

# IS OUR COMPLEX CODE TOO TAXING ON THE ECONOMY?

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## HEARING BEFORE THE JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES ONE HUNDRED FOURTEENTH CONGRESS SECOND SESSION

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APRIL 20, 2016

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## IS OUR COMPLEX CODE TOO TAXING ON THE ECONOMY?

WEDNESDAY, APRIL 20, 2016

CONGRESS OF THE UNITED STATES,  
JOINT ECONOMIC COMMITTEE,  
*Washington, DC.*

The Committee met, pursuant to call, at 2:33 p.m. in Room 562 of the Dirksen Senate Office Building, the Honorable Daniel Coats, Chairman, presiding.

**Representatives present:** Tiberi, Paulsen, Maloney, Hanna, Schweikert, Grothman, Delaney, and Adams.

**Senators present:** Coats, Cotton, Klobuchar, Sasse, Casey, Heinrich, and Peters.

**Staff present:** Breann Almos, Ted Boll, Doug Branch, Whitney Daffner, Barry Dexter, Connie Foster, Harry Gural, Colleen Healy, Matt Kaido, Jason Kanter, Christina King, Yana Mayayeva, Viraj Mirani, Brian Neale, Thomas Nicholas, Brian Phillips, Ken Scudder, and Phoebe Wong.

### OPENING STATEMENT OF HON. DANIEL COATS, CHAIRMAN, A U.S. SENATOR FROM INDIANA

**Chairman Coats.** The Committee will come to order.

It is fitting that this hearing falls between Tax Filing Day, which was moved to April 18 this year—in case you haven't filed your taxes—and Tax Freedom Day, which occurs on April 24th. As Mr. Hodge may explain, Tax Freedom Day represents the day taxpayers can stop working to pay off what they owe the government and start earning for themselves and their families.

Unfortunately, Tax Freedom Day does not include freedom from complexity. Throughout the year, taxpayers will have to gather and store receipts and records to deal with next year's filing deadline. Some taxpayers will even make business or even personal life decisions based on some quirk in the tax code.

I was looking for a tangible example at this hearing of just how complex our tax law is and, rather than stack up and tear down a whole forest of trees to print, that is why these boxes are stacked up in front of the dias. In 2014, a publication that includes the tax code, regulations, and court decisions that determine tax law totaled over 74,000 pages. If my staff had printed this out, we would need 15 boxes of paper that are represented here.

Now I have got good news and bad news to report with respect to 2015. The good news is that the latest version of the tax code has fewer pages. We wondered how that could happen, since I think as we will hear from our witnesses we are adding to and not

taking from, simplifying the tax code in any way, but was due to not an increase in the number of tax laws; it was because an explosion of pages no longer could fit in the binders. So the publisher shrank the font size. For those of us whose eyesight is not as good as it used to be, it will be ever harder to pay attention to the fine print that exists in our tax code.

It is no wonder 90 percent of taxpayers pay a tax preparer or buy computer software to help them figure out their tax burden.

Even before the new tax complications of the Affordable Care Act, the Internal Revenue Service estimated that taxpayers spent over 6 billion hours each year preparing and filing taxes. Estimates of the dollar cost to taxpayers range in the hundreds of billions of dollars.

Complexity comes with many costs. Aside from the frustration and anxiety, it causes taxpayers to spend time and energy that could be put to much more productive uses.

It costs the Treasury, since taxpayers make innocent mistakes and are never exactly sure what they owe. And it breeds a sense of distrust in the system when taxpayers suspect others are getting a better deal because they figured out how to game the tax code.

But is there a real economic cost? Would America as a whole be dramatically better off with a much simpler, much fairer, much more pro-growth tax code?

I think I know the answer, but I look forward to hearing from our witnesses with their views on this subject.

Today we will hear from Dr. Art Laffer, known as the father of supply-side economics. We also have Scott Hodge of the Tax Foundation, which is famous for its tax research. We will also hear real-life stories from Joe Grossbauer, a small business owner who lives with tax complexity every day. And our final witness is Jared Bernstein of the Center on Budget and Policy Priorities.

My thanks to all of you for coming here today. We look forward to your testimony.

I now recognize Ranking Member Maloney for her opening statement.

[The prepared statement of Chairman Coats appears in the Submissions for the Record on page 32.]

**OPENING STATEMENT OF HON. CAROLYN B. MALONEY,  
RANKING MEMBER, A U.S. REPRESENTATIVE FROM NEW YORK**

**Representative Maloney.** Thank you so much, Chairman Coats, for calling this hearing, and to all of our panelists. We are here today to talk about simplifying the tax code.

Most Americans think our tax system is too complex, and I believe we all agree. But simplifying the tax code will be a massive undertaking. It will be politically difficult. It will create winners and losers. That is because simplifying the code requires eliminating some of the tax credits, deductions, and exemptions that make it complicated.

Those who benefit from these provisions will fight tooth and nail to protect them. That is why we should be very wary of anyone who offers a quick and seemingly painless fix. Some things are worth protecting, like the home mortgage interest deduction that enables Americans to achieve the American Dream of owning a home. Oth-

ers widely benefit society, like the charitable deduction that helps support museums, parks, and other important charities. And some credits incentivize behavior that broadly benefits the economy like the research and development tax credit. Some credits are critical to giving working families a chance to succeed, like the Earned Income Tax Credit.

However, many loopholes in our tax code are just giveaways to narrow, special interests. These are often buried deep in the fine print, making the tax code more complicated and less fair.

So, yes, we should simplify our tax system. We should make it as easy as possible for individuals and small businesses to do their own taxes and pay them. We should enable companies to spend less money on tax accountants and more on building their businesses. And we should plug some of the thousands of loopholes that not only complicate the tax code but allow some to take unfair advantage of it.

But at the same time, we should make sure that our tax system raises enough revenue to provide Americans the services they expect from their government, and that they need. And we should create one that makes the vast majority of Americans better off than they are today, or at least not worse off.

But I fear that many proposals the conservatives claim would simplify the tax code are not really about simplification. Rather, they are about radically restructuring who pays how much.

One proposal in the House Republican Budget is to reduce the number of brackets in order to lessen complexity. Some would go further. A plan backed by Witness Arthur Laffer is to create one flat tax. This would reduce the total number of brackets to one. This means that a family that earns \$50,000 would pay the same tax rate as the family earning \$50 million.

Many conservatives claim these simplification plans that translate into huge tax cuts for the wealthy will not increase deficits and won't affect the government services that many Americans believe are necessary.

The theory is that tax cuts pay for themselves. In other words, cutting taxes can translate into such massive economic growth that it leads to higher government revenues.

This means that tax cuts supposedly can take place without offsetting spending cuts. Americans supposedly won't lose any of the government services on which they depend.

Social Security won't be touched, or Medicare, or education funding. Our national defense will remain strong. Our highways won't be allowed to fall into disrepair. We won't have to cut funding for dreaded diseases like the Zika Virus. But this math simply does not add up.

Tax cuts don't pay for themselves. Tax cuts don't necessarily lead to strong economic growth. But they do lead to lost revenue and higher deficits. This is the lesson of the past 35 years.

Despite tax increases under President Bill Clinton, we had a booming economy and created more than 22 million private-sector jobs, and four straight years of budget surpluses. And then we had two tax cuts under former President George Bush which contributed to massive budget deficits, with the tax cuts by themselves

adding, according to some economists, \$1.5 trillion to deficits over 10 years.

So in summary, when we talk about making the tax code less complex, let's not be fooled into claims that we simply need to flatten the code. My time is up, I guess. This will make it more regressive, shifting more of the tax burden onto the middle class and the poor.

And let's not continue to pretend that tax cuts pay for themselves. History has shown that they do not in recent history, and so let's get down to the business of simplifying the tax code and making it more fair.

I truly look forward to this very impressive panel and hearing your testimony today. Thank you.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 32.]

**Chairman Coats.** Thank you, Ranking Member Maloney. Thank you very much.

I would like to introduce our panel of witnesses.

Dr. Arthur Laffer is an incredibly well known figure in tax policy circles. He is currently the Chairman of Laffer Associates in Nashville, Tennessee, and long before that he held various esteemed positions, including Chief Economist at the Office of Management and Budget, and a member of President Reagan's Economic Advisory Board.

Most economists and policymakers are familiar with the Laffer Curve which shows the tradeoff between tax rates and revenues. As legend has it, Dr. Laffer pitched it by drawing it on a napkin at a dinner. Since then, he has been a prolific author on tax policy.

Dr. Laffer, we welcome you.

Mr. Scott Hodge is another well known expert in tax policy, and the President of the Tax Foundation, which calculates the Tax Freedom Day that I mentioned in my opening statement.

He is one of the many creative drivers behind both the Tax Foundation's Dynamic Scoring Model and the State Business Tax Climate Index. Mr. Hodge has authored over 100 studies and conducted hundreds of interviews on tax policy and government spending.

Mr. Hodge, we appreciate you joining us today.

From Chesterton, Indiana, we have a fellow Hoosier, Mr. Joseph Grossbauer, the founder, President and CEO of GGNet Technologies.

His company provides IT management, data security, and data center services for a variety of clients. Previously, Mr. Grossbauer was the Director of Mercy Hospital and Medical Center in Chicago, and an Adjunct Faculty Member at Colombia College.

Mr. Grossbauer, it is a pleasure to have a Hoosier business owner with us today, and I thank you for taking time out of your schedule to come down to D.C. and testify.

And finally, we have Dr. Jared Bernstein, Senior Fellow at the Center on Budget and Policy Priorities here in Washington, D.C.

Before joining the Center for Budget Policy and Priorities, Dr. Bernstein served as the Chief Economist and Economic Adviser to Vice President Joe Biden, and Executive Director of the White House Task Force on the Middle Class.



Before joining the Obama Administration, Dr. Bernstein was a Senior Economist and Director of the Living Standards Program at the Economic Policy Institute.

Dr. Bernstein, we welcome you also.

With that, I would like to turn to Dr. Laffer as our first witness, followed by Mr. Hodge, Mr. Grossbauer, and then Dr. Bernstein. In accord with our procedures here, we would like to get your conclusions and summaries in a roughly five-minute time frame so it gives us plenty of time. We have a number of our members here from both the House and the Senate that would like to ask you questions and hear from you.

So, Dr. Laffer, you're on.

**STATEMENT OF DR. ARTHUR B. LAFFER, CHAIRMAN, LAFFER ASSOCIATES, NASHVILLE, TN**

**Dr. Laffer.** I guess it is sort of like putting the TV inside the microwave so you can watch 60 Minutes in 30 seconds. Just teasing. It is really fun being with these other witnesses here today, as well, especially Jared Bernstein, who is a dear, dear friend for many, many, many years, and an excellent economist and good friend, and being with all of you.

I guess I haven't been before this Committee for 35 years, and I think it's about time we started doing tax codes again. I would like to also have read into the record, if I might, a paper I did with John Childs, which is "The Economic Burden Caused By Tax Code Complexity," which covers a lot of what you just talked about, Mr. Chairman.

**Chairman Coats.** Without objection, we will put that into the record.

**Dr. Laffer.** Thank you.

[The report titled "The Economic Burden Caused By Tax Code Complexity," appears in the Submissions for the Record on page 35.]

**Dr. Laffer.** But what I would like to do is, Mrs. Maloney, I would like to go right to the comments you made that were very interesting. What I would like to do is remove this from being partisan, if I may. It is not Republican, it's not Democrat, it's not liberal, it's not conservative, it's not left-wing, it's not right-wing. This is economics.

And in fact, as some of you may know, I was a huge fan and voted for and did campaigning for Bill Clinton when he ran for office as President. I voted for him twice. I also did Jerry Brown's flat tax. In fact, I did it verbatim when he ran in the primary in 1992. And what I would like——

**Chairman Coats.** Art, don't go too far, because we invited you——

[Laughter.]

**Dr. Laffer** [continuing]. You know I'm a Reagan guy all the way.

**Chairman Coats.** All right, that eases the problem.

**Dr. Laffer.** But it is not a partisan issue. It is all about economics, and about the incentives here. When you say tax complexity, it doesn't just mean lowering rates, or making one rate. It means changing the base, as well.

I would like to give you an example of tax complexity and what it leads to. And this is someone you all are very familiar with, a man named Warren Buffett, a Frenchman from Omaha, Nebraska—you know “Warren Buffett.” And what he did was he wrote a letter to The New York Times in 2011 which described how he pays less in taxes than his secretary does. In fact, he pays half as much in taxes as his secretary does.

And in the letter he said: Now I pay a lot in taxes. I pay, and he said six million nine hundred and whatever it is, I’ve got the exact numbers, but a little bit less than \$7 million in taxes, which may seem like a lot of money to you, but in fact relative to my income it is not very much at all.

In fact, he said, relative to my income it is only 17.4 percent of my income. Now being the math whiz I am, I went and took that tax bill, which was a little less than \$7 million, divided it by 17.4, and I got Warren Buffett’s adjusted gross income, which was a little bit less, just a wee bit less than \$40 million, which is a heck of a lot of money for one man to earn in one year in 2010.

But then I went back to my Chicago training, University of Chicago training, and asked myself: What really is “income”? Not the definition for the tax code, but the definition you and I would like to have, Mrs. Maloney, I mean very seriously. And your income should be how much you spend in a year, how much you give away in a year, and your increase in wealth.

Now think about that income. It’s what you spend in a year, what you give away in a year, and the increase in your wealth. That’s your income from that year that you have to dispose of as you see fit.

So I went to Warren Buffett, the records there, and I looked up in the Forbes Magazine to find out what happened to his wealth. He owns a company called Berkshire Hathaway, you know. The stock is fully traded, so we know how much he owns and what happened to his wealth. And in the Forbes Magazine that year his increase in wealth was a little over \$10 billion.

It went from \$37 billion at the beginning of 2010 to \$47 billion at the end of the year. I then went to the Bill & Melinda Gates Foundation Web site. They announced that he had given \$1.6 billion that year to the Bill & Melinda Gates Foundation. I didn’t go to his two sons’ Web sites, nor do I go to his daughter’s, but he gave them a lot of money as well.

I didn’t look at his checking account to see how much he spent. But when I looked at his total income for the year 2010, it wasn’t \$40 million. His income for 2010 was \$11.6 billion, and his total tax bill was less than \$7 million.

He paid in taxes 6/100ths of 1 percent of his income that year. All legal. What he did was his whole increase in his wealth was in unrealized capital gains. As you know, the tax rate on unrealized capital gains is zero, and on the increase it is also zero. The gifts to the Bill & Melinda Gates Foundation and the other foundations also pay no tax whatsoever there.

If you look, he owns Berkshire Hathaway, so he never has to buy and sell a company stock. It is all below the shelter there of the company. So all the realized capital gains do not come to him in taxes; they just go to the company.

You know, this is all because of complexity. And all of it—and he is not the only example. If you have a low rate, broad-based, flat tax that defines comprehensive income the way Jerry Brown proposed it in 1992, you would catch all of this. This is what we really mean by a simplified code.

Now the code I wrote for Jerry Brown was not a tax rate reduction; it was much more like the 1986 Tax Act which had, for every rate reduction you had a broadening of the base to make it static revenue neutral. So all of this revenue feedback stuff is not true for complexity.

Now the 1986 Tax Act, which was very—I was very involved in. I had done this paper of my own, as well as worked with Jack Kemp, as well as Bill Bradley. What we did there was we took the income tax down to two brackets, 15 percent and 28 percent.

We got rid of deductions, exemptions, exclusions. We dropped the corporate rate from 46 to 34 percent. And it was static revenue neutral. If you look at that bill at that time, we passed in the Senate—and I will just use the Senate vote—the Senate voted 97 to 3 to pass that bill.

Now can you imagine that bill being done today where we drop the corporate rate from 46 to 34 percent, then the lowest in the OECD, and dropped the highest personal income tax rate from 50 percent to 28 percent, and yet we got 97 votes in there? It led to enormous prosperity, and my next-door neighbor and dear, dear friend, a guy named Al Gore, who I did the blurb on his latest book “The Future,” said it led to 20 years worth of prosperity and it was the best economic vote he has ever done, period.

That is what we are talking about: bipartisan pro-growth, lowering the rates, broadening the base, and not making revenue shortfalls, not worrying about spending, but trying to create economic growth by really, really significantly reducing complexity.

Thank you.

[The prepared statement of Dr. Laffer appears in the Submissions for the Record on page 34.]

**Chairman Coats.** Thank you.

Mr. Hodge.

#### **STATEMENT OF MR. SCOTT A. HODGE, PRESIDENT, TAX FOUNDATION, WASHINGTON, DC**

**Mr. Hodge.** Thank you very much, Mr. Chairman, and Ranking Member Maloney, and all the members of the Committee. I appreciate the opportunity to talk about tax complexity.

Tax complexity is the number one issue facing Americans today. In addition to robbing us of 6 billion hours of our lives complying with the tax system, tax complexity punishes success and hard work, which robs the economy of its ability to create jobs and prosperity and better living standards.

And over the past few months, Tax Foundation economists have actually been measuring the cost of complex provisions in the tax code using our Taxes and Growth macroeconomic tax model. In May we will publish these case studies in a new book titled “Options For Reforming America’s Tax Code.” I hope that these case studies provide you with some dos and don’ts as you go about thinking about fundamental tax reform.

What we find is that much of the complexity of our individual tax code in particular results from our attempts to make the tax system more progressive, either overtly through multiple brackets and rates, or covertly through backdoor clawbacks.

And as we all know, and as Dr. Laffer has talked about, high marginal tax rates really matter. They work to diminish incentives and that ultimately undermines economic growth. Economists have referred to these high tax rates as “success taxes.”

For example, we can make our current income tax system a lot simpler by reducing the number of tax brackets from seven to say three. It would be simpler, more pro-growth, and still progressive if we had rates of say 10, 25, and 35 percent.

Our model estimates that this would boost the long-term level of GDP by 1.4 percent, lift after-tax incomes by 3 percent, and create more than a million jobs.

But we also find that our policies aimed at helping the working poor also have unintended consequences.

The complex structure of the Earned Income Tax Credit has the ironic effect of encouraging more growth as the subsidy phases in, but discouraging work effort as the subsidy phases out, because it penalizes workers for every new dollar that they earn above the poverty level.

However, we can reduce those tax penalties with a slower phase out rate for the EITC. Our model finds that this would raise workers’ after-tax incomes by 1 percent, and create as many as 164,000 new jobs.

You know, I think we all want to simplify the number of loopholes and itemized deductions in the code, but we should use the savings from that simplification for lower tax rates. We found that if you were to eliminate most itemized deductions, except for the charitable deduction and home mortgage interest deduction, and reduced tax rates across the board by 10 percent, it would increase GDP by 0.6 percent, and create more than 577,000 jobs.

On the business side, everyone on this Committee knows that the U.S. has the highest corporate tax rate in the industrialized world, along with an obsolete world-wide tax system. Cutting the corporate tax rate and moving to a territorial system would not only simplify the tax code but make the U.S. a more competitive place to do business in and do business from.

But just as important, we should replace our immensely complicated depreciation and cost-recovery system with a much simpler system of full expensing for capital investment. Dollar-for-dollar, full expensing is one of the most pro-growth tax simplification measures this Congress could enact immediately.

And by our estimates, full-expensing would increase the long-run level of GDP by over 5 percent, boost our capital stock by 16 percent, increase wages by more than 4 percent, and create more than a million new jobs.

Over the past year, the Tax Foundation has been very fortunate. We have gained a lot of special insights into what kinds of tax policies lead to greater investment, wages, jobs, and economic growth, and what kind of policies actually retard that.

We have scored the tax plans for every Presidential candidate, as well as numerous plans developed by Members of the House and Senate.

In fact, we have scored the plans of two members of this Committee—Senator Lee’s Rubio-Lee Tax Plan; and Senator Cruz’s Tax Reform Plan, as well. And during this experience we have modeled every conceivable tax reform plan one can think of, including the flat tax, fair tax, Bradford X-tax, Value-added tax, and numerous plans that blend all of those different things together.

And to one degree or another, the plans that produce the most economic growth tend to incorporate many of the things that I have just outlined. They simplify the tax code. They reduce marginal tax rates. They reduce taxes on capital. They reduce or eliminate the double taxation of savings and investment. And they move toward a neutral or consumption tax base.

Well to wrap up, I hope that members of this Committee as well as all of your colleagues take some of these lessons to heart and start us down the road to fundamental tax reform sooner rather than later.

Thank you, very much. I appreciate the time and will answer any questions you may have.

[The prepared statement of Mr. Hodge appears in the Submissions for the Record on page 63.]

**Chairman Coats.** You nailed the five-minute time limit. We give stars for that. So we thank you.

[Laughter.]

Mr. Grossbauer, you are joining some rarified company here. Warren Buffett, Bill Gates, Jerry Brown, Al Gore, Bill Bradley, Jack Kemp. What does a small business owner want to tell us about our tax code?

**STATEMENT OF MR. JOSEPH GROSSBAUER, PRESIDENT AND  
CEO, GGNET TECHNOLOGIES, CHESTERTON, IN**

**Mr. Grossbauer.** Thank you, Senator Coats. And listening to the billions of dollars being spoken of here and, you know, they say a billion here, a billion there and, you know, the hundreds of thousands of jobs being created or could be created, I want to preface my presentation by saying that a thousand dollar investment, a thousand dollar outlay, is a significant outlay for me. It is something that I think about very seriously. I think about, you know, when I capitalize a piece of equipment and it costs me \$5,000, that is a big deal to my small company.

Expanding by one or two employees is a really big deal for my company. I just have to say, it is a really great honor to be here, and I really appreciate the opportunity to share my story. I want to thank you all for allowing me to be here.

I also have to warn you, I am quite nervous. This is something that is clearly out of my comfort zone. So if I flub a word here or there, please excuse me. And now let me get on to my points.

I want to say good morning, Chairman Coats, Ranking Member Maloney, and members of the Joint Economic Committee. Thank you for the opportunity to testify today. I am pleased to be here on behalf of the National Federation of Independent Business, NFIB, as the Committee discusses the issue of tax complexity and its neg-

ative impact on our Nation's economy, and especially small businesses.

NFIB is the Nation's leading small business advocacy organization. The typical NFIB member employs 8 to 10 people with an annual gross receipts of about \$500,000. So when you talk billions, we're not talking billions here, but we are talking about people who are really in the trenches every day, you know, growing their business.

All NFIB members are independently owned, which is to say none are publicly traded corporations. While there is no one definition of "small business," the problems NFIB members confront relative to the tax code are representative of the vast majority of small businesses.

And I am glad the hearing was this week and not last week, because I really literally could not have attended last week. And I did not know that Tax Day was due Monday because I was so busy worrying about taxes I got panicky on Friday the 15th thinking I needed to file my taxes, and luckily I had an extension over the weekend.

A few consistent concerns are raised regardless of the trade or industry in which small businesses are engaged, and 5 of the top 10 small business concerns are tax related. And these tax problems fall into three categories: cost, complexity, and frequent changes.

And I would submit that frequent changes are just additions to tax complexity.

When I started my business 10 years ago, I could prepare my taxes myself. But now I have a—and you've got to remember, I have a staff of six people. I have a staff bookkeeper. I use an accounting firm. And for the really tricky questions, I have a tax attorney. This is really crazy. I'm serious. This is really crazy to have a small business having to, you know, call up their accountant or their tax attorney just to check on something.

I will give you a very specific example. I serve as president and CEO of GGNet Technologies, which is a technology company that provides IT and data center services, along with cyber security, breach analysis, and mitigation. We are an S Corporation.

Since our founding in 2006, our accounting costs have risen more than 400 percent. Some of that can be attributed to company growth, but much of it is in the rise of accounting costs due to the complexity of the tax code.

It seems like the harder I work, the more I grow, not necessarily the more taxes I pay, it's really the more complex the tax code has made my life. You know, I deal with things like, you know, deductions, and how do we, you know, deal with those deductions?

Do I deduct something? I deal with passthroughs, active and passive incomes, classification of items. You know, tax compliance is really now way beyond my capability, and I can deal with pretty complex situations in my business. I am no longer small enough to prepare my own taxes, but I am not large enough to have an entire accounting staff.

My bookkeeper spends roughly 40 percent of her time working on tax-related functions, classifying various items, and filing federal, state, and local taxes. Like the doctor in surgery discovering a

much more complex situation and having to call in other specialists, it takes much more time and a much higher cost.

Between February and April, my bookkeeper and I are frozen. We don't focus on anything else primarily except taxes. Business reports and planning are put on hold or delayed because we are so focused on taxes. We are unable to produce timely reports on cash flow or profit/loss. This is not the way to run a business.

I can't even during this time accurately project my staffing needs. I do it, but it is not as good as it normally would be. If the tax code were less burdensome, I would be able to focus more time and resources on my customers, product development, and services rather than taxes. And even a small company like mine, you know, looks for innovation. How can we be different?

And I don't have the time to do that. Every day I have to think about taxes. How do I classify an item? Do I classify it under "operations"? "Capital"? Or "minor equipment"? And if "capital," I have to consider the depreciation formula. I mean, really. You know? I always seem to be calling my accountant.

Another decision. We talk about job opportunities. I would really like to add more staff, but I just keep using contract workers and I follow the IRS Code, rather than hire a new employee knowing that the new employee would bring additional costs in tax overhead.

Payroll complexity forces me to use software. Software doesn't always classify well, and we end up with support calls to companies and my accountant.

And now we talk about economic development, and we talk about economic development in northwest Indiana. I discovered an underutilized fiber optic network in my community. I teamed up with three partners to set up an LLC to acquire the SASA. This would bring—and we all talk about gigabit service to communities. This would bring gigabit service to homes and businesses.

I would need to build a network operations center, small. I would have to hire an engineering staff, well-paid engineers, to make this opportunity work. As we developed our business plan and pro forma, we recognized the need for correct interpretation of the tax code in order to determine if this was a profitable or unprofitable venture.

We did the market analysis. We projected income. Everything looked good. We calculated startup costs. Good. Everything looked really good. But as part of the due diligence we needed to project our tax liability.

The fiber in the ground became the problem. One accountant said it was a capital asset and we'd have to depreciate it like that. This just didn't work. The numbers didn't work. The bottom line is, the numbers didn't work.

So on the recommendation of one of our partners, we went to his accountant, reviewed it, looked at it, and said the same thing. Fiber in the ground is a capital expenditure. You have to depreciate it as capital.

So I finally went to an accountant friend of mine, just handed this off to him and said, you know, what can I do? And he said, you're stuck. So at this point, acquiring the fiber became a risky venture and the partners were getting nervous. Out of the blue, or

call it dumb luck, I read an article in one of my news feeds telling me that the IRS has reclassified fiber as real estate.

So I went back to my accountant and showed him this, and he said, oh, no, no, no, it was capital. It's capital. I know the law. It's capital.

Okay, so now I said, okay, let me go to my tax attorney, you know, who always deals with these kind of situations. And he read the article, and he said, well, it sure still seems like capital. So I pushed him, and he called an associate of his. I don't know where he ended up calling, but he checked further and he said, ah, yes, this can now be classified as real estate. That changed the entire picture.

So I've yet to receive all the bills for this, but I think that the investment, you know, will be worth it. But I want to say, no small business should have to go through this trying to build a company and create jobs.

The tax law—and I can't emphasize this enough—the tax law should not be a barrier to growth, and they are a barrier to my small business. I am a middle class person. I am not a Warren Buffett, you know? I really work very hard. And all of my staff are middle class people, and the current tax laws are truly a barrier—when I look at that wall over there—they are a barrier to my growth.

In conclusion, small businesses are the engines of economic growth. This is not just a slogan. Small business—I'll give you some statistics—created two-thirds of the net new jobs over the past decade.

**Chairman Coats.** Mr. Grossbauer, I've given you extra time here—

**Mr. Grossbauer.** Okay, I'm sorry—

**Chairman Coats.** But I did so because you are giving us a real live example of the average guy/gal out there trying to run a business in everyday life and make a little bit of profit. And you have given us a real, live example of this.

We talk in mega terms up here in terms of theory and so forth, and you have brought it down to us.

**Mr. Grossbauer.** I appreciate that. Yes.

**Chairman Coats.** So I am going to just cut you off at that point.

**Mr. Grossbauer.** That's fine.

**Chairman Coats.** Thank you.

**Mr. Grossbauer.** Thank you.

[The prepared statement of Mr. Grossbauer appears in the Submissions for the Record on page 74.]

