

***Tax Notes* 30th Anniversary**

Remarks

by

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Over the past thirty years, *Tax Notes* has become the way to keep up with developments in tax policy. However, it is instructive to realize that, as elsewhere in life, in taxes “the more things change the more they stay the same.” The September 25, 1972, *Tax Notes* featured a story on lobbying efforts by grain exporters to qualify for DISC (Domestic International Sales Corporation) benefits on exports to Russia. Imagine that – a story on agriculture policy and international taxation! And the pattern continues. In April 1974, the focus was on financing a health bill. The January 28, 1980 issue contained “Quotations from Chairman Long” – has there ever been a more widely quoted Ways and Means Chairman? The January 7, 1985 issue “Environmental groups and energy industry split over Treasury reform plan.” Sound familiar? Or, how about the January 1, 1990 headline “U.S. foreign tax law poses future challenge” or January 2, 1995 “Tax cuts and the deficit”? You get the idea. Indeed, it is probably fair to include as well the observation that the January 3, 2000 issue covered “Seize the day – valuation and post-death events,” “Biggest news for EOs: birth of TE/GE disclosure requirements,” and “From shelters to hookers, 1999 was a lively year in the courts.” The moral here is that an awful lot of important tax policy takes place below the headlines.

Nevertheless, even if many of the issues were recurring, keeping up has been quite a challenge. In the thirty years since its inception, the United States has witnessed the Tax Reform Act of 1976, the Revenue Act of 1978, The Economic Recovery Tax Act (1981), the Tax Equity and Fiscal Responsibility Act (1982), the Deficit Reduction Act (1984), the Tax Reform Act of 1986, the Revenue Reconciliation Act of 1993, the Taxpayer Relief Act of 1997, the Economic Growth and Tax Relief Reconciliation Act of 2001, and the Job Creation and Worker Assistance Act in 2002. Because the significance of tax law changes are greatly in the eye of the beholder, another speaker might have a different list. And certainly everyone is entitled to their own ranking of the good (the broad rate reductions in the 1981 Act), the bad (raising marginal rates in

1993), and the ugly (the continued creeping expansion of the Alternative Minimum Tax). But I am getting a bit ahead of myself, as I should not be passing out final grades before covering the material. With that in mind, let me turn to the fiscal and intellectual currents during the *Tax Notes* era thus far.

The Evolution of Federal Government Receipts

The fundamental purpose of taxes is to provide receipts necessary to fund the operation of government. As the table below reminds us, this task has become much larger with the passage of time. Between 1970 and 2000, the receipts raised by federal taxes rose over tenfold in nominal terms, and by over 130 percent when adjusted for inflation (as measured by the Consumer Price Index). Of course, the underlying economy grew as well, with the result that federal receipts as a share of Gross Domestic Product rose from 18.6 percent to 20.6 percent.

The composition of federal receipts has changed dramatically over the *Tax Notes* era. As the table indicates, the share of federal receipts derived from the individual income tax has crept up modestly over the period, while the share accounted for by various “other” receipts was essentially unchanged. In contrast, the remainder of federal finance showed large changes. Reflecting the well-known rise in the importance of Social Security and Medicare entitlements, the share from payroll taxes rose by over fifty percent, while the shares derived from corporation income taxes and excise taxes dropped noticeably.

The Evolution of Federal Government Receipts

Year	Federal Receipts (Billions)	Income Taxes		Social Insurance Taxes and Contributions		Excise Taxes	Other
		Individual (percent)	Corporate (percent)				
1970	193	46.9%	17.0%	23.0%	8.1%	4.9%	
1975	279	43.9%	14.6%	30.3%	5.9%	5.4%	
1980	517	47.2%	12.5%	30.5%	4.7%	5.1%	
1985	734	45.6%	8.4%	36.1%	4.9%	5.1%	
1990	1,032	45.2%	9.1%	36.8%	3.4%	5.4%	
1995	1,352	43.7%	11.6%	35.8%	4.3%	4.6%	
2000	2,025	49.6%	10.2%	32.2%	3.4%	4.5%	

Source: Budget of the United States Government, Historical Tables, 2003.

