TESTIMONY OF R. GLENN HUBBARD
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
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Thank you, Mr. Chairman, for the opportunity to appear before the Committee today to discuss options for fundamental reform of the Nation's tax code. The discussion that you and the President are leading offers an opportunity for public policy to improve living standards for all Americans, while providing a simpler and fairer tax code. Indeed, given recent estimates that annual gains in household income made possible by tax reform are as high as nine percent, few policy changes you evaluate are as significant.

CAPITAL INCOME TAXATION AS A PROBLEM

The bulk of the considerable efficiency gains from fundamental tax reform are achieved by reducing the burden of capital income taxation, which arises from the multiple layers of taxation on certain forms of productive business investment. Capital income taxation is also at center stage in the complexity of the present tax system (for example, measurement of capital gains and depreciation and the numbing complexity of tax rules governing multinational companies).

President George W. Bush has pursued an agenda of reducing the efficiency and complexity costs associated with capital income taxation. Yet fundamental tax reform – moving from the current tax system to a broad-based income tax or consumption tax with a simpler structure and lower marginal rates – would be on the watch list for action even without the President's interest. Part of this emphasis reflects the concerns of economists and policy mavens that tax reform could improve the efficiency of the economy and generate extra income for U.S. citizens. But practical factors in policy debates loom much larger – the perceived declining competitiveness of U.S. firms, the low rate of saving by most Americans, and the growing reach of the alternative minimum tax into the lives of millions of middle-income households.

These real-world pressures supported President Bush's tax cuts of 2001, 2002, and 2003. By means of his tax cuts and discussions of tax reform, President Bush has quietly made the case for a simpler tax system that would remove or at least sharply reduce the current-law tax bias against saving and investment. Indeed, the president's framing of the tax reform debate has corralled the real-world pressures for reform into a discussion of a consumption tax as a way of flushing out the familiar "simpler, fairer, flatter" goals of tax reform. And one would hope that this discussion will focus on how to broaden the tax base to make the marginal tax rates on investment (and work and entrepreneurship) as low as possible.

So, if capital income taxation is the "elephant in the room" of tax reform discussions, why is fundamental tax reform so difficult to accomplish? This framing will likely provoke loud outcries that consumption-based tax reform is unfair or, in the language of economists, “regressive.”

One “fairness” concern about any fundamental tax reform that would broaden the tax base and reduce marginal tax rates is that top rate reductions would benefit only a handful of affluent taxpayers. This “snapshot” distributional analysis calls to mind the imagination of Tevye the Milkman in *Fiddler on the Roof*, who in the song “If I Were a Rich Man” thinks of one staircase just going up and another just going down. But in the same way that actual staircases allow for both upward and downward mobility, the tax system sees considerable income and tax rate mobility on the part of households. As a result, the reductions in marginal rates made possible by tax reform affect many more individuals than a snapshot would suggest.

In 2003, the White House Council of Economic Advisers used Treasury Department Data on households for the years 1987 to 1996 to study how households change income tax brackets over time (see Council of Economic Advisers, 2003, Exhibit 5.4). More specifically, the economists used the data to ask what tax rates would households have faced had President Bush’s Economic Growth and Tax Relief Reconciliation Act of 2001 been in place over this period. The tabulations revealed that more than half of taxpayers were in a different tax rate bracket at the end of the period and that the upward and downward mobility was significant: Two-thirds of taxpayers in the lowest bracket had moved to a higher bracket after ten years, and four times more taxpayers were subject to one of the top two tax rates in at least one of the ten years than was indicated by the initial snapshot.

Another significant “fairness” concern about tax reform in the form of a consumption tax is the claim that such a tax would exempt income from saving from tax. To the extent that higher-income and wealthier houses save more, a shift to a consumption tax might appear to favor these households. Such an argument is intuitive – but wrong (see Hubbard, 2005). A broad-based consumption tax need not be more regressive than a broad-based income tax. The real challenge for tax reform is to accomplish either one.

BENCHMARKS FOR TAX REFORM

I suggest as benchmark tax reforms systems that would tax income once. To facilitate comparison between “income tax” and “consumption tax” versions of reform, I focus on two-part tax systems, with a business tax and a household tax. While I describe examples with a uniform rate of tax, it is easy to introduce progressivity with multiple tax brackets and an exemption in the household tax.

Proposals for fundamental tax reform typically suggest moving to either a more pure income tax or a more pure consumption tax. Although these two proposals appear to be on opposite ends of a spectrum, the purer income tax and the purer consumption tax may affect economic and corporate financing decisions in similar ways. Moving to a purer tax system of either type also would reduce tax-planning opportunities because tax-minimizing strategies often involve combining transactions with different tax treatments (that is, part of the transaction receives pure income-tax treatment, while another part receives consumption-tax treatment) or by taking advantages of disparities in tax rates across investors.

Broad-Based Income-Tax Reform

For economic and corporate financing decisions, the critical element of fundamental reform of the income tax is the integration of the corporate and the personal income-tax systems. In theory, integrating the systems would eliminate two distortions from the current tax system. First, integration would eliminate the distinction between corporate and noncorporate businesses by abolishing the double taxation of corporate income. Second, this reform would remove the differential taxation of debt and equity financing.

