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The U.S. Tax System in International Perspective

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All governments face two important decisions. They must choose the scope and scale of public goods and services to provide for their citizens, and they must also decide how to collect the funds to finance those public services. Chapter 5, The U.S. Tax System in International Perspective, examines U.S. choices in the context of other countries. It makes three key points:

- Fundamental choices about tax systems matter because they affect the living standards of citizens.
- The United States has made different choices from other countries. The United States has a relatively low tax burden compared to the rest of the world, and we finance more of that burden with a tax on personal income instead of consumption.
- When viewed in an international perspective, the U.S. system has been significantly improved in recent years but could benefit greatly from additional reforms, particularly those focused on the taxation of capital income.

CHAPTER 5

The U.S. Tax System in International Perspective

All governments face two important decisions. They must choose the scope and scale of public goods and services to provide for their citizens, including national defense, public safety, education, law enforcement, and social insurance. They must also decide how to collect the funds to finance those public services, including what things to tax and at what rate to tax them. These tax policy decisions affect job creation, the allocation of resources, economic efficiency, economic growth, and ultimately the living standards of their citizens. In this chapter, we examine U.S. choices in the context of the varied choices of other countries around the world.

Recent calls for fundamental tax reform reflect long-standing public frustration with the complexity of the U.S. system and dissatisfaction with its economic effects. Last year's *Economic Report of the President* outlined the need for tax reform and evaluated several prototypes for reform. The President created a bipartisan Advisory Panel on Federal Tax Reform that spent the year evaluating the current tax system and recommended two options for reform. This chapter provides a broader context for evaluating these and other potential reforms.

This chapter makes three essential points:

- Every country makes fundamental choices about its tax system: what level of overall tax burden to impose, what to tax, and what tax rates to apply. These choices matter because they have important economic consequences that affect the living standards of their citizens.
- The United States has made different choices than other countries: We have a relatively low tax burden, and we finance more of that burden with a tax on personal income instead of consumption.
- When viewed in an international perspective, the U.S. system has been improved by some significant changes but could benefit greatly from others, particularly those focused on reforming the taxation of capital income.

Fundamental Choices in Tax Systems

The two fundamental questions that must be answered in designing a tax system to raise revenue for government expenditures are what to tax (the "base") and how much to tax it (the "rates"). Public discussion of tax policy often also focuses on the distributional consequences of these decisions, which

are certainly important. However, economists point out that the answers to these two fundamental questions have equally important implications for the economic decisions made by individuals and small and large businesses, and thus for the overall performance of the economy. In this section we discuss these tax policy choices and their effects on economic decisions.

Designing a Tax System

Governments choose the size and scope of the public services they wish to provide and the corresponding level of spending required. At the same time, they choose how to finance that spending, through a combination of taxation and borrowing. The use of borrowing (deficits) to finance government spending has varied over time, and the optimal level depends on many factors. For example, economists have argued that it is reasonable to borrow to finance temporary increases in spending (e.g., during times of war or to provide aid after a disaster) or temporary declines in revenue (as in a recession). In any case, the cost of government borrowing must ultimately be financed by tax revenues, and so we focus here on the tax system.

Every tax system is defined by two factors: the tax base and the tax rate structure. The base defines what is subject to taxation and the rate determines what portion is taken in tax. We begin by considering two of the most common tax bases used: income and consumption.

A tax system with a pure income tax base is designed to tax all of the resources that increase a taxpayer's ability to consume, regardless of what that taxpayer actually does consume. Taxable income under this system includes all wage and salary income, interest income, and dividends, and also can include increases in wealth such as unrealized capital gains and noncash income such as the implicit rental value of owner-occupied housing. In short, under a pure income-based tax system, all income plus all increases in wealth can be subject to taxation.

A consumption-based tax system, in contrast, taxes only the share of income that is consumed, exempting the share that is saved. Examples of consumption-based tax systems, such as a national retail sales tax, a value-added tax, a consumption-based Flat Tax, or a consumed-income tax, were presented in Chapter 3 of the 2005 *Economic Report of the President*, which addressed "Options for Tax Reform."

The U.S. tax system is neither a pure income tax nor a pure consumption tax, but rather a hybrid of the two. Although nominally based on income, the U.S. system excludes significant portions of the return to savings from the tax base (e.g., interest earned on assets held in a 401(k) employment-based retirement plan or an Individual Retirement Account). The U.S. system also excludes other forms of income from the tax base, two key examples being the

premiums paid by employers for employee health insurance and the implicit rental value of owner-occupied housing.

Another central aspect of designing a tax base is the treatment of international activity, both of foreigners acting within U.S. borders and of U.S. citizens and corporations conducting business abroad. Currently, the United States applies its income tax, in principle, on a *worldwide* basis, taxing all income earned by U.S. residents on their economic activity in the United States and the rest of the world, and allowing a limited credit for taxes paid to foreign governments. Taxing on a worldwide basis means the U.S. applies its tax to all economic activity in the country (regardless of the nationality of ownership) and to all activity of U.S. residents and U.S.-owned companies (regardless of the country in which that activity occurs). The United States could, alternatively, tax on a *territorial* basis, taxing all income earned within U.S. borders regardless of the nationality of the person or corporations earning the income, but not taxing income earned abroad. Territorial tax treatment would exclude from the tax base all foreign earnings of U.S. residents (both individuals and corporations). With increasing competition among the United States and other countries for economic activity, this choice also has important implications for economic growth and efficiency.

