personal exemption for children with earnings who were also claimed by their parents. This created much additional filing complexity and a significant increase in children required to file. Simplification requires a restoration of something like an additional personal

exemption for children, even though on strict equity grounds some children would thereby generate more personal exemption than others.

F. The Standard Deduction and Tax Free Levels of Income

The tax-free level under current law is determined by two mechanisms: the taxpayer exemption and the standard deduction. For 1996, the taxpayer exemption was set at $2,550. This is the same amount as the dependency deduction. These personal exemptions were set at $2,000 after the phase-in of the 1986 tax act (1989) and have been adjusted upwards for inflation since then.

Each type of filing unit has its own standard deduction level. For married couples in 1996 it was $6,700 for a per capita standard deduction of $3,350. Heads of household received a standard deduction of $5,900, while single individuals could claim a standard deduction of $4,000. Relative to being single, the standard deduction creates a modest marriage penalty for many moderate income couples typically amounting to $195 in extra tax liability.

Personal exemptions, on the other hand, are of equal size for all persons. Together with the standard deduction they provide for a tax-free level of income of $6,550 for a single individual, $8,450 for a head of household, and $5,900 for each member of a couple (Table 1). Excluding the earned income tax credit (EITC), most reform proposals would increase this tax exempt amount. Only flat and retail sales tax proposals usually remove marriage penalties from this source, although there is no reason that other reforms could not also achieve that goal.

Table 1

Family-Sensitive Provisions Relating to Marital Status of Parent: Current Law, Flat Tax, USA Tax and 10-Percent Tax

Features of Tax Regimes	Current Law (1996)	Flat Tax (wage tax component)	USA Tax (personal tax component)	10-Percent Tax
Tax-exempt amounts for adult individuals:				
married (per capita)	$5,900	$10,700*	$6,250	$6,925
single	6,550	10,700	6,550	7,750
head of household	8,450	14,000*	7,950	10,100
Total Exempt amount, 2-parent family of four (husband, wife, 2 children)	16,900	31,400*	17,600	19,350
Total exampt amount, 1-parent family of three (parent, 2 children)	13,550	24,000*	13,050	15,600
Marriage penalty from rate structure	yes	no	yes	yes
Marriage penalty from exemptions	yes	no	yes	yes
Alimony deduction	yes	no	yes	yes
Child-support deduction	no	no	yes	no

*Exemption does not appy to in-kind fringe benefits or employer share of FICA payroll tax, although both are fully taxable under business tax.

NOTE: The tax-exempt amounts do not include the amounts that would be exempt to low-income familes on account of the earned income tax credit.

Source: Michael J. McIntyre and C. Eugene Steuerle, Federal Tax Reform: A Family Perspective (1996, p. 44).

G. The Head of Household Schedule

The head-of-household schedule was introduced into the tax code in 1951. Its purpose was to extend to one-parent families some portion of the tax benefits that two-parent families received under the marital income splitting regime adopted nationally in 1948. Under that regime, marital partners were allowed to report one-half of the total income of their marital partnership on the same rate schedule used by single individuals. In contrast to the head of household schedule, the benefits of marital income splitting were available to all marital couples, whether or not they had dependent children.

The purpose of the head-of-household schedule is to take account of the differences in ability to pay of heads of households relative to equal-income single individuals due to the difference in their support obligations. In effect, the head of a one-parent family is allowed to split income with a dependent child, with the child's portion of the parent's income being taxed at a low or zero rate. The head-of-household schedule operates like a dependency exemption that increases in value with increases n the total income level of the one-parent family.

The special rate schedule for one-parent families creates the potential for marriage penalty because a husband and wife with children could reduce their taxes under current law by getting a divorce, using the deduction for alimony to equalize their individual incomes, and then having one former spouse file as a head of household and the other spouse file as a single person. The former spouses cannot both file as a head of household under current law and still live together, because a head of household is defined as a person providing more than half of the cost of maintaining the household. It does not appear that significant numbers of married couples have availed themselves of this tax-avoidance opportunity.

Heads of household bore significantly higher tax burdens because of the decline in dependent exemptions noted above. If child allowances were raised significantly, this would reduce the need for a separate head of household rate schedule.

H. Marital Income Splitting

The modern history of the current federal system of marital taxation begins in 1948, when Congress adopted marital income splitting as a conscious federal policy. Before the 1948 reform, federal family taxation policy was in disarray.

In a tax system that provides for full marital income splitting, each spouse is taxable as an individual on one-half of the total income of their marital partnership. Such a system is not designed primarily to benefit dependent children. It is available, after all, to childless couples and to couples with adult children no longer dependent on their parents. Its purpose is to tax each spouse on that share of the total income of their marital partnership that is used to enhance their material well-being. It can be viewed as implementing the traditional income tax policy goal of relating the burdens of taxation to the consumption and net savings of individual taxpayers.

In 1969, Congress adopted a special tax rate for single individuals that guaranteed that they would pay no more than 120 percent of the tax imposed on marital partners having the same aggregate income. This 120-percent rule reflected a political compromise between those who contended that equal-income marital couples should bear equal taxes and those who contended that individuals with equal income or equal earnings should pay equal taxes notwithstanding differences in their marital status. The revenue cost of introducing the "singles" rate schedule was modest—on the order of $200 million per year in forgone revenue. Despite the low cost, the implications of this change for federal tax policy were very large, for reasons explained below.

Under the system adopted in 1969, marital partners became taxable on their aggregate incomes as a unit, under a rate schedule with brackets exactly twice as wide as the brackets under the rate schedule of prior law. The tax brackets on the marital unit schedule, however, were less than twice as wide as the brackets on the newly created schedule for single persons. The effect was that two marital partners having approximately equal separate incomes would pay less in tax if they were allowed to file separate tax returns and to compute their separate tax liabilities on the new singles schedule. The only way to do so, however, was to terminate their marriage. The tax savings that marital partners could obtain from getting a divorce and filing separately came to be called a "tax on marriage" or a "marriage penalty."

Congress has adopted legislation from time to time to reduce the marriage penalties created by the 1969 act. Other legislation, unfortunately, has increased those penalties. Marriage penalties were reduced sharply under the 1986 tax act, due to the flattening of the rate structure and the introduction of fuller income splitting at middle-income levels. Marriage penalties were increased significantly by the way that the 1993 tax act increased tax rates for high-income individuals. No changes have been made in the basic system of multiple graduated rate schedules introduced in 1969, which necessarily produces marriage penalties. Plans that attempt to replicate the existing distribution of tax burdens, such as the USA plan and Gephardt 10-percent tax, tend to continue that basic structure.

A perfectly flat tax would eliminate all marriage penalties created by the graduated structure. This approach, combined with the equal per capita standard deductions provided to single and married persons, would eliminate almost all marriage penalties created by the rate structure, although not—as mentioned above—the very large penalties due to welfare and EITC type of provisions. To eliminate marriage penalties, one also needs to eliminate phase-outs such as the phase out of itemized deductions and the personal exemption phase out.

I. Alimony and Child Support Payments

Under current law, alimony is deductible to the payor and taxable to the recipient. The effect of this arrangement is to extend some degree of income splitting to

formerly married individuals. Thus, the treatment of current law is consistent with the income splitting approach to family taxation.

In the typical case, alimony flows from the higher-earner taxpayer to the lower-earner taxpayer. In a tax system having graduated rates, therefore, taxing the recipient of alimony rather than the payor results in a net reduction in the aggregate tax burdens of the two former spouses. If the tax savings to the payor and the tax detriment to the recipient are properly taken into account in setting the level of the alimony payments, the alimony recipient should obtain a net benefit from having been made taxable on the alimony payments. That is, the recipient would receive an additional alimony payment sufficient to pay the tax and to give that individual some fair share of the resulting tax savings. Divorce settlements that provide for the payment of alimony are typically structured so that they deflect some or all of the tax savings from the alimony deduction to the alimony recipient.

The proper tax policy treatment of child-support payments is unclear. Those who hold that the earner is the proper taxpayer on earned income presumably would oppose the deduction of support payments. The earner rule, however, is inconsistent with marital income splitting—an approach endorsed under current law and under several reform proposals. If an income splitting approach is carried over to children, then child-support payments would be deductible to the payor and taxable to the child, not to the custodial parent. It certainly would be an odd result, however, to allow income splitting between separated parents and their children and to not allow it within fully intact families.

As discussed above, the dependency exemption can be understood as a mechanism for allowing limited income splitting with children. If the dependency exemption, or a child credit, is generous, then the issue of who to tax on support payments has reduced importance, because the parent taxable on the support payments presumably would be the one who would be allowed to claim the dependency exemption or credit.

Despite all of these arguments, perhaps the simplest system administratively, and the one with the fewest enforcement problems, is to tax income to the earner and to grant exemptions and credits primarily upon the basis of with whom the child lives most of the year. In a tax system with graduated tax rates, a rule that taxed child-support payments to the recipient parent and made them deductible by the payor parent typically would result in lower aggregate taxes on those parents, assuming that the payments flow from the higher-bracket taxpayer to the lower-bracket taxpayer. The point is similar to one that can be made with respect to alimony payments. Both parents would be better off under a deduction rule as long as some mechanism was in place that would require them to share fairly the net tax savings. Even in a single-rate system, such as a flat tax, divorced or separated parents would obtain a net benefit from the deduction rule whenever the recipient parent's income otherwise would have been below the tax-exempt level. For simplification purposes, however, most flat and consumption-based taxes would assume that the flat rate structure eliminated most concerns over who paid tax and would rely upon withholding of the tax at the source of payment, such as the employer or business.

CONCLUSION

My testimony today has dealt with the many family-sensitive provisions that must be dealt with in any major tax reform effort. Several of these family related issues affect very large numbers of taxpayers and involve significant amounts of revenues. While certain types of reform efforts technically may move beyond an income tax, they often cannot bypass these family issues. Thus, earned income tax credits and welfare programs have income phase outs that operate like income taxes even in the presence of a consumption tax. In a consumption tax or value-added tax or retail sales tax that did not allow for a child care deduction, a decision would still have to be made as to whether child care expenses were to be taxable as consumption services. Some divorce settlements would have to be renegotiated under major tax reform, especially when they were based on the allocation of tax benefits under current law.

Of all the issues I have raised, perhaps the largest and most important are those that relate to the ways that any tax system adjusts for the presence of children through child credits, dependent exemptions, and the earned income tax credit. Recent bipartisan support for child credits and the push for tax reform create a unique opportunity to lessen the increasing reliance of our tax system on families with children, to expand significantly health insurance for children, and, at the same time, to reduce the extraordinarily high tax rates and marriage penalties on those low-income individuals who decide to work rather than rely on welfare.

Chairman ARCHER. Thank you, Mr. Steuerle. Our next witness is Mr. Glenn Hubbard.

STATEMENT OF R. GLENN HUBBARD, RUSSELL L. CARSON PROFESSOR OF ECONOMICS AND FINANCE, COLUMBIA UNIVERSITY, NEW YORK, NEW YORK; RESEARCH ASSOCIATE, NATIONAL BUREAU OF ECONOMIC RESEARCH; AND DIRECTOR, TAX POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. HUBBARD. Thank you, Mr. Chairman. My name is Glenn Hubbard. I am an economics professor at Columbia University in New York.

I have on the wall in my office at Columbia a framed copy of the four pages of the original income tax form, including both the instructions and schedule. Compared with the stack of papers that was on my desk as I prepared my 1040 this year, I observe that the tax system has obviously gone through a stark and twisted change.

The most vocal discussion about which you have been hearing on fundamental tax reform has to do with changing the tax base from an income tax to a consumption tax. Many economists support such a move, based on economic efficiency, fairness, and simplicity.

Perhaps less vocal but, I would argue, also quite important are voices for fundamental income tax reform—that is, taxing broad measures of income, but tax them only once, as Mr. Armey was suggesting.

An example of this debate is the discussion of corporate tax integration. The U.S. Treasury has put forth a proposal forward that end in 1992.

An interesting point—to which I will return in a moment—is that many of the improvements that economists identify for consumption taxation could be achieved with fundamental income tax reform. I would encourage you to step back from labels except one—"radical."

The current tax system is widely and properly regarded as a patchwork quilt of incentives and disincentives. It is tempting to call the current tax an "income tax," and, by extension characterize a "consumption tax" as its savior. The current tax system is, however, in fact, a hybrid of income and consumption tax characteristics.

Forgetting about labels for a moment, I would like to define a fundamental tax reform as one satisfying the following characteristics: First, a combination of a business level tax, which would either be on cash flow or business income, depending on the system, and a household wage tax. Second, for an income tax version of tax reform, let depreciation allowances approximate economic depreciation, and for consumption taxation, let businesses deduct capital expenditures. Third, the business level tax would not distinguish between debt and equity financing. Fourth, in order to minimize marginal tax rate differences across businesses and investments, firms could carry forward net operating losses with interest. Finally, the system would have lower marginal rates, preferably with

a single marginal rate across businesses and households, but with personal or family exemptions.

To fix ideas, an example of an income tax version of this kind of reform, is the comprehensive business income tax that the Treasury suggested in 1992, in which there would be no interest deduction but no taxation of interest and dividends at the individual level.

On the consumption tax side, one logical prototype would be the flat tax that Mr. Armey described. Such a tax would include both a business cash flow tax and a household wage tax. Is one of these more radical than the other? They are both quite radical, and both worthy of consideration.

The only difference in the stylized descriptions I gave you for the two systems is that the income tax depreciates capital expenditures, while the consumption tax expenses them.

That is an important point, because one argument that is often raised against consumption taxation and in favor of income taxation is that consumption taxes do not tax capital income, and are hence unfair. But not so fast.

Remember that the only difference between those two fundamental reforms, income tax and consumption tax, as I described them, is depreciation versus expensing. That really amounts to the consumption tax forgiving the tax on the time value of money on depreciation allowances. That's a very small component of what is commonly called capital income, most of which represents returns to risk or entrepreneurial skill.

What are the implications of this observation? Again, I think it serves to underscore that we think more about "radical" than "income tax" versus "consumption tax." Thinking about the underlying characteristics, of the reforms, it is possible to get there from here. One way, of course, would be an overhaul; simpler still would be to begin with corporate tax integration and possibly saving incentives.