**STATEMENT OF DR. JARED BERNSTEIN, SENIOR FELLOW,  
CENTER ON BUDGET AND POLICY PRIORITIES, WASHINGTON, DC**

**Dr. Bernstein.** Well thanks very much for the invitation. I too appreciate your testimony, Mr. Grossbauer, in that spirit. And I want to try to emulate my old friend, Art, here and begin with a kind of broader view of the question at hand.

Today's hearing is about tax complexity, but we cannot really address that issue unless we ask a broader question, which is: What is the goal of the federal tax system?



This goal should be to raise the revenue necessary to fund the government's services and public goods that Americans want and need, but to do so in a way that is fair, equitable, pro-growth, and avoids unnecessary complexity.

So my testimony has three main findings.

Fairness, simplicity, and revenue raising are often complementary. By closing regressive loopholes in the tax code, we reduce incentives to game the system, close wasteful tax breaks that exacerbate inequality without promoting growth, and raise more revenues. Based on demographics, inflation, debt service, and rising health costs, a substantial fiscal policy—I should say, a sustainable fiscal policy will likely require more, not less, revenue going forward.

And finally, I find no evidence in support of the claim that supply-side tax cuts come anywhere close to paying for themselves, or even are particularly pro-growth.

Now the complexity in the tax code has nothing to do with the number of tax brackets and rates. If taxable income were easy to define, it would not matter how many rates existed in the code. All taxpayers would have to do is to look up their liabilities in the table or an online calculator.

Instead—and the other witnesses have all said the same thing—what makes our system so complex are the exemptions, deductions, privileges for certain types of incomes and activities, and other loopholes that often allow wealthy and businesses flush with tax lawyers to pay less than their fair share. This problem is readily seen on the business side of the tax code which is so fraught with complex loopholes that the effective corporate tax rate is 10 to 15 percentage points below our uniquely high top statutory rate of 35 percent.

One knowable distortion here is the fact that debt financing for business investments is heavily subsidized by the tax code. Another is the infinite deferral of foreign earnings.

That is one reason why the foreign income of U.S. multi-nationals is taxed at a rate 10 percentage points lower than their domestic income. Now think about this for a second. Our tax system actually incentivizes production in Guangdong Province vs. Providence, Rhode Island.

What should we do? Cutting taxes is no free lunch. In my testimony I have a bunch of scatter plots. I have a few here up on the slide projector here, showing that the top marginal rates faced by wealthy Americans have historically been uncorrelated with GDP growth, employment growth, investment growth, productivity, middle class income, as far back as we have the data.

As Ranking Member Maloney said, this should come as no surprise to those who have lived through the Clinton years where higher top rates coincided with economic outcomes much better than those during the George W. Bush years when rates were lowest—lower.

The State of Kansas' recent experience has proved the prediction of the supply side tax cuts spectacularly wrong as cuts recommended by advocates of the trickle-down theory have both caused serious underfunding of the state's education system, and have coincided with weak job and GDP growth.

Fortunately, there are changes to the tax code that could simultaneously simplify it, raise revenues, improve fairness, and enhance economic efficiency. My testimony provides examples of such changes.

An easy and obvious starting point is closing the so-called “carried interest loophole” which allows hedge fund managers to face favorable asset-based rates on their earnings. Those who claim to want to undertake major tax reform, yet are unwilling to close this loophole, one with virtually no defenders, should be considered akin to those who say they are ready to run a marathon but get winded walking up the stairs.

Broadening the estate tax base and ending step-up basis would reduce the preferential treatment on inheritances of millionaires. A minimum tax on foreign earnings would help fix the deferral problem, as would efforts to crack down on the increasingly evident problem of illegal tax evasion.

One last point. U.S. foreign profits booked in tax havens have grown sharply in recent years. In 2010, foreign subsidiaries of U.S. firms reported profits in the Cayman Islands that were more than 20 times that country’s entire economic output—20 times their GDP. This simple fact alone provides overwhelming evidence of base-eroding profit shifting from where income is earned to where it will be taxed.

I look forward to further discussion of these and other ways to dial back the complexity in the code while dialing up its fairness.

[The prepared statement of Dr. Bernstein appears in the Submissions for the Record on page 79.]

**Chairman Coats.** Dr. Bernstein, thank you. Let me start with some questions here. I am going to try to only do five minutes so I set the example for my colleagues here.

But, you know, I cannot resist asking Dr. Laffer to respond to what you said, Dr. Bernstein, particularly in terms of pro-growth and supply-side economics. My recollection is that after the 1986 Act we were growing at a rate I have never seen in my lifetime.

But I would like—and then I want to give you a chance to rebut that. So within five minutes, Art, you have about two-and-a-half minutes to give us your thoughts on this subject. And then, Dr. Bernstein, if you want to go back and forth I think it would be entertaining for us.

**Dr. Bernstein.** Just like the old days, Art.

**Chairman Coats.** Like the old days, and informative——

**Mr. Hodge.** Should I sit back away?

[Laughter.]

**Chairman Coats.** When it comes to the next questioner, hopefully somebody will ask you, Mr. Hodge, what your opinion is. I am just trying to stay within my five minutes. Go ahead, Art.

**Dr. Laffer.** If you take the states with no earned income tax and compare them with the nine states that have the highest tax rates—oh, sorry [microphone was turned off]. I pressed it again wrong. Sorry.

If you take the states that have no earned income tax in the U.S., and you take the states with the highest tax rates, if you look at the growth rates over the last 50 years, every single year, the nine states without income taxes, earned income taxes, have grown

much faster in every single metric than have the states with the highest income tax rates.

A clear-cut example of growth rates, taxes, same country, same time, same place, same station. If you look at the 11 states that have introduced an income tax in the last 55-plus years, starting with West Virginia and ending with Connecticut in 1991, each and every one of those states, in every single metric, each and every one in every metric—population, employment, labor force, and, yes, even tax revenues—declined relative to the rest of the Nation, without exception.

If you look at the growth rates of Germany and Japan in the post-war period, all of these, but most of all in the academic literature, if you go to the academic literature of the top journals, you can find all over the place measures of taxes affecting growth.

In fact, Christina Romer, in her famous article shows the effect of tax rate reductions on economic growth, and she I think was Obama's chief economist there for awhile. So the literature is just full of those examples when done carefully and academically that really show that tax rates do matter.

You know, if you tax people who work, and you pay people who don't work, do I need to say the next sentence to you? Don't be surprised if you find a lot of people not working. That's all we're talking about.

We tax speeders to get them to stop speeding. We tax smokers to get them to stop smoking. Why on earth do we tax people who earn income? Why do we tax people who employ other people? Why do we tax businesses that make wonderful products at very low cost? To get them to stop earning income? To get them to stop employing other people? To get them to stop making wonderful products at low cost? No. We don't. We do it to get the revenues.

But don't for a moment believe that these taxes don't have negative consequences. That is the ultimate false hope. You've got to have a clear eye to be able to also have a warm heart. You've got to be able to look at the consequences and make a tax plan that does have tradeoffs.

Taxes do affect growth. They do affect incomes. They do affect jobs. But we need the money. And how do you get those revenues in the least-costly fashion and provide those resources to government for the most beneficial uses possible?

**Chairman Coats.** Dr. Bernstein.

**Dr. Bernstein.** Thank you very much. I appreciate your giving me the opportunity to go back and forth.

In my testimony I list five scatter plots that I would like to share a couple of with you right now. This idea cannot be asserted, it cannot be found in the literature the way my friend Art does because I can find just as many studies that go the other way. It must be empirically tested.

What we did here is we took every single year we have on record of tax changes, and a whole set of variables. There are five of these slides in my testimony: GDP, productivity, labor supply, capital supply, investment, median family income. And we simply asked: To what extent does the growth in these economic variables correlate with the top rate in the income tax code?

If the supply side claims were correct, we would see an inverse correlation. We would see that growth was consistently more positive, whether it is investment, income, GDP, productivity, when rates were low, and vice versa when they were high.

Instead, in every single plot we made—I mean, I really bent over backwards to try to get to the bottom of this—the correlation was about zero. In fact, if anything it was slightly positive and significantly positive when we looked at median family income, meaning that over the course of history family income grew more quickly when rates were higher than when they were lower.

Now I am not saying, and I am not at all claiming—I want to be clear about this—that higher rates in fact drive growth and investment up. I am saying that the correlations are not there. And if the correlations are not there, it would be an extremely I think reckless mistake to try these supply side solutions at home. And by “home”—and I’ll finish with this because I know we’re crunched for time—by “home” I mean Kansas, for example.

In Kansas, the Governor and the legislature aggressively cut taxes urged by policy officials touting the benefits of supply side tax cuts. They have blown a hole in their budget, about a \$400 million hole in the state budget. Serious under-funding to the state’s education system, of great concern to constituents throughout the state. And jobs now in Kansas have been growing half as fast, at a rate that is half as fast, as jobs growing in the four surrounding states.

So this is an empirical question. It is not a theoretical question. And the empirics I think tell you the answer that I stress in my testimony.

**Chairman Coats.** Well I would love to get into a debate here, but two things have happened. One, I have been just handed a note that the House is expecting to begin votes at 3:30, a series of those votes. Our House Members will have to leave. I want to quickly turn it over here to our Ranking House Member, Mrs. Maloney, for her questions, and knowing you have to hustle out of here. So you are on.

**Representative Maloney.** Dr. Laffer, you were quoted in The Washington Post yesterday saying that the tax plans proposed by Republican presidential candidates Trump and Cruz could lead to, quote, “massive revenue increases,” end quote, to the Federal Treasury. Is that correct? Yes, or no?

**Dr. Laffer.** Yes, that’s correct.

**Representative Maloney.** Okay. But, Mr. Hodge, you have written something very different. In an op-ed last month, you wrote that the Republican candidates’ tax plans would, quote, “cut federal tax revenues substantially,” end quote. This was your article on which GOP candidate’s tax plan is——

**Mr. Hodge.** That’s correct.

**Representative Maloney.** And, Mr. Hodge, would the Trump and Cruz tax plans increase revenues, or reduce revenues?

**Mr. Hodge.** Both of the plans are tax cut plans, and they are intended to be tax cut plans. We modeled all the Presidential candidates’ plans. We found that there is an interesting tradeoff, sort of three tradeoffs——

**Representative Maloney.** But, first of all, just can you answer for me, because I want to go back to the tax brackets and I don't have much time.

**Mr. Hodge.** Sure.

**Representative Maloney.** You said that they would, quote, "cut federal tax revenues substantially."

**Mr. Hodge.** Right. The Trump plan is, in conventional terms, is a \$12 trillion tax cut. After we factored in the economic growth, it is a \$10 trillion tax cut.

The Cruz plan we find that if measured on a conventional basis, it costs a little over \$3 trillion. But once you factor in the substantial economic growth that it generates, about a 14 percent increase in GDP, that cost comes down to about \$800 billion over 10 years.

**Representative Maloney.** But you wrote that they cut federal tax revenues substantially.

**Mr. Hodge.** That's what I'm saying, yes.

**Representative Maloney.** I want to go back. We have two proposals before Congress right now. There is one, and I would like to ask Jared Bernstein, one would reduce the number of tax brackets to three. This is one put forward by the Republicans. And some have supported cutting, following Dr. Laffer's suggestion of a flat tax, the number of brackets to one rate for everyone.

So I would like to ask Dr. Bernstein, is this an effective way to reduce tax complexity? What would be the impact of fewer tax brackets on the share of the tax burden shouldered by the middle class? And how would the wealthiest one percent do under these two proposals?

**Dr. Bernstein.** Well as I tried to stress in my testimony, the complications of the tax code, all those boxes over there, are simply not driven by the number of rates. This, by the way, is a finding I have seen in all the testimonies you've heard today.

The complications are driven by all the different definitions of income, the exemptions, the incentives to defer income overseas, to finance investments with debt vs. equity, to defer foreign earnings, and so on. All the things we have been talking about today and the things that Mr. Grossbauer is busy with February through April.

That would not change one whit if he or other filers had 1 rate as opposed to 3, or as opposed to 12. I actually asked a tax accountant about this, and I quote her in my testimony, about this question of rates vs. the other aspects of complexity, and she called it, quote, "gut-busting laughable" that somehow reducing the rates—reducing the number of rates would make a difference, if you left all these other complexities in place.

The other problem you face, as you intimated in your question, is that typically if we are trying to be revenue neutral, and we reduce taxes at the top, which is characteristic of the kinds of plans you have been talking about, and certainly characteristic of those put forth by Republican candidates mentioned earlier, if those are going to be revenue neutral, you have to make the revenue up somewhere else.

And so typically they increase the tax burden on the middle class.

**Representative Maloney.** And what does history show us about the impact of tax cuts on revenue?

**Dr. Bernstein.** If you—this is actually a fairly simple relationship that can be I think distracting and made more complicated by some of the mythology around supply side taxes. Historically if you cut tax rates significantly, you will lose revenue on net.

Now I want to be very clear. I am not contradicting my fellow witnesses in terms of the following point: There will be potentially, under certain conditions, more capital investment, more labor supply, under some tax cuts. That is not saying—but on net, the question is how much will you get back through these growth effects vs. how much will you lose?

And I think history is pretty clear on this point, that the growth effects of the kinds of tax cuts that are being bandied about here today do not come anywhere close to offsetting the revenue costs.

**Representative Maloney.** My time has expired. Thank you.

**Chairman Coats.** Thank you. Our Vice Chairman, Mr. Tiberi.

**Vice Chairman Tiberi.** Thank you all for being here.

Mr. Hodge, something in your testimony really jumped out at me. You mentioned that the multiple depreciation schedules that we have in place create often a complex and arbitrary process.

As you know, we have talked about before, I introduced a bill to make 50 percent depreciation permanent. I was pleased with what was included in the PATH Act that was passed last year and signed by the President to extend it for five years, but I think we should go further and I know you do, as well.

You mentioned in your written testimony that one way to both simplify the tax code and increase economic growth would be through full expensing. You have modeled my 50 percent current depreciation bill, and I think you have also modeled Representative Nunes's ABC permanent expensing, full expensing bill. And I know in my bill's case you stated that it would increase GDP by over one percent a year, and create over 200,000 jobs.

And you mentioned in your verbal testimony what full expensing would do. But you also say, and I quote from your written testimony, "Dollar for dollar, full expensing is one of the most pro-growth tax changes that Congress could enact."

And last week I asked that same question to Tom Barthold, who as you know is the Chief of Staff at JCT, and I gave him a story about a manufacturer in my state that said they modeled whether to build a plant overseas or in the United States, and because of the temporary law of bonus depreciation they decided to build the plant in Ohio, thereby providing more employment and paying more taxes in our state.

So to me, expensing and full expensing in particular seem like a no-brainer. When I asked Mr. Barthold about his thoughts and gave that example about expensing and bonus, he explained that, and I'm going to quote, "While expensing reduces the cost of capital and increases investment," he also said, "there are tradeoffs that occur at the same time."

That government receipts would decrease, creating a larger government deficit, driving up interest costs, which could in turn ultimately increase the cost of capital.

I know your modeling has maybe a different approach than that, that those tradeoffs might not occur, but more importantly even if

they do, that we would see GDP growth at 5 percent, which we would obviously love to see and have not seen for a long, long time.

Could you tell us why you believe that even with those tradeoffs that growth would be around 5 percent in your modeling?

**Mr. Hodge.** Well I think that in this case the Joint Tax's model is incorrect, that deficits cause some increase in interest rates. I think the last seven years have sort of proved that wrong.

And especially with the small numbers that we are talking about, with the size of global capital markets, a little bit of a deficit to pay for full expensing would not drive interest rates at all. In our model we hold Federal Reserve policy constant. So we don't measure that at all. And we just figure that the Fed would be accommodative of this.

And so what we are looking at is the pure effects of moving to full expensing, which, as Mr. Barthold mentioned, dramatically lowers the cost of capital. That drives investment in new plant and equipment. Ultimately that makes the workers far more productive.

More productive people earn more. And in turn that leads to a growing healthy economy. And it leads to better living standards. And that is ultimately what tax policy should be doing. And I think that full expensing really ought to be first and foremost on the top of our agenda here, along with lowering tax rates, obviously. But expensing would be a powerful tool to gaining U.S. competitiveness, to bringing jobs back to the United States, especially high-paying manufacturing jobs.

**Vice Chairman Tiberi.** Thank you. I am going to yield back because we have a vote coming up, Mr. Chairman.

**Chairman Coats.** Thank you. I am going to get my list here. It is unfortunate that votes have made a play here, but it does open up the possibility and the probability and the ability for Senator Klobuchar to go next.

**Senator Klobuchar.** Okay. Well as I said, I could defer to one more House Member if you would like, and then go after that.

**Chairman Coats.** You offered to do that, and I thank you for doing that.

**Senator Klobuchar.** Okay.

**Chairman Coats.** Your colleague, Congressman Paulsen.

**Representative Paulsen.** All right. Thank you. I thank my colleague from Minnesota. Minnesotans are Minnesota nice, so I appreciate that.

[Laughter.]

Mr. Chairman, thanks for holding this hearing. I think the focus has been very apt, in terms of the impact of a very complex tax code on our economy. It doesn't matter if you are an individual, a small business, a large employer, this is probably one of the top concerns I hear about from many folks in Minnesota. The tax code is too complex, too costly, it takes too much time to comply with.

Nine out of 10 Americans have to pay someone to do their taxes for them or purchase the financial software to do their taxes.

I remember one company, a large employer—you shared some great testimony, Mr. Grossbauer—but there was a large employer who spoke at the Ways and Means Committee not too long ago, and they talked about having a 17,000 page tax return. So, think

of the army of accountants that have to go through that process, and the ingenuity and the know-how that is not employed in helping the company produce more growth.

So, I guess my question is this. Dr. Laffer, you have already dated yourself a little bit with the Reagan tax reform initiatives back in 1986, but if you could give some additional advice, you did some comparisons before with states and international, but if you could give simple, straightforward advice about what we should focus on when we talk about growth, what would you advise? We are going through this once-in-a-generation opportunity to get it right, to do it right. We will do this right hopefully right after the next Presidential election. We'll be ready to go.

**Dr. Laffer.** Yes, and that is the reason I am here today. I took a hiatus for 35 years. I'm here because I think the opportunity is right now. And I think if we did the first thing here, what has been talked about here, expensing, corporate tax rate reduction, to really kickstart the system, I think that would be a wonderful one. Not unlike Reagan's 1981 tax bill.

But that should be considered a first step. You can do some simplification of personal income taxes, as well. But the long run position should be to make the tax code do the least damage possible to collect the requisite revenues to run government.

And if you look at that, what you want to do is have the lowest possible tax rate to provide people with the least incentives to evade, avoid, or otherwise not report taxable income. That is why I used the Warren Buffett example there. You want the lowest possible rate to do that, and the broadest possible tax base, so you provide people with the least places in which they can place their income to avoid paying taxes.

So you really want to do the least damage. All taxes are bad. Some are worse than others. The reason we have taxes is to collect the revenues to run government. Then you want to spend your money in the best way possible.

Both of those are really, really important. I mean, Mrs. Maloney, the issue there is that tax simplification includes tax rates and the tax base. And you can make it static revenue neutral like we did in the 1986 Tax Act, and there is no reason why you can't do—that is what I did with Jerry Brown's flat tax, as well, in 1992. There was no net revenue loss on a static basis.

And what you will do is just generate pure economic growth. But the first ones I would kickstart tax reform with some of the biggest types of taxes we dropped, with a Democrat, by the way, through an amendment that we cut the unearned income tax rate from 70 percent to 50 percent with Reagan. That was, I believe it was, I forget whose amendment it was (it was the Brodhead Amendment) to the bill, but Reagan agreed to do. It also cut the capital gains tax.

That is what we have to do to kickstart. Once this economy starts growing, then you can afford to really go into a much broader tax reform just like we did in the 1980s.

**Representative Paulsen.** Mr. Grossbauer, you talked about fiber optics getting categorized as real estate. Is there another example you have of what you think the focus should be on, or what



small businesses or the entrepreneurs as the engine of the economy would want to have us focus on first and foremost?

**Mr. Grossbauer.** Well, you know, listening to full expensing, one of the most difficult—am I on [referring to the microphone]—one of the most difficult things is depreciation, and how do we depreciate capital items.

I have data center space in Chicago. I have a lot of servers in Chicago. It is all capitalized. It is all capital equipment. And the depreciation laws are really, really—you know, hit my company very hard.

And I can only imagine how it affects, you know, Arcelor-Mittal and U.S. Steel, but it does impact my company. So that's something that would make a clear impact on my company.

As we think about, you know, growth, this becomes a barrier.

**Representative Paulsen.** Thank you, Mr. Chairman.

**Chairman Coats.** Thank you. Now, Senator Klobuchar.

**Senator Klobuchar.** Thank you very much, Mr. Chairman.

I am a big fan on moving forward on tax reform, and doing something about the trillions of dollars overseas. We certainly know this in Minnesota with the Medtronic situation, although that has worked out for us in terms of adding jobs in our state. But overall that's just not how we should run our business situation. And so we not only need some rules. Mostly I'm interested in corporate tax reform and trying to bring that money from overseas, and creating incentives.

But ours was kind of—however, I do have one. You will probably call it an aberration, but CNBC did the rankings of the best states to do business in, and maybe Dr. Bernstein knows this, but the number one state to do business in was?

**Dr. Laffer.** Minnesota.

**Senator Klobuchar.** Minnesota. And we actually have a 3.7 percent unemployment rate. Yet our taxes—we were just checking this—are somewhere in the middle. But of the top earners, Governor Dayton made some changes because we had a \$6 billion budget gap, and put them at 9.85 percent. So they are one of the higher tax rates for top earners.

And CNBC said they have never had a state quite like ours. It is a bit more pro-union. It is a bit more higher wages. And it is also clearly not in a low tax. I think Texas was second. But what they noted was, more and more with the economy stable companies are looking at places with good infrastructure, high quality of life, well educated employees. And I just thought maybe you wanted to, might want to comment on that, Dr. Bernstein.

And I have another question of you, Dr. Laffer, but I thought you might want to look at this strange aberration.

**Dr. Bernstein.** So if you look at the Kansas story, the slide over there shows that for all their tax cuts not only did they blow a revenue hole in their budget, but their job growth is half as fast as those of surrounding states.

Well if you break down those surrounding states, the states that are doing the best tend to be the ones whose taxes are actually higher. The ones who have experimented with supply side, Missouri to some extent, Oklahoma, they are finding economic results that are relatively worse than the others.

And I do think—again, I am not trying to say that raise your taxes and watch growth bust out everywhere, because what really matters is what you do with it. And here I strongly disagree with Art’s “I hate taxes,” or “no taxes are good.” It is all a matter of what you do with them.

When you say taxes are all bad, you are also saying Social Security and Medicare are bad

**Senator Klobuchar.** Okay—

**Dr. Bernstein.** No, my point is that if you are going to use your tax revenue to create a business friendly environment, through infrastructure, through an educated workforce, you are going to draw business in. That has certainly been the Minnesota case. You know that better than I do.

**Senator Klobuchar.** Well we have 17 Fortune 500 companies. We are second per capita for Fortune 500. We may be something of a unique situation, making everything from the pacemaker to the Post-it note.

But I do think that is an issue. Now where we are having some major challenges, and Dr. Laffer you are an expert on this, is the steel industry. Iron ore, we’ve lost 2,000 workers, in the part of the state where my grandpa was an iron ore miner. The plants are idled because of steel dumping, because of overproduction, because of Chinese currency manipulation, and the White House is actually working on this quite a bit, but we invited Dennis McDonough to Minnesota and he went up north. We are really concerned about security if we do not have a steel industry, and we are also worried about how we get ourselves out of this.

So if you could, in my remaining minute and a half here, if you could comment on that and what you think we could do there.

**Dr. Laffer.** Well I was born in Youngstown, raised in a steel family, all the way back. The problem with steel, as I see it, is location. And location is because of tax, in part. Obviously a lot of other factors come in. And Minnesota is a lovely, wonderful state, by the way, it really is.

And if you look at my Rich States/Poor States ranking, which I do every year, I have for the last 10 years with ALEC, you can see the ranking—

**Senator Klobuchar.** Okay, alright, but let’s get to—

**Dr. Laffer.** What you have now is U.S. companies are taxed at U.S. rates, no matter where they make their profits, etc. If you have two locations, A and B, if you raise taxes in B and you lower them in A, producers and manufacturers and people are going to move from B to A.

What we have done is increased tax structures on manufacturers, especially steel and these types of things, depreciation schedules all play in this both for the customers, etc., that have made the U.S. a not favored location.

We have the highest corporate tax rate in the OECD, and that clearly causes discrimination. And our corporate taxes are global. And so therefore no matter where the U.S. company is located, it has to pay the U.S. tax rate, even if these companies are competing against other companies with much lower tax rates in those foreign locations.

And that to me explains a large reason of why we did so well during the 1980s and are doing less well now.

**Senator Klobuchar.** How about the currency manipulation? Do you believe that's a part of it?

**Dr. Laffer.** I do. I testified for TPP, and I think currency manipulation is a serious issue with TPP. I think all of these things combined make a lot of difference. But the tax rates really have a hammering effect on U.S. companies in aggregate, and especially on manufacturing companies and, if I may double down, especially on steel companies from my home town of Youngstown, Ohio, steel, which is pretty important.

**Senator Klobuchar.** Right. Thank you, very much.

**Dr. Laffer.** Thank you.

**Chairman Coats.** Senator Cotton.

**Senator Cotton.** Thank you.

Dr. Laffer, Mr. Hodge, one of the two of you said that obviously taxes are necessary and always have been to fund the legitimate and needful functions of government. Some are better, and some are worse.

Would you care to characterize which ones are the worst in terms of their impact on economic growth? What the alternatives might be, and whether they are politically feasible?

**Mr. Hodge.** Sure. In fact, economists at the OECD have looked at this in a very interesting study a few years ago. They found that corporate income taxes and taxes on capital are the most harmful taxes for economic growth, followed by taxes on income, followed by taxes on consumption, and finally taxes on property. And why is that?

It all has to do with the mobility of the factor in the economy. Capital is the most mobile factor in the economy, and thus the most sensitive to high tax rates. And you see that with our corporate tax system.

Income taxes are slightly less sensitive because people are less mobile. I cannot follow my employer to Ireland to take advantage of that 12½ percent corporate tax rate. And obviously property tax, you can't move property. So it is less sensitive to tax policy.

So keeping that in mind should guide our tax reform measures as we go about trying to reform the tax system. And that is why things like full expensing are such a powerful engine for growth, is because it is reducing the cost of capital.

**Senator Cotton.** Dr. Laffer.

**Dr. Laffer.** I totally agree. Corporate and personal income taxes are key. I would rank the order the other way around. The literature has a great deal to say on this, and progressive income taxes are killers. The more successful you are, the higher the rate you pay, which really teaches you how to change where you live, where you report income, how you report income.

If you are facing a 50 percent marginal income tax rate, you are going to spend 50 percent of your time trying to reduce your tax bill rather than trying to earn more income. It is just simple math.

And the literature is unambiguous that the income taxes, both corporate and personal, are the key drivers. And progressive taxes are much worse than flat taxes.

**Senator Cotton.** It sounds like you are saying to Senator Klobuchar, as revealed in some of your research, about people moving from higher tax states to lower tax states?

**Dr. Laffer.** Well I just finished my book, which is “The Wealth of States,” which is about 430 pages of combining all the literature and all the data on states. As you all know, I do Rich States/Poor States every single year, have done it forever. We look at all these metrics, and we rank the states. And it is unambiguous how important taxes are for a movement of people, movement of jobs, and prosperity. If you don’t believe me, look at West Virginia, unfortunately.

**Senator Cotton.** Dr. Bernstein, so the hierarchy we just heard from Mr. Hodge and Dr. Laffer, capital, income, consumption, property. Would you care to reflect on that?

**Dr. Bernstein.** Yeah. I am much less moved by all of the discussion on how responsive capital income is to these changes. I think the evidentiary record is quite different than has been represented.

So if you look at the relationship between real investment and changes in capital tax rates, there is just nothing there. So I think that they are very much exaggerating that.

If I may say, where I think I would answer your question, where I would make a change, is on the estate, inheritance side of the code. And actually Art might agree with me on this. The extent to which we favor inherited income, step-up basis, I’m sure you’re familiar with, step-up basis is a huge waste of money. And it is also an economic distortion because it creates a lock-in effect. So that is where I would start.