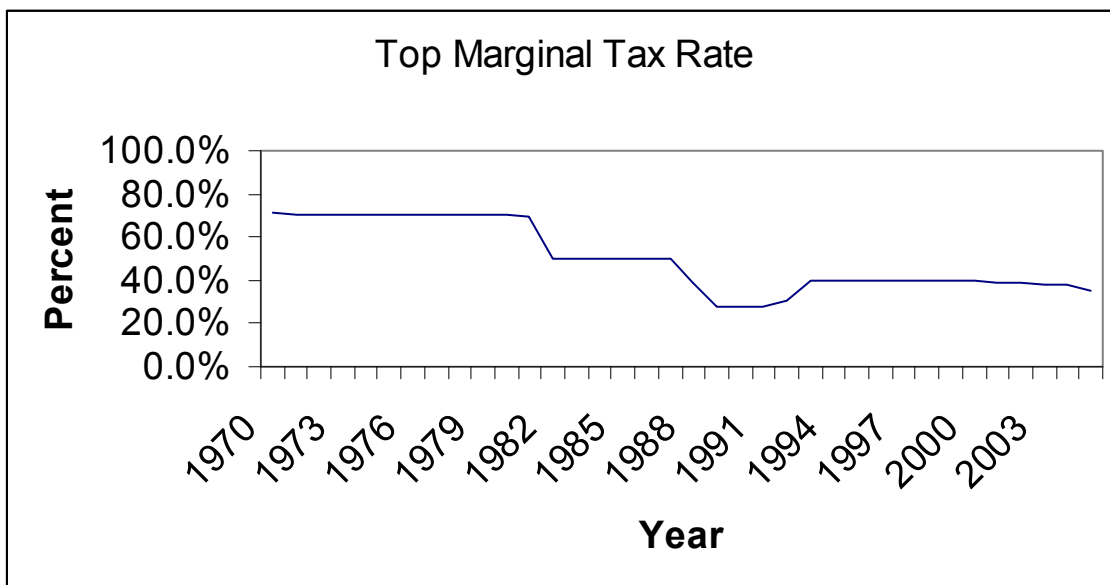
Over the same period, there has been considerable shift in the sources of individual income taxes. In 1970, the top one percent of taxpayers accounted for roughly 17 percent of all tax receipts, while the top 50 percent were the source of 83 percent. By 1985, these shares were 21 percent and 88 percent, respectively, in part due to a rise in the shares of adjusted gross income (AGI) accruing to these groups. The share of AGI for the top one percent rose from 7 percent to 10 percent, while the share for the top 50 percent rose from 75 percent to 78 percent.

This growth in the concentration of tax payments has continued over the latter half of the period (data from 1986 onward are derived from a different source, accounting for the sharp change shown in the table). By 2000, the top one percent of taxpayers were the source of 37 percent of individual income tax receipts, while the top five percent accounted for more than one-half (57 percent) of receipts. Strikingly, the top one-half of taxpayers pay 96 percent of the individual income taxes. In light of these figures, academic discussions of the progressivity of the income tax often have a “missing the forest for the trees” feel to them – the income tax is paid almost entirely by the relatively well-to-do.

Shares of Income Taxes and Income Share of Individual Income Taxes [Share of Adjusted Gross Income]					
Year	Top 1%	Top 5%	Top 10%	Top 25%	Top 50%
1970	16.7 [7.4]	31.4 [18.3]	41.8 [28.0]	62.2 [49.4]	83.0 [74.7]
1975	16.8 [7.2]	32.7 [18.3]	43.5 [27.9]	64.3 [49.5]	84.9 [74.9]
1980	17.4 [7.8]	33.7 [19.2]	45.0 [29.1]	66.6 [51.4]	87.0 [76.7]
1985	20.9 [9.6]	37.0 [21.3]	48.1 [31.2]	68.9 [53.6]	88.3 [78.3]
1990	25.1 [14.0]	43.6 [27.6]	55.4 [38.8]	77.0 [62.1]	94.2 [85.0]
1995	30.3 [14.0]	48.91 [28.8]	60.8 [40.2]	80.4 [63.4]	95.4 [85.5]
2000	37.4 [20.8]	56.5 [35.3]	67.3 [46.0]	84.0 [67.2]	96.1 [87.0]

Source: IRS and CEA calculations based on IRS Publication 1304, various years.