In addition to choosing the tax base, the tax authorities must also determine the tax rate structure. This choice has significant effects on both the efficiency and the equity of the tax system. Countries might choose one tax rate to apply to the entire tax base, or a progressive schedule of tax rates, with higher rates applying to those with greater resources. A key determinant of the effect of the tax system on the efficiency of the economy is the tax rate that is applied to the incremental use of resources—such as an additional dollar of income or an additional dollar of consumption. This *marginal tax* rate is important because it affects the taxpayers' incentives, and thus their economic behavior, inducing them to make decisions that are different from those they might have made in the absence of the tax. These "distortions" of behavior (relative to the no-tax benchmark) are the major channel through which the tax system affects the efficiency of the economy.

Taxes Distort Economic Decisions

Virtually all forms of taxation distort economic decision making because they change the cost of allocating resources to different uses. Those distortions have a real economic cost that goes beyond the burden of the tax being paid. The reduction in economic efficiency generated by the changes in economic behavior that a tax induces is called the *excess burden* of the tax. The excess burden imposed by a tax increases dramatically as the marginal tax rate increases. A standard demonstration in economics textbooks is that excess

burden is proportional to the square of the tax rate, so that doubling the marginal tax rate roughly quadruples the excess burden of the tax. This relationship between marginal tax rates and economic efficiency is the reason that tax systems with broad bases and low rates are generally considered the most efficient way to raise revenue.

Of course, the tax rate specified in statute may not correspond with what businesses and individuals actually pay in taxes because of exemptions, deductions, and credits that reduce their tax burden. The *effective tax* rate that people pay (and that drives their behavior) may thus be lower than the *statutory rate*. Designing a tax system involves choosing the statutory tax rates, defining the tax base including any exemptions and deductions, and specifying tax credits. The combination of those choices determines the effective tax rate that people and firms pay, and that can alter their behavior and cause distortions in the economy. In the next section we discuss the distortions created by different tax systems.

Tax Systems and Economic Distortions

The complexities of modern tax systems can change many decisions made by individuals and businesses alike. For example, individuals choose how much they work, the forms of compensation they receive (such as wages or health insurance), how much they save, and whether they own or rent a home. Businesses must choose how many workers to hire, where to locate workers and capital assets around the world, the types of assets in which to invest, and the means of financing these assets (e.g., debt, equity, or retained earnings). Taxes can affect all of these decisions.

The choice between an income-based and a consumption-based tax system affects the labor market decisions of workers, the savings decisions of families, and the behavior of entrepreneurs. For example, a worker facing a marginal tax rate of 40 percent on income (who would thus take home only $6 for an additional $10 earned) may decide to work less than someone who faces a marginal tax rate of 20 percent (and would thus take home $8 for an additional $10 earned).

Relative to a consumption tax base, the use of an income tax base increases the costs to individuals of saving for the future, as detailed in Chapter 3 of the 2005 *Economic Report of the President*. A tax system with the property of *static efficiency* does not distort the choices that people make about how to allocate resources today (for example, it does not affect their decision about whether to consume apples or oranges). A system with the property of *dynamic efficiency* does not distort the choice of how to allocate resources between today and tomorrow (it does not affect the choice between consuming apples today and consuming apples in the future).

Consumption-based taxes are more likely to be dynamically efficient than income-based taxes. Someone earning a higher return on a savings account can expect to consume more in the future for each dollar saved, and is thus likely to save more. Taxing savings (as is done in a pure income-based system) makes future consumption relatively more costly, which leads people to save and invest less, with adverse consequences for economic growth.

Further distortions are introduced into the U.S. economy by the separate taxation of corporate income, rather than integration of taxation of corporate and personal income. Corporate profits are essentially taxed twice, first under the corporate income tax and again under the personal income tax when corporate profits are paid out as dividends. The result is a higher tax on income earned in the corporate sector than that earned elsewhere in the economy. For corporate income that is paid out as dividends, the combined tax rate can be remarkably high: as much as 35 percent at the corporate level and another 15 percent through the individual income tax, considering Federal taxes alone. Including state tax rates and accounting for deductibility, the Organization for Economic Cooperation and Development (OECD) estimates the U.S. combined tax rate can be as high as 50.8 percent. This double-taxation of corporate income creates both static and dynamic inefficiencies. It is also inconsistent with either a pure income tax base or a pure consumption tax base.

The U.S. tax code also makes it costlier for firms to make some kinds of investments than others, leading to additional distortions of economic decision making. For example, investment financed from prior earnings (equity) and investment financed from borrowing (debt) are taxed differently, various assets are subject to different depreciation rules, and dividend income received by shareholders is taxed differently from capital gains. There are also ways that U.S. firms can reduce their effective tax rate by deferring their tax payments. Each of these differences affects the choices that businesses make about where and how much to invest.