There are some pitfalls to avoid: I urge you to avoid the Trojan horse of small simplification proposals, and to avoid very expensive departures from fundamental tax reform such as education tax credits.

In closing, Mr. Chairman, on a day when the national attention is drawn to the problems of the tax system, thank you for allowing me the opportunity to appear.

[The prepared statement follows:]

Statement R. Glenn Hubbbard, Russell L. Carson, Professor of Economics and Finance, Columbia University Research Associate, National Bureau of Economic Research, Director of Tax Policy Studies, American Enterprise Institute

Mr. Chairman, Ranking Member Rangel, and members of this distinguished Committee, I appreciate the opportunity to appear before you today. It is fitting, Mr. Chairman, that you have chosen "Tax Day" as an occasion for investigating the impact of fundamental tax reform on individuals and families. Policymakers and economists rightly focus on three criteria for judging changes in the tax system: economic efficiency, fairness, and simplicity. On all three grounds, fundamental tax reform is likely to improve the economic well-being of American individuals and families.

THE NEED FOR FUNDAMENTAL TAX REFORM

Many recent proposals for fundamental tax reform have advocated replacing the current tax system with a broad-based consumption tax.[1] Economists' support for such proposals centers on gains in economic well-being made possible by tax reform. Three sources of efficiency gains, it is argued, would accompany a switch to consumption taxation. First, the removal of the current tax on returns to new saving and investment would increase capital accumulation and, ultimately, family incomes. Second, the consumption tax would remove distortions in the allocation of capital across sectors and types of capital. Third, a broad-based consumption tax would avoid potentially costly distortions of firms' financial structures. Recent estimates suggest that efficiency gains from consumption tax reform could be substantial. Professor Dale Jorgenson of Harvard University estimates the present value of growth opportunities created by the move from the 1985 tax law to the Tax Reform Act of 1986 to be about $1 trillion in 1987 dollars (Jorgenson, 1996). Jorgenson estimates that, had the United States moved from the 1985 income tax law to a broad-based consumption tax, gains in growth opportunities would have doubled to about $2 trillion. The additional gains are due to leveling the playing field and expensing business investment. Professor Alan Auerbach of the University of California, Berkeley estimates that the move from the current tax system to a broad-based consumption tax would raise output per capita by about eight percent (Auerbach, 1996).

With respect to fairness, many economists believe that consumption represents a better measure of "ability to pay" than does current income, because households' consumption decisions depend on wealth and expected future income as well a current income. Finally, a properly designed broad-based consumption tax promotes simplicity. Several consumption tax systems avoid much of the costly complexity associated with the present income tax.

Another group of proposals has suggested reforming the income tax, in particular toward taxing broad measures of income—once.[2] While the debate between "income tax reform" and "consumption taxation reform" often characterizes the differences between the two plans for reform as significant, I argue below that, with respect to efficiency gains, the distinction between reform toward a broad-based income tax and reform toward a broad-based consumption tax is relatively minor. This is not to say that there are not important efficiency consequences of moving from the current tax system to a broad-based consumption tax. Instead, I mean simply that most such consequences can be traced to reform of the income tax. In addition, the distributional consequences of broad-based income tax reform and consumption tax reform are broadly similar. Much, though not all, of the simplification made possible by consumption tax reform can be achieved through income tax reform.

FUNDAMENTAL TAX REFORM

The current tax system is widely regarded by economists, policymakers, and taxpayers generally as a patchwork quilt of incentives and disincentives. In addition, while it is tempting to call the current tax system an "income tax," that system is in fact a hybrid of income and consumption tax characteristics. Hence, to fix ideas, I use the term "fundamental tax reform" to represent tax proposals with the following characteristics:

(1) A combination of a business-level tax (with either cash flow or business income the base) and a household wage tax.

(2) For an income tax version of reform, I assume that depreciation allowances approximate economic depreciation; for the consumption tax version of reform, businesses will deduct capital expenditures.

(3) The business-level tax does not distinguish between debt and equity financing.

(4) In order to minimize the differences in marginal tax rates across business entities and investments, firms will be allowed to carry net operating losses forward with interest.

(5) Lower marginal tax rates, with single marginal tax rate across business entities and households; the household tax can have a personal or family exemption.

While not all tax reform proposals share these characteristics, I focus on the characteristics to make a simple comparison between fundamental income and consumption tax reforms. I would also hesitate to add that fundamental income tax reform put this way is very much in the spirit of radical tax reform.

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[1] See, for example, Robert E. Hall and Alvin Rabushka (1983, 1995), Nicholas Brady (1992), and Alliance USA (1995).

[2] See, for example, American Law Institute (1992) and U.S. Department of the Treasury (1992).

Bases of Income and Consumption Taxes

To illustrate the difference between broad-based income and consumption taxes (of the form I just described), compare two hypothetical taxes—a pure uniform rate income tax and a subtraction-method value-added tax (as a representative consumption tax). The base of a pure uniform-rate income tax includes all forms of labor and capital income; the tax applies a flat rate against this income. Such an income tax could be implemented by means of a business-level (both corporate and noncorporate business) tax on receipts less wages, materials costs, and capital depreciation, plus a household-level tax on wages. For simplicity, suppose that the same (flat) rate is imposed in both the business and household tax. Abstracting from risk considerations (which I discuss below), then, the revised income tax has three components: (1) a wage tax, (2) a tax on returns from marginal investment projects, and (3) a cash flow tax on returns from existing capital and investment projects yielding economic profits. Within the context of broad-based income tax reform, the Treasury Department's (1992) Comprehensive Business Income Tax (CBIT) proposal generally followed this model. That proposal would deny deductibility at the business level of payments to debtholders and equityholders, but it would not tax such distributions at the investor level. Hence, in principle, the tax base is receipts less payments for employee compensation and other variable inputs and capital depreciation charges.

Under a subtraction-method value-added tax (VAT), each business has a tax base equal to the difference between receipts from sales of goods and services and purchases of good and services from other businesses. This measure of value added is then taxed at a fixed tax rate. Because the aggregate business tax base equals aggregate sales by businesses to non-businesses, the tax base is equivalent to aggregate consumption. As long as the tax rates are the same, such a tax is equivalent to a European-style credit-invoice value-added tax.

Following the Hall-Rabushka Flat Tax (Hall and Rabushka, 1983,1995), one could equivalently permit a deduction for wages at the business level with wage taxation at the same rate for individuals. Hence the subtraction-method VAT can be thought of as a combination of a wage tax and a tax on business cash flow. Viewed in this way, (this form of) a consumption tax is quite similar to the broad-based income tax.[3] The difference between the two taxes is that the income tax base depreciates capital expenditures, while the consumption tax base deducts capital expenditures.

Differences in the Taxation of Capital Income

The conventional description of a consumption tax or a cash flow tax assumes that all income from capital is exempt from taxation. To explain this view, one can decompose the base of the Flat Tax into two parts: The first is a business cash flow tax, the base of which is receipts from sales of goods and services less purchases for labor and materials and expenditure on capital goods. The second is a wage tax.[4]

Under the cash flow tax, the present value of depreciation allowances for one dollar of current investment is one dollar, while under the income tax, the present value is less than one dollar. For a risk-free investment project, the tax savings from depreciation allowances represent risk-free cash flows, which the firm would discount at the risk-free rate of interest. For a marginal investment—one in which the expected rate of return just equals the discount rate—the upfront subsidy to investment provided by expensing equals the expected future tax payments. It is in this sense that the return to capital is not taxed under a cash flow tax or a consumption tax.

Life-cycle simulation models used to evaluate tax reforms follow this intuition and generally assume one risk-free return on accumulated savings.[5] In such models, the shift from an income tax to a consumption tax is equivalent to forgiving the taxation of capital income from new saving and imposing a one-time tax on existing saving used to finance consumption.

What about investments which yield economic profits? That is, in addition to risk-free projects, suppose that certain entrepreneurs have access to investments with returns associated with rents to ideas, managerial skill, or market power. In this case, rates of cash flow in excess of the firm's discount rate for depreciation allowances are taxed. Cash flows representing economic profits are taxed equivalently under the broad-based income tax and the cash flow tax (or consumption tax). As

[3] This similarity is true in the context of business taxation. The Flat Tax addresses the distortion between housing capital and nonhousing capital more completely than CBIT.

[4] The subtraction-method VAT combines the two pieces, with a base equal to receipts less the sum of wages and purchases from other firms.

[5] See, for example, Alan Auerbach and Laurence Kotlikoff (1987); R. Glenn Hubbard and Kenneth Judd (1987); and R. Glenn Hubbard, Jonathon Skinner, and Stephen P. Zeldes (1995)

long as the scale of projects with economic profits is limited, the tax saving from expensing should be invested in another risk-free asset. Hence, for projects yielding economic returns, only the return representing the risk-free rate is untaxed under the cash flow tax or consumption tax.

What about risky investments? First, risky investments generate high or low returns after the investment is made. The component of capital income that represents luck after a risky investment has been made can be treated like the economic profit in the foregoing example of the income tax and the cash flow tax.

Second, risky investments have a higher required rate of return before the investment is made than risk-free investments, reflecting a risk premium to compensate savers for bearing risk. Whether either tax system levies a tax on the risk premium depends on how one defines a "tax." If a tax is defined as an increase in expected government revenue, then both the income tax and the cash flow tax include the risk premium. If, in contrast, a tax is an increase in the discounted present value of government revenue, then neither tax system includes the risk premium. In either case, the central point is that the stylized income tax and the consumption tax treat the return to risk-taking similarly.

To summarize, what is often called the return to capital can be thought of as the sum of the risk-free return, economic profits, and returns to risk taking (payment for bearing risk and luck). In contrast to the base of the consumption tax, the income tax includes the opportunity cost of capital, which equals the rate of return on a marginal riskless project.

EFFICIENCY AND DISTRIBUTIONAL CONSEQUENCES OF CONSUMPTION TAXATION

Acknowledging that, relative to a broad-based income tax, a consumption tax exempts only the risk-free component of capital income may warrant a reconsideration of the efficiency and distributional consequences of a shift toward consumption taxation. In the interest of brevity, I discuss below only five areas that need to be reconsidered: (1) saving and investment, (2) intersectoral and interasset distortions, (3) distortions of business financing decisions, (4) asset price effects, and (5) long-run distributional consequences.

Saving and Investment

Much of the interest by economists and policymakers in consumption taxation reflects a belief that such tax reform will increase domestic saving and investment. While the responsiveness of saving to changes in the net return can be large in life-cycle simulation models, available empirical evidence based on household data suggests that the sensitivity of household saving to changes in the net return is modest, at least for most households.[6] In addition, if only the risk-free interest rate is exempt under a consumption tax (relative to an income tax), the stimulus to domestic household saving may not be large. For business investment, however, the combination of the shift to expensing and recent large estimates of the responsiveness of investment to changes in the user cost of capital suggests that consumption tax reform can still be a potent stimulus for domestic investment.[7]

Intersectoral and Interasset Distortions

Moving to a broad-based consumption tax eliminates current distortions in the tax treatment of alternative sectors (for example, corporate versus noncorporate) and of alternative assets (for example, owner-occupied housing versus business capital). Efficiency gains from removing these distortions are likely to be large.[8] It is important to note, however, that these gains—essentially arising from eliminating differential taxation of alternative forms of capital income—arise from income tax reform. That is, while substantial intersectoral and interasset gains may be achieved from a shift from the current tax systems to a broad-based consumption tax, most such gains are achievable in a move from the current tax system to an integrated income tax system, as in the Treasury Department's CBIT proposal.

Financial Distortions

While life-cycle simulation models of tax reform do not consider distortions of business financing, some evaluations of tax reform have concluded that tax-induced distortions of corporate capital structure and dividend decisions can generate significant efficiency costs (see, in particular, U.S. Department of the Treasury, 1992). A move to a broad-based consumption tax of the "flat tax" form would clearly remove

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[6] See, for example, the review in Eric Engen and William Gale (1996).
[7] See Kevin Hassett and R. Glenn Hubbard (1997).
[8] See, for example, the estimates reported in Alan Auerbach (1996).

these distortions; neither interest payments nor dividends is a deductible business expense, and neither is taxed to investors. The same outcome would obtain under income tax reform of the CBIT form, however.

Asset Price Effects of Tax Reform

Conventional analyses of tax reform using life-cycle simulation models focus distributional analysis on the short run—in particular asset price effects in the transition from the current tax system to a broad-based consumption tax. In such models in which there is a representative household within a cohort, asset price effects represent a redistribution across generations. Relative to fundamental income tax reform, the shift to a broad-based consumption tax entails two potentially significant asset price effects. For equities, the shift from depreciation to expensing reduces the value of old capital and equity. In life-cycle models with a representative household within a cohort, the decline in the value of old capital is largely borne by older generations, who own a disproportionately large share of the capital. For debt, to the extent that the price level rises in response to a shift to a consumption tax, the value of existing nominal bonds falls. Other significant asset price effects of tax reform stem from the shift from the current tax system to a broad-based income tax with uniform capital income taxation. For example, the adverse consequences of tax reform for the prices of existing homes reflects this shift in the income tax. In addition, many effects of tax reform on equity values (through the removal of dividend and capital gains taxes) arise from corporate tax integration an income tax reform and not from the shift to consumption taxation per se. These effects on equity values would, for example, have accompanied the Treasury Department's 1992 proposals via dividend exclusion or CBIT.[9]

Long-Run Distributional Consequences of Tax Reform

Critics of consumption tax reform sometimes claim that, as a tax base, "consumption" is less equitable than "income" because the benefits of not taxing capital income accrue to households with high levels of economic well-being.[10] Recall, however, that, relative to a uniform income tax, a consumption tax exempts only the opportunity cost return to capital from taxation. Using U.S. household data, William Gentry and I (1997) found that heterogeneity of household portfolios within a cohort is significant, highlighting the significance of examining consequences of eliminating differential taxation of capital income in tax reform. We also found that holdings of assets most easily identified with economic profits (for example, active business interests of the households) and risky returns (for example, equities) are highly concentrated among high-income and high-net-worth households. This finding suggests a more progressive distribution of the tax change than that generated under the assumption that all capital income represents opportunity cost. Furthermore, our distributional analysis indicates that this qualification is economically important. Designing "distribution tables" similar to those used in Washington practice, we find that more than one-third of the reduction in the shore of taxes paid by very high-income households in switching from an income tax to a consumption tax is offset by assuming that only the risk-free return to saving is exempt from taxation in the reform.