**Senator Cotton.** Mr. Hodge, you look like you wanted to respond.

**Mr. Hodge.** Well, I kind of find it interesting when people say that they are unmoved by the effect that taxes on capital can have. Then people complain about the profit-shifting behavior of U.S. companies out of the United States to lower tax jurisdictions.

The reason we have profit shifting, and we have seen economists such as Kim Clausing demonstrate that about a third of our corporate tax base is being moved out of the U.S. because of our high corporate tax rate.

So the key to moving that tax base back into the U.S. is to cut our corporate tax rate.

**Senator Cotton.** Dr. Bernstein.

**Dr. Bernstein.** The extent of tax evasion and tax avoidance is remarkably insensitive to changes in the tax rate. Now it may be the case, where Scott and I might agree, it may be the case that if you took our corporate tax rate down to 10 or 12 percent you would see the kind of differences he’s talking about. But the damage that that would do to our fiscal accounts and the knock-on damage it would do to the rest of the economy would make that prohibitive.

So again, I really think you have to be driven by the empirical record here, and you simply don’t see the kind of elasticity responses that not only are these guys talking about, but that they are erroneously building into their models.

**Senator Cotton.** Do you have anything to say about the distribution of Dr. Laffer's, Mr. Hodge's hierarchy of capital income—

**Dr. Bernstein.** I think that they're—I agree with them, and I think that there is wide bipartisan agreement, and again this agrees a little bit with what Scott just said, that the corporate side of the code is a mess. And, that our statutory rate is uncompetitively high.

I think the difference between us is that I recognize that very few corporations in the multinational space pay anything like that.

**Senator Cotton.** Dr. Laffer.

**Dr. Laffer.** Yeah, but it's not just what they pay. It's what the expenses are that they go through to avoid paying taxes. And what I've done here on this is shown that there are huge expenses that companies pay, but that don't get collected by the government in tax revenues.

What we want to do, and what my paper that I read into the record does, is try to eliminate or reduce the difference between the cost to the company and what the actual government collects.

And what happens is, people will spend fortunes getting around the taxes so that the government doesn't get the revenue and there are damages done to the companies as well. And that just makes no sense whatsoever.

If you are going to pay taxes, at least let the government collect them. But that is not what these tax codes—and if I can say, Jared, I mean very seriously the complexity of these tax codes, and all of this stuff you're talking about, is just disastrous. And you used Kansas as an example, which is really unfair because I've done the response to Kansas in the Investors Business Daily. You know those numbers.

Look at North Carolina. Look at Indiana. Look at these states that have done major tax reform. Look at Texas vs. California. Look at Florida vs. New York. Look at Tennessee vs. Kentucky. Look at any of these states. For goodness sakes, the evidence couldn't be more obvious.

It takes—it takes—I mean sophistry of the worst kind to be able to convolute these results into something that goes in the opposite direction.

**Dr. Bernstein.** Well let me disagree—

**Dr. Laffer.** Let me finish, first.

**Dr. Bernstein.** Sorry.

**Dr. Laffer.** You cannot tax an economy into prosperity. You just plain can't. Everyone knows that from first grade on. And the Tax Foundation has done wonderful work on this. I would just disagree with them that they're not quite as strong a result as I think they really are, but, hey, I love ya. But it's just silly to argue that taxes don't matter. They matter, and matter a lot, and everyone knows that. Everyone who has been in business knows that.

**Dr. Bernstein.** Thank you. If I may—

**Senator Cotton.** If we have the time—

The Chairman . We have the luxury of more time here.

**Senator Cotton.** Well I'm having fun, and I have the floor until someone else comes in.

**Chairman Coats.** Senator Cotton and I are having a great time, and——

**Senator Cotton.** And Dr. Bernstein——

**Chairman Coats.** He is still on the floor, and he is going to give you some time.

**Dr. Bernstein.** Well I appreciate the opportunity because I think there are actually some common views here that I would like to amplify, and I suspect you share them, Senator.

Which is that the problems with the corporate side of the code that were just described by Art strike me as spot on. And the expenses that businesses have to go through to bend themselves into a pretzel, I mean last I looked GE, which I don't think makes tax law, has something like a thousand tax lawyers on staff. And just like Mr. Grossbauer was saying, that's inefficient.

That said, it is not that the politicians and the people on this panel disagree with broadening the base and lowering the corporate rate. It is all of the industries and their lobbyists who would get dinged, because let's face it, if you are going to do tax revenue neutral, corporate tax reform, and I think that's the lowest bar, I think we need more revenue. You are going to have winners and losers.

And the losers do not like it. We can sit around all day and agree.

Secondly, look, Art and I have a fundamental factual disagreement on the state-based evidence. We are not going to hash it out here. But I would be happy to submit evidence to the Committee in very much support of states that have in fact raised their taxes who are doing a whole lot better than states that have lowered them, and vice versa. It goes both ways.

**Chairman Coats.** Well, the Committee, I can tell you, would welcome both of you submitting that. That is what we're here—we are not the Joint Tax Committee, but we are the Joint Economic Committee, and we do have a tax component. So we would appreciate all the information that either one of you can give us.

Senator Cotton, take whatever time——

**Senator Cotton.** Yes, I will keep rolling if no one else is.

Dr. Bernstein, what about the fairness of that hierarchy? So here at capital income, rich people can have more of that than poor people. Consumption is a higher percentage of poor people's income than it is for rich people. And property has a smaller variance, either a small, single family home to a billionaire's home who can only have a certain number of square feet, and bathrooms, and car garages, and all the rest.

But income can be infinite. Do you have concerns that the hierarchy that Dr. Laffer and Mr. Hodge have laid out is not fair?

**Dr. Bernstein.** Well, it's a good question because I think they were largely answering questions vis-à-vis growth in their hierarchy. And I think that when we talk about fairness or distribution, I do think you probably have to flip that hierarchy considerably.

The fact that capital income is largely concentrated among the wealthy, the ownership therein, and that it is taxed at a privileged rate, builds in a level of unfairness, or regressivity into a tax code.

Now broadly our tax code is progressive, but that is on the income side.

If you actually look at the benefits of favorable treatment of capital-based income, they flow exclusively to the top 20 percent. And within the top 20 percent, the top 10, 5, 1 percent. So that is a regressive problem.

**Senator Cotton.** And Dr. Laffer or Mr. Hodge, would you care to respond?

**Mr. Hodge.** Do you want me to go first?

**Dr. Laffer.** Go ahead.

**Mr. Hodge.** One of the challenges of tax reform is that what is politically popular—and that is tax cuts for individuals—is not really the biggest driver of economic growth. And what is not politically popular—and that is, cutting capital taxes—is the biggest driver.

So you have this sort of I think conflict there between politics and good economics. And somehow trying to balance that is one of the challenges of fundamental tax reform.

**Dr. Laffer.** Let me, if I can, just say on the income distribution and what's going on, high tax rates are not paid by the top one percent of income earners. End of discussion. If you look at the effective tax rate of the top one percent of income earners, it is flat all the way across history with statutory rates going up and down and all over the place. The top one percent of income earners find exemptions, loopholes, that's why I used the Warren Buffett example.

It is a perfect example of how you get around your taxes, and how he personally has gotten around his taxes. All legal. When you look at the migration of income from high income tax states to low income tax states, the wealthy move from California to Texas. They do. All of that you can see "How Money Walks," or in my book "The Wealth of States." We have documented IRS data from the beginning of time.

If you look at estate taxes; those estate taxes filed in states that don't have an estate tax and in those that do have an estate tax, there's two times as many filed in a state that does not have an estate tax as there are in states that have estate taxes. And the size of the estates is nearly twice as large.

People really like their own money and will go to great lengths to go around taxation. It is pure and simple common sense. And that is what they do.

And, Jared, all your talk notwithstanding, if you look at North Carolina, we cut the highest tax rate by two percentage points. We cut the welfare generosity variables. We cut welfare eligibility. And now look at North Carolina. Huge surpluses are going on there, and prosperous, and all the boycotts have been gone there a long time. And that is Governor McCrory, as you know.

If you look at the other states. Indiana. Your state. Look at what's happened with Mike Pence, and before Mike, whatchamacallit—

**Chairman Coats.** Mitch Daniels.

**Dr. Laffer.** Mitch Daniels. I mean, it's great. Look what happened with right-to-work there. If you look at the states, right-to-work is the way it's going. Look at right-to-work states' growth vs. nonright-to-work states' growth. You can see it clearly. You can see

it with income taxes. Jared, I just don't know where you're getting your evidence because the academic literature is replete with the examples I am describing. I could send you hundreds and hundreds of articles that show this. Now they show it in different ways, different magnitudes, but no one thinks that raising tax rates increases growth.

**Chairman Coats.** I feel like the moderator at a debate, a Presidential debate here——

**Dr. Laffer.** He's wrong on that.

**Chairman Coats.** You have raised Dr. Bernstein's name again, and he has 30 seconds to respond.

**Dr. Bernstein.** Well, thank you. Thank you.

**Mr. Hodge.** Could somebody pick on me, please?

**Dr. Bernstein.** I'm sorry?

**Mr. Hodge.** Could somebody pick on me, please?

[Laughter.]

**Dr. Bernstein.** I think I can arrange that, Scott. Art doesn't want to talk about Kansas. Art was instrumental in nudging Kansas to embrace the kind of supply-side tax cuts he has been arguing are absolutely, unequivocally associated with higher growth. He predicted, quote, "an immediate and lasting boost to the Kansas economy."

Not only has the budget there been seriously underfunded, the state's education system is in trouble there. It is widely recognized that the tax cuts were the reason for that. And as I've mentioned, job and GDP growth have really done poorly relative to neighboring places, including places that actually either increased or certainly did not lower their tax.

The Kansas Legislative Research Department's projection suggested the economy is going to remain weaker relative to the overall U.S. economy for the foreseeable future. This is an experiment.

In fact, Governor Brownback called it an experiment. And it is a failed experiment. And you can bang the table with your shoe all day, but the data tell you what they tell you.

**Senator Cotton.** Dr. Bernstein, rather than talking about Kansas, let's talk about Arkansas for a minute, since we pronounced the last six words of that name correctly, you brought up the stepped up basis for the estate tax. Dr. Laffer just brought it up as a critic. I want to talk about the impact it has, particularly in rural areas. I think a lot of people, when they think about the estate tax, have the image of, you know, wealthy investors who have highly liquid assets like marketable securities that when they pass away could be easily sold to pay off the tax. It's not always the case.

In rural areas, the classic example in Arkansas would be timber forestry products. You own a lot of land. You have a lot of trees. It takes 40 years to make a tree. Very asset high. Very cash poor. Regardless of the threshold or the exemptions, you still often see families having to break up family businesses to pay the tax.

What is the right solution to that if it is not simply repealing the estate tax, which as you might guess would be my proposal.

**Dr. Bernstein.** Well, the exemption for the estate tax for couples is \$11 million. And the estate tax hits 0.2 percent of estates—not



2 percent, 0.2—so 2 out of 1,000. And for those who get hit by it, the average tax rate is 17 percent.

So I would consider that to be, if anything, an extremely fair and even a regressive treatment. So I would probably push the other way, as suggested in the President's budget, to lower that threshold. He suggests a threshold of \$7 million for couples. Instead of hitting 0.2 percent of estates, that would hit 0.3. And I think that would be, that would be a smart thing to do in the sense of revenue, meeting some of our revenue needs.

**Senator Cotton.** Dr. Laffer.

**Dr. Laffer.** Yeah, I think he missed your question. I think you were talking about state taxes and what happens with them.

**Senator Cotton.** No, I was talking primarily about federal—

**Dr. Laffer.** Oh, you were—

**Senator Cotton** [continuing]. The same economic—

**Dr. Laffer** [continuing]. The movement among states with and without estate taxes is just unambiguous. Rich people move to lower estate tax states, and they take their money and their jobs with them. And they move a long time ahead of time because they are not quite sure when they are going to die, and they do it in massive—the best one of all was the very famous Senator, a guy named Howard Metzenbaum from my home state of Ohio, and Howard Metzenbaum, weeks before he died, moved to Florida where there is no estate tax. And he wasn't wrong to move to Florida. He just was wrong in espousing an estate tax for everyone else except himself.

And we see it all the time. Rich people move from California. And if they don't move, they shelter their income. That's what they do. And all these data are just clear as bells. And, you know, when you look at the U.S., if you take tax revenues from the top one percent of incomers, we have the data back to 1913. We've got it all, by account. If you look at it, when we've cut statutory rates, revenues from the top one percent of income earners rises as a share of GDP, which also rises very rapidly. When we've raised rates, tax revenues from the top one percent have declined as a share of GDP.

In 1978, tax revenues from the top one percent of income were 1½ percent of GDP. In 2007, tax revenues from the top 1 percent of income earners were 3.1 percent of GDP, with all those tax rate reductions. If you look at that period, it is unambiguous. Rich people respond to tax rates, and they pay you more money at lower rates within reason. And that is why we want a low-rate, broad-based tax so when we collect those monies from the rich people, and not just have them go into shelters and not pay any taxes like Warren Buffett.

**Chairman Coats.** Senator Cotton—

**Senator Cotton.** I am exhausted.

**Chairman Coats** [continuing]. Good—

**Senator Cotton.** I am out of questions. Thank you all very much.

**Chairman Coats.** You set the record for time allotted to members of this Committee. Just two points in closing.

This has been fascinating. I mean, we could go on for hours here.

**Dr. Laffer.** Jared would run out—no, just kidding.

[Laughter.]

**Chairman Coats.** No, we don't want to be too hard on him. But our Finance Committee on which I sit, we brought back Bob Packwood and Bill Bradley to tell us how did you guys get it done in 1986? Well, it was an exhausting series of opportunities, and doors opened, and doors closed, and work-arounds, and so forth.

There is strong bipartisan support for, and need for comprehensive tax reform, but we just cannot seem to get the thing moving, for whatever number of reasons. But I think all of you have laid out some real reasons why we need to keep pushing on this, and why it is important for the country.

By the way, Dr. Bernstein, I was handed a note here from my tax staff which said that during the last two years Kansas has exploded in growth. Labor force participation is nearly 5.3 points higher than national average. So maybe it just took longer to kick in.

**Dr. Bernstein.** The slide in my testimony on the job growth, we made that yesterday with the most up-to-date data there is.

**Chairman Coats.** Alright. Well——

**Dr. Bernstein.** I challenge that.

**Chairman Coats.** I'm not trying to promote Art's book on the states. Some of my information comes from some people we know in Kansas that basically have said, look, as long as the Royals are competing for the World Series, and the Jay Hawks are competing for the Final Four, life is still good in Kansas. So I don't want to denigrate Kansas too much.

But nevertheless, this has been a fascinating time here with the Committee. I love the back and forth. It is so much more dynamic—so is dynamic scoring—so much more dynamic than it is just simply the question and the time to move on, etc., etc., etc.

Mr. Grossbauer, you were part of a very, very interesting hearing here.

**Mr. Grossbauer.** It was. It was quite fascinating.

**Chairman Coats.** I hope you enjoyed it.

**Mr. Grossbauer.** I did.

**Senator Cotton.** If I can say, if you had simply rolled your eyes and sighed more at your panelists' responses, you would have gotten called on more in that last long round.

[Laughter.]

**Chairman Coats.** That is true. Listen, this is terrific. I want to thank all four of you for being here. You added a real dynamic to a very, very important debate for the future of this country. And, frankly, it has been 30 years and we are falling further and further behind. If there is a consensus here on anything, it is that we need comprehensive tax reform, and we need it now. And our country will benefit from it.

Thank you all very, very much. This hearing is adjourned.

(Whereupon, at 4:01 p.m., Wednesday, April 20, 2016, the hearing was adjourned.)

## **SUBMISSIONS FOR THE RECORD**

PREPARED STATEMENT OF HON. DANIEL COATS, CHAIRMAN, JOINT ECONOMIC  
COMMITTEE

It's fitting that this hearing falls between Tax Filing Day, which was moved to April 18 this year, and Tax Freedom Day on April 24. As Mr. Hodge may explain, Tax Freedom Day represents the day taxpayers can stop working to pay off what they owe the government and start earning for themselves and their families.

Unfortunately, Tax Freedom Day does not include freedom from complexity. Throughout the year, taxpayers will have to gather and store receipts and records to deal with next year's filing deadline. Some taxpayers will even make business or even personal life decisions based on some quirk in the tax code.

I wanted a tangible example at this hearing of just how complex tax law is. That's why these boxes are stacked in front of the dais. In 2014, a publication that includes the tax code, regulations, and court decisions that determine tax law totaled over 74,000 pages. If my staff had printed this out, they would need the 15 boxes of paper represented here.

I have good news and bad news to report with respect to 2015. The good news is that the latest version has fewer pages.

The bad news is this was not due to a decrease in the number of tax laws. It was because the explosion of pages no longer fit in the binders, so the publisher shrank the font size. Now taxpayers really have to pay attention to the fine print because it's all fine print.

No wonder 90 percent of taxpayers pay a tax preparer or buy computer software to help them figure out their tax burden.

Even before the new tax complications of the Affordable Care Act, the Internal Revenue Service estimated that taxpayers spent over 6 billion hours each year preparing and filing taxes. Estimates of the dollar cost to taxpayers range in the hundreds of billions.

Complexity comes with many costs. Aside from frustration and anxiety, it causes taxpayers to spend time and energy that could be put to much more productive uses, including time with family.

It costs the Treasury, since taxpayers make innocent mistakes and are never sure exactly what they owe. And it breeds a sense of distrust in the system when taxpayers suspect others are getting a better deal because they figured out how to game the tax code.

But is there a real economic cost? Would America as a whole be dramatically better off with a much simpler, pro-growth tax code?

I think I know the answer, but I look forward to hearing the views of our distinguished witnesses.

Today we will hear from Dr. Art Laffer, known as the father of supply-side economics. We also have Scott Hodge of the Tax Foundation, which is famous for its tax research. We will also hear real-life stories from Joe Grossbauer, a small business owner who lives with tax complexity every day. Our final witness is Jared Bernstein of the Center on Budget and Policy Priorities.

My thanks to all of you for tackling this complex issue, which I hope will become much simpler.

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PREPARED STATEMENT OF CAROLYN B. MALONEY, RANKING DEMOCRAT, JOINT  
ECONOMIC COMMITTEE

Thank you so much Chairman Coats for calling this hearing, and to all of our panelists.

We are here today to talk about simplifying the tax code. Most Americans think our tax system is too complex, and I believe we all agree.

But simplifying the tax code will be a massive undertaking. It will be politically difficult. It will create winners and losers.

That's because simplifying the code requires eliminating some of the tax credits, deductions and exemptions that make it complicated. Those who benefit from these provisions will fight tooth and nail to protect them.

That's why we should be very wary of anyone who offers a quick and seemingly painless fix.

Some things are worth protecting, like the home mortgage interest deduction that enables Americans to achieve the American Dream of owning a home.

Others widely benefit society, like the charitable deduction that helps support museums, parks, and other important charities.

And some credits incentivize behavior that broadly benefits the economy, like the Research and Development Tax Credit.

Some credits are critical to giving working families a chance to succeed, like the Earned Income Tax Credit.

However, many loopholes in our tax code are just giveaways to narrow special interests. These are often buried deep in the fine print, making the tax code more complicated and less fair.

So yes, we should simplify our tax system. We should make it as easy as possible for individuals and small businesses to do their own taxes and pay them. We should enable companies to spend less money on tax accountants and more on building their businesses.

And we should plug some of the thousands of loopholes that not only complicate the tax code, but allow some to take unfair advantage of it.

But at the same time, we should make sure that our tax system raises enough revenue to provide Americans the services they expect from their government and that they need.

And we should create one that makes the vast majority of Americans better off than they are today—or at least not worse.

But I fear that many proposals that conservatives claim would simplify the tax code are not really about simplification. Rather, they are about radically restructuring who pays how much.

One proposal in the House Republican Budget is to reduce the number of brackets in order to lessen complexity.

Some would go further. A plan backed by hearing witness Arthur Laffer is to create one “Flat Tax.”

This would reduce the total number of brackets to ONE. This means that a family that earns \$50,000 would pay the same tax rate as a family earning \$50 million.

Many conservatives claim these simplification plans that translate into huge tax cuts for the wealthy won’t increase deficits and won’t affect the government services that many Americans believe are necessary.

The theory is that “tax cuts pay for themselves”—in other words, cutting taxes can translate into such massive economic growth that it leads to higher government revenues.

This means that tax cuts SUPPOSEDLY can take place without offsetting spending cuts. Americans SUPPOSEDLY won’t lose any of the government services on which they depend.

Social Security won’t be touched. Or Medicare. Or Education funding. Our national defense will remain strong. Our highways won’t be allowed to fall into disrepair. We won’t have to cut funding for dreaded diseases like the Zika Virus.

But this math simply does not add up. Tax cuts don’t pay for themselves. Tax cuts don’t necessarily lead to strong economic growth.

But they do lead to lost revenue and higher deficits.

This is the lesson of the past 35 years.

Despite tax increases under President Bill Clinton we had a booming economy, and created more than 22 million private-sector jobs, and four straight years of budget surpluses.

And then we had two tax cuts under former President George Bush which contributed to massive budget deficits, with the tax cuts by themselves adding, according to some economists, \$1.5 TRILLION to deficits over ten years.

So in summary, when we talk about making the tax code less complex, let’s not be fooled by claims that we simply need to “flatten” the code.

This will make it more regressive, shifting more of the tax burden onto the middle class and the poor.

And let’s not continue to pretend that “tax cuts pay for themselves.” History has shown that they do not, in recent history.

And so let’s get down to the business of simplifying the tax code and making it more fair.

I truly look forward to this very impressive panel and hearing your testimony today.

Thank you.

**Testimony of Arthur B. Laffer, Ph.D  
Chairman, Laffer Associates**

**Joint Economic Committee  
Hearing entitled, "Is Our Complex Code Too Taxing on the Economy?"  
April 20, 2016**

***Dr. Laffer submits the following study as his written testimony.***



## The Economic Burden Caused by Tax Code Complexity

Arthur B. Laffer, Ph.D.  
Wayne H. Winegarden, Ph.D.  
& John Childs

April 2011



## The Economic Burden Caused by Tax Code Complexity\*

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## The Economic Burden Caused by Tax Code Complexity

Arthur B. Laffer, Ph.D., Wayne H. Winegarden, Ph.D., & John Childs

### Executive Summary

To pay taxes, the costs taxpayers actually incur are far greater than the net sums the government collects. Individuals and businesses as taxpayers must pay substantially more than \$1 in order for government beneficiaries to receive \$1 of federal government services. Before individuals and businesses pay their tax liability (TB in Figure ES 1), they must first spend time collecting records, organizing files, and wading through the tax code (B in Figure ES 1) to determine exactly what their tax liability is. In addition, individuals purchase products and services, such as tax software or an accountant, to assist them in determining their tax liability. These are tax compliance outlays (C in Figure ES 1). Thirdly, in effect, taxpayers must also pay the administrative costs needed to run the IRS etc., solely for tax collection purposes (D in Figure ES 1). Still there is more.

Businesses, large and small, hire teams of accountants, lawyers, and tax professionals to track, measure, and pay their taxes. This tax infrastructure is also used to optimize the tax liability of the business. Individuals and businesses change their behavior in response to tax policies, hiring tax experts to discover ways to minimize their tax liabilities. The efficiency costs from both legal tax avoidance and illegal tax evasion are difficult to quantify, but could be the highest costs of all (A in Figure ES 1).

This is their story.

This study creates a comprehensive estimate of the total administrative costs, time costs, and direct tax compliance costs created by the complex U.S. federal income tax code. This paper deals only with Segments B, C, D and E from Figure ES 1. One can only imagine what the full burden of government on the well-being of society might be. In our analysis we estimate that U.S. taxpayers pay \$431.1 billion annually, or 30 percent of total income taxes collected, just to comply with and administer the U.S. income tax system.\* This cost estimate includes:

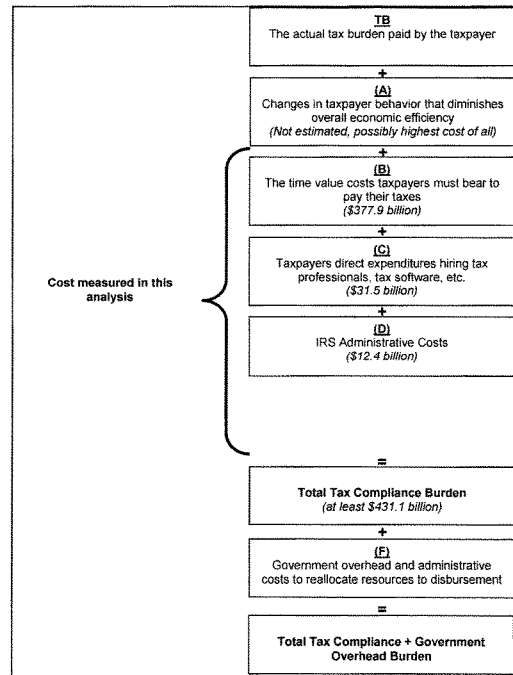
- Approximately \$31.5 billion in direct outlays (e.g. paying a professional tax preparer such as H&R Block or purchasing tax software) (2010 data).
- Total IRS administrative costs of \$12.4 billion (2010 data).
- The Taxpayer Advocacy Service of the IRS estimates that *individuals and businesses also spent 6.1 billion hours complying with the filing requirements of the U.S. income tax code. We estimate the dollar value or cost of these hours to be \$377.9 billion as of 2008.* The 6.1 billion hours number was estimated by multiplying the number of copies of each form filed in tax year 2008 by the average amount of time the IRS estimated it took to complete the form.
- Individuals spent 3.16 billion hours complying with the income tax code, which weighted by time spent by income group, costs the U.S. economy \$216.2 billion annually.
- Businesses spent 2.94 billion complying with the business income tax code, which costs the U.S. economy \$161.7 billion.
- Comprehensive audits also impose an additional taxpayer burden of at least \$9.3 billion annually.

\* According to the IRS, total gross individual income tax collections in 2008 were \$1.4 trillion; <http://www.irs.gov/pub/irs-soi/08db01co.xls>. Although as of this writing total tax collections from 2010 are available, the detailed breakdown of income taxes paid by adjusted gross income are only available through 2008. For consistency, data on tax collections from 2008 are used throughout this study.

People will also alter their work and leisure, savings and consumption, as well as their investments in response to tax incentives. The estimated \$431.1 billion in tax compliance costs does not include any of these behavioral changes that misallocate resources from their most economically-efficient uses toward their most tax-efficient uses. Nor do these costs account for the lost economic opportunities caused by the uncertainty and confusion of our complex tax code. Goodness knows what the costs would be if taxpayers' pain and suffering were included. Think of how you feel when you go to your mailbox and there is a letter for you from the IRS.

This study also outlines what the potential benefits to economic growth could be from a reduction in tax complexity. Large reductions in taxpayer compliance costs are more than feasible under comprehensive tax reform, namely a low rate flat tax on a broad tax base. The administrative costs, time costs, and compliance outlays resulting from a low rate broad based flat tax would be substantially lower than they are today, while inefficiencies caused by tax code complexity would be greatly reduced. As a result, overall economic efficiency would increase, capital and labor would flow to more highly valued uses, and the growth in income and wealth in the U.S. would increase substantially. Over 10 years, an increase in our annual economic growth rate between 0.45 percent (the low-end estimate

**Figure ES 1**  
**Total Compliance Burden of U.S. Federal Income Tax System**



from a 50 percent reduction in tax complexity) and 0.9 percent (the high-end estimate from a 90 percent reduction in tax complexity) becomes significant. By the 10th year, per capita incomes would be \$2,800 to \$6,000 higher. Not too shabby.

Of course, higher economic growth by itself would raise tax revenues as well. Due to enhanced economic growth, over the entire 10-year period, increased tax revenues at current tax rates are between \$650 billion and \$1.4 trillion in net present value terms. For perspective, based on President Obama's FY2012 budget, the estimated FY2011 net national debt is \$10.9 trillion.\* The benefit from reduced tax complexity would significantly reduce our national debt.

#### Government Overhead and Beneficiary Considerations

The actual separation between the dollar taken away from the taxpayer and the dollar spent by the government is even further than the above analysis indicates. A complete accounting of the costs of administering any tax system must also include the money that the federal government must spend on overhead and other administrative costs to simply reallocate the resources from the tax collection process to the appropriate disbursement venue (F in Figure ES 1). These allocation costs are present in any tax system; however such costs further increase the amount of money a taxpayer must pay in order to provide \$1 of government services to the recipients.