Finally, the U.S. application of a worldwide tax base affects firms' decisions about where to locate and where to make investments. Foreign-sourced income of U.S. companies is taxable, but the credits taxpayers receive for foreign taxes paid are not applied uniformly. There are limits to the amount of foreign tax credit a firm can claim, which can create incentives for firms to change their investment and business activity patterns across countries based on international tax rates. Under this worldwide system, U.S. firms operating in a foreign country may eventually be liable for not just that host country's taxes, but also for U.S. taxes under some circumstances. Competitors from countries taxing on a territorial basis are not subject to this U.S. tax, and therefore may have a competitive advantage, all else being equal.

More generally, the tax treatment of the foreign-source income of U.S. multinationals under the current worldwide system is widely thought to be one of the most complex aspects of U.S. taxation. This complexity itself imposes a burden on these companies, causing them to allocate substantial resources to tax planning and compliance. With globalization and the increasing importance of international capital flows, the distortions and complexity generated by the current U.S. system are increasingly costly to the U.S. economy.

U.S. Tax Policy in International Perspective

In this section we examine the choices the United States has made about the size of the national tax burden, the forms of taxation to employ, and the tax rates applied. We compare these choices to those made by other countries and show that the United States has a relatively low overall tax burden, and its choices about which tax sources to rely upon differ substantially. Recent reforms in other countries are highlighted.

International Comparison of Overall Tax Burdens

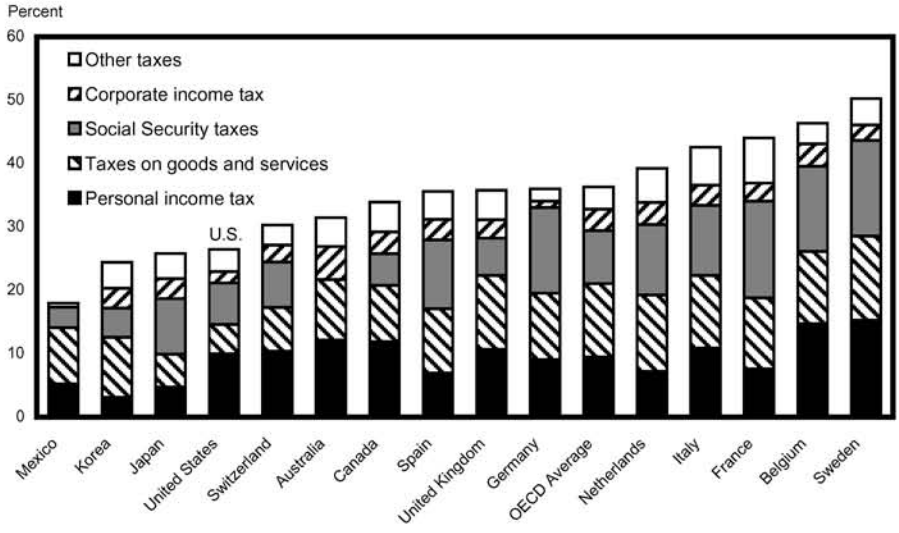
A common measure of the overall tax burden is the ratio of total taxes paid to all levels of government to the gross domestic product (GDP). This share represents the fraction of the total output of the economy that is taken in taxes in any given year, or the average tax rate. This measure of overall tax burden is particularly useful for international comparisons. First, it is unaffected by international differences in national versus subnational government responsibilities. Second, it adjusts for differences in the overall size of the countries' economies.

Among countries in the OECD, the United States has a relatively low total tax burden (including Federal, state, and local taxes). Total taxes in the United States at all levels of government amounted to 26.4 percent of GDP in 2002, substantially lower than the OECD average of 36.3 percent. This share is also below the European Union (EU) average of 40.6 percent.

Chart 5-1 uses OECD data from 2002 to illustrate the average tax rates (total taxes as a share of GDP) for the 15 largest countries of the OECD. Only Mexico, Korea, and Japan had total tax burdens smaller than that of the United States in 2002. OECD countries such as Sweden and Denmark, on the other hand, had tax burdens that were as much as 20 percentage points of GDP higher than that of the United States.

The United States faces a significant fiscal challenge in keeping the overall tax burden low in the future. Growth in Federal entitlement spending if not checked, threatens to require substantial increases in taxes, significantly altering the tax choices the United States has made in the past. Box 5-1 provides an overview of this fiscal challenge and its implications for tax policy.

Chart 5-1 **Tax Revenues as a Percent of GDP for the OECD Countries in 2002**
The United States has a relatively small total tax burden and uses personal income taxes to collect a larger share of total revenue than most other countries.



Note: The countries shown have the 15 largest economies in the OECD. Mexico's personal and corporate tax revenues are combined, as they were not available separately.
Source: Organization for Economic Cooperation and Development.

International Comparison of Tax Bases and Rate Structures

Beyond different choices about the scope and size of government, the OECD countries have also made different choices about the tax systems used to raise funds. Almost all of the OECD countries use some mix of personal income, corporate income, payroll, sales, and other taxes (e.g., estate and excise taxes), but they differ significantly in their degree of reliance on each. Chart 5-1 illustrates the composition of each country's tax revenue sources: personal income taxes, taxes on goods and services (consumption taxes), social security taxes, corporate income taxes, and other taxes.

