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ENCOURAGING SAVINGS AND INVESTMENT: STAY THE COURSE OR CHANGE DIRECTION?

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BEFORE THE

SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

OF THE

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ENCOURAGING SAVINGS AND INVESTMENT: STAY THE COURSE OR CHANGE DIRECTION?

THURSDAY, JUNE 30, 2005

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Jon Kyl (chairman of the subcommittee) presiding.

Also present: Senators Hatch, Thomas, Crapo, Jeffords, and Wyden.

OPENING STATEMENT OF HON. JON KYL, A U.S. SENATOR FROM ARIZONA, CHAIRMAN, SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

Senator KYL. Welcome, all of you, to this hearing. I would like to announce preliminarily that you are all privileged to be in attendance at the very first hearing in this beautiful hearing room since it has been refurbished.

I mention that to confirm that with Senator Grassley's staff, who said, gee, I hope everything works out all right. So if there are any problems here, we will attribute it to this being the shake-down cruise for this refurbished hearing room. But, welcome to you all to this hearing of the Subcommittee on Taxation and IRS Oversight.

Our hearing today is entitled, "Encouraging Savings and Investment: Stay the Course or Change Direction?" I think we will start by noting the fact that, in coming years, Congress will be faced with an avalanche of expiring tax provisions, and so we must begin the process, anyway, of deciding which provisions to keep and which ones should be allowed to expire.

While most of the widely used provisions, those that apply to broad classes of taxpayers, expire at the end of 2010, a handful of such provisions expire between 2006 and 2008.*

Today's hearing is designed to review whether four particular policies that expire before the 2010 date are accomplishing what Congress intended, and if the cost is worth the economic benefit.

*For more information on this topic, *see also,* "Present Law and Background Information on Certain Expiring Tax Provisions," Joint Committee on Taxation staff report, June 27, 2005 (JCX–50–05).

This type of oversight is essential for Congress to undertake if we are to pursue sound tax policies, and I do hope that we will do more of it here in the Senate Finance Committee.

Our first witness, Scott Harding, will talk about the importance of Section 179 expensing to small businesses. This provision, which allows up to $100,000 worth of property to be expensed per year, expires at the end of 2007, at which time the amount would revert back to $25,000.

Our second witness, Robert Weinberger, will discuss the effectiveness of the saver's credit in encouraging retirement savings by lower-income taxpayers. This credit expires at the end of 2006.

The remainder of our witnesses, David Malpass, Eric Toder, Stephen Entin, and Brian Graff, will all speak to the 15-percent individual rate for most dividends and capital gains.

While I expect we will hear some disagreement over whether the lower rates should be continued, or even made permanent, I think the trends we are seeing for revenues coming into the Treasury and the sustained economic growth we are experiencing argue strongly that these rates must be made permanent.

In fact, the Republican leadership of the Senate is committed to extending the lower rates for dividends in capital gains as part of reconciliation later this fall, and to making these rates permanent as soon as possible.

Before we begin, I want to ask unanimous consent to put a survey, conducted by the Securities Industry Association, in the record. Is there any objection?

Senator JEFFORDS. No objection.

Senator KYL. If not, so ordered.

[The survey appears in the appendix on page 116.]

Senator KYL. I certainly look forward to hearing from all of our witnesses.

At this time, let me call upon Senator Jeffords, the Ranking Minority member, for any statement he would wish to make.

OPENING STATEMENT OF HON. JAMES M. JEFFORDS, A U.S. SENATOR FROM VERMONT

Senator JEFFORDS. Thank you, Mr. Chairman, for calling today's hearing. Thanks to all the witnesses for offering their views on how best to encourage savings and investment in our country.

The personal savings rate in our country is now close to zero. Perhaps even more troubling, that rate has been on a steady downward trend for the past 2 decades.

Many households, of course, have experienced a growth in their net worth as a result of asset appreciation in stocks and real estate, but many others are living paycheck to paycheck, only one layoff or illness away from financial disaster.

We all want to encourage people to save and invest, but we also want to be able to help those people who lack the means to do so, and give them the foundation for success.

I supported the tax cuts in 2001. I did so because taxes had reached almost 21 percent of the GDP and we thought we had a 10-year surplus on the order of $5 trillion. In my mind, a surplus of that magnitude gave us the room, both to cut taxes and bolster

Social Security, and a healthy margin of error, since we knew that the projections might not materialize.

Of course, that did not come true. There is no need to rehash why. It is enough to recognize that, instead of a large surplus, we are looking at a $2-trillion deficit over the coming decade.

In the face of these changed circumstances, Congress must decide whether the tax cuts, begun in 2001 and accelerated in 2003, still make sense today. I suppose it is old-fashioned, but I think deficits do matter: $400 billion here, $300 billion there, pretty soon you are talking some real bucks.

Also, President Bush has warned that the Social Security system is on the road to bankruptcy because, in 40 years, it will only be taking in 70 cents of every dollar that it was supposed to pay out.

Well, if you accept that definition of the path to bankruptcy, the Federal Government has already arrived. Setting aside Social Security, the Federal Government took in just 70 cents for every dollar it spent last year; budget receipts were $1.3 trillion, but outlays were $1.9 trillion, almost $600 billion of red ink.

And these are in the good times. The baby boom is just in its peak earning period and has not yet begun to retire. How will we cope from a fiscal standpoint in the next 10 or 20 years if we do not regain some fiscal discipline now?

All the provisions we will discuss today are attractive, for good reasons. There is not a politician alive who does not like to cut taxes. But I think it is time that Congress stop digging itself into a deeper hole.

The cost of extending the provisions that are the topic of today's hearing is more than $200 billion over the next 10 years, and we will soon be considering proposals on the AMT extenders and the estate tax. All told, they could easily top a trillion-dollar loss in revenues.

Finally, beyond the cost of all of these items are the questions of equity. The Joint Committee on Taxation estimates Americans will realize $327 billion in capital gains this year; $307 billion of these gains, almost 94 percent, will go to taxpayers making more than $100,000. Taxpayers with income of under $50,000 will see less than $5 billion of these gains. I think those figures speak for themselves.

All of us would like to lower tax rates, but in a time of chronic deficits, cutting taxes just dumps more debt on our children.

Mr. Chairman, I thank you, and look forward to today's testimony.

Senator KYL. Thank you very much, Senator Jeffords.

Let me, just very briefly, introduce each of our witnesses. Then, since you are all on the same panel, just ask each of you to testify in the order from my left to your right.

Mr. G. Scott Harding is president and CEO of F.B. Harding, Incorporated, in Rockville, MD. I indicated what each of you would be testifying about, so I will not repeat that.

Mr. Robert Weinberger is vice president of government relations at H&R Block here in Washington.

Mr. David Malpass is chief economist at Bear Stearns in New York.

Dr. Eric Toder is senior fellow at The Urban Institute in Washington, DC.

Mr. Stephen Entin is president and executive director of the Institute for Research on the Economics of Taxation in Washington.

Mr. Brian Graff is executive director and CEO of the American Society of Pension Professionals and Actuaries, in Arlington, VA.

Mr. Harding, we will begin with you. I think you are being shown right now how you push the button, as Strom Thurmond used to say, to make the machine work.

Mr. HARDING. Yes, sir.

Senator KYL. Thank you.

STATEMENT OF G. SCOTT HARDING, PRESIDENT AND CEO, F.B. HARDING, INCORPORATED, ROCKVILLE, MD

Mr. HARDING. Good afternoon. I am Scott Harding, president and CEO of F.B. Harding Electrical Contractors located in Rockville, MD. I am very proud to say that our company has been in business since 1949.

Thank you, Chairman Kyl and Ranking Member Jeffords, for giving me the opportunity to speak to you today on behalf of the National Federation of Independent Businesses regarding Section 179 of the Internal Revenue Code.

As a business owner, I am very pleased to see that the committee is interested in addressing this important issue. Small business owners do our jobs using our hard-earned experience and applied common sense. In business, we make many decisions daily that affect the life of our companies, and thus the livelihood of our employees and their families.

Business, like life, can get complicated. When it comes to complications, the U.S. tax code ranks among the top. I am sure most small business owners would agree with me on that.

So when I heard that Section 179 limits had been increased, I was eager to understand how our business could benefit from this legislation.

Working together with President Bush, Congress enacted into law the Jobs and Growth Tax Relief Reconciliation Act of 2003, which increased the limits on expensing from $25,000 to $100,000.

This was a positive step to help small business owners, and is one of the most significant changes to our tax code in years. The old threshold of a $25,000 limit was, quite frankly, restrictive, outdated, and simply unfair.

Under current law, Section 179 allows small business owners to expense—that is, fully deduct from taxable income—$100,000 of the cost of new business equipment in a year.

This tax benefit is limited by a provision stipulating that the expensing amount is phased out, dollar for dollar, for any amount of investment above $400,000 in a given year.

However, in 2007, the law expires, and small businesses will only be able to expense up to $25,000 in new investment per year. Additionally, the $400,000 limit will be reduced to $200,000, severely limiting the number of small businesses that can qualify for this important revision.

In order to assist small business owners as they make investments necessary to grow and expand their businesses, I would suggest three proposals: number one, make permanent the current law of allowing $100,000 to be expensed in a given year; number two, make permanent the $400,000 investment limit; and number three, index both of these, the $100,000 and the $400,000 limits for inflation.

Allowing small business owners to expense our critical investments immediately is a key component to the expansion of the economy. It will put money into the hands of small business owners so they can hire new workers. It will put money directly into the economy, as owners will be more likely to purchase new equipment.

By indexing the limits to inflation, the bill provides stability for small business owners. It assures owners that they will not have to come back to Congress and ask for additional increases to keep up with inflation. This helps us to do our long-term planning.

In my business specifically, last year alone we spent $106,000 on our capital expenditures. We were able to purchase tools, computers, and four vehicles. The expansion of Section 179 made these investments much more prudent for our business and helps us to compete in the marketplace.

Under the old rules, we would have only been able to expense $25,000, which is paltry, considering a new vehicle uses up nearly all of that limitation. Under the expanded rule, we were able to expense $100,000.

This translated into a tax savings of approximately $27,000. In other words, because of the increased limits, we were not penalized, but given the incentive to invest in our business.

As business people, we are risk takers. We do not take extra money and hide it under the mattress. When given the opportunity, we will spend. When given the incentive, we will invest.

This is how you create more jobs and grow your business. In fact, according to the U.S. Small Business Administration, small business has generated 60 to 80 percent of net new jobs annually over the last decade.

If small business benefits, the employees benefit. The government ultimately benefits because more money is pumped into the economy. That is what makes America a great place.

I commend the committee for holding this hearing, and I look forward to working with the Congress and the President in the future to help make Section 179 permanent.

Thank you for the opportunity to testify on this important issue, and I will be happy to take any questions that you may have.

Senator KYL. Thank you for that testimony, Mr. Harding.

[The prepared statement of Mr. Harding appears in the appendix.]

Senator KYL. Mr. Weinberger?

STATEMENT OF ROBERT A. WEINBERGER, VICE PRESIDENT, GOVERNMENT RELATIONS, H&R BLOCK, WASHINGTON, DC

Mr. WEINBERGER. Mr. Chairman, members of the committee, thank you for the invitation to appear. H&R Block serves nearly 20 million taxpayers, most at 11,000 offices spread out across America, including 252 in Arizona, 22 offices in Vermont, 105 offices in Utah, 25 offices in Wyoming, and 137 offices in Oregon.

In our 50th year, we are evolving from a firm devoted to helping families with taxes to one also advising them on financial issues, including the need to save for retirement.

Our recent experience with the Retirement Saver's Credit and a new Saver's Match study may be helpful to the committee.

Enacted in 2001, the Saver's Credit provides a non-refundable tax credit of up to 50 percent for contributions to 401(k)s, IRAs, and similar retirement plans. It covers taxpayers who have incomes up to $50,000, and who have income tax liability.

Millions of eligible taxpayers were unaware of the credit when it was first enacted. We put on a full-court press to advise our tax clients and develop a low-cost "Express IRA" to help more clients save.

As a result, we have helped 1.2 million clients a year use the credit to save, about 25 percent of all savers credits claimed. They saved an average of $529 yearly, and received a credit averaging $167. This includes nearly 21,000 Arizonans, who saved $19.5 million, and 2,800 Vermonters, who saved $3 million.

While most use the credit to match contributions to an existing 401(k), IRA, or other retirement plan, nearly a quarter of a million clients opened a new IRA through us. A majority were first-time savers with an average income of $27,000 a year; two-thirds were Earned Income Tax Credit recipients; and half were considered "unbanked."

The credit has been successful for at least five reasons. First, it relies on personal responsibility and requires a commitment to save. Second, it leverages tax time to promote savings, drawing on refunds averaging $2,100, and professional advice. Third, it supports existing private retirement accounts, a system in place already. Fourth, its top credit rate is large enough to encourage existing savers and to jump-start new savers. Finally, it targets benefits to those most in need by giving a higher match to savers with lower incomes.

To improve it, we encourage the committee to consider extending the credit beyond 2006; simplifying it with a single 50-percent rate or easing the steep cliffs that drop benefits as income rises; excluding retirement savings from asset tests that deny benefits like food stamps to those who save $2,000, penalizing thrift; and expanding it to cover more low- and middle-income taxpayers.

Making the credit refundable would enable it to reach the 40 percent of households, including families of four with incomes of up to $41,000, who, as a result of recent tax cuts, no longer have income tax liability.

For example, Mr. Chairman, in Arizona, about 20 percent of our clients eligible by income for the credit used it. Of the 80 percent who did not, over half were shut out by having no tax liability to offset.

Mr. Chairman, to test new ways to encourage savings by low- and middle-income families, H&R Block participated in a 2005 study led by a respected group of scholars.

The study of 15,000 Block clients at 60 offices in St. Louis found that dollar matches of up to 50 percent increased savings take-up rates by 6-fold and increased savings amounts 4 to 8 times, as compared to a zero-match control group.

The study confirmed that savings incentives are most effective when they are clear and understandable, coupled with low-cost, accessible savings vehicles, linked to tax refunds, and facilitated by a knowledgeable tax professional.

You may want to also consider a Saver's Match program based on the St. Louis results. Savers could deposit $1,000 to $2,000 in a 401(k), IRA, or similar vehicle and receive a 50-percent match from employers or financial institutions, which would be reimbursed through a tax credit for the match and a small administrative fee.

A Saver's Match would have several advantages. It is based on what somewhat saves, not what he or she earns. It immediately deposits the match into the savings account rather than delivering it later as a tax refund that can be used for other aims. It broadens the Saver's Credit audience, but under the same $50,000 cap to ensure focus. And it encourages employer involvement and adds to their match of 401(k) savings.

Mr. Chairman, we know from our experience that the Saver's Credit works, and so does the Saver's Match. As you discuss ways to spur savings, we encourage you to consider these kinds of permanent and expanded financial incentives to help low- and middle-income families save for retirement. Thank you.

Senator KYL. Thank you very much. Those are exactly the kinds of constructive suggestions we are trying to get out of this hearing. Thank you very much.

[The prepared statement of Mr. Weinberger appears in the appendix.]

Senator KYL. Now, our next four witnesses will all be talking about capital gains and dividends provisions, primarily, so we will focus on those, starting with Mr. Malpass.

STATEMENT OF DAVID MALPASS, CHIEF ECONOMIST, BEAR STEARNS, NEW YORK, NY

Mr. MALPASS. Thank you, Mr. Chairman and Senator Jeffords, Senator Hatch, and members of the subcommittee. It is a privilege to testify to you today.

I am the chief economist of Bear Stearns in New York. The views I express today are my own and not necessarily those of my employer.

I stepped away moments ago to hear about the outcome of the Federal Open Market Committee meeting. Apparently, they raised interest rates by 25 basis points, and there were no major changes in the statement that we could detect yet.

Turning to the tax issues, the 2003 tax cut was a critical part of the recovery from the 2001 recession. One of the bill's most important features was the reduction in the tax rate on dividends and capital gains.

This reduction in the cost of capital is a key to the economy's fast growth since then. When you tax something less, you get more of it, in this case, dividends, capital, capital gains, and the associated jobs and economic growth that go with it.

The cuts in the dividend and capital gains rates are also a structural improvement in the economy. They allow an improved allocation of capital, which will provide increasing growth benefits over time.

The graph on the first page of my written testimony shows that, when the taxes were cut, the stock market began going up immediately, and these are sizeable gains, $1 trillion in just the first 2 weeks after the tax cut materialized, and $3 trillion in the 9 months after the tax cut materialized.

If the existing rates are allowed to increase, I would expect a large negative reaction—in other words, we will undo some of the benefits that came out of the tax cut—in the economy and equity market, reversing some of those gains.

Higher dividend and capital gains taxes would unwind the improvement in the capital structure. It would likely lead to less economic growth, slower job creation, and stock market losses.

In my view, this impact would not drag out over a 10-year budget horizon, but would hit the economy and markets immediately.

As Congress considers extending the existing dividend and capital gains rates, I hope it will also consider the flaws in the 2003 tax scoring process.

That process completely ignored the growth and asset price benefits of the tax cut. That left Congress to make a major tax decision based on partial information. You had extensive cost data about the Federal Government's assumed revenue loss, but you did not have any official information on the benefits to the government and the private sector from making that tax cut.

The rest of my testimony goes through two sections, and I would like to summarize quite briefly. In 2003, I think it was predictable that the tax cut would have big benefits for the economy and stock market. We wrote about those at the time, pointing out that even in the first weeks after the tax cut there were extensive gains in the economy.

I testified in April of 2003, showing that when you cut the capital gains tax rate on housing, house prices went up substantially in the aftermath. So, we have a predictable process: when you cut the tax on assets, the assets are immediately more valuable because people price assets on an after-tax basis.

In addition—I am on page 4, now—the faster growth in the economy was marked. In June of 2003, when you were making the tax cut, the consensus expectation of the economy for the third quarter was that it would grow 3.2 percent.

In reality, it grew 7.4 percent, more than double what the expectation was. In the subsequent 2 quarters, that pattern continued, with the economy growing well above expectations. That creates a huge stimulus for the economy and for job growth.

As we have seen, tax receipts surged after the passage of the tax cut. Job growth surged—I am on page 5, with a graph of the gains in jobs, the gains in dividends that are paid.

So, one of the side benefits of this tax cut, actually a principal benefit, is when you cut the tax on dividends, companies begin disgorging dividends, so you have unlocked the locked-in capital.

For example, one major software maker was able to do a gigantic dividend in December of last year based on the lower tax rate. That is great for capital mobility, meaning they are dumping cash out of corporations that do not need it, and it finds its way into small businesses that do need it.

The graph on page 6 shows you the gains in income for small businesses in America after the tax cut. When you add it up, the 2003 tax cut ended up with $3 trillion of gains in market capitalization in just the 3 quarters, and more since then.

GDP was $160 billion above the consensus expectation; employment grew by 1.3 million in those first 9 months, and this compares very favorably, in my view, to the $350 billion scoring estimate for the 10-year cost to the government of the cut.

On the final 2 pages of my testimony, I described the risk: if you do not extend the existing tax rates, you run the risk of reversing some of these benefits.

I think it is also important to make the tax law permanent.

If you embark on this every-2-years kind of extension process, it creates an uncertainty that drags on the economy. We will go into that, I am quite sure, in 2006 and 2007 if you have not already extended the existing tax law.

The final point I will make is that scoring goes to the heart of this problem. The current scoring system blocks effective tax reform because it assumes tax changes do not improve the economy or asset prices.

You are making major tax changes, and the explicit assumption of the scoring is that there will be no impact on the economy. Well, then why will you do anything? Of course you are making tax changes to improve the economy. But that, simply, is not scored.

In my view, if you were able to make an improvement in the scoring system, you would come up with better tax law, you would have more honest information on what the effects of the tax changes would be. That, by itself, would be an important structural improvement for the U.S.

We would start having better tax law, and that would be priced in by the markets and by the economy quite quickly if you were able to make that change.

Thank you, sir.

Senator KYL. Thank you, Mr. Malpass. I especially appreciate the last minute or so of editorial comment about the totally artificial, negative, and I think quite unproductive, scoring that we have to contend with here, which most of us do not believe properly evaluates the consequences of our tax decisions, but which, under current law, we are required to take into consideration. It does distort our decision-making process considerably. And, as the facts demonstrate, the end result to the economy can be quite different. Thank you.

[The prepared statement of Mr. Malpass appears in the appendix.]

Dr. Toder?

STATEMENT OF DR. ERIC TODER, SENIOR FELLOW, THE URBAN INSTITUTE, WASHINGTON, DC

Dr. TODER. Thank you very much, Chairman Kyl, Ranking Member Jeffords, and members of the subcommittee. Thank you for inviting me to testify today at this hearing on extending incentives for saving and investment.

I will comment on lower tax rates for capital gains and dividend income, and my testimony also addresses, briefly, the Saver's Credit and the deduction for qualified post-secondary education.

I, first, address lower rates on dividends and capital gains. Because corporations cannot deduct dividends to shareholders, dividends can be taxable to both corporations and individuals. Capital gains on corporate shares also represent a second level of tax.

However, much corporate income is less than fully taxed, and a significant portion of dividends and capital gains go untaxed at the shareholder level as well. The current and prior administrations have proposed double tax relief, either by itself or as part of broader tax reform.

The current partial exemption of dividends and capital gains differs from these previous proposals in two important ways. Tax relief on dividends and capital gains is provided without regard to whether any tax was paid at the corporate level.

In contrast, prior proposals, including the current administration's 2003 proposal, sought to provide credits or exemptions only to offset corporate taxes actually paid.

The proposal, by itself and in conjunction with the other proposals in the bill, increases the Federal budget deficit and provides disproportionate relief to high-income taxpayers.

In contrast, the Ford and Reagan integration proposals were included in larger tax reforms that were revenue-neutral and maintained the distribution of the tax burden, and the Treasury report in the first Bush administration included an option that actually raised revenue by eliminating corporate interest deductibility.

These differences are important, because, instead of moving toward a system in which all capital income is taxed once, the current provisions create new distinctions among taxation of different forms of income. I go into that in the testimony.

Finally, I guess another point is that extending the current tax cuts on dividends and capital gains will provide disproportionate benefits to the highest-income taxpayers, and tables on the distributional effects are presented in my written testimony.

Seventy-two percent of the benefit goes to taxpayers with income over $200,000, and 46 percent to taxpayers with over $1 million of income.

Proposals to reduce or eliminate double taxation of corporate income could be part of a tax reform that reduced preferences and set rates to maintain revenue and keep the tax system from becoming less progressive.

The President has endorsed the goal of revenue neutrality and a progressive system in his instructions to the Tax Reform Commission. It is in this context, I believe, that double tax relief should be considered.

I also want to comment a little bit about the growth issue. Cutting taxes on savings certainly can increase saving, but it also creates offsetting effects that may not increase saving.

The research on the relationship between saving and after-tax returns is very divided. Certainly, if you are increasing public dissaving by increasing the deficit, the net effect is probably that national saving will decrease. A number of the economic models, both private and public, that looked at the 2003 Act, indeed, found that the Act would reduce economic growth in the long run.

I would now comment, just very briefly, on the Saver's Credit. The credit provides a match of up to 50 percent for contributions to qualified retirement savings plans by taxpayers with income below certain amounts. By providing a larger subsidy rate for lower income taxpayers, the credit differs from other incentives that are worth more to taxpayers in higher tax brackets.

We do not know if IRAs and 401(k)s raise private saving or merely cause people to shift assets to tax-preferred accounts, but research suggests that deposits to accounts by low-income individuals are more likely to represent new saving.

Bob has described the work that H&R Block has done and the research experiment. I do believe this is a credit that potentially could be effective in increasing saving among low-income people who now save little, and encouraging more people to provide for their own retirement needs. In my statement, I have a few suggestions on how it might be made more effective.

In conclusion, I appreciate the opportunity to present my views before the committee. Thank you.

Senator KYL. Thank you very much, Dr. Toder.

[The prepared statement of Dr. Toder appears in the appendix.]

Senator KYL. Now, Mr. Entin?

STATEMENT OF STEPHEN J. ENTIN, PRESIDENT AND EXECUTIVE DIRECTOR, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, WASHINGTON, DC

Mr. ENTIN. Chairman Kyl, Ranking Member Jeffords, and members of the subcommittee, I thank you for the chance to testify on the importance of extending recent tax reductions that affect capital formation, wages, and employment.

Three key provisions of the 2001–2003 tax cuts helped to end the recession and spur the recovery by turning around a severe slump in investment: the 15-percent top tax rate on dividends and capital gains that will expire at the end of 2008; the marginal income tax rate cuts enacted in 2001 and accelerated to full effect in 2003, that will expire at the end of 2010; and the 50-percent expensing provision in the 2003 Act that was unfortunately allowed to expire at the end of 2004.

Allowing the remaining investment incentives to expire would jeopardize the economic recovery. Extending them now would reduce uncertainty and would boost investment spending, employment, and wages starting now, not 3 to 5 years down the road. People look ahead.

The main cause of the 2001 recession was the sharp drop in investment. If you take a look at Chart 1 of my testimony, you will see the various twists and turns that investment spending has made in recent years. The 2001 tax cut was passed in May of 2001, but investment spending continued to slip. The bill did little in the short run for investment. The marginal rate cuts were largely deferred; only half a percentage point was effective in 2001.

The 2002 tax cut had a special 30 percent "bonus" expensing provision for investment in equipment and software, but not for structures. The second half-point step in the income tax rate cuts was effective that year. Investment in equipment and software, but not structures, began to recover modestly over the next 4 quarters, as the graph indicates.

Look at the effect of the 2003 Act. It upped special expensing to 50 percent for equipment and software. It brought forward the remaining 2- to 3.6-percentage point cuts in marginal income tax rates. Most importantly, it cut tax rates on dividends and on capital gains through 2008.

Investment in equipment and software shot up almost at once. Investment in non-residential structures abruptly stopped falling, and rose by a slight amount. Investment and growth remained strong throughout 2004. Employment and wage growth began to advance, and we ended the notion of a jobless recovery.

The 50-percent expensing provision expired at the end of 2004. Investment growth seems to have slowed since then, knocking off about half of its rate of improvement since last year.

Let me explain that the tax cuts worked mainly by lowering the service price of capital. Failure to extend them would raise the service price and reduce GDP. The size of the capital stock and the level of investment depend on what we call the service price of capital, which is the cost of capital that David referred to, plus a return for the replacement of the investment as it wears out.

The service price is the rate of return that an investment must earn to pay the taxes owed, cover its cost and its depreciation, and yield a normal after-tax rate of return to the owner.

A tax increase on capital income raises the service price and blocks investment projects that cannot meet the higher service price; a tax reduction does the opposite.

