Written Testimony of John L. Buckley Senate Budget Committee

April 8, 2014

INTRODUCTION

Madam Chairman, Ranking Member Sessions, I want to thank you and the other Members of the Committee for the opportunity to appear before you today.

Madam Chairman, I applaud you for holding this hearing and hope that this hearing is an indication that you and this Committee intend to play an active role in the tax reform debate. Tax reform will not be enacted this year, but I believe that it will happen in the future. How that tax reform is structured could have an enormous impact on our economy and long-term fiscal challenges. Tax reform if properly structured could be a first step in resolving those fiscal issues. But, tax reform as currently proposed in the House could worsen the already bleak long-term fiscal problems. If such a plan were enacted, this Committee and its House counterpart would be the ones charged with the politically difficult task of developing a budget plan to reverse that impact. And the adverse effects are likely to be felt at around the same time this Committee could be dealing with the demographic problems associated with entitlements. This Committee simply cannot ignore the debate.

I strongly believe that our tax system is in need of significant reform and expect that virtually every Member of this Committee would agree. Notwithstanding that consensus, there is little prospect for reform in the near future for one reason. Many of you and other tax reform proponents define tax reform in sharply different ways.

For many, the concept of tax reform is defined by reference to the 1986 tax reform; a significant reduction in rates financed by a broadening of the tax base with the goals of revenue neutrality and distributional neutrality (not altering the current distribution of tax burden). Recently, House Ways and Means Committee Chairman Dave Camp released a comprehensive tax reform plan that in many respects is consistent with the 1986 model. It contains significant marginal rate reductions for most individuals and for corporations.[1] Like the 1986 Act, it is advertised as achieving both revenue neutrality and distributional neutrality. The same type of economic theories that promised increased economic growth from the 1986 reform are now being used to promise increased growth from the Camp plan.

[1] The most notable exception is the approximately 50 million individuals in the current 10 and 25% brackets who will not see a reduction in their marginal rate. Many single taxpayers with children also may see little rate relief since the Camp draft eliminates current law favorable filing status for those taxpayers.

Surprisingly, the Camp plan, like the 1986 Act, contains a significant net tax increase on business income to finance reductions in personal income taxes.[2]

I believe that the question for this Committee is not whether a tax reform plan is consistent with the 1986 model. The real question is whether tax reform should follow that model.

1986 TAX REFORM

I would argue that the 1986 Tax Reform Act is at best an imperfect model for future tax reform efforts. The 1986 Act was a product of some unique circumstances.

Arguably, the Congress in 1986 had earned the luxury of being able to pursue a revenue- neutral tax reform. It enacted major tax increases in 1982 (the Tax Equity and Fiscal Responsibility act of 1982) and 1984 (the revenue provisions of the Deficit Reduction Act of 1984). The estimated revenue increases from those two laws, signed by President Reagan, were sizable even by today's standards, a combined revenue increase in fiscal 1987 of approximately $90 billion.[3] In terms of its relationship to the then level of the economy, the revenue increases are even more dramatic. Also in 1983, the Congress enacted a major restructuring of the Social Security system that contained both benefit reductions and revenue increases.[4] That law was an extraordinary accomplishment and it has remained in effect without any significant change for the last 30 years.

Perhaps even more important, in 1986, the long-term fiscal problems discussed at length in the recent CBO budget projections were 28 years further in the future than they are now.

Another unique circumstance behind the 1986 Act was the fact that the Congress was able to finance the rate reductions in part by addressing widespread tax sheltering and other "loopholes". Those changes were not without controversy, but their availability reduced the need to address the generally applicable benefits for individuals or incentives for domestic investment that are "on the table" in the current debate. In contrast to 1986, many of the so-called base broadeners or "tax expenditures" under consideration in the current discussion of tax reform are longstanding features of our system embedded in the fabric of our economy.

I do believe that the 1986 reform was an enormous accomplishment in many respects. Its attack on tax shelters was critical to the integrity of the tax system and maintaining the voluntary compliance necessary for the collection of tax liabilities. But, as "past is prologue", most important for this Committee is the fact that the 1986 reform failed in two major respects.

---

[2] See JCT macroeconomic analysis of Camp plan, page 6.

[3] See revenue tables appearing at the end of the 1982 and 1984 JCT "bluebooks.

[4] The Social Security Amendments of 1983.