The United States relies more heavily on personal income taxation than other OECD countries do. Indeed, in 2002 the United States collected 37.7 percent of its total taxes through the personal income tax compared to an OECD average of 26.0 percent. Given this difference, one might then ask how other countries finance their spending. The primary alternative tax base is consumption. OECD countries collected an average of 31.9 percent of total revenues from taxes on goods and services, mainly through value-added taxes (VATs). A VAT is a tax applied to the gross receipts earned by sellers of products, but sellers receive a tax credit for taxes paid on the inputs they use, so the tax effectively applies only to the value that they themselves added in the

Box 5-1: Fiscal Challenges Ahead

U.S. Federal tax revenues and Federal expenditures have remained fairly stable as a share of national output (GDP) over the past four decades. Despite this overall stability, substantial changes have occurred in the composition of both revenues and expenditures. These expenditure trends in particular foreshadow a major fiscal challenge facing the United States.

Total Federal revenues have averaged 18.2 percent of GDP since the 1960s, with only modest variation around that average, although the composition of revenues has shifted toward payroll taxes and away from excise and corporate income taxes. As discussed in this chapter, the income tax base and rates have changed many times during this period, but the overall contribution of income taxes to total revenues has been fairly stable.

Total Federal outlays since the 1960s have also remained close to the long-run average of about 20.4 percent of GDP, despite many changes in the economy and the mix of government programs that have occurred since 1962. This stability masks important underlying trends, however, in the composition of expenditures. The share of GDP and of the government's budget allocated to spending on Medicare, Medicaid, and Social Security has risen steadily, while the share devoted to defense has fallen. If the growth of spending on these programs goes unchecked, there will soon be a major break in the generally stable fiscal situation that the United States has enjoyed for most of the postwar period.

The cost to the Federal government of these three entitlement programs is expected to rise from 8.0 percent of GDP today to about 15.6 percent of GDP in 2045. In 2005, all other spending programs of the Federal government, excluding interest payments on the national debt, amounted to 9.0 percent of GDP. With this growth, and other programs remaining constant as a share of GDP, in 2045 the Federal budget excluding interest on the debt will consume 24.6 percent of the GDP, compared to 17.0 percent today, with continuing increases beyond that date. Adding back interest on the national debt could make the share of GDP absorbed by the Federal budget even larger.

The implications of these trends are grave. If the major entitlement programs grow as forecast, future generations will be forced to choose between massive tax increases, near-elimination of all government programs outside of entitlements (including defense and essential services), or some combination.

making of the product. Only 17.6 percent of U.S. tax revenues came from taxes on goods and services in 2002, primarily through state and local sales and excise taxes. Recall, however, that the personal income tax is actually a hybrid income-consumption tax, so that some of the taxes collected through the U.S. income tax system, and those of other countries, might be thought of as taxes on consumption.

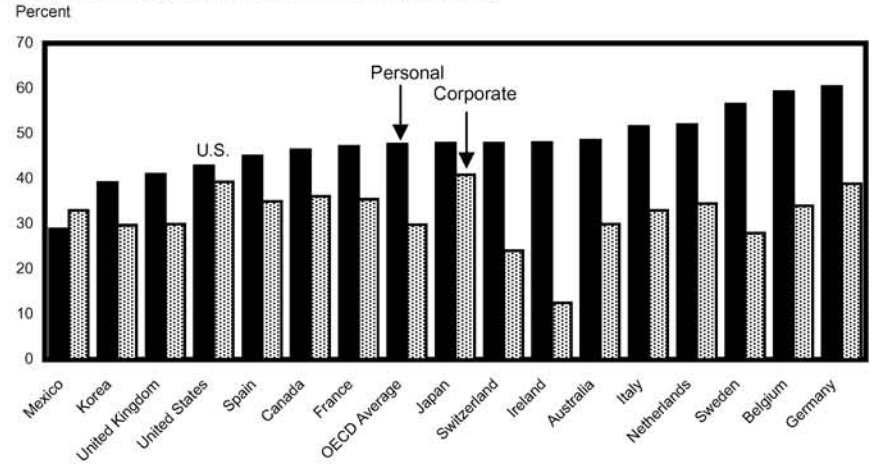
The United States has also made different choices about the marginal tax rate structure to impose on its tax base. Chart 5-2 shows the top marginal personal income and corporate income tax rates in various OECD countries, including the 15 largest OECD economies and Ireland. The black bars illustrate the personal rate and the gray bars illustrate the corporate rate. The chart shows the OECD's "all-in" definition of the top rate, which includes taxes collected by all levels of government and the employee portion of the social security tax. The top marginal personal income tax rate of 43 percent in the United States is comparable to that of several of the OECD countries such as the United Kingdom (41 percent), and slightly lower than those in France (47 percent) and Japan (48 percent), which matches the OECD average (48 percent), and significantly below the rates in Germany and the Scandinavian countries (all 55 percent or higher). At the same time, the United States has a combined (Federal and state) marginal corporate income tax rate of 39 percent, well above the OECD average of 30 percent, and second highest to that of Japan.