And, while beyond the scope of the current analysis, even at the tail end of the process where beneficiaries actually receive their benefits there are usually lots of hurdles the potential beneficiaries must overcome to "qualify" for the money. As anyone who watched the FEMA fiasco following hurricane Katrina in New Orleans can tell you, qualifying costs can represent a significant reduction in the value of government benefits.

Accounting for these costs to provide \$1 of net government services, individuals and businesses must pay the \$1 plus their own time costs, the IRS administrative costs, government overhead costs, direct tax compliance outlays by individuals and businesses, efficiency costs, and the costs of qualifying.

And finally, there are the costs associated with changes in the behavior of government beneficiaries. On a dynamics basis this last cost may well have the greatest impact of all on economic growth. For the very existence of payments for people who don't work or who otherwise use their time less productively is conceptually no different than paying people to work or otherwise to use their time more productively. The volume and efficiency of work can be impaired significantly by how and to whom benefits are distributed. On the end of the spectrum—all the way to the other end—if government taxes work, output, and employment and pays people not to work and businesses not to produce, the country will end up with less work output and employment.

\*According to the Office of Management Budget, Historical Tables the "Gross Federal Debt" of the federal government in 2011 is estimated to be \$15.5 trillion. \$4.6 trillion of this debt is estimated to be held by the federal government itself. The total debt held by the public—or the net national debt—is estimated to be \$10.9 trillion. Total debt held by the public represents the outstanding liability that the federal government must pay to someone else and represents the federal government's actual financial liability. See the Office of Management and Budget; <http://www.whitehouse.gov/omb/budget/Historicals>.

### The Economic Burden Caused by Tax Code Complexity

The "Patient Protection and Affordable Care Act" (ObamaCare), as passed, requires by law tucked away a footnote forcing all companies to submit a 1099 form to the IRS for all annual business-to-business transactions over \$600. Attempting to raise an estimated \$17.1 billion in taxes, this mandate is the poster-child for the economic burden caused by the tax code. The 1099 requirement covers all the basics of bureaucratic inefficiency: increased time, administrative, and overhead costs, as well as uncertainty over future tax liabilities. Any revenue that this mandate could possibly raise will surely be accompanied by comparable compliance costs and efficiency losses. The compliance costs to the private sector from the 1099 mandate is but a drop in the bucket compared to the compliance costs associated with the full U.S. tax code.

In the intense global race to attract factories, jobs, cutting edge technologies, and corporate headquarters, the winners are determined in part by the attractiveness of their economic environment. The friendliness, or hostility, of a country to labor and capital as reflected in its tax, regulatory, and legal environment play a key role in a business' resource allocation decision. Among these, tax policy is one of the most important factors, directly impacting after-tax income, profitability and return on invested capital. Many factors contribute to the total taxpayer cost of taxation in any particular country, one of which *should not be* the self-inflicted and largely unproductive cost of complying with the tax system.

Individuals and businesses can change the composition of their income, the location of their income, the timing of their income, and the volume of their income in order to minimize their tax liabilities. But each of these strategies to minimize tax liabilities comes at a cost. In order to be worthwhile for the individual, the costs can rise up to, but cannot exceed, the level of the tax savings. The more complex a tax system is, the higher the compliance costs will be. Higher compliance costs increase the returns from tax minimization strategies. It's hard to range these costs, but they most likely represent a sizeable percent of the taxes the government actually collects. One thing is sure, the magnitude of the taxpayers' actual cost is far greater than the net taxes the government collects.

Individual and business taxpayers must pay much more than \$1 in order for government to receive \$1 of tax revenues. Individuals and businesses must devote a significant amount of time collecting records, organizing files, and wading through the tax code in order to determine their actual tax liability. They must also spend time to physically pay their taxes.

Taxpayers must also pay the administration costs of the IRS. The greater the administration costs of the IRS, the higher taxes must be in order to provide \$1 in net taxes. There is, in effect, an internal government tax collection wedge separating tax receipts from the government's usable funds.

Still there is more. It has become commonplace for taxpayers to spend money, on products and services such as tax software or an accountant, to assist them in determining their tax liability—tax compliance outlays. These tax compliance outlays are clearly undertaken for the sole purpose of paying taxes and would not exist otherwise. Our running total is now the actual \$1 spent on the government service plus taxpayers' time costs, government administrative overhead costs, and tax compliance outlays by individuals. Businesses face tax compliance costs as well. Businesses, large and small, hire teams of accountants, lawyers and tax professionals to track, measure, and pay their taxes. This tax infrastructure is also used to optimize the tax liability of the business. Considering only the compliance aspect of the job, in order to provide \$1 of government services the private sector must spend \$1 plus

taxpayers' time costs, government tax collection costs, and direct tax compliance outlays by individuals and businesses.

Finally, individuals and businesses change their behavior in response to tax policies. Individuals and businesses change the composition of their income, the location of their income, the timing of their income, and the volume of their income in order to minimize the effect of the tax codes on their own well-being. Individuals and businesses spend money hiring tax experts to discover ways to reduce the negative impact of taxes. While such actions are perfectly legal, they come with a cost to economic efficiency and growth. Other actions, either intentional or accidental, employ tax evasion strategies that are not legal which create both economic and social costs for the country. The efficiency costs from both legal tax avoidance and illegal tax evasion are difficult to quantify, but could be the highest costs of all. Accounting for these costs to provide \$1 of government services, individuals and businesses must pay the \$1 plus their own time costs, tax collection costs, tax compliance outlays by individuals, tax compliance outlays by businesses, and tax avoidance and evasion efficiency costs. All in all these additional costs are undoubtedly huge and may well over time swamp the actual tax payments as impediments to economic growth.

If the compliance costs for an income tax are minimal, then their impact on gross output will also be minimal. However, as is the case with the United States, when compliance costs compose 30 percent of the current tax receipts collected and these taxes are inefficiently collected, they represent a totally unproductive economic force that drives down the returns on labor and capital while producing *no* additional revenue for the government.

A reduction in the tax burden, including the cost of compliance, reduces the cost of doing business in a country. Lower costs of doing business increase the demand for the now less-expensive goods and services produced within the country. This higher demand will result in increased profitability for businesses located within the country. Business failures will decrease in countries with declining relative tax burdens and business starts will rise. If all else remains the same, a reduction in the tax burden increases the return to capital and work effort, leading to increases in the supplies of capital and labor within the country.

Complex tax systems increase the costs of doing business and diminish the incentive to work, produce and invest. The costs incurred by tax complexity are similar to the costs of actual taxes, burdening workers, savers, and investors, only without the tax revenues. Tax complexity, *per se*, is detrimental to a country's economy and every individual adhering to the tax code. The consequence of this "complexity tax" is a diminished ability to compete in the global economy. The complexity tax is particularly problematic because it creates all of the negative incentives of a high tax burden, but nets the government no additional tax revenues.

We estimate that the annual compliance cost of the U.S. tax code for income taxes alone is approximately \$431.1 billion.\* These annual expenditures could be directed toward productive activities, but are currently being wasted. The growing tax complexity problem in

*Accounting for these costs to provide \$1 of government services, individuals and businesses must pay the \$1 plus their own time costs, tax collection costs, tax compliance outlays by individuals, tax compliance outlays by businesses, and efficiency costs.*

\*In the 2008 National Taxpayer Advocate Service's (TAS) report to Congress, the TAS estimated that "U.S. taxpayers and businesses spend about 7.6 billion hours a year complying with the requirements of the Internal Revenue Code;" see (2008) "2008 Annual Report to Congress" *National Taxpayer Advocate*, Volume 1, December 31. Based on the estimated 7.6 billion hours we estimated the total annual compliance costs were \$521.20. Based on the 2010 TAS report to Congress, (2010) "2010 Annual Report to Congress" *National Taxpayer Advocate*, Volume 1, "Most Serious Problems, #1," the total estimated compliance hours fell to 6.1 billion hours. Even with this large reduction in compliance hours, our estimate for the total tax complexity costs remains excessively large.

the United States is literally “de-stimulating” the economy at the same time that the government has spent hundreds of billions of dollars in an attempt to stimulate the economy. Below, we illustrate the adverse economic impact on the U.S. economy caused by unnecessary tax code complexity. Our results indicate the enormous power tax simplification would have on our tax-burdened economy.

And, while beyond the scope of the current analysis, the actual separation between the dollar taken away from the taxpayer and the dollar spent by the government is even larger than indicated above. A complete accounting of the costs of administering any tax system must also include the money that the federal government must spend on overhead and other administrative costs to simply reallocate the resources from the tax collection process to the appropriate disbursement venue. These allocation costs are present in any tax system; however such costs further increase the amount of money a taxpayer must pay in order to provide \$1 of government services to the recipients.

Even at the tail end of the process where beneficiaries actually receive their benefits there are usually lots of hurdles the potential beneficiaries must overcome or dollars recipients have to spend to “qualify” for government benefits. As anyone who watched the FEMA fiasco following hurricane Katrina in New Orleans can tell you, qualifying costs can represent a significant reduction in the value of government benefits. As another example, to get unemployment benefits you do after all have to be unemployed. That’s one heckuva cost to one and all.

#### SECTION I: AN OVERVIEW OF TAX COMPLEXITY IN THE U.S.

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According to the IRS Taxpayer Advocate’s 2008 report to Congress tax complexity is the *number one problem* facing taxpayers. In fact due to this excessive complexity, “The National Taxpayer Advocate recommends that Congress substantially simplify the Internal Revenue Code.”<sup>1</sup>

In the 2009 report to Congress, the IRS reiterated the tax complexity problem: “In several prior reports, I have designated the complexity of the tax code as the most serious problem facing taxpayers and the IRS alike. The need for tax simplification is not highlighted as a separate discussion in this year’s report to avoid repetition, but the omission of a detailed discussion in no way suggests the lessening of its importance.”<sup>2</sup>

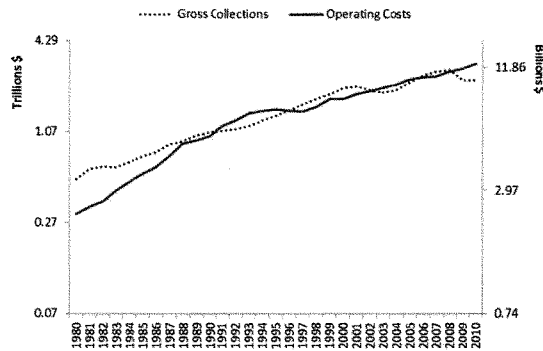
Consider the following facts from the IRS Taxpayer Advocate’s 2010 report to Congress, which again called tax complexity the *number one problem* facing taxpayers:<sup>3</sup>

- In the last 10 years there have been approximately 4,428 tax code changes including an estimated 579 changes in 2010 alone.
- As of an analysis in early 2010, the tax code contained 3.8 million words, which is dramatically higher than the 1.4 million words the tax code contained in 2001.

Tax code complexity also negatively affects overall taxpayer compliance. The tax gap is the amount of taxes the government believes it should have collected but didn’t and is viewed as a proxy for declining voluntary compliance with the tax code. Despite one hun-

dred thousand IRS workers employed to enforce the tax code with a 2010 budget of \$12.4 billion (Figure 1),<sup>4</sup> the latest estimate of the tax gap was \$345 billion (as of 2001).<sup>5</sup>

**Figure 1**  
**Total Administrative Costs and Gross Tax Collections (log scale)**



Source: IRS Chief Financial Officer, Corporate Performance Budgeting, Corporate Policy and Labor Analysis; <http://www.irs.gov/pub/irs-soi/10db29ps.xls>.

The U.S. tax code is so complex that even experts disagree on the correct tax liability. The “correct answer” to questions about the liability of any specific taxpayer is becoming difficult to calculate. In 2002, the IRS help centers provided wrong answers to taxpayers 29 percent of the time.<sup>6</sup> According to the 2010 TAS report, “Despite the fact that about 90 percent of taxpayers rely on preparers or tax software packages, the IRS received 110 million calls in each of the last two fiscal years. That is a staggering number, and not surprisingly, the IRS was unable to answer more than 25 percent of them.”<sup>7</sup>

And, it is not just the IRS that does not understand the tax code. Because of the tax code’s complexity, even hiring a tax professional does not guarantee that your tax returns will be filled out correctly. In the 1990s, when the tax code was less complex than it is today, *Money Magazine* conducted an annual survey of professional tax preparers. In the 1996 survey, the magazine asked 45 different professionals to prepare a tax return for the same hypothetical family. The financials for this hypothetical family were not simple—for instance, the husband received both self employment income and retirement income during the year—but not necessarily uncommon for many families. The details on the hypothetical family were:

*[Curt Baker, the husband, made]... \$30,831 in 1996. He also received a \$60,000 lump-sum payout from his 401(k) when he retired. Ann, a lawyer, switched from one corporate job to another in '96. Her income for the year: \$80,900. She also inherited \$30,500 from her uncle. The Bakers' investments include a mix of stocks, bonds and mutual funds that threw off \$21,298 in interest, dividends and capital gains. The couple, whose joint income put them in the 36% tax bracket, own their own home, which they refinanced in February 1996.<sup>8</sup>*

*Our tax system is complex because taxes are not levied simply to raise the necessary revenues for the government to operate—ostensibly the purpose of taxes.*

The 45 different professional tax preparers estimated 45 different tax liabilities that this hypothetical family would owe that ranged from \$36,000 to \$94,000. *USA Today* did a smaller survey in 2007 of only five professionals asking these professionals to calculate a hypothetical family's tax bill. Consistent with the *Money Magazine* survey of the 1990s, each of the five tax professionals provided different personal income tax liabilities for the exact same family. *USA Today's* commentary from their experiment says it all: "As the Tax Code turns ever more unwieldy, deciphering it has become more art than science..."<sup>9</sup>

#### The Root Cause of Complexity

Our tax system is in part so complex because taxes are not levied simply to raise revenues. Policymakers use tax policies to achieve other goals that are, ultimately, unrelated to revenue needs and which create significant complexity.

According to the Government Accountability Office (GAO), "the goal of tax policy is *not to eliminate compliance and efficiency costs*. The goal of tax policy is to design a tax system that produces the desired amount of revenue and balances the minimization of these costs with other objectives, such as equity, transparency, and administrability."<sup>10</sup> Gale and Holtzblatt put the problem as a basic conflict between simplicity and fairness: "Simplicity and common approaches to fairness in taxation often conflict."<sup>11</sup>

This desire to alter people's behavior and advance social agendas pervades the tax code. For instance, as of 2008 the tax code had at least 11 different education incentives and 16 different retirement incentives.<sup>12</sup> To advance social and equality causes, the tax code now contains the Alternative Minimum Tax (AMT), the Earned Income Tax Credit (EITC), numerous tax advantages for home ownership, as well as progressive tax rates. Each one of these provisions increases the complexity, and thus the compliance costs, associated with our tax code.

Complexity also arises because the tax code is an ever moving target—never stationary long enough to be understood. New amendments and changes to the tax code are made every year. The last time Congress passed major tax simplification was in 1986. In 2006, President Bush's Commissioner of Internal Revenue testified to Congress that "since the adoption of 1986 tax reform, Congress has passed 14,400 amendment to the tax code. That's an average of 2.9 changes for every single working day in the year for 19 years."<sup>13</sup> Even as recently as last year, President Obama's Commissioner of Internal Revenue said "There have been an astonishing 4,400 changes to the Code from 2000 to September [2010]."<sup>14</sup> On average, this means one change per day for 10 years.

These constant changes increase the overall complexity of the tax code. Also, federal tax laws sometimes conflict with state tax laws, other federal laws (securities law, labor law, GAAP Accounting Standards), or even foreign tax treaties. Nothing is ever easy when it comes to the tax code.

#### Consequences of Tax Code Complexity

As the analysis demonstrates below, tax complexity is diminishing the potential economic growth of the U.S., Tax complexity as often as not works against the very groups and societal goals it intends to assist.<sup>15</sup> Some criteria for judging the efficiency of a tax system were summarized by the 19th century American Economist Henry George:



*The best tax by which public revenues can be raised is evidently that which will closest conform to the following conditions:*

1. *That it bear as lightly as possible upon production—so as least to check the increase of the general fund from which taxes must be paid and the community maintained.*
2. *That it be easily and cheaply collected, and fall as directly as may be upon the ultimate payers—so as to take from the people as little as possible in addition to what it yields the government.*
3. *That it be certain—so as to give the least opportunity for tyranny or corruption on the part of officials, and the least temptation to lawbreaking and evasion on the part of the taxpayers.*
4. *That it bear equally—so as to give no citizen an advantage or put any at a disadvantage, as compared with others.<sup>16</sup>*

Complex tax systems violate all four of Henry George's principles. Complex tax systems impose large burdens on taxpayers in excess of their tax liability, thus violating the first two principles. Complex tax codes also create opportunities for individuals to hide their taxable income in ways that may or may not be legal. As Krause (2000) illustrates, tax "complexity undermines the IRS's ability to distinguish among intentional evasion, honest misinterpretation of the tax code, and legitimate tax avoidance."<sup>17</sup> Therefore, tax complexity violates principle three. Complex tax codes contain provisions that favor one constituency over another. For instance, our current tax system offers a tax break to homeowners but not to renters. As a consequence, a homeowner can pay less tax than a renter even if both individuals earn the exact same income and face the exact same expenses. Complex tax systems, therefore, violate principle four, which is also referred to as horizontal equity or the notion that the tax system should treat similar taxpayers in a similar manner.

The President's Advisory Panel on Federal Tax Reform found evidence that the complexity of the current U.S. tax code actually hurts low-income individuals as opposed to helping them.<sup>18</sup> For instance, low-income individuals must file tax returns in order to receive the Earned Income Tax Credit (EITC) payments, but, nearly three-fourths of the families claiming an EITC had to hire a tax preparer in order to receive their payments because the EITC is one of the most complex parts of the tax code.<sup>19</sup>

A 2001 study by the Joint Committee on Taxation identified four adverse consequences from tax complexity:

- Decreased levels of voluntary compliance,
- Increased cost for taxpayers,
- Reduced perception of fairness, and
- Increased difficulties in tax administration.<sup>20</sup>

Other organizations have also expressed concern. For instance, according to the American Institute of Certified Public Accountants (AICPA), "many tax professionals believe that significant simplification is needed to ensure the continued viability of our self-assessment approach."<sup>21</sup>

The AICPA illustrates how tax complexity undermines the principles of a sound tax system. Specifically, excessive tax complexity erodes the following principles:

*“Equity and fairness: Complexity contributes to public perceptions that the tax law is unfair.*

*Certainty: Complexity due to constant change and lags in administrative guidance heighten taxpayer uncertainty.*

*Economy of collection: Complexity increases the costs of tax administration, including the costs associated with collecting taxes, examining returns, and resolving disputes.*

*Neutrality: Complexity may cause similarly-situated taxpayers to pay different amounts of tax.*

*Economic growth and efficiency: Complexity diverts resources from productive activities and investments to excessive and nonproductive compliance costs.*

*Transparency and visibility: Complexity leaves taxpayers perplexed about how the tax law applies to them and others.*

*Minimum tax gap: Complexity increases the size of the tax gap by making taxpayers less willing and able to comply. The tax gap is the difference between taxes that are owed and taxes that are voluntarily paid.”<sup>22</sup>*

Both the actual tax burden and the costs associated with tax complexity diminish the after-tax returns to work, savings, and investment. Often, tax complexity and the size of the tax burden will go hand in hand. As a result, we can apply our understanding of the impact on the economy from the tax burden to create an estimate of the economic costs created by tax complexity. The negative economic consequences from excessive taxation arise because taxes create a wedge between what it costs to hire a worker (invest) and how much that worker receives (investment returns). A tax wedge occurs anytime there is a separation of effort and reward. It is intrinsically an economic variable that operates at the margin where incentives come into play and the decisions are made to, say, allocate capital between one project and another or work one more hour. Consequently, understanding the economic impact of the tax wedge provides the proper framework in which to assess the economic costs created by the complexity of our tax system.

## SECTION II: THE MACROECONOMIC THEORY OF TAX WEDGES

*The essential tenet of classical economic analysis is that people alter their behavior when economic incentives change.*

The adverse economic impact created by tax wedges begins with the basic tenets of classical economics. The essential tenet of classical economic analysis is that people alter their behavior when economic incentives change. If the incentives for doing an activity increase relative to the incentives for doing alternative activities, more of the now more attractive activity will be done. Likewise, if impediments are imposed upon an activity, less of the now diminished-incentive activity will be forthcoming. Basically, people have both time and resource constraints. With limited resources and time, the explicit attainment of objectives necessitates prudent management within the structure of constraints imposed by nature and man. Thus, government, with its full power of enforcement, has the ability to alter the constraints affecting economic factors. Changes in the structure of these governmentally imposed constraints alter the economy's behavior.

Firms base their decisions to employ workers or acquire capital assets, in part, on the total cost to the firm of employing workers or acquiring capital, always with an eye to enhancing the value of the firm. Holding all else equal, the greater the cost of employing each worker, the fewer workers the firm will employ. Conversely, the lower the cost per worker, the more workers the firm hires. Incorporated in the decision making process are all costs associated with each worker's employment, including payroll taxes and fringe benefits. For the firm, the decision to employ is based upon gross wages paid, a concept which encompasses all costs borne by the firm.

In a *Wall Street Journal* editorial, Michael Fleisher, President of Bogen Communications in Ramsey N.J., eloquently made these exact points when discussing the incentives for his firm to expand:

*When you add it all up, it costs \$74,000 to put \$44,000 in Sally's pocket and give her \$12,000 in benefits. Bottom line: Governments impose a 33% surtax on Sally's job each year...*

*As much as I might want to hire new salespeople, engineers and marketing staff in an effort to grow, I would be increasing my company's vulnerability to government decisions to raise taxes, to policies that make health insurance more expensive, and to the difficulties of this economic environment.*

*A life in business is filled with uncertainties, but I can be quite sure that every time I hire someone my obligations to the government go up. From where I sit, the government's message is unmistakable: Creating a new job carries a punishing price.<sup>23</sup>*

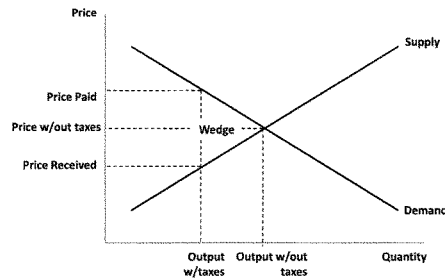
A similar set of criteria can be applied when contemplating whether or not to acquire capital. Again, from the perspective of the firm, the explicit objective is to create surplus value from each decision by choosing investments whose returns exceed the cost of capital. The tax wedge reduces return and thus reduces the number of attractive investment opportunities.

The worker and the saver, on the other hand, care little about the cost of either employing a new worker or acquiring new capital. The worker's primary concern is how much he receives for providing his work effort, net of all deductions and taxes. Conversely, the savers abstain from consuming in order to earn an after tax return on that savings. Within the classical framework, workers concentrate on net wages received, while savers are preoccupied with their yields after tax. The greater net wages received, the more willing the worker is to work; the higher the net yield on savings, the greater total savings will be. Conversely, if net wages received fall, workers will find work effort less attractive and they will do less of it. Savers will also save less if the net yield to savings declines.

The difference between what it costs a firm to employ a worker or acquire a unit of capital, and what that worker or saver receives net, is the tax wedge (**Figure 2**). From the standpoint of a single worker or a single unit of capital, an increase in the wedge has two effects. An increase in the wedge raises the cost to the employer in the form of higher wages paid for workers or higher costs paid for capital. Clearly, firms will employ fewer workers and acquire less capital. On the supply side, an increase in the wedge reduces net wages received and the net yields savers receive. Again, less work and savings will be supplied.

*Firms base their decisions to employ workers or acquire capital assets, in part, on the total cost to the firm of employing workers or acquiring capital, always with an eye to enhancing the value of the firm.*

Figure 2  
The Tax Wedge



In sum, an increase in the wedge reduces the demand for, and the supply of, productive factors. An increase in the wedge, therefore, is associated with less employment, less investment and lower output. In dynamic formulations, as the wedge grows, output growth falls, and *vice versa*. Within the context of classical economics, regulations, and restrictions, along with explicit taxes, are all parts of the wedge. This is the theoretical foundation to our empirical assessment of the costs imposed on the U.S. economy from excessive tax complexity.

The government finances itself in different ways leading to various estimates of the tax wedge created by our current tax system. On the most general level, the U.S. federal government can finance its spending by imposing a tax on people working today. Alternatively, if the federal government is running a budget deficit then only a portion of the spending is financed by taxes on people working today. The remainder of this spending is financed by shifting resources from the future into the present. This deficit spending is empowering current workers to levy a tax on future workers—some of which will still be current workers (i.e., the younger current workers) while others will not (i.e., the older current workers).

As a consequence, the broadest measure of the total tax burden being created by the government is the government tax and expenditure wedge.\* This wedge measures the total value of the current government taxes on current and future workers (total current federal, state and local government spending) relative to the private sector's current ability to finance that spending. The private sector's ability to finance that spending is the value of the production of all private businesses—an approximation of the private business contribution to GDP.

\*The government tax and expenditure wedge is defined as the cost of government relative to the size of the private sector economy. The size of the private sector economy is based on the production of all businesses in the domestic economy—or net domestic business income adjusted for inflation. The cost of government is defined as total federal, state and local government expenditures. The government tax and expenditure wedge is calculated by dividing total government expenditures by net domestic business output.

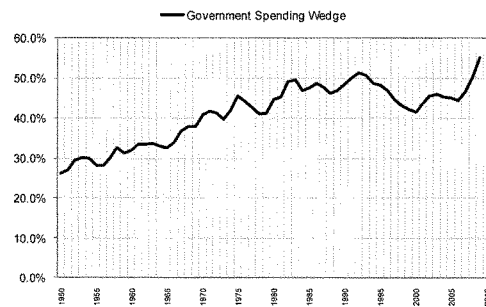
This measure of the tax wedge is a measure of the average tax burden. While an accurate measure of the marginal tax burden is ideal, in practice accurately measuring the marginal tax burden is difficult. However, when the total costs of the tax system are above the cost minimizing level, as they are in our current tax system, the marginal costs of the system will be higher than average costs—the further above the cost minimizing level, the greater marginal costs will be over average costs. As a consequence, our calculations based on the average cost burden will likely understate the estimated economic impacts based on the marginal costs.

As of 2009, total government expenditures were \$5.0 trillion.<sup>24</sup> The value of the production of all businesses (corporate and non-corporate income adjusted for depreciation) for 2009 was \$9.0 trillion.<sup>25</sup> Dividing the value of the production of all businesses in 2009 (\$9.0 trillion) by the total government expenditures (\$5.0 trillion) results in the government tax and expenditure wedge for 2009 of 55.2 percent (numbers do not add due to rounding).

**Figure 3** tracks the growth in this government tax and expenditure wedge between 1950 and 2009 (the latest full data set available). Figure 3 also labels the sub-periods where changes in the path of the government tax and expenditure wedge are evident. Total government expenditures were relatively flat to slightly growing between 1950 and 1961.

Between 1961 and 1965 (the Kennedy era) the slight growth in expenditures that had been occurring since 1950 was arrested for five years. Beginning in 1966, there is a dramatic change in the rate of expenditure growth that continued until 1983. The growth in government expenditures then slowed until 1989. A renewed, but short-lived, pick-up in government expenditures occurred between 1989 and 1993. The trend toward lower government expenditures then resumed until 2001, following which there has been a renewed increase in total government expenditures.

**Figure 3**  
Total Federal, State and Local Government Tax and Expenditure Wedge as a Percent of Business Output (1950-2009)



Source: Laffer Associates calculations based on Bureau of Economic Analysis data.

**Table 1** summarizes the primary negative impact that a high and growing government tax and expenditure wedge has on private sector activity, as well as the positive impact of a lower and declining tax and expenditure wedge. Of course, missing from these data are the indirect costs born by the private sector that have never been collected via taxes past, present, or future. Table 1 combines the 1950-1965 and 1983-2000 eras in order to create three relatively similar time periods in which to judge the relationship between the government tax and expenditure wedge and economic growth. We break out the noteworthy sub-periods as sub-bullets.