Chart 2 and Table 1 show the service prices of various types of capital in the corporate and non-corporate sectors under 2004 law, with all these investment incentives in place, and what would happen to service prices if you allowed them to expire. They cover the private business sector, which is about 80 percent of GDP.

The tax changes of 2003 lowered the service price of private sector capital in 2004 by about 2.5 percentage points. This may seem like a small number, but it is not. You have a roughly corresponding impact on GDP over time.

The biggest reductions were due to the 15-percent rate cap on dividends and capital gains, which reduced the double taxation of corporate income. This was followed in size by the marginal rate tax reductions on the shareholders, and then the expensing provision.

Allowing the expensing provision to expire eliminated about 8 percent of the added incentive to invest in 2004; allowing the 15-percent rate cap on dividends and capital gains to lapse would eliminate about 56 percent of the cut in the service price of capital; and allowing the marginal rate reductions to expire would eliminate the rest.

Each percentage point reduction in the service price of capital increases the capital stock over time by about 1.5 percent and private GDP rises by about the same percent, or about $140 to $150 billion. Ninety-five to $100 billion of that goes to labor.

That is far greater than the tax reductions in the burden tables that appear to go to the upper income. Labor benefits the most from reductions in taxes on capital, because such capital taxes are generally shifted to labor.

The shifting occurs because the capital stock is highly sensitive to taxation and will shrink if taxed more heavily. That reduces the productivity and wages of labor. The effect on labor is greater than on capital returns.

I would suggest, as a procedural step, that you get the Joint Tax Committee to give you, with each revenue estimate, an estimate of the effect of your bills on the service prices of capital.

They will not go on to tell you how much that is going to affect the economy because they are still studying that, but at least they will give you the initial impetus, and you can decide how much of an effect it will have on GDP. I think it will have a fairly large one, if you look at the historical record.

The burden tables only show you the initial incidences of tax. They are really incidence tables, not burden tables. To get the burden on the economy, you have to judge what happens to people's after-tax incomes after everything adapts, including the demand for labor and wages.

The revenue estimates have been covered by David. I will not go into them very much, except to say that when the Joint Tax Committee considers tax relief for dividends, capital gains, and even marginal tax rates for individuals, they try to take certain behavior changes into account, but not others.

On the dividends side, they will try to guess how many more dividends might be paid as a result of the rate cut, but they will not tell you how much the relief on dividends will boost capital formation, wages, and employment, so you will not get that revenue feedback into the revenue estimate.

With capital gains, they will try to tell you how many more gains people will take because the rate has gone down. That is the realizations effect. They tend to underestimate that, but they try. They will not, however, calculate the reduction in the service price of capital and the gains for GDP and employment, and the added taxes that you get from wages from the payroll tax and the income tax.

However, if they will at least tell you what you have done to the service prices, and possibly the marginal tax rates on labor, you will have an idea what direction your bill is moving. If it moves adversely in these areas, you are going to be throwing people out of work.

Thank you.

Senator KYL. Very interesting, Mr. Entin. Thank you very much.

[The prepared statement of Mr. Entin appears in the appendix.]

Senator KYL. Finally, Mr. Graff. Thank you.

STATEMENT OF BRIAN GRAFF, EXECUTIVE DIRECTOR AND CEO, AMERICAN SOCIETY OF PENSION PROFESSIONALS AND ACTUARIES, ARLINGTON, VA

Mr. GRAFF. Thank you, Mr. Chairman, Senator Jeffords, and other members of the subcommittee, for allowing me to speak on this important subject affecting the retirement security of American workers.

My organization, ASPPA, is a national organization of over 5,500 retirement-plan professionals who help small businesses offer retirement plans covering millions of American workers.

I am also, today, speaking on behalf of the Small Business Council of America. The SBCA is a national organization representing the Federal income tax, estate tax, pension, and other benefit interests of privately held and family-owned businesses.

Not all savings is alike. For many years, Congress has been clear that encouraging long-term retirement savings comes first. This message has been consistently sent by providing the best tax treatment to workplace retirement plans.

However, in the last few years, Congress has focused more on incentives for saving outside of traditional retirement plans. These incentives include reduced tax rates for capital gains and dividends, a primary focus of this hearing.

We also have good reason to expect proposals soon to eliminate taxes on capital gains and dividends as part of the upcoming tax reform debate.

Today I will focus on the impact these proposals would have on long-term retirement savings and how further capital gains and dividend tax cuts could upset the critical balance required to sustain our longstanding and successful workplace retirement plan system.

Our policy to promote long-term retirement savings has encouraged a significant number of Americans of modest means to save for retirement. Almost 70 percent of American households own their mutual funds through a retirement plan. Retirement plans have made American workers part of the "ownership society" to which the President often refers.

Simply put, retirement plans are the only effective means to get low- to moderate-income workers to save. According to the Employee Benefits Research Institute, workers who are earning between $30,000 and $50,000 are 20 times more likely to save when covered by a workplace retirement plan—yes, 20 times.

Small business owners incur a substantial cost when offering a retirement plan. This cost is due to mandatory contributions for employees which are required in order for the owner to save.

For a small business with less than 25 employees, the costs of these mandatory contributions can typically be at least 30 cents for every dollar that the owner wants to save. Effectively, these costs are like a tax that must be paid in order for the owner to participate in the plan.

As discussed in more detail in my written testimony, assume a small business owner, instead, chooses to invest his or her savings, plus the cost of these mandatory contributions for employees, outside of a plan on an after-tax basis.

Assuming a 7-percent rate of return, the 15-percent capital gains rate will produce 30 percent more in accumulated after-tax savings after 15 years; at a zero-percent capital gains rate, this differential grows to over 40 percent.

ASPPA members have currently been able to rebut this math to small business owners by arguing that the 15-percent rate is temporary, whereas the tax incentives for qualified plans have been around for decades.

The permanent extension of the 15-percent rate will make that rebuttal more difficult. A further reduction in the tax rate of capital gains to zero will make it virtually impossible to convince a small business owner to adopt a retirement plan.

I am not trying to say that all small business owners are greedy; however, the reality is that most small businesses have been operating quite successfully without a retirement plan.

The decision to adopt the retirement plan will only be made if it makes financial sense for the small business owner to do so. Reduced tax rates for capital gains and dividends will make that no longer the case, consequently, the future retirement security of millions of small business employees will be at risk.

For these reasons, ASPPA believes that long-term retirement savings must come first over all other forms of savings. Therefore, we urge you to adopt three principles as part of our Nation's savings policy.

First, increasing savings by moderate- and low-income workers must be a priority. These are the Americans who save the least and whose future financial security is most at risk. I note that, based on IRS data, less than 5 percent of American households benefit from the reduced tax rates on capital gains and dividends.

Second, long-term retirement savings must be favored over all others. If not favored, workers will instead save on a short-term basis, if at all, where there is ready access to the money, making it less likely it will be there for retirement.

Third, workplace retirement plans play a critical role in achieving the first two principles. They are by far the most effective way to get these workers to save, and expanding retirement plan coverage must be emphasized.

We urge you to carefully consider proposals to reduce tax rates on capital gains and dividends, since their impact over time could be to drive small business owners away from workplace plans.

With no plans, the evidence strongly suggests small business workers will not save on their own. With retirees living longer and the strain on Social Security evident, we must take steps to promote small business retirement plans, not push them out of existence. ASPPA remains committed to helping you make sure workers can secure a comfortable retirement.

Thank you.

Senator KYL. Thank you very much, Mr. Graff.

[The prepared statement of Mr. Graff appears in the appendix.]

Senator KYL. Now, Senator Hatch has asked that he be permitted to ask a couple of questions out of order here. Senator Wyden, you are the only one I have not checked with who would agree to this. Do you object to Senator Hatch?

Senator WYDEN. Absolutely.

Senator KYL. All right. Fine.

Senator Hatch?

Senator HATCH. Well, thank you, Mr. Chairman.

Let me just go to you, Mr. Weinberger. H&R Block's experience with the Saver's Credit is very interesting. It seems obvious that strong incentives do have a powerful effect on encouraging even lower-income individuals to save.

Now, as you probably know, there is quite a debate going on in Congress right now over personal accounts to enhance Social Security, whether they be carve-out accounts or add-on accounts.

I am working on a proposal that would create a new add-on account that would offer a Federal match of up to 100 percent of the first $1,000 saved by workers each year, for those making $20,000 or less.

The match would gradually go down, up to those earning $80,000 a year, and then it would be phased out for those earning over $80,000, but they would still have the tax-free ability to save.

Now, in your experience, how compelling would a 100-percent match be for lower-income workers if there were no income tax limitations, and how might the take-up rate for such a program compare with the results of your St. Louis study?

Mr. WEINBERGER. Well, I would have to defer to the scholars on how it would compare fully with the St. Louis study, but the proposal you described sounds attractive. It has one very positive feature, that as income goes down, the savings incentive goes up.

I think our experience is that the lowest-income individuals have the greatest difficulty saving, so that would be appropriate. The match also sounds attractive, as you describe it, as a compelling incentive to encourage people to save.

One of the important aspects of the current saving structure that is an impediment to saving is its non-refundability.

For example, under the Saver's Credit, about 59 million Americans are eligible to save based on income. But because the credit is not refundable, only one-seventh are eligible to save at the maximum rate, and then only 43,000 people, or less than one-tenth of 1 percent, are able to get it at the full rate.

If your proposal expands eligibility to get to this 40 percent of Americans who, as a result of tax cuts today, do not have income tax liability, I think it would be all the more attractive.

Senator HATCH. Well, that is interesting. I wish I could ask you some more questions. In fact, I wish I could ask all of you some questions.

But let me just ask you, Mr. Entin. It is good to see you back up here. We appreciated you when you were here. I notice you have not changed much in your economic outlook, and that is great.

Recent data from the Treasury Department showed that lower rates on dividends and long-term capital gains saved 24 million taxpayers an average of $950 on their 2004 taxes, including 7 million seniors, whose average tax savings exceeded $1,200.

Now, given the importance of dividend income to retirees, could the failure to extend these rates not be considered a "senior's tax"?

Mr. ENTIN. They certainly do receive a disproportionate share of the dividends. If they get used to them or they plan their retirement on what they are currently able to take from them, then removing it would be an extraordinary inconvenience, I think that would be fair to say.

I must, by the way, mention that I have been talking with you about these issues since 1977. It was a pleasure to work with you then, and it is a pleasure to work with you again.

Senator HATCH. Well, we are pleased to have you before the committee. I want to compliment the Chairman and the Ranking Member.

Could I ask just one more question?

Senator KYL. Yes.

Senator HATCH. Just one more of you, Mr. Entin. I wish I could ask of all of you, because you have all been very excellent. But stock ownership is rising most quickly among low-income households, as I view it.

According to Federal Reserve data analyzed by the American Shareholders Association, there was a 91-percent increase between 1995 and 2001 in the number of households in the bottom quintile owning stock.

Now, those in the second quintile saw ownership rates increase by 35 percent during that time. Now, how important do you think the zero-percent rate that starts in 2008 will be to encourage continued increases in savings and investing among low- and middle-income families?

Mr. ENTIN. It increases the reward to the saving and investment, which makes it more attractive relative to consumption. I think it would have to have an impact. We believe that all income levels respond to incentives, and this is a powerful one.

Let me also note, the Treasury figures look even stronger if you look over time. People may take capital gains only occasionally. In any one year, a small group may appear to be taking the gain and getting the immediate benefit, but over several years, many more people are taking gains and getting the benefits. The Treasury panel studies would make the argument that you are making here today even more powerful, I believe, if you would take a look at those.

Senator HATCH. Well, thank you.

Thank you, Mr. Chairman. I appreciate you letting me go because of my schedule.

Senator KYL. You are welcome, Senator Hatch.

Let me turn, now, to Senator Jeffords.

Senator JEFFORDS. Dr. Toder, you argue that lowering the rate on capital gains and dividends, without offsets in spending or taxes, will likely reduce national savings and economic growth. Would you explain that?

Dr. TODER. Sure. Basically, when you are lowering the tax rate on dividend income, you are having two effects on people. One, you are raising their rate of return they get from an additional dollar of saving, and that does make consumption in the future, saving for that, more attractive than consuming today, and tends to cause saving to increase.

You have a second effect: you are making them wealthier. Then for any target of wealth they want to have, they do not have to save as much, they can consume more. So, those are offsetting effects.

Empirically, a number of people have studied the return to saving. Some studies have shown a positive effect of after-tax returns, some have shown zero effect. So, there is a very mixed result from studies on that.

What we do know for sure is that, if you are increasing the Federal deficit, that is directly a reduction in national saving. So I believe that any reasonable estimate of how much private saving would be increased would be swamped by the reduction in public saving, and there would be less national saving, higher interest rates, more borrowing from overseas, and so forth, and, by the way, an increase in the cost of capital as a result of that.

Senator JEFFORDS. Thank you very much.

Senator KYL. Thank you, Senator Jeffords.

Just to follow up on that, let me ask what some of the rest of you think about the last observation of Dr. Toder.

Mr. Malpass, in your testimony, it appears to me that you pretty much directly contradict that point of view, and I wondered if you would like to speak to the issue.

Mr. MALPASS. I would, Senator, in one way. It seems to me that it follows from Dr. Toder's argument that any type of gains that are made in the economy will end up reducing the savings rate.

Senator Jeffords was talking about the savings rate being close to zero. One powerful part of that is because, in calculating the savings rate, they do not include the gains going on in the economy.

Capital gains, for example, or pension payments, are not counted in income. So the better the economy is doing, the more it pushes down that recorded savings rate. One of the things that I would wonder about with Eric's work, he is saying the national savings rate goes down, but what I would be looking at is the accumulated savings of the economy. I think it would be going up rapidly.

If the economy grows, the amount of total savings in the economy will go up, and that is a very powerful positive effect from these lower tax rates. But the recorded savings rate is going to go down because the government does not count gains in calculating the savings rate.

Senator KYL. Could I ask Mr. Entin something about your testimony that labor, as opposed to capital, benefits the most from the reduction in the cost of capital. Would you explain what you mean by that, how that works, why that is true, and why the dividends and capital gains reductions would therefore impact that observation?

Mr. ENTIN. Charts 3, 4 and 5 are the ones that apply to that argument in the testimony. A reduction in the service price of capital will cause people to want to add more capital to the economy.

You are going to get more plant, equipment, buildings, residential and non-residential, and so forth. The higher capital stock makes labor more productive. Wages are tied to productivity. More people will be hired and the wage will be higher with a higher capital-to-labor ratio.

One of the main reasons that living standards have risen over the centuries is that we have had more capital to work with and it has let us accomplish more, and wages go up to match. Those gains in wages are a part of the effect in the change of the tax, and the burden of a tax is the change in people's incomes.

Let me give you an example of a small trucking company. Suppose you have a company with five trucks. The fifth truck is only being run part-time. It is barely earning its keep. It is wearing out.

You take a change in the tax law. Instead of writing the truck off over 3 years, you are now going to make the owner write the truck off over 5 years. You have changed the depreciation rules.

The truck which was marginally profitable before is now marginally unprofitable. The owner decides not to replace it. He is barely inconvenienced; he was not getting much of a revenue stream from the truck anyway. But let me ask you, what happens to the wages of the fifth truck driver? That is how the taxes on capital are shifted to labor.

When GDP goes up by a dollar because of some increase in investment, of that increase in the dollar of GDP, pre-tax, about two-thirds goes to labor and about one-third goes to capital.

But after taxes, here is the split: a little bit more than half goes to labor after tax; State, local, and Federal Government taxes take in a little over 30 percent. You have about 15 percent left. About 10 percent is depreciation on the new capital that has to be set aside to replace it. About a nickel goes, net, to the owners of capital. The government gets 6 times as much, and the workforce gets 10 times as much, after tax.

That is how taxes on capital are shifted to labor. That is why fundamental tax reform generally consists of lowering the excess layers of tax we currently place on capital and treating capital more neutrally relative to consumption.

To tax capital that is more sensitive to taxation higher than anything else, more heavily than anything else, is utterly absurd, and it hurts all the other factors of production.

Senator KYL. Just in the half a minute I have left, let me ask you, Mr. Harding, what is the effect of uncertainty with respect to somebody that has to deal with investment decisions and worry about the bottom line from day to day? Uncertainty of the tax code.

Mr. HARDING. Well, in the construction business, sometimes I say, Mr. Chairman, it is an adventure every day. We have a lot of problems that we run into. So any time that we can bring certainty to anything, it is extremely important to us.

That is what I pointed out in my testimony: we can index for inflation and make it permanent. Taxes are a huge cost of doing business. Sometimes people do not realize that, but it is a huge cost of business.

So, if we can get our arms around what it is going to be and still benefit when given the incentives, that makes it much easier for us to plan. I thought the gentleman's example of the truck was a beautiful example of how business looks at things. We are going to make an investment here, and taxes are a big cost of the investment. If taxes are lower, we are going to want to invest more.

Senator KYL. Have you ever faced a decision like that in your business?

Mr. HARDING. Oh, absolutely. We have tools, computers, trucks. We have looked at everything like that, and we always do.

Senator KYL. All right. Thank you. I am over my time.

Senator Thomas is next.

Senator THOMAS. I will pass at this time.

Senator KYL. All right.

Let me ask Senator Wyden, then. You can be reloading while he is shooting. How is that?

Senator WYDEN. Thank you, Mr. Chairman. I commend you for an excellent hearing.

What seems to me, though, has been missing, is a discussion now of choices. Because what we have entered into is a world where you cannot have it all. I have always said that the most important choices are areas that promote saving and investment, ones devoted to cut capital gains, devoted to cut the estate tax, because I want to be a Democrat who supports growth. If we have growth, that generates revenue for some of the social needs that I care about: kids, seniors, schools, and the like.

So I want to ask you all about what I think is the overriding choice as it relates to saving and investment. That is, that if the Congress now passes on renewing the President's proposal to extend the personal tax cut, it seems to me you free up vast sums for the kind of saving and investment that is being talked about, and even have some left over for deficit reduction and other kinds of areas.

Our calculation is that, if you look at the President's two tax cuts to date, upwards of $1 trillion has been used for the personal tax cut. That is where the big chunk of money went.

I find very few of my wealthy constituents say, gee, Ron, I want to have the personal tax cut again. What they talk about is what you all are talking about, which is more saving and investment.

So I think what I would like to do is ask the four of you who have been talking about capital gains and savings and investment—and I would welcome the other two as well to chime in if they want—what do you think of the idea of the beneficial ramifications of Congress passing on renewing the personal tax cut and using some of those dollars to work in a bipartisan way for some of the saving and investment incentives that are being discussed here, and even have some left over for deficit reduction?

Why do we not start with you, Mr. Malpass, and go down the row? The other two are certainly welcome to chime in. I do not want to discriminate against you, either.

Mr. Malpass?

Mr. MALPASS. Thank you, Senator Wyden. I commend you for the idea of promoting savings and investment, and growth. I think that is a very good starting point for dialogue and discussion.

On the specific issue, though, I think the top marginal rate is simply very important to the growth in the economy. It may be that some of the recorded benefits, the direct benefits, can end up going to the wealthy or to people with higher incomes, but the top marginal rate is also paid by many sole proprietors, small businesses, and by both big and small corporations that create jobs within the economy.

If you are planning to take a big chunk of what someone earns, they are not going to work in the same way, they are not going to create jobs in the same way.

In my view, one of the very effective uses of limited resources is to hold down the top marginal rate because it is not really the loss that you think. You are looking at a $1 trillion loss to the government, but the reality is, there is a huge growth benefit associated with that.

I would note that I have heard talk of people proposing what is called a HOT tax, which is a Higher Optional Tax rate. In other words, on the 1040 Form, you could put a box for those that would like to pay a higher rate, and they would have the certainty that that money would go to the government so they could fill in a higher rate. I do not think very many would take advantage of that kind of opportunity.

I really want to emphasize that we are talking about your assumption of $1 trillion.

Senator WYDEN. That is the CRS's figure.

Mr. MALPASS. Yes. I think you have to ask, what would happen to the growth rate of the economy and to the job creation of the economy if you raised taxes that much.

Senator WYDEN. Nobody is talking about raising taxes that much, sir. What I am talking about, is whether or not you take some of that money that affluent people tell me is not much of a factor in their saving and investing and put it into areas that I know produce economic growth, such as the capital gains reductions and investment incentives. That is what we are talking about.

Let us go to Dr. Toder.

Dr. TODER. Well, thank you. That is a very thoughtful question, and it illustrates that we certainly do have trade-offs in tax policy. I think we ought to be thinking about this realistically in the context of the structure of the tax system, how we want to raise revenues, as opposed to thinking that something is a free lunch. So, I am glad you raised the question in that form.

I do agree with David that marginal tax rates do have adverse effects on the economy and adverse effects on efficiency, so I would not take the position that we should unrestrictedly raise tax rates on labor income or on income generally and use that for targeted incentives. I think you have to be very careful about what the structure of the incentives are and whether they really work.

Senator WYDEN. Again, what I want to make clear is, I think the debate is about growth and how we are going to best bring it about. What I am interested in doing is getting on the record what you all think about the choice of a direct kind of incentive, which I think is the capital gains break, dividends, and some of the areas that I have been voting for as opposed to what my most affluent constituents tell me is not a factor in their investment decisions.

Mr. Chairman? I guess we have got lots of chairmen up there. We have got Chairman Jeffords. We lost Chairman Kyl. Maybe I will just, if it is all right with my colleagues, will let these two finish up. Then I know colleagues want to ask questions.

Let us go to our next witness.

Mr. ENTIN. Senator, in theory, you can switch from an income tax, which has several layers of tax on capital, to a consumed income tax, or consumption-based tax, which is more even-handed, and do less damage to the economy for the same revenue.

So you could, in a sense, stand a slightly higher rate structure on the remaining tax base and still come up with the same GDP, which is another way of saying you can, indeed, make efficiency gains within the tax system.

The very top rates on labor do have a powerful influence on the length of time worked and the number of small businesses, and so forth, as David has mentioned. I would be careful about raising tax rates at the top much past the mid-30s. You begin to see reactions at that point.

The bottom tax rates are the ones you can play with with the least effect, but we have an equity problem with that. But, nonetheless, if you do rearrange the tax system in certain ways, you can, indeed, get efficiency gains.

I think that is why, when the Europeans decide to carry their tax system from 30-some percent of GDP up to 45, they would use the value-added tax, which is a consumption tax, rather than tinker with income taxes that discourage saving and investment excessively.

I would be careful doing it. As you do it, please look at the after-tax returns to the various labor groups and the savers, because if you do not lower those tax rates and raise the after-tax returns, you will not get the good benefits.

Senator WYDEN. I will tell you again, I did not ask the question about a value-added tax. I asked the question with respect to where that personal income tax reduction money was going. So, I hope that we can continue to work with you on that proposition and not these various other things about value-added taxes.

One last witness.

Mr. GRAFF. Let me give it a shot. I do agree with you, that it is a question of priority. I think, as I said earlier, from my standpoint the priority has to be increasing savings rates by low- and moderate-income working Americans.

We have seen some great history and statistics that Mr. Weinberger talked about in terms of the impact of the Saver's Credit. I think that should be greatly expanded to cover more middle-income Americans.

Right now, for families making $32,501, the credit drops down to 10 percent, like a cliff. It also does not cover a lot of working families, as Mr. Weinberger said, because it is not refundable.

We think that the Saver's Credit really works. If we can expand it even more, we could have a real effective government matching program that would seriously increase savings rates among a very large number of working Americans, possibly covering 70 million American households.

That is quite a contrast to what the impact of the reduced capital gains and dividends tax rates is, which basically benefit less than 10 percent of American households. So I do agree with you, it is a question of priorities. Increasing saving should be a priority, and we think the Saver's Credit is a great way to do that.

Senator WYDEN. My time is up. I knew if I asked the question of enough people, somebody would pick up on essentially what my theme has been. I think the first three thought that I was interested in pitting wealthy people against people in more modest income.

I am not interested in that at all. I am interested in saying, there is a fixed number of dollars, and it seems to me that there are some sure-fire investment winners.

Capital gains incentives, which I have been voting to reduce consistently, strike me as a very good example of that. I am more interested in seeing if we can target there rather than to just kind of go in on automatic pilot and keep going forward with the personal tax cut, which my most affluent constituents tell me they do not really see as a particularly important investment tool.

They all say, just like you said, they would love to have it. Nobody is going to volunteer not to have it. But if we are going to have a debate about investment, it has to be a debate about choices. That is why I asked the question, and I thank my colleagues.

I know Senator Crapo has been waiting, and I have imposed on his time, and I thank him for it.

Senator CRAPO. Thank you.

Chairman Kyl indicated that he had to step out for a moment to go to another hearing. He wants to come back and ask some more questions as well.

But let me ask my questions while we are waiting for him to return. I know we need to go back to Senator Jeffords as well.

I am going to focus in a different way. Mr. Malpass, I noted with great interest that a part of your testimony which you presented here in your written testimony related to the scoring system that Congress uses for evaluating tax cuts.

When you included that in your testimony, you hit a very favorite topic of mine, so I want to go through that with you a little bit, because I have had a tremendous frustration with the way we score and analyze tax cuts as we debate them here in Congress.

Frankly, I believe that we create a false impression to the American public about what the impact of what we are doing really is, and we create hurdles for the development of proper tax policy by essentially creating numbers about what the impact of the tax cuts will be that we know are inaccurate. It seems to me that that is what your opinion is as well, from what I can tell from your written testimony.

Mr. MALPASS. Yes, sir.

Senator CRAPO. I was interested that you said that, by itself, a better scoring system in Congress would actually constitute a very helpful, pro-growth structural reform. Would you elaborate on that a little bit?

Mr. MALPASS. Yes, Senator. Thank you for the question and the opportunity. As the economy thinks about how much it is going to grow, it is making a constant evaluation of what the future tax climate is going to be.

Right now, the way taxes are written, Congress has explicitly ignored whether a tax change is going to affect the growth of the economy. That makes it very hard for you to pass, for example, a tax simplification.

Let us say there was a major tax simplification which everyone agreed was good for the economy. Let us say there was bipartisan support, but it would not score very well because, the way that tax changes are scored now, they would concentrate on the loss of immediate revenues to the government rather than the gains to the economy and the faster growth that would come out of the simplification.

We are in a system where it is unlikely that we can actually improve this tax code that we all labor under. It is an abomination, as people have called it. Yet, there is no way out, because you do not get to score the benefits of what you are proposing.

Senator CRAPO. One thought that I have had is, if we move to a more dynamic system, we ought to be evaluating at least two factors.