CONCLUSIONS AND IMPLICATIONS FOR THE TAX REFORM DEBATE

A shift from the current tax system to a broad-based consumption tax is best thought of as a two-step process. First, most elements of consumption tax reform are consistent with moving to a pure income tax with uniform capital taxation. Second, for a switch from this pure income tax to a consumption tax, the key element of reform is replacing depreciation allowances for physical investment with expensing of capital assets. These points suggest the need for reevaluating conventional conclusions about efficiency and distributional consequences of tax reform. They also indicate that fundamental income tax reform and consumption tax reform are not in many responses significantly different directions in tax reform.

The observation that fundamental income tax reform and fundamental consumption tax reform have similar consequences also has several implications for policy analysis of tax reform. First, policy analysis should study effects of tax reform on economic well-being within cohorts as well as across cohorts. Second, because many

[9] The Treasury Department's "dividend exclusion" proposal follows the CBIT proposal for equityholders would neither be deductible at the business level nor taxable at the investor level.

[10] This would be true, for example, if the ratio of household wealth to permanent income, all other things being equal, increase with permanent income, as suggested by R. Glenn Hubbard, Jonathon Skinner, and Stephen P. Zeldes (1995).

of the gains made possible by consumption tax reform can be achieved through income tax reform—and in particular, through integrating corporate and individual income taxation—income tax reform should occupy a prominent place in the tax reform debate. Third, incremental reforms toward integration and toward making capital taxation more uniform may offer a significant starting point for more fundamental tax reform. Finally, Mr. Chairman, while the Committee is rightly concerned with the need for radical reform of the current tax system, both radical income tax reform and radical consumption tax reform are likely to improve the economic well-being of American individuals and families.

Thank you again, Mr. Chairman, for the opportunity to be with you today.

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Chairman ARCHER. Thank you, Mr. Hubbard.

Dr. Asmus.

STATEMENT OF BARRY ASMUS, Ph.D., SENIOR ECONOMIST, NATIONAL CENTER FOR POLICY ANALYSIS

Mr. ASMUS. Thank you, Mr. Chairman. My name is Barry Asmus. I'm a senior economist at the National Center for Policy Analysis. And thank you, Chairman Archer, for coming out and saying hi to us a few months ago.

Good morning to you, and to the distinguished Members of the Committee on Ways and Means. I cannot think of a more important task than the need for tax reform on this April 15 day of "send me the money."

I'm hopeful that this Committee and this Congress can help make tax reform a reality. The global information economy is indeed much different than the industrial one. Labor and capital are highly mobile.

All you need to start a business today is to have a fax machine, a modem, and a brain, and you can have a business anywhere in the world. Labor is highly mobile, but indeed, capital also is highly mobile. Capital flows are 100 times greater than world trade flows.

So the world can no longer be understood as a collection of national economies. Indeed, we're in a situation where boundaries are porous, and we have to think of the global economy as an electric highway where capital gets up and goes to where it's wanted and stays where it's well treated.

This globalized information economy is driving distribution costs down and transaction costs to zero. Everything is becoming more efficient, everything except the way we do taxes.

We can no longer afford $200 to $300 billion of compliance costs. We can no longer afford to treat capital with double and triple taxation. We can no longer afford a capital gains tax that locks capital to less productive uses.

Taxing income was always wrong, because it's a tax on production, supply, output and employment. But now it makes even less sense in a global, information economy.

The income tax was designed for the industrial age, people working in factories, on farms and for large companies. Taxes were withheld. Compliance was relatively easy. That day is over.

The electronic infrastructure is creating a worldwide economy where products have value added all over the world. The dress or shirt you buy at a store in St. Louis may have originated with cloth woven in Korea, finished in Taiwan, and cut and sewn in India. Then there is a brief stop in Milan to pick up its "made in Italy" label, before its final journey to a store in St. Louis.

In short, economic transactions will happen anywhere, and individual income will come from everywhere.

In my recent book, "When Riding a Dead Horse, For Heaven's Sake Dismount," I argue that we're moving toward the contract society. A growing number of American workers will become entrepreneurs as we enter the 21st century. Many of them will be working on a contractual basis as a means to earn their income. There will be more than one employer, and many sources of income.

Those of us that work for a large company would be assigned to certain tasks, and will proceed to contract them out to the high quality, low price bidder. The contractual economy will make individual income more difficult to track, and the IRS will have to become even more intrusive in the individual taxpayer's life.

A consumption tax is the answer for the global economy, it is efficient and doable in a contractual economy, and it makes much more sense if we want a growth economy. I strongly agree with Professor Dale Jorgenson, chairman of the department of economics of Harvard University, that a revenue neutral substitution of a consumption tax for the existing income tax would have an immediate and powerful impact on the level of economic activity.

There would be a drastic jump in savings, a substantial rise in labor supply. There would be a huge shift toward investments, and exports would increase. The fundamental tax reform we are talking about today would enhance prospects for U.S. growth and would benefit families.

As America becomes more entrepreneurial and the world economy more global, taxpayers do not need the high compliance costs that go with defining and tracing income from a growing number of sources. Taxpayers do not need an intrusive IRS that invades their privacy. They do not need a tax that jettisons incentives to work, produce, create and be employed. They do not need a tax that reduces wages and is widely perceived as unfair.

But American families do need a tax that is simple to comply with, that removes the disincentives to work, that encourages savings and investment, that will equip them with more capital, that will empower them by giving them choices as to how much tax they pay, and will expand their job opportunities.

Members of the Ways and Means Committee, I ask you: how many families do you know that would appreciate a tax where compliance is simple, a tax that is proportional and fair, a tax that eliminates the underground economy, a tax that provides the right incentives to save, work and produce, a tax that abolishes the IRS, a tax that increases their disposable incomes, a tax that in essence transfers income from a government that does not earn the money to those people who do.

Imagine with me an American future where the only memorable thing about April 15 was that it was just another beautiful spring day. Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Barry Asmus, Ph.D., Senior Economist, National Center for Policy Analysis

TAX REFORM: THE NEED FOR A CONSUMPTION TAX

Perhaps the most urgent reason for tax reform is that we risk a breakdown in the implied contract Americans have with their government, as our system of generally voluntary tax compliance erodes under abuses by, and mistrust of, the Internal Revenue Service. However, my remarks today do not address that point directly, but rather deal with the changing nature of the workplace which will in the not too distant future dramatically increase the difficulty of identifying income, tracking income and collecting a tax on income.

The current income tax system relies heavily on employers to collect taxes from employees. Employers receive tax preferences for benefits furnished their employees. But that employer-employee structure is changing in the Information Age:

(1) The workplace is decentralizing as more and more people are becoming independent contractors and consultants, receiving income from a range of diverse sources.

(2) The family and how it functions is evolving, as wives enter the workforce and both partners assume nontraditional roles.

These trends will intensify and, as they do, the current tax system will become even more cumbersome, intrusive and inefficient than it is today. A consumption tax makes sense today and it will make even more sense as the decentralization of work becomes more defined. Technological advances portend a time in the not too distant future when governments will be forced to turn to new ways of gathering revenue in a global economy.

TECHNOLOGY AND THE ABILITY TO TAX

In the Information Age, the new source of wealth is not mainly material. It is information. Knowledge extraction, integration and application are replacing the shipment of raw materials from remote locations to manufacturing centers as the dominant world business. Knowledge has become the main source of economic value. Matter matters less and less. Knowledge and ideas matter more and more.

Labor in the global economy is highly mobile. What do you need to be in business around the world? Four things: a telephone, a modem, a fax machine, and a brain. It is one thing to rely on an income tax when people work in factories and taxes

are deducted monthly. But the income tax was an Industrial Age solution meant for Industrial Age employers and family structure.

It will be much more difficult to rely on an income tax when entrepreneurs are multiplying by the millions. Compliance costs are already too high. They will get worse as the society evolves. Not only will it be necessary to enlarge the Internal Revenue Service as people find more and more ways to create wealth, but the IRS will become more intrusive and its procedures more subject to abuse than at present as it struggles to trace income. In a one-family-one-paycheck economy, compliance verification is minimal. But that scenario is disappearing.

On the other hand, with a national sales tax there would be no need for the government to know the amount of a person's income. For purposes of taxation, it would be irrelevant.

And what of tax deductions and credits granted employers under the present system for their employees' fringe benefits? Congress spends a lot of time proposing legislation such as the $500 per child tax credit in an effort to make the current system fair. The decentralizing workplace will exacerbate the problems arising from the tax system's current bias toward working for an employer. By contrast, either a flat tax or a national sales tax would remove these problems, although the sales tax would be preferable.

Capital, too, is less likely to be fixed. On the electronic highway, it can instantly go where it is wanted, and stay where it is well treated. As information and knowledge are forged into capital, the world is connected by blips on the computer screen that race across countries and continents in microseconds. The dollar amounts we are talking about are huge; sometimes a hundred times larger than current world trade flows on an annual basis. How does government track transactions that get more complicated and cross many national lines?

Adjusting to a Global Economy

The world can no longer be understood as a collection of national economies. Electronic infrastructure is creating a world-wide economy. Products have value added all over the world. The dress you buy in St. Louis may have originated with cloth woven in Korea, finished in Taiwan and cut and sewn in India. Then, there was the brief stop in Milan to pick up its Made in Italy label before the final journey to a store in St. Louis.

The principles of freedom, private property and the free market coupled with an intellectual system driven by knowledge and technology will render obsolete the old paradigm of extraction and central control by governments and business. The growing global economy enhances the importance of economic trade while reducing the influence of politics and control. How easy it is to walk through a customs checkpoint declaring "nothing" when a billion dollar software package resides in your head.

In the new paradigm, the means of production in capitalism are not chiefly land, labor, and machines which traditionally have been regulated, controlled, and taxed by government, but rather emancipated human intelligence. Under capitalism, the mind-generated production system, the driving force of growth is innovation and discovery. Governments must let go of their paternalistic control over people. So must corporations. The antiquated income tax must give way to the consumption tax just as corporate hierarchies yield to flat, horizontal management controls.

A consumption tax can maximize market efficiencies, broaden the tax base, encourage growth, savings and investment and thus promote the economic growth needed to meet the needs of our social and economic system. It is the only type of tax that can meet the needs of workers, whether self-employed or working for an employer, and families in an Information Age.

But American workers and families cannot go forward with an Industrial Age behemoth like the Internal Revenue Service grasping at them to hold them back. We need a tax system as innovative and creative as the American worker. A national sales tax can meet that need.

Chairman ARCHER. Thank you, Dr. Asmus.

Our next witness is Dr. Sullivan.

STATEMENT OF MARTIN A. SULLIVAN, Ph.D., ECONOMIST, TAX ANALYSTS, ARLINGTON, VIRGINIA

Mr. SULLIVAN. Good morning, Mr. Chairman, and Members of the Committee. My name is Martin Sullivan. I'm a tax economist. In the past, I've worked at the Treasury Department, at the Joint Committee on Taxation, and as a consultant in the private sector.

Now I work as an economist for Tax Analysts, a nonprofit organization in Arlington, Virginia.

It's truly an honor for me to be here today before the Ways and Means Committee, and I'll try my best to make useful comments.

Let me say at the outset that I firmly believe that the U.S. tax system needs reform. Americans should not have an anxiety attack every time they do their taxes. And the Tax Code should not be a repository of dozens and dozens and dozens of tax breaks, for everything from historical structures to sewage treatment facilities.

Mr. Armey's proposed flat tax is a very intriguing piece of legislation. It certainly does simplify the tax system. All my friends downtown who practice corporate tax law and international tax law and pension tax law would be out of business if the flat tax were enacted.

But on the other hand, the proponents of the flat tax overplay their hand when they say the tax system would not just be simpler, but simple, under a flat tax. Under the flat tax you would still have hundreds of millions of tax forms. You'd still have complex Tax Court cases. You'd still have an intrusive IRS, and you'd still have tax lobbyists.

Mr. Armey's flat tax eliminates every—let me say it again—every single tax loophole in the Code. No more deductions, except for business expenses, and no more tax credits. For this, I think, the Majority Leader needs to be commended.

I mean, who would have ever thought 10 years ago that the Majority Leader of the House of Representatives would be taking the lead on repealing the mortgage interest deduction. I think it's extraordinary, and he deserves a lot of credit.

Finally, the flat tax, with its $22,000 standard deduction for married couples, and its $5,000 of additional deductions for each child, does, indeed, provide a lot of tax relief for middle-income families.

So let's review what we've got here. We've got tax simplification. We've got loophole closing, and we've got big tax relief for middle class families. So why don't we go ahead right away and enact this middle class flat tax cut?

Well, there's one little problem. The plan doesn't hold together. From both an economic and a political point of view, it's not credible. Like my grandmother once told me, if it's too good to be true, then it probably is.

The flat tax simply isn't as good as its proponents make it out to be, and let me explain why.

The first big problem with the flat tax is the 17-percent rate. This rate is way too low for revenue neutrality. The Treasury says the rate has to be closer to 21 percent. I know some people don't trust the political motives of the Treasury Department, but I think this number is a very solid number, and I think Mr. Armey said it himself a few minutes ago when he said at 20 percent his pro-

posal falls $30 billion short. So that means 21 percent is a revenue neutral flat tax.

But I think 21 percent is too low realistically, and let me explain why. The Armey bill doesn't have any transition relief. If you don't have transition relief, many businesses will be unfairly saddled with retroactive tax increases.

I think in the end there will be transition relief for any bill that gets through this Committee. Unfortunately, transition relief is extremely expensive, and that would add at least 2 percentage points to the flat tax.

Finally, the third problem with Mr. Armey's flat tax is its repeal of the earned income tax credit. Does anybody for a moment really think that this Committee is going to pass a major tax reform bill with massive cuts in benefits for the poor?

If I were advising my clients, I'd say that's absolutely unrealistic. I think you have to add another percentage point to the flat tax rate when you take into account that the EITC or something exactly like it is going to be enacted into law.