- During the first period (1950-1965) the government tax and expenditure wedge is relatively low (32.5% in 1965) and growing slowly (rose 5.5 percentage points during the entire period). Total business output (adjusted for inflation) grew, on average, 3.5 percent per year during this period.
  - During the 1961 to 1965 period the relatively low government tax and expenditure wedge fell 0.9 percentage points and total business output adjusted for inflation grew, on average, 5.8 percent per year during this period.
- In the second period (1966-1982), the government tax and expenditure wedge grew robustly by 16.5 percentage points to 49.0 percent by 1982. Total business output (adjusted for inflation) grew a much slower 2.2 percent per year.
- In the third period (1983-2000) the government tax and expenditure wedge fell by 7.4 percentage points ending at a low of 41.5 percent in 2000. Total business output (adjusted for inflation) grew a robust 3.9 percent per year during this period.
  - Following the full implementation of the Reagan tax cuts in 1983 the tax and expenditure wedge fell 3.3 percentage points and total business output adjusted for inflation grew, on average, 5.0 percent per year during this period.

**Table 1**  
**Negative Relationship between Tax and Expenditure Wedge and**  
**Private Sector Growth (1950-2000)**

|           | % Change Net Inflation<br>adjusted Business<br>Output (CAGR) | Government Tax and<br>expenditure wedge at<br>end of period | Change Wedge<br>(peak to trough,<br>trough to peak) |
|-----------|--|---|---|
| 1950-1965 | 3.4%   | 32.5%   | 6.4%  |
| 1961-1965 | 5.8%   | 32.5%   | -0.9%   |
| 1966-1982 | 2.4%   | 49.0%   | 16.5%   |
| 1983-2000 | 3.9%   | 41.5%   | -7.4%   |
| 1983-1988 | 5.0%   | 46.2%   | -3.3%   |

*Source: Laffer Associates calculations based on Bureau of Economic Analysis data.*

Since 2000, the government tax and expenditure wedge has once again been on the rise. As expected, average real business output growth has been only 1.9 percent per year. One can conclude that during periods of a growing government tax and expenditure wedge the growth in the private sector is below average. During the periods when the government tax and expenditure wedge was either low or declining, growth in the private sector is above average. Below we provide a more rigorous analysis that provides further support for this relationship.

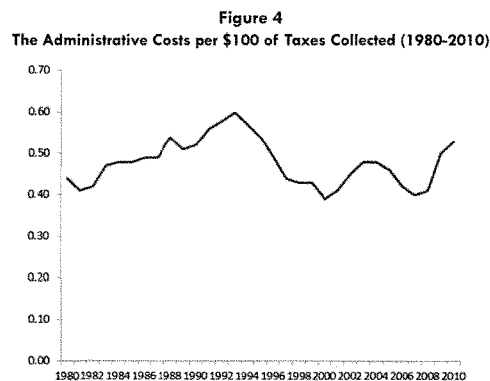
### SECTION III: ESTIMATING THE TOTAL COMPLEXITY COSTS CREATED BY THE U.S. TAX SYSTEM

The total government tax and expenditure wedge is an accurate proxy for the total current and future tax burden on the private sector. But, these figures do not address the additional negative impact created by the tax code's complexity.

The first step to estimating the complexity tax wedge is a definition of the dollar payments (including the monetary value of time). Remember that this wedge only estimates the impact from the federal income tax system and as such is a lower-end estimate of the total complexity burden. The total tax burden can be broken down into four categories: actual tax payments, government administration costs, compliance costs and efficiency costs.

The most straightforward portion of the total tax burden is the actual tax payments made by taxpayers. In the wedge model of Section II we use total government spending as the measure of all current and future tax liabilities created by government actions.\*

Also straightforward are the administration costs of the income tax system—the cost to physically administer the IRS. Figure 1 illustrated that these costs have been steadily growing since 1980 and were \$12.4 billion in 2010. Of course, total tax revenues collected by the IRS have also been growing. As a result the administrative costs relative to total tax collections have been fairly constant. Between 1980 and 2009 total administrative costs have been around \$0.48 per \$100 collected; and a lower \$0.45 per \$100 collected between 2000 and 2010, see **Figure 4**. The collection costs relative to tax collections in 2009 and 2010 rose significantly due to the large drop in total tax collections caused by the national recession.



Source: IRS Chief Financial Officer, *Corporate Performance Budgeting, Corporate Policy and Labor Analysis*.

The last two components of the tax burden are the compliance costs—the cost a taxpayer incurs in order to pay his or her taxes—and the efficiency costs—the lost economic opportunities resulting from the complexity of the tax code. These components directly measure the economic costs created by the overly-complex tax system.

\*These costs do not include an important future tax cost looming on the financial horizon. The U.S. government has promised to make payments to individuals in the future without having either the current resources or future taxes in place to pay for these promises (unfunded liabilities). Unfunded liabilities include things like Social Security, Medicare, retirement benefits for federal employees, as well as the explicit backing given to the Pension Benefit Guaranty Corporation and Fannie Mae/Freddie Mac. While some of these obligations, such as the cost to backing Fannie Mae or the ultimate costs from ObamaCare, are not known, the known unfunded liabilities already total over \$65 trillion—every household in the U.S. today owes \$557,745 due to the current federal unfunded liabilities. And, this does not even include the unfunded liabilities of state and local governments.

Many studies have directly measured the compliance costs associated with our complex tax system. Compliance costs measure the time spent conforming to the tax system and the actual dollars spent complying with the tax system, which include the cost of hiring tax preparers and the purchase of computer software. As we mentioned earlier, the efficiency costs that occur due to taxpayers changing their behavior in response to tax complexity are not included in this analysis, but may actually be the largest economic impact of all.

With respect to the actual dollars spent complying with the tax code, the National Taxpayers Union estimates that total out of pocket costs are approximately \$31.5 billion annually as of April 15, 2010.<sup>26</sup> These costs include the 60 percent of individuals who pay a professional tax preparer to assist in filing their taxes compared to 38 percent of individuals who paid a professional in 1980.<sup>27</sup> An additional 29 percent buy tax software to help them complete their taxes.<sup>28</sup> A vast majority of Americans now must spend money in order to file their income taxes as a direct result of the large and growing complexity of the income tax code.

With respect to the time spent complying with the tax code, the IRS Taxpayer Advocate calculated in 2010 that individuals and businesses spent 6.1 billion hours a year complying with the filing requirements of the U.S. income tax code as of 2008.<sup>29</sup> The IRS Taxpayer advocate “arrived at this estimate by multiplying the number of copies of each form filed in tax year 2008 by the average amount of time the IRS estimated it took to complete the form.”<sup>30</sup> And, “that figure does not even include the millions of additional hours that taxpayers must spend when they are required to respond to an IRS notice or an audit ... If tax compliance were an industry, it would be one of the largest in the United States. To consume 6.1 billion hours, the ‘tax industry’ requires the equivalent of more than 3.0 million full-time workers.”<sup>31</sup>

David Keating of the National Taxpayers Union provides a perspective on the hours we dedicate to complying with the U.S. income tax code. As of 2009, the income tax industry employs “... more workers than are employed at the five biggest employers among Fortune 500 companies—more than all the workers at Wal-Mart Stores, United Parcel Service, McDonald’s, International Business Machines, and Citigroup combined.”<sup>32</sup>

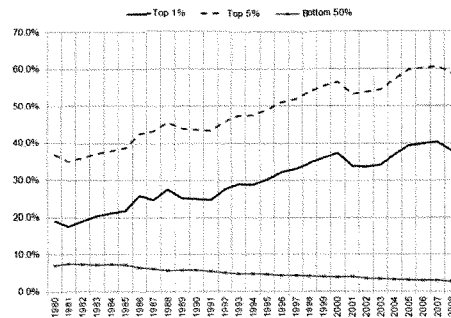
As we all know, time is money. Estimates of the dollar value on all these hours vary by researcher depending upon the estimated hourly rate that is used. Based on the average hourly cost of a civilian employee, the IRS Taxpayer Advocate Service “... estimates that the costs of complying with the individual and corporate income tax requirements in 2008 amounted to \$163 billion—or a staggering 11 percent of aggregate income tax receipts.”<sup>33</sup>

While the IRS estimated compliance costs are excessively high already, higher income individuals pay the majority of federal income taxes; see Figure 5, thus skewing the tax complexity burden considerably. The IRS estimates do not adequately account for the payment biases and, consequently, underestimates the value of the compliance costs.

**Figure 5** illustrates that in 2008 the top 1 percent of income earners paid 38.0 percent of all federal taxes and the top 5 percent paid nearly 58.7 percent. The share of income taxes paid by these groups has been growing over time despite the fact that the top marginal tax rate—the rate these individuals pay—has changed over this period.<sup>34</sup> For instance, in 1980, the top tax rate was 70 percent. Today, the top rate is 35 percent. Compare the share of income taxes paid by the top 1 percent and 5 percent of income earners to the income taxes paid by the entire bottom half of income earners. As of 2008, the bottom 50 percent of income earners paid less than 3 percent of total income taxes.



**Figure 5**  
**Share of Federal Income Tax Paid by Income Earning Percentile (1980-2008)**



Source: The Tax Foundation. According to the Tax Foundation because the definition of AGI changed following the 1986 tax reform the data before and after 1986 may not be strictly comparable.  
<http://www.taxfoundation.org/news/show/250.html>

Not only do the top income earners pay the majority of federal income taxes, their share of the income tax burden is disproportionate to their share of income. In 2008 the top 1 percent of taxpayers earned 20 percent of total AGI but paid 38 percent of total federal income taxes. The top 5 percent of taxpayers earned 34.7 percent of total Adjusted Gross Income (AGI) but paid 58.7 percent of total federal income taxes. The bottom 50 percent of income earners, on the other hand, earned 12.8 percent of total AGI but paid only 2.7 percent of total federal income taxes.

The data also illustrate that higher income taxpayers spend more time and resources complying with the tax code, and face greater tax complexities. Consequently, the value of the hours spent complying with the tax code should account for the skewed nature of the tax complexity burden, which the IRS estimate presented above does not adequately consider. As we demonstrate below, a more realistic valuation of time value creates a larger estimated compliance burden—*around twice as much*. Additionally, the estimated burdens above do not include the time and costs created by IRS audits, which we estimate separately. Below, we estimate the hourly value of time spent complying with the tax code for both individuals and businesses. Total compliance costs can be estimated by including the direct dollar costs of complying with the tax code, along with a proxy we estimate for the additional costs of audits.

#### Individual Income Tax Compliance Costs

To calculate a weighted average hourly cost for tax compliance we relied on two major data sources. First, we used data from the IRS Table 1.1—Selected Income and Tax Items, by Size and Accumulated Size of Adjusted Gross Income, Tax Year 2008.<sup>35</sup> These data, detailed in Table A-1 in the Appendix, summarize total tax returns filed by Adjusted Gross Income (AGI). The second major source was based on Guyton et.al (2003) and provides estimates for total hours spent on tax compliance sorted by AGI.<sup>36</sup> Table A-2 in the Appendix is reproduced from Guyton et.al.

Combining the hours per return in Table A-2 with the number of returns in Table A-1, we calculated the total number of hours spent complying with the tax code by AGI.<sup>37</sup> These values are summarized in Table A-3. Using the mid-point for each AGI category as the dollar value of AGI in each category (\$50 million was used as a proxy for the top category) the total weighted dollar value of compliance costs can be calculated by multiplying each categories number of hours by the average wage. The results of this calculation are presented in Table 2.

**Table 2**  
**Weighted Average Dollar Value of Time Spent**  
**Complying with the Tax Code**

|                                | Dollar Value of Hours<br>Spent in Compliance |
|--------------------------------|--|
| Weighted Average Hourly Income | \$68.42                                      |
| Weighted Average Annual Income | \$136,839.71                                 |

One additional adjustment to the above calculation has been made. AGI is less than total market wages. The Bureau of Economic Analysis tracks total personal income minus government transfer payments, which is a proxy for total earned income of residents in the U.S. In 2004, the latest data available, total personal income minus government transfer payments was 23 percent higher than total AGI.<sup>38</sup> The \$68.42 hourly value (\$137 thousand annual value) of time uses this 23 percent scalar applied to AGI.

The weighted average income calculated in Table 2 is significantly higher than the median income figure that the IRS estimate cited above relies upon. However, as we illustrated above, the bottom half of income filers only paid less than 3 percent of the tax revenues. The median income of the U.S. is, consequently, not representative of the average income of the average taxpayer. Based on this higher value of income, these results indicate that the 3.16 billion hours spent complying with the individual tax code have a value of \$216.2 billion.

#### **Business Income Tax Compliance Costs**

The IRS has estimated that the total time spent complying with the U.S. tax code is estimated to be 6.1 billion hours. Because individuals spend 3.16 billion hours complying with the individual income tax code, the balance—2.94 billion hours—is spent by businesses complying with the tax code. These hours are valued at \$55 per hour, based on a weighted average salary for a tax accountant, with bonuses and benefits, of \$102,184.50.<sup>39</sup> Including the employer portion of Social Security and Medicare taxes, the total annual costs per tax accountant is a bit more than \$110 thousand a year, or \$55 per hour. Based on a rate of \$55 per hour and a total of 2.94 billion hours, a total of \$161.7 billion is spent by businesses complying with the tax code.

#### **Total Income Tax Compliance Costs**

Adding together these estimates, the value of the time that individuals and business spend complying with the tax code, not including any direct expenditure, is a total of \$377.9 billion. This equates to a blended hourly rate of \$61.95. Including the estimated direct outlays of \$31.5 billion and the administrative costs of the IRS of \$12.4 billion, the total annual costs that U.S. taxpayers must endure to pay their Federal income taxes are \$421.8 billion – again this estimate only includes the federal income tax compliance costs.

But, what about audit costs? Tax audits vary in complexity ranging from a letter asking for further explanation about certain items on a tax return to the Taxpayer Compliance Measurement Program (TCMP), which is the IRS's most comprehensive tax audit. According to the IRS Data book, 1 percent of taxable tax returns were examined in 2008.<sup>40</sup> Also, the chances of an audit for higher income taxpayers are higher than the chances of an audit for lower income taxpayers.<sup>41</sup>

Table A-4 in the Appendix presents the examination coverage rates from the 2010 IRS Data Book.<sup>42</sup> Based on these data and the total number of returns filed by AGI we can estimate the total number of audits by AGI class. Relying on the same hourly estimate per return—assuming an audit requires a doubling of the filing effort of the taxpayer—taxpayer audits in 2010 added an additional taxpayer burden of \$9.3 billion.

Pulling these numbers together, to simply pay their income taxes and deal with IRS audits, we estimate that the costs U.S. taxpayers must bear just to comply with the provisions of our income tax code is \$431.1 billion.

In addition to these costs, the aforementioned \$345 billion tax gap is a manifestation of the problems created by our overly-complex tax system. These problems are not reflected in our estimates. Additionally, as noted above, the \$345 billion does not include potential tax revenues from the underground economy that avoids the federal tax system. Estimating the size of the underground economy is difficult by definition (these people don't want you to know what they are doing). According to *The Wall Street Journal* (2009), "a range of reports estimate the underground economy's size at \$1 trillion or higher."<sup>43</sup> This \$1 trillion represents a substantial amount of potential revenues. During the entire post-WWII period, total federal tax revenues have been around 19 percent to 20 percent of GDP even though the highest tax rates and the number of income tax brackets have fluctuated dramatically. W. Kurt Hauser and David Ranson (Hauser, 1993 and Ranson, 2010) go so far as to argue that this level of taxation in the U.S. (19.5% of GDP) will hold regardless of the tax rates or other tax changes—what they term Hauser's law. In 2009 total federal tax revenues were 15.6 percent of GDP, significantly below this historic rate. Using this historically low average tax collection number, if the underground economy were taxed, then the federal government would gain at least an additional \$156.1 billion in tax revenues.

*Pulling these numbers together, to simply pay their income taxes and deal with IRS audits, we estimate that the costs U.S. taxpayers must bear just to comply with the provisions of our income tax code is \$431.1 billion.*

#### SECTION IV: APPLYING THE TAX WEDGE LESSONS TO TAX COMPLEXITY

While some level of compliance costs are a necessary evil, the evidence presented above describes an income tax system that is excessively complex. To estimate the potential gain from simplifying our current income tax system, we relate the complexity tax burden (the government tax and expenditure wedge) to its impact on the growth of Gross Domestic Product (GDP) adjusted for inflation. The government tax and expenditure wedge discussed in Section II should have a negative impact on GDP growth (i.e., when the tax and expenditure wedge grows, economic growth should weaken).

One common predictor of economic growth is the slope of the yield curve.<sup>44</sup> As the yield curve becomes flatter (short-term interest rates approach long-term rates), the market is predicting slower economic growth in the future, and vice versa when it steepens. The steepness of the yield curve can be measured by subtracting the annual federal funds rate from the annual rate on a 10-year treasury bond. This variable predicts the rate of economic growth in the following year. A large positive value (steep yield curve) in the current year should be followed by strong GDP growth in the next year.

A negative relationship between economic downturns and the relative size of government spending is also expected. The government expenditure wedge should increase during economic downturns due to decreased private sector growth and constant (or even increased) government spending. Because of this relationship, the government expenditure wedge should be expected to increase during economic downturns (a negative relationship). We control for this expected negative relationship by incorporating a recession variable (what is called a dummy variable) into the analysis.

Table 3 displays a simple model relating the slope of the yield curve, the recession variable, and the government tax and expenditure wedge to economic growth. The results confirm our expectations.

**Table 3**  
**Least Squares Regression Results**  
**Dependent Variable: Percent Change in Real Gross Domestic Product**

|                    | Coefficients | Standard Error | t Stat    | P-value  |
|--------------------|--------------|----------------|-----------|----------|
| Tax and exp. wedge | -0.211812    | 0.047482       | -4.460935 | 1.00E-04 |
| Slope (-1)         | 0.613324     | 0.186001       | 3.297422  | 2.10E-03 |
| Recession          | -0.013701    | 0.006234       | -2.197633 | 0.0338   |
| Intercept          | 0.124807     | 0.020286       | 6.152434  | 0.0000   |
| AR(1)              | 0.081204     | 0.156234       | 0.519761  | 0.6061   |
| Adj. R-Square      | 0.629429     |                |           |          |
| F-Statistic        | 1.97E+01     |                |           |          |
| Durbin-Watson      | 2.010316     |                |           |          |

The first row in Table 3 provides the statistical relationship between the tax and expenditure wedge and GDP growth. The second column (the Coefficient) is negative; indicating that a higher tax and expenditure wedge reduces GDP growth or alternatively that a lower tax and expenditure wedge encourages GDP growth.<sup>45</sup> This is consistent with what we expected a priori. The next three columns indicate that the negative relationship between the tax and expenditure wedge and GDP growth is statistically significant.

The second row in Table 3 provides the same information with respect to the steepness of the yield curve in the prior year (Slope (-1)). In this case, the second column (the Coefficient) is positive; indicating that when the yield curve is steep, GDP growth is strong and when the yield curve is flat or inverted (when short-term rates are higher than long-term rates), GDP growth is slow or declining. This is also consistent with what we expected a priori. The next three columns indicate that the positive relationship between the slope of the yield curve in the prior year and GDP growth is statistically significant.

The third row in Table 3 provides the same information for the recession variable. When the economy is in a recession real GDP growth is lower, which conforms to the common definition of a recession. The next three columns illustrate that this relationship is statistically significant. Notably, when the impact of a recession is taken into account, the tax and expenditure wedge still has a statistically significant negative relationship to changes in real GDP growth.

The next two rows in Table 3 provide basic data on a constant and techniques used to correct for autocorrelation in the data (which if not corrected reduces the accuracy of the results). Finally, the last 3 rows have information about the overall equation. These values illustrate that the estimated equation has the power to explain the observed changes in GDP, resolving the aforementioned problem.

Using the coefficient from Table 3 and the current government expenditure level, every \$100 billion reduction in the compliance costs tax burden will increase economic growth (GDP growth adjusted for inflation) between 0.21 percent and 0.24 percent annually or between \$30 billion and \$34 billion. Many other studies have confirmed this negative relationship between government spending and economic growth including: Barro (1991), Gwartney, Lawson, and Holcombe (1998), Laffer (1971), Laffer (1979), Landau (1983), Mitchell (2005), and Scully (2006).

Halving our current estimated compliance costs of \$431.1 billion would increase total annual economic growth between 0.45 percent and 0.52 percent. A 90 percent drop in compliance costs, equal to a \$388 billion reduction in tax complexity,<sup>46</sup> would increase GDP growth between 0.8 percent and 0.9 percent.

Between 1950 and 2009, the compound annual growth rate in real GDP was 3.2 percent. If the tax complexity burden were cut in half, the historical average annual growth rate of 3.2 percent would increase to between 3.65 percent and 3.72 percent. Over 10 years, the U.S. economy would become approximately \$870 billion to \$1.0 trillion larger, see **Figure 6**. The U.S. would be approximately \$2,800 to \$3,300 wealthier per person in the 10th year following a major tax simplification.

Increased economic growth would immediately follow a major tax simplification and would continue each and every year. The discounted present value of the increased cumulative economic growth over the first 10 years following a major tax simplification is around \$3.2 trillion to \$3.7 trillion; this equates to an increase of approximately \$10,600 to \$12,100 per person.

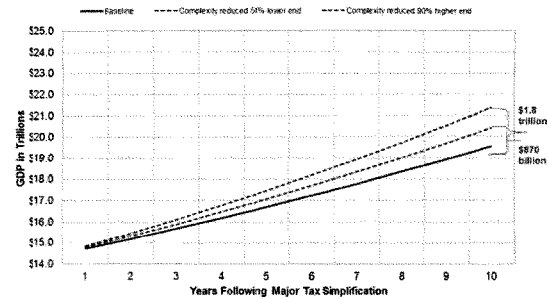
If the tax complexity burden were reduced by 90 percent, the historical average annual growth rate of 3.2 percent would increase to between 4.02 percent and 4.13 percent. Over 10 years, the U.S. economy would become approximately \$1.6 trillion to \$1.8 trillion larger, see **Figure 6** (next page). The U.S. would be approximately \$5,200 to \$6,000 wealthier per person in the 10th year following a major tax simplification.

The discounted present value of the cumulative increase in economic growth over the first 10 years following a 90 percent reduction in tax complexity is around \$5.9 trillion to \$6.8 trillion, equal to an increase in wealth of approximately \$19,200 to \$22,000 per person.

Of course, higher economic growth benefits tax revenues as well. Due to the enhanced economic growth, the discounted present value of the increased tax revenues at current rates over the entire 10-year period is between \$650 billion and \$740 billion for a 50 percent reduction in tax complexity and between \$1.2 trillion and \$1.4 trillion for a 90 percent reduction in tax complexity. For perspective, the estimated FY2010 national debt is \$10.9 trillion.

*If the tax complexity burden was reduced by 90 percent, the historical average annual growth rate of 3.2 percent would increase to between 4.02 percent and 4.13 percent. The U.S. would be approximately \$5,200 to \$6,000 wealthier per person in the 10th year following a major tax simplification.*

**Figure 6**  
**Yearly Increase in Economic Growth Due to Reduced Tax Complexity**



Relating these figures to the \$780 billion stimulus program the Obama Administration and Congress passed in February 2009, a total of \$623 billion in grants, loans, entitlements and tax rebates had been spent through February 18, 2011.<sup>47</sup> Research by Christina Romer (Chair, President Obama's Council of Economic Advisors) and Jared Bernstein (Vice President Joe Biden's Chief Economist) estimated that for every \$1 of the stimulus package, \$1.60 in economic activity will be created.<sup>48</sup> Based on this arithmetic, the Obama Administration was hoping that the stimulus money already spent should have boosted GDP by over \$997 billion over two years.

Disregarding the debate about whether the stimulus is actually having a positive impact on GDP, a 50 percent reduction in tax complexity reduces costs on taxpayers by \$216 billion. Reducing tax complexity can have an impact on the economy that is similar to the desired stimulus package and *this stimulus package would occur on an annual basis without reducing any government revenues and without requiring any new government spending program*. Consequently, efforts at curtailing tax complexity have the potential to significantly impact total economic activity in the U.S.

#### HOW TO REDUCE THE COMPLEXITY BURDEN

Much of the complexity of the current tax code centers on the definition of income. Consequently, the significant reductions in complexity discussed above could not likely be achieved without comprehensive tax reform, like a flat tax or a national sales tax. A properly designed flat income tax or a national sales tax would simplify the definition of income and curtail complexity.

For a flat tax there should be only one tax rate for all taxpayers, and it should apply to the first dollar of income earned. Income thresholds, while well intentioned, introduce a significant amount of complexity into a flat tax system. Also, a flat income tax should minimize all exclusions and deductions and have a simple definition of income. An appropriately structured flat tax creates significant pro-growth incentives for the economy while eliminating unnecessary complexity.

Similar to the flat income tax, the national sales tax should be designed so that there is only one true flat tax rate. The definitions of income and exemptions are automatically eliminated under a national sales tax because income is no longer taxed, consumption is. Therefore, all of the complexities regarding income and expense definitions disappear. A national sales tax also reduces complexity by limiting the number of residents that actually need to physically interact with the tax collectors—only final providers of newly produced goods and services.

#### CONCLUDING THOUGHTS

While some compliance time is necessary under any tax system, reducing the annual compliance costs of our tax system provides an effective stimulus to our economy that recurs each and every year without the need for federal government spending. The benefits from such a boost would be greater income and job growth for all Americans.

The potential benefits to reducing tax complexity go beyond the dollar impact as well. As the AICPA has noted, the U.S. income tax system relies on taxpayers to self-report their income—the system only works if most taxpayers view the outcomes as fair and accurately self-report their income. As such, excessive tax complexity is undermining the very foundations of our current tax code. Ultimately, what we do about complexity is a political and social issue. This study is intended only to calculate the direct and measurable costs of complexity; it does not, for instance, guess at the economic benefit which would flow from improved allocation of capital undistorted by tax considerations.

The bottom line of tax complexity is as simple as our current tax code is complex: simplifying the tax code should be a top priority. Regardless of the reform approach taken, the U.S. economy will be enhanced greatly by significantly reducing the complexity of the current tax code. In a time of global economic competition the U.S. cannot afford the luxury of a Byzantine tax system. **LC**

## APPENDIX

| Table A-1<br>Number of 2008 Returns by AGI (in millions) |                   |
|--|-------------------|
| Size of Adjusted Gross Income                            | Number of Returns |
| <b>Total</b>   | <b>142.4</b>      |
| No adjusted gross income                                 | 2.4               |
| \$1 under \$5,000  | 11.5              |
| \$5,000 under \$10,000                                   | 12.9              |
| \$10,000 under \$15,000                                  | 11.0              |
| \$15,000 under \$20,000                                  | 12.1              |
| \$20,000 under \$25,000                                  | 8.9               |
| \$25,000 under \$30,000                                  | 8.7               |
| \$30,000 under \$40,000                                  | 14.5              |
| \$40,000 under \$50,000                                  | 11.1              |
| \$50,000 under \$75,000                                  | 19.2              |
| \$75,000 under \$100,000                                 | 11.8              |
| \$100,000 under \$200,000                                | 13.9              |
| \$200,000 under \$500,000                                | 3.5               |
| \$500,000 under \$1,000,000                              | 0.6               |
| \$1,000,000 under \$1,500,000                            | 0.1               |
| \$1,500,000 under \$2,000,000                            | 0.06              |
| \$2,000,000 under \$5,000,000                            | 0.09              |
| \$5,000,000 under \$10,000,000                           | 0.02              |
| \$10,000,000 or more                                     | 0.01              |

Source: <http://www.irs.gov/taxstats/index.html>

| Table A-2<br>Compliance Burden by Taxpayer Characteristics |   |
|--|---|
|  | Hours per Return by Adjusted Gross Income |
| Negative AGI   | 35.6                                      |
| \$0 < \$15,000   | 14.4                                      |
| \$15,000 < \$30,000  | 17.3                                      |
| \$30,000 < \$45,000  | 22.1                                      |
| \$45,000 < \$60,000  | 28.0                                      |
| \$60,000 < \$90,000  | 38.1                                      |
| \$90,000 < \$120,000                                       | 48.4                                      |
| \$120,000 or more  | 70.8                                      |

Source: Guyton, John L., O'Hare John F., Stavrianos Michael P., Toder, Eric J. (2003) "Estimating the Compliance Cost of the U.S. Individual Income Tax" Presented at the 2003 National Tax Association Spring Symposium.

| Table A-3<br>Total Number of Compliance Hours by AGI |                                     |
|--|-------------------------------------|
| Size of Adjusted Gross Income                        | Number of Hours Spent in Compliance |
| <b>Total</b>   | <b>3,160,368,690.1</b>              |
| No adjusted gross income                             | 27,338,974.9                        |
| \$1 under \$5,000                                    | 133,081,067.4                       |
| \$5,000 under \$10,000                               | 148,693,898.3                       |
| \$10,000 under \$15,000                              | 127,524,564.2                       |
| \$15,000 under \$20,000                              | 167,411,729.8                       |
| \$20,000 under \$25,000                              | 123,817,495.0                       |
| \$25,000 under \$30,000                              | 121,316,357.7                       |
| \$30,000 under \$40,000                              | 257,811,495.4                       |
| \$40,000 under \$50,000                              | 222,457,138.1                       |
| \$50,000 under \$75,000                              | 510,497,681.9                       |
| \$75,000 under \$100,000                             | 409,580,987.9                       |
| \$100,000 under \$200,000                            | 662,597,619.5                       |
| \$200,000 under \$500,000                            | 197,581,576.8                       |
| \$500,000 under \$1,000,000                          | 32,671,551.5                        |
| \$1,000,000 under \$1,500,000                        | 7,775,715.3                         |
| \$1,500,000 under \$2,000,000                        | 3,355,821.3                         |
| \$2,000,000 under \$5,000,000                        | 4,870,640.4                         |
| \$5,000,000 under \$10,000,000                       | 1,211,991.7                         |
| \$10,000,000 or more                                 | 772,383.3                           |

| Table A-4<br>IRS 2010 Examination Coverage by AGI |                       |
|---|-----------------------|
|   | Examination Coverage* |
| No adjusted gross income                          | 3.19                  |
| \$1 under \$25,000                                | 1.18                  |
| \$25,000 under \$50,000                           | 0.73                  |
| \$50,000 under \$75,000                           | 0.78                  |
| \$75,000 under \$100,000                          | 0.64                  |
| \$100,000 under \$200,000                         | 0.71                  |
| \$200,000 under \$500,000                         | 1.92                  |
| \$500,000 under \$1,000,000                       | 3.37                  |
| \$1,000,000 under \$5,000,000                     | 6.67                  |
| \$5,000,000 under \$10,000,000                    | 11.55                 |
| \$10,000,000 or more                              | 18.38                 |

Examination Coverage is defined by the IRS as the number of returns examined for each AGI class as a percentage of the total number of returns filed.