One, the net cost of the tax cut to the Federal budget. In other words, there are going to be losses of revenue from the loss of tax revenue through a tax cut, and then that is going to have some kind of an impact on the economy, and theoretically that will generate some more tax revenue coming in. The net figure would be the true cost to the Federal Treasury. It seems to me that that is the one obvious change that we should seek in developing a dynamic scoring system.

But it also seems to me that we should try to put some kind of figure or some kind of analysis into the impact on growth in the economy that will occur as opposed to simply the impact in the budget numbers that we deal with here in the Federal Government.

Is that doable? In other words, do we have the ability to evaluate in the way that we are discussing here?

Mr. MALPASS. I think it can be a goal. I think the problem with economics is, even though it is portrayed often as a science, it is a very abstract and a very soft science. So if you get a group of economists in a room and say, what will happen to the economy if we have tax simplification, you are not going to find agreement on the amounts. There have been efforts over the years to begin to bring economic growth into the equation.

Also, asset prices should be considered. In 2003, when you cut the tax on capital gains and on dividends, the value of stocks in the Nation went up by $3 trillion in just 9 months, and it has gone up from there. A chunk of that is directly attributable to the tax change, and yet not in any way comprehended within the scoring process.

I think perhaps you could phrase it—well, Senator Wyden is gone. He had said he was in favor of the capital gains tax cuts. That can help then allow tax cuts in other areas because of the benefits from these higher asset prices.

I think what you could consider doing would be challenging the CBO and Joint Tax Committee to present systems that could take economic changes into account and then have some kind of an open process to say, how much is tax simplification actually worth to the economy?

I think we have to go from a starting point that, if you had a major tax reform that simplified the U.S. code, you would be adding a quarter of a percent, half a percent, or three-quarters of a percent to the expected growth rate.

My point here is, that would be immediately picked up in the stock market, in people's investment decisions, and you would start getting a positive impact just from embarking on this structural change.

Senator CRAPO. Thank you very much.

Senator JEFFORDS. I would ask to place members' opening statements in the record.

Senator KYL. Absolutely. Senator Jeffords, if you would like to resume questioning now, please go ahead.

Senator JEFFORDS. Yes, please. Thank you.

Dr. Toder, I was interested to read your findings about the mixed results of the rate resulting from cuts in the capital income.

Have you seen any evidence that the lower tax rates have led to an increase in these investments by ordinary taxpayers or even an increase in an overall national savings rate? If we continue to cut taxes on capital income, what do you think this means for taxpayers who rely exclusively on wage income?

Dr. TODER. All right. There are two parts to your question.

Senator JEFFORDS. Yes.

Dr. TODER. One, I would have to say, I am always cautious about trying to make an interpretation from one event causing an event at the same time. You have cut the taxes on interest and dividends. There are lots of factors that are driving the savings rate one way or another.

It is true that, since those cuts, the personal saving rate has actually continued to drop, so there is no evidence that it has moved up. But again, there could be other factors going in either direction that are resulting in that.

I would not expect, for the reasons I stated before and also because low- and middle-income people get a very small proportion of the dividends and capital gains, that that would really have too much effect on their behavior.

People do own a lot of stocks in the middle class, but a good deal of that is owned through IRAs and 401(k) plans and other tax-exempt retirement savings vehicles, so the cut in the capital gains and dividends does not really have much influence on them.

What was your second question?

Senator JEFFORDS. Wage income.

Dr. TODER. Yes. Would it benefit wage earners, these cuts.

Senator JEFFORDS. Yes. Right.

Dr. TODER. Thank you for asking that, because I do want to respond to some things that Steve has said. I really do not know of anybody who thinks that a cut on capital income at the individual level—the story is a little different for corporate tax cuts—is going to have an effect, a significant beneficial effect, on labor income, or will have a significant amount of shifting.

The reason is simple. We live in an international economy and capital income taxes are not all of one type. Capital income taxes are either taxing residents on their income from worldwide sources or they are taxing investment that is located in the United States and not located in other places.

When you are taxing residents on their worldwide income, even if they did not save more, it is not clear at the margin how much of that saving would flow, in an open economy, into increased capital in the United States.

When you change the rates on capital that is sourced in the United States, and the corporate tax largely does that, you could arguably have an effect, if corporate income and investment goes overseas because of higher rates in the U.S. or lower rates in the

U.S. that attracts capital from overseas, we could have a larger capital stock, and that benefit would in turn be shifted to labor. So, it really depends on the kind of tax.

But as for the particular provisions, I see very little shifting of those provisions to labor income. I think most economists would support my point of view. Maybe not the people in this room, but outside.

Senator JEFFORDS. I have one for Mr. Graff.

Senator KYL. Go ahead.

Senator JEFFORDS. Mr. Graff, when it comes down to retirement savings, I think we do need to change direction, not by working against the employer-based system, but by maybe strengthening it.

My hunch is that the small business owners are not indifferent, but their employees probably rank a retirement plan behind wages and health insurance, and other benefits. Is that your experience? If so, how do we turn it around?

Mr. GRAFF. It is. I mean, unfortunately the retirement plan is the last thing that the employer or the employees think about before they adopt a plan. They are worried about their health care. They are worried about their wages. So, they need some motivation.

Frankly, from a cost perspective, it is a lot more costly for a small business to pay for a plan than it is for a larger firm, because they cannot spread the costs over a larger number of workers. The smaller number of workers you have, the more cost per employee goes up.

So one idea that was worked on by this committee, actually passed this committee, passed the Senate in 2001 as part of the 2001 tax bill, was a tax credit for new small business retirement plans.

It provided a 50-percent tax credit for qualified retirement plan contributions on behalf of lower-paid workers by new small business retirement plans for the first 3 years of the plan. It was well supported by this committee.

It was dropped in conference for revenue reasons having to do with other costs associated with the 2001 bill. We think that proposal would do a great deal in terms of increasing small business retirement plan coverage, which would allow a lot more small business workers to have a meaningful opportunity to save.

Senator JEFFORDS. Well, thank you. That is very helpful.

Senator KYL. First of all, I think we have three pure economists here. I guess we are all economists of a sort, but three, at least, with credentials. Now, we have had an assertion by Dr. Toder about, most people would agree with him and disagree with Mr. Entin.

Mr. Malpass, you are the decider here. Does a reduction in capital gains and dividends help labor at least as much, if not more, than capital?

Mr. MALPASS. I think it does. Clearly, we have to somehow bring into the debate and the discussion the lower cost of capital. If I reduce the cost of capital, I am going to get more of it. Somehow, I think that is missing in the discussion. The lower cost of capital elicits more capital, and that is vital in creating higher labor income.

If your worker is able to use a machine, you are going to pay that worker more than if they are not able to use a machine. So, if you lower the cost of capital and you get more machines, you are going to have higher-paid workers.

I think that is clear in American history. As we applied more capital, the living standards have gone up. You can think of it as a cause-and-effect kind of a step. If we look outside the U.S., countries that do not have capital, do not have a friendly climate for capital, maybe they tax capital more heavily, their workers are simply paid less.

Senator KYL. Dr. Toder, since I have picked on you here, let me give you a chance to respond. But is that last comment not absolutely true? If you look at the societies in which people are laboring with their hands and without the aid of a lot of capital versus societies like ours in which capital has enabled us all to become more productive, has it not benefitted everyone, including those in labor, to have the lower tax rates that provide the capital liquidity that permits that to occur?

Dr. TODER. Well, there is a long chain of reasoning there, and I certainly do not disagree that capital is very valuable to the productivity of the economy. I also do not disagree that policies that lower the cost of capital would help labor.

What I am asserting is, these particular policies will not significantly lower the cost of capital. The reason is 2-fold. The people who are getting the tax cuts are not likely to be saving much more on that, and also those tax cuts are not going based on capital supplied in the United States, they are based on capital that is being supplied in a worldwide economy.

So, it is not likely to cause much more investment in the U.S. and much of a reduction in U.S. capital costs. That is the basis of my argument. In fact, I believe capital is a very important ingredient in economic growth. I think everyone in my profession would say so.

Senator KYL. All of the economists would agree with that.

Mr. Entin?

Mr. ENTIN. Eric has made a good point. You have to take the international sector into account. In other writing, I have mentioned how that interacts with these contentions.

The small business, or non-corporate sector, which is less likely to be involved in cross-border transactions, is about 26 percent of GDP, and the corporate sector is about 56, I think I said.

The corporate sector, some of which is very much engaged with the world, could put a plant anywhere. If I save more, General Motors might borrow it and put the plant in Turkey instead of in Kentucky. Well, that can happen.

But many corporations are more domestically oriented. There is a tendency of shareholders to buy stock in the known local companies rather than in the global market, so you have to look at where the marginal investor is in any of this. The marginal saver and investor in the United States is more likely to be the marginal lender to the individual trying to invest here in the United States.

Having said that, if we improve the tax treatment of capital here with the dividend rate relief and avoid taxing foreign shareholders, they may put more money into the U.S., just as we are putting more money into global mutual funds. So, the attraction goes in both directions.

Having said all of that, it is also important to lower the corporate rate and to speed the write-off of plant and equipment located in the United States, so that when we do do our saving and the firms do borrow the money, they have the incentive to put the plant in Kentucky rather than Cambodia.

For that, you need to address the corporate side as well as the individual side. I am not suggesting that you just do one. I was only asked to testify on one thing here today. But, definitely, you need to look at the global consequences of this.

I would suggest to you that this is why the European countries, in the last 20 years, have been lowering their corporate taxes, even while they have been increasing their value-added taxes and making other reshufflings in their tax systems to try to remain competitive while they are burdening their labor with the most incredible tax rates for social insurance and income, and scrambling not to have a complete collapse of their growth rates as they attempt to claw their way up to 40 and 50 percent of GDP in the money they take through government. They have been aware of the international consequences.

We have had, fortunately, a much lower tax burden in the United States, and this has perhaps made us a little bit lackadaisical about how we regard international capital flows in the tax treatments of corporate income.

I would suggest, for starters, that when you really do a job on corporate reform, that you have a territorial system rather than a global one, and go to expensing and get the investments here, while letting our companies actually compete abroad so that our foreign subsidiaries can buy things produced here to finish abroad and compete with third country companies. Thank you.

Senator KYL. I have a feeling that some of those concepts are going to be discussed in the recommendations of the President in the so-called Mack-Breaux Commission. At least, that is my understanding, having talked to some of them.

I have a couple of other questions. But Senator Jeffords, if you have some at this point, I would be willing to defer to you.

Senator JEFFORDS. I have no further questions.

Senator KYL. All right. Thanks.

Senator JEFFORDS. This has been very informative. I want to thank the panel for the exceptional answers that have helped us very much in understanding the problem.

Senator KYL. I agree. This is very helpful. It is like an economic seminar in school, but it is more fun than it seems like it was back then.

Senator JEFFORDS. Mr. Harding, do you want to say a word?

Mr. HARDING. Yes.

Senator KYL. We are not done here. I have some other things, too. But go ahead, Mr. Harding.

Mr. HARDING. Well, thank you, Senator. I just want to say, I am certainly not a world-class economist and do not belong up here with these fine gentlemen, but let me just address a couple of things about how somebody behaves on the ground in business, versus some of the comments I have heard.

Number one, if we have a chance to invest, we are going to go out there and spend more money. If we spend more money and grow, then labor, people that work for our companies, have a chance to get better, move up through the ranks, and earn more money. So, certainly, any time we have a chance to invest, people get a chance to grow and earn more money, period. It is just that simple.

I was a little surprised that the gentleman at the end, with all due respect, said that as business people, we are discouraged from wanting to have retirement plans.

It is tough to get qualified workers today. The way you get qualified workers is to have good benefits and a good retirement plan. So, we are always going to be encouraged to do those things, if we want to last. We have been in business since 1949.

I always say, if we are going to stay around another 50 years, another 60 years, whatever it is, we have to do the things that are smart, take care of our people, and get a chance to grow. That is the longevity.

I mean, that is on the ground, what we look at. I am not smart enough to know all the graphs and everything, but that is how we behave. So, I apologize if I am out of order.

Senator KYL. No, no. Thanks.

Senator JEFFORDS. Those are excellent comments.

Senator KYL. Yes. I was reminded, those of us who are not economists, we have our favorite little sayings about economists, one of which is that an economist sees something working in practice and wonders if it will work in theory. [Laughter.]

Now, let me apply that. Here is one where we may get unanimity. Mr. Harding has talked about the practical problems with uncertainty in the tax code. I wonder if our experts would agree, and each would be willing to make a little comment, about the impact of uncertainty.

Let me precede that with this confession. One of the reasons why we have these temporary provisions in the tax code is that we have not had the consensus to get 60 votes on some of these provisions, which would be the necessary number of votes to effectuate permanent policy.

So instead, we work within the budget window. If we have a 5-year budget, then we can do a tax policy that is good for only 5 years. If we have a 10-year budget, we can have a tax policy that is good for only 10 years. Well, it is as good as we can do without 60 votes, but it sure creates some problems, as Mr. Harding suggests.

I wonder what that kind of uncertainty means, both as a matter of theory and practice, from those of you who work on this every day, and therefore what recommendations you have with respect to policies, such as the dividends and capital gains rates, which in fact do expire in the year 2008 unless they are dealt with? That is to say, the 15-percent rates expire at that time.

Mr. Weinberger, let me start with you and just go on down the panel.

Mr. WEINBERGER. Well, Senator, there may be some virtue to those windows, because as circumstances change, there is an opportunity to make adjustments. It is the functional equivalent, I guess, of a sunset law.

For example, with the Saver's Credit, as we were discussing today, which expires in 2006, we are before you essentially looking at the evidence to see whether it works, whether there are better alternatives, what the evidence actually shows.

I think that can be a healthy process, especially so knowing how sometimes late at night, when tax bills are cobbled together and various considerations are at play, they may not always get the same thoughtful consideration that time allows. If certainty is a virtue, so is flexibility in adjusting, I think, to changed circumstances.

Mr. MALPASS. Senator, I am a little concerned that a growing portion of the tax code is going to get subjected to this budget window constraint that you are working on. The R&D tax credit seems to be under it. It looks as if the 2003 tax cut will be under it, and might even be out into the future. There is a growing problem that you are addressing, so I think that it's good to think about it as a problem.

It would be very good for long-term capital formation in the U.S. to make permanent the lower rates on dividends and capital gains. I think that would be a good goal. I do not know how you can work that out with the rules that you are dealing with now.

With regard to uncertainty, it is worse than you might think. If something is uncertain, and half the people want one outcome and half the people want the other outcome, as long as you do not decide the outcome, then both of them may be paralyzed. Neither side may want to make the decision as long as the uncertainty persists.

It actually turns out that uncertainty stops decision making, as well as changes people's decisions. I think that is a growing problem. You can imagine business executives around the country saying, I am going to wait to make this decision until I see what the tax code is going to look like in 2011.

Senator KYL. Thank you.

Dr. Toder?

Dr. TODER. Thank you. I really do share your concerns about the overuse of sunset provisions in the tax law, for a number of reasons. One, obviously, is the uncertainty it provides to business planning and people knowing what their tax circumstances will be 3 or 4 years from now, and how the provisions will affect them.

I also think, as someone who is concerned about long-term deficits and fiscal responsibility, that it gives the illusion of fiscal responsibility, because provisions sunset. But, in fact, it is very difficult, once you have cut taxes on someone, to raise them back again.

So, particularly I am thinking of provisions like the AMT, which is a time bomb for the tax system. But when you extend relief 1 year at a time, it really looks like it does not cost much money. But if you did that every year, it really would cost a lot of money. It is something that I would hope the Congress would face up to at some point and deal with.

David Malpass mentioned the R&D credit. I had to smile when he said that, because that was actually enacted in 1981, originally. It has been with us for 25 years. I would guess, probably, business thinks it is permanent by now, since you always tend to extend it. So why not just do it?

Senator KYL. A 1-year credit.

Dr. TODER. Right. Right. So I guess, even though I do not share the other witnesses' views on extending this particular provision, I think it would be, again, better to deal with it one way or another than to have a 3-year extension.

Senator KYL. Mr. Entin?

Mr. ENTIN. You might try reforming the R&D credit the next time you extend it. It is kind of a mess. But that is an aside.

Treasury is thinking about reinstituting the 30-year bond. Well, even if they do not go that far, just think about the 20-year bond. A new one being sold today extends well past the time that the rates are supposed to go back up to the old pre-2001 levels.

What interest rate does a saver want to see so that he can get a targeted after-tax return on that bond? Is he going to assume the rates stay down? Is he going to assume the rates go up?

Is he going to give some probability distribution to it? Where is the coin flip going to come down? Is he going to want a 4-percent return on that bond, or 4.5 percent? You are going to see a change on your budget right now from the failure to create certainty on that bond over time.

What about the tax treatment of shareholders? What about the dividend? What about the perceived cost of capital? What about the perceived share price?

A company may be thinking of issuing new shares to build a new factory. Maybe the machinery will wear out in 3 or 4 years, before 2011, so they can decide then whether to replace the machinery. But the factory building may last 50 years, and you need a building to put the machinery in. So, at least part of the investment is going to be hit, as it earns its returns in the future, on what happens to returns after these provisions expire. The tax outlook is going to affect corporate planning today, and affect investment today, and affect the number of people working in the United States today, and what you get in payroll taxes and income taxes on wages.

So the more certainty you can create, the stronger these responses on investment are going to be, the more people will be put to work sooner, at higher wages.

Yes, I think these provisions really need to be made permanent, but to do so you are going to have to get a better understanding of what they do for people, because the burden tables do not show you that, and the benefit to the truck driver of having his boss keep the fifth truck does not show up in the burden tables.

Senator KYL. That is one of the most useful things, at least to me, that has come out of the hearing today.

Mr. Graff, you talked about the complexities and difficulties of administering these plans, and I presume that uncertainty is another variable that you can factor in there as well.

Mr. GRAFF. Absolutely.

Senator KYL. We have a unanimous panel on at least this one point.

Mr. GRAFF. Uncertainty. I suppose uncertainty and your views on whether a provision sunsets or not, to some degree, depends on whether you like it or not.

I think, with respect to many provisions in the tax code, obviously, it would be preferable that there not be a question as to whether or not they are going to continue, certainly. The rules in ERISA have been relatively constant. Although ERISA has been amended 25 times, in general, most of the basic rules have remained unchanged.

However, I think there is some benefit associated with provisions that do sunset, in that it allows Congress to decide what priorities should be on a going-forward basis to reassess whether this makes the most sense, or doing something else might be an opportunity to achieve the policy objective in a more effective means. So, I do think, to some degree, from a tax policy perspective, there are some advantages.

If I could just take a moment to respond to something Mr. Harding said.

Senator KYL. Yes.

Mr. GRAFF. I have no doubt that his opinion is certainly genuine with respect to his own firm, but our members' experience has been that profit-maximizing small business owners rarely adopt these retirement plans due to employee pressure.

The small business has been operating quite successfully for some time without the plan. Rather, the retirement security of the owner generally is the driving force behind the adoption of the plan, and the owner is fine to make contributions on behalf of the workers, and likes to, if it makes financial sense for the owner to do so.

However, assume a small business owner is thinking about adopting a 401(k) plan for the first time. If I can go in and tell that small business owner, like I used to do—I used to sell retirement plans for a living at one point—and tell him or her that I can generate 30 percent more in accumulated savings after taxes by not having a retirement plan, that owner is going to think long and hard before adopting one of these plans, assuming all the costs, and assuming the potential risk and liability that goes along with having one of these plans.

Ultimately, I think the proof of my point is in the tax code itself. I would refer you to code section 416, the top-heavy rules. These rules, by operation, apply only to the smallest of small businesses, those with less than 25 employees.

These rules mandate contributions be made on behalf of workers if the owner wants to save in the plan. This rule has been around for 23 years. Why would Congress mandate small businesses make these contributions if it was not concerned that, without the rule, small business owners might not feel the need to provide the benefits to workers?

We really do think this is a real issue and a concern, and we hope you will consider carefully the potential risks to the retirement security of small business owners.

Senator KYL. Yes. Let me make this point, though. You have complained, I think with some good reason, that Congress imposes a lot of burdens on these retirement accounts that you have to set up and administer, talk people into setting up, and so on.

You say, actually, you can compare favorably other kinds of investments to these kind of plans. But is the answer for us not to remove the difficult burdens of the kind of section that you just mentioned, and a lot of other complexities, to the creation and operation of these kind of plans rather than increasing a tax someplace, like dividends and capital gains?

And, in fact, is it not true that the substantial dividends that were paid after we cut the dividend rate to 15 percent have benefitted these kinds of plans, the people who are in the plans, tremendously since we set it up?

Microsoft never paid dividends. If I am in one of these plans and I had Microsoft stock, it did not do me any good. In that case, I think you are right. You would want to have that stock outside of the plan.

Once you have this kind of dividend rate and companies paying that dividend rate, these plans are benefitting from that. They are not losing from it. They are benefitting to the same extent as if you had the investment outside the account.

So it seems to me that what we ought to do is get all the ideas from you we can about how to make these plans simpler, less costly, easier to administrator, easier to establish, but not try to raise taxes someplace else so that these plans will compete favorably with some other kind of investment.

Mr. GRAFF. I understand what you are saying. I, like Senator Jeffords, am all for cutting taxes. It is a great thing. The question is priority and revenue dollars. There is no question that, as I said before, 70 percent of American households own their mutual funds through these retirement plans. They do not directly benefit from a cut on tax, capital gains, and dividends.

Senator KYL. They do not?

Mr. GRAFF. They do not directly benefit. When the money comes out of the retirement plan, it is taxed at ordinary income rates.

Senator KYL. Well, I understand. Our portfolio of stocks in the country all benefitted from the reduction in dividends rates, even though not all the corporations paid dividends out to their stockholders. Right?

Mr. GRAFF. There are a number of economists here. They can tell you whether the incidental effect of the reductions in capital gains and dividends have had a direct impact on the values of the stock market. You may be right, to some degree it has. But is that the most efficient way?

Senator KYL. Excuse me. Not to mention the effect on corporate governance, the policies toward equity versus debt financing. I mean, there were a lot of reasons why we did this.

Mr. GRAFF. Again, I am not differing with you. There are some positive things, in general, about the concept of reducing capital gains and dividends rates. That is not what I am concerned about.

What I am concerned about is, if we continue to provide added incentives to those non-qualified investments, we have to, by definition, reduce the relative incentives for qualified plan investing. And you are right. We need to look very hard at making sure that we do not create disintermediation that is going to result in people saving less——

Senator KYL. Excuse me for interrupting, but you have persuaded me. I will sign up for your plan to reduce the burdens on your kind of investments so they are just as low as the ones over here. How is that?

Mr. GRAFF. It would be great. If we had unlimited resources, I am with you.

Senator KYL. All right. Good. Thanks.

Mr. Entin?

Mr. ENTIN. In ordinary saving, you pay tax, then you take your after-tax money and you put it into stock, and you are paying tax every year on the dividends and any capital gain. So, you are basically paying two layers of tax on that saving.

In a qualified plan, you get to defer the tax on the principal, or if it is a Roth-type plan, you pay it up front, but then do not pay tax on the returns. The qualified plan is always going to do better than the ordinary saving.

Even if you lowered the tax rate on the ordinary saving, it is still not going to accumulate as much over time as if one or the other of the taxes was completely removed. The relatives do shift, but you do not end up being worse off in the qualified plan if the ordinary tax is simply reduced.

Now, the person about to buy the fifth truck does not care whether the bank got the money from someone who was putting it into an IRA or an ordinary savings account. The truck driver, whose job is spared because the fifth truck is kept, does not care where the saving came from.

It may be nice to have people protected against poverty and old age so they do not end up knocking on your door for welfare when they get old, and that is a social concern which probably should be addressed with personal accounts via the Social Security system. But to try to restrict tax benefits only to retirement saving instead of spreading it more widely so that all saving is not double-taxed, and so we get more total saving, is a mistake because all saving is good for growth and for wages.

Now, one of the things we have observed is that people are much more likely to save out of an increase in pay than out of their current level of pay. Try to talk them out of consuming less and saving more today without a raise. But if they get the raise, they are much more likely to put it into the 401(k).

Increasing capital formation and increasing wages is a darn good way to encourage people to save, and restricting favorable tax treatment of saving is not the way to get there. I think all saving should have neutral treatment, and we should not favor one type of saving plan or one industry group over another. All the saving should be treated the way it would be under a neutral tax system.

Senator KYL. I could go on here for a long time, but I think, in the interest of everybody's time, we should probably finish the hearing.

If there are questions from members who could not be here, we will take some of those for the record. I am not sure. We will leave it open until close of business tomorrow, so some of you might get some love letters from us wondering about some additional things.

But I really want, both on behalf of Senators Jeffords and myself, to thank all of you for your contribution to this debate. The purpose of this hearing was to figure out what kind of arguments there are, pro and con, for extending the tax policies that we have been talking about here, or terminating them, allowing them to lapse. I think you know where I stand on that.

But, clearly, we are going to have some more debate about this in the Congress, then probably at the time of the reconciliation bill, take a lot of these things up. One of you started by talking about the market today.

Mr. MALPASS. That was me.

Senator KYL. Mr. Malpass, yes. About the Federal Reserve rate increase. Let me just send a little message, for whatever it matters, to anybody who is listening to me.

That is, it has been my intention to demonstrate that the desire to continue to extend rate cuts—such as the 15-percent capital gains and dividends—for another couple of years—even though we cannot do that permanently right now—should be seen as a signal of our intention to continue, as we have with the R&D tax credit, to make this an essentially permanent feature of our code, even though we have not made it into permanent law.

So, that is my hope in achieving at least that degree of certainty at this point, and we will just have to keep on working on all of the other provisions.

By the way, almost all of them will now be coming due in 2010. I think you were pointing out, Mr. Graff, that every now and then it is a good idea to be forced to kind of look at these things. Well, we are going to be forced to look at them, if not before, at least by 2010, when all of these things, including the marginal rate cuts, would expire.

If there is nothing else then from our panelists, again, thank you. Your testimony was terrific. We appreciate all of you being here.

I will declare this hearing adjourned.

[Whereupon, at 3:47 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Hearing on Savings and Investment
Statement by Senator Max Baucus
June 30, 2005

MR. CHAIRMAN and Mr. Jeffords, thank you for calling this hearing today on the potential extension of certain expiring tax provisions and ways to encourage savings and investment. I think we can find common ground on many of these ideas, starting with the Saver's Credit.

Today, we will hear from a representative of H&R Block, a company which has seen first-hand how millions of low-income taxpayers have started these retirement savings accounts with a matching contribution in the form of a tax credit. As Congress debates ways to get more Americans saving for the future, this is surely one success story we should study.