First, it did not result in a stable rate structure. The reversal of the rate reductions started fairly quickly. In 1990, then President George Bush signed legislation increasing the top individual rate from 28% to 31%. Perhaps merely a coincidence, that revenue increase took effect in the last year of the 5-year budget window used in estimating the revenue effects of 1986 reform. The 1993 deficit reduction legislation increased the top rate to its current level of 39.6%.

In my opinion, the structure of the 1986 Act made those rate increases inevitable. The 1986 Act resulted in a net permanent reduction in individual income tax liability. I use the term permanent to describe a provision that results in a change in liability in one year without a reversal in later years. A rate reduction is an example of a permanent benefit; whereas a repeal of an itemized deduction is an example of a permanent tax increase.

In no small part, the permanent individual income tax reductions in the 1986 reform were financed with timing changes that did not alter the ultimate size of a deduction or income inclusion, merely the year in which that item is taken into account. Even the anti-tax shelter provisions were largely timing changes. Repealing a timing benefit can result in a temporary tax increase during the budget window due to transition effects of moving to the new system.

In summary, a rate reduction financed by repeal of timing benefits can be revenue-neutral during the budget window but result in growing and non-sustainable revenue losses outside the budget window when the temporary, transition effects disappear. I believe that is what occurred in the case of the 1986 Reform.

Second, the economic benefits predicted from the rate reductions and base broadening of the 1986 Act simply never materialized. The 1986 Act was not unique in that respect. The cumulative economic data of the last 30 years suggests that that the 30-year experiment with tax policy guided by supply-side economic principles and notions of the primacy of market outcomes has failed. One cannot find in the economic data for the last 30 years any evidence that supply-side-based tax policy has delivered its promised benefits. Also, there is no evidence that the 1993 tax increase had the negative effects predicted by many supply-side economists before its enactment.

TAX REFORM OBJECTIVES

Instead of simply following the 1986 model, I would suggest that a future tax reform plan should have the following objectives.

Stable Rate Structure

Much of the debate over tax reform ignores the fact that the fundamental purpose of our tax system is to raise sufficient funds to cover reasonably expected government expenditures. Tax reform should be

based on accomplishing that purpose, not some arbitrarily selected top tax rate. Also, the Congress should not be bound by the 10-year budget window in assessing the impact of reform. I assure you that the budget window is easily manipulated. Proponents of substantial changes to entitlement programs point to problems largely occurring outside the budget window. Proponents of tax reform should not be able to ignore the impact of the legislation outside the budget window.

Most budget analysts support the notion that a combination of additional revenue and spending reductions will be necessary to address long-term budget issues. Tax reform offers the opportunity to begin the necessary response to those issues. With regard to the need for additional revenue, I would note that the last Federal budget to show a modest surplus came in fiscal year 2000 when receipts were approximately 20% of GDP, substantially higher than the current level of 17.5%.

But above all, tax reform should not worsen the long-term budget problems. There seems little benefit in repeating the experience of the 1986 Reform Act, unsustainable low rates followed by politically painful responses to the resulting deficits.

Economic Growth and Expanding Job Opportunities

As with the basic notion of the need for tax reform, few would argue with the proposition that tax reform should be designed with the goal of expanding economic opportunities in this country. But, again there are disagreements on how to accomplish that goal.

During the last 30 years, most major tax legislation has been shaped by supply side principles and the notion that market outcomes not affected by tax incentives offer the best path for economic growth. Underlying those economic principles are the assumptions that the “amount of output is determined by the availability of labor and capital”[5] and the demand for labor and capital will equal supply (ie. no unemployment or unused business capital). The assumption of equilibrium of supply and demand is critical for projections of positive economic growth from tax policy changes designed to increase the supply of labor and capital.

A recent article by Sandille Hlatshwayo and Nobel Laureate economist Michael Spence suggests that those economic theories have little relevance now when “the global economy has an abundance of human resources and they are becoming more accessible as time goes on.” [6] Those resources are becoming more accessible because multinationals have become adept at creating and managing global supply chains and they are getting better all the time.

The Spence article looks at employment growth in the US between 1990 and 2008 in what is referred to as the tradable sector of the economy (the sector subject to cross-border competition) and the non-tradable sector. Not surprisingly, virtually all the domestic employment growth during that period

[5] JCT macroeconomic analysis of Camp plan.

[6] Michael and Sandile Hlatshwayo, “The Evolving Structure of the American Economy and the Employment Challenge”, Council on Foreign Relations, March 2011.