Now, when you put this all together, you get a revenue neutral flat tax rate of 24 percent, and I haven't even talked about mortgage interest deduction, or charitable deduction, or deduction for payroll taxes.

Now, I know a lot of the proponents of the flat tax are going to say well economic growth is going to take care of all these problems. I do think the flat tax will help economic growth, but it's all orders of magnitude we're talking about here.

I think if you do a survey, the best you're going to get is 2 or 3 or 4 or 5 percent economic growth after 10 years from this flat tax. What does that mean in terms of the revenue neutral tax rate? It means 1 percentage point higher.

So that means you take that 24 percent, you could bring it down to 23 percent maybe. And when you put all that together, and then you start doing the calculations, you're going to find that not everybody gets a tax cut under the flat tax. Namely, businesses are going to pay more—a lot more— under the flat tax. And single individuals are going to pay a lot more under the flat tax.

For example, under a 23-percent flat tax, the not so uncommon case of a single worker earning $30,000 would pay 25 percent more in taxes. This would be a little hard to swallow, considering the fact that many wealthy people would receive enormous tax cuts under the flat tax.

Under the flat tax it would not be uncommon for wealthy individuals to have their taxes cut in half. Under the flat tax in many cases, millionaires would pay no tax at all.

If Congress wishes to provide tax relief for middle income families, it does not have to radically restructure the tax system. It could simply raise the standard deduction, or as now being actively negotiated, a $500 child credit could be added to the Code.

Finally, I would be remiss if at this hearing I did not mention that the flat tax would repeal many family friendly features of the current Tax Code. The flat tax would repeal the child care credit. It would repeal the adoption credit. It would repeal medical savings accounts. It would repeal the deduction for extraordinary medical

expenses. It would repeal the deduction for losses from thefts, fires, floods and other disasters.

Most importantly, the flat tax would eliminate the tax benefits for employer-provided health care. This would likely result in reduction of health insurance coverage for working families.

This concludes my testimony, and I'm very grateful to the Committee for this opportunity to share my views.

Chairman ARCHER. Thank you, Mr. Sullivan. Our next witness is Mr. Mitchell. Mr. Mitchell, if you would identify yourself and proceed.

STATEMENT OF DANIEL J. MITCHELL, McKENNA SENIOR FELLOW IN POLITICAL ECONOMY, HERITAGE FOUNDATION

Mr. MITCHELL. Mr. Chairman, and Members of the Committee, my name is Daniel Mitchell. I serve as McKenna Senior Fellow at the Heritage Foundation, and the views I express in this testimony are my own and should not be construed as representing any official position of the foundation.

Thank you for holding this hearing and giving me the opportunity to discuss why fundamental tax reform will benefit individuals and families. In my comments I will be discussing the flat tax, but it should be noted that other proposed alternatives that tax economic activity only one time at one low rate, such as a national sales tax, would have similar economic benefits.

America's tax system is a disgrace. Productive economic behavior is severely penalized. Savings and investment are subjected to as many as four layers of taxation. Billions of hours are required each year to comply with an increasingly incomprehensible maze of tax forms, regulations and documents.

The economic damage imposed by our antigrowth Tax Code is staggering, with economic output reduced by hundreds of billions of dollars every year. The real cost, however, should be measured in terms of lost jobs, foregone income, lower living standards, and reduced economic security.

The problems of the current code are almost too numerous to quantify, but they can be lumped into three main categories. Number one is excessive marginal tax rates. The Federal income tax has a top rate of 39.6 percent, meaning that successful entrepreneurs receive barely 60 cents of benefit for every dollar they contribute to the Nation's well-being.

This burden clearly reduces incentives to engage in productive behavior leading to lower levels of work, saving, investment, risk taking and entrepreneurship. And, of course, added on to the Federal income tax are numerous other Federal, State and local taxes.

The second problem is the bias against savings and investment. And this is perhaps the most pernicious feature of the current Tax Code, in the way that capital income is subjected to discriminatory treatment.

Between the capital gains tax, the corporate income tax, the personal income tax and the death tax, the government penalizes any returns with as many as four layers of tax. Needless to say, this means some income faces effective tax rates of 80 percent, 90 percent or more.

Not only is this policy unfair. It has profoundly adverse economic consequences on the economy, since every school of thought, even Marxism, agrees that the only way to generate higher wages and rising living standards is through savings and investment.

And finally we have complexity. We have 5.4 billion hours spent every year on tax returns. This is more than all the man hours used in the entire automotive industry in America. The Tax Foundation estimates that just the income tax system alone imposes $157 billion of compliance costs on the economy. This is not the money sent to Washington, DC. It's not the foregone economic growth. It is simply the lawyers, the accountants, the lobbyists, the tax preparers and the manhours needed to comply with the current system.

Well, the Tax Code today is so fundamentally flawed the only realistic solution is to completely scrap it and start all over. Fortunately, there is widespread recognition that it does need radical reform. Indeed, the two major alternatives, the flat tax and the sales tax would solve all three of the aforementioned problems.

Both proposals satisfy the following criteria of a simple, fair, progrowth Tax Code, namely that all income should be taxed at one low rate, and only one time and the tax should be collected in the least intrusive way possible.

Let me explain that further. Taxing income at one rate. The flat tax does tax economic activity at one low rate. Not only does this ensure equal treatment under the law; it also minimizes tax penalties against productive economic behavior.

Taxing all income one time: the flat tax eliminates the myriad forms of double taxation in the Tax Code. By taxing income only one time, tax reform would substantially increase savings and investment, which is a prerequisite for economic growth.

And then simplification: by discarding all the special provisions in the Tax Code, a flat tax makes the calculation of tax liability considerably simpler than it is today. Moreover, the level playingfield created by the flat tax means that taxpayers no longer have any incentive to time their income and deductions in ways that minimize tax liability.

As a result, business and personal decisions will be guided by consumer preference and economic efficiency, rather than tax consideration. But while the key principle of the flat tax is equality, it turns out that a simple system based on taxing all income one time at one low rate will lead to substantially faster economic growth.

This is confirmed by numerous academic studies, and was also revealed at a conference of economic forecasters sponsored by the Joint Committee on Taxation. And while the estimates obviously vary of the additional economic growth, it is worth noting that even an increase of just one-half of 1 percent in the growth rate would by the tenth year mean $5,000 of additional output for an average family of four.

Faster economic growth is not the only reason why tax reform will help families. The substantial reduction in compliance costs will mean additional savings for the average family. Moreover, if lawmakers decide to combine tax reform with tax relief, as almost

certainly would have to occur to overcome political inspired objections, taxpayers could benefit from immediate tax relief.

A 17-percent flat tax, for instance, would reduce tax liabilities by an average of $1,100.

Thank you very much. I'll be happy to answer any questions.

[The prepared statement follows:]

Statement of Daniel J. Mitchell, McKenna Senior Fellow in Political Economy, The Heritage Foundation

Mr. Chairman and members of the Committee, my name is Daniel Mitchell, and I serve as Mckenna Senior Fellow with the Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation. Thank you for holding this hearing and giving me the opportunity to discuss why fundamental tax reform will benefit individuals and families. In my comments, I will be discussing the flat tax, but it should be noted that other proposed alternatives that tax economic activity only one time at one low rate, such as a national sales tax, would have similar economic benefits.

America's tax system is a disgrace. Productive economic behavior is severely penalized. Savings and investment are subjected to as many as four layers of taxation. Billions of hours are required each year to comply with an increasingly incomprehensible maze of tax forms, regulations, and documents. The economic damage imposed by our anti-growth tax code is staggering, with economic output being reduced by hundreds of billions of dollars every year. The real cost, however, should be measured in terms of lost jobs, foregone income, lower living standards, and reduced economic security.

The problems of the tax code are almost too numerous to quantify, but they can be lumped into three main categories. These are:

Excessive marginal tax rates

The federal income tax has a top rate of 39.6 percent, meaning that successful entrepreneurs receive barely 60 cents of benefit for every dollar they contribute to the nation's economy. This burden clearly reduces incentives to engage in productive behavior, leading to lower levels of work, saving, investment, risk-taking, and entrepreneurship. Added on top of the federal income tax, of course, are numerous other federal, state, and local taxes.

Bias against savings and investment

Perhaps the most pernicious feature of the tax code is the way in which capital income is subjected to discriminatory treatment. Between the capital gains tax, the corporate income tax, the personal income tax, and the estate or death tax, the government paralizes any returns with as many as four layers of tax. Needless to say, this means some income faces effective tax rates of 80 percent, 90 percent, or more. Not only is this policy unfair, it has profoundly adverse consequences on the economy since all economic theories—even Marxism—agree that the only way to generate higher wages and rising living standards is through savings and investment.

Complexity

An IRS-commissioned study several years ago estimated that taxpayers spend 5.4 billion hours on their tax returns. That is more than all the man-hours used in the entire automative industry in America. According to the Tax Foundation, our income tax system alone imposes $157 billion of compliance costs on the economy. This is not the money sent to Washington. Nor is it the amount of foregone economic growth. It is the cost of the lawyers, accountants, lobbyists, tax preparers, and man-hours needed to comply with the current tax code.

The tax system today is so fundamentally flawed that the only realistic solution is to completely scrap it and start all over. Fortunately, there is widespread recognition that the current tax system needs radical reform. Indeed, the two major alternatives, the flat tax and the sales tax, would solve the three aforementioned problems. Both proposals satisfy the following criteria of a fair, simple, pro-growth tax code:

"All income should be taxed at one low rate and only one time, and the tax should be collected in the least intrusive way possible."

- Taxing all income at one rate. The flat tax taxes economic activity at one low rate. Not only does this ensure equal treatment under the law, it also minimizes tax penalties against productive economic behavior.

• Taxing all income one time. The flat tax eliminates the myriad forms of double taxation in the tax code. By taxing income only one time, tax reform would substantially increase savings and investment, which is a prerequisite of increased economic growth.

• Simplification. By discarding all the special provisions in the tax code, a flat tax makes the calculation of tax liability considerably simpler than it is today. Moreover, the level playing field created by the flat tax means that taxpayers no longer have any incentive to time their income and deductions in ways that minimize tax liability. As a result, business and personal decisions will be guided by consumer preference and economic efficiency rather than tax considerations.

While the key principle of the flat tax is equality, it turns out that a simple system based on taxing all income just one time at one low rate will lead to substantially faster economic growth. Numerous academic studies conclude that tax reform would boost economic growth, and a conference of economic forecasters sponsored by the Joint Committee on Taxation also found strong agreement that shifting to a tax system that follows the aforementioned principles will increase the economy's output. Estimates of the additional growth, needless to say, were varied. It is worth noting, however, than even an increase of just one-half of one percent in the growth rate would, by the tenth year, mean $5,000 of additional output for an average family of four.

Faster economic growth is not the only reason why tax reform will help families and individuals. Any analysis of the impact on real people should include the substantial savings in compliance costs. The Tax Foundation estimates that sweeping tax reform could reduce compliance costs by more than 90 percent. The bulk of those savings will occur on the business side, but that will translate into higher wages, lower prices, and greater returns to workers, consumers, and shareholders. Moreover, if lawmakers decide to combine tax reform with tax relief, as almost certainly would have to occur to overcome politically-inspired objections, taxpayers could benefit from immediate tax relief. The 17 percent flat tax, for instance, would reduce income tax liabilities for individuals by an average of more than $1,100. Even at a 20 percent rate, the flat tax would provide relief for individuals averaging more than $500.

Finally, although it would be impossible to put a price tag on this benefit, fundamental tax reform could have a significant effect on the level of distrust and hostility which the public feels toward our tax system. The current system is riddled with discrimination. Taxpayers are either penalized or subsidized on the basis of how they earn their income, how they spend their income, or the level of their income. By adopting a flat tax, which makes all taxpayers play by the same rules, lawmakers could help restore confidence is a system that has lost moral legitimacy.

Thank you and I will be happy to answer any questions.

Chairman ARCHER. Thank you, Mr. Mitchell.

Our next and last witness is Mr. Dannenfelser. Please identify yourself for the record, sir, and you may proceed.

STATEMENT OF MARTIN J. DANNENFELSER, JR., ASSISTANT TO THE PRESIDENT FOR GOVERNMENT RELATIONS, FAMILY RESEARCH COUNCIL

Mr. DANNENFELSER. Thank you, Mr. Chairman. My name is Martin Dannenfelser. I'm assistant to the president for government relations at the Family Research Council. Mr. Chairman, and Members of the Committee, I deeply appreciate this opportunity to discuss the issue of tax reform with particular emphasis on the need to provide relief to working American families.

A brief glance at the Federal tax situation for families in the early fifties will illustrate the urgency felt by me and my associates at the Family Research Council. At that time, only about half of working families were subject to the personal income tax. That is, the $600 personal exemption, plus the standard deduction were

enough to leave the bottom half of family incomes at the zero tax level.

The payroll tax was paid by virtually everyone, as it is now, but at much lower levels—under 4 percent, counting the employee and employer share combined, for the first part of the fifties.

Today, the median income family is paying around 30 percent of their income in taxes, about half of that in income taxes, and about half in payroll taxes.

Should there be any surprise in the light of these figures that despite the enormous economic progress of recent decades there is so much talk of a middle class squeeze? Even leaving aside the relative stagnation in pay growth that began in the early seventies, this trend in Federal tax burdens on working families would be enough to make families feel squeezed.

Mr. Chairman, no one is saying that the tax incidence of the early fifties is something we can return to now. In particular, the families of that era benefited from the nature of Social Security's start up as a pay as you go system of retirement insurance. The first generation of workers had a lighter burden of retirees to support, and therefore lighter payroll taxes than would be possible for any subsequent generation to enjoy.

But consider this simple fact: Year after year in most countries at most times, workers earn about two thirds of national income on a pretax basis. The remainder is earned by holders of capital. This latter kind of income comes not in wages, but in such forms as corporate profits, rents, interest income and capital gains, yet workers who account for roughly 67 percent of pretax income are currently paying more than 75 percent of Federal taxes, a share that has been steadily rising in recent decades.