We will also hear testimony today from a small business owner who has utilized the enhanced incentives for investment in business equipment and machinery. I look forward to hearing his testimony about how this additional expensing for investments has helped his business become more competitive and more successful.

Our subcommittee will also hear testimony on a potential extension of the capital gains and dividends tax cuts. On this issue, we will hear divided opinions of the efficacy of these cuts, the distribution of the benefits, and the negative impact on some forms of qualified pension plans.

Mr. Chairman, the pamphlet prepared by the Joint Tax Committee for this hearing shows that 84% of capital gains are reaped by taxpayers making over $200,000, while taxpayers earning less than $50,000 only have 1% of all capital gains for calendar year 2005. The total amount of capital gains earned in 2005 by those making over $200,000 was $275 billion, while those earning less than $50,000 saw only $4 billion. Further, almost half of all dividends are received by those making over $200,000, while only 12% of the total goes to those earning less than $50,000. From these statistics, it does not appear that the 2003 incentives have done much to change what we thought the distribution of these benefits would be.

Even putting aside the distribution, only 7% of all American households filing returns show any capital gains and only 14% have dividends, with a significant crossover between the two groups. The numbers are little better in my home state of Montana, with 22% of returns with capital gains income and 26% with dividend income, but still not what I would have thought given the promises that these cuts would raise savings and investment across the board.

Now, what can we learn from these facts? This Committee will be faced with some hard choices on priorities this year and this hearing today provides just such a comparison. Joint Tax has estimated a permanent extension of the Saver's Credit will cost only $10 billion. However, a permanent extension of the dividends and capital gains cuts would cost almost $160 billion over the next decade even though the current cuts do not even expire until 2009. It is my hope that our experts today can help us answer these questions of how best to allocate our scarce resources for tax incentives.

I would also like to add another concern as we debate the appropriate level of tax for savings and capital. I understand that a proposal being considered by the President's tax reform panel is one that would shift our tax system to a wage-based tax. One step towards such a system would be a zero rate of tax on capital gains and dividend income. I would hope that this Committee would consider any such proposal by not only looking at the static revenue impact, but also at what such change means for our economy and for the American worker.

I believe that one of the most important things to keep in mind in any tax reform effort is fairness. I will not raise taxes on working families in Montana – or across the nation – under the guise of tax simplification. I believe in our progressive tax system. And any proposal that would shift the lion's share of the tax burden onto the backs of the American worker would not be a welcomed change. The farmers and ranchers in my home state of Montana already struggle under significant tax burdens. Shifting more of the burden onto working families simply because they receive a paycheck is the wrong way to go.

Thank you, Mr. Chairman and Mr. Jeffords. I look forward to the testimony.

IRET *Institute for Research on the Economics of Taxation.*

Extending the Fifteen Percent Tax Rate on Dividends and Capital Gains

Statement of Stephen J. Entin
President & Executive Director
Institute for Research on the Economics of Taxation

before the
United States Senate Committee on Finance
Subcommittee on Taxation and IRS Oversight

Hearing on
Encouraging Savings and Investment: Stay the Course or Change Direction?

June 30, 2005

Several provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001, as amended by the Jobs and Growth Tax Relief Reconciliation Act of 2003, helped to end the recession by turning around a severe slump in investment. Three key provisions either have expired, or soon will expire, if not extended by the Congress. The 15% top tax rates on dividends and capital gains, enacted in 2003, will expire at the end of 2008. The marginal income tax rate cuts enacted in 2001, and accelerated to full effect in 2003, will expire at the end of 2010. The 50% expensing provision in the 2003 Act was billed as a temporary jump start for investment and the recovery, and was allowed to expire at the end of 2004.

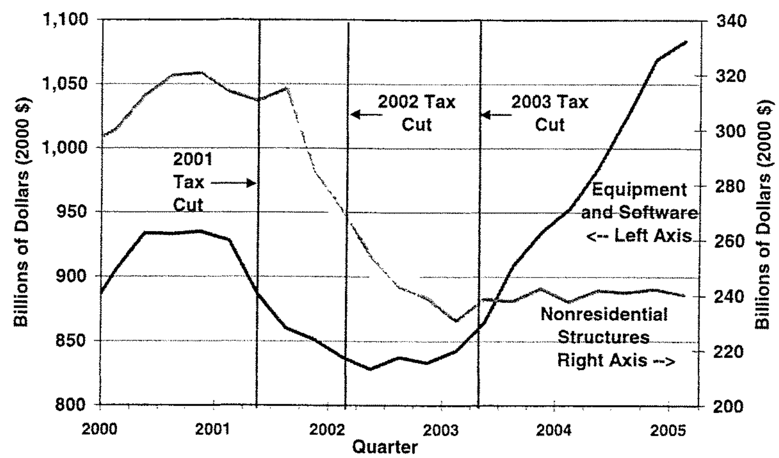
The expected future tax treatment of saving and investment affects saving and investment being done today. Allowing the remaining investment-related provisions to expire would jeopardize the economic recovery. Extending them now, rather than waiting until the last minute, would reduce uncertainty as to whether the more favorable tax treatment will be available for investments whose lives extend beyond the sunset dates of the tax provisions. Immediate extension would boost investment spending, employment, and wages starting now, not three to five years down the road.

Recent swings in the economy have mirrored swings in investment.

The main cause of the 2001 recession was a sharp drop in investment. The decline in spending on equipment and software, and in non-residential structures, is shown in Chart 1. The chart also shows the response of investment to subsequent tax changes.

The 2001 Tax Act cut passed the Congress on May 26, 2001, but investment spending continued to slip for the rest of the year. That tax reduction did very little to encourage additional investment spending in the short run, giving out money mainly for social policies that are not related to economic growth. The bill's marginal tax rate reductions on small business owners, corporate shareholders, and

Chart 1 Real Private Investment And 2001, 2002, and 2003 Tax Cuts



Data Source: BEA, National Income and Product Accounts, Table 5.3.6, accessed via www.bea.gov.

other savers, which would have reduced the service price of capital and encouraged investment, were largely deferred until later years, with only half a percentage point effective in 2001. There was nothing else in the bill that directly lowered the cost of business investment.

The early stages of the economic recovery in 2002 were weak because investment remained weak. The Jobs Creation and Worker Assistance Act of 2002 was signed into law on March 9, 2002. It contained a special 30% "bonus expensing" provision for investment in equipment and software (but not for most structures). Also, the second half-point step in the phased income tax rate reduction became effective in 2002. Investment in equipment and software (but not structures) began to recover, modestly, over the next four quarters.

The 2003 Tax Act was signed into law on May 28, 2003. It upped the special expensing provision to 50%, directly cutting the cost of equipment and software (but not most structures) for corporate and non-corporate businesses. More importantly, it also brought forward to 2003 the remaining 2 to 3.6 percentage points marginal income tax rate reductions on small business owners, shareholders, and savers scheduled for 2004 and 2006. Most importantly, for taxpayers in the top four brackets, it cut the top tax rates on dividends and capital gains from 20% to 15% through 2008. For taxpayers in the 10% and 15% brackets, the rates were set at 5% through 2007, and zero in 2008.

Investment in equipment and software shot up almost at once. Investment in non-residential structures, which was helped by the capital gains, dividend, and marginal tax rate cuts, but got no direct depreciation relief, abruptly stopped its decline and rose by a slight amount. Investment and growth remained strong throughout 2004. Employment and wage growth advanced. The expensing provision expired at the end of 2004. Investment growth seems to have slowed a bit since.

The tax cuts lowered the service price of capital. Failure to extend them would raise the service price and reduce GDP.

The size of the capital stock and the level of investment depend on the service price of capital. The service price is the rate of return that an investment must earn to pay the taxes owed, cover its cost (depreciation), and yield a normal after-tax return to its owner. A tax increase on capital income raises the service price, and renders impractical any investment projects that cannot meet the higher service price. A tax reduction on capital income lowers the service price, and makes additional investment projects possible.

Chart 2 and Table 1 show the service prices of various types of capital (equipment and software, structures, inventory, land) in the corporate and non-corporate sectors under 2004 law, with all three investment-related tax provisions in place. They also show the higher service prices that would result from their expirations, first of the expensing provision, then the 15% tax cap (corporate sector only), and then the marginal rate reductions. The numbers are for the private business sector, which is about 80% of GDP. The corporate sector is about 56%, and the non-corporate private sector about 24% of GDP.

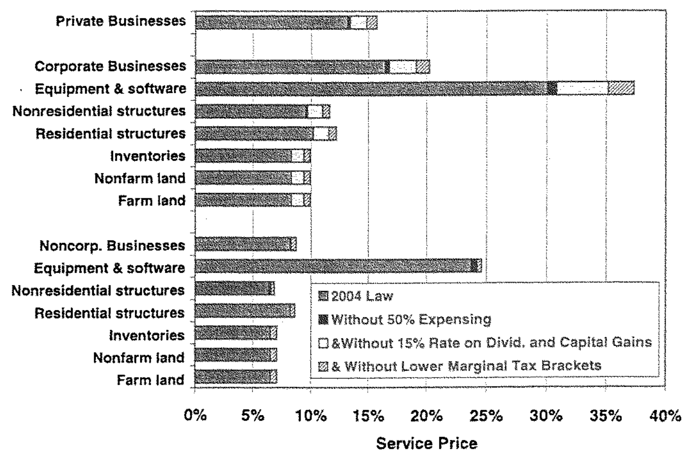
The tax changes of 2003 boosted investment and GDP by lowering the service prices of various types of capital to the 2004 levels shown. For the whole private sector, the reduction was 2.5 percentage points, from 15.7% to 13.2%. The biggest reduction was in the corporate sector (a drop of 3.7 points, from 20.2% to 16.5%), where the largest cut was on equipment and software (7.2 points, from 37.3% to 30.1%). All three of the investment-related tax provisions, including the 15% tax rate on dividends, applied to the corporate sector. The non-corporate sector benefitted mainly from the individual marginal income tax rate reductions and the expensing provision. The service price in the non-corporate sector, which fell from 8.7% to 8.2%, is far lower than in the double-taxed corporate sector.

The biggest reduction in the corporate service price on equipment and software (over 4 points) was due to the 15% rate cap on dividends and capital gains, which reduced the double taxation of corporate income. Next in size was the marginal tax rate reductions on shareholders (about 2 points), then the expensing provision (under 1 point). In the non-corporate sector, on all assets together, the marginal tax rate reductions had the bigger impact, with expensing larger for equipment and software.

Allowing the expensing provision to expire eliminated about 8 percent of the cut in the service price available in 2004. Allowing the 15% rate cap on dividends and capital gains to lapse would eliminate about 56% of the cut in the service price. Allowing the marginal tax rate reductions to expire would end the remaining 36%.

Each percentage point reduction in the service price of capital increases the capital stock over time by about 1.5%. The resulting increase in the productivity of labor increases the demand for labor, and raises the total wage bill by a roughly similar percent. Private sector GDP rises by about 1.5%, with about two-thirds going to labor income and about one-third going to capital income, pre-tax. Various layers of government take a bit over 30% of the increase in income as taxes, a revenue gain of about $40 billion to $50 billion a year. Increases in the service price have the opposite effect on incomes and tax

Chart 2 Service Price Of Private Business Capital



Data Source: Gary Robbins, Heritage Center for Data Analysis

Table 1 Service Price of Private Business Capital

	2004 Law	Without 50% Expensing	Without 15% Rate on Dividends and Capital Gains	Without Lower Marginal Tax Brackets
Private Businesses	**0.132**	**0.134**	**0.148**	**0.157**
Corporate Businesses	**0.165**	**0.168**	**0.191**	**0.202**
Equipment & software	0.301	0.308	0.352	0.373
Nonresidential structures	0.096	0.097	0.110	0.116
Residential structures	0.102	0.102	0.115	0.122
Inventories	0.083	0.083	0.094	0.099
Nonfarm land	0.083	0.083	0.094	0.099
Farm land	0.083	0.083	0.094	0.099
Noncorporate Businesses	**0.082**	**0.083**		**0.087**
Equipment & software	0.237	0.243		0.246
Nonresidential structures	0.064	0.066		0.069
Residential structures	0.082	0.082		0.086
Inventories	0.065	0.065		0.071
Nonfarm land	0.065	0.065		0.071
Farm land	0.065	0.065		0.071

Data Source: Gary Robbins, Heritage Center for Data Analysis revenues. Failure to account for the changes in GDP and incomes, particularly labor incomes, seriously distorts the estimated revenue consequence of changes in taxation of capital.

Every tax bill relating to capital income and cost recovery that Congress considers should be examined for its effect on the service price of capital. The Joint Committee on Taxation, in conjunction with the Congressional Budget Office, should develop or borrow the software to conduct that calculation, and report the result to the Finance and Ways and Means Committees along with the (static) revenue estimate. If the bill increases the service price, it will reduce investment and GDP, which will reduce or eliminate the expected revenue from the provision. If the bill lowers the service price, it will raise GDP, which will provide some revenue reflow. If you are comparing two tax provisions, and one raises the service price more than the other relative to the amount of revenue expected to be raised, then that bill will do more economic damage, per dollar of revenue raised, than the other.

Current tax system is biased against saving and investment.

The 15% top tax rate on capital gains and dividends is a step toward fundamental tax reform. It may be thought of as mitigating the double taxation of corporate income. Alternatively, it may be viewed as offsetting some of the basic income tax bias against saving, in effect extending to more saving about half of the tax relief given under Roth IRAs.

Federal and state tax systems hit income that is saved harder than income used for consumption. At the federal level there are at least four layers of possible tax on income that is saved.

1) Income is taxed when first earned (the initial layer of tax). If one uses the after-tax income to buy food, clothing, or a television, one can generally eat, stay warm, and enjoy the entertainment with no additional federal tax (except for a few federal excise taxes).

2) But if one buys a bond or stock or invests in a small business with that after-tax income there is another layer of personal income tax on the stream of interest, dividends, profits or capital gains received on the saving (which is a tax on the "enjoyment" that one "buys" when one saves). The added layer of tax on these purchased income streams is the ***basic income tax bias against saving***.

3) If the saving is in corporate stock, there is also the corporate tax to be paid before any distribution to the shareholder, or any reinvestment of retained after-tax earnings to increase the value of the business. (Whether the after-tax corporate income is paid as a dividend, or reinvested to raise the value of the business, which creates a capital gain, corporate income is taxed twice — ***the double taxation of corporate income***.)

4) If a modest amount is left at death (beyond an exempt amount that is barely enough to keep a couple in an assisted living facility for a decade), it is taxed again by ***the estate and gift tax***.

Eliminating the estate and gift tax and the corporate tax would remove two layers of bias. Granting all saving the treatment given to pensions or IRAs, either by deferring tax on saving until the money is withdrawn for consumption (as in a regular IRA), or by taxing income before it is saved and not taxing the returns (as in a Roth IRA), would remove the basic bias. Saving-deferred taxes, the Flat Tax, VATs, and retail sales taxes are examples of saving-consumption neutral taxes.

The tax on capital gains is a double tax even for the non-corporate sector. The current value of a share of stock or a non-corporate business is the present (discounted) value of its future after-tax earnings. If for any reason (reinvested earnings, discovery of a better mousetrap, etc.) future earnings are expected to rise, the current value of the business or price of the stock will rise. If the future income does rise, that added income will be taxed when earned. To also tax the associated increase in the present value of the business is to double tax the future income.

Effects of marginal income tax rates on labor and capital.

Taxes on labor and capital income force up the cost of labor and capital, and reduce the quantity offered and employed. The supply of labor is not very elastic. Consequently, much of any tax imposed on labor is borne by the workers. [Chart 3.] Most people must work to have a satisfactory income, and many must conform their hours of work to the requirements of their employers. Moving across national borders is less of an option for labor than for capital. (Workers have some choices — to take or reject overtime, to contribute a second family earner to the labor force, how long to vacation, and when to retire.)

The quantity of capital is more sensitive to taxes than is the quantity of labor. When a tax is imposed on capital, the quantity of capital employed falls until the rate of return rises to cover the tax, leaving the after-tax return about where it was before the tax. The tax is largely shifted to users of capital and those who work with it. [Chart 4.] Capital is easily reproduced (elastic supply) and it takes a large change in the quantity to make a large change in its rate of return. As for people's willingness to finance capital formation, people can always consume instead of save, or invest abroad instead of in the United States, if the rate of return on saving and investment is driven down by rising taxes.

The differences in the elasticities of supply and demand for labor and capital suggest that there is an economic advantage to moving away from the so-called broad-based income tax, which taxes income used for saving and capital formation *more heavily* than income used for consumption, to various taxes that are saving-consumption neutral.[1]

The tax treatment of capital hurts labor.

The more there is of any one type of factor, the higher will be the productivity and incomes of the other factors that work with it and gain from its presence. A tax that reduces the quantity of capital lowers the wages of labor. Labor thus bears much of the burden of the tax on capital. (See Chart 5.) Because capital is more sensitive to taxation than labor, a tax on capital will have a relatively large adverse impact on the quantity of capital, which will then cause a relatively large drop in the marginal product and compensation of labor.

Consider a small trucking company with five vehicles. Suppose that the rules for depreciating trucks for tax purposes change, with the government demanding that the trucks be written off over five years instead of three. The owner has had enough business to run four trucks flat out, and a fifth part time. He is barely breaking even on the fifth truck under old law. It is now time to replace one of the trucks. Under the new tax regime, it does not quite pay to maintain the fifth truck. The owner decides not to replace it, and his income is only slightly affected. But what happens to the wages of the fifth truck driver? If he is laid off, who bears the burden of the tax increase on the capital?

Chart 3 Effect of Tax On Labor

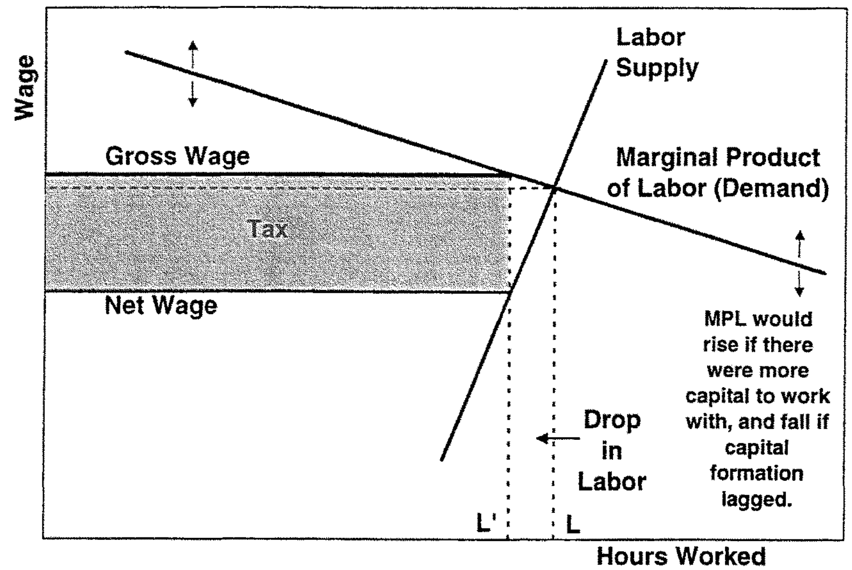
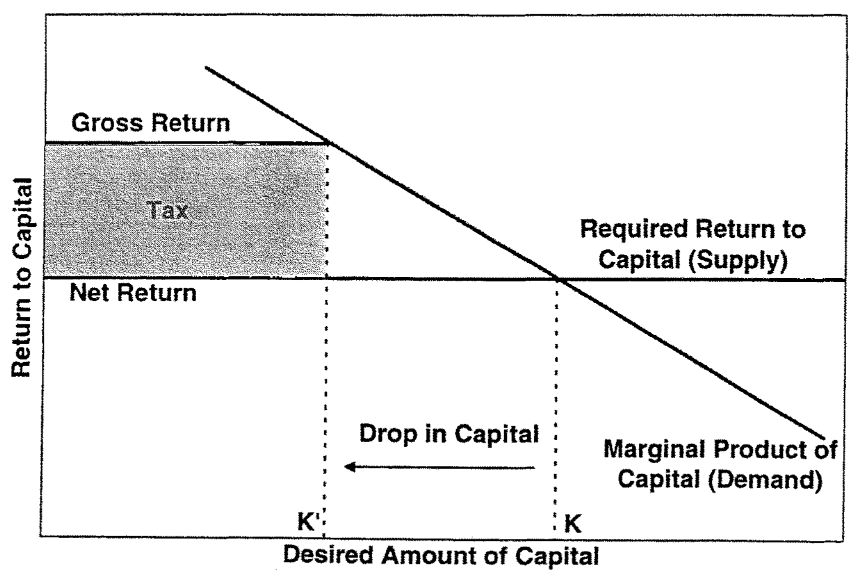


Chart 4 Effect of Tax On Desired Capital Stock



Several studies in the economic literature illustrate that a zero tax rate on capital income would raise the after-tax income of labor, in present value terms, even if labor must pick up the tab for the lost tax revenue.[2] Productivity and wages would be higher (Chart 4 in reverse), leaving workers with higher gross wages and more after-tax income.

Budget impact.

The faster economic recovery since the 2003 Tax Act has improved the budget outlook. For the fiscal year to date, through April, federal revenues are running 13.7%, or $146 billion, ahead of 2004 levels. The deficit for the first 7 months of fiscal 2005 is running 15.8%, or $47 billion, below that of fiscal 2004. There have been large gains in taxes not withheld. These revenues are from non-corporate business income, bonuses and options, and capital gains and dividends. A large part of the improvement in FY 2005 receipts is due to higher capital gains realizations and higher dividend payments.

Dividend payments have risen sharply since the 2003 Act.[3] They would rise further if the 15% tax rate were made permanent. More companies are paying dividends. Many are raising dividends. More would do so if the rate reductions on their shareholders were made permanent. Added dividend payouts reduce the revenue loss from lowering the rate on dividends already being paid. Under their revenue estimating rules, the JCT and Treasury try to gauge the increase in dividends due to a tax rate cut. This will be new territory for them, however. Furthermore, they do not go on to calculate the reduction in the service price of capital and the resulting increases in investment, employment, and wages, and so they miss the higher tax revenues resulting from the higher incomes.

Treasury estimates for extending the 15% tax rate cap on dividends beyond 2008 include revenue gains of about half a billion a year from higher dividend payments in 2005-2008. Treasury is acknowledging that some firms have hesitated to raise dividends, or have limited the increases, due to uncertainty about how long the lower rate will last. Extension would boost payouts starting now, adding to short term revenue. Treasury shows losses in the out years from lowering the rates on dividends they assume would have been paid in their baseline. This loss is exaggerated by failure to take account of the economic impact on investment, employment, and wages.

The Treasury, the Congressional Budget Office, and the Joint Committee on Taxation underestimate swings in revenue from tax rate changes on capital gains. A tax rate reduction has three effects: an "unlocking" effect as people choose to realize ("take") more gains at low tax rates; a valuation effect, as the lower tax rate increases the market value of stocks and increases the quantity of gains available to be taken; and an economic effect, as the lower tax rate on capital reduces the service price of capital, and raises the desired capital stock, investment, employment, output, and taxable incomes.

Federal revenue estimators try to account for the unlocking effect under their revenue scoring rules, but they ignore the market effect (stock markets have risen since the 15% capital gains rate was enacted) and, most importantly, they ignore the economic effect of the reduction in the service price of capital. In addition, the unlocking effects have generally been larger than the estimators anticipated. Studies in the mid-1980s at Treasury suggested that the reductions in the capital gains tax rate from nearly 40% to 28% in 1979 and from 28% to 20% in 1981 have raised revenue.[4] By contrast, the capital gains rate hike, from 20% to 28%, enacted in 1986, was followed by a collapse in realizations. Long term gains as a share of GDP did not recover to 1985 levels for twelve years. [Chart 6.]

Chart 5 A Smaller Stock Of Capital Reduces Wages

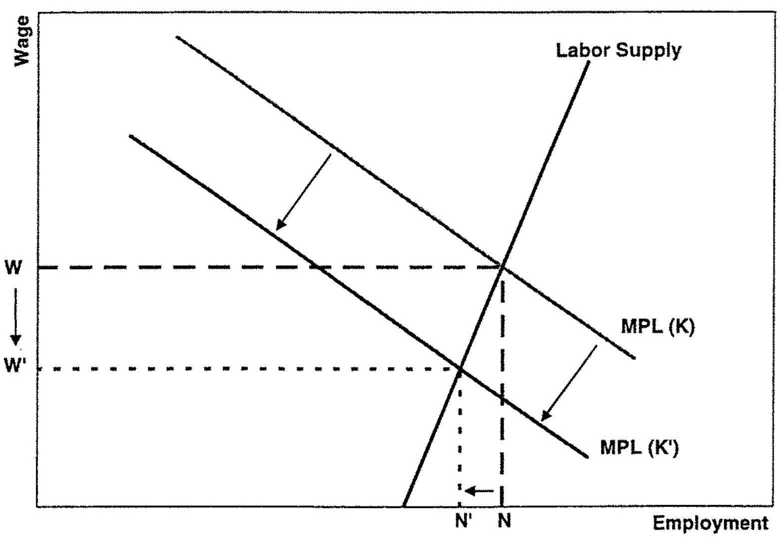
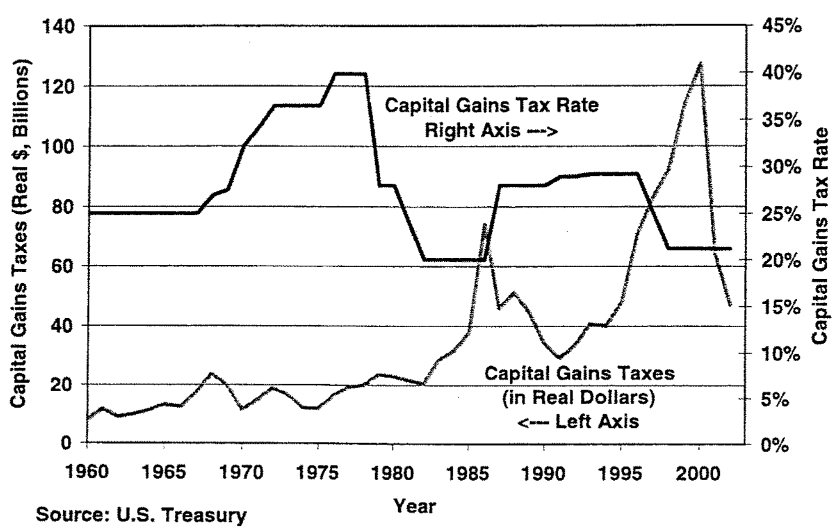


Chart 6 The Capital Gains Tax Rate And The Amount The Tax Collects Often Move In Opposite Directions



Source: U.S. Treasury

Extending the 15% top tax rate on dividends and capital gains now would be excellent insurance against renewed weakness in investment. It would lower the projected service price of capital, and would improve the economic outlook. The revenue consequences would be positive in the short run, and less negative than the static revenue projections from Treasury and the JCT in the long run. More importantly, the effect on the economy, wages, and employment would be sharply positive.