(97.7%) occurred in the non-tradable sector, with growth in government, healthcare, and retail accounting for most of that growth. In the tradable sector, there was growth in high end services that balanced declines in manufacturing. The article concludes that continued large employment growth in those non-tradable sectors is unlikely and, therefore, there is “a long-term structural challenge with respect to the quantity and quality of employment opportunities in the United States”.

In the opinion of the authors, the domestic employment challenge is not the result of market failures. Multinational enterprises moving jobs overseas are doing exactly what the market is telling them to do. A tax reform based on the primacy of market outcomes will not reverse the declines in domestic manufacturing employment. Indeed, it could worsen the domestic employment challenges by repealing incentives for domestic investment under the guise of economic neutrality and liberalizing tax rules for the foreign operations of US multinationals.

In summary, the question for tax reform is whether the problem facing this country is lack of labor supply or reduced employment opportunities which by itself tends to reduce labor supply. I believe that the Spence article makes a convincing case that the lack of employment opportunities is our main challenge. If that is the case, the Spence article concludes that tax reform could help if “it were to clearly favor investment in a broad range of productive assets of all kinds, including hard and soft infrastructure and human capital”. Such a reform might violate notions of economic efficiency, but as the Spence article concludes every good cause is worth some inefficiency.

It is worth noting that many other countries see expanding job opportunities in their country as a “good cause” and pursue non-neutral tax policies to accomplish that goal.

Distributional Neutrality

Few would disagree with the proposition that tax reform should not increase the growing inequality in income and wealth in this country. Ways and Means Committee Chairman Dave Camp has advertised his plan as not altering the current distribution of tax burden. In doing so, he relies on the analysis of the Joint Committee on Taxation (JCT).

In analyzing the distributional effect of changes to tax laws, the JCT uses what I call a “cash flow” method. Its analysis is based on the actual revenue gains or losses in each of the 10 years in the budget window, rather than an attempt to measure the economic burdens or benefits of the changes or do the analysis on the basis of the law in effect after transition effects (the fully-phased- in law).[7] The amount distributed by the JCT will include both purely one-time revenue increases and the temporary revenue increases from repeal of timing benefits.

[7] This means that the benefit or burden for any one year roughly reflects the revenue gain or loss for that year. Discrepancies can occur for amounts allocated to nontaxable persons (foreign persons) or where there is uncertainty about income levels of the persons subject to the changes (repeal of exclusions where there is insufficient data on income levels of individuals receiving those exclusions)

The JCT changed its distributional method last year by including corporate taxes and taxes on the income of pass-through entities in the analysis, but retained its cash flow approach.[8] That change was consistent with the treatment of those taxes by the Treasury and CBO. In the long run which is generally assumed to be the end of the 10-year budget window, the JCT allocates 75% of those taxes to owners of domestic capital and 25% to labor. Initially, 100% of those taxes will be allocated to owners of domestic capital, with ratable changes until the allocation reaches the final 75/25% split. Most of those taxes will be allocated to upper income taxpayers because of income inequality and the fact that the distribution of capital ownership is dramatically more unequal than income.[9]

Most business tax preferences are timing changes, the repeal of which would result in temporary tax increases during the budget window. Most of those temporary tax increases would be allocated to upper income taxpayers because of inequality in both income and wealth. As a result, a tax reform plan that relies on those temporary tax increases for distributional purposes could become sharply regressive as those temporary tax increases disappear after the 10-year budget window.

CAMP TAX REFORM PLAN

It is clear that the tax reform plan released by Ways and Means Committee Chairman Dave Camp will not see action this year. But, some suggest that it will be the model for future reform efforts and I see it as an example of why this Committee should be an active participant in the tax reform debate.

Revenue Neutrality

The Camp tax reform plan is advertised as revenue neutral, but even a brief examination of how it nominally complies with that standard makes it clear that it would result in a substantial reduction in revenues after the 10 year budget window. If the permanent tax benefits and permanent tax increases in the Camp reform plan were netted, it would show a permanent tax reduction over the 10-year budget window of well over $1 trillion. Following are examples of the temporary tax increases used to offset the cost of that permanent tax reduction.

- The Camp draft contains a substantial amount of purely one-time tax increases. One example is the one-time tax of $170 billion on the un-repatriated foreign earnings of US multinationals. Other examples include the estimated $79 billion from repeal of the LIFO accounting method and the estimated $23 billion from limitations on the cash method of accounting. Most of the revenue from those accounting changes reflects one-time tax increases that recapture the previous benefits of using the current law accounting methods.