Chart 5-2 illustrates several important points. First, while the U.S. top individual income tax rate is comparable to those of other OECD countries, its top corporate rate is relatively high. Second, except for Mexico, each country's top personal rate is higher than its top corporate rate. Third, there is no clear correlation between the top personal and corporate tax rates. Ireland, for example, has a moderately high personal rate but a very low corporate rate, while Germany has high rates in both cases.

The United States has also chosen to tax on a worldwide basis, as discussed above, unlike some other countries. In 2003, 13 of 30 OECD countries taxed on a worldwide basis, including Japan, Korea, Mexico, and the United Kingdom. The majority of OECD countries (17 countries in 2003) tax on a territorial basis, including Canada, France, Germany, Ireland, Netherlands, Spain, and Sweden.

Finally, the United States has made different choices about the integration of personal and corporate income tax structures. The United States uses a *classical system*, which taxes corporate and personal income separately, based on the status of corporations as separate legal entities. This results in the double taxation of income earned in the corporate sector. Other countries using this system include Ireland, Sweden, and Switzerland. Alternatives to the classical system provide some form of dividend tax relief, thereby avoiding

Chart 5-2 **Top Marginal Personal and Corporate Tax Rates for the OECD Countries in 2004**
The United States has a relatively high top corporate tax rate and a moderately low personal income tax rate in comparison with other large economies in the OECD.



Note: The countries shown include the 15 largest OECD economies plus Ireland, which is interesting because of its relatively low corporate tax rate. The personal rates are the OECD's "all-in" (top marginal) tax rates, which are calculated as the additional central and subcentral government personal income tax, plus employee social security contribution, resulting from a unit increase in gross wage earnings. The corporate rates are the OECD's top combined central and subcentral government rates, with the deductibility of subcentral government taxes taken into account.
Source: Organization for Economic Cooperation and Development.

or reducing double taxation. Under the *imputation system*, shareholders are given a personal income tax credit for tax paid by the corporation on that portion of its profit. Countries using imputation systems (wholly or partially) include Australia, New Zealand, Norway, Canada, and the United Kingdom. Another alternative is the *dividend exclusion method*, under which a portion of dividends paid to individuals is excluded from tax at the individual level. Countries using this method include Germany, France, Finland, and Italy. A final method that can be used to avoid double taxation of dividend income is to apply a *two-rate system*. Under this approach, distributed corporate profits (paid out in dividends) and undistributed profits are taxed at two different rates with undistributed profits taxed at a higher rate. The extent to which this approach eliminates the double taxation of dividend income depends on the rates chosen.

Recent International Tax Reforms

We begin by reviewing several common trends in recent tax reforms that have been adopted by a diverse set of nations. We then examine the implications of these reforms for international tax competition and for reform of the U.S. system.

International Tax Reform Trends

According to the OECD, most countries making changes in their tax systems since 1999 have lowered personal and corporate income tax rates. Those rate reductions were often financed, at least in part, by base broadening. Within this overall pattern of lower personal and corporate income tax rates, there are four discernible trends.

One clear trend among OECD countries is r*educing the taxation of wage and salary income*. These taxes have been reduced through both rate reductions and increases in taxable income thresholds. The OECD average "all in" tax rate for a full-time production worker fell from 25.6 percent in 2000 to 24.8 percent in 2003. The corresponding marginal tax rate fell from 35.4 percent to 34.3 percent. Among G-8 countries since the year 2000, France, Germany, Japan, Russia, and the United States have all lowered personal income tax rates that apply to wage and salary income. Changes in the tax brackets and rate structures generally made these tax systems less progressive, although accompanying changes in exemptions, deductions, and credits complicate the distributional picture.

A second trend is *reducing the tax rates applied to corporate income*. The OECD average corporate income tax rate fell from 33.6 percent in 2000 to 30.8 percent in 2003. As in the case of wage and salary taxation, these rate reductions have typically been accompanied by base-broadening measures. Since 1999, the G-8 countries of France, Germany, Italy, and Japan all reduced their corporate tax rates.

A third trend is *reducing the taxation of capital income* (especially capital gains and dividends) under the personal income tax. Top marginal tax rates on dividend income (corporate plus personal) fell over the period 2000-2003 among OECD countries from 50.1 percent to 46.4 percent. Reforms in Italy, Japan, and the United States, in particular, all reduced the personal income tax rates applied to interest, dividends, or capital gains. Six of the G-8 countries have also altered their tax systems to better coordinate their personal and corporate income taxes. Several countries of the EU, including France, Germany, and Italy, applied partial dividend exclusions, and Russia lowered its dividend tax rate.

A fourth trend is the increasing popularity of *flat rate* income tax schedules. Since the mid-1990s, eight Eastern European countries, including Russia, have adopted income taxes with flat rate structures. The personal tax rates among these eight reform countries range from a low of 12 percent in Georgia to a high of 33 percent in Lithuania, and average 20.6 percent. On the corporate income side, the tax rates range from a low of 10 percent in Serbia to a high of 24 percent in both Estonia and Russia, and average 17.9 percent. Countries adopting these flat income tax structures tend to also apply value-added taxes at relatively high rates, typically 18%.