Endnotes

1. For a further explanation of the biases against saving in the current income tax, see Stephen J. Entin, "Fixing the Saving Problem: How the Tax System Depresses Saving and What To Do About It," *IRET Policy Bulletin*, No. 85, August 6, 2001, p. 15 ff., Institute for Research on the Economics of Taxation, available at www.iret.org. Also see David F. Bradford and the U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform*, second edition, revised (Arlington, VA: Tax Analysts, 1985).

2. Martin Feldstein, "Incidence of a Capital Income Tax in a Growing Economy with Variable Savings Rates," *The Review of Economic Studies*, 41(4), 1974, pp. 505-513. Christophe Chamley, "Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives," *Econometrica*, 54, May 1986, pp. 607-22. Kenneth L. Judd, "Redistributive Taxation in a Simple Perfect Foresight Model," *Journal of Public Economics*, 28, October 1985, pp. 59-83. Also, see Kenneth L. Judd, "A Dynamic Theory of Factor Taxation," *American Economic Review*, 77, May 1987, pp. 42-48; H. Greg Mankiw, "The Savers-Spenders Theory of Fiscal Policy," *American Economic Review*, 90(2), 2000, pp. 120-125; and Casey B. Mulligan, "Capital Tax Incidence: First Impressions from the Time Series," NBER Working Paper 9374, National Bureau of Economic Research, Cambridge, MA, December 2002. Andrew Atkeson, V.V. Chari, and Patrick J. Kehoe, "Taxing Capital Income: A Bad Idea," *Federal Reserve Bank of Minneapolis Quarterly Review*, Vol. 23, No. 3, Summer 1999, pp. 3-17.

3. See Daniel Clifton and Elizabeth Karas, "Two Years Later: Tax Cut Still Paying Dividends for American Shareholders", American Shareholders Association, Washington, DC, June 2005, pages 11-12, analyzing Standard and Poors 500 historical dividend data. Also Stephen Moore and Phil Kerpen, "Show Me the Money! Dividend Payouts after the Bush Tax Cut", CATO Institute Briefing Papers No. 88, Washington DC, October 11, 2004.

4. See the following Treasury Department Papers: the panel study in "Report to Congress on the Capital Gains Tax Reduction of 1978", Office of Tax Analysis, September, 1985; Michael R. Darby, Robert Gillingham, and John S. Greenlees, "The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time Series Evidence", Research Paper 8801, Office of the Assistant Secretary for Economic Policy, May 24, 1988; Gillingham, Greenlees, and Kimberly D. Zieschang, "New Estimates of Capital Gains Realization Behavior: Evidence from Pooled Cross-Section Data", OTA Paper 66, May 1989, and Gerald E. Auten, Leonard E. Burman, and William C. Randolph, "Estimation and Interpretation of Capital Gains Realization Behavior: Evidence from Panel Data", OTA Paper 67, May 1989, both from the Assistant Secretary for Tax Policy, Office of Tax Analysis; Gillingham and Greenlees, "Evaluating Recent Evidence on Capital Gains Realization Behavior", August 4, 1989; and "The Effect of Marginal Tax Rates on Capital Gains Revenue, Another Look at the Evidence", Research Paper 9003, Dec. 1, 1990, both from the Office of Economic Policy. Also see Gillingham, Greenlees, and Zieschang, "An Econometric Model of Capital Gains Realization Behavior", presented at the 65th Annual Conference of the Western Economic Association, July 1, 1990.

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Testimony Presented to the Senate Committee on Finance
Subcommittee on Taxation and IRS Oversight

Hearing on Encouraging Savings and Investment: Stay the Course or Change Direction
June 30, 2005

Introduction

Thank you Mr. Chairman and other members of the subcommittee for this opportunity to testify on this important subject affecting the financial and retirement security of tens of millions of American workers. My name is Brian Graff, and I am the Executive Director/CEO of the American Society of Pension Professionals & Actuaries (ASPPA).

ASPPA is a national organization of over 5,500 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants, and attorneys. Our large and broad-based membership gives it unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small to medium-sized employers. ASPPA's membership is diverse, but united by a common dedication to the private retirement plan system.

The direction of savings policy has changed in recent years. Increasingly, Congress has either enacted or has been considering tax incentives for savings outside of the traditional employer-sponsored retirement plan system. These tax incentives include various legislative proposals introduced in the House and the Senate to provide special tax breaks to nonqualified annuities, as well as the present law for reduced tax rates for capital gains and dividends, which is a primary focus of this hearing.

ASPPA believes that if this trend should continue and further tax breaks for nonqualified investments are enacted, it will begin to undermine our current employer-based qualified retirement plan system, which has been successful in encouraging low- to moderate-income workers to finally save. Of particular concern are proposals likely to arise in the context of the upcoming tax reform debate to further reduce or eliminate the tax on capital gains and dividends.

The ASPPA Pension Education and Research Foundation (PERF) recently issued a report, authored by two former staff members of the Joint Committee on Taxation, Judy Xanthopoulos and Mary Schmitt, outlining the potential effects such tax reform options would have on the employer-sponsored retirement plan system. This report—"Savings Under

Tax Reform: What Is The Cost to Retirement Savings?"—discusses these concerns in depth and can be found at www.asppa.org.

ASPPA applauds the subcommittee's leadership in examining our nation's savings policy, and the tax incentives designed to implement that policy. In doing so, ASPPA encourages the subcommittee to examine the crucial role played by the employer-sponsored retirement plan system in promoting savings by low- to moderate-income American workers. We implore the subcommittee to be wary of any proposed tax incentives for nonqualified investments that will potentially lessen the attractiveness of savings in a qualified retirement plan. This is especially true in the context of small businesses, whose costs for maintaining a retirement plan are much greater on a per employee basis than for larger firms. As the tax incentives for nonqualified investments become more favorable on a relative basis, ASPPA is concerned that many small business owners, faced with higher costs for maintaining a retirement plan, will instead forego the plan and invest on their own, leaving their workers without a meaningful opportunity to save.

Not all savings are alike. Through the special incentives afforded the qualified retirement plan system, Congress has always acknowledged the importance of encouraging long-term retirement savings by our nation's workers. These plans are designed to ensure that needed savings will be available for retirement through restrictions on distributions and/or penalties for early withdrawal. However, improved tax incentives for nonqualified short-term investments run counter to that message. The zero capital gains and dividends tax rate for lower-income taxpayers that goes into effect for 2008 is a perfect example. The tax incentive of a zero capital gains rate is economically equivalent to a tax-deductible contribution to an IRA or 401(k) plan. Given that, why would a worker contribute on a long-term basis to an IRA or 401(k) plan if they can get the same tax break outside of a plan and always have access to their money?[1] Without the savings discipline implicit in an IRA or 401(k) plan, how likely is it that savings in short-term nonqualified investment vehicles will be there for retirement? These are important questions the subcommittee should consider in reviewing our nation's savings policy.

Finally, in considering our nation's savings policy, high priority must be placed in encouraging greater savings by low- to moderate-income workers. With increasing pressure on the solvency and continued viability of the Social Security system, it is this sector of Americans whose future economic security is most at risk. The empirical evidence clearly suggests that further strengthening our employer-based retirement plan system will most effectively and efficiently achieve that objective.

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[1] It is true that the Saver's Credit provides an added tax incentive to American workers to save in an IRA or 401(k) plan. However, there are literally millions of American households that would be eligible for the zero capital gains and dividends tax rate that are not eligible for the Saver's Credit. The Saver's Credit is equal to 10 percent of contributions to an IRA or 401(k) plan up to $2,000 for married taxpayers with adjusted gross income between $32,500 and $50,000. The zero capital gains and dividend tax rate is available for married taxpayers with taxable income up to $58,100 and whose adjusted gross income could be well in excess of that in light of the standard deduction and personal exemptions. In addition, many working families have no tax liability. Since the Saver's Credit is not refundable, it offers no incentive to these families.

The Success of the Employer-Sponsored Retirement Plan System in Encouraging Savings by Low- to Moderate-Income Workers

America is not inherently a nation of savers. Even today about a third of workers are not saving for retirement and many who are saving have retirement accounts that are inadequate to fund a comfortable retirement. Further, demographic shifts illustrate a growing retiree problem: approximately 85 million Americans will be 65 or older in 2050 compared to 36 million in 2000.

The existing provisions of our nation's income tax system that provide incentives for long-term retirement savings have encouraged a significant number of Americans of modest means to save for their retirement. In fact, the current employment-based retirement plan system, which has made middle-income Americans significant investors in the stock market,[2] has been a major contributing force to the "ownership society," to which the President often refers.

Simply put, employer-sponsored retirement plans have been the only effective means to get low- to moderate-income workers to save. According to the Employee Benefits Research Institute, low- to moderate-income workers are almost 20 times more likely to save when covered by a workplace retirement plan. Of workers who earned $30,000 to $50,000 and were covered by an employer sponsored 401(k)-type plan, 77.7 percent actually saved in the plan, while only 4 percent of workers at the same level of income, but not covered by a 401(k)-type plan, saved in an individual retirement account.[3] This stunning disparity cannot be overlooked when evaluating our nation's savings policy. In large part, the difference is due to the convenience of payroll deductions, the culture of savings fostered in the workplace and the incentive of the matching contributions provided by the employer.

Certainly, no one is suggesting that the employer-based retirement plan system is perfect. Coverage rates still need to be improved. In 2003, only 64.9 percent of full-time workers were employed by a firm sponsoring a qualified retirement plan.[4] The lack of coverage is most acute among small business employees. In 2003, at firms with less than 25 employees, only 31.4 percent of full-time workers had access to an employer sponsored qualified retirement plan.[5]

However, the failure to achieve universal coverage should not be an excuse to abandon a system that so successfully encourages savings, particular by those workers who otherwise are not likely to save. Improvements to the system can be made. From 1994 to 2003, the percentage of full-time workers at small businesses with less than 25 employees that sponsored a qualified retirement plan increased from 26.5 percent to 31.4 percent.[6] In many respects, this substantial increase in retirement plan coverage is due to positive legislation

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[2] As of July 2003, an estimated 36.4 million US households, or almost 70 percent of all US households owning mutual funds, held mutual funds in employer-sponsored retirement plans. *Investment Company Institute, US Household Ownership of Mutual Funds in 2003, Vol. 12, No. 4 (October 2003).*

[3] Employee Benefits Research Institute (EBRI, based on 2003 data). It should be noted that this disparity exists notwithstanding likely eligibility for the Saver's Credit.

[4] Congressional Research Service (September 10, 2004), Pension Sponsorship and Participation: Summary of Recent Trends.

[5] Id.

[6] Id.

enacted by Congress specifically designed to increase the number of small business retirement plans.[7]

When it comes to encouraging savings, the employer-sponsored retirement plan system has a proven track record. It is not surprising that one study showed that households covered by an employer-sponsored retirement plan are more than twice as likely to achieve retirement income adequacy as households not covered by a plan. As a result, ASPPA believes that any examination of our nation's savings policy must include consideration of new ways to expand coverage under the employer-sponsored retirement plan system.

In 2001, the Senate-passed version of the tax bill that ultimately became the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) included a 50 percent tax credit for qualified retirement plan contributions made on behalf of lower-paid workers, for the first three years of a new small business retirement plan. The provision was dropped in conference for revenue reasons.[8] ASPPA strongly feels that enactment of such a provision would dramatically increase small business retirement plan coverage, thereby increasing the savings rates of small business workers.

Preferential Tax Rates for Nonqualified Investments Could Undermine Long-term Retirement Savings

Impact on Small Business Retirement Plan Coverage

The ASPPA PERF report entitled "Savings Under Tax Reform: What Is The Cost to Retirement Savings?" (Report) examines several possible tax reforms and their impact on retirement savings.[9] We ask that the Report be included as an attachment to this testimony.

The Report looks specifically at several suggested tax reform options, including the reduction or elimination of the tax on capital gains and dividend payments, as a strategy to boost national savings. Many tax reform advocates favor proposals such as these. The Report concludes that while this strategy might be achieved, it would be at a high cost—the loss of retirement savings plans for millions of Americans with modest means who already have difficulty putting aside adequate funds to support their senior years. Frankly, this is too high a price to pay, particularly when there are other mechanisms that could increase savings without jeopardizing the nation's retirement system.

The reduction or elimination of tax rates for capital gains and dividends threatens small business retirement plan coverage. Small employers hesitate to offer retirement plans for several reasons, including administrative complexity and cost, and the unpredictability of their financial condition. These hurdles are offset partly by the knowledge that the small business owner cannot maximize personal retirement savings without providing a plan for

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[7] For example, the Small Business Job Protection Act of 1996 created the SIMPLE plan, a simplified retirement plan for small businesses with lower administrative costs. The Economic Growth and Tax Relief Reconciliation Act of 2001 included, among other things, a tax credit for the start-up costs for establishing a new small business retirement plan.

[8] At the time, the Joint Committee on Taxation estimated the revenue cost of the provision to be approximately $2.8 billion over 10 years.

[9] The Report and its Executive Summary can be found at www.asppa.org.

workers as well. Any changes that allow small business owners to meet their personal retirement savings goals on an individual basis, such as through a reduction or elimination of the tax on capital gains and dividends, would inevitably threaten the future of the plans they provide their workers.

Because small businesses have fewer employees, the cost of maintaining the plan on a per employee basis is higher as compared to larger firms. Costs are further heightened by ERISA mandated nondiscrimination rules which generally mandate contributions (*e.g.*, matching contributions) be made on behalf of employees in order for the small business owner(s) to save in the plan.[10] For small businesses with less than 25 employees, the cost to the small business owner of these mandatory contributions (plus administrative costs) will typically be at least 30 cents for every dollar that he or she wants to save in the plan. Effectively from the small business owner's perspective, these costs are like a tax that must be paid in order for the owner to participate in the plan.

It has been the longstanding experience of ASPPA members that profit-maximizing small business owners rarely adopt retirement plans due to employee pressure. The small business has usually operated successfully without a retirement plan for some time. Rather, the retirement security of the small business owner is the motivating factor, and the owner is typically happy to provide retirement benefits for workers if it makes financial sense from his or her perspective.

When capital gains and dividends were taxed at ordinary income rates, it always made sense for small business owners to save through a workplace retirement plan because of the incentive of the upfront deduction, notwithstanding the 30 percent cost for mandatory contributions for employees. However, as Figure 1 illustrates, that advantage went away somewhat with the enactment of the 15 percent rate on capital gains and dividends and goes away dramatically if tax rates on capital gains and dividends are further reduced.

Figure 1 assumes a small business owner contributing $1,000 per year toward savings over a 15, 20 and 30 year period and earning a 7 percent annual rate of return. Column A shows the accumulations if the owner invests in a tax-deductible qualified retirement plan. Column B shows the accumulation if the owner invests all of the money, including the 30 percent cost for mandatory employee contributions on the owner's behalf outside of a plan on an after-tax basis assuming a 15 percent capital gains tax rate. Column C shows the accumulation if the owner invests the same amounts in Column B on the owner's behalf outside of a plan on an after-tax basis assuming a zero capital gains and dividends tax rate.

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[10] In fact, there is a special nondiscrimination rule that is applicable only to small business retirement plans called the top heavy rules, which often mandate that a small business must make a retirement plan contribution on behalf of lower-paid workers equal to 3 percent of their compensation. See IRC Section 416.

Figure 1

Owner Savings Realized from Qualified Plan vs. Nonqualified Investments

	A	B	C
	Pre-tax qualified plan contribution	After-tax savings, increased for 30% cost of mandatory employee contributions, subject to present law capital gains and dividend tax rate (15%)	After-tax savings, increased for 30% cost of mandatory employee contributions, subject to zero capital gains and dividend tax rate
15 years	$17,477	$22,812	$24,967
20 years	$28,512	$35,997	$40,732
30 years	$65,697	$77,098	$93,854

As you can see, from the small business owner's perspective, the reduced tax rates on capital gains and dividends make investing on their own more financially advantageous compared to establishing a workplace retirement plan. As a general matter, ASPPA members have currently been able to rebut this math to small business owners by arguing that the 15 percent rate is temporary whereas the tax incentives for qualified retirement plans have been around for decades. The permanent extension of the 15 percent rate will make that rebuttal much more difficult. A further reduction in the tax rate on capital gains will make it virtually impossible to convince a small business owner to adopt a retirement plan, since the owner would have to forego the significantly greater accumulations afforded by investing outside of a plan.

Reducing the tax rates on nonqualified investments erodes the value of the tax incentives for investing in an employer-sponsored retirement plan from the small business owner's perspective. Without those incentives, small business owners will choose not to establish qualified retirement plans for themselves and therefore their workers. As the evidence shows, these workers are significantly less likely to save on their own without the convenience of a workplace retirement plan. As a consequence, the future financial retirement security of tens of millions of small business employees will be seriously at risk.

Impact on Long-term Retirement Savings

On their own accord, American workers do not save adequately for their retirement and other long-term financial needs. While 63 percent of Americans are saving to some extent for retirement, more than one-third of the working population is not. Meanwhile, demographic shifts illustrate a growing retiree population. Approximately 85 million Americans will be 65 or older in 2050 compared to 36 million in 2000. The growing retiree population also reflects increased longevity, with the number of people aged 85 or older expected to increase five-fold in 2050 over the 2000 population. The policy implications of these demographic changes are substantial, particularly given the projected shortfalls in Social Security and the need for current and future retirees to supplement their Social Security benefits with personal savings.

Our current tax system provides a strong incentive for taxpayers to accumulate assets for long-term savings through the employer-sponsored retirement plan system by providing for an exclusion from income for contributions made to a qualified retirement plan or IRA. The current system also works to ensure that the savings is there for retirement by placing restrictions on distributions and imposing tax penalties for early withdrawals. However, putting aside issues affecting small business owners, any further reductions in capital gains and dividends tax rates could seriously undercut the current incentives for long-term retirement savings.

Figure 2 illustrates this concern with respect to an employee's decision to save. Figure 2 assumes an employee contributing $1,000 per year toward savings over a 15, 20 and 30 year period and earning a 7 percent annual rate of return. Column A shows the accumulations if the employee invests in a tax-deductible qualified retirement plan. Column B shows the accumulation if the employee invests outside of a plan on an after-tax basis assuming a 15 percent capital gains tax rate and Column C shows the accumulation if the employee invests outside of a plan on an after-tax basis assuming a zero capital gains and dividends tax rate.

Figure 2

Employee Savings Realized from a Qualified Plan vs. Nonqualified Investments

	A	B	C
	Pre-tax qualified plan contribution	After-tax savings, present law capital gains and dividend tax rate (15%)	After-tax savings, zero capital gains and dividend tax rate
15 years	$17,477	$15,969	$17,477
20 years	$28,512	$25,198	$28,512
30 years	$65,697	$53,969	$65,697

Figure 2 shows that the employee's tax incentives are identical for investing in a qualified retirement plan (Column A) as compared to investing outside of a plan with zero capital gains and dividend tax rate (Column C).[11] However, investing outside of a plan has a major advantage over investing in a qualified retirement plan. Such nonqualified investments are not subject to distribution restrictions or any tax penalties for early withdrawal. If the tax incentives for long-term retirement plan savings and nonqualified investments are economically equivalent, investing outside of a plan will always be favored since it allows for current, unfettered access to the savings.

If middle-income Americans begin to choose to save outside of a workplace retirement plan as a result, there is serious concern that such savings will not be there when needed for retirement. Without the discipline inherent in saving in a qualified retirement plan, it will naturally be more likely that savings will be spent for other reasons before retirement. The potential policy implications of such a shift away from long-term retirement savings will be significant. The future retirement security of middle-income working families would likely be impaired.

Beginning in 2008, this becomes a very real issue. In 2008, the capital gains and dividends tax rates drops to zero for middle-income Americans. As noted earlier, although the Saver's Credit provides added incentive for lower-income individuals to save in a qualified retirement plan, there will literally be millions of American workers who will now have no real incentive to lock up their savings for retirement. It is true that many workers will be provided matching contributions by their employer, which will act as an incentive to invest in the plan. However, the matching contributions may not be enough of an incentive for some workers, or workers may choose to invest outside of the plan once they have taken full advantage of the matching contribution.[12] Further, many employers do not offer matching contributions at all. Finally, there are tens of millions of working Americans who are still not covered by a workplace retirement plan, and only have an IRA as an option. How many of them will choose to save on a long-term basis in an IRA where there is absolutely no tax incentive to do so?

ASPPA is very concerned that the permanent extension of the current reduced tax rates for capital gains and dividends or any further reductions in such rates will lead to reduced long-term savings. If long-term savings no longer enjoy a special tax advantage, low- to moderate-income workers will save less for retirement. Instead, if they save at all, it will likely be in a short-term savings plan to which they will have ready access, making it more likely than not that these savings will be spent, in whole or in part, well before retirement, thereby threatening their future economic security.

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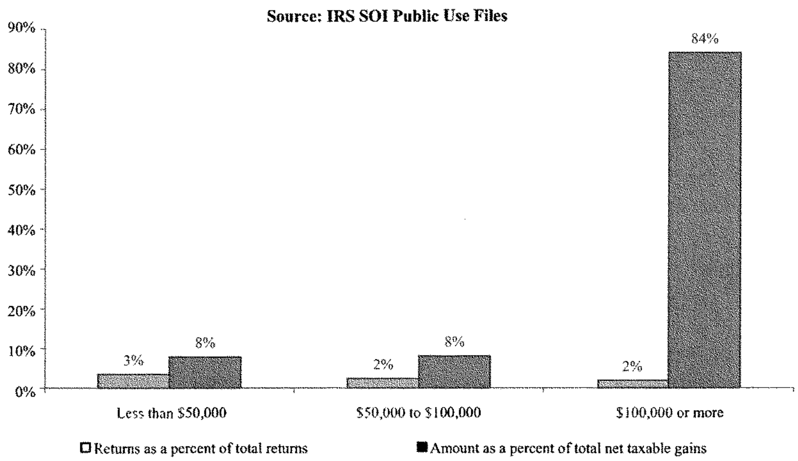
[11] Although Figure 2 shows a continued tax advantage for qualified retirement plan investing as compared to investing outside of a plan subject to a 15 capital gains and dividends tax rate, there is some concern that the differential may not be sufficient to make up for the fact that the qualified retirement plan investments are "locked up" and not generally accessible without substantial penalty. Further, some different economic modeling by other organizations suggests that the 15 percent tax rate can be more favorable in certain cases. See Dalbar Inc., *Dalbar Model Uncovers Benefits and Risks of Tax Cut to 401(k) Retirement Plans*.

[12] For example, if an employer matches up to 3 percent of pay, a worker may choose to save just up to 3 percent of pay to take advantage of the match and then do any further saving outside of the plan.

Figure 3

Distribution of Net Taxable Capital Gains
Tax Year 2002



We also note that the permanent extension of the current reduced tax rates for capital gains and dividends will do very little to promote savings by low- to moderate-income individuals. For example, as Figure 3 shows based on 2002 IRS data, less than 8 percent of tax returns filed reported capital gains income. This translates to about 12 million individuals or only 4 percent of the US population. Further, 84 percent of filings reporting capital gains are by households with more than $100,000 in adjusted gross income, while only 8 percent of filings reporting capital gains are by households with less than $50,000 in adjusted gross income.[13] Given this, we question whether the permanent extension of the reduced rates on capital gains and dividends makes sense given scarce revenue dollars and ASPPA's belief that the priority should be placed on increasing savings rates by low- to moderate-income Americans.

ASPPA alternatively suggests making the current law Saver's Credit permanent. We would further recommend that the credit be made refundable so that it provides a real incentive to working families that have no tax liability. Finally, we recommend that the Saver's Credit be greatly expanded so that more middle-income families are eligible and incentives are provided for greater levels of contributions. Specifically, we believe that households with adjusted gross incomes up to $75,000 should be eligible for some level of Saver's Credit and that the credit should apply to annual savings contributions up to $2,000 per individual. We believe this proposal would be less costly from a revenue perspective while providing a meaningful savings incentive for almost 70 percent of American households as compared to

[13] Although this data is from a period when the reduced tax rates on capital gains and dividends were not in effect, we do not believe the data will materially change in future years particularly among the lower-income brackets.

the less than 10 percent of American households likely to benefit from the reduced tax rates on capital gains. We strongly feel this is a much more efficient and effective use of precious revenue dollars to actually fulfill the priority of increasing lower-income savings rates.

Summary

As the Social Security debate has shown, Americans are appropriately worried about economic security in retirement. Consequently, it has never been more appropriate to examine our nation's savings policy and the various incentives provided for savings. We again applaud the members of the subcommittee for conducting this hearing.

ASPPA believes that a sound national savings policy must abide by the following three principles:

- Priority must be given to promoting increased savings by low- to moderate-income workers. These are the Americans who save the least and whose future financial security is most at risk.
- A national savings policy should favor long-term retirement savings with distribution restrictions over other savings vehicles that are readily accessible to help ensure that working families have some needed savings when they reach retirement.
- Recognition must be given to the critical role played by the employer-sponsored retirement plan system in achieving the first two principles. Workplace retirement plans have been, by far, the most effective way to encourage long-term savings by low- to moderate-income workers.

ASPPA believes that continued and further reduced tax rates for capital gains and dividends may run counter to the above principles. As discussed earlier, more favorable tax rates for nonqualified investments would create a significant disadvantage to investing through the employer-sponsored retirement plan system because individual savings in capital investments generally are not "locked-up" until retirement. If long-term retirement savings no longer enjoy a special tax advantage, low- to moderate-income workers will save less for retirement. Instead, if they save at all, it will likely be in a short-term savings plan to which they will have ready access, making it more likely than not that these savings will be spent, in whole or in part, well before retirement.

Further, with continued reduced or eliminated tax rates for capital gains and dividends employers, particularly small business owners, would be able to accomplish their savings objectives outside of a qualified retirement plan and would be unlikely to incur the cost and potential liability associated with establishing or maintaining a qualified retirement plan. Such plans have clearly shown to be the most effective way to get low- to moderate-income workers to save. Given this track record, a sensible national savings policy should emphasize greater employer-sponsored retirement plan coverage, not less.

Instead, ASPPA believes our national savings policy should focus on tax incentives that will most effectively accomplish the above three principles. Such tax incentives would include an expanded and refundable Saver's Credit and greater incentives for the establishment of workplace retirement plans, particularly by small employers.