Source: IRS Data Book, <http://www.irs.gov/pub/irs-soi/10db09bex.xls>



- <sup>1</sup> "2008 Annual Report to Congress" *National Taxpayer Advocate*, Volume 1 (31 Dec. 2008).
- <sup>2</sup> "2009 Annual Report to Congress" *National Taxpayer Advocate*, Volume 1 (31 Dec. 2009).
- <sup>3</sup> "2010 Annual Report to Congress" *National Taxpayer Advocate*, Volume 1, "Most Serious Problems, #1" (2010).
- <sup>4</sup> IRS Chief Financial Officer, Corporate Performance Budgeting, Corporate Policy and Labor Analysis.
- <sup>5</sup> "Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap" GAO (2007). Statement of Michael Brostek Director, Tax Issues Strategic Issues Team, GAO-07-391T. The tax gap estimate does not include any estimate for taxes due from illegal sources of income.
- <sup>6</sup> "Management Advisory Report: Taxpayers Continue to Receive Incorrect Answers to Some Tax Law Questions" Treasury Inspector General for Tax Administration (Apr. 2002) 2002-40-086.
- <sup>7</sup> "2010 Annual Report to Congress" *National Taxpayer Advocate*, Volume 1, "Most Serious Problems, #1" (2010).
- <sup>8</sup> Trith, Teresa, "Why Your Tax Return Could Cost You A Bundle: We Asked 45 Tax Preparers to Fill Out One Hypothetical Family's Tax Return -- And We Got 45 Different Answers. Here's What You Can Learn from the Pro's Many Mistakes" CNN Money.com (1 Mar. 1997) [http://money.cnn.com/magazines/moneymag/moneymag\\_archive/1997/03/01/222962/index.htm](http://money.cnn.com/magazines/moneymag/moneymag_archive/1997/03/01/222962/index.htm).
- <sup>9</sup> Block, Sandra, "A taxing challenge: Even experts can't agree when preparing a sample tax return" *USA Today* (26 Mar. 2007) <http://www.usatoday.com/story/money/personal/2007-03-25-tax-preparers-hypothetical/1.111111>.
- <sup>10</sup> "Tax Policy: Summary of Estimates of the Costs of the Federal Tax System" GAO (Aug. 2005) GAO-05-878.
- <sup>11</sup> Gale, William G. and Holtzblatt, Janet (2000) "The Role of Administrative Factors in Tax Reform: Simplicity, Compliance and Enforcement"
- <sup>12</sup> "2008 Annual Report to Congress" *National Taxpayer Advocate*, Volume 1 (31 Dec. 2008).
- <sup>13</sup> Rossetti, Charles O., Commissioner of Internal Revenue, 1997-2002 Testimony before the U.S. Senate Finance Committee (20 Sept. 2006).
- <sup>14</sup> <http://www.irs.gov/newsroom/article/0,jid=229675,00.html>.
- <sup>15</sup> As an example of the many studies that also document the excessive costs of the current U.S. tax system see: Edwards, Chris (2006) "Income Tax Rife with Complexity and Inefficiency" *Cato Institute*, April No. 33; Slemrod, J. & Sorum, N., (1984) "The Compliance Cost of the U.S. Individual Income Tax System" *National Tax Journal* 461; Blumenthal, M. & Slemrod, J., (1992) "The Compliance Cost of the U.S. Individual Tax System: A Second Look After Tax Reform" *National Tax Journal* 185; Slemrod, J. & Blumenthal M., (1996) "The Income Tax Compliance Cost of Big Business" *Public Finance Quarterly* 441; Bankman, Joseph (2003) "Who Should Bear Tax Compliance Costs?" Berkeley Program in Law and Economics, Working Paper Series, Berkeley Program in Law and Economics, UC Berkeley; <http://www.escholarship.org/uc/item/2t3c5dr>.
- <sup>16</sup> George, Henry (1879) *Progress and Poverty*.
- <sup>17</sup> Krause, Kate, "Tax Complexity: Problem or Opportunity" *Public Finance Review*, Vol. 28, No. 5 (2000) 395-414.
- <sup>18</sup> Report of the President's Advisory Panel on Federal Tax Reform (Nov. 2005).
- <sup>19</sup> Forman, Jonathan, "Simplification for Low Income Taxpayers" Joint Committee on Taxation: Study of the Overall State of the Federal Tax System (2001); and Nellen, Annette, "Simplification of the EITC through Structural Changes," Joint Committee on Taxation: Study of the Overall State of the Federal Tax System (2001).
- <sup>20</sup> Staff of the Joint Committee on Taxation, "Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3) (B) of the Internal Revenue Code of 1986, Volume III: Academic Papers Submitted to the Joint Committee on Taxation" Joint Committee on Taxation (Apr. 2001).
- <sup>21</sup> The American Institute of Certified Public Accountants, "Guiding Principles for Tax Simplification" <http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/Advocacy/DownloadableDocuments/TPCS%20-%20principles%20for%20tax%20simplification.pdf>
- <sup>22</sup> The American Institute of Certified Public Accountants, "Guiding Principles for Tax Simplification."
- <sup>23</sup> Fleisher, Michael P., "Why I'm Not Hiring," *The Wall Street Journal* (9 Aug. 2010).
- <sup>24</sup> National Economic Accounts, Table 3.1. Government Current Receipts and Expenditures; [www.bea.gov](http://www.bea.gov).
- <sup>25</sup> National Economic Accounts, Table 1.1.3. Government Current Receipts and Expenditures; [www.bea.gov](http://www.bea.gov).
- <sup>26</sup> Keating, David, "A Taxing Trend: The Rise in Complexity, Forms, and Paperwork Burdens" National Taxpayers Union, NTU Policy Paper 127 (15 April 2010).
- <sup>27</sup> "2008 Annual Report to Congress" *National Taxpayer Advocate*, Volume 1 (31 Dec. 2008).
- <sup>28</sup> "2010 Annual Report to Congress" *National Taxpayer Advocate*, "Most Serious Problems #1," Volume 1 (2010).
- <sup>29</sup> The 6.1 billion figure is a reduction from the previous estimate of 7.6 billion hours. The Taxpayer Advocate noted "that the aggregate burden of 6.1 billion hours is lower than the 7.6 billion hour estimate included in our 2008 report. Analysts in the IRS Office of Research, Analysis and Statistics (RAS) have advised us that the lower burden estimates likely reflect efficiency gains attributable to wider use of tax software, particularly by higher income business taxpayers. However, these efficiency gains have not necessarily reduced the burden on middle income and lower income taxpayers. Indeed, measured by dollars, RAS estimates that the mean burden has declined but the median burden has increased. RAS cannot independently determine the margin of error of existing estimates, and RAS acknowledges that the reduction in the time burden estimates may be at least partially attributable to measurement error."
- <sup>30</sup> Ibid.
- <sup>31</sup> Ibid.
- <sup>32</sup> Keating, David, "A Taxing Trend: The Rise in Complexity, Forms, and Paperwork Burdens" NTU Policy Paper 126 (15 Apr. 2009).
- <sup>33</sup> "2010 Annual Report to Congress," *National Taxpayer Advocate*, Volume 1 (Jan. 2010). These figures are down from \$193 billion and 14% of receipts in the 2008 report.
- <sup>34</sup> Figure 5 also illustrates the cyclical volatility of income taxes paid by the top income earners. This cyclicity is the expected outcome from progressive taxes and the boom-bust cycles of the economy.
- <sup>35</sup> <http://www.irs.gov/taxstats/index.html>.
- <sup>36</sup> Guyton, John L., O'Hare John F., Stavrianos Michael P., Toder, Eric J., "Estimating the Compliance Cost of the U.S. Individual Income Tax" Presented at the 2003 National Tax Association Spring Symposium (2003). The Guyton et al., estimates were adjusted based on the reduced compliance time estimated by the IRS.
- <sup>37</sup> The total number of hours spent complying with the tax code in Table 4 reflects the latest IRS dataset available as of this writing (2008).
- <sup>38</sup> <http://www.bea.gov>.

- <sup>39</sup> Salary and bonus information is from [www.payscale.com](http://www.payscale.com); benefit costs are based on data from the Bureau of Labor Statistics, which states that on average wages and salaries comprise 70.7 percent of total compensation, <http://www.bls.gov/news.release/ecec.nr0.htm>.
- <sup>40</sup> IRS Data Book, <http://www.irs.gov/taxstats/article/0,jid=102174,00.html>.
- <sup>41</sup> Gillen, Michael A. and Packer, Steven M., "New IRS Strategic Initiative: Increased Audit Activity on Its Way?" *The Legal Intelligencer* Duane Morris, (1 Sept. 2009).
- <sup>42</sup> <http://www.irs.gov/pub/irs-soi/10db09bex.xls>
- <sup>43</sup> Barta, Patrick, "The Rise of the Underground," *The Wall Street Journal* (14 March 2009) <http://online.wsj.com/article/SB123698646833925567.html>.
- <sup>44</sup> Many other variables are used as forward looking indicators such as changes in the stock market or the current value of the credit spread between borrowers of different credit worthiness (interest rates on Moody's Baa rated companies—interest rates on Moody's AAA rated companies). Because the yield curve specification illustrated the highest explanatory power of the variables tested, this specification was used in the analysis.
- <sup>45</sup> Many other studies have also found a significant and negative relationship between higher government burdens/taxes and lower rates of economic growth including: Sully, Gerald W., "Taxes and Economic Growth," National Center for Policy Analysis, NCPA Policy Report No. 292 (Nov. 2006); Robert J. Barro, "Economic Growth in a Cross Section of Countries," *Quarterly Journal of Economics*, Vol. 106, No. 2 (May 1991); Landau, Daniel L. "Government Expenditure and Economic Growth: A Cross-Country Study" *Southern Economic Journal*, 49 (Jan. 1983); Mitchell, Daniel J., "The Impact of Government Spending on Economic Growth," Heritage Foundation, *Backgrounder* #1831 (15 Mar. 2005); Gwartney, James, Lawson, Robert and Holcombe, Randall, "The Size and Functions of Government and Economic Growth" Joint Economic Committee, U.S. Congress (Apr. 1998).
- <sup>46</sup> According to FairTax.org, "With a national retail sales tax, the Tax Foundation has estimated that compliance costs drop more than 90 percent." (2007) "A FairTax White Paper: The FairTax reduces complexity, compliance costs, and noncompliance" FairTax.org.
- <sup>47</sup> See <http://www.recovery.gov/Pages/home.aspx>; accessed August 9, 2010.
- <sup>48</sup> Romer, Christina and Bernstein, Jared, *Job Impact of the American Recovery and Reinvestment Plan* (9 Jan. 2009).





Written Testimony  
Of  
Scott A. Hodge  
President  
Tax Foundation  
Before the Joint Economic Committee

"The Economic Consequences of Tax Complexity"

Thank you Chairman Coats and Ranking Member Maloney for the opportunity to talk with you today about the tax code's complexity and its impact on the economy.

Anyone who has studied federal tax law or has tried to prepare their own taxes knows that the U.S. tax code is a mind-numbingly complex document.

Over the last century, the federal tax code has expanded dramatically in size and scope. In 1955, the Internal Revenue Code stood at 409,000 words in length. Since then, it has grown to a total of 2.4 million words: almost six times as long as it was in 1955 and almost twice its length in 1985.

However, the tax statutes passed by Congress are only the tip of the iceberg, when it comes to tax complexity. There are roughly 7.7 million words of tax regulations, promulgated by the IRS over the last century, which clarify how the U.S. tax statutes work in practice. On top of that, there are almost 60,000 pages of tax-related case law, which are indispensable for accountants and tax lawyers trying to figure out how much their clients actually owe.

Tax complexity creates real costs for American households and businesses, starting with just the time it takes us to comply with the tax code. The National Taxpayer Advocate estimates that Americans spend over 6 billion hours complying with tax filing requirements, equal to more than 3 million full-time workers doing nothing but tax return paperwork.<sup>1</sup> Indeed, the IRS recently revised its estimate of the hours required to comply with business tax returns from 363 million to 2.8 billion.<sup>2</sup> Put in dollar terms, those 6 billion hours add up to at least \$168 billion each year, or about 15 percent of total income tax revenues.<sup>3</sup>

The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and local levels. We are a 501(c)(3) non-profit organization.

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<sup>1</sup> National Taxpayer Advocate, "The Complexity of the Tax Code," *Annual Report to Congress, 2012*, pp 5-6. <http://taxpayeradvocate.irs.gov/2012-Annual-Report/downloads/Most-Serious-Problems-Tax-Code-Complexity.pdf>

<sup>2</sup> Dan Goldbeck, "The IRS's New Year's Resolution," *Insight*, American Action Forum, January 4, 2016. <http://www.americanactionforum.org/insight/the-irs-new-years-resolution/>

<sup>3</sup> Taxpayer Advocate, *Annual Report to Congress, 2012*, *ibid*.

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Tax complexity, and the fear of making mistakes, motivates about 62 percent of all taxpayers to use tax return preparers, but the percentage climbs to about 73 percent for the poorest Americans claiming the EITC.<sup>4</sup>

But tax complexity creates other costs as well, besides our time. Specifically, many of the most complex features of the tax code distort individual and business behavior in numerous ways that leads to long-run economic harm. And we can measure that economic harm using the Tax Foundation's Taxes and Growth (TAG) Macroeconomic Tax Model.

To illustrate the tax code's harmful economic effects, I've selected a number of examples from the Tax Foundation's forthcoming *Options for Reforming America's Tax Code*. The *Options* book will contain nearly 100 specific policy changes to the individual and corporate tax code that have been scored with the TAG model. Each "Option" will include an estimate of the policy's economic effects (such as on GDP, wages, and jobs), revenue effects (measured conventionally and dynamically), and the distributional effects (also measured conventionally and dynamically).

### The Individual Income Tax

I'll begin with the individual income tax code, which is filled with dozens of credits, deductions, limitations and other special provisions that make life more complex for American taxpayers.

Much of the complexity in our tax code results from our attempts to make the system progressive, insuring that as taxpayer's income rise, so too does their tax liability. Over the decades, lawmakers have attempted numerous ways of making the tax system progressive, overtly with graduated tax brackets and subtlety with back-door claw backs.

### Progressive Tax Rates

Before the 1986 Tax Reform Act, a married couple was faced with 15 separate tax brackets as high as 50 percent. During the 1970s, those couples face as many as 26 different brackets as high as 70 percent. A taxpayer claiming Head of Household status faced 34 brackets as high as 70 percent.

Today, the tax code has seven brackets, with rates of 10, 15, 25, 28, 33, 35, and 39.6 percent. In many ways, this makes no sense because progressivity can be accomplished with as few as two rates—zero and 15 percent, for example.

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<sup>4</sup> National Taxpayer Advocate, Report to Congress: Fiscal 2010 Objectives, June 30, 2009, p. xxii, [http://www.irs.gov/pub/irs-utl/fy2010\\_objectivesreport.pdf](http://www.irs.gov/pub/irs-utl/fy2010_objectivesreport.pdf)

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Naturally, those paying at the 15 percent rate would pay a greater share of their income in taxes than those paying at the zero rate. We know too that marginal tax rates matter. When the "tax price" of earning the next dollar of income gets too high, people will stop working to earn that extra dollar. Economists have referred to these as "success taxes."<sup>5</sup>

To illustrate the economic benefits of simplifying the progressive tax bracket structure, we consolidated the current bracket structure into three of 10, 25, and 35 percent. The TAG model estimates that this simplification would boost the long-run level of GDP by 1.4 percent, lift after-tax incomes by an average of 3 percent, and create the full-time equivalent of more than 1.1 million jobs.

### PEP and Pease

Recognizing that statutory tax rates matter, lawmakers have often turned instead to backdoor efforts to raise additional taxes from higher-income households. Two particular tax code provisions stand out as overly complex attempts to increase taxes on the wealthy: the Pease limitation on itemized deductions and the personal exemption phase-out (PEP).

The Pease limitation on itemized deductions reduces the value of a taxpayer's itemized deductions by three cents for every additional dollar of income they earn. While the Pease limitation is framed as a limit on itemized deductions, it actually resembles a marginal surtax on high-income taxpayers, with a top rate of 1.188 percent. As a result, repealing the Pease limitation would not only make the tax code less complex, but would increase long-run GDP by 0.3 percent, by removing disincentives on work and investment, and create the equivalent of 187,000 jobs.

Similarly, PEP reduces the value of the personal exemption for upper-middle income households. Because each additional dollar that these households earn leads to a smaller personal exemption, PEP is essentially equivalent to a marginal surtax of at least 1 percent. Repealing PEP would increase long-run GDP by 0.1 percent, by lowering marginal tax rates on upper-middle income households, and would create the equivalent of 87,000 jobs.

### The Earned Income Tax Credit

At the other end of the spectrum, lawmakers' well-intended attempts to use tax policy to help the working poor has not only added vast complexity, but unintentionally added features that can discourage poor people from working more as their incomes rise. A good example is the way in which the Earned Income Tax Credit phases out as a worker's income increases. Consider this another hidden success tax.

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<sup>5</sup> Gentry, William H. & R. Glenn Hubbard (2004). Success Taxes. *Entrepreneurial Entry and Innovation*, NBER Working Paper No. w10551.

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The EITC calculation formula includes four different phase-in rates, four phase-out rates, and different calculations based on filing status and number of children. It is no surprise that Americans made 219,122 math errors when calculating the EITC in 2014, or that the credit had an improper payment rate of between 22 and 26 percent in 2013.<sup>6</sup>

The complex structure of the EITC has the ironic effect of encouraging more work as the subsidy phases-in, but then it discourages work effort as the subsidy phases out by levying high marginal tax rates on households just over the poverty line. When a married household with two children begins to earn more than \$23,630, the EITC starts to phase out at a rate of 21.06 percent. This high phase-out rate has the perverse effect of penalizing a worker for every dollar they earn above the poverty line, thus discouraging that extra work effort.

We can measure the macroeconomic cost of this phase-out penalty by substituting a different phase-out rate. For example, if we substitute a uniform 10 percent phase-out rate for the EITC for the current 21.06 percent phase-out rate, the TAG model finds that this would reduce the penalizing marginal tax rate effect on working households, thus increasing long-run GDP by 0.1 percent, raising the after-tax incomes of the working poor by more than 1 percent, and creating 164,000 jobs.

#### Itemized Deductions

For middle-income households, one of the most complex areas of the tax code is itemized deductions. Only 30 percent of taxpayers choose to itemize their deductions, but it is likely that many other households devote significant time and energy determining whether it would be advantageous or not to itemize.

Certainly, one way to reduce the complexity of itemized deductions is to simply eliminate many of these deductions from the tax code. However, simply eliminating itemized deductions alone could actually produce harmful macroeconomic effects, as this would bump some taxpayers into higher brackets, increasing their marginal tax rates, and discouraging work and investment.

For example, the TAG model indicates that the marginal rate effects of simply eliminating all itemized deductions except for the charitable and mortgage interest deductions would lead to a long-term reduction in GDP of 0.4 percent and the loss of 290,000 jobs.

**Swap itemized deductions for lower rates.** However, if the additional revenue from eliminating those same itemized deductions were then used to cut every income tax rate by 10 percent, this would increase long-run GDP by 0.6 percent and create 577,000 jobs.<sup>7</sup>

<sup>6</sup> Internal Revenue Service, *Data Book*, 2015, <https://www.irs.gov/pub/irs-soi/15databk.pdf>; Treasury Inspector General for Tax Administration, *The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act*, 2014, <https://www.treasury.gov/tigta/auditreports/2014reports/201440027fr.pdf>.

<sup>7</sup> For this example, it was necessary to eliminate the AMT because the loss of so many itemized deductions threw many taxpayers into the AMT.

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**Double the standard deduction.** Another way of simplifying the tax code while reducing reliance on itemized deductions is to expand the standard deduction. A larger standard deduction would mean that fewer taxpayers would feel the need to keep detailed records of their expenses and fill out Schedule A.

A larger standard deduction could be economically beneficial, by bumping many households into lower marginal rates. The TAG model shows that doubling the standard deduction for all households would increase long-run GDP by 0.5 percent and create 463,000 full-time equivalent jobs.

#### Estate and Gift Taxes

Another unduly complicated area of the tax code aimed at stemming income inequality is the federal estate and gift tax. Albeit a minor source of federal revenues—it collected \$19 billion in 2014, just 0.6 percent of federal receipts—it has outsized economic effects because it strongly depresses capital formation relative to the modest amount it collects. Some have estimated that just the costs associated with complying with the estate tax exceed the revenue it generates.

Advocates say that it impacts very few estates since the first \$5.45 million of gifts and bequests is excluded from tax, and the amount is indexed for inflation. Thus, they say, it has minimal economic effect. However, critics say that by making it harder to pass family businesses and farms to the next generation, the estate tax is yet another "success tax."

We find that eliminating the federal estate and gift tax would increase long-run GDP by 0.8 percent, lift the stock of private business capital (e.g., equipment, structures) by 2.3 percent, boost wages by 0.7 percent, and create for 159,000 new jobs.

#### Business Income Taxes

It is now well known that the U.S. has the highest corporate income tax among the leading industrialized nations. Indeed, Tax Foundation economists determined that the U.S. has the third highest corporate income tax among the 165 nations we surveyed. Only Chad and the United Arab Emirates levied a higher corporate tax rate than the U.S.

Economists at the OECD determined that the corporate income tax is the most harmful tax a national can impose. Individual income taxes, sales taxes, and property taxes were found to be less harmful.

One way of measuring the economic effects of our high corporate tax rate is simply to lower the rate in our TAG model. For example, the model shows that cutting the corporate tax rate to 25 percent from 35 percent (with no offsets) would boost the long-term level of GDP by 2.3 percent, increase wages by 1.9 percent, and create 443,000 jobs.

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Aside from our uncompetitive corporate tax rate, there are many complex elements of the corporate code that have harmful effects too. We can estimate those costs as well.

### Cost Recovery

Under the current tax code, when a business makes a capital investment, it required to deduct the cost of the asset over time, according to one of over a dozen depreciation schedules. These schedules are essentially arbitrary, and the process of determining how to properly depreciate an asset is complex.

One tax code change that could make the tax code both less complex and more favorable to investment is moving to full expensing of capital investment. Allowing businesses to deduct the full cost of their investments immediately would encourage significantly higher investment levels.<sup>8</sup>

According to the TAG model, full expensing would increase long-run level of GDP by 5.4 percent, by growing the nation's capital stock by 16 percent, increasing wages by 4.5 percent, and creating more than 1 million full-time equivalent jobs.

Dollar-for-dollar, full expensing is one of the most pro-growth tax changes that Congress could enact.

### Corporate Integration

Another complex feature of the business tax code is that firms face significantly different tax regimes depending on their legal form. For instance, traditional C-corporations typically face a much higher marginal tax burden than partnerships because corporate income is tax twice, first at the entity level at 35 percent, and then at the shareholder level when capital gains and dividends are taxed at rates as high as 24 percent. Partnership and S-corporation income is taxed only once when the profits are distributed to the owner.

Over the past few decades, there have been several notable proposals to equalize the tax treatment of all businesses, regardless of their legal form or financing method. This approach is known as corporate integration, and it would vastly simplify the taxation of U.S. businesses. Under corporate integration, companies would no longer have to spend time and resources determining what legal form to adopt or planning tax-efficient financing strategies.

Recently, the Tax Foundation modeled a version of corporate integration that would allow corporations to deduct dividends paid and would tax dividends received by individuals at ordinary income rates. In addition to greatly simplifying the business tax code, such a proposal would increase U.S. GDP by 2.9 percent over the long run, boost wages by 2.5 percent, and create 535,000 jobs.

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<sup>8</sup> See Zwick and Mahon, *Tax Policy and Heterogeneous Investment Behavior*, National Bureau of Economic Research, 2016, <http://www.nber.org/papers/w21876>



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## Business Tax Expenditures

There are roughly 80 so-called tax expenditures in the corporate tax code, with a budgetary value of more than \$120 billion. It's often thought that businesses and the economy would be better off if all of those tax breaks were eliminated in exchange for a lower corporate tax rate. However, our research has found that eliminating all business tax expenditures in exchange for a lower tax rate would actually negate the expected growth from the rate cut itself.<sup>9</sup>

The reason for this is that a number of corporate tax provisions—such as accelerated depreciation and the expensing of research and development costs—help move the tax code towards a more neutral treatment of capital investment. Eliminating these cost-recovery provisions raises the cost of capital and, thus, neutralizes any of the economic benefits of a lower tax rate.

However, there are many other tax preferences—such as energy credits, or interest exclusions on bonds—that could be eliminated with minimal economic harm, and provide revenue for overall rate cuts.

For instance, eliminating all business tax expenditures that are not connected to cost recovery would raise enough revenue to cut the overall corporate tax rate to 28 percent. This combination of changes would increase the size of the U.S. economy by 1.4 percent in the long run and create 275,000 jobs. Moreover, the new economic growth would actually increase federal revenues by more than \$550 billion over a decade.

## International Taxation

Perhaps the most complex aspect of the U.S. tax code is the treatment of income earned overseas. Under current law, U.S. multinational corporations are required to pay tax on their worldwide income. If a corporation earns income in England, it is required to pay tax to Her Majesty's Revenue and Customs. As long as that company keeps those profits overseas, it can defer the additional payment of U.S. tax. Once that corporation decides to bring that income back to the United States, it is required to pay tax again to the U.S. government at 35 percent, minus a foreign tax credit.

Major complexities arise for multinational corporations operating abroad. The foreign tax credit, which prevents double-taxation of foreign profits, is littered with rules and exceptions. It includes strict rules limiting how much a company can claim in foreign taxes. In addition, the foreign tax credit has complicated rules determining what taxes that businesses pay overseas can be credited against U.S. tax liability. In the past, the IRS has used these rules to deny foreign tax credits to multinational corporations. This leads businesses to go to court against the IRS, costing time and resources.

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<sup>9</sup> Scott A. Hodge, "The Challenges of Corporate-Only Revenue Neutral Tax Reform," Tax Foundation Fiscal Fact No. 471, June 18, 2015.