One reason for the relatively schizophrenic discussions of progressivity has been the evolution of marginal tax rates over this period. As shown below, the top marginal tax rate has declined considerably over this period, falling from 71.75 percent in 1970 to 35 percent when the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) law is fully phased-in, despite taking a detour in the early 1990s. Declines in marginal tax rates have had beneficial effects in reducing the deadweight loss of the tax system, removing hindrances to risk-taking and entrepreneurship, and providing incentives for work and saving. High marginal tax rates encourage a wide range of avoidance activities that inevitably lead to subsequent regulations and reporting in an attempt to control these actions. The result is a tax code that is needlessly complex and intrusive. Continued attempts to keep marginal tax rates low will minimize these corrosive impacts on our revenue system.



Standing in stark contrast to the overall decline in marginal tax rates has been the growth in social policy through the tax code. One way to see this is to compare the targeted tax preferences such as adjustments to income (exclusions for targeted purposes in addition to the costs of earning income) or tax credits in 1970 versus now. A glance at the comparison (see the table, below) is makes the basic point quite clearly: the tax code has grown more complicated through efforts to use it for purposes well beyond the objective of financing government operations.

Adjustments to Income and Credits: Then and Now	
1970	2002
<i>ADJUSTMENTS TO INCOME</i>	
Sick pay	IRA deduction
Moving expenses	Student loan interest deduction
Employee business expense (itemized deduction in 2002)	Archer MSA deduction
Self-employed retirement plan contributions	Moving expenses
	Higher education expense deduction
	One-half self employment taxes
	Self-employed health insurance
	Self-employed SEP, SIMPLE, and qualified plans
	Penalty on early withdrawal of savings
<i>TAX CREDITS</i>	
Retirement income credit	Child tax credit
Investment tax credit (form 3468)	Foreign tax credit (form 1116)
Foreign tax credit (form 1116)	Lifetime Learning credit (form 8863)
Throwback credit (for certain beneficiaries of a trust)	Hope credit (form 8863)
	Adoption credit (form 8839)
	Earned income tax credit
	General business credit (form 3800)
	Credit for prior year minimum tax (form 8801)
	Mortgage interest credit (form 8396)
	Qualified electric vehicle credit (form 8834)
	Empowerment zone employment credit (form 8844)
	District of Columbia first-time homebuyer credit (form 8859)
	Nonconventional source fuel credit

What insights emerge from this cursory review of the *Tax Notes* era? Certainly the pages of *Tax Notes* have documented the rising dissatisfaction with the current tax system, bringing tax

reform to the front burner of policy issues, At the same time, however, the increasing reliance on taxing higher-income households and targeted social preferences at lower incomes stands in the way of moving to a simpler, flatter tax system. Reform is more important than ever, but will not be easy.

These shifts in the structure of federal revenues reflect the well chronicled – at least by *Tax Notes* – influences of larger budgetary currents, political considerations, and charismatic figures in Congress and the White House. But they also reflect – or perhaps my academic roots make me hope they reflect – the large body of tax-related research and the shifting tides of intellectual sentiment.

The prevailing intellectual mindset in 1970 reflected a very “static” vision in two ways. First, individuals and firms were perceived to be unresponsive to the influences of marginal tax rates. Labor supply was equated to hours of work and viewed as inelastically supplied. Reflecting the Keynesian consensus, saving was a fixed fraction of income. Business investment was viewed as unresponsive to the cost of capital – indeed it was driven by “animal spirits” if anything at all. In short, behavioral responses to “price” incentives were not at the center of tax policy analysis. In similar fashion, the overall paradigm was equally static – typified by the *IS-LM* analysis of macroeconomic equilibrium.

