PLANNED ORAL TESTIMONY BEFORE SENATE FINANCE, 5/3/11

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Mister Chairman, Ranking Member Hatch, and Members of the Committee, thank you for the opportunity to appear today to discuss tax equity issues. My written testimony addresses three specific topics: the changes in U.S. income distribution since 1986, how tax expenditures affect the distribution of tax burdens, and the implications for tax rate design of curtailing tax expenditures.

The Tax Reform Act of 1986 was designed to be distributionally neutral relative to prior law through the tradeoff between reducing tax rates and broadening the base. In assessing high-end distributional neutrality, the Treasury and Congress looked at only two high-income groups: those earning from $100,000 to $200,000, and $200,000 or more. In 2011, by contrast, the President's Fiscal Commission examined how its proposal would affect each of the following groups: the 80th to 90th percentile, 90th to 95th, 95th to 99th, the top 1 percent, and the top 0.1 percent.

A similar change in focus emerged during the 2010 debate concerning extending the Bush tax cuts for people at the top of the income distribution. Many on both sides of the debate argued that people at the very top were importantly different from those earning only, say, $250,000.

This change reflects widespread public awareness of rising high-end income concentration – a trend on which there is almost 100 percent academic consensus, *not* depending on people's policy preferences. Rising high-end income concentration has also been widely noticed in our society, and has so strongly influenced broader social and political attitudes, that Congress, when evaluating tax reform and more particularly tax rates, may want to think about it.

My second point pertains to the distributional effects of the big tax expenditures for middle and upper income taxpayers – for example, the home mortgage interest deduction, exclusion for employer-provided health insurance, and charitable deduction. Two things are clear. First, financial benefit from these items rises faster than income as one goes from the bottom of the income distribution to the 99^{th} percentile. Second, at the very top the benefit shrinks as a percentage of income. This means that a 1986-style trade of lower rates for base-broadening would likely create winners at the very top, at least absent the repeal of items, such as the 15 percent dividend rate, that arguably aren't tax expenditures.

Congress could, if it chose, address these items' distributional effect without entirely repealing them. For example, it could create or reduce dollar caps on items such as home mortgage loan principal, and/or it could convert various deductions and exclusions into uniform-rate percentage credits.

My third point concerns the relationship between repealing tax expenditures and deciding whether to reduce marginal tax rates. Often the two changes are grouped together, 1986-style, on the view that base-broadening alone would excessively increase tax revenues.

But to view repealing tax expenditures as a tax increase requires forgetting the very point that often motivates calls for repeal, which is that they are "spending through the Tax Code," as the Fiscal Commission said. The House of Representatives' Fiscal Year 2012 Budget Resolution essentially agrees.

The late economist David Bradford offered a powerful illustration of the point that tax expenditures are actually disguised spending. He described a pretended "secret plan" to eliminate the budget deficit by formally cutting spending rather than taxes. In Step 1, suppose $50 billion of defense spending on weapons procurement is eliminated. In Step 2, a new $50 billion "weapons supplier tax credit" is enacted to make sure that the Pentagon gets the very same weapons from the very same suppliers, effectively at the very same prices.

While nothing actually changes, officially both "tax revenues" and "spending" decline by $50 billion. Thus, the accompanying enactment of a $50 billion tax increase, accomplished by raising tax rates, would mean that deficit reduction – officially, but not in economic substance – had been accomplished purely by cutting "spending" in the amount of $50 billion.

For any tax expenditure that similarly is disguised spending – although the label doesn't always fit items on official lists – repealing it is in economic substance a spending cut, not a tax increase. Thus, while stand-alone tax expenditure repeal would increase officially measured tax revenues, it would not make the government "larger" in any meaningful economic sense. And that is presumably what people have in mind when they debate tax and spending levels in the federal budget.

Given how tax expenditures are misclassified, officially measured revenue neutrality (as distinct from budget neutrality) is merely a semantic goal, unrelated to economic substance. So tax rates should be cut if and only if that is Congress's independent policy preference, not due to base-broadening as such. Congress also should keep in mind that base-broadening generally *reduces* the efficiency loss from a given statutory tax rate, by making the tax harder to avoid.

Let me close by quickly mentioning two further points from my written testimony. *First*, there is no chance, given where U.S. marginal income tax rates on individuals are today, that reducing them would raise revenue. *Second*, the economic growth dividend that a tax rate cut would yield, even if fully financed, is probably modest at best. A huge body of data fails to provide the evidence for a significant growth effect that would be impossible to miss if that effect were large, rather than at best quite small.