Holders of capital earn one-third of national income, yet are paying only one-fourth of Federal taxes. Mr. Chairman, my guess is that most Americans are unaware of this trend toward higher taxes on workers, and lighter taxes on capital, even though they feel the impact of the trend in their take home pay.

There may even be a surprising number of economists who are unaware of it. But to the degree that economists are aware of it, I believe they tend to think this trend is not such a bad thing. They assume that capital as defined in the lead economic studies, machines and buildings, is what drives economic growth, and that the trend of the tax burden away from physical capital and on to working families will help the overall economy in the long run more than if the trend were in the opposite direction.

The problem, Mr. Chairman, is that such economists are working under an obsolete definition of capital. When capital theory was formulated in the 19th century, most workers, the bulk of whom were farm laborers, and a minority of whom were in factories, had little education. Many if not most were, in fact, illiterate.

In the 19th century, quantum leaps in economic efficiency often did not coincide with the invention and use of new types of machines. The 20th century, which has featured the rise of management and information technologies is very different.

Today the quantum leaps in economic growth are more often associated with the education level of a country's work force. A country can lose virtually all of its buildings and machines, as Germany

and Japan did as a result of Allied bombing in World War II, and still regain high rates of economic growth within a few short years.

Why? Germany and Japan lost a much smaller percentage of their trained workers in the war than they did of their buildings and machines. And in a modern economy, human capital is much more important than physical capital.

One of the greatest economists of the 20th century, the late Theodore Schultz, Nobel prize winner, of the University of Chicago, recognized the centrality of human capital in modern economies in part by studying the postwar German and Japanese experiences.

What is the nature of human capital? Mr. Chairman, we are back to the tax treatment of the family. Human capital is created by the family. No other institution is so essential to the raising of children, and hopefully their development into the well-fed, healthy, educated workers of the future.

Given what modern economics has learned about the roots of economic growth, there is no way that the income of working families should be taxed more heavily than the owners of machines and buildings. Should tax reform proposals considered by this Congress put even more of the burden on working families than is the case today?

Given these realities, I would propose several guidelines for the Congress to keep in mind as it goes forward with changing the Tax Code. One, investment in human capital should be treated no better, but also no worse than investment in physical capital. Two, just as proper maintenance of machines and buildings is a necessary business experience, and thus is fully recognized as such by the Tax Code, proper maintenance of human capital should also be part of the Tax Code.

Once basic maintenance has been exempted from taxable income, the most economically efficiency tax system is likely to involve the widest possible definition of income, and at the same time as a result, the lowest possible rate of taxation, consistent with current and projected revenues.

I appreciate the opportunity to share these views, and look forward to answering your questions.

[The prepared statement follows:]

Statement of Martin J. Dannenfelser, Jr., Assistant to the President for Government Relations, Family Research Council

Mr. Chairman, I deeply appreciate this opportunity to discuss the issue of tax reform with particular emphasis on the need to provide relief to working American families.

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Today, the median family is paying around 30 percent of their income in taxes—about half of that in income taxes and half in payroll taxes. Should there be any surprise, in the light of these figures, that despite the enormous economic progress of recent decades, there is so much talk of a middle-class squeeze? Even leaving aside the relative stagnation in pay growth that began in the early l970s, this trend in Federal tax burdens on working families would be enough to make families feel squeezed.

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But consider this simple fact: year after year, in most countries at most times, workers earn about two-thirds of national income on a pre-tax basis. The remainder is earned by holders of capital. This latter kind of income comes not in wages, but in such forms as corporate profits, rents, interest income, and capital gains.

Yet workers, who account for roughly 67 percent of pre-tax income, are currently paying more than 75 percent of Federal taxes, a share that has been steadily rising in recent decades. Holders of capital earn one-third of national income, yet are paying only one-fourth of Federal taxes.

Mr. Chairman, my guess is that most Americans are unaware of this trend toward higher taxes on workers and lighter taxes on capital, even though they feel the impact of the trend in their take-home pay. There may even be a surprising number of economists who are unaware of it. But to the degree economists are aware of it, I believe they tend to think this trend is not such a bad thing. They assume that capital as defined in elite economics—that is, machines and buildings—is what drives economic growth, and that the sub rosa trend of the tax burden away from physical capital and onto working families will help the overall economy in the long run more than if the trend were in the opposite direction.

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The 20th century, which has featured the rise of management and information technologies, is very different. Today the quantum leaps in economic growth are more often associated with the education level of a country's work force. A country can lose virtually all its buildings and machines—as Germany and Japan did as a result of Allied bombing in World War II—and still regain high rates of economic growth within a few short years. Why? Germany and Japan lost a much smaller percentage of their trained workers in the war than they did of their buildings and machines. And in a modern economy, human capital is much more important than physical capital. One of the greatest economists of the 20th century, the late Nobel Prize winner Theodore Schultz, of the University of Chicago, recognized the centrality of human capital in modern economies, in part by studying the post-war German and Japanese experiences.

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Given what modern economics has learned about the roots of economic growth, there is no way that the income of working families should be taxed more heavily than the owners of machines and buildings. Still less should tax reform proposals considered by this Congress put even more of the burden on working families than is the case today.

Given these realities, I would propose several guidelines for the Congress to keep in mind as it goes forward with changing the tax code:

l. Investment in human capital should be treated no better, but also no worse, than investment in physical capital.

2. Just as proper maintenance of machines and buildings is a necessary business expense, and thus is fully recognized as such by the tax code, proper maintenance of human capital should also be part of the tax code. This implies a much more generous tax exemption or credit for family members than we have today.

3. Once basic maintenance has been exempted from taxable income, the most economically efficient tax system is likely to involve the widest possible definition of income and, at the same time and as a result, the lowest possible rate of taxation consistent with current and projected revenue needs.

Mr. Chairman, a flat rate tax system that is family friendly is a tax system that is achievable as a practical legislative goal. It also makes the most sense for the future not just of American families, but for the productivity of our information economy. I sincerely hope the Ways and Means Committee and Congress will move in this direction in the months ahead.

Chairman ARCHER. Thank you. I'm particularly grateful that each of you stayed within the suggested 5-minute period, which is not easy to do. And we'll have an opportunity to elaborate on your views during the inquiry period.

Let me ask each of you, as a basic question, how many of you feel that our current tax system is desirable? Raise your hands. The clerk should record there are no hands raised.

So it's simply a question of how do we reform it? And I wonder if what we seemed to learn from history is that we never seem to learn from history, because we have been trying to reform the income tax since its initiation in 1913.

It seems to me that one of the core problems is that there probably are not two of you out there, or two economists in this country who can define income in the same way. It is a subjective term. Do any of you disagree with that?

[No response.]

Chairman ARCHER. So as long as we have income as the base of taxation, will we not forever be going through the exercise of defining income? Or do you think we can get around that.

Mr. Hubbard.

Mr. HUBBARD. No. You have identified a critical point. The major source of complexity is that from measuring income, and from measuring certain kinds of expenses—depreciation, the issue of basis, and international tax provisions.

You are correct in thinking that a consumption tax would considerably simplify matters.

Chairman ARCHER. Dr. Sullivan.

Mr. SULLIVAN. I would add, I entirely agree with Glenn, but there are still issues under a consumption tax that are still very thorny, like determining what are proper business expenses, home office deduction. Those issues would still be out there under a consumption tax.

But I agree with Glenn.

Chairman ARCHER. Well, they would not be there under a sales tax.

Mr. SULLIVAN. Not under a sales tax.

Chairman ARCHER. It depends on how you would implement—what vehicle you would use to implement a consumption tax.

Mr. SULLIVAN. That's correct. But under the flat tax, that would be.

Chairman ARCHER. And just to further develop this basic concept, Dr. Sullivan, you said that the flat tax would be very simple for business because it's just a matter of businesses taking their business expenses.

That, as I listen to you, presumes that we could know between us what business expenses are. We have seen a Cato Institute report where they say they're defining corporate welfare. And one of the items that they claim is corporate welfare is the business expense of advertising.

So do we not further get into the problem of defining what business expenses are ultimately even under a flat tax?

Mr. SULLIVAN. We still have——

Chairman ARCHER. I mean, what is a legitimate business expense. Obviously it's like beauty. It's in the eye of the beholder.

Mr. SULLIVAN. Yes.

Chairman ARCHER. Clearly because we hear these debates going on over and over again today in this country. It fascinates me that we now have a recommendation, a proposal from the administration to simplify the Tax Code, and to pay for that, they want to complicate the foreign source income provisions.

And in their proposals in their budget, where they want to do a number of things that are highly desirable politically, they add significant additional complications to the Code.

And so I simply say that there are a lot of basic things here, other than just distribution of income, economic activity, and so forth, that we should look at that are difficult, I know, for economists to be able to quantify and to put into their formulations.

How much is freedom and privacy worth to every individual in this country? If I file a flat tax it clearly is simpler than the current income tax, and I think it is desirable in comparison to the current income tax. But does it not still leave the IRS in my life?

Can they not come back on me and ask me to provide the records to support the number on my post card tax return for 7 years, and to prove the accuracy of that? Are they not still in my life, as an individual? And all of you are nodding your heads, I think.

So I say that preliminarily to asking each of you this question: How much would each of you individually pay each year not to have to deal with the IRS?

Mr. Dannenfelser, what would it be worth to you as an individual, not speaking for your organization, but you as an individual?

Mr. ASMUS. In an average year for me, I'd be willing to pay $3,000. But on the bad years of the IRS chasing me down, those years I'd be willing to pay $10,000 to $20,000.

Chairman ARCHER. All right. Mr. Dannenfelser, how much would you pay not to have to deal with the IRS every year personally?

Mr. DANNENFELSER. My taxes have probably not been as complex as some others, and I have a CPA who does them for me, so I can factor in his costs. And with some of the other things we get from employers, I think there are probably other people who have much more complex situations.

Probably I would be willing to pay somewhere between $500 and $1,000—that's for my own direct costs. But there are many other indirect costs that I'm not seeing probably.

Chairman ARCHER. Mr. Mitchell, what about you?

Mr. MITCHELL. Assuming that we're talking about replacing the current system with a low rate consumption tax, I'm sure I'd be willing to pay several thousand dollars just to reflect the tax savings that I would hopefully receive.

Chairman ARCHER. Yes. Well, but if it were possible for us through structural tax reform to get the IRS completely and totally out of your individual life, how much would that be worth to you personally?

Mr. MITCHELL. That would probably be worth $1,000, $2,000.

Chairman ARCHER. OK.

Dr. Sullivan.

Mr. SULLIVAN. I'd pay $500 a year to get the IRS out of my life.

Chairman ARCHER. For your tax preparer.

Mr. SULLIVAN. Yes.

Chairman ARCHER. How many of you does his own tax return? And you still pay your tax preparer, Dr. Sullivan?

Mr. SULLIVAN. I don't have a tax preparer. I do it all myself.

Chairman ARCHER. All right. So you don't pay anything to a tax preparer. OK. And it's worth $500 to you not to have to do that every year?

Mr. SULLIVAN. Roughly. Maybe more.

Chairman ARCHER. Maybe more. OK.

Mr. Steuerle.

Mr. STEUERLE. I'd say about the same. About $500, if I can avoid all interactions with tax authorities. Although I'm not sure that's possible.

Chairman ARCHER. Mr. Hubbard.

Mr. HUBBARD. I would likely pay I think several thousand dollars because of the wasted time. But if I might, Mr. Chairman, I think there are two issues raised by your concern. One is the "hassle factor," and the other is the "anxiety factor."

I am not anxious about the IRS. Compliance is complicated, and filling my tax form out is a pain. But I view that as a hassle. I think many people whose tax returns are simpler than mine are far more anxious. It is the anxiety about the IRS that seems to be the public's great fear, not the number of hours that relatively high income taxpayers might spend filling out their forms.

Chairman ARCHER. And it's really very hard to quantify that, isn't it. That is, what is the price of liberty, privacy in your individual life? And to each of us, it's a different thing.

I had a middle-income lady from Connecticut who sat in that chair where you are, Mr. Hubbard, last year. And I asked this question of all the witnesses. And the answers were all similar to the ones you gave until it got to her, and she said I would give my first born child.

Needless to say, she had had an untoward experience with the IRS. It wasn't just the monetary costs.

But I do think it's important, as we look at these things, that we take into account some of the broader aspects of what the tax system does. Then when you get over into the issue of economic growth, it seems to me that it doesn't get adequately handicapped when you talk about distribution tables.

But most of you have alluded to the fact that if we had a better tax system we could have some degree of economic growth in excess of what we have under the current system. Does any one of you disagree with that, that we could actually impact on our economic growth if we had a different system from the one that we have now?

Mr. MITCHELL. I think the evidence is very clear on that. The fastest growing economy in the world in the last 50 years has been Hong Kong, and they have a 15-percent flat tax rate now for the majority of filers. And the fastly growing economy coming out of the former Soviet empire is Estonia. They have a single rate tax system as well.

And you look at our own history, when we reduced tax rates under Kennedy and under Reagan, the economy grew faster. I have

a hard time believing that anybody could reject the proposition that a better Tax Code would lead to more economic growth.

Mr. SULLIVAN. I think the evidence is very unclear on whether there's economic growth. I think there's a lot of uncertainty. I think the best guesses are that there are some, and I think it's worth going for. But I think there's been a lot of overblown claims about this is going to solve all of our problems.

We'll get a little bit of growth from a consumption tax, and I think we should move in that direction. But I think the claims are way overblown, and there is no certainty about it.

Mr. ASMUS. Dale Jorgenson of Harvard University, Mr. Chairman, isn't known for his overstatements. In fact, I think his testimony before this Committee a year ago were full of understatements.

But he argued that there would be a 10- to 13-percent growth in the gross domestic product or GDP. So he would argue there's significant growth, massive investment and saving and great increase in the labor supply and so on.

So I think most economists would say that we would have significant growth under a national retail sales tax.

Mr. HUBBARD. Mr. Chairman, if I might offer an observation.

Chairman ARCHER. Mr. Hubbard.

Mr. HUBBARD. All of the above might be close to correct. There is sometimes a confusion between a change in the rate of growth and the change in the level of output. In the long run, most economists believe output per worker will be higher as a consequence of tax reform. That is, there will be a higher level of output and a higher level of consumption.