In this setting, the objectives of tax policy were to achieve a “fair” distribution of the tax burden – after all there was little in the way of a perceived efficiency-equity tradeoff. Moreover, with little focus on intertemporal issues, there was no reason to distinguish among different of income. The upshot was a goal of levying a progressive tax on comprehensive, Haig-Simons income with the objective of satisfying horizontal and vertical equity considerations. Periodically, the entire tax burden might be modified for macroeconomic stabilization purposes, but the microeconomic goal was to translate pre-tax to after-tax incomes statically in a “fair” fashion.

Over the succeeding three decades, research and policy objectives diverged for a decade or so, and then again joined forces. On the research side, the development of large-scale

databases, increased computational power, and sophisticated econometric techniques permitted investigators to begin to develop a greater appreciation of the role of taxes in economic activity. Studies revealed that labor supply had many dimensions – hours, effort, occupation, human capital accumulation, and entrepreneurship – and that these responded to tax-induced incentives. A closer examination of tax-based savings incentives suggested large responses, while microeconomic analysis of firms’ investment and financing incentives revealed a comparable sensitivity to tax considerations. With rise of large international capital flows in the 1980s, international tax considerations arose, with evidence of strong incentives to locate foreign investment on the basis of tax considerations and suggesting that tax policy was at the heart of many financial flows such as dividend repatriation. Finally, a large body of research on income reporting, tax avoidance, and tax evasion indicated that the effect of taxes extended beyond “real economic” behavior to include a wide variety of accounting and reporting incentives.

A parallel growth occurred in the quality of tax simulation models. Life-cycle models for tax policy evaluation – as typified by the work of Alan Auerbach and Larry Kotlikoff and others – indicated the potential for efficiency gains from alternative tax systems such as a consumption-based tax. Life-cycle analysis also brought to the forefront entirely different notions of equity based on lifetime income, or lifetime consumption.

The sharp reduction in marginal tax rates in the 1981 Economic Recovery Tax Act stands as tribute to the success of this research in chipping away at the intellectual consensus of the 1970s. However, the power of the Haig-Simons dream is best illustrated by the Tax Reform Act of 1986. While far from a complete success, the most striking aspect of that Act was its basic objective—a comprehensive income tax with progressive rates.

Given this, it is probably not surprising that the Tax Reform Act began to unravel nearly immediately. Indeed, looking back from the current interest in tax reform, to the predecessor efforts dating from *Blueprints for Basic Tax Reform*, the Tax Reform Act reflected neither an appreciation for the importance of integration as a key feature of any fundamental tax reform nor for the importance of recognizing the complexity effects of a progressive income tax.

Where do we go from here? What will future issues of *Tax Notes* document in the tax policy debate? Of course, some things are likely to be the same. Certainly, the impact of tax policy changes on the overall federal fiscal situation will continue to figure into future debates. Here, at least, one can hope that the discussion will move away from the current fixation with linking budget deficits with interest rates. This linkage does not make a great deal of sense in a world in which global capital markets move trillions of dollars, and federal borrowing is only one— and far from the primary — use of funds. Not surprisingly, the evidence is that long-term interest rates do not move in lockstep with actual or expected federal budget changes.

For example, between 1993 and 1994, the federal deficit fell by one percent of GDP, and between 1999 and 2000, the federal surplus rose by one percent of GDP. In both instances, the yield on 30-year Treasury securities increased; not decreased. Or, recall that in January 2001, the CBO projected the FY2002 budget surplus at \$313 billion. Ten-year treasuries averaged 5.16 percent that month. Currently, it turns out that the actual FY2002 deficit is \$159, a swing of \$472 billion. The impact on interest rates? Ten-year Treasury yields are now 4.19 percent. Finally, a look across the globe immediately highlights the contrasts between the United States and Japan. Compared to the United States, Japan has run chronic budget deficits and has a ratio of debt to GDP roughly twice that of the United States. Using the most recent (August) data, the 10-year government bond yield was 1.26 percent in Japan, and consumer deflation was 1.19 percent — yielding real interest rate of 2.5 percent. In the United States, Ten-year Treasuries averaged 3.87 percent in September and core CPI inflation was 1.26 percent — a 2.6 percent real interest rate (and very close to the 2.35 percent yield on Ten-year TIPS).