The policy implications of reduced long-term retirement savings by working Americans could be substantial, particularly given potential limitations of Social Security and the need for current and future retirees to supplement their Social Security benefits with personal savings. ASPPA stands ready to work closely with the members of this subcommittee and Congress to make sure this does not happen.

Savings Under Tax Reform: What is the Cost to Retirement Savings?

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ASPPA Pension Education™
and Research Foundation

Savings Under Tax Reform: What Is The Cost To Retirement Savings?

Summary—Retirement plans and personal savings, along with Social Security, are essential parts of the American retirement system. Policy changes that affect the ability to save or the composition of overall savings pose potential threats to retirement plan savings. There is a strong public interest in assuring that Americans have adequate resources during their retirement years; as policymakers consider alternatives to the current law tax system, it is important to consider whether potential reforms will put more Americans at risk of having inadequate savings during their retirement years.

Employers face substantial costs to establish and maintain qualified retirement plans for employees. These costs, coupled with the fact that employers are generally indifferent from a tax perspective whether an employee's compensation is provided as cash or tax-advantaged retirement savings, present a significant deterrent, even under current law, to retirement savings through employer-sponsored retirement plans.

Furthermore, our present tax system dilutes the demand for retirement savings by offering favorable tax treatment for investments that compete with qualified retirement plan savings.

Despite these impediments to retirement savings under current law, the employer-sponsored retirement plan system has proven effective for delivering retirement benefits to workers who would not otherwise save for retirement.

The President has established a tax reform commission that is exploring various alternatives to the current tax system. Many of the reform options under consideration would provide greater tax preferences for general savings such as consumption-style taxes or more targeted approaches such as those that eliminate the tax on capital gains and dividend income. Consumption taxes, in general, tax amounts consumed and, thus, do not tax amounts that are saved. Similarly, eliminating the tax on capital gains and dividends would provide a specific tax incentive for saving through investment in capital assets.

These reform proposals may increase aggregate savings by taxpayers. However, this increase in aggregate saving may come at the expense of retirement saving and may not provide uniform saving across all income classes. Evidence with lump-sum distributions from existing qualified retirement plans shows that employees, particularly lower income employees, who have access to their savings before retirement tend to spend these funds, rather than saving them for their retirement years. Thus, an overall increase in saving will not necessarily translate into an increase in saving for lower income individuals or to an increase in retirement savings.

Employer-sponsored qualified retirement plans generally offer all eligible workers the opportunity to save for retirement. The minimum participation and nondiscrimination rules guarantee that the tax benefits of qualified retirement plans are only available if the plan provides comparable benefits to all eligible employees. Many employer-sponsored qualified retirement plans provide additional incentives to workers to encourage savings, such as matching contributions. Indeed, under current law, an additional tax incentive (the SAVER's Credit) is provided to low-income individuals to help them save for retirement. As a result, qualified retirement plans provide the best opportunity for low-income workers to save for retirement. If qualified retirement plans were no longer offered by their employers, many low-income individuals would not possess adequate resources or motivation to save on their own for retirement.

Reform and targeted relief proposals that have been proposed will do little to alter the fact that individual savings tends to be very low among lower income individuals. Therefore, although tax reform potentially will increase overall saving, it is likely to come at the cost of retirement savings by lower-income individuals. As a result, providing favorable tax treatment for individual savings may erode retirement savings, leading to greater wealth disparities among retirees and threatening the financial security of a significant number of people.

I. Introduction

With the creation of the President's tax reform commission, there is increased debate about the advantages and disadvantages of the current tax system. Tax reform advocates are advancing proposals either to alter fundamentally or to eliminate the current law system. Among the proposals that are attracting the most attention is a consumption tax as an alternative or add-on to the current law system. In addition, there is ongoing interest in proposals to eliminate taxes on capital gains and dividends.

When considering tax reform proposals, policymakers need to be aware of the potential consequences of a consumption tax system on savings for retirement. Our current tax system provides a strong incentive for taxpayers to save for retirement by excluding from income contributions to a qualified pension plan or an Individual Retirement Arrangement (IRA). Even with this strong incentive, many people do not save enough for retirement and the saving that does occur tends to be positively correlated with income levels. However, if a consumption tax system is developed in which taxpayers are generally encouraged to save to avoid current tax, the current system's strong incentive to save specifically for retirement will be significantly reduced. Thus, it is reasonable to assume that under a consumption tax system, taxpayers will be less likely to favor saving for retirement because of the preference provided to savings in general. The implications of such a reduction in retirement saving could be devastating, particularly given the projected shortfalls in the Social Security system.

Employer-sponsored qualified retirement plans, personal savings and Social Security are all considered essential elements of the American retirement system (the so-called "three-legged stool"[1]). However, projected demographic trends and solvency concerns suggest that Social Security, if available, may offer lower benefits, which places greater emphasis on both qualified retirement savings and personal savings.[2] Encouraging retirement saving, through both employers *and* individual saving plans, remains critical to ensure the retirement security of future retirees.

In general, the current tax system provides the strongest incentive for retirement saving to occur through the employer-sponsored qualified retirement plan system. There is a substantially higher limit on the amount of permissible tax-qualified retirement savings if the savings occurs through an employer-sponsored plan. However, it is important to remember that employers are generally

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[1] More recently, the three-legged stool analogy is changing to a four-legged stool to include wage income, as many retirees must continue to work in part-time positions throughout their retirement.

[2] The current Social Security debate focuses on the solvency of the system and the projected elimination of the trust fund in 2042. Proposals consider price-indexing benefits, delaying retirement age, as well as introducing personal accounts. In any event, any potential solution to the problems will likely reduce the amount of benefits that retirees will receive.

entitled to deduct compensation expenses, whether they are made in the form of cash or in contributions to a qualified retirement plan. Thus, an employer may be generally indifferent whether to pay employees in current compensation or to make contributions on their behalf to a qualified retirement plan. Furthermore, the costs of establishing and maintaining a qualified retirement plan can provide a significant deterrent to small and mid-sized employers.

Although the current tax system provides a strong incentive for employees to save through a qualified retirement plan, current law rules create substantial barriers to the establishment of such plans. The costs of establishing a plan can be significant. Once established, the plan must meet standards for participation and nondiscrimination so that the benefits are generally available to all eligible employees, regardless of income or ability to save. In the case of defined benefit pension plans, the plan also must satisfy annual minimum funding requirements. The costs of complying with these minimum funding requirements are significant.

Changes to the rules for qualified retirement plans occur with alarming regularity. Thus, employers are constantly facing the costs of amending their plans to comply with new laws and regulations. In recent years, the Congress has recognized that the incentives of current law may not be sufficient to induce employers to establish and continue qualified retirement plans. Thus, Congress has passed additional laws to assist smaller employers offer alternatives to defined benefit plans and expand existing retirement savings options. The available plans, from which employers may choose, each with detailed rules on participation and contributions, create a complex system.

Many people believe that some form of change or reform is necessary to reduce the barriers to employer sponsored retirement plans and expand further the coverage of workers. Yet, most discussions of reform focus on revamping the tax code through consumption or national sales taxes or through such targeted reform as decreasing the capital gains rate or eliminating tax on other forms of investment. These approaches may increase savings outside of qualified retirement plans and permit business owners to accomplish their savings objective without offering qualified retirement plans to their employees. Given the ambivalence of employers toward maintaining qualified retirement plans due to their costs and complexities, these changes are likely to have a detrimental effect on qualified retirement plans and, as a result, savings by employees.

Without careful consideration, both major reform and targeted preferential treatment of nonqualified investments could erode both sponsorship and participation in qualified retirement savings plans. Such tax policy could add further instability to an already unstable component of retirement security—qualified retirement plan savings—and place further pressure on personal savings and the Social Security system.

The following sections examine the potential impact of tax reform on retirement savings. The first section presents background information on the need for qualified retirement plan savings and examines available qualified retirement plans, providing an overview of the rules facing plan sponsors. The second section examines past tax provisions and the impact on qualified retirement plans. The final section looks ahead to reform, considering consumption based taxes and targeted preferential treatment of nonqualified investments.

A. Retirement Savings Reasons for Concern

Retirement saving remains an important policy issue for the US Congress. During the past ten years, the Congress passed major legislation that expanded qualified retirement savings, created new qualified savings vehicles and attempted to simplify existing policy. Changing demographics, low overall savings rates, inadequate savings for many retirees and problems with Social Security make retirement savings a critical policy issue; individually each issue raises important concerns for the retirement security of our aging populations, but collectively they underscore the need for maintaining a strong retirement savings system.

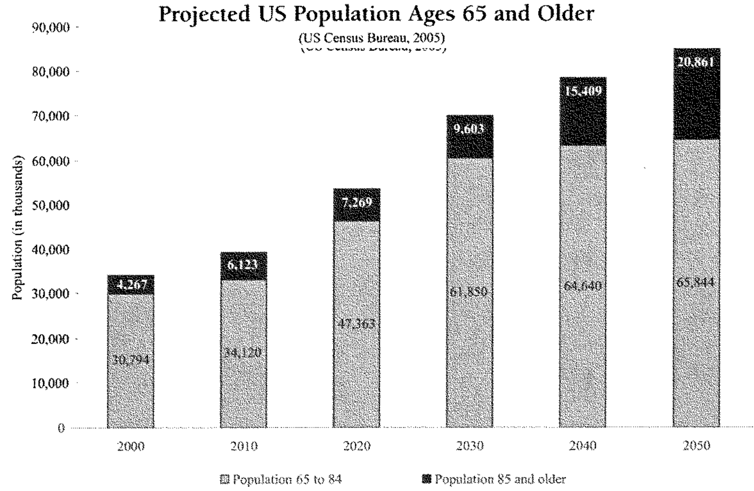
Demographic Shifts—During the next ten to 15 years, the largest birth cohort, baby boomers, will begin to retire.[3] The Census Bureau estimates that in 2050 approximately 87 million Americans will be aged 65 or older compared to 36 million in 2000.

Within the overall growth of seniors, another trend emerges. The number of people aged 85 and older increases five-fold in 2050 over the 2000 population as shown in Graph 1. By 2050, Census estimates that approximately 21 million Americans will be over the age of 85. This trend reflects not only the growing retiree population, but increased longevity.

The 2005 Social Security Trustees Report estimates life expectancy as 17.0 years for a man and 19.7 years for a woman who becomes 65 in 2005. By 2050, life expectancy increases to 19.7 years for men and 22.2 years for women. Compared to life expectancy in 1960, projected life expectancies for 2050 reflect an increase of 52 percent for men and 46 percent for women.[4]

[3] The Census Bureau defines the baby-boomer cohort to include people born between 1946 and 1964.
[4] Social Security Administration, 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Dis.ability Insurance Trust Funds, March 23, 2005.

Graph 1
Projected US Population Ages 65 and Older
(US Census Bureau, 2005)



In addition to larger numbers of retirees who live longer, another trend emerges for seniors, that of declining retirement ages. In general, men are retiring earlier than previous generations. Since 1950, fewer men aged 55 to 64 were working or looking for work, as the proportion fell from 87 percent in 1950 to 68 percent in 1985.[5] Since 1985, this proportion remains stable fluctuating between 67 to 69 percent.

With respect to retirement savings, these trends mean increased pressure on public systems. To the extent that Social Security and Medicare are unable to provide the same level of benefits, retirees must rely increasingly on qualified retirement plan and individual savings. While a majority of Americans indicate they are saving for retirement, the question remains of whether amounts saved are adequate to meet growing retirement needs.

[5] See the US Department of Labor, Bureau of Labor Statistics Web site, 2005.

Are We Saving Too Little?—Evidence indicates that Americans have become increasingly aware of the importance of personal savings for retirement security. The Employee Benefits Research Institute (EBRI) 2005 Retirement Confidence Survey (RCS) reveals that seven in ten (nearly 69 percent) workers are saving money for retirement or starting to save for retirement. Nonetheless, many of those who are saving apparently are not saving amounts necessary to ensure an adequate retirement. Estimates indicate that most families are saving at only one-third the rate necessary to maintain their present standard of living in retirement.[6]

There are two commonly cited measures of personal savings, the National Income and Products Accounts (NIPA) and the Flow of Funds Accounts (FFA). The NIPA reports that the rate of personal savings declined steadily over the past few decades and is approaching historic lows. The FFA shows a decline, but not nearly as steep as that shown in the NIPA. The EBRI finds that while the rate of personal savings is declining, overall the personal savings rate of US workers generally is higher than typically reported.[7] However, the question of whether the current level of personal savings is adequate to meet future retirement needs still remains. The EBRI 2005 RCS finds that of the 69 percent that are saving for retirement, most do not have an idea of the level of savings necessary to live comfortably in retirement.

Although nearly 69 percent of American workers are saving to some extent for retirement, more than one-third of the working population is not saving for retirement at all. Ironically, of those not saving, almost half express some confidence in their ability to fund their retirement. Some indicate that they will save "later," while others believe they will obtain support from employers and family or friends.[8]

As retirement saving grows, through employer sponsored plans or through individual savings, other forms of savings decline. It is significant to note that retirement and other savings are largely substitutes for one another, not complementary. With respect to retirement security and the importance of both retirement and personal savings, this suggests that as people contribute to one form of savings, contributions to the other will decline.

EBRI reports that retirement savings as a percentage of total personal savings is growing. In other words, as workers save through employer-sponsored retirement plans they are less likely to save outside of those plans.

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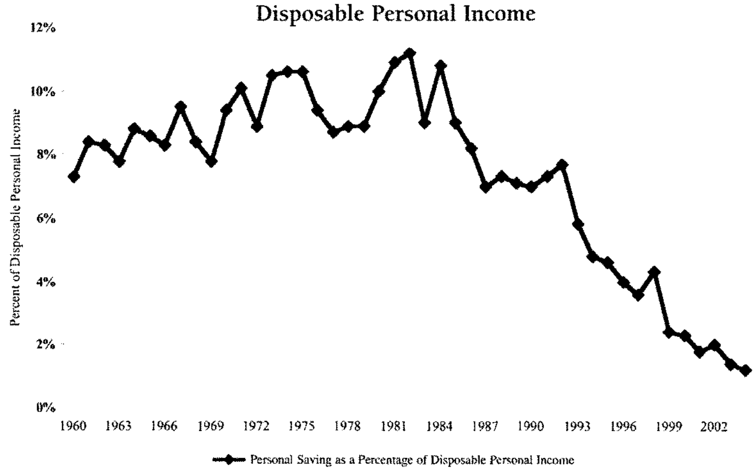
[6] US Congressional Budget Office, "Social Security and Private Savings: A review of the Empirical Evidence," July 1998.

[7] The National Income and Product Accounts shows a dramatic decrease in personal savings over the past ten years. However, Yakoboski and Devine indicate that NIPA does not measure realized capital gains on stocks and other assets which contributes to a significant increase in wealth.

[8] See EBRI Retirement Confidence Survey, 2005.

Graph 2
Personal Saving as a Percentage of Disposable Personal Income



Graph 2 shows personal savings as a percentage of disposable income from 1960 to 2004. As personal savings rates continue to decline, retirement savings becomes more and more important to retirement security. The EBRI analysis, coupled with the decline in personal savings, suggests that individuals are saving more through qualified retirement plans and less in non-qualified savings vehicles.

Research indicates that the likelihood of saving for retirement increases when the individual has access to an employer-sponsored plan. EBRI reports that 77.9 percent of workers making from $30,000 to $50,000 who are covered by an employer-sponsored 401(k)-type plan actually saved in that plan. However, only 7.1 percent of workers at the same income level not covered by a plan saved in an IRA. Low- to moderate-income workers are 11 times more likely to save when covered by an employer-sponsored plan.

A similar trend emerges when considering participation in the stock market and mutual funds. Many studies cite statistics indicating that half of all households participate in the stock market or own mutual funds. However, closer examination reveals that almost half of all households indirectly own such assets through their retirement account.[9] The Federal Reserve cites similar

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[9] As of July 2003, an estimated 36.4 million US households, or almost half of all US households owning mutual funds, held such funds in employer-sponsored retirement plans. See Investment Company Institute, US Households Ownership of Mutual Funds in 2003, Vol. 12, No. 4 (October 2003).

statistics for stock market participation, reporting that individuals hold approximately 50 percent of all stocks through their retirement account. They find that as income falls, so does the likelihood of stock ownership outside a plan. They report that less than 25 percent of moderate-income and less than 10 percent of low-income households own stock outside of their retirement plan.[10]

Employer-Sponsored Retirement Plans—Many private-and public-sector employers offer either defined benefit or defined contribution retirement plans. Defined benefit plans offer a defined future benefit based on years of service and past salary levels. Defined contribution plans offer a future benefit determined by a defined level of contributions during the worker's participation.

Recent statistics show that 66 percent of private- and public-sector employers make available some form of retirement plan to their employees (full-time and part-time workers). Public sector employers offer plans at a much greater rate than private sector employers with approximately 87 percent of public and 62 percent of private employers offering a retirement plan.

These percentages fall when considering plan participation as opposed to availability. Approximately 79 percent of public-sector and 50 percent of private-sector employees actually participate in their employers' plans.[11] In most cases, employees do not participate because they do not meet certain eligibility criteria (for example, some part-time workers may not work sufficient hours for eligibility or seasonal workers may not work sufficient weeks during the year). In other cases, surveys indicate that workers do not feel they have sufficient disposable income to participate or they lack the knowledge or an understanding of plan benefits. In general, participation rates are lowest among lower income workers and women, both of whom are likely to have periods of part-time work, high turnover or absences from the workforce.

Worker turnover presents another problem for both employers that sponsor plans and employees wanting to participate. When worker turnover is high, employers often feel reluctant to sponsor or maintain a retirement plan. The employer faces ongoing costs when former employees leave small inactive accounts. When workers are entitled to the benefits, many plans do not want to hold inactive accounts for former employees. Also, workers with frequent job changes often are not fully vested when leaving the firm. In this case, they will forfeit some or all of their accumulated plan benefits. Further, workers with small vested accounts will frequently take their benefit in a lump sum distribution, pay the penalty and income taxes, and use the money for some other purpose (see the discussion below about this issue).

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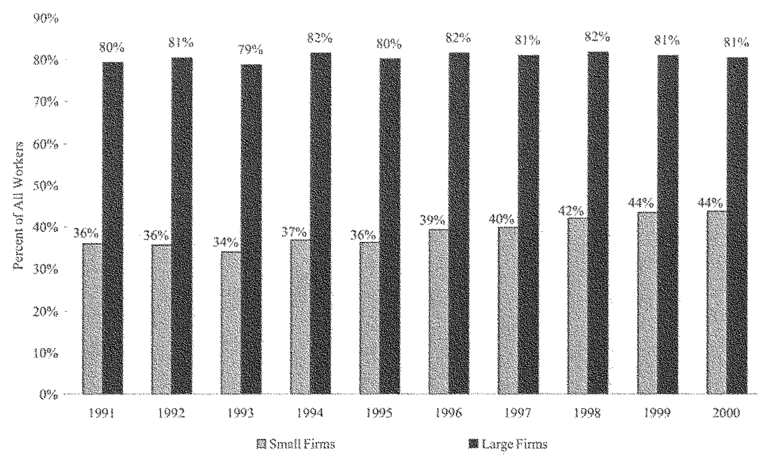
[10] See "Remarks by Governor Edward Gramlich at the National Savings Forum," July 2001.
[11] See Patrick Purcell, Pension Sponsorship and Participation: Trends and Policy Issues, Social Security Bulletin, Volume 64, Number 2, 2001/2002. Statistics include part-time workers.

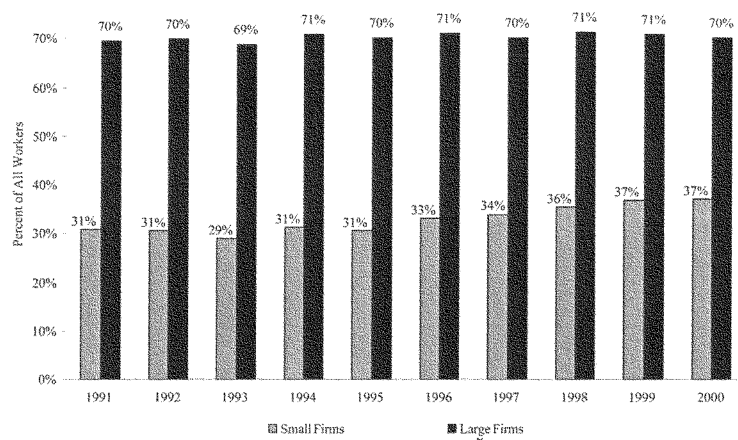
Another area of concern with respect to the availability of employer-sponsored plans is firm size. Private sector employment is bimodal, meaning that approximately the same number of employees work in large firms as do in small. Therefore, when considering plan sponsorship among small employers, it is important to remember that nearly 50 percent of the private-sector workforce works for small employers.

Graph 3
Availability of Retirement Plans by Firm Size
(Purcell, Patrick, "Pension Sponsorship and Participation: Trends and Policy Issues")



In general, larger firms are more likely to offer pension plans compared with firms that employ fewer than 100 employees. Approximately 81 percent of firms that employ 100 or more employees offer some retirement plan compared to only 44 percent of employers with fewer than 100 employees as shown in Graph 3. Participation rates for larger firms are approximately 70 percent for full-time workers (about 30 percent for part-time workers). Participation rates in smaller firms are significantly less: approximately 37 percent for full-time workers (about 20 percent for part-time workers) as shown in Graph 4. As is discussed below, the barriers to plan sponsorship can be a particular problem for small and mid-sized employers.

Graph 4
Retirement Plan Participation by Firm Size
(Purcell, Patrick, "Pension Sponsorship and Participation: Trends and Policy Issues")



The Leakage of Retirement Savings—Retirement assets do not contribute to retirement security if the assets do not accumulate When workers take pre-retirement distributions and do not roll over their benefits to other tax-qualified savings, retirement assets begin to erode.

As mentioned, worker turnover often provides employees the ability to access their retirement savings balances prior to retirement. When workers change jobs, many receive the value of their retirement benefits in the form of a lump-sum distribution. Some will roll over such distributions to other tax-qualified savings to preserve their benefits. However, others may pay the income and penalty tax, taking pre-retirement withdrawals in lump sums to finance other spending.

With respect to lump-sum distributions resulting from a job change, EBRI finds that the size of the distribution and the recipient's age will influence the person's decision to spend or save the pension distribution.[12] As the size of the distribution increases, the individual is more likely to roll over the funds to another tax-qualified savings vehicle.[13] Not surprisingly, as the age at which a lump-sum distribution is received increases, the more likely the individual will preserve those assets rather than spend the assets. Approximately 25 percent of teens compared to 62 percent of those 50 or older saved their lump-sum distributions.

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[12] EBRI Data Book, Chapter 9.
[13] The National Commission on Retirement Security Final Report indicates that individuals with smaller accounts are less likely to preserve those assets. Specifically, only 20 percent of distributions of less then $3,500 were rolled over into tax-deferred retirement accounts.

Many who receive lump-sum distributions report using those assets for a new home purchase, educational expenses, debt elimination or starting a new business. However, the most common use of pre-retirement distributions was other spending. Consequently, those individuals not only lost retirement assets, but also shortened their savings horizon and the corresponding gains from compounding interest.

Workforce turnover can also affect the accumulation of pension assets. It is not unusual for a worker to have many different employers throughout their employment history. Each transition to a new employer may mean a waiting period before the worker becomes fully vested in the plan. If the worker should move to another employer prior to vesting, the worker may lose accumulated benefits. Depending upon the type of plan, some benefits may move with the employee (fully portable); however, when workers are unable to transfer pension assets, the result is slower accumulations and lower yields for their retirement assets.

Accumulated Retirement Assets—Most studies confirm that about 60 percent of households have some type of retirement asset. However, it is more important to ask if the savings will be sufficient to maintain a person's or a family's pre-retirement standard of living. One general rule of thumb is that retirees will need to replace approximately 75 percent of their pre-retirement income to maintain their living standard. Circumstances will vary with each individual situation, suggesting that some will require greater savings and others less. For instance, the 75 percent replacement estimate assumes that retirees will have fewer household members during their retirement years and lower job-related costs in retirement. Often those owning their own home will have paid off their mortgage before retiring, lowering their overall need for higher income. One study estimates that only 44 percent of households will accumulate adequate retirement savings to maintain pre-retirement living standards throughout their retirement years.[14]

The likelihood of owning any retirement assets increases with age and educational attainment. As shown in Table 1, there is a greater prevalence of retirement savings as age and educational attainment rise.

Table 1
Prevalence of Retirement Assets by Age and Education
("Retirement Savings of American Households: Asset Levels and Adequacy", CP Montalto.)

Age	Reporting Any Retirement Asset	Educational Attainment	Reporting Any Retirement Asset
Less than 35 years	47.6%	Less than High School	37.5 %
35 to 44 years	67.1 %	High School	57.6 %
45 to 54 years	71.0 %	Some College	66.5 %
55 to 64 years	71.4 %	Bachelor's Degree	80.0 %
65 years and older	60.4 %	Graduate School	84.3 %

Estimates of adequate retirement savings rely on a life-cycle model that incorporates projected Social Security benefits, employer-sponsored and non-employer based retirement plans, as well as private savings. When evaluating the levels of saving and the adequacy of such savings, another important trend emerges. Specifically, higher income households are most likely to have adequate retirement savings. Approximately 54 percent of households with incomes between $50,000 and $100,000 will retire with adequate savings. Further, as income increases above $100,000, 69 percent of households will have adequate retirement savings.[14]

This direct positive correlation between adequate retirement saving and income makes intuitive sense. Low-income individuals frequently do not have the disposable income to make contributions to qualified retirement plans, even if they qualify to participate in such plans. The percentage of low-income individuals making IRA contributions is significantly lower than other income levels. Congress has recognized that low-income taxpayers face significant barriers to retirement saving by enacting a temporary tax credit (SAVER's Credit) to provide a greater subsidy for retirement contributions by low-income individuals. Under the temporary SAVER's Credit (which is due to expire in 2006), the Congress provides a special tax subsidy up to $1,000 for low-income individuals who make contributions to qualified cash or deferred arrangements, IRAs and certain other plans.