Over the short term, then, there will be a higher rate of growth. Very few economists would say that tax reform would permanently increase a growth rate. That's the sense in which I think there may be some confusion.

Still, again, most of the evidence from the profession suggests that there would be significantly higher levels of output and consumption in response to the kind of tax reforms you are considering.

Mr. STEUERLE. One thing economists don't measure very well, Mr. Chairman, too, are the gains from simplification. And in my own book, I think, some of the gains from simplification are far in excess of some of the gains we're claiming we might get because of some more elaborate adjustments and incentives of the system.

I think simplification is a major goal.

Chairman ARCHER. I'm grateful that you said that, because the compliance costs today that are a result of complexity in this country are to me just wasted energy. And the great minds that are working in trying to cope with this Tax Code if they were producing wealth would, I think, create significant economic benefit for this country.

So I'm really glad you threw that in there. I'm also disturbed, I must say—and there's not been much discussion about it today—about the underground economy, and our inability to collect the income tax.

And I believe that one of you alluded to the electronic age and the way things are changing and shifting now. I've been told by

some experts that the amount of uncollected taxes today will jump dramatically in the next century with the advent of the smart card and the ability to transfer money electronically without trace, which will basically defy the ability of the IRS to be able to enforce the income tax in bigger and bigger proportions.

Does any one of you have any concern about that?

Mr. DANNENFELSER. We think that that is something that would be desirable. Looking at the consumption tax, of course, there would be—some things which would have to be looked at because whenever you get into higher excise tax and so on, you create the situation of black market economies, which you may have to deal with a consumption tax as well.

But to the extent that this is becoming a more serious problem, that is a very reasonable point to look at.

Our main concern, whether with an income tax or a consumption tax is to look at families. And with the issue of a consumption tax we feel that you would need to have some means, starting with the first dollar or compensating families for those expenses.

With the income tax, of course, you have the personal exemption and that sort of thing. There would have to be some mechanism built in, some kind of rebate that we would hope would take into account the amount—per family member—would take into account the family income and the number of family members to somehow provide a rebate against what people are paying in consumption taxes, just as we would suggest in an income tax that you take into account income taxes and payroll taxes and provide some deduction in that area.

Chairman ARCHER. Yes. Mr. Mitchell.

Mr. MITCHELL. I think we want to be cautious about how much money we assume that tax reform will get out of the underground economy. Whether you have a flat tax or a sales tax, a drug dealer is not going to report his income, nor is he going to levy a tax on his sales.

Likewise, if somebody wants to evade taxes on the Internet, whether they earn income that way, or they sell things that way, if they want to simply remain anonymous, you're going to have great difficulty under either tax reform collecting money on people who are either illegal or simply have the ability to remain anonymous.

But that's an argument for at least having a low rate so that their incentives to remain illegal or anonymous are lower.

Chairman ARCHER. Well, I think it is a sine qua non that there will be leakage in any tax system—in any tax system. The question is the magnitude of the leakage, and the degree to which the American people perceive that that leakage is massive unfair or not.

At least the drug dealer, when they buy a Mercedes is going to pay under the consumption tax. And the government, for tax collecting purposes, doesn't need to know their records.

Let me go to other Members for inquiry. Thank you very much.

Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman. Let me thank members of the panel for being here. As long as there is a government, there will be taxes. As long as there are taxes there will be a government agency to collect them. Citizens pay taxes. The IRS or some other

government agency cannot collect taxes without interacting with citizens.

It is impossible. To say otherwise is to mislead the American people. We must not attack the IRS for doing its job. Yes, there are problems with the Tax Code. Yes, some IRS employees could do a better job. But we must not attack the IRS.

To attack the IRS is to attack ourselves. Fiery rhetoric leads to mistrust of the Federal Government, attacks on Federal employees, and worse.

My question to you, members of this panel, is this: under any of these proposals, who will collect the taxes and how will they do so?

Mr. MITCHELL. I guess I'll start. I agree with you. As long as the government is going to take a $1.5 trillion out of the economy, they are going to need somebody with a gun as the ultimate enforcement vehicle saying give us the money.

And whether it's one IRS in Washington or 50 different States collecting it under a sales tax, we're going to have a tax system that is based on the government being able to force people to give them the money.

And I don't really blame the IRS. I blame the tax laws for being so complicated that it causes people to mistrust and dislike government.

Mr. STEUERLE. Mr. Lewis, I may be the only person in the United States that ever wrote a book which I dedicated to the IRS. I wrote a book about the IRS, and after interviewing a number of employees there, I was very impressed by their dedication.

Having said that, when I examined the IRS, I also concluded that they had many more functions put upon them than they could possibly fulfill, and that that was perhaps the principal reason for their current problems.

In a couple of columns that I have written, sort of open letters to the Restructuring Commission, I have made this same point, that if they really want to solve the IRS' problems, they've got to get at some of these fundamental issues of how much is demanded of the tax system. That is, you can't totally separate the issue of tax policy from tax administration.

Policy has to be made somewhat simpler if we want an IRS that is able to administer the system, and provide the advice we really think the taxpayers deserve, but we're not willing to pay for as a people, because we're not willing to pay the agents the money to provide us the advice, and so on.

Mr. LEWIS. Thank you.

Mr. DANNENFELSER. Mr. Lewis, one of the other things I know was alluded to here earlier is one of the great frustrations is that taxpayers can't get an answer from the IRS that they can rely on and point to as being something where they know they're in compliance.

And it's very difficult for a taxpayer to know when they're in compliance with the law. And there was a survey that said that 78 percent of the questions were answered incorrectly by the IRS agents.

Now, that doesn't mean that the IRS agents should be totally to blame, because the system is unrealistic. But there needs to be a way to make it simpler so that people can understand it, but that

also they can go to someone and get a clear answer and that they acted in good faith with that clear answer by somebody who is accountable, so that they are not held liable and penalized for following the advice that the government agent gave them.

And that would do a great deal to restore the confidence of the people in the system.

Mr. ASMUS. Mr. Lewis, John Neisbet wrote a famous book 15 years ago called "Megatrends." And what gave him the idea for that book was that if someone would have subscribed to all the German newspapers during World War II—about 600 newspapers—you literally could have predicted what the Nazis were going to do in World War II.

So he said what about the idea then of subscribing to a lot of newspapers, bringing together all the ideas, the column inches, and see if any "megatrends" begin to exist. And so that was the genesis of writing that book.

Before coming to this Committee, I thought it would be fun to go on CompuServe and America On Line and pull up all the stories I possibly could from all the major newspapers in the United States—the Chicago Tribune, the New York Times, and right across the country.

And I've got a stack of articles about 3 feet deep. I think what—if the average American taxpayer knew what was happening with their fellow taxpayers concerning the IRS, there would be even more anger than there is now.

What we all go through now is we read an occasional article in the Wall Street Journal or the New York Times and maybe in our local newspaper, and so over the course of a year we will read three or four things about the IRS, but when you kind of bring all these things together, as Neisbet tried to do as he put "Megatrends" together, it does shift the debate.

Again, it's not that these are mean, ornery people. It's just that there's no competition. There's no accountability. There's no control, and they have enormous power over people's lives. And I think, Mr. Lewis, it would make you angry as well as it does myself.

Mr. LEWIS. OK. I notice my time has expired, Mr. Chairman. Thank you very much.

Chairman ARCHER. Thank you, Mr. Lewis. The Chair totally empathizes and agrees with the comments you made, Mr. Steuerle. And I will say to my friend, Mr. Lewis, I don't believe there's been an utterance out of the Chair today bashing the IRS.

There are abuses in the IRS.

Mr. LEWIS. Mr. Chairman, I didn't mean to imply that you had bashed. But I think one of my colleagues said earlier, and others have said from this position and on the floor and in other places around the country that we should abolish the IRS.

People have been coming down pretty hard on hard working, dedicated Federal employees that work for the IRS.

Chairman ARCHER. Well, I do want to abolish the IRS, because I want to get the privacy and the freedom of every individual back into their lives. And there are abuses in the IRS. But the major problem, I believe, is the complexity of the Code.

I've been told that something as simple as head of a household, which is a basic part of our code, that determines how you are taxed, that if you call the IRS that an agent has to ask you 42 questions and get the answers to those before they can with certainty tell you that you qualify as head of a household.

Now, that to me makes this code virtually obscene on such simple things as that. And so I really don't want to just bash the IRS. I want to talk about a code that we have given to them that is virtually impossible to administer and that has too many gray areas with too much subjectivity where there cannot be agreement, where too many taxpayers ending up having to negotiate their tax liability with the IRS, and reach a settlement.

We should not have a tax system that puts taxpayers in that kind of position, or puts the IRS in that kind of a position.

Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman. Dr. Sullivan, I want to start with you, if I may. You didn't raise your hand when the Chairman asked if the present tax system was as good as we can do. Basically that's what he asked.

Mr. SULLIVAN. Oh, I think we could.

Mr. MCCRERY. You think we can do better?

Mr. SULLIVAN. We can do better, yes.

Mr. MCCRERY. OK. In your testimony you didn't really say how we could do better. You just really ragged on the flat tax. But give us some positive suggestions. What should we do to make the current Tax Code better?

Mr. SULLIVAN. I think I pointed out a lot of positive aspects of the flat tax.

Mr. MCCRERY. You did. But your final analysis was we can't do it.

Mr. SULLIVAN. Well, no. I'm saying that if we do it, I think we have to be realistic about the rate. That we could do it with a 23-percent tax rate. As I say, I think we should try to keep rates as low as possible. I think we should absolutely try to eliminate all types of deductions and credits in the Code, so that we can have a fairer and simpler tax system.

Mr. MCCRERY. So is the 23-percent flat tax preferable to what we have now, in your view?

Mr. SULLIVAN. I'm not trying to be cute, but I'll answer it in two ways: from an economic point of view, I think it is absolutely superior to what we currently have. From a personal point of view, or a philosophical point of view, there's a question about progressivity of the tax system. Everybody is entitled to their own opinion about progressivity.

I would like to report that the flat tax would be much more—much less progressive than current law. If everybody felt comfortable with a tax system which was much less progressive than current law, and if I felt that way, then I think it would be a better system, yes.

Mr. MCCRERY. So would your concerns be calmed if we had a simple tax system that had three simple rates, with no deductions?

Mr. SULLIVAN. Right.

Mr. MCCRERY. That would be better than a single rate system?

Mr. SULLIVAN. If one desired to have more progressivity, or to retain the current level of progressivity that we now have, then yes, I think that would be better than the current system.

It would be simpler. It would have a broader tax base, with a lot less loopholes. And that type of system would have—you would try to approximate the progressivity that we have now.

Mr. MCCRERY. And how, if the base rate is, say, 15 percent, how high would you go?

Mr. SULLIVAN. Well, again, that's a matter of personal preference on what one desires.

Mr. MCCRERY. Have you looked at the numbers, though, given your personal bias that we ought to have a more progressive, simpler tax system? Have you looked at the numbers to show us where we would be in terms of rates to get a revenue neutral proposal?

Mr. SULLIVAN. First of all, I don't have a personal bias, I don't think I've expressed a personal bias in favor of a progressive or whatever system, and I haven't looked at the numbers. I haven't done those calculations.

I think it's perfectly legitimate to argue that the current tax system should be less regressive. It's a very valid point of view. All I am pointing out today is that consumption taxes would be less progressive than current law. That's all.

Mr. MCCRERY. Thank you. I'm just a lawyer. I'm not an economist, and I'm not a tax expert, really. And I am convinced that the current Tax Code is a drag on economic activity in this country, and certainly is not what we ought to have in the next century. And frankly I lean toward the Chairman's idea of some sort of consumption tax, but I'm not there yet.

So let me ask the panel a few questions about the consumption tax. And as I say, I'm not really an economist, so bear with me.

I read that a huge percentage of our GDP occurs as a result of consumer activity. Consumption. So if we impose a consumption tax, wouldn't that dampen consumer activity, at least initially, and wouldn't that perhaps bring down our GDP, at least initially?

Where am I wrong in that analysis? Explain that to me.

Mr. HUBBARD. Your question, Mr. McCrery, raises both a short-run and a long-run issue. Part of the goal of the consumption tax is to raise savings rates, which would ultimately lead to a higher capital stock, which would ultimately lead to higher wages and higher consumption.

In your GDP accounting, another component of GDP is investment, which would respond very positively to a consumption tax. Most economists would argue that in the long run—whatever that means, of course—output per worker and consumption per worker would be higher as a result of the consumption tax.

Mr. MCCRERY. Yes. That's what concerns me, is what is the long run? How many years does it take for us to get to the long run, and what do we do in the meantime?

Mr. MITCHELL. Well, if I could jump in. Even though I'm a flat tax fan, I think the sales tax wouldn't really have short term consequences in the sense that if you eliminate the income tax—and truly can do that, which is my concern with the sales tax—don't forget everyone gets a big boost in take home pay by the elimination of their withholding and for income taxes.

And so even though retail prices might rise by whatever the tax rate is, you'd have that much higher take-home pay. The only short term consequence that I think might be significant is everybody might not rush out and buy all their big consumer purchases December 31, and then for the first 3, 6 months of a sales tax, or whatever that period would be, you might have some sort of big, artificial jump up and drop off. But I think that would be a relatively short-term phenomenon.

Mr. STEUERLE. There is, Mr. McCrery, a major issue among people who get into the technicalities of how you design consumption taxes, and that has to do with what one would do with existing pension savings, which are on the order of about $7 trillion in the economy.

In fact, one of the fears is that if you immediately go to a consumption tax where you no longer favor pension savings, that in fact it would lead to a consumption binge by some current owners of pensions. And so that's one of the issues. It's actually in the opposite direction.

Mr. MCCRERY [presiding]. I have a lot more questions, but I will allow my colleagues to follow their own line.

Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman. Mr. Steuerle, you do bring up a very interesting and important point there about the transition problem with funds that are already in savings.

We've talked a lot about the consumption tax versus the flat tax, but in reality both of them levied would be assessed at a flat rate.

The flat rate on income would have your standard and your personal deductions, but then would also tax income on savings. Whereas the consumption tax, and a flat rate, would only tax those that are expended funds from an income, and the difference would be the income tax flat rate would be levied at the end of the year, and the consumption would be immediately.