The U.S. Treasury Department's study of corporate tax integration (see U.S. Department of the Treasury, 1992) presents several alternative approaches to integrating the individual and corporate tax systems. One proposal, the Comprehensive Business Income Tax (CBIT) seeks is to tax business income once. CBIT is a business-level tax on the return to capital of businesses. Broadly speaking, the business-level tax base under CBIT is revenue from the sale of goods or real assets less wages, material costs, and depreciation allowances for capital investments. To conform to standard income accounting principles, the CBIT base uses depreciation allowances that follow as closely as possible economic depreciation. CBIT does not distinguish whether investment is financed by debt or equity. That is, in contrast with the current tax system, CBIT would not allow businesses to deduct interest payments from their tax base. Because CBIT taxes business income at the entity level, there is no need for investor-level taxes on capital gains, interest, or dividends received. CBIT can be thought of as the capital income tax component of a broad-based income tax that collects taxes form labor income through a household-level wage tax.

Converting the Income Tax into a Consumption Tax

Converting CBIT into a consumption tax turns out to be quite straightforward. Instead of measuring business income through depreciation allowances, a consumption-tax version of CBIT would allow businesses a deduction for capital investments when assets are purchased. This "expensing" adjustment converts the combination of CBIT and a wage tax into the flat tax proposed by Hall and Rabushka (1983).

Having described CBIT and the flat tax in this way, we can see that the flat tax does not exempt all of what is commonly called "capital income" from taxation (see also Gentry and Hubbard, 1997, 1998). Under the business cash-flow tax component of the flat tax, the present value of depreciation allowances for one dollar of current investment is one dollar, while the present value is less than one dollar under the income tax. For an investment project, the tax savings from depreciation allowances represent risk-free flows, which the firm would discount at the risk-free rate of interest. For a marginal investment (in which the expected rate of return just equals the discount rate), the upfront subsidy to investment provided by expensing equals the expected future tax payments. It is only in this sense that the "return to capital" is not taxed under a cash-flow tax or a consumption tax. But returns attributable to entrepreneurial skill or risk bearing are, in principle, taxed equivalently under fundamental income or consumption tax reform prototypes.

To summarize, then, I use the term "fundamental tax reform" to represent tax proposals with the following characteristics:

1. It is a combination of a business-level tax (with either cash flow or business income as the base) and a household wage tax.
2. For an income-tax version of reform, depreciation allowances are as close to economic depreciation as possible; for a consumption-tax version of reform, businesses will deduct capital expenditures.
3. The business-level tax does not distinguish between debt and equity financing.
4. In order to minimize the differences in marginal tax rates across business entities and investments, firms carry net operating losses forward with interest.
5. There are lower marginal tax rates with a single marginal tax rate across business entities and households; the household tax can have a personal or family exemption.

Fundamental income tax reform and consumption tax reform contribute to economic efficiency by accomplishing corporate tax integration. Returns to business investment would be taxed once at the business level and not again at the household level. Both reforms eliminate financial distortions under current law (that arise from the tax bias against corporate equity and dividends – see, for example, Gertler and Hubbard, 1993) and organizational distortions under current law (that arise from the tax bias against C corporations). Both reforms are consistent with a "dividend exemption" or territorial tax system for multinational companies, and this consistency is desirable (Devereux and Hubbard, 2003).

The consumption tax version of tax reform offers an added benefit: the benefit of expensing of business investment will stimulate investment, capital formation, and economic activity. Such a business tax system would also be simpler. While expensing entails a greater revenue cost than depreciation, one must be careful to note that over the long run, the difference is only the time value of money on depreciation allowances (that is, comparing the value of allowances all at once – expensing – versus allowances taken over time – depreciation).

Substantial efficiency gains estimated for corporate tax integration (see, for example, U.S. Department of the Treasury, 1992; Altig, *et al.*, 2001; and Hubbard, 2003) do not capture all the possible sources of economic gains. First, as noted above, expensing offers an incremental gain. Second, reductions in marginal tax rates can increase growth through human capital investment (as in Lucas, 1988) and entrepreneurial risk taking (Gentry and Hubbard, 2004; and Cullen and Gordon, 2002). A third channel arises if base broadening in tax reform permits a lower business tax rate. Lee and Gordon (2005) estimate using cross-country data that a lower corporate tax rate is associated with more rapid economic growth, a correlation they attribute to a lower corporate tax encouraging more entrepreneurial activity.

THE WAY FORWARD

Mr. Chairman, this Committee has the opportunity to reform the nation's tax code in ways that will enhance living standards, improve tax fairness, and reduce the enormous complexity that wastes billions of dollars each year. Reform of business taxation will be a major element of the overall reform debate, particularly given the overarching interest of tax reform in reducing tax burdens on saving and investment to promote economic growth.

As you evaluate options for tax reform, I urge you to focus on prospects for improving growth. You can address tax fairness concerns as well by broadening the tax base of both the business and household tax systems. I also urge you to include estimated effects on economic growth and incomes of tax reform in your evaluation of revenue and distributional impacts of tax reform. While many interests will approach you for "transitional relief," the case for large "transition costs" of tax reform for businesses as a whole is more difficult to make than is often thought (see, for example, the discussion in Hassett and Hubbard, 2001). Finally, as you know well, it is possible to implement tax reform as a series of steps, necessitating caution in evaluating a "horse race" among proposals for fundamental tax reform.

Thank you, again, Mr. Chairman, for the opportunity to appear before you today on the important subject of fundamental tax reform. I look forward to your questions.

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