The likelihood of retiring with adequate savings also depends upon whether the individual participated in an employer-sponsored plan. Overall, 55 percent of households covered by employer-sponsored plans will have adequate savings compared to 24 percent of those without employer plans.[14]

Reliance on Social Security—When evaluating adequacy of retirement savings, most studies include Social Security. We know that Social Security is a pivotal part of most workers' retirement security. In fact, Social Security provided 43 percent of all income received by Americans aged 65 or older in 2002. Nearly two-thirds of the current 40 million Social Security recipients receive more than half of their retirement income from this source.[15] One current policy debate centers on reforming the Social Security system, which faces significant solvency issues in the future. Social Security will not have the legal authority to pay promised benefits when the trust fund balances are exhausted.[16]

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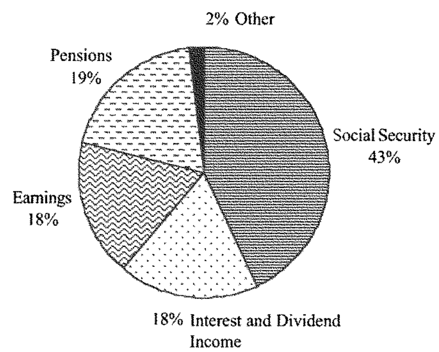
[14] See Montalto, CP, "Retirement Savings of American Households: Asset Levels and Adequacy," for a further statistics and analysis.

[15] EBRI Data Book, 4th Edition, Chapter 7. See also, Ettlinger, Michael and Chapman, Jeff, "Social Security and the Income of the Elderly," EPI Issue Brief #206, March 23, 2005.

[16] While estimates vary about when that may happen, it is clear that the spend-down of the trust fund will begin as more of the baby boomer cohort begins to retire.

When Social Security reform takes place, retirees may need to rely much more heavily on qualified retirement plan savings and personal savings, making these forms of savings an even more critical component of retirement savings. However, most studies indicate that retirement savings, both in qualified retirement plans and private saving, are inadequate to substitute for the potential loss of Social Security income. Graph 5 shows the composition of current retirement income by category.

Graph 5
Composition of Retirement Income
(EBRI Data Book, 4th Edition, Chapter 7)



As current retirees do now, future retirees will have to supplement Social Security payments with personal savings. Financial experts tell us, however, that current levels of personal retirement savings are not nearly adequate to ensure financial independence for most Americans when they retire—even *with* pension and Social Security income. According to some estimates, the oldest baby boomer cohort is saving just one-third of what they will need to maintain their current standard of living during retirement.[17]

B. Qualified Retirement Plan Rules

Under current law, federal tax benefits are provided to encourage employers to establish qualified retirement plans on behalf of their employees. These retirement plans are classified into two broad categories—defined benefit pension plans and defined contribution plans. A defined benefit pension plan generally promises a plan participant a specific annual benefit payable when the

[17] US Congressional Budget Office, "Social Security and Private Savings: A review of the Empirical Evidence," July 1998.

participant retires. Under a defined contribution plan, a participant is entitled to the contributions (plus earnings) in an account that has been established on the participant's behalf. Under a qualified retirement plan, contributions may be made to the plan by the employer, by the plan participants or by both.

A significant difference between a defined benefit plan and a defined contribution plan is that the employer sponsoring a defined benefit pension plan bears the risk of investment losses. Thus, plan participants are entitled to their promised benefits at retirement irrespective of whether there are adequate assets in the plan. A minimum level of pension benefits is guaranteed by the Pension Benefit Guaranty Corporation in the event that a defined benefit pension lacks sufficient assets to pay promised benefits.

The employer-based qualified retirement plan system is a voluntary system. Employers are not required to establish or maintain qualified retirement plans. An employer that chooses to establish a qualified retirement plan is required to comply with a complex set of rules that govern a wide range of issues relating to the plan's operation, including: (1) the employees who are required to participate in the plan, (2) benefits that may be provided under the plan, (3) the extent to which the plan can favor highly-compensated employees, (4) contributions that may or must be made to the plan, (5) the tax deduction that is permitted for employer contributions to the plan and (6) disclosure of information to plan participants and the federal government. The plan must meet the approval of the federal government both in form and in operation. The costs of complying with these rules are a significant reason why many employers either do not establish or decide to terminate qualified retirement plans.

Plan Participation, Vesting and Nondiscrimination—The qualified retirement plan participation rules require that employers permit employees to participate in a qualified retirement plan as long as the employee meets certain minimum eligibility requirements. In general, employees who have one year of service with an employer and have attained age 21 must be entitled to participate in an employer's qualified retirement plan. However, certain classes of employees (*e.g.*, part-time and seasonal employees) can be excluded from plan participation. Employers in certain industries (*e.g.*, fast food) have significant turnover so that a large percentage of employees leave employment before becoming eligible to participate in an employer's plan. In addition to the minimum participation requirements, qualified retirement plans also are required to satisfy rules to prevent the plan from discriminating in favor of highly compensated employees.

Employees who participate in an employer's qualified retirement plan are required to become fully vested (*i.e.*, entitled to receive 100 percent of their accrued benefit upon termination or other payment events) after either five years of service with the employer or, if the plan uses a graduated vesting schedule, after seven years of service.[18]

[18] Employer contributions made in proportion to the employee's own savings are required to be vested faster—after three years, or using a graduated six year vesting schedule.

General nondiscrimination rules also apply to qualified retirement plans. A qualified retirement plan cannot discriminate in contributions or benefits in favor of highly compensated employees. In the case of certain plans, such as qualified cash or deferred arrangements [*i.e.*,401(k) plans], these nondiscrimination rules contain very detailed testing requirements to ensure that highly compensated employees are not disproportionately benefiting under the plan.

Together, the participation, vesting and nondiscrimination rules are designed to ensure that employer-sponsored qualified retirement plans benefit a broad-based group of employees. This is the price that employers and employees pay for the higher contribution and benefit limits that apply to qualified retirement plan savings compared to other tax-favored forms of retirement savings (such as IRAs).

Benefit Limits—Qualified retirement plans are subject to dollar limits on contributions and benefits. For 2005, the annual limit on benefits under a defined benefit pension plan is $170,000. The 2005 annual limit on contributions to a defined contribution plan is $42,000. The 2005 elective deferral limit (*i.e.*, the amount of compensation that an individual employee can elect to defer) for a qualified cash or deferred arrangement is $14,000.

The dollar limits on contributions to qualified retirement plans are significantly higher than the limits on other tax-favored forms of retirement savings, such as IRAs. For 2005, the limit on contributions to an IRA is $4,000 ($4,500 for taxpayers who have reached age 50). Thus, individuals generally prefer to save for retirement through a qualified retirement plan because they are able to accumulate greater retirement savings. See the discussion below of the tax benefits attributable to a qualified retirement plan.

Funding and Deductions—Employers who establish qualified retirement plans are subject to specific rules governing the plan's funding and the extent to which the employer can deduct contributions to the plan.

The rules governing defined benefit pension plans are particularly detailed and complex. These rules not only specify the extent to which an employer is required to make annual plan contributions to ensure that there will be adequate funds available in the plan to pay promised benefits, but also provide limits on employer contributions designed to preclude overfunding of a plan. Substantial taxes are imposed on the termination of an overfunded defined benefit plan if the excess assets revert to the employer. Defined benefit pension plans carry significantly higher costs to establish and maintain than defined contribution plans. For small to mid-sized employers, the burdens of complying with the rules for defined benefit pension plans often are prohibitively expensive.

Treatment of Withdrawals—The amounts participants withdraw from qualified retirement plans by plan participants are subject to restrictions on both the timing and the nature of the benefit payments. Participants may be subject to a 10 percent tax penalty if they make a withdrawal prior to retirement or the attainment of age 59 1/2, unless the amounts withdrawn are used for certain specified purposes.

In addition, a qualified retirement plan participant who is no longer working is required to commence receiving retirement benefits and paying tax on such benefits at age 70 1/2 whether or not the individual needs the retirement income at that time. This provision encourages the depletion of retirement savings without regard to the individual's specific needs of the individual.

C. Tax Benefits of Qualified Retirement Plans

Under current law, an employer is permitted, within limits, to deduct contributions to a qualified retirement plan. The contributions are made to a trust that generally is exempt from federal income tax. Employees who participate in these plans are not required to include amounts contributed to the plans in gross income until the amounts are withdrawn by the employee.

From a federal tax perspective, an employer is generally indifferent as to whether current wages are paid to employees or whether contributions are made on behalf of the employees to a qualified retirement plan because the employer generally is entitled to a current deduction with respect to both payments. Certain employer contributions to qualified retirement plans are also not subject to Social Security and Medicare taxes (employment taxes), so the employer and employee share of these taxes may be reduced.[19]

On the other hand, employees generally should prefer to have contributions made to a qualified retirement plan on their behalf because the contributions will reduce their current tax liability.[20] However, employees should be indifferent to receiving compensation in the form of contributions to qualified retirement plans and other forms of tax-favored compensation that permit the accumulation of savings on a tax-free basis.[21] Despite the federal tax benefits for saving for retirement in a qualified pension plan, some employees might prefer to receive compensation in the form of current salary if they have insufficient disposable income to meet their current needs.

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[19] Economists generally believe that employees bear the incidence of these taxes.

[20] Certain employer contributions to qualified retirement plans are also excluded from income for purposes of calculating the employer and employee share of Social Security and Medicare payroll taxes. While this increases the incentive for retirement savings because it further lowers current federal tax liability, there is a trade-off for employees whose compensation is below the social security taxable wage base because their credits for social security benefits are reduced to the extent their current compensation is reduced. Thus, if an employer makes a contribution on behalf of an employee to a qualified retirement plan, the employee's current taxable compensation is reduced for income and employment tax purposes, but the employee's future social security benefits may be reduced as a result.

[21] Additional discussion of this issue is below. For example, under current law, certain tax benefits are provided for savings for education. These tax benefits not only provide a deferral of tax on the amounts contributed, but in some cases, the individual is entitled to a tax exemption for the withdrawal of amounts contributed. In such cases, the tax benefits of saving for education are more generous than the tax benefits attributable to qualified retirement plans.

Some of the reasons that an employer might prefer a qualified retirement plan over current wages include:

- The owner of the business might prefer to defer paying taxes on some of his or her own current income and a qualified retirement plan provides one mechanism for doing this;
- Employees have indicated their preference to have a qualified retirement plan; and
- The employer feels that it has an obligation to assist employees in saving for retirement.

The desire of a business owner to defer paying taxes on some of his or her own current income is likely a significant factor in the formation of a qualified pension plan by small and mid-sized firms.

On the other hand, employers might prefer to pay current wages instead of contributions to a qualified retirement plan because:

- There are significant regulatory burdens and costs to establishing and maintaining a qualified retirement plan;
- Certain types of qualified retirement plans (*e.g.*, defined benefit pension plans) require a long and ongoing commitment of contributions and the employer may be concerned for various reasons (*e.g.*, projected profits) to take on such a commitment; or
- Employees do not prefer to have contributions made to a qualified retirement plan (*e.g.*, if the employees generally are lower paid and cannot afford to save for retirement).

Value of Tax Benefits of Qualified retirement plans to Employees—From an economic perspective, the tax benefits of a qualified retirement plan are generally equivalent to a permanent exemption from tax of the earnings on contributions made to the plan. This principle can be illustrated with the following example:

> Assume that a $10,000 contribution is made to a qualified retirement plan on behalf of an employee. Assume that the employee's marginal tax bracket is 28 percent, so the employee would have $2,800 of current income tax if the contribution had been received as taxable compensation. Assume that the $10,000 earns an 8 percent return ($800) in Year 1 so at the end of Year 1; there is a balance of $10,800. Further assume that the $10,800 is withdrawn at the beginning of Year 2 and no penalty taxes apply to the withdrawal. In Year 2, the amount withdrawn is subject to $3,024 of tax ($10,800 times 28 percent), leaving a balance of $7,776.

If the taxpayer had received instead taxable compensation and invested in a taxable account, he or she would have had $7,200 [$10,000 minus $2,800 (the tax on the compensation)] to invest. The earnings on this amount at 8 percent would be $576, subject to tax of $161.28 for a net of $414.72. Thus, upon withdrawal, the taxpayer would have $7,614.72.

The difference in what the taxpayer has available under the two options ($7,776 versus $7614.72) is the $161.28 tax on the earnings. It should be noted that, if the taxpayer is in a different marginal tax bracket when the withdrawal is taken, the tax benefits will be different (see the example below).

In addition to the value of the exemption of earnings from tax, the contributions that are made on an employee's behalf to a qualified retirement plan may reduce the employer and employee share of employment taxes that are owed.[22]

The value of tax incentives for savings is further illustrated in Table 2. For this purpose, tax-preferred retirement savings refers to plans that allow taxpayers to deduct from taxable income their contributions to such plans and accumulate earnings on the account on a tax-deferred basis.[23] In this form of savings, withdrawals are fully taxed. Tax-free savings refers to plans (such as Roth IRAs) in which contributions are made on an after-tax basis (*i.e.*, no deduction or exclusion for contributions), earnings accumulate tax-free, and there is no tax on withdrawals.

Tax-preferred savings, through an employer plan and through personal savings, may have a positive effect on the saving decision. In general, the current tax incentives encourage tax-preferred savings (*e.g.*, retirement savings) over savings for other purposes. The advantages of tax-preferred savings are that taxpayers earn a tax-free rate of return on their investments and postpone their tax liability until retirement, when presumably they have a lower tax rate. Table 2 compares the benefits of tax-preferred and tax-free savings plans to a taxable savings plan. In this example, a taxpayer who is in a 28 percent marginal tax bracket has $10,000 of compensation available for savings and investment. The initial contribution (minus income taxes, where applicable) accumulates for ten years at 8 percent annual interest and is withdrawn when the taxpayer is in a 15 percent marginal tax bracket.

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[22] This exemption from employment taxes does not apply to elective deferrals under a qualified cash or deferred arrangement. In addition, the exemption may reduce the amount of social security benefits to which an individual is ultimately entitled.

[23] In addition to traditional defined benefit and defined contribution plans, this includes IRAs, 401(k) and other contributory savings plans.

Table 2
Compare Tax-Preferred. Tax-Free and Fully-Tax Savings Plans
Amount Available for Deposit = $10,000
Interest Rate = 8%
Tax Rates = 28% (pre-retirement) and 15% (retirement)
Years of Accumulation = 10

	Tax-Preferred	Tax-Free	Fully Taxed Savings
Initial Deposit	$10,000	$7,200	$7,200
Accumulated Balance	$21,589	$15,544	$12,605
Available after paying tax	**$18,350**	**$15,544**	**$12,605**

As the above example indicates, an individual saving $10,000 in a tax-preferred savings vehicle generally will have a greater amount to invest, because the dollars are pre-tax dollars. If the tax rate is, indeed, lower at retirement, the benefits of the tax-preference remain. It is important to note that the majority of taxpayers will face a lower tax rate at retirement. Therefore, the benefits of the tax deduction and inside buildup are measurable.

If a taxpayer faces the same marginal tax rate in retirement as he or she does when a contribution is made, the effect of the tax-deferred and tax-free savings vehicles would be equal. As noted above, these plans generally provide the equivalent of an exemption from tax for the earnings on the amounts contributed. In reality, most taxpayers face a lower tax rate in retirement than during their working years, so if all other things are equal, they should prefer the tax-deferred form of saving to the tax-free form.

Compared to other savings, tax-preferred or tax-free retirement savings may encourage individuals to save for retirement. However, as the types of tax-preferred savings vehicles increase, there is a danger that savings become diluted as individuals direct their tax-preferred savings to shorter-term savings needs (*e.g.*, first time home purchase or higher education for child or spouse).

II. Effect of Tax Reform On Qualified Retirement Plan Savings

The tax benefits available for retirement savings through an employer-sponsored qualified retirement plan often are not sufficiently large to overcome the substantial costs that employers must incur to establish and maintain these plans. This fact is particularly true for small and mid-sized employers. The statistics on plan formation and termination bear this out by showing that small and mid-sized employers are much less likely to establish qualified retirement plans (only 44 percent of employers with fewer than 100 employees establish plans) and much more likely to terminate the plans that they do establish (see graph 3).

In addition, certain statutory provisions that either provide tax incentives for non-retirement saving or specifically discourage retirement savings impact the amount of retirement savings that accumulate under current law. These provisions include preferential tax rates for capital gains and dividends, tax incentives for such other types of savings such as health savings accounts and education savings accounts, and limits on the amount of qualified retirement savings.

Despite the fact that there is a recognized need to encourage individuals to save for retirement, few policymakers focus on the devastating effect that various tax reform proposals may have on saving for retirement. While many focus on the advantages or disadvantages of a consumption tax as an addition to or alternative to the current law income tax system, few are aware that the switch to a consumption tax system or an elimination of the tax on capital gains and dividends will likely result in an alarming reduction in individuals' retirement saving.

This section provides an overview of the current tax provisions of current law that potentially affect a taxpayer's decision to save for retirement and provides an overview of the potential direction of various tax reform proposals.

A. Tax Provisions That Affect Retirement Savings

Capital Gains and Dividends—Reductions in capital gains rates have long been touted as a way to stimulate the economy, reduce the economic distortions of current law that favor debt versus equity and increase national savings. Reduced capital gains and dividend tax rates make investments in stock and other capital assets more tax favored relative to other investments.

Under current law, capital gains generally are subject to tax rates below the ordinary income tax rates. The gains are included in income when they are recognized, which generally occurs when the asset is sold or otherwise disposed of. Long-term capital gains generally are subject to tax at a maximum rate of 20 percent (10 percent for income that would be subject to ordinary income tax at a 15 percent rate). From 2003 through 2008, these rates are reduced to 15 percent and 5 percent, respectively (the 5 percent rate is reduced to zero in 2008).[24] After 2008, the 20 percent/10 percent rate structure again applies.

These reduced tax rates also apply to dividends received by individuals for 2003 through 2008.[24] After 2008, dividends received by individuals are subject to tax at ordinary income tax rates.

Lower tax rates on capital gains and dividends can affect an individual's decision when making investments in retirement savings. All amounts withdrawn from qualified pension plans are subject to income tax as ordinary income.

There is a significant disadvantage to investing qualified retirement plan assets in stocks and capital assets because of the greater tax advantages available if the assets are held directly by individuals. For example, if a qualified pension plan holds a capital asset that was purchased for $1,000 and sold for $10,000, the $9,000 of capital gain will be taxed at ordinary income rates when it is distributed to a plan participant. A taxpayer in the 28 percent marginal rate bracket would pay $2,520 ($9,000 x .28) of federal income tax. If the same taxpayer held the capital asset directly, rather than through a qualified pension plan, he or she would pay $1,350 of federal income tax ($9,000 x .15) on the gain.

If the current tax provisions imposing a 15 percent/5 percent rate structure for capital gains and dividends expire as scheduled, the tax advantage to holding capital assets and stocks directly is reduced, but not eliminated, as the rates return to 20 percent/10 percent. Taxpayers still have an incentive to reduce their holding in capital assets in qualified retirement plans and increase their personal holdings in taxable capital assets. In the example above, the taxpayer would pay $1,800 ($9,000 x .20) of federal income tax if the capital asset is held directly, rather than $2,520 if the asset is held in a qualified retirement plan, which is still a substantial difference in tax benefits and one that makes saving outside the qualified retirement plan more attractive.

Furthermore, it is important to remember that withdrawals from qualified pension plans may be subject to an early withdrawal penalty if they occur prior to retirement. On the other hand, as long as a capital asset is held for at least one year, the reduced tax rates apply. In general, taxpayers can control the timing of taxation on capital gains by selling the asset when the gains are needed. Thus, an additional advantage of holding capital assets directly is that taxpayers can avoid paying any penalty taxes for accessing their gains.

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[24] Various other special provisions apply to specific types of capital gains, so lower or higher rates may apply depending upon the nature of the investment. For example, capital gains on collectibles generally are taxed at either 15 or 28 percent.

Similarly, taxpayers who invest directly in capital assets may hold the asset as long as they want, whereas taxpayers whose assets are invested in qualified retirement plans are generally required to begin receiving distributions (and, therefore, paying federal income tax) at the later of (1) attainment of age 70 1/2 or (2) retirement.

The bottom line is that taxpayers with adequate resources can effectively establish what amount they will accumulate for retirement by investing their money in capital assets and dividend-producing stocks. Taxpayers can time the recognition of their capital gains to match their income needs in retirement. Taxpayers who need to access funds at an earlier time will not be subject to any specific tax penalty as long as they have held a capital asset for at least one year. Furthermore, there are no limits on the amount of tax-favored investments that can occur in this manner, unlike qualified pension plans, which are available on a dollar-limited basis.

This incentive to invest outside of qualified retirement plans may, over time, reduce small business owners' decisions to offer qualified retirement pension plans as they find that the costs and administrative burdens of maintaining qualified retirement plans, combined with the favorable tax treatment of capital gains and dividends, make saving in qualified retirement plans far less attractive than personal savings.

This situation is most relevant to small employers, with one or two more highly compensated employees and several lower-compensated employees. As the costs and administrative burdens rise, the small employer is more likely to view other savings options as more attractive than sponsoring a qualified retirement plan. The small employer could eliminate the qualified retirement plan and offer bonuses to his employees. By depositing the after-tax bonus in stock or equity investment funds, the favorable capital gains and dividend tax treatment could provide benefits greater than or equal to those in the qualified retirement plan—with far less effort and expense.

In addition to the current tax incentives for saving for retirement, there are a number of tax incentives for "special purpose" saving. The two most significant "special purpose" federal tax incentives are the incentives for savings for education and those for health savings accounts (HSAs).

Tax Incentives for Education Savings—The tax incentives for saving for education may take one of two principal forms—Section 529 qualified tuition programs and Coverdell education savings accounts. A qualified tuition program is established by a state or a qualified educational institution to provide a mechanism for higher education saving.[25] Amounts contributed to such a program are not deductible, but the earnings accumulate on a tax-free basis and withdrawals used for qualified education expenses are not included in income. There is no dollar limit on contributions to a qualified tuition program. However, withdrawals not used for qualified

[25] Certain of the special provisions for qualified tuition programs expire at the end of 2011.

education expenses are included in income and subject to a 10 percent penalty tax. Because the exclusion from income is available only for withdrawals for qualified education expenses, there is an inherent limit on the amount of savings invested under these programs.

A Coverdell education savings account is a trust or custodial account where contributions are made for a beneficiary who generally is under age 18 (unless the beneficiary has special needs) to save for qualified education expenses. The maximum annual contribution to a Coverdell education savings account is $2,000 (after 2011, the annual contribution limit becomes $500). The annual contribution limit is phased out for taxpayers with income above certain levels. The amounts contributed to a Coverdell education savings account are not deductible, but the earnings grow on a tax-free basis and withdrawals used for qualified education expenses are not included in income. Like the qualified tuition program, withdrawals that are not used for qualified education expenses are included in income and subject to a 10 percent penalty tax. The allowable qualified education expenses for purposes of a Coverdell education savings account are broader than those for a qualified tuition program because they include expenses for elementary and secondary education.

In addition to the qualified tuition programs and the Coverdell education savings accounts, current tax provides an exclusion from income for interest earned on qualified US Series EE savings bonds issued after 1989 to the extent the proceeds of the bond do not exceed the qualified higher education expenses of the taxpayer during the year.

The tax benefits attributable to qualified tuition programs and Coverdell education savings accounts are similar to the tax benefits attributable to saving in a Roth IRA. Contributions are not deductible, earnings are excluded from income and withdrawals are not subject to tax (provided the withdrawals are used for the permitted purposes). If a taxpayer's marginal tax rate remains the same over time, this tax treatment is equivalent to the treatment accorded to qualified retirement plans in which the initial contribution is not taxed, earnings are tax free and withdrawals are included in income.[26]

The tax incentive for saving through a qualified tuition program or a Coverdell education savings account is in general equivalent to the incentive to save in a qualified retirement plan. However, fewer taxpayers are likely to anticipate that they will incur qualified education expenses eligible for the special tax treatment. While any taxpayer can ultimately utilize the favorable tax benefits of qualified retirement plan saving, only those taxpayers who actually have qualified education expenses will enjoy the full benefit from these education tax incentives. Thus, it is likely that the saving for education will attract a more narrow class of taxpayers who anticipate such expenditures.

[26] In reality, the taxpayer who receives a withdrawal from one of these programs may be in a lower tax bracket than the taxpayer who made the initial contribution to the program or account.

Yet saving in these plans may encourage some taxpayers to divert retirement savings to educational savings, as most families have limited resources for savings. The addition of such plans provides a competing, not complementary, form of savings.

Also, because saving under a qualified tuition program is not dollar-limited, those taxpayers who anticipate incurring qualified higher education expenses have a substantial incentive to make contributions to such a program to take advantage of the tax saving.

In addition, taxpayers who do not anticipate incurring qualified education expenses might also find the vehicles attractive. This is because, under certain situations, the 10 percent penalty tax on withdrawals not used for qualified education expenses may not fully cancel the tax advantages of these programs relative to a taxable account. Thus, for a taxpayer whose retirement saving is limited by the dollar limits for qualified retirement plans, the education savings vehicles may still provide an attractive form of tax-favored savings.

Tax Incentives for Health Savings—Current law provides tax incentives for savings for health care expense through HSAs. These accounts are a tax-exempt trust or custodial account created exclusively to pay qualified medical expenses. The accounts are similar to IRAs. However, in some cases, the tax advantages of HSAs are more favorable than those for qualified requirement savings. Contributions to an HSA are deductible, earnings grow on a tax-free basis and withdrawals from the HSA for qualified medical expenses are excluded from income. Thus, by providing an exclusion from income for such withdrawals, an HSA provides a greater tax benefit than qualified retirement saving.[27]

An individual must have coverage under a high deductible health plan and have no other health plan to make contributions to an HSA. In general, the annual limit on contributions to an HSA is $2,650 (for 2005) for a taxpayer with self-only coverage and $5,250 for a taxpayer with family coverage. The annual limit increases for individuals over age 55. A high deductible health plan has a deductible of at least $1,000 for self-only coverage and $2,000 for family coverage.

While the annual dollar limits on the deduction are relatively low, HSAs are likely to be attractive savings vehicles, because they offer benefits that are greater than those offered by qualified retirement savings. Because HSAs are fairly new savings vehicles, it is likely that their use will continue to grow. It is too early to have any reliable statistics on HSA use.

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[27] Withdrawals that are not used for qualified medical expenses are subject to both an income and a 10 percent penalty tax.

Limits on Qualified Retirement Plan Savings—Recent legislation has continued to erode the tax incentive for qualified retirement plan saving by introducing different tax incentives for different forms of saving. As more and more taxpayers begin to consider alternative tax-favored forms of saving, the dollar limits that apply to qualified retirement savings are likely to continue to be a deterrent to the establishment and maintenance of qualified retirement plans by small and mid-sized businesses.