So that both are a flat tax as they affect the taxpayer. And in talking about flat tax and consumption tax, we fail to mention anything about payroll tax. Because the payroll tax has been one of the most concerned areas due to the fact of how much it's increased in recent years, and what it will increase or potentially increase for what's out there for potential long term liability based on those of us who happen to be born in or around or right after World War II and what that's going to do to those entitlement programs that address the payroll tax.

That is a real concern. So that has not been mentioned, but I did want to bring that point up.

Mr. Dannenfelser, you mentioned physical capital versus human capital. I'm a firm believer that physical capital also creates human capital by encouraging investments in machines and buildings that results in jobs of manufacturing or construction.

But my question is this, because it's been mentioned, too, by several of you on the child tax credit—should we be looking at a child tax credit? Or should we be looking at possible increase, both phased in over the next 5 years, in the dependent and standard deductions, one versus the other?

I think both would have substantial reduction in the tax liability of families. What are your comments in those areas? Child tax credit versus an increase in standard or dependent deductions?

Mr. DANNENFELSER. They would have similar effects. We believe that in the short run, at least looking at the $500-per-child tax credit, that the costs associated with raising children are such a burden for families right now. And that with the increased tax burdens and so on that you've mentioned, such as payroll taxes and others, that it is becoming much more difficult.

That is a part of people's wages that are just disappearing, and it's not accounted for in some of the other calculations. But certainly either one would be a benefit to families. But I think our preference in the short run would be for the $500-per-child tax credit.

Mr. STEUERLE. Mr. Collins, may I add to that?

Mr. COLLINS. Yes.

Mr. STEUERLE. In theory, if all families were the same size, I could in theory design a tax system rate structure with a credit that was exactly identical to a rate structure that had an exemption. I won't go into the details of why, but I could literally make them replicate each other exactly.

But what complicates matters significantly is that we also have a lot of welfare transfer systems, earned income credits out there. The existence of these systems, all of which in some sense you might think of as credit based, there's kind of a basis of support that phases out, as one's income goes up. This leads me to believe that one could get a better integrated system by thinking about a child credit as a mechanism.

So that when one moved out of welfare, or never went on welfare in the first place, one had something like a child credit that went with one's family. If you do that, I think you can not only reduce some of these large work disincentives in welfare, you can also reduce where the really largest marriage penalties are, for low income people who marry. I mean, tremendous marriage penalties. They lose 30 percent of their income in some cases just because they marry.

If you start going toward a child credit that is available that kind of goes with the child, independently of marital status, you can get at some of these problems. And it's for those reasons, primarily, that I tend to favor a child credit as opposed to a dependent exemption.

But I say in theory, the pure tax system without welfare transfers or anything else, you could design systems that would be roughly approximately the same.

Mr. COLLINS. Another difference, too, though would be the credit again is issued at the end of the year, where if you had an increase in the standard deduction or dependent deduction, that could be on a weekly or biweekly or monthly payroll.

Mr. STEUERLE. I think you could effect both of them with withholding, I think.

Mr. COLLINS. I have one other question. We're down to short rows. May I ask it, Mr. Chairman?

Mr. MCCRERY. Sure, Mr. Collins.

Mr. COLLINS. The next question, if we should change—and I'd like to use a good Southern word, supposing—supposing we should change from the current system after making some interim changes, like the capital gains and dealing with the death tax and the alternative minimum tax and such, what would be your suggested date of implementation of that change? 1998, 1999, 2000, 2001?

Mr. MITCHELL. I assume, just on the basis of avoiding a presidential veto, we're not talking about actually doing this legislation until 2001. But you all on the other side have probably better control of that than I do.

Mr. COLLINS. Anyone else have a date they would like to throw out? A year? I agree with the 2000's, implementation in 2001. To take the presidential politics out of it. Any other comments?

Thank you, Mr. Chairman. Thank you all. It's been very interesting listening to you.

Mr. MCCRERY. Thank you. Mr. Hayworth.

Mr. HAYWORTH. Thank you, Mr. Chairman. For the purposes of full disclosure I should make mention of preexisting association with two of our panelists today. First, Dr. Barry Asmus, who I enjoy. He had the great good sense to live in Arizona, although I would like to see him move to the Sixth District instead of the Fourth District. But his daughter and my daughter went to high school together.

And I also appreciated Dr. Asmus and his unique free market perspective, offering a humorous perspective, often when he would come to visit the Rotary Club of Phoenix, of which I was a member. And to Mr. Mitchell, my sometime broadcast partner, on National Empowerment Television.

I thank you all for coming down today.

Dr. Asmus, I want to return to a line of questioning that my colleague from Louisiana brought up, about a consumption tax, most often reflected in a national retail sales tax.

I apologize, because I was meeting with other Arizonans out here, so perhaps this question has been asked before. And, Mr. Mitchell talked about it in passing a couple of moments ago.

And that is the impact, again to use the term, the colloquialism of the gentleman from Georgia—suppose. Suppose we go to a national consumption tax, reflected in a national retail sales tax. You're looking at a one-time increase in prices of *x* amount.

Now, we have seen comments from retailers saying, no, no, no. Let's not do this. It puts too much of a burden on retailers and point of sale, and it's very difficult for the retailers to do this, they maintain, or it adds another burden on them.

I'm curious about the temptation factor, I'll call it. Let's say that prices have to increase, obviously to pay the tax, retail sales tax. Is there temptation for retailers then to add in an extra percentage for the amount of work they have to do?

In other words, if we had to see a one time increase in prices of 17 percent, does the temptation exist for retailers to say, you know, that's worth about 3 percent to us with the extra work we have to kick in. Let's just jack up prices to 20 percent.

And would that not unintentionally—could that not within the realm of possibility unintentionally trigger an inflationary spiral?

Or would that be—even with the increase, that would still be desirable over the system we have today?

Mr. ASMUS. Business and corporations do not pay taxes. Individuals do. They're reflected in the higher price of the products that people buy. The problem with our system today, that it's all hidden taxes, and everybody is not only confused, but truly does not know how much tax is represented in the price that they pay.

So as we go to a national retail sales tax, it's clean, it's fair, it's above board. We can see it very clearly. Now, Dale Jorgenson says that producer prices probably would lower by about 20 percent.

So if we are talking about a national retail sales tax of, say, 20 percent, I think this should net out at about the same consumer prices as we went in. But what's nice about this system that we're talking about today is now the consumer sees very clearly the tax portion of that.

Furthermore, on your question, I do not think, if we're going to make retailers not only collect the State sales tax, but the Federal sales tax, I think there has got to be a remuneration for them providing that service.

I don't think that it would be fair to have them have to bring in a lot more people or whatever it would take to do that for nothing.

Mr. MITCHELL. If I could just add to that, Congressmen Schaefer and Tauzin, I believe we need to have a one-half percent rebate to retailers to reflect the cost of collection.

Mr. HAYWORTH. Dr. Asmus, you mentioned Dr. Jorgenson, and his estimation of the decrease in the production costs of some 20 percent. Again, I guess it echoes what my colleague from Louisiana talked about, and that is the timeframe involved to do this. Those who proposed a flat tax, those who champion a consumption tax talk about this transition phase, how do we get there from here?

Dr. Asmus, from your perspective, what should we keep in mind in that transition that would help to ease some of the problems that might be presented?

Mr. ASMUS. Well, I think the thing that would help ease some of the problem is if we're going to continue to stress progressivity on the taxing end of it, we've got some really, really serious problems here. But if we begin to say let's deliver our progressivity on the government expenditure end of it, we can begin to mitigate some of those problems.

So as this discussion heats up and we continue to move into it, if progressivity is going to be the bending point, and it certainly bothers a lot of people, this is going to be a very difficult transition. But if we can say, look, is there a law on high, on Mount Sinai, that says that taxes, that we have to be as progressive as the current system that we have now?

And we begin to then do it on the expenditure side, I think we can get from point A to point B.

The point that I was trying to make in my testimony is this: that in a global economy and in a contractual economy, the question is not if we have to do this. The question is only when and how we are going to do this, because tracing income, as Chairman Archer has already pointed out, is one difficult problem. And it's going to get more complicated with each passing month, as we go into the global information economy.

And so I think it is not going to be long when everybody is going to be sitting around this Committee saying, we know we have to do it. Now the question is how do we get there. And there are some transitional problems without question.

Mr. HAYWORTH. Mr. Chairman, I have no further questions. I would just simply like to thank the panel for their attendance, and I look forward to continuing this discussion and moving past words to actions in the years ahead. Thank you very much.

Mr. MCCRERY. Thank you, Mr. Hayworth.

Gentlemen, if you would indulge me for just a couple of more minutes. First of all, Dr. Asmus, you said that we could infuse our system with progressivity through the spending side of government. Would you elaborate on that, please?

Mr. ASMUS. If we're concerned that we have a situation where people are too rich and other people are too poor, then we obviously have to do some things that would make it more pleasant for those that are on the poor side.

For example, Dick Armey says we're going to make the first $33,800 of income exempt from a flat tax.

Mr. MCCRERY. That's progressivity in the Tax Code. I'm talking about some examples of providing progressivity through spending—not tax expenditures, but spending.

Mr. ASMUS. Well, I think we would have to look at corporate welfare and say we must and should back away from that. And we leave welfare, poor welfare in place.

Mr. MCCRERY. That's what I was afraid you were going to say. It frightens me to think that we're going to create progressivity through the spending side. We've tried that for a long, long time, and it hasn't worked very well.

It infuses our society with all kinds of perverse incentives, none of which, I hope, we want to continue. So I would like for you to think about that long and hard, and when you come back here next time maybe have some more concrete examples of what you mean that maybe would allay my fears.

Mr. Mitchell.

Mr. MITCHELL. Let me just comment that I think that the concerns about progressivity are greatly overblown, because they rest on—I'm talking the tax side—because they rest on the assumption that the economy is a fixed pie, and it's simply the job of you, the policy maker, to figure out who gets what slice.

We saw in the twenties when we cut tax rates, the sixties when we cut tax rates, and the eighties when we cut tax rates, the rich reported more taxable income. Now, whether that was income they were hiding or whether that was new income they earned, the point is, at the end of these period of tax rate reductions, they wound up shouldering a greater share of the tax burden.

And I think if we lose that fundamental understanding, that the whole reason we're doing tax reform is because we want the pie to get bigger, then it's going to be impossible to do tax reform, and that's an issue that has to be taken on directly.

Mr. MCCRERY. Well, isn't there an inherent progressivity in a consumption tax?

Mr. MITCHELL. Well, that also depends on whether you're talking about just proportional progressivity, where Donald Trump makes

a million times more than me under a flat tax will pay a million times more in taxes. Or are you talking about a system where you want him to pay at even higher and higher rates, and then you get into all the questions about will he simply start hiding or not earning as much income, and thereby avoid the payment of tax?

Mr. MCCRERY. But in Chairman Archer's national sales tax, isn't there inherent progressivity in that system?

Mr. MITCHELL. Are you talking about the universal rebate? As far as I understand he doesn't have a bill.

Mr. MCCRERY. No. I'm talking about those who consume more, pay more.

Mr. MITCHELL. Yes, but it's always measured on the basis of what is your total amount of resources you have available divided by how much tax you're paying. I think the progressivity in a flat tax and sales tax would be identical, and I think it would be the right definition of progressivity, which is everybody being treated equally under the law.

Mr. MCCRERY. You touched on this earlier, gentlemen. What about the issue of, the transition from an income tax to a consumption tax system—say, the national sales tax for the elderly? For those who have saved under the current system, paid taxes on their income, saved after tax dollars, and now they're at the point where they have no income to speak of, but they are consuming.

Doesn't that present a problem of fairness to the elderly? You're nodding yes. No one wants to speak to it.

Mr. HUBBARD. There is no easy answer to your question, Mr. McCrery. Transfer payments to the elderly could certainly be indexed. In that sense, the elderly would be indemnified.

Regarding their wealth, the jury is actually out as to what the effect on asset prices is of fundamental tax reforms, because those reforms also involve forgiving the income tax.

Imagine that I am a little old lady on Park Avenue, and I own stocks. While it is true that depreciation deductions are being disallowed in the companies in which I am holding stock, there is no more tax on dividends and capital gains.

So it's not altogether clear that the elderly would be significantly worse off.

Mr. MCCRERY. That's not what I'm hearing from the elderly.

Mr. ASMUS. And if you could also convince them that there's already probably a disproportionate share of transfer of income toward the elderly, vis-a-vis Social Security, Medicare, and so forth, that then certainly middle aged people and younger people could argue that our society is already transferring more income to the elderly than, quote unquote, their fair share.

So you take that with his point and maybe this isn't as difficult as it might seem.

Mr. MCCRERY. That's a good point. That's not easily made, but that's a good point.

Mr. STEUERLE. Mr. McCrery, a long time ago, I discovered that the only way to have legal change that doesn't create winners and losers is to maintain the status quo. And I'm not trying to be entirely facetious.

There's a danger, and even people like myself play this game about identifying losers of, say, a proposal I might not like. But in

fact all proposals, typically if there's a legal change, involves some transfer of functions, or some taking away of something government does, and it does create some set of losers and winners.

And so despite the fact that we're not sure who all those are going to be, you certainly are going to face that issue no matter what reform you would undertake.

Mr. MCCRERY. I agree, and certainly I want to make it clear that I am—I've already said this—I think the current system is terrible, and it ought to be junked, literally, thrown into the trash can. And we ought to start all over. And there are going to be winners and losers. No question about that.

But in order to move this process forward, we're going to have to bluntly face these questions that are being asked by my constituents, by various interest groups. You can't just wave a wand and make it happen. You have to meet all these political objectives to get there.

So I thought as long as I had such a distinguished panel, I would at least broach a few of these and get some ideas.

Another question, and then I'll let you go. Another concern is people who have put much of their savings, their life time savings, frankly, into purchasing their own home. And now you're going to change the way that you tax not only purchasing that home, but the gain that's from the home.

It presents us with some terribly difficult questions, I think, of fairness, generational fairness, and all those things.

But I really want to commend you for excellent testimony. I think you have helped establish the case for a new Tax Code. And I hope you will be willing to help us figure out a way to construct a new Tax Code that is, indeed, fair. Can be defended as fair, and also more advantageous for our economy.