Most nations do not require this level of complexity. Instead, they have territorial tax systems, which only require domestic multinationals to pay tax to the countries in which they conduct their business. These systems make the foreign tax credit rules unnecessary and eliminate much of the complexities of our worldwide system.

Tax Foundation economists are currently developing an extension of our TAG model to measure the economic and revenue effects of moving to a territorial tax system.

### Replacing the Corporate Income Tax with a Value-Added Tax

Considering the complexity and economic harm caused by the corporate income tax, it makes sense to ask "what if it was replaced by a tax that was less damaging?" As a thought experiment, and we don't necessarily advocate this policy, Tax Foundation economists modeled the effects of replacing the corporate income tax with a Value Added Tax (VAT).

A value-added tax is a consumption tax, levied at the business level on all profits and payroll. Unlike the current corporate income tax, value-added taxes are generally broad-based and simple, and they contain no bias against saving and investment.

There are two ways to administer a value-added tax. Under a credit-invoice method, businesses pay VAT on their gross sales and receive a credit for value-added taxes previously paid on their business inputs. Under a subtraction method, businesses calculate their VAT base by subtracting their operating expenses and capital expenditures from their revenues.

Replacing the corporate income tax with a 5 percent value-added tax would eliminate many of the complexities in the current tax code and leave federal revenues roughly unchanged, as measured on a conventional basis. According to the TAG model, by eliminating the double taxation of saving and investment in the current corporate tax code, this swap would raise long-run GDP by 5.8 percent, create 532,000 jobs, and actually raise \$1.8 trillion in new revenue after accounting for the economic growth effects.

Again, this is not necessarily a policy we would endorse, but two presidential candidates proposed tax reform plans that included such a tax swap so it is a policy that should be taken seriously.

### Lessons from Modeling Tax Reform Plans

Over the past year, Tax Foundation economists have gained special insights into what kind of tax policies boost investment, wages, jobs, and economic growth, and which policies lead to less of those things.

Using our Taxes and Growth (TAG) Macroeconomic Tax Model, we have scored the tax plans of every presidential candidate<sup>10</sup>, as well as numerous tax plans developed by members of the House and Senate. For example, we have modeled the plans of two members of this committee, Senator Lee's Lee-Rubio tax plan and Senator Cruz's tax plan, as well as Senator Ben Cardin's Progressive Consumption Tax plan and the business tax reform plan designed by Congressman Devin Nunes.

During this experience, we have modeled every conceivable tax reform plan one can think of, including the Flat Tax, FairTax, Bradford X-Tax, Value Added Tax (VAT), and numerous plans that incorporate features of each of these.

To one degree or another, the more pro-growth of these plans incorporate many of the lessons that I've outlined in the first portion of this testimony: they reduce marginal tax rates; reduce taxes on capital; reduce or eliminate the double-taxation of savings and investment; and, move toward a neutral or consumption tax base.

Here are four examples:

#### Senator Ben Cardin's Progressive Consumption Tax<sup>11</sup>

Senator Ben Cardin's proposal would dramatically scale back the individual and corporate income taxes. Because the plan would exempt a couple's first \$100,000 of wages from the income tax, most people would no longer owe the individual income tax. Incomes above that amount would be subject to rates of 15, 25, and 28 percent. The corporate income tax rate would be cut to 17 percent.

The Cardin plan is intended to be revenue neutral. He would finance this with a value added tax, which he calls the Progressive Consumption Tax (PCT). Large rebates would make the overall package progressive.

At a PCT tax rate of 10 percent, the TAG model estimates that in the long run the plan would raise the level of gross domestic product (GDP) by 4.4 percent, increase the stock of capital used in production by 15.2 percent, and boost the number of jobs by 1.1 million.

#### Ben Carson's Flat Tax<sup>12</sup>

During his presidential bid, Dr. Ben Carson proposed to replace the current federal income tax (both individual and corporate) with a Hall-Rabushka-style flat tax. The plan would tax all wage income and business income at 14.9 percent, but exempt taxes on capital gains, dividends, and interest income at the individual level.

<sup>10</sup> These scores can be found at: <http://taxfoundation.org/blog/comparison-presidential-tax-plans-and-their-economic-effects>

<sup>11</sup> Michael Schuyler, "An Analysis of Senator Cardin's Progressive Consumption Tax," Tax Foundation Fiscal Fact No. 473, July 8, 2015. <http://taxfoundation.org/article/analysis-senator-cardin-s-progressive-consumption-tax>

<sup>12</sup> Kyle Pomerleau, "Details and Analysis of Dr. Ben Carson's Tax Plan," Tax Foundation Fiscal Fact No. 493, January 6, 2016. <http://taxfoundation.org/article/details-and-analysis-dr-ben-carson-s-tax-plan>

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Businesses would be allowed to fully expense capital investment, but would no longer be able to deduct interest expenses. The plan would also eliminate all itemized deductions and all tax credits except for the foreign tax credit. The plan would further expand the tax base by including fringe benefits, such as employer-provided health insurance, in the tax base.

Our analysis found that the plan would reduce federal revenues by \$2.5 trillion over the next decade. However, it also would improve incentives to work and invest, which would increase gross domestic product (GDP) by 16 percent over the long term if the tax cuts were appropriately financed. This increase in GDP would translate into 10.9 percent higher wages and 5.2 million new full-time equivalent jobs.

#### The Lee-Rubio Tax Reform Plan<sup>13</sup>

In March 2014, Senators Mike Lee and Marco Rubio introduced a comprehensive tax reform plan. While the plan has attracted a great deal of attention for its generous child tax credits, the structure of the plan incorporates the core planks of David Bradford's "X-Tax," or progressive consumption tax.<sup>14</sup> The Lee-Rubio plan achieves this by cutting both corporate and passthrough business tax rates to 25 percent, moving to full expensing for all capital investment, eliminating the second layer of corporate taxation by repealing taxes on dividends and capital gains, and moving to a full territorial tax system. For individuals, the plan taxes wages at rates of 15 and 35 percent.

According to the Tax Policy Center, these measures reduce the marginal effective tax rate on new investment to zero. The Tax Foundation's model estimates that the Rubio plan would boost the long-term level of GDP by roughly 15 percent, the capital stock by 49 percent, which, in turn, would raise wages by 12.5 percent and create 2.7 million new jobs. We also found that the plan would reduce federal tax revenues by \$2.4 trillion over a decade.

#### Ted Cruz's Tax Plan<sup>15 16</sup>

The plan proposed by Senator Ted Cruz takes a different approach to get to nearly the same place as these other tax reform plans. The plan would replace the corporate income tax and all payroll taxes with a 16 percent "Business Flat Tax," or value-added tax (VAT). This allows for the full expensing of all capital investment, but shifts the tax burden away from capital to labor. Cruz compensates workers for this shift by creating a single individual tax rate of 10 percent and expanding the Earned Income Tax Credit.

<sup>13</sup> Michael Schuyler and Will McBride, "The Economic Effects of the Rubio-Lee Tax Reform Plan," Tax Foundation Fiscal Fact No. 457, March 9, 2015. <http://taxfoundation.org/article/economic-effects-rubio-lee-tax-reform-plan>

<sup>14</sup> The corporate side of the Lee-Rubio plan shares many similar components to the Nunes tax plan. <http://taxfoundation.org/article/updated-details-and-analysis-nunes-plan-reform-business-taxation>

<sup>15</sup> Kyle Pomerleau and Michael Schuyler, "Details and Analysis of Senator Ted Cruz's Tax Plan," Tax Foundation Fiscal Fact No. 489, October 29, 2015. <http://taxfoundation.org/article/details-and-analysis-senator-ted-cruz-s-tax-plan>

<sup>16</sup> Rand Paul's tax plan was very similar to Cruz's plan. See: Andrew Lundeen and Michael Schuyler, "The Economic Effects of Rand Paul's Tax Reform Plan," Tax Foundation Blog, June 18, 2015. <http://taxfoundation.org/blog/economic-effects-rand-paul-s-tax-reform-plan>

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The Tax Foundation's model estimates that the Cruz plan would boost the long-term level of GDP by 14 percent. This is slightly less growth than the Lee-Rubio plan because it does not eliminate the second layer of tax on corporate income. Still, the plan would increase the capital stock by 44 percent and wages by 12 percent. And because the 10 percent individual flat tax rate would encourage more people to enter the workforce, Cruz's plan would create nearly 5 million new jobs. We also estimate the plan would reduce federal revenues by \$758 billion over a decade.

## Conclusion

A few years ago, the National Taxpayer Advocate named tax complexity the number one issue facing American taxpayers. In addition to robbing us of 6 billion hours of our lives complying with its Byzantine rules, our complex tax system punishes success and hard work, thus, robbing the economy of its ability to create jobs and better living standards.

Using the Tax Foundation's Taxes and Growth (TAG) Macroeconomic Tax Model, we are able to measure and quantify the cost of complex tax provisions on GDP, investment, and jobs. We find that the complexity caused by measures designed to make the tax code more progressive shrink the economy and kill jobs. We find that the complexity caused by tax policies to help the poor can discourage work and shrink wages. We find that the extremely complex corporate income tax—from its high rate, badly designed cost recovery systems, and twin layers of taxation—leads to less investment, fewer jobs, and a smaller economy.

Finally, by scoring a wide variety of tax reform plans with our TAG model, we learned that there are many valid ways of ridding the tax code of its worst parts and creating a new tax system that boosts economic growth, creates jobs, and lifts living standards.

I hope that the members of this committee, as well as your fellow lawmakers, take these lessons to heart and start us down the road to fundamental tax reform soon.

Thank you for your time. I welcome any questions that you may have.



Testimony of

**Mr. Joe Grossbauer**  
*President and CEO, GGNET Technologies*

before the

**Joint Economic Committee**

on the subject of

**Is Our Complex Code Too Taxing on the Economy?**

on the date of

**April 20, 2016**

Good morning Chairman Coats, Ranking Member Maloney, and members of the Joint Economic Committee. Thank you for the opportunity to testify today. I am pleased to be here on behalf of the National Federation of Independent Business (NFIB) as the Committee discusses the issue of tax complexity and its negative impact on our nation's economy.

NFIB is the nation's leading small business advocacy organization. The typical NFIB member employs 8 to 10 employees with annual gross receipts of about \$500,000. All of NFIB's members are independently owned, which is to say that none are publicly-traded corporations. While there is no one definition of small business, the problems NFIB members confront, relative to the tax code, are representative of most small businesses. A few consistent concerns are raised regardless of the trade or industry in which the small business is engaged.

As part of representing small business owners, NFIB frequently conducts surveys of both the NFIB membership and small business population as a whole, and taxes consistently rank as one of their greatest concerns. In the most recent publication of the NFIB Research Foundation's *Small Business Problems and Priorities*, 5 of the top 10 small business concerns are tax-related, and these tax problems fall into three categories: cost, complexity, and frequent changes.<sup>1</sup>

Tax complexity, in particular, is a problem for small businesses because spending time and money on tax compliance drains financial resources. Small businesses annually spend between 1.7 billion and 1.8 billion hours on tax compliance and \$15 billion to \$16 billion on compliance costs.<sup>2</sup> It is no wonder that 91 percent of NFIB members hire a professional tax

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<sup>1</sup> [nfib.com/problems&priorities2012](http://nfib.com/problems&priorities2012)

<sup>2</sup> Donald DeLuca and Scott Stilmar, *Aggregate Estimates of Small Business Taxpayer Compliance Burden*, IRS Research Bulletin, 2007.

preparer to handle their taxes and the majority let their tax preparer worry about added complexity in the tax code.<sup>3</sup>

I serve as President and CEO of GGNet Technologies, which is a technology company that provides IT and datacenter services, along with cybersecurity breach analysis and mitigation. We are an S-corporation that employs six full-time employees. Since our founding in 2006, our accounting costs have risen by 400 percent. Some of that can be attributed to company growth, but much of the rise in accounting costs is due to complexity of the tax code and our need to dedicate additional accounting time simply in order to maintain compliance.

We are frozen during tax season. Business reports and planning between February and April are put on hold or delayed because we are so focused on taxes. We are unable to produce timely reports on cash flow, profit/loss, etc. during this time. I also feel tax complexity has a disproportionate impact on small businesses like mine. I do not have the same financial resources as larger companies. If the tax code was less burdensome, I would be able to focus more time and resources on my customers rather than taxes.

It seems that the harder I work, the more complex my taxes become. When I first started out I was only billing out my time and taking the normal deductions for working out of my home. I spent 18 hours doing my taxes, but I was able to complete them myself. Now, with deductions, pass-throughs, and active and passive income, tax compliance is beyond my own ability, or even that of my bookkeeper. I am not small enough to be able to prepare taxes myself, but I am also not large enough to employ an entire accounting staff. As a very small business, I have one full-time employee devoted to addressing accounting and taxes, and approximately 40

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<sup>3</sup> *Taxes and Spending: Small Business Owner Opinions* – NFIB Member Poll, NFIB Research Foundation, Washington, DC, March, 2013.



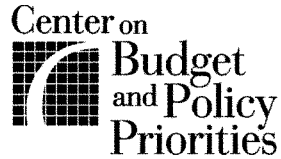
percent of her time is spent working on tax-related functions, including classifying and filing federal, state and local taxes.

Furthermore, taxes impact every aspect of my operations and decision-making. Due to complexity in the code, I am confronted daily with the question of how to classify an item, whether it be operations, capital, minor equipment, or how to differentiate between a contract worker and employee. Payroll complexity forces us to utilize software, but often times the software will not classify properly and I am forced to spend valuable time on support calls with my accountant. A personal example is when I teamed up with three partners to set up an LLC to acquire an underused fiber optic backbone in Chesterton, Indiana. This would bring gigabit service to homes and businesses in our community. As we developed our business plan and pro forma, we recognized the need for correct interpretation of the tax code in order to determine if this was a profitable or unprofitable venture. We contacted three different accounting firms and a tax attorney and experienced, first-hand, the challenges in determining what is or is not considered real property for tax purposes. Tax complexity also impacts my more routine decision-making such as those relating to inventory. For example, navigating the complexity in the areas of liquidity and depreciation creates significant frustration and uncertainty as I operate the business on a daily basis.

In addition to spending increased time and financial resources on tax compliance, my company is further inhibited by last-minute changes to the code. I create our budget for the upcoming year in December, but it is hard to accurately project when the tax rules impacting our budget are not released until November or late January. Businesses, such as mine, are reluctant to buy equipment, make investments, and hire new employees when there is that degree of uncertainty regarding their tax liability.

In conclusion, small businesses truly are the engine of economic growth. This is not just a slogan, as small businesses created two-thirds of the net new jobs over the last decade. The current tax code has become a confusing and unpredictable challenge for the vast majority of small business owners, like myself. Our tax laws should not deter or hinder the ability of small business owners to create or expand their businesses. After decades of patchwork changes to the tax code, Congress needs to make major adjustments to our tax laws to reduce complexity and confusion and encourage business growth.

As Congress takes a serious look at reforming the code, I urge you to keep in mind the unique challenges that face small businesses. Alleviating tax code complexity is an essential component in creating a strong, healthy environment for small business owners to operate and grow their businesses. I appreciate the opportunity to testify today and look forward to answering any questions you might have.



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April 20, 2016

## Testimony of Jared Bernstein, Senior Fellow, Before the Joint Economic Committee

### Meeting the Goals of the Federal Tax System

Thank you very much for the invitation to testify. Today's hearing is nominally about the complexity in the tax code, but we cannot adequately address that issue without asking a broader question: what is the goal of the federal tax system? To underscore this point, consider a simple, flat tax code wherein filing taxes took minutes instead of hours yet significantly increased the tax burden on the broad middle class. I suspect such "simplicity" would be unacceptable to members of this committee.

The goal of the system should be to raise the revenue necessary to fund the government services and public goods Americans want and need, and to do so in a way that's fair, equitable, pro-growth, and avoids unnecessary complexity.

- An equitable tax code is a progressive one with rates that rise with income so as to reduce, as opposed to exacerbate, market-driven inequalities.
- A tax code that privileges some types of income over others, contains unnecessary exemptions and deductions, and offers numerous opportunities for tax avoidance and evasion is unfair, wasteful, *and* too complex.
- A pro-growth tax code raises ample revenue to provide households and businesses with the infrastructure and security they need to prosper, and does so in ways that best promote work and investment. Moreover, the relationship between taxes and growth is not simplistic: the empirical record shows strong growth periods amidst higher tax rates and weak growth periods amidst lower tax rates.

In what follows, I evaluate the extent to which the current U.S. federal tax code meets these criteria and where it falls short. I also offer suggestions to boost its fairness, simplicity, growth, and revenue-adequacy objectives.

My three main findings are:

- Fairness, simplicity, and revenue raising are often complementary: by closing regressive loopholes in the tax code, we reduce incentives to game the system, eliminate wasteful tax breaks that exacerbate inequality without promoting growth, and raise more revenues.
- Based on demographics, inflation, debt service, and rising health costs (though measures in the Affordable Care Act have helped to slow that growth rate), a sustainable fiscal policy will likely require more, not less, revenues going forward.
- I find no evidence to support the claim that supply-side tax cuts come anywhere close to paying for themselves or are even particularly pro-growth.

### **Tax Fairness and Tax Complexity: How Can We Have More of the Former and Less of the Latter?**

Policy makers and taxpayers often lament the complexity of the tax code, and with good reason. But it's important to remember that complexity has nothing to do with the number of tax brackets and rates. If taxable income were easy to define, it wouldn't matter how many rates existed in the code; all taxpayers would have to do is look up their liabilities in a table or online calculator. Any computation, including one based on dozens of rates, would be easily done in the background.

What makes our system so complex are the exemptions, deductions, other tax subsidies, and privileges for one type of income, industry, or activity over another. On the corporate side, these include "transfer pricing" opportunities (the ability to book income in low-tax countries and deductible expenses in high-tax countries), deferral of foreign earnings, inversions, and the many other loopholes that explain why the effective corporate rate is at least 10 percentage points below the top statutory rate (about 25 percent versus 35 percent).

To be clear, not all subsidies in the tax code are poorly targeted and inefficient. Research shows the Earned Income Tax Credit and Child Tax Credit, for example, encourage work and prevent millions of people from falling into or deeper into poverty, and children in families receiving the tax credits do better in school, are likelier to attend college, and can be expected to earn more as adults. But well-targeted, effective subsidies like the EITC and CTC are unfortunately more the exception than the rule.

I asked one very busy and experienced tax preparer, "What makes filing taxes complicated?" She responded that blaming "too many rates" was "gut-busting laughable." Once you determine taxable income, calculating liabilities takes seconds. "But," she went on, "how much time do I, a seasoned professional with great software and lots of research resources, spend dealing with the complexities of the tax code? Too often, it's hours and hours (and I can't often bill for it)."<sup>1</sup>

A flat tax (one rate), though often touted as the pinnacle of simplicity, could be immensely complex if taxpayers have to spend hours categorizing different types of income, taking deductions, and so on before applying the rate to their taxable income.

When a particular income source is privileged by the tax code, people and businesses are incentivized to spend considerable time and money redefining their income as coming from the

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<sup>1</sup> Personal correspondence with Mary Ellen Arndorfer.

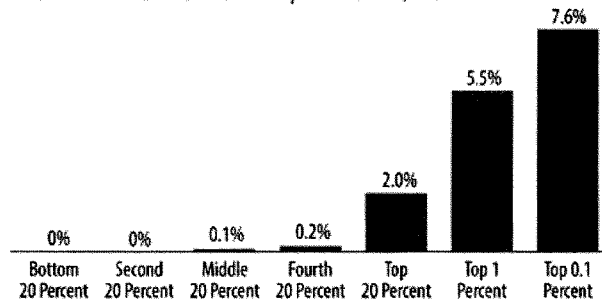
privileged source. Such complexities in the tax code may thus create jobs for tax lawyers, but they often don't contribute to productive activities. They also often reduce fairness and erode the tax base.

Consider:

- Preferential rates for investment income (capital gains, dividends) mostly benefit the wealthy, who receive a disproportionate share of non-labor income. As the figure below shows, lower rates for these income sources have virtually no impact on those in the bottom 80 percent but raise the post-tax income of the wealthiest families by about 5 to 8 percent, thus exacerbating market-driven income inequalities.

### Preferential Rates for Capital Gains and Dividends Are Highly Regressive

Percent increase in after-tax income from preferential rates, 2015



Source: Tax Policy Center Table T13-0269

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- Our tax code heavily favors very high levels of inherited incomes. Due to the high exemption threshold (\$10.9 million for couples, \$5.4 million for individuals), our current estate-tax base is extremely narrow, reaching only 2 of every 1,000 estates. Numerous loopholes also ensure that the millionaires who do pay the estate tax pay low effective rates (on average, less than 17 percent) on their fortunes. And then there's "step-up basis," which wipes out the taxes on capital gains (already taxed at a privileged rate relative to earned income) when a wealthy individual passes them on to a descendant.
- On the corporate side of the tax code, many of the loopholes cited above explain why the *effective* corporate tax rate is at least 10 percentage points below the top *statutory* rate (35 percent). As noted, a source of this difference is the ability to indefinitely defer foreign earnings. The huge differential between how the code treats debt- and equity-financed investment is underappreciated but also important. Because interest payments, unlike dividend payments, are deductible from corporate income, the effective marginal tax rate on debt-financed investment is *minus* 39 percent. The rate on equity financing for corporations is 27 percent (see Figure 2 [here](#)). In other words, there is a very large subsidy for debt-financed investment; it's little wonder that American businesses are prone to excessive leverage.

- Business income “passed through” to the individual level (to take advantage of the lower tax rate on capital gains) is the single largest source of the “tax gap” (the difference between what people owe and what they pay). When last measured for the year 2006, the tax gap amounted to some \$385 billion a year, or about 10 percent of the federal budget and 2 percent of today’s GDP. Sole proprietors, for example, have been found to report less than half of their income to the IRS.
- In research that has become especially topical with the discovery of extensive tax evasion in Panama, economist Gabriel Zucman documents that, since the early 1980s, the share of profits that U.S.-based firms book in tax havens has grown from about 20 percent to 50 percent. New analysis by Kimberly Clausing “suggests that base erosion and profit shifting is a larger problem today than even before.” She estimates the revenue loss from such activities to be between \$77 billion and \$111 billion by 2012, about 4 percent of federal revenues that year.<sup>2</sup>
- Further evidence of increasingly aggressive profit shifting is easily gleaned from the amount of income that U.S.-based multinationals book in tax havens known for their extremely low-tax rates. As a joint report from the White House and the U.S. Treasury recently reported, in 2010, foreign subsidiaries of U.S. firms “reported profits in the Cayman Islands that were more than 20 times that country’s entire economic output.”<sup>3</sup> This simple fact alone provides overwhelming evidence of base-eroding profit shifting from where income is earned to where it will be least taxed.
- As Austin, Burman, and Rosenthal show in a forthcoming paper, the share of corporate stock held in taxable household accounts has fallen from around 80 percent in the mid-1960s to about 25 percent now, meaning most such stock is now untaxed by U.S. authorities or held in tax-favored vehicles like individual retirement accounts or by nonprofits or foreigners.

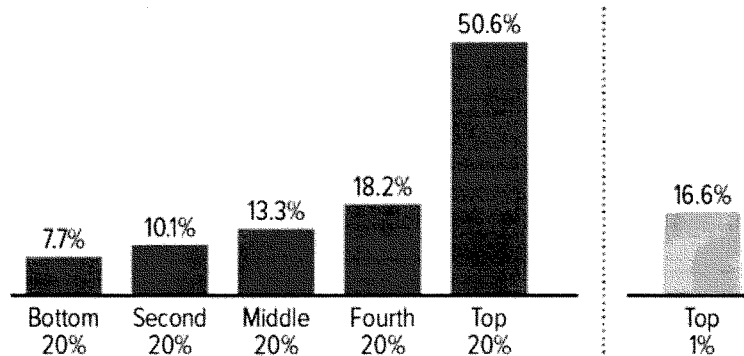
All told, the extensive set of *legal* subsidies to individuals or businesses through exemptions, deductions, and other tax subsidies, generally referred to as tax expenditures, cut federal income tax revenue by over \$1.2 trillion last year—more than the cost of Social Security or the combined cost of Medicare and Medicaid. Moreover, as shown in the figure below, these tax breaks disproportionately benefit higher-income households, often wastefully subsidizing behavior that would occur anyway. The top 1 percent of households get almost 17 percent of the benefit of the ten largest tax expenditures, almost as much as the bottom 40 percent of households.

<sup>2</sup> Kimberly Clausing, “The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond,” 2016, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2685442](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685442).

<sup>3</sup> The President’s Framework For Business Tax Reform: An Update, April 2016, <https://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-An-Update-04-04-2016.pdf>.

## Spending Through the Tax Code Skews Towards the Top

Share of ten largest federal income tax expenditures by income group, 2013



Source: Congressional Budget Office

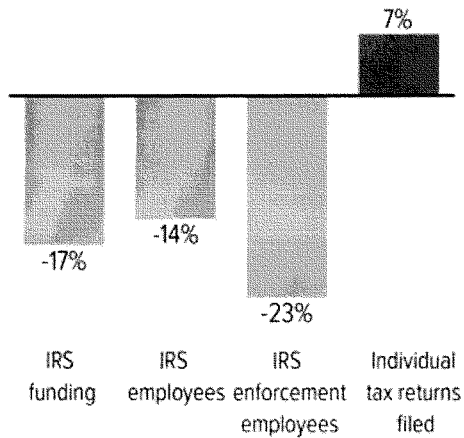
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Why do all of these loopholes, deductions, and favorable rates exist? One explanation, often proffered with no supporting evidence, is that these complexities create incentives for growth. In some cases, such claims are *prima facie* indefensible. Step-up basis, for instance, encourages wealthy individuals to hold assets until death even if the gains from selling the assets might be more productively deployed elsewhere in the economy. As another example, the huge discrepancy in the tax cost of debt financing versus equity financing has no obvious growth justification. And the fact that it's cheaper, from an effective-tax-rate perspective, for multinational American companies to create real economic activity abroad rather than here disincentivizes job creation in the United States.

There's also no defense at all for exacerbating the problem of *illegal* tax evasion, as congressional conservatives have been doing by cutting the budget of the IRS. As the figure below from CBPP Tax Policy Director Chuck Marr reveals, compared to 2010, the IRS budget is down 17 percent in real dollars and enforcement staffing is down by 23 percent, while individual filings are up 7 percent. Treasury estimates that each additional \$1 spent on IRS enforcement yields \$6 of additional revenue.

## IRS Funding Cut As Workload Grows

Percent change since 2010



Source: CBPP calculation based on IRS, National Taxpayer Advocate, and Congressional Budget Office data

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It is therefore essential, in the name of fairness, simplicity, and revenue collection, to curb tax avoidance and evasion. The next section focuses on the revenue issue and the final section examines the fundamental claim of “supply-side” tax cuts: that rate cuts reliably generate significant economic growth. Both theory and evidence find little support for this claim.

### Meeting Our Revenue Needs

Even with no policy changes in major government programs, our revenues must increase for “mechanical” reasons. Simply holding real spending per capita constant, population growth and inflation together will require a 40 percent increase in revenues over the next decade. As the share of Americans who are 65 and older will increase from the current 15 percent to 20 percent by around 2040, Medicare and Social Security will cost more. CBO estimates that, by 2026, spending on these two programs will need to go up by just under 2 percent of GDP (over \$500 billion of projected 2026 GDP).

Along with demographics, another source of pressure on future revenues is health-care cost growth, which has historically outpaced overall growth, thus absorbing an increasing share of GDP. Clearly, attacking the inefficiencies behind this excess growth rate was a goal of the Affordable Care



Act (ACA), and it has been a notable success thus far. Today's budget projections of health care costs are down 30 percent from those made prior to the ACA, and that improvement includes the costs of the health care reform itself.

Finally, CBO expects interest payments on government debt to rise from 1.4 to 3 percent of GDP over the next decade. Like other forecasters, CBO has overestimated the path of interest rates in recent years, so perhaps, if rates remain as low as forward market indicators expect them to, there will be some debt relief. But the path of future interest rates is unknowable, so fiscal rectitude should lead us to plan for the possibility of rising interest payments.

To meet these needs and leave ourselves room for necessary additional investments in infrastructure and human capital while sticking to the principles outlined above, we should adopt revenue raisers that increase fairness and simplicity (or, at least, that avoid new complexities).