Evidence on International Tax Competition

Evaluating the U.S. tax system in relation to other national tax systems is particularly important in a world where nations compete for business and mobile capital (including physical, financial, and human capital) by making their tax systems more attractive. A recent review of evidence on international tax competition suggests a systematic change in the pattern of tax rate setting. From 1982 to 1999, there was a substantial increase in international capital mobility, reflected in the amount of foreign direct investment (purchase of buildings, machinery, and equipment) and other measures of the flow of international capital. At the same time, statutory corporate tax rates (tax rates established in the law) declined all around the world and corporate tax bases were broadened, resulting in little change in effective average rates. An exception to that general rule is that effective tax rates for foreign subsidiaries of U.S. firms located in small countries fell sharply between 1992 and 2000.

While the United States reduced its top combined corporate tax rate from 50 percent in 1982 to 39 percent in 2005, as measured by the Institute for Fiscal Studies, other countries have made even more significant reductions. The United States now has the second highest combined corporate income tax rate among OECD countries, behind only Japan. With international tax rates falling overall, and a convergence between rates applied by large and small countries, the United States risks becoming less competitive in attracting capital. As capital becomes more mobile, it is increasingly easy for companies to move their productive activities, including physical capital, export/import operations, research and development activities, and other forms of knowledge creation, around the world in response to tax incentives. (Chapter 7, The History and Future of International Trade, discusses the role of global engagement in firm performance.) In the current environment of international tax competition, the United States will be increasingly challenged as the destination of choice for internationally mobile capital and jobs.

U.S. Tax Reforms: Past, Present, and Future

Reform of the U.S. tax system can play a critical role in improving economic efficiency and the competitiveness of U.S. firms In this section, we examine past tax-reform efforts in the United States, starting with the Tax Reform Act of 1986 (TRA86), and project potential future reforms. We focus in particular on reform of the U.S. tax base and on the taxation of savings or the return to savings, such as interest, dividends, and capital gains.

Twenty Years of Tax Reform

The U.S tax code has many provisions that give preferential treatment to certain types of income. In some instances, these preferences may improve efficiency, such as incentives to increase retirement saving or investment in new equipment that offset distortions introduced by the income tax system. In other cases, tax preferences intentionally distort economic decisions in order to promote certain kinds of economic activity, such as the introduction of tax credits that subsidize advanced education, labor market participation, research and experimentation, or the employment of disadvantaged workers. These provisions narrow the tax base and result in higher marginal tax rates for at least some taxpayers. They also add complexity to the tax code. The President's Advisory Panel on Federal Tax Reform illustrated the trade-off between tax rates and the tax base in the current U.S. tax system. Their calculations suggest that with a broader tax base, tax rates in all tax brackets could be reduced by about a third. Multiple changes to the tax base in the last two decades reflect this tension.

The Effect of Recent Reforms on the Tax Base

We have ample evidence from the last two decades that tax policy is always evolving. The last comprehensive U.S. tax reform was the Tax Reform Act of 1986. That reform was revenue-neutral, broadening income tax bases and lowering marginal tax rates dramatically. TRA86 actually built on reductions in marginal tax rates that began in 1981 when the top rate was reduced from 70 percent to 50 percent. Under the base-broadening provisions of TRA86, marginal tax rates were reduced further, with the top rate cut to 28 percent. Rates applied to different types of income were also made more uniform. For example, one study estimated that effective capital tax rates (taking into account depreciation schedules and other tax provisions that differ across types of capital) prior to TRA86 ranged from a 45.6 percent tax on income from industrial buildings to a 3.3 percent subsidy of income from general industrial machinery. After TRA86 those effective tax rates converged to 37 percent and 38 percent, respectively. Leveling the playing field in this way reduces the distortions to investment across various forms of capital. While TRA86 made effective tax rates more similar across types of capital income, it also raised the overall cost of capital, which likely discouraged investment and reduced dynamic efficiency.

Since TRA86, there have been more than 100 different acts of Congress making nearly 15,000 changes to the tax code. These changes have altered both the individual and the corporate tax bases. Some changes have narrowed

the tax base (such as the 1997 repeal of the Alternative Minimum Tax for small business and the 2001 increase in the standard deduction for joint filers), while others have broadened it (such as the 1990 and 1993 limits on itemized deductions and the 1993 expansion of the taxability of Social Security benefits). Other reforms have changed the tax rates applied to this base, such as the rate reductions enacted in 2001 and accelerated in 2003. The introduction and expansion of numerous tax credits, such as the Child, HOPE, Lifetime Learning, Welfare to Work, and Renewal Communities credits, have narrowed the base and introduced disparities in tax rates applied to different types of income.

Disparities in effective marginal tax rates on capital are once again quite large, varying with the method by which capital is financed and by the type of asset. A recent study finds that the effective tax rate on corporations ranges between a tax of 36.1 percent on equity-financed activity to a subsidy of 6.4 percent of debt-financed activity. Furthermore, that study finds that the effective marginal tax rate varies from a high of 36.9 percent to a low of 9.2 percent, depending on the asset type. The current piecemeal tax system is thus both complex and inefficient. In the following section, we examine potential reforms to address these issues.