Thank you all.

[Whereupon, at 12:57 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Steven Cord, President, Center for the Study of Economics

The Federal Government should tax land values, exactly as it has already done in 1798, 1811 and 1861, instead of taxing income, sales, estates, gifts or value-added. Why?

- Income, sales, estates, gifts and value-added are all desirable, so they should not be penalized by taxes. If they are taxed, the government is creating poverty and much irksome tax-preparation for American individuals and families.
- If land values are taxed instead, land-sites will have to be efficiently used, thereby creating jobs and economic growth. If those sites are under-used, then the improvements on them will not generate enough income to pay the higher land tax as well as a reasonable profit for the improvements, so they are likely to be fully used. Here is a tax which actually creates not only revenue for the federal government but also jobs and economic growth.
- Most Americans will pay less with this land value tax, aud so it could generate political support. It is more based on ability-to-pay than any current or suggested taxes.

EVERY study that has been made of the 18 jurisdictions that have implemented a tax shift to land values has demonstrated that a spurt in new construction has followed the shift. No wonder that eight (8) recent American winners of the Nobel Prize in economics have endorsed laud value taxation.

A land value tax should not be confused with taxes on workers aud businesses. It differs completely from those bummers. It can provide revenue while promoting the economy. The more of it, the better.

But a federal land value tax must be properly implemented. This non-profit organization has studied LVT implementation for over 40 years and we have been inti-

mately involved in the 18 jurisdictions mentioned above so that we have hands-on experience. If the Committee is interested in learning more about this untapped revenue source, it should contact us for further information.

It is not worthwhile to replace a bad tax with a maybe not-so-bad tax. Be kind to American individuals and families.

Steven Cord testifies here on behalf of the Center for the Study of Economics, 2000 Century Plaza (#238), Columbia MD 21044, (Ph.) 410–740–1177, (Fax) 410–740–3279, (E-mail) hgeorge(@ smart.net, (Web) http://www.smart.net/hgeorge.

Statement of Hon. Dan Schaefer (R–CO)

Thank you, Mr. Chairman, for inviting all of us here to testify before the Committee. I commend you for holding this series of hearings. Comprehensive tax reform is an issue that enjoys broad and clear support from citizens across the country, and will undoubtedly dominate this nation's agenda in the coming years. Your leadership in the tax reform debate is critical if we are to move forward on this issue.

As you know, Congressman Billy Tauzin (R–LA) and I introduced legislation in the 104th Congress to close the Internal Revenue Service (IRS), eliminate the federal income tax and replace it with a National Retail Sales Tax. Today, Representative Billy Tauzin and I, joined by Representatives Joel Hefley, Charlie Norwood, Sonny Bono, John Linder, Bob Stump, Sue Myrick, Ralph Hall, and Roger Wicker, have introduced H.R. 2001, the National Retail Sales Tax Act of 1997.

The federal income tax system is impossibly complex, overly intrusive and economically destructive. Americans will spend over five billion hours and at least $200 billion complying with the income tax this year alone. That is the equivalent of three million Americans working full time just to fill out paperwork for the IRS.

According to Stephen Moore of the CATO Institute, "The average fee for preparation of a tax return is now almost $200. IRS data confirm that, in 1992, more than 50 million individual returns were done by tax preparers at an average fee of $200. Today, 80 percent of those using professional preparers have incomes below $50,000 of adjusted gross income. All told, Americans spend about $30 billion a year for the services of tax accountants and lawyers." Mr. Chairman, with all due respect to tax accountants and lawyers, those services add nothing to our national wealth.

Tracking all this paperwork requires an IRS five times the size of the Federal Bureau of Investigation to watch our every financial move. The powerful IRS may search our property and records without a court order. When challenged by the IRS, Americans are considered guilty until they can prove themselves innocent.

However, the most disturbing aspect of the income tax is its bias against hard work, savings and investment. Every dollar saved or invested by Americans is taxed at least twice—lowering savings, driving up interest rates and weakening economic growth. As a result, the average family today earns 15–20 percent less than they would without the biases of the income tax code.

Contrast that to a National Retail Sales Tax, which would be easy to understand, visible and conducive to economic growth. A National Retail Sales Tax would be similar to the sales tax currently imposed by 45 states. Because H.R. 2001 would eliminate the IRS, the states would collect the 15 percent national sales tax just as they collect the state tax today. Both states and retailers would receive generous payments to cover their administrative costs.

SO HOW WOULD THE SCHAEFER-TAUZIN NATIONAL RETAIL SALES TAX ACT OF 1997 AFFECT INDIVIDUALS AND FAMILIES?

To begin, the Schaefer-Tauzin legislation repeals federal personal and corporate income taxes, capital gains taxes, estate and gift taxes and all non-trust fund dedicated excise taxes. For families and individuals, this means no more hidden income tax withholding or complicated tax forms to file every year. The National Retail Sales Tax Act of 1997 would end the multiple taxation of economically productive savings and investment by imposing a single 15 percent consumption tax on the final retail sale of all goods or services.

Regardless of whether income is derived from wages, dividends, capital gains or any other source, it would not be taxed until it is consumed at the retail level. For example, the purchase of stock would not be taxed, but the brokerage fee would be, since it represents a service. Likewise, the proceeds from the sale of a stock would not be taxed as long as that money stays invested in the economy. On the other hand, if those proceeds were consumed for personal enjoyment, they would be taxed.

Laurence Kotlikoff, a professor of economics at Boston University, conducted a study on the economic impact of replacing federal income taxes with a national retail sales tax. His computer-simulated model evaluated the impact on U.S. savings by replacing all federal personal and corporate income taxes with a national retail sales tax.

Professor Kotlikoff's study concluded that a national sales tax "would do away with the differential tax treatment of corporate and non-corporate businesses, which distorts business decisions; of capital gains and dividends, which affects decisions about retaining earnings; and of investment in equipment, structures, and inventories. A sales tax would also end encouragement of current relative to future consumption, the tax exemption for health insurance premiums."

Additionally, the study concluded that, in the long-run, a shift to a National Retail Sales Tax would raise the stock of U.S. capital between 29 and 49 percent and raise living standards in the U.S. between 7 and 14 percent. Further, Koflikoff found that a National Retail Sales Tax would end the work disincentive associated with the current tax structure.

The Schaefer-Tauzin proposal would encourage savings and investment and discourage frivolous consumption. Savings are critical to a growing economy because they provide the pool of money that can then be used to invest in capital and equipment. Stimulated by new investment capital, the economy would respond with strong and steady growth. And since greater economic expansion and job creation would create a larger tax base, the National Retail Sales Tax could raise more revenue than the income tax does today.

Mr. Chairman, I believe the greatest strength of the National Retail Sales Tax is that it exposes the hidden tax burden on every American. Under the federal income tax, personal and corporate income taxes are hidden in each and every consumer transaction. First, personal income tax is withheld from the consumer's paycheck, requiring every purchase to be made in after-tax dollars. The second hit comes at the cash register, when the consumer pays the hidden business taxes and compliance costs of every business that had a hand in producing that good or service.

To help ensure that a national sales tax is not regressive, the Schaefer-Tauzin proposal provides a tax credit to guarantee that all workers receive a refund equal to the sales tax rate times the poverty level (adjusted for the number of dependents) in every paycheck. As a result, every wage earner will earn up to the poverty level tax free.

Further, in an effort to help protect senior citizens against any increase in prices that may be caused by a shift to the National Retail Sales Tax, the Schaefer-Tauzin legislation requires the Social Security Administration to include the national sales tax in their benefit formula when determining cost-of-living adjustments for Social Security recipients.

Finally, in the Schaefer-Tauzin legislation, the burden of proof lies with the government in any dispute with a taxpayer. And since H.R. 2001 closes the IRS, taxpayers will no longer have to worry about being intimidated by overzealous IRS agents.

As consensus builds in America that the income tax should be reformed, it is clear that the National Retail Sales Tax would provide the greatest benefit to American taxpayers. Again, I want to thank the Chairman for holding these hearings and for his leadership in this most critical of debates.

Statement of Hon. W.J. "Billy" Tauzin (R–LA)

Mr. Chairman, it is my honor to address the Committee on the benefits of a national retail sales tax, and its impact on individuals and families. Today, Congressman Dan Schaefer (R–CO) and I introduced the National Retail Sales Tax Act of 1997. In the 104th Congress we received overwhelming support from citizens across the country and are dedicated to pursuing this endeavor in the 105th. I look forward to working with you and the members of the Committee to overhaul our current system and lift the burden of the income tax from the shoulders of all Americans.

Mr. Chairman, all taxes reduce our ability to consume and are really "consumption taxes." Everyone I know intends to consume all the money they make, now or in the future. Some of us want to defer the consumption until we retire or until our kids are ready to go to college. Others want to consume a part of their earnings by donating it to a church or other organization. Others just use their earnings to con-

sume today. However, anything we decide to do with the money we earn is consumption.

Now, anytime government taxes away part of my money, it is reducing my ability to consume. Therefore, a 15% tax withheld from my income at 15% reduces the money I have with which to consume goods and services. For example, to purchase a $10 item of clothing with an income tax of 15%, I would actually have to make $11.80, pay 15% of this amount or $1.80 of income tax, and then use the remaining $10.00 to purchase the clothing.

With a 15% national retail sales tax, I would have to earn $11.50 in order to pay the $1.50 in national retail sales tax and net the $10.00 needed to buy the article of clothing. In the case of an income tax or of a national retail sales tax, the taxes reduce my ability to consume because I have fewer dollars to use for consumption.

My question to the committee is this, if all taxes are really consumption taxes, shouldn't we replace the present failed income tax system with a national retail sales tax that accomplishes the following:

1. Frees individuals from filing any type of federal tax returns;
2. Requires only simple returns from retail businesses;
3. Abolishes the IRS and tears the income tax out by the roots;
4. Increases our competitiveness in the world economy;
5. Ensures that the members of the underground economy pay their share;
6. Eliminates the taxes on production, investment and savings;
7. Requires illegal immigrants and importers to pay taxes in the U.S;
8. Empowers all Americans by giving them the choice as to how much tax they pay.

HOW WOULD THE SCHAEFER-TAUZIN RETAIL SALES TAX ACT OF 1997 AFFECT INDIVIDUALS AND FAMILIES?

First, the Schaefer-Tauzin bill frees individuals from filing any type of federal tax returns. In 1994, there were 107,291,000 individual income tax returns filed. 107,291,000 Americans were forced to spend in excess of 2 billion hours trying to calculate the amount of income taxes owed to the federal government. This is absurd.

The national retail sales tax requires no federal individual tax returns of any kind. Individual Americans will pay their taxes when they make purchases of retail goods and services. No receipts, no tax returns, no audits, no hassle.

Our legislation eliminates the taxes on work, investment and savings. Legislators understand that taxing something will produce less of it. By eliminating the income tax which penalizes work, investment and savings, we will get more work, investment and savings. Dr. Lawrence Kotlikoff and Dr. John Qualls both conducted detailed studies about the impact of replacing the present income tax with the national retail sales tax. They both found that the national retail sales tax causes the private savings rate (both personal and business savings) to rise substantially and produces faster economic growth and higher productivity. In both studies, the higher level of capital stock created under the national retail sales tax results in more job creation. More earnings by employees in the private sector fuels more consumer spending. Consumer spending thus rises from its current level, but actually declines as a percentage of GNP.

There will also be what some economists call the "sponge effect." The U.S. is the world's largest market and has the best infrastructure of any country on earth. When the income tax is replaced with the national retail sales tax, it will become the world's largest tax haven and a "sponge" for capital from around the world. According to Martin Armstrong of the Princeton Economic Institute, replacing the income tax with a national retail sales tax will create an inflow of foreign capitol into this country like we have never seen. Mr. Armstrong points out that the nearest comparable period in modern history was in 1940. Seeking to avoid the ravages of World War II, capital flooded into the United States and government bond rates were at one percent.

A conservative estimate is that the adoption of the national retail sales tax will lower interest rates between 200 and 300 basis points. Overnight we will see the debt service on our national debt reduced, perhaps enough to bring the budget in balance. Our businesses will be more able to purchase equipment and rapidly increase productivity. Our citizens will be able to refinance their homes and save hundreds of dollars per month in interest payments. In short, the United States will experience the greatest economic boom in our history which will be felt by all Americans.

Finally, the Schaefer-Tauzin National Retail Sales Tax Act of 1997 will empower all Americans by giving them the choice as to how much tax they pay. Our present

income tax system takes our money through withholding before we even receive it. Most of us now consider that our wages are really the "take-home pay" that we get net of all the deductions. Under the present system, it doesn't matter if one of us is more frugal than the other because we all pay the same amount of tax. In fact, if we are more frugal than our neighbor we are actually going to pay more and more tax because our earnings on our savings will be taxed each year.

With the national retail sales tax we receive all of the money we earn. Our checks are increased by the amount previously deducted for federal income tax. With this money in hand, we have the power to determine the amount of federal tax we pay based on how much we choose to spend. The American people, not some bureaucrat lawmaker in Congress, will have the power.

Also because of the way that the present income tax system hides the amount of taxes we pay in the price of goods and through withholding, I don't think any of us can really tell how much tax we are paying to the federal government. By eliminating the individual and corporate income tax, the estate and gift tax and all non-trust fund excise taxes and replacing them with a simple national retail sales tax, all of us will see the amount of federal tax we pay each time we make a purchase.

For each of us who really wants to make the government more accountable this is a compelling difference between the present income tax, the other income tax proposals and the national retail sales tax. When our citizens see how much they are paying in federal taxes they will demand that we become more efficient and deliver better services to them.

In closing, I believe that we should re-examine the basic ideas on which this government was founded. Our Founding Fathers insisted on the use of indirect taxes on individuals and specifically forbade direct taxes like the income tax. They did this because they were students of history and they know that every despotic country had one thing in common—direct taxation which helped enslave the people. We have an opportunity to eliminate the income tax, the IRS, tax returns, audits, and the penalties of our work, savings and investments and replace them with an indirect national retail sales tax. For all individuals and families, we must free America from the income tax.

Mr. Chairman, thank you again for holding these hearings and for your leadership on this critical issue.

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