The price of admission to any discussion of tax reform should thus be a willingness to close the so-called "carried interest loophole," which allows hedge fund managers to face favorable asset-based rates on their earnings at a cost of \$19 billion in lost revenue over ten years. Those who claim to want to do major tax reform yet are unwilling to simplify the code by first closing this loophole — one with virtually no defenders — should be considered akin to those who say they're ready to run a marathon but get winded walking up the stairs.

The preferential treatment of wealthy inheritances would be another great place to start. The President's recent budget would lower the estate-tax exemption threshold from \$10.9 million to \$7 million for couples (and from \$5.4 million to \$3.5 million for individuals) and increase the top marginal estate-tax rate from 40 percent to 45 percent. It would also close a few estate and gift-tax loopholes, one of which (the Grantor Retained Annuity Trust loophole) allows an estate to put an investment in a trust to avoid paying capital gains. Under these changes, which would raise \$226 billion over 10 years, the estate tax would still affect only about 0.3 percent of decedents.<sup>4</sup>

In a similar vein, the President's budget proposes to close the "step-up" loophole discussed above, while leaving in significant exemptions so that the change only affects wealthy heirs. Combined with his proposal to raise the capital gains rate from its current 23.8 percent to 28 percent, ending step-up basis raises \$235 billion over ten years. Note that reducing the tax differential between capital gains and income helps to simplify the system as well, by reducing a distortionary incentive to redefine earnings and income (one exploited, for example, by those who tap the carried interest loophole).

When it comes to some of the other wasteful subsidies in the tax code, it's hard politically to target one over another — behind every loophole is a lobbyist whose salary depends on defending that tax break as a treasured "job creation" program. Rather than go after these loopholes one at a time, it would thus be both easier and fairer to limit *all* deductions to 28 percent instead of the top income tax rate of almost 40 percent.

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<sup>4</sup> I discuss these and some of the other suggested revenue raisers in this section in a recent American Prospect article: "We're going to need more revenue," Vol 27, #2, Spring 2016.

This approach avoids picking winners and losers and boosts economic efficiency by reducing the extent to which we subsidize behaviors that would occur anyway among the wealthy, like saving for retirement or buying a home. Applied to incomes of \$250,000 or more, this cap would generate savings of more than \$640 billion over ten years.

Turning to the corporate side of the tax code, the simplest way to shut down companies' deferral of foreign earnings is a minimum tax that multinationals must pay on those earnings when they earn them, after which they could repatriate their earnings without further taxation. The Obama administration plugs in 19 percent for this tax, which would raise \$350 billion over ten years.<sup>5</sup>

Finally, it is time to raise the federal gas tax. This tax is how we fund both highway infrastructure and the federal contribution to public transit, and it has been stuck at 18.4 cents a gallon in nominal terms since 1993. Meanwhile, the costs of maintenance have gone up, as has vehicle mileage, leading to perennial shortfalls in the Highway Trust Fund. A tax on fossil fuels is also smart environmental policy, and there's even been some bipartisan support for the idea. One plan would raise the gas tax by 12 cents a gallon over two years (6 cents per year) and then index it to inflation. That would raise \$180 billion over ten years. With gas prices still very low, the sooner such an increase goes into effect, the better.

### The Non-Relationship Between Supply-Side Tax Cuts and Growth

For decades, some policymakers and economists have maintained that cuts in tax rates will lead to faster growth by raising "supply-side" inputs including labor, capital, and other forms of investment. The argument is that lowering the after-tax cost of investment and raising the after-tax wage will cause the economy's labor supply and capital investment to go up, boosting productivity and growth. The gains will then trickle down to the jobs and incomes of low- and middle-income people.

There's a degree of logic to the first part of this claim, but it is woefully incomplete, even in a theoretical sense. Tax economists Bill Gale and Andrew Samwick recently noted three ways in which this simple supply-side theory must be amended.<sup>6</sup>

First, Gale and Samwick point out that, "while there is no doubt that tax policy can influence economic choices, it is by no means obvious ... that tax rate cuts will ultimately lead to a larger economy in the long run." They note the predicted impacts on wages and investing, but go on to

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<sup>5</sup> Don't conflate this minimum tax on foreign earnings with a repatriation tax holiday. That's a big money loser, as it allows multinationals to bring foreign earnings home from abroad at a much reduced rate, only to start storing them overseas again once the "holiday" has expired (note also that some foreign earnings are merely "booked" abroad to tap the benefits of deferral, but are already accessed by the US parent company). JCT scores tax repatriation as *costing* about \$100 billion over 10 years. A tax holiday cannot constitute a "pay-for" for infrastructure investment (or anything else), as is often suggested, because it is a revenue loser in the long run.

Instead, "deemed" or compulsory repatriation as part of a transition to a more efficient international tax regime would be a very sensible source of income for a sizable, one-time infrastructure investment. Under any transition, there needs to be a process for dealing with the large stock on deferred earnings that is currently booked abroad, which is thought to be in the neighborhood of \$2 trillion. The common approach is a one-time transition tax. President Obama's proposal calls for a 14 percent transition tax, yielding over \$200 billion that could be applied to infrastructure investment.

<sup>6</sup> "Effects of Income Tax Changes on Economic Growth," by William Gale and Andrew Samwick, February 2016.

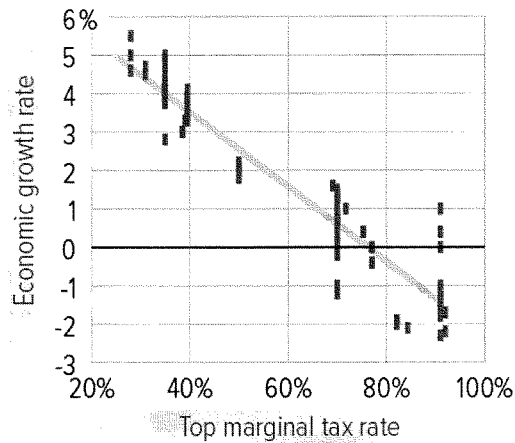
stress that tax cuts “would also raise the after-tax income people receive from their current level of activities, which lessens their need to work, save, and invest. The first effect normally raises economic activity (through so-called substitution effects), while the second effect normally reduces it (through so-called income effects).” On net, some empirical research finds substitution effects to dominate income effects, but Gale and Samwick point out that this outcome is often conditional on the design of the tax cut.

Second, they point out that the growth effects of tax cuts also depend on how they are financed: “Tax cuts financed by immediate cuts in unproductive government spending could raise output, but tax cuts financed by reductions in government investment [e.g., in productive infrastructure or human capital] could reduce output.” They add that deficit-financed tax cuts that increase federal borrowing can reduce long-term growth: “The historical evidence and simulation analyses suggest that tax cuts that are financed by debt for an extended period of time will have little positive impact on long-term growth and could reduce growth.”

Finally, Gale and Samwick argue that rate cuts matched with base-broadeners — the central mantra of tax reform — will raise the effective tax rates faced by some households and firms (due, for example, to the elimination of various tax expenditures). Such increases, they argue, will operate “...in a direction opposite to rate cuts and mitigate their effects on economic growth.” Conversely, they entertain the possibility that base-broadening could reallocate “resources from sectors that are currently tax-preferred to sectors that have the highest economic (pre-tax) return, which should increase the overall size of the economy.”

Given these considerations, the claim that supply-side tax cuts boost investment, jobs, and GDP growth, like any economic theory, must be empirically scrutinized. One simple way to do so is to make scatterplots of the top tax rate in a given year against the growth in the economic variables that those rates are supposed to push up. If the theory is correct, high top marginal rates should be associated with weaker growth and low top marginal rates with stronger growth — that is, we’d expect the dots on the scatterplot to line up as they do in the next figure, showing a made-up inverse relationship between rates and growth, just to give a reference point by which to judge the following plots.

### Example: What Supply-Side Tax Cutters Would Like to See



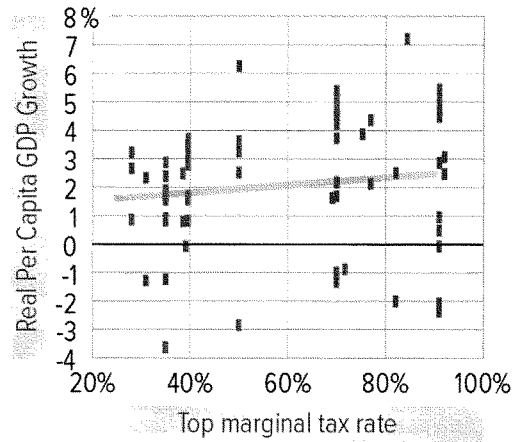
Note: The data in this chart are not real.

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Unfortunately for supply-side theory, the actual graphs, as opposed to the above imaginary one, do not reveal this pattern at all. The five scatterplots below plot the annual percentage change in real per capita GDP, employment, capital investment, productivity, and pretax median family income (respectively) relative to top marginal rates, with annual data running from 1947 to the most recent observation (2014 or 2015). In each case, the top marginal rate is plotted on the X-axis against the percent change in the variable in question on the Y-axis. A “best-fit” line is plotted through the dots.

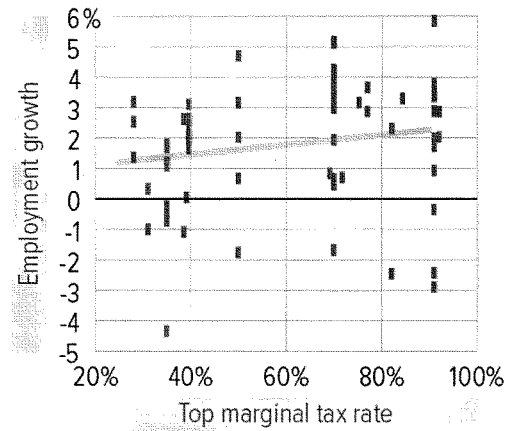
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## No Correlation Between Real Per Capita GDP Growth and Top Tax Rate



Source: CBPP analysis of Bureau of Economic Analysis, Bureau of Labor Statistics, Social Security Administration, and Tax Policy Center data.

## No Correlation Between Employment Growth and Top Tax Rate

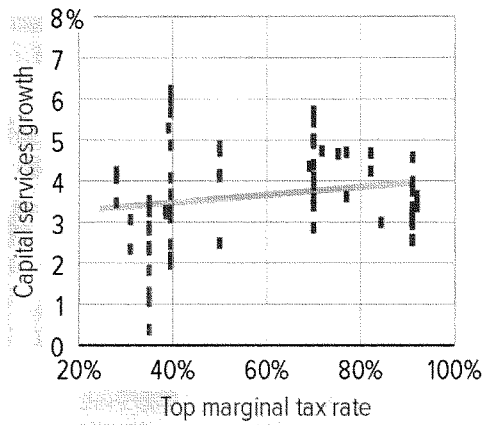


Source: CBPP analysis of Bureau of Labor Statistics and Tax Policy Center data.

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### No Correlation Between Capital Services Growth and Top Tax Rate



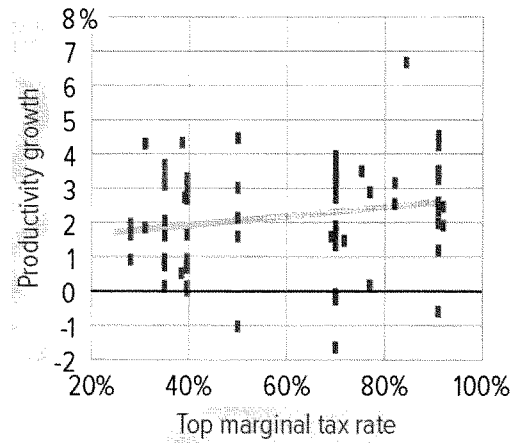
Source: CBPP analysis of John Fernald's growth accounting dataset and Tax Policy Center data.

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## No Correlation Between Productivity Growth and Top Tax Rate



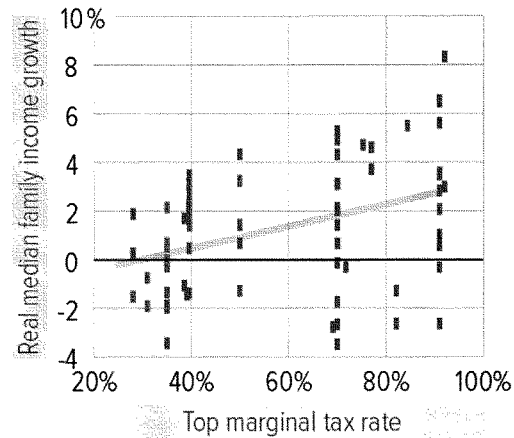
Source: CBPP analysis of Bureau of Labor Statistics and Tax Policy Center data.

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## No Negative Correlation Between Real Median Income Growth and Top Tax Rate



Source: CBPP analysis of Census Bureau and Tax Policy Center data.

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In no case is the relationship negative, as predicted by supply-side theory. To the contrary, the slope of the regression line tends to be positive, though its rise is too mild to be statistically significant (with the exception of pretax median family income).

To be clear, these graphs do not show that higher tax rates *promote* investment, growth, and jobs. First, as noted above, the impact of tax cuts on growth is conditional on numerous factors, including the tradeoff between income and substitution effects, how the cuts are financed, changes in effective rates, and, I'd add, broader economic conditions (for example, temporary tax cuts for low- and middle-income people are likely to be growth-inducing during recessions through demand-side impacts).

Second, the factors that determine growth and its supply-side inputs are many and varied, including demographics, "innovation" (total factor productivity, or output growth net of all relevant inputs), monetary policy, other fiscal policies, and much more, including intangibles such as "animal spirits" and consumer confidence.

But the fact that the simple empirical record is uniformly hostile to the supply-side story, coupled with that story's theoretical shortcomings, should put the burden of proof squarely on those arguing that supply-side tax cuts will be pro-growth.

Piketty, Saez, and Stantcheva have developed evidence similar to that above using cross-country variation. Looking at numerous economies between 1960 and 2010, they show that cuts in top marginal rates were not associated with faster per capita income growth. Instead, they were negatively and significantly correlated with a greater share of national income accruing to the top 1 percent. That is, supply-side tax cuts didn't raise growth; they raised inequality.<sup>7</sup>

Evidence at the sub-national level — where various states, led by Kansas, have been aggressively cutting taxes while policy officials tout the benefits of supply-side tax cuts — also tilts strongly against tax cuts as a growth strategy. The cuts in Kansas that took effect in 2013, for example, have now blown a \$400 million hole in the state's budget. When one of my fellow witnesses, Art Laffer, helped design these cuts, he predicted (along with Stephen Moore of the Heritage Foundation) that they would provide an “immediate and lasting boost” to the Kansas economy. Yet not only have the cuts caused serious underfunding of the state's education system, they've also coincided with weak job and GDP growth. The Kansas Legislative Research Department's projections suggest that the economy will remain weaker than the overall US economy for the foreseeable future.

Advocates of supply-side theory may argue that the benefits of the cuts are just taking longer to appear than they originally predicted, but based on the wealth of empirical evidence shown here and in other analyses I've cited, policymakers would be wise to reject such arguments.

## Conclusion

The goal of a tax code in an advanced economy must be to raise ample revenues in ways that are efficient, pro-growth, and, perhaps most importantly, widely perceived as fair. Complexity is not a function of the number of rates; it is driven by the spate of deductions, credits, exemptions, and myriad other opportunities to avoid taxes through complicated redefinitions of income into forms given preferential treatment by the code.

Of course, our economic lives can themselves be complex, and the tax code will inevitably reflect them to some degree. We very much want, for example, to both prevent poverty and incentivize work among the least well off, and the work-based refundable credits mentioned above have been a highly successful tax expenditure. In fact, there is bipartisan support to increase the EITC for childless adults, who current receive only a very small amount from that worthy program.

We should, however, pursue changes that constitute a “three-fer” by simultaneously boosting revenues, fairness, and simplicity. That means adequately funding the IRS, closing the many loopholes identified in this testimony, and avoiding the supply-side tax cuts that cut strongly against fairness and progressivity with little to nothing to show for them in the way of economic growth. If we do that, we'll have a much-improved tax code.

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<sup>7</sup> One possible explanation is that at higher tax rates, the wealthiest individuals bargain less aggressively for higher pretax compensation (since they'll be able to keep less of each marginal dollar they earn). See Bivens and Mishel (2013): <https://www.aeaweb.org/articles?id=10.1257/jep.27.3.57>.

**Data Note**

Each data point in each chart represents a calendar year. The top federal marginal income tax rate (from the [Tax Policy Center](#)) is on the X-axis of each chart; the Y-axes represent the growth, from one year prior, of the variables in question. Productivity is for the nonfarm business sector; real capital services come from economist John Fernald's growth accounting dataset; GDP has been adjusted for both inflation and population size; and the 2013 value for real median family income (Census Bureau) has been imputed because of changing survey methods.

While these charts only show the non-relationship between top marginal tax rates and contemporaneous economic activity, looking two, three, or four years out does not change the findings. In fact, longer lags often lead to an increased positive correlation with higher top marginal tax rates, a result that stands in direct contrast to what tax cut proponents typically predict.

QUESTIONS FOR THE RECORD FOR DR. ARTHUR LAFFER FROM SENATOR DAN COATS,  
CHAIRMAN

1. In response to a question, you compared the difference in growth between states with an income tax and those without one. How many states are you referencing and could you elaborate in more detail what performance measures you used and how those states compare to their higher-taxed counterparts?

Mr. Chairman, thank you for this question.

As of 2016—and ever since the early 1990s when Connecticut was the last state without an income tax to implement one—there have been nine states without earned income taxes. These states are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming.

The distinction of “earned” income tax is necessary because both Tennessee and New Hampshire have taxes on so-called “unearned” income such as interest and dividend income, although Tennessee is just starting the process of phasing out its “unearned” income tax.

A simple way to examine the effects of earned income taxes on economic growth in states is to compare those nine zero-earned-income-tax states with the nine states with the highest earned income tax rates. Figure 1 below shows this exact comparison over the most recent 10-year window for which data are available.

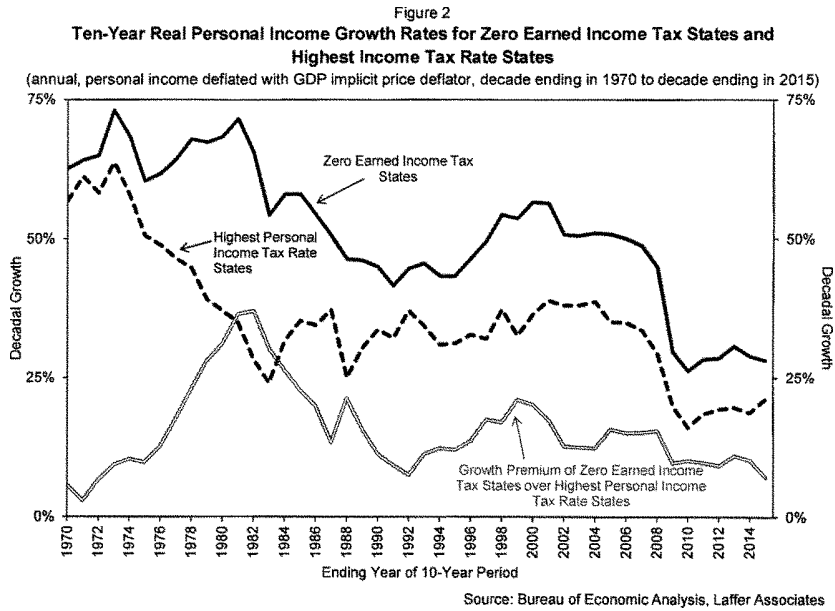
Figure 1  
Nine Zero Earned Income Tax vs. Nine Highest Earned Income Tax Rate States

| State   | As of<br>1/1/2016 | 10-Yr. Growth |                                  |                 |                                     | 9-Yr. Growth                                 |
|---|-------------------|---------------|----------------------------------|-----------------|-------------------------------------|--|
|   |                   | 2005-2015     |                                  |                 | 2004-2014                           | 2004-2013                                    |
|   |                   | Population    | Nonfarm<br>Payroll<br>Employment | Personal Income | Gross State<br>Product <sup>‡</sup> | State & Local<br>Tax<br>Revenue <sup>§</sup> |
| Avg. of 9 Zero Earned<br>Income Tax Rate States*  | 0.00%             | 12.9%         | 8.7%                             | 50.1%           | 50.8%                               | 57.3%  |
| 50-State Avg.*  | 5.74%             | 8.8%          | 5.6%                             | 44.4%           | 41.2%                               | 44.0%  |
| Avg. of 9 Highest Earned<br>Income Tax Rate States*   | 10.09%            | 6.6%          | 3.7%                             | 43.2%           | 39.3%                               | 49.9%  |
| <small>* Averages are equal-weighted. † Top Marginal PIT Rate is the top marginal rate on personal earned income imposed as of 1/1/2016 using the tax rate of each state's largest city as a proxy for the local tax. The deductibility of federal taxes from state tax liability is included where applicable. ‡ Gross State Product growth data are 2004 to 2014 because of data release lag. § State &amp; Local Tax Revenue is the growth in state and local tax revenue from the Census Bureau's State &amp; Local Government Finances survey. Because the U.S. Census Bureau did not release state &amp; local finance data for 2003 and due to data release lag, these data are 2004 to 2013. ¶ New Hampshire and Tennessee tax interest and dividend income—so-called “unearned” income—but not ordinary wage income.</small> |                   |               |                                  |                 |                                     |  |
| <small>Source: Laffer Associates, U.S. Census Bureau, Bureau of Labor Statistics, Bureau of Economic Analysis</small>   |                   |               |                                  |                 |                                     |  |

The metrics examined in Figure 1 are all of the typical measures of a state's economic growth—decadal growth in population, employment, personal income, gross state product and state and local tax revenue. And the results in Figure 1 are clear as bells—the nine states without earned income taxes are vastly outperforming the nine states with the highest earned income tax rates.

And this trend is not a new development that only applies to the most recent ten years. In fact, I've extended this analysis back in time using historical state income tax rates, examining real personal income growth rates in the states without earned income taxes vs. an equivalent number of the highest earned income tax rates (e.g., if, at a point in history, there were 12 states without earned income taxes, I compared growth in those 12 states to growth in the 12 states with the highest earned income tax rates). Again, the results are astounding. Figure 2 below shows that, on a rolling 10-year basis,<sup>1</sup> there hasn't been a single 10-year period over the past 55 years in which the highest earned income tax rate states outperformed the states without earned income taxes.

<sup>1</sup>A “rolling 10-year basis,” means that data are measured in 10-year increments at a frequency of every year. For example, the first data point plotted in Figure 2 would be 10-year growth between 1960 and 1970; the second data point would be ten-year growth between 1961 and 1971, etc.



**Joint Economic Committee Hearing**  
**“Is Our Complex Code Too Taxing on the Economy?”**

**Question for the Record**

**Congresswoman Carolyn B. Maloney, Ranking Member**

**April 20, 2016**

**Question for Dr. Jared Bernstein**

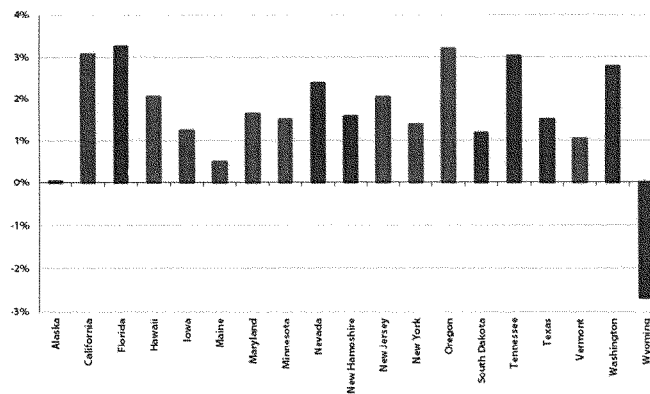
Q. At the hearing, Dr. Laffer made the following statement:

*“If you take the nine states that have no earned income tax in the U.S., if you take the nine states with the highest tax rates, if you look at the growth rates, over the last 50 years, every single year, the nine states without income taxes, earned income taxes, have grown much faster in every single metric than have the nine states with the highest income tax rates.”*

- How does the economic performance of those states with no income tax and those with the highest tax rates compare in 2015?

Economic performance was similar in no-income-tax states and states with the highest top marginal tax rates in 2015. For example, as the graph below illustrates, there is substantial variation in employment among states in each category. While all of the “high-income-tax” states (blue bars) saw employment gains of some magnitude in 2015, for example, no-income tax Wyoming saw a *drop* in employment. Some states with no income tax, like Florida, did rather well, but so did some states with high top marginal income tax rates, like California.

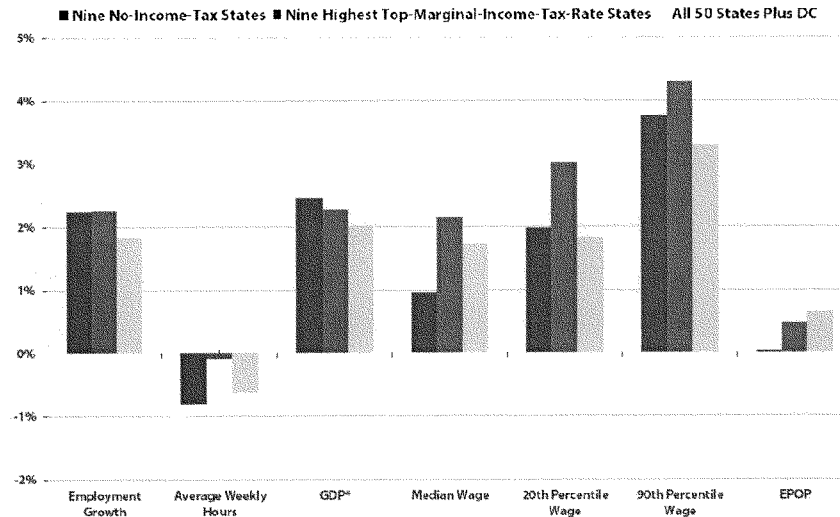
**2015 employment growth (Dec./Dec.), no-earned-income-tax states (red) and high-top-marginal-income-tax states (blue)**



Source: Bureau of Labor Statistics

On average, there were few differences in economic performance between the sets of states in each category – and the differences there were tended to favor states with the highest top marginal tax rates.

#### Economic growth in high-top-marginal-income-tax and no-earned-income-tax states in 2015



\*Growth is measured between December 2015 and December 2014 for jobs and hours, between 2015 Q3 and 2014 Q3 for GDP, and between 12-month averages for the other variables. Sources are the Bureau of Labor Statistics, Bureau of Economic Analysis and the Economic Policy Institute.

- Do GDP and employment grow faster in states with no income tax relative to states with higher income taxes, as Dr. Laffer suggested?

There is no consistent relationship between GDP or employment growth and state income tax rates. 2015 is a good example, as shown in the graphs above; both variables behaved similarly on average in no-income-tax and high-top-marginal-income-tax-rate states in 2015 and there was substantial variation in each variable among both types of states.

- What about if you look at state tax changes and different measures of economic growth over longer time frames – what does that show?

There has long been substantial variation in economic performance among both lower- and higher-taxed states and tax cuts have long failed to deliver on the promises with which they've been sold. In fact, as Michael Leachman and Michael Mazerov described in May of 2015:<sup>1</sup>

<sup>1</sup> <http://www.cbpp.org/research/state-budget-and-tax/state-personal-income-tax-cuts-still-a-poor-strategy-for-economic>

- “Four of the five states that enacted the largest personal income tax cuts in the last few years have had *slower* job growth since enacting their cuts than the nation as a whole.
- Four of the six states that cut personal income taxes significantly in the 2000s have seen their share of national employment *decline* since enacting the cuts. The exceptions — New Mexico and Oklahoma — grew mostly because of a sharp run-up in oil prices in the mid-2000s.
- States with the biggest tax cuts in the 1990s grew jobs during the next economic cycle at an average rate only *one-third* as large as more cautious states.”

Going back even further, the “11 states that enacted income taxes over the past 50 years...on average have *out-performed* the nation since enacting income taxes.”<sup>2</sup> In other words, the evidence over a longer time period also quite clearly contradicts the arguments of proponents of supply-side tax cuts.

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<sup>2</sup> <http://www.cbpp.org/research/alec-tax-and-budget-proposals-would-slash-public-services-and-jeopardize-economic-growth>