Potential Reforms to the Tax System

The increasingly globalized business environment in which U.S. investors and firms operate makes the design of an efficient and competitive tax system particularly crucial. Two central issues in the current tax reform debate are the choice of tax base along the income-consumption spectrum and the coordination of personal and corporate tax rates. Recent U.S. tax reforms have lowered the tax rates on capital income. Comprehensive reform could uniformly lower the level of capital income taxation, and could thus reduce the distortions of the current tax system and support greater potential economic growth.

Comprehensive Business Taxation

One shortcoming of the U.S. tax system, discussed above, is the double taxation of corporate income, which subjects capital income to a high effective rate. Since 2003, the United States has taken steps to reduce this problem by applying a substantially lower (15 percent) individual tax rate to dividend and capital gains income, thereby implicitly applying a two-rate system. The President has recommended making permanent these lower tax rates on capital.

Over the years, several comprehensive reforms to integrate corporate and personal income taxes have been proposed. The Treasury Department developed a proposal for a Comprehensive Business Income Tax (CBIT) in the 1990s. The proposed system was designed to give equal tax treatment to

corporate debt and equity, tax corporate and noncorporate businesses alike, and reduce the tax distortions between retained and distributed earnings. The CBIT still provides a relevant prototype for integration within the context of an income tax system. Alternatives have also been proposed that move away from reliance on an income tax by implementing a cash-flow business tax (see Box 5-2, for example).

Box 5-2: *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*

Recommendations of the President's Advisory Panel on Federal Tax Reform

The President's Advisory Panel on Federal Tax Reform was charged with evaluating the current Federal tax system and developing alternatives that achieved improvements in simplicity, fairness, and growth potential. They were asked to make at least one recommendation based on the current income tax system, to make their recommendations revenue-neutral, and to preserve incentives for charitable giving and home ownership. In addition, the panel chose to design their recommendations to preserve the current distribution of tax burden. Their 2005 report recommends two alternatives to the present income tax system: a Simplified Income Tax (SIT) and a Growth and Investment Tax (GIT). The SIT plan is a simplified version of the current income tax system. The GIT plan moves to a modified consumption tax that retains some income tax elements.

These two proposals have several features in common. They both have fewer tax brackets and lower top marginal tax rates for individuals and families than the current system. Both plans would repeal the Alternative Minimum Tax (AMT) for families and corporations. Both simplify the tax treatment of savings and lower the tax burden on productivity-enhancing investments by businesses. Either plan would be substantially simpler than the present tax system, and both plans maintain the present distribution of tax burden across income groups.

The two plans diverge primarily in their taxation of business and capital income, using different bases for business taxation. The SIT plan retains a simplified income tax applied to corporations, while the GIT plan would apply a cash-flow tax to all businesses (not just corporations). While they both lower the effective tax rate on capital income, they use different approaches to do so. The SIT plan excludes dividends paid to individuals from the individual income tax base and excludes 75 percent

Box 5-2 — *continued*

of corporate capital gains from U.S. companies, while the GIT plan applies a uniform 15 percent tax to interest, dividends, and capital gains at the individual level. The SIT plan adopts a simple accelerated depreciation method for investments, while the GIT plan would permit full expensing of investment. The plans also tax foreign income differently. The SIT plan taxes income on a territorial basis (with foreign-sourced income untaxed), while the GIT cash-flow tax is destination-based (with exports untaxed).

Either of these two recommendations represents a significant step forward in making the U.S. tax system simpler, fairer, and growth-enhancing, but each would involve substantial transition costs. They deserve serious consideration and more comprehensive analysis.

The President's Tax Reform Panel

The broader goals of any comprehensive tax reform should be the creation of a system that is simple, is fair, and promotes economic growth. The President's Tax Reform Panel sought to design revenue-neutral and distribution-neutral plans to achieve these goals. The panel proposed two prototypes for reform: a Simplified Income Tax (SIT) and a Growth and Investment Tax (GIT), summarized in Box 5-2. Both of these proposals fundamentally alter the tax bases for individuals and businesses as well as the treatment of capital income. Either of these reforms would represent a large change and involve important transition issues. While each plan embodies features that are attractive from the point of view of efficiency, fairness, and simplicity, comprehensive review of these plans and policy debate is needed before making such substantial changes to the tax system.

Conclusion

Every government faces choices about how to design its tax system in order to finance the services it provides for its citizens. Because virtually all forms of taxation distort economic decision making, each country faces the challenge of designing a tax system that raises needed revenue and achieves distributional and other goals while distorting economic decisions as little as possible. By taking into account the effects of tax rules on the economic behavior of individuals and firms, governments can provide a tax environment that fosters the most-efficient allocation of resources and the best economic performance possible.

The United States has chosen to impose an overall tax burden that is low relative to most other industrial countries and to rely most heavily on the personal income tax. Governments of other advanced economies rely less on personal income taxation and more on consumption taxes, such as value-added taxes, in order to finance a larger public sector. Given the U.S. reliance on the personal income tax, we face the continuing challenge of keeping the income tax base broad and the rates low in order to keep the economic burden of taxation as small as possible.