[8] See Modeling the Distribution of Taxes on Business Income, JCX-14-13, October 16,2013.
[9] Compare table 1 to table 5 in JCX-14-13.

- The Camp draft contains two provisions that are designed to shift individual retirement contributions from pre-tax, deductible contributions to nondeductible, Roth-type contributions. Those provisions would raise approximately $161 billion in the budget window. Essentially, these provisions are timing changes, but they are extremely favorable timing changes. The taxpayer making the Roth-type contributions is compensated for the acceleration of tax on wage income by an exemption from tax for the investment earnings on the contribution. Depending on the assumed rate of return on the investment of the contributions, these provisions could be a tax benefit masquerading as a tax increase.
- Finally, there a large number of pure timing changes, such as repeal of accelerated depreciation (approximately $270 billion), repeal of expense treatment for research expenses (approximately $192 billion) , repeal of expense treatment for advertising expenses (approximately $169 billion), limitations on the use of net operating losses (approximately $70 billion), changes in reserves and accounting methods affecting insurance companies (approximately $54 billion) and repeal of non-recognition treatment for like kind exchanges (approximately $40 billion) . A substantial amount of those revenue gains reflects temporary tax increases in the budget window as a result of the transition to the new rules.

The JCT revenue table for the Camp plans shows a significant revenue loss in the last year of the budget window, a small indication of its long-term impact on deficits.

Distributional Neutrality

The claim that the Camp plan meets the goal of distributional neutrality depends on the distribution of the one-time and temporary tax increases discussed above. Once those revenues disappear, the Camp plan will contribute to income inequality. The JCT distribution table for the last year in the budget window shows a net tax reduction for individuals earning over $1 million per year, another small indication of things to come.

JCT Macroeconomic Analysis

Chairman Camp has used the JCT macroeconomic analysis in promoting his tax reform plan, but the conclusions reached by the JCT are far more ambiguous than his rhetoric would suggest.

First, the JCT analysis shows the limitations of macroeconomic analysis. There is no consensus on models or assumptions used in making that analysis. As a result, the JCT used two models and sets of different assumptions that provided a broad range of potential results.

Second, the model that showed the greatest growth from the Camp plan (the OLG model) contains a set of assumptions that bear no relationship to the real world. It assumes that there is no unemployment or capital that is not fully invested. It assumes that the federal budget problem has been solved through an

assumed set of tax increases and entitlement reductions. It assumes that individuals can predict the future with accuracy. We would all scoff if the JCT did its revenue estimates against such a fictional baseline. I see no reason why we should not scoff at a macroeconomic analysis done against a fictional baseline.

The other model used by the JCT (the MEG model) was developed by them. I may disagree with the supply-side principles used in the model because I agree with the Spence article conclusion that lack of job opportunities is the largest challenge faced by this country. I believe that greater job opportunities will increase labor supply to a greater extent than marginal rate reductions. However, you have to respect the work and intellectual discipline reflected in the model. The model analyzes the Camp plan using a baseline that reflects our actual economy and budget situation. It has the added benefit of not assuming individuals can predict the future with accuracy.

The MEG model shows that the Camp plan rejects the Spence advice that tax reform should clearly favor investment of all kinds. According to the JCT analysis, the Camp proposal "is expected to increase the cost of capital for domestic firms, thus reducing the incentive for investment in domestic capital stock". The MEG model analyzes the effect of those reduced incentives and concludes that in the second half of the budget window, the Camp plan would reduce domestic investment capital under each of 6 different assumptions.

A 2007 Bush Treasury report also suggests that a business tax reform like the Camp plan " might well have little or no effect on the level of real output because the economic gain from the lower corporate rate may well be largely offset by the economic cost of eliminating accelerated depreciation".

Notwithstanding the decreased domestic investment capital, the MEG model shows modest increases in growth due to the increase in labor supply due to the marginal rate reductions and the economic stimulus provided by the net $590 billion reduction in personal income taxes. Essentially, the model projects increased growth by increasing taxes on businesses and transferring that amount to individuals who have a greater propensity to spend.

CONCLUSION

Madam Chairman, I will simply conclude by repeating what I said at the beginning of my testimony. This Committee should be fully engaged in the tax reform process as the form of tax reform ultimately chosen will dramatically affect long-term budget and economic conditions. If you do not, this Committee could find itself in the position of prescribing the politically painful medicine required to respond to even more daunting long-term fiscal issues.

l