The bottom line is that real interest rates are not dictated by country-specific short-term deficits. Moreover, the unified deficit can be a very misleading indicator of the overall federal fiscal position. A vivid, and widely-acknowledged example, is that current commitments to spending on entitlements like Social Security and Medicare far outstrip the revenues allocated to these programs. Put differently, the balance-sheet position of the federal government, particularly the present value of liabilities, better reflects the fiscal position. Hopefully, future discussions of tax policy, the budget outlook, and fiscal discipline will be framed by a discussion of how policy changes alter the balance sheet position of the government. In this framework, the

contribution of pro-growth tax policies to the future resource base would be accurately reflected, as would the detrimental effects of out-year expansions of entitlements.

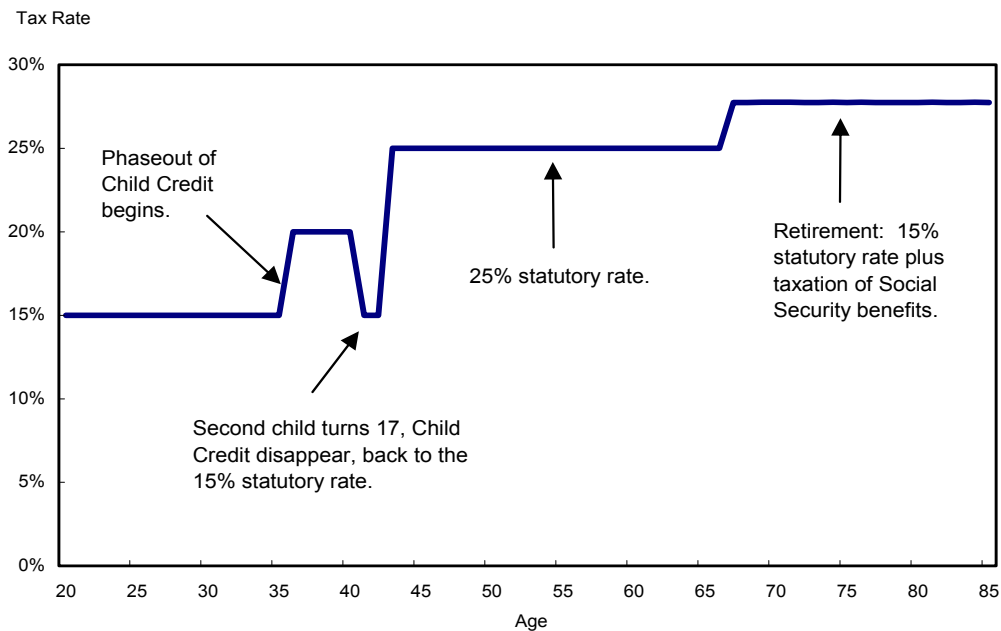
Another perennial that is likely to continue to flower is the distributional aspects of tax policy. In this regard, probably the most important development will be to bring our notions of distributional analysis in line with the general progress on issues of lifetime incidence and other approaches that incorporate more information than the conventional, one-year snapshot. Put differently, it is important to recognize the mobility of taxpayers across tax brackets and preferences.

Of course, taxpayers do not face the same tax rate over time, but rather shift across tax rate brackets in response to a broad number of changes in their lives. For example, in looking at the implications of the fully-phased-in EGTRAA law, one finds that over a ten-year period about 53 percent of the taxpayers moved to a different tax rate bracket. There was significant movement toward higher tax brackets – upward mobility – as about 28 percent of taxpayers moved to a higher tax rate bracket after ten years. In particular, roughly 66 percent of the taxpayers in the bottom bracket moved to a higher bracket after ten years – mostly to the 10 percent or 15 percent brackets. At the same time, there is also substantial movement down the brackets, as about 26 percent of taxpayers moved to a lower tax bracket. About 51 percent of the taxpayers in the top rate bracket in the first year were in a lower tax bracket after ten years.