Global tax reforms have changed the tax landscape substantially in recent years. Other advanced economies have generally reduced taxes on wage and salary income, reduced taxes on capital income under the personal income tax (in particular, capital gains and dividends), and reduced taxes on corporate income. While our personal income tax rates are comparable to those of other countries, our corporate tax rate is now the second highest among OECD countries. These international differences could endanger the ability of the U.S. economy to attract capital in a world where capital is increasingly mobile. Any reform of the U.S. tax system should aim to improve the performance of the U.S. economy and to spread the burden of financing government spending simply and fairly.

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Transmitted to the Congress February 2006

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The Staff of the Council of Economic Advisers

The professional staff of the Council consists of the Chief of Staff, the Chief Economist, the Director of Macroeconomic Forecasting and Statistics, nine senior economists, four staff economists, and five research assistants. The professional staff and their areas of concentration at the end of 2005 were:

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Chief Economist
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Diana C. Wielocha	Macroeconomics, Finance, and Regulation
Jonathan A. Wolfson	Health and Regulation

Statistical Office

The Statistical Office maintains and updates the Council's statistical information, oversees the publication of the monthly *Economic Indicators* and the statistical appendix to the *Economic Report of the President*, and verifies statistics in Presidential and Council memoranda, testimony, and speeches.

Linda A. Reilly	Program Analyst (Statistical)
Brian A. Amorosi	Program Analyst (Statistical)
Dagmara A. Mocala	Research Assistant

Catherine Furlong retired from Federal service on September 2, 2005. She had worked in the CEA Statistical Office for 54 years, and had been its Senior Statistician since 1977. A retirement ceremony was held on September 30, where she was honored in comments by present and former Council Chairmen, Ben Bernanke, Alan Greenspan, and Charles Schultz. Chairman Raymond Saulinier was also in attendance. Her untiring dedication to accuracy, detail and the reputation of the Council will indeed be missed. All future Councils will benefit from that wisdom.

Administrative Office

The Administrative Office provides general support for the Council's activities. This includes financial management, human resource management, and travel, facility, security, information, and telecommunications management support.

Rosemary M. Rogers	Administrative Officer

Office of the Chairman

Alice H. Williams	Executive Assistant to the Chairman
Sandra F. Daigle	Executive Assistant to the Chairman and Assistant to the Chief of Staff

Lisa D. Branch..... Executive Assistant to Dr. Slaughter
Mary E. Jones ..... Executive Assistant to Dr. Baicker

Staff Support

Sharon K. Thomas..... Administrative Support Assistant

Jane Tufts and Barbara Pendergast provided editorial assistance in the preparation of the 2006 Economic Report of the President.

Student Interns during the year were: Matthew B. Adler, Taylor W. Buley, Sean D. Clifford, Andrew M. Dietrich, Alan Y. Gu, Brett W. Hollenbeck, Rebecca L. Homkes, Thomas R. Johnson, Aaron W. Kletzing, Edwin H. Lee, Stephanie Mak, Andrew Park, Sean X. Qin, Elizabeth M. Schultz, Brian C. Tucci, and Joseph S. Vavra.

Fellows during the year were: Courtney Biesecker, Kenneth Gillingham, and Neal Rappaport.

Departures

Phillip P. Swagel left the Council as Chief of Staff in February of 2005 to join the American Enterprise Institute as a resident scholar.

Donald B. Marron left the Council as Chief Economist in October of 2005 to join the Congressional Budget Office where he is currently the Acting Director.

The Council's senior economists, in most cases, are on leave of absence from faculty positions at academic institutions or from other government agencies or research institutions. Their tenure with the Council is usually limited to one or two years. Some of the senior economists who resigned during the year returned to their previous affiliations. They are: Raymond R. Geddes (Cornell University), Pia M. Orrenius (Federal Reserve Bank of Dallas), John C. Driscoll (Federal Reserve Board), Joshua S. Graff Zivin (Columbia University), Gerald Auten (Department of the Treasury), Alexander Raskovich (Department of Justice), Philip Levy (State Department)

Staff economists are generally graduate students who spend one year with the Council and then return to complete their dissertations. Those who departed the Council in 2005 are: Maria Damon, Peter R. Kingston, Anne Berry, and Carol Cohen.

Those who served as research assistants at the Council and resigned during 2005 were: Namita K. Kalyan, Therese C. Scharlemann, Derek A. Haas, James Soldano, and Daniel Ramsey.

Brenda Compton, Finance Manager, accepted a position with the Census Bureau.

Satiah Pee, Information Management Assistant accepted a position with the Discovery Channel.

Public Information

The Council's annual *Economic Report of the President* is an important vehicle for presenting the Administration's domestic and international economic policies. It is available on the Internet at www.gpoaccess.gov/eop. The Council also has responsibility for compiling the monthly *Economic Indicators*. The Internet address for the *Economic Indicators* is www.gpoaccess.gov/indicators. The Council's home page is located at www.whitehouse.gov/cea.