A number of factors explain the fluidity of taxpayers across the tax rate brackets over time. One piece of the puzzle is that most taxpayers' incomes grow as they gain job experience and education, but decline in retirement as they leave the workforce and rely on their Social Security benefits, pensions, and savings, which may be nontaxable. To be concrete, think of a two-earner couple with two children making about \$65,000 when they are both 30. Suppose that over their life they work, pay income and Social Security taxes, buy a home, save for life's uncertainties, kids, education, and retirement in taxable accounts plus a 401(k), retire, collect Social Security, and live to the age of 85. For simplicity, assume they do not benefit from an inheritance, nor leave a bequest.

As the chart below shows, the taxpayer's effective marginal tax rate varies greatly over the life cycle, with rates rising, falling, and then increasing once more. This pattern of effective marginal tax rates is particularly influenced by the phase-outs of tax preferences like the child credit, and the taxation of Social Security benefits.

Marginal Tax Rates for the Hypothetical Couple



Note: Calculations are for joint two-earner family with moderate lifetime income and assume not subject to the alternative minimum tax.
Source: CEA Calculations

Many taxpayers also have short-term fluctuations in their income as they move in and out of the labor force or between jobs, or their business and investment income are hit by the ebbs and flows of the business cycle. Finally, factors other than income, such as having children, marriage and divorce, giving to charity, unusually high medical expenses, and home mortgage interest, can all affect in which tax bracket a taxpayer falls.

The need for more sophisticated distributional analyses that incorporate life-cycle and mobility elements will raise the stakes for tax policy analysts. As I noted earlier, considerable progress has been made in using life-cycle models for policy analysis. However, these models generally suffer from an inability to capture the sources of the observed distribution of income and wealth. In particular, there is a widely documented research literature noting the difficulties

of the life-cycle model in accounting for wealth accumulation. An important reason for this is that it is typically the case that the only way to “get rich” in these models is to save at the risk-free rate of return. In reality, an enormous fraction of the observed differences in wealth and income derive from returns to luck, risk-taking, and monopoly rents of some duration. Until tax policy models incorporate these features, they will fall short of our needs for realistic distributional analyses.

A similar modeling problem arises in the context of macroeconomic dynamics. Most recently, this has been couched in terms of dynamic scoring. Clearly, the idea of dynamic scoring is conceptually correct. The basic notion in revenue estimation is to calculate the yearly revenue – from all relevant sources – over the appropriate budget window under current law. To do so requires evaluating the economic activity that would prevail using current tax rules, redoing the calculation using the tax code as modified by the proposal (which clearly requires knowing the economic activity – including all relevant tax bases – under the alternative tax rules), and comparing the revenue in the latter to the revenue in the former. It may be difficult in practice to estimate each step, but this should not disguise the basic objectives.

The main desirable feature of is to provide additional information about the tax policy process. A cost of the tax system is the distortion that taxes cause to incentives to undertake a wide range of economic activities – such as work, saving, investment, and entrepreneurship. The distortion causes GDP to be lower than it would be in the absence of the tax system, or at least lower than it would be in the presence of a more efficient tax system. Adding this information aids policymakers in making the right choices for the economy.

Put differently, we should make efforts to ensure that policy decisions should reflect economic effects; not just revenue effects. To do so raises the bar on the standards for models of the impact of taxes on the economy and economic growth. I trust that *Tax Notes* will spend much of the next thirty years chronicling these developments.

This suggests, of course, that *Tax Notes* stories thirty years from now will look both very different and very similar to the survey at the outset. There will still be a “Focus on Treasury?”

and a need for “IRS Regulations,” but my hope is that in the face of sophisticated, dynamic analyses of a pro-growth tax code the balance will have shifted more toward the former and away from the latter.