It is important to recognize that a major impetus to small business owner forming a qualified retirement plan is the ability to shelter the owner's current income from tax. The limits on contributions and benefits under qualified retirement plans can be juxtaposed against the substantial costs of establishing and maintaining a qualified retirement plan.[28] Ultimately, a small business owner may conclude that other forms of tax-favored savings that do not entail such costs are a more efficient use of the owner's resources.

B. Direction for Reform

Advocates of tax reform—those seeking to overhaul the income tax system—are encouraging the move toward consumption taxes (pure consumption or national sales tax) and away from income taxes. Any minor tax change creates winners and losers. Such a dramatic reform would generate considerable change and inevitably, raises many questions about who wins or loses. We focus our attention on the effect major tax reform might have on retirement savings, both from the perspective of individual savings and retirement security and of the desire or willingness of employers to offer retirement plans as a part of total compensation.

[28] For 2005, the dollar limit on contributions to a defined contribution plan is $42,000. The dollar limit on benefits under a defined benefit pension plan is $170,000.

III. Closer Look at The Impact—Effect On Qualified Retirement Plans

A. Consumption-Based Taxes

In principle, the difference between a consumption tax and income tax is the treatment of savings. Consumption is income less savings. Conversely, income is equal to consumption plus savings. These simple identities form the basis for either taxing consumption or income.

Economists define income as anything that increases an individual's ability to consume. Thus, income includes compensation for services, rents, royalties, life insurance proceeds and alimony. Under a pure income tax, anything that increases the ability to consume is income that is subject to tax. Under a pure consumption tax, taxpayers must consume a portion of their income or savings to incur a tax liability. Therefore, if a person chooses to delay consumption and save their income, they will also delay the tax until such time as they consume their savings.

In a pure income tax world, all income (both from capital and labor) is subject to tax. In a pure consumption tax world, only amounts spent on goods and services are subject to tax. However, in the real world, any tax system—whether income or consumption tax—might exhibit characteristics of one or the other or combine elements of both tax systems.

For example, under our present income tax system, we treat certain tax qualified savings as if it were savings in a consumption tax world. In other words, we allow taxpayers to deduct from income amounts saved in a tax-qualified retirement plan and exempt from income any earnings on that savings until amounts are withdrawn at retirement when withdrawals are then treated as income.

Excluding contributions to qualified pension plans and IRAs from current income in essence provides consumption tax treatment for these amounts by excluding them from income when they are contributed and taxing them only upon withdrawal.[29] Because the contributions to these plans and accounts are limited under current law, the consumption tax treatment is limited to the permitted dollar limits on contributions. Similarly, current law provides consumption tax treatment for unrealized capital gains and to the extent that certain capital expenditures can be expensed by small businesses. However, because current law provides limited consumption tax treatment for specific items, many argue that current law provides consumption tax treatment for certain income as a way of encouraging specific behavior by taxpayers, such as retirement saving.

In general, consumption taxes tax the purchase or use of goods and services and therefore, by their nature, favor savings. Consumption taxes make it more expensive to purchase goods and

[29] It should be noted that Roth IRAs are essentially equivalent to deductible IRAs by taxing the income that is contributed to a Roth IRA and providing an exclusion from income for any withdrawals, as long as the tax rate faced by the taxpayer is the same when a contribution is made and when a withdrawal is taken.

services. Thus, the less a taxpayer consumes and, therefore, the more he or she saves, the less tax is paid. A consumption tax could replace the current federal income tax, or supplement the income tax with a separate revenue raising structure.

Consumption taxes may take a variety of forms. These include the value-added tax (VAT) or retail sales tax and consumed income tax. There are two features that distinguish the various types of consumption-style taxes—the source of the tax revenue and the source of the tax burden. In general, with a VAT the producer pays the tax and wages or workers bear the tax burden (depending upon whether there is a tax on old capital). With retail sales and consumed income taxes the consumer pays the tax and all consumers share the tax burden, regardless of their employment status.

Value Added Tax—The most common form of consumption tax used throughout the world is the VAT. A value-added tax generally is a tax imposed and collected on the "value added" at every stage in the production and distribution process of a good or service. Although there are various ways to compute the value added (*i.e.,* taxable base) for a VAT, in general the amount of value added are the difference between the value of sales (outputs) and the value of purchases (inputs) of a business.[30]

An important feature of a consumption-style VAT is that a company's investment is expensed rather than depreciated, causing the effective tax rates on investment to be zero with full expensing. Rather than taxing directly the investment, the return from the investment generates the tax. This return is the increase in value of the goods and services generated by the investment.

Another way to think about the VAT is in terms of the value of the inputs—labor and capital. During the production process, the labor and capital inputs add value as the product moves from raw materials to finished goods. If all new investment avoids tax through expensing, the labor through the value of their wages and old capital would bear the burden of the VAT.

When considering tax reform that relies on a VAT, it is important to consider the impact on old capital or capital acquired before tax reform. This distinction between old and new investment is an important one. Because of this distinction, the transition from an income tax system to a VAT system would not flow seamlessly. If the new VAT does not impose taxes on old capital, then the VAT becomes purely a wage tax. However, if old capital is subject to tax, then capital is taxed twice—once under the former income tax system and again through the VAT system.

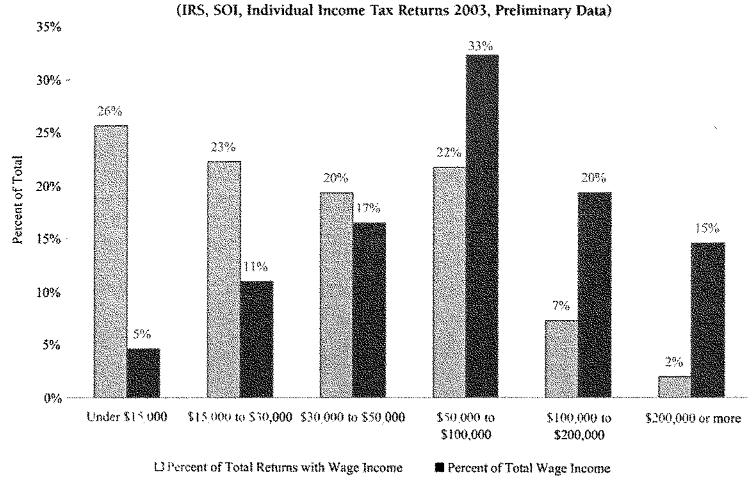
The VAT also differs from other forms of consumption taxes in the way that other assets avoid tax. Consider for example, a person who discovers a valuable resource on otherwise worthless land or a

[30] There are two primary types of VAT—the credit invoice method and the subtraction method (sometimes referred to as a business transfer tax).

person who develops an idea. Under a VAT, consumption from the proceeds of the resource or the idea would escape tax. Generally speaking, any consumption financed with savings acquired prior to the VAT would also avoid tax.

These simple situations suggest more complicated policy questions to consider when thinking of implementing a VAT under tax reform, specifically whether the VAT would be more or less progressive (regressive) than the current income-based tax system. While the answer to that question is complicated, some simple statistics provide an intuitive indication to that answer. Consider first the income distribution of those earning wages. Graph 6 shows the wage income (as a percentage of total wage income) and returns reporting wage income (as a percentage of total returns) distributed by income class. The percentage of returns is concentrated at the lowest income levels, but upper-middle income returns report the greatest share of wage income.

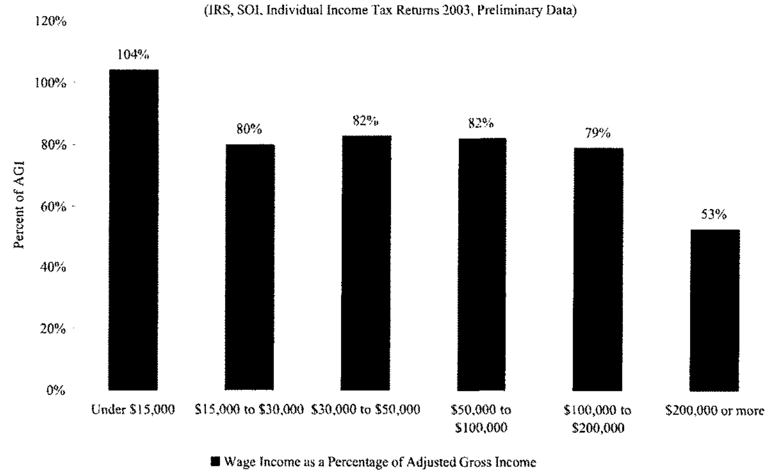
Graph 6
Wage and Salary Income, Percent of Total Return and Percent of Total Wage and Salary Income, 2003
(IRS, SOI, Individual Income Tax Returns 2003, Preliminary Data)



It appears based on gross reporting of wage and salary income that a VAT that derives its value from wages would derive its greatest source of revenue from higher income classes. However, consider wage income as a percentage of total adjusted gross income and a different picture emerges as shown in Graph 7. Wage income comprises the majority of income for the lowest income classes.[31] As incomes rise, the VAT derives tax on a smaller share of total income, as defined under the present system.

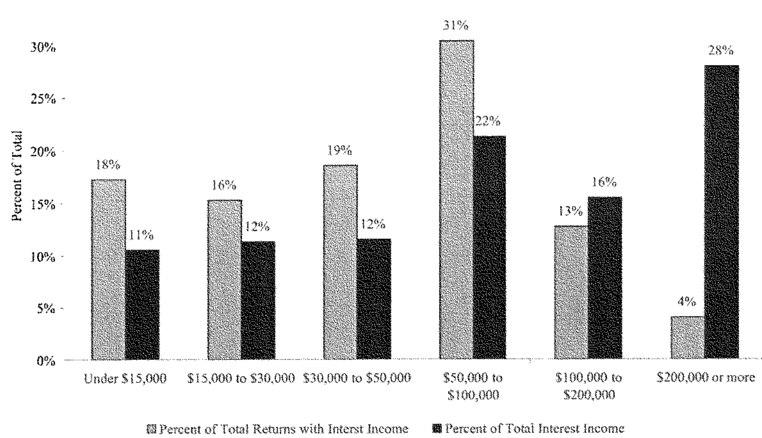
[31] Note that adjusted gross incomes for the lowest income classes typically include net capital losses, making wage income greater than the total.

Graph 7
Wage Income as a Percentage of AGI, 2003
(IRS, SOI, Individual Income Tax Returns 2003, Preliminary Data)



If a VAT does not tax old capital or assets accumulated before implementing a VAT consumption financed by such assets is not subject to tax. As one might expect, the accumulation of assets is positively correlated with income as Graph 8 suggests, which considers interest income as a proxy for the base of accumulated assets. As incomes rise, the percent of total taxable interest income also rises. This positive correlation reinforces the fact that savings is positively correlated with income and that lower income households generally do not save outside employer-sponsored plans.

Graph 8
Taxable Interest Income as a Percent of Total Returns and Total Interest Income, 2003
(IRS, SOI, Individual Income Tax Returns 2003, Preliminary Data)



National Retail Sales Taxes—Retail sales taxes are a common form of consumption tax used by state and local governments. Under a national retail sales tax, goods and services sold to households would be subject to sales taxes.[32] However, only the new sales or production is subject to tax. Sales of used goods or previously owned items would not constitute retail sales.

In general, a national retail sales tax would tax all goods and services. Note that state and local governments generally exempt from the base such items as food, housing and health care. However, if certain goods and services are exempt from the national sales tax, the rate must increase.[33]

Advocates of this approach believe that a flat tax would apply to all retail sales, and that this flat tax would greatly simplify the tax system. Further, they believe that a retail sales tax would eliminate the need for deductions, exemptions and tax preferences. Taxpayer compliance and tax administration would focus on the base of retail sales, rather than the income generated to pay for those sales. Advocates of national sales tax proposals suggest lower tax rates would be revenue neutral, but generally do not consider compliance costs and tax avoidance schemes.

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[32] Business-to-business and household-to-household transactions would qualify as retail sales.
[33] Some studies estimate that a budget-neutral move to a national sales tax from the present income tax would require a 60 percent tax rate. The 60 percent tax rate is a "tax-exclusive" rate. The tax-inclusive rate is 38 percent. See Gale, William, "National Retail Sales Tax," Brookings Institute, 2004.

Whatever the sales tax rate, it is important to consider that most states impose sales taxes in addition to state income taxes. Eliminating the federal income tax system would require states to increase their sales tax rates.

With respect to existing savings, imposing a national sales tax raises equity issues. Consider a person in retirement that finances consumption exclusively from retirement savings and Social Security income. Assume that the individual's annual Social Security benefits are $9,000 and retirement benefits are $6,000 for a combined retirement income of $15,000. Under present law, with limited income, the Social Security benefits are not taxable. After a personal exemption and standard deduction, the retirement income is also not taxable. This retiree would not pay any federal income taxes under the present system. However, under a national retail sales tax, every dollar spent would include sales taxes. Regardless of the rate, 20, 30 or 60 percent, this represents a significant tax increase and a reduction in consumption for retirees.

Moving from an income tax system to a national sales tax system raises many questions with respect to the tax treatment of existing savings, both tax-preferred savings and after-tax savings. Such distinctions create the need for complex transition rules or potentially excluding certain items from the retails sales tax base. However, as mentioned above, reducing the tax base would increase the sales tax rate.

Consumption represents a larger share of income for lower income households. A recent Tax Policy Center publication estimated the amount of income spent on consumption. They estimated that households with incomes between $10,000 and $20,000 per year spend 75 percent of their total income on food, housing and clothing. Households with incomes greater than $200,000 spend approximately 16 percent on these necessities. Overall when considering consumption of both necessities and other goods, low-income families consume virtually all of their income, compared to their high-income counterparts that consume approximately 37 percent.[34] Implementing a flat national retail sales tax rate on all consumption would create a regressive tax system compared to the current income tax system, by taxing a greater share income earned by low income households compared to higher income households.

However, if policy makers wished to minimize the regressive nature of a national retail sales tax, they have limited options. Ideally, one might to impose different rates by income class. However, to do so means that tax rates would gradually increase with income to create a more progressive

[34] See Burman, Leonard and Troy Kravitz, "Lower-Income Households Spend Largest Share of Income," Tax Analysts, Tax Facts, Tax Policy Center, November 8, 2004.

tax system. Functionally, this would be impossible, because retailers would not be able to determine the right level of tax at the time of purchase. In order to make a retail sales tax more progressive, policy makers would have to exclude certain goods and necessities from the tax base. Again, excluding items from the base would necessitate increasing the tax rates that consumers would face.

Consumed Income Tax—In addition, a consumption tax could be constructed in a manner that retains the current law structure of the federal income tax, but imposes a zero tax rate on a taxpayer's savings; this is commonly referred to as a consumed income tax. For example, the current tax structure could be modified to provide an exclusion from the income tax for all amounts contributed by a taxpayer to a savings account. This approach would provide a current deduction for contributions to a specified savings account and an exemption from tax for earnings on the account. Under this approach, withdrawals from the savings account would be taxed as income because these amounts represent negative savings. Also, rarely mentioned, loans received by individuals and used for consumption would also be subject to tax.

The consumed income tax would again favor higher income taxpayers who consume only a small portion of their income. Further, from a policy perspective, this tax also raises issues about the distribution of wealth and wealth accumulation. Much of the wealth in our country remains concentrated in a small segment of our total population. Moving to a consumed income tax system would further this concentrated wealth accumulation and expand the wealth distribution. Since low income households spend all or most of their incomes, they are unable to save outside qualified retirement plans and would not accumulate any personal savings.

One might assume that taxing consumption and excluding all savings from tax might produce greater retirement savings and improve overall income security for retirees. However, looking more closely at the effects of tax reform on qualified retirement plan savings offers a very different conclusion.

Possible Effects of a Consumption Tax System on Qualified Retirement Plans—As we have discussed above, from a tax perspective, employers generally are indifferent with respect to whether they pay current wages or make contributions for employees to a qualified retirement plan. However, for a small employer, the regulatory and maintenance costs attributable to a qualified retirement plan are a significant deterrent to establishing and maintaining such a plan. Often, employers will establish the plans because the business owner or employees wish to use available tax benefits for themselves.

Current law can be viewed as having a consumption tax component to the extent that there is a tax benefit provided for savings. However, under current law, only specified types of savings are given favorable tax treatment, which provides a powerful incentive for savings to occur in the favored form. From an individual's perspective, saving for retirement is one of the more tax-favored forms of saving. The limits on the amounts that can be saved on a tax-favored basis are considerably greater for retirement savings than for other forms of savings, such as savings for education.

The introduction of a consumption tax, either as an alternative to the current tax system or in addition to such a system, fundamentally alters the decision to establish and maintain a qualified retirement plan. Under a consumption tax system, whether an employer makes contributions to a qualified retirement plan will not affect the employer's tax liability or the employee's tax liability. Consequently, there would no longer be any tax incentives to establish and maintain a qualified retirement plan within its accompanying distribution restrictions.

Effect of a Consumption Tax System on Withdrawals from Existing Qualified Retirement Plans—A significant issue to be addressed if a substantial consumption tax system is adopted is the proper treatment of existing assets in qualified pension plans. Under current law, if a participant makes a withdrawal from a qualified retirement plan, the withdrawal is treated as taxable ordinary income and may be subject to a 10 percent early withdrawal penalty tax.[35] The early withdrawal tax generally is intended to discourage the use of retirement savings for non-retirement purposes. However, if taxpayers are generally encouraged to save under a consumption tax system, will the penalty tax continue to apply? If the penalty tax continues to apply to qualified retirement plan withdrawals for nonretirement purposes, then taxpayers who want to consume a portion of savings will likely consume from general savings rather than from their retirement savings. In a sense, the continued imposition of the penalty tax would continue the current tax incentive to use savings in a qualified retirement plan for retirement purposes only.

On the other hand, if general savings face a potential consumption tax, some might argue that it is inequitable to impose a penalty on consumption from one source of savings rather than another. Since money is fungible, it does not necessarily make sense to impose a penalty on consumption from one particular source of savings.

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[35] The early withdrawal penalty tax does not apply if the withdrawal is made (1) on or after the participant attains age 59 1/2, (2) to a beneficiary after the death of the participant, (3) on account of the participant's becoming disabled, (4) as part of a series of substantially equal periodic payments over the employee's (or the employee's and his or her spouse's) life or life expectancy, (5) after separation from service after attainment of age 55, (6) for certain medical expenses, (7) to a former spouse under a qualified domestic relations order or (8) to certain unemployed individuals for health insurance premiums.

B. Reduced Taxation of Capital Gains And Dividends

Under current law, a reduced tax rate applies to capital gains realizations and dividends received by an individual from a domestic corporation and from certain qualified foreign corporations. The reduced tax rate generally is 15 percent, except that it is 5 percent for taxpayers in the 10 or 15 percent income tax bracket. The 5 percent rate is reduced to zero in 2008. After 2008, the rates of tax applicable to capital gains realizations will be 20 percent (10 percent for taxpayers in the 15 percent income tax bracket). After 2008, individuals must report dividends as ordinary income making them subject to the ordinary income tax rates.

Some proponents would like to make permanent the reduced tax rate for capitals gains and dividends received by individuals. In addition, others would like to further reduce the rates to zero or eliminate entirely the tax on these sources of income. Both proposals assume that our current tax system remains intact, rather than considering these proposals as part of a larger reform that changes the tax system from income-based to consumption based.

Proponents believe that eliminating tax on capital gains and dividends will reduce economic distortions created by the income tax system. Relative to other investments, this approach would make investments in stock and other capital assets more tax favored than under current law and would end the current tax benefit of debt versus equity. Consequently, many argue that this proposal would increase savings and investments.

Because the proposal is assumed to occur as a modification to the current tax system, investments in qualified retirement plans would continue to be tax favored. However, because taxpayers generally could gain similar tax benefits by investing in capital assets, taxpayers may prefer to hold their savings outside of a qualified retirement plan by investing directly in stock and other capital assets. The owners of small and mid-sized businesses may particularly find that the costs of maintaining a qualified retirement plan outweigh the benefits of holding assets in a qualified pension trust if there are substantial benefits that accrue to direct investments in stock and other capital assets.

It is important to remember that taxpayers must include in income all amounts withdrawn from qualified pension plans and treat those withdrawals as ordinary income. Thus, it would not make sense to invest qualified retirement plan assets in stocks and capital assets because assets held directly receive greater tax advantages if the proposal eliminating tax on capital gains and dividends is enacted. For example, if a qualified pension plan holds a capital asset that was purchased for $1,000 and is sold for $10,000, the $9,000 of capital gain is taxed at ordinary income rates when it is distributed to plan participants.

Table 3 shows the potential erosion of qualified retirement plan benefits compared to saving outside of the qualified retirement plan when capital gains and dividends receive preferential treatment. Assume that the business owner contributes $1,000 per year to his qualified retirement plan. The plan invests in an equity fund and earns 7 percent each year on that return. Column two shows the benefits of the qualified retirement plan over 15, 20 and 30 year savings horizons. The results reflect the tax deduction received for the contribution and the tax-free accumulations over time. Further, the final balance from the qualified retirement plan is the after-tax balance (assuming a 35 percent ordinary income tax rate).

Column three shows the accumulated balance if the same person invests the funds outside of the pension plan. In this case, if the business owner treats the $1,000 as a bonus, the after-tax amount deposited each year is $650 [$1,000 x (1 - .35) = $650]. This example assumes that present law tax treatment of capital gains and dividends applies. Again, if the account invests in an equity fund earning an after-tax return of 6 percent [7 x (1 - .15) = 6], the accumulated balance is not subject to tax at the end of the time horizon. In this case, the qualified retirement plan maintains a slight advantage over the bonus account.

Column four shows the accumulated balance if the same person invests funds outside the pension plan, but the tax rate applied to capital gains and dividends falls to zero from 15 percent. In this case, the accumulated bonus is equivalent to those amounts accumulated in the qualified retirement plan after taxes paid upon distribution.

Consider one more situation that accounts for the administrative costs to maintaining a qualified retirement plan. If the business owner faces a 10 percent plan administrative cost of the plan, but decides to increase the bonus to account for this cost, then the after-tax amount of the contribution increases from $650 to $722. In light of zero capital gains and dividend taxes, the benefit of investing in an equity plan would exceed those of investing in a qualified retirement plan.

Table 3
Compare Accumulated Account Balances, Qualified Retirement Plans and Bonuses under Various Tax Treatments

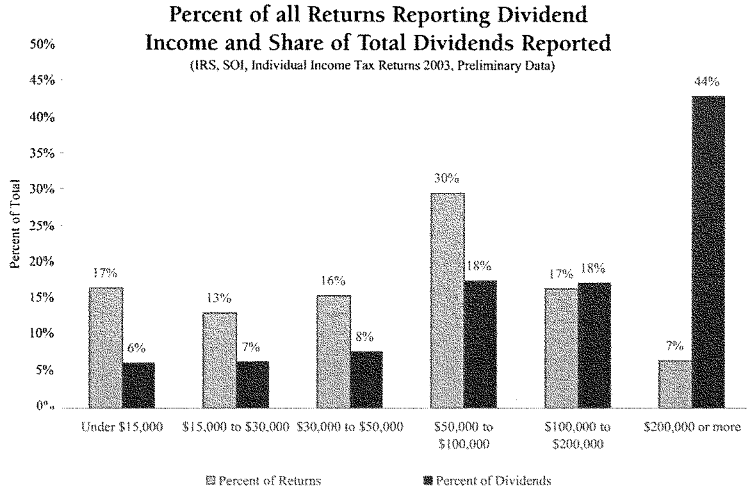
	Qualified retirement plan	Bonus, present law capital gains and dividend tax rates	Bonus, zero capital gains and dividend tax rates	Bonus, increased for administrative costs, subject to zero capital gains and dividend tax rates.
15 years	$17,477	$15,969	$17,477	$19,419
20 years	$28,512	$25,198	$28,512	$31,680
30 years	$65,697	$53,969	$65,697	$72,997

Eliminating taxes on capital gains distributions and dividend income has obvious benefits for higher income taxpayers. About 50 percent of all households report owning stock, either directly or through their retirement account.[36] But less than 10 percent of low income households own stock directly.

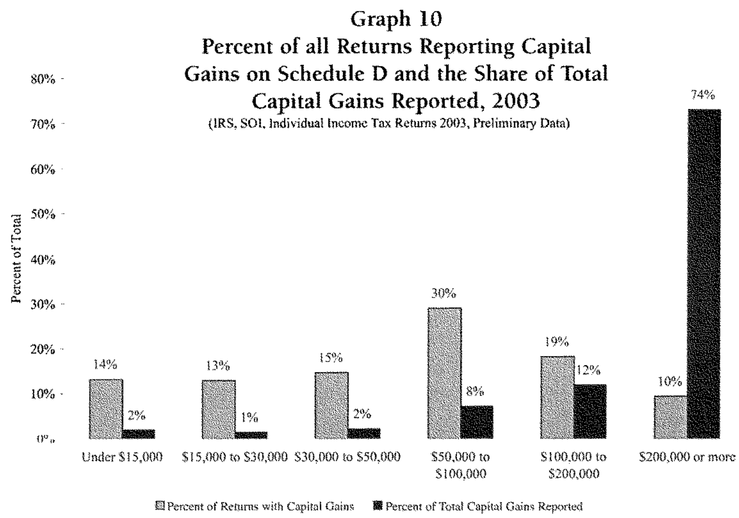
Referring to Graphs 9 and 10, in 2003, returns with adjusted gross income less than $15,000 reported only 6.3 percent of all dividend income. Returns with adjusted gross income in excess of $200,000 reported 43.8 percent of all dividend income. Similar trends are present in reporting of capital gains distributions. Returns with adjusted gross income less than $15,000 reported 2.1 percent of all net capital gains while returns with adjusted gross income in excess of $200,000 reported 74.4 percent.

The most important point is not that such a disparity in wealth exists, rather that eliminating tax on dividend and capital gains provides benefits to a select segment of the population. It is true that this targeted tax relief would increase savings, but only for a small segment of taxpayers.

Graph 9
Percent of all Returns Reporting Dividend Income and Share of Total Dividends Reported
(IRS, SOI, Individual Income Tax Returns 2003, Preliminary Data)



[36] Comments made by Federal Reserve Governor Gramlich to the National Savings Forum, 2001.



The Joint Committee on Taxation estimates the tax expenditure or cost of the current reduced rates on dividends and long-term capital gains is approximately $357 billion over the next five years.[37] Estimates of eliminating the tax on dividends project a reduction in federal receipts by approximately $300 to $400 billion over the next ten years. Given the behavioral response of eliminating the capital gains tax on long-term gains, it is unclear how large the revenue loss would be.[38] However, given the magnitude of the current tax expenditure and the potential increased costs of eliminating taxes on dividends and capital gains, it is important to consider the effect on retirement savings and overall wealth accumulation. The purpose of qualified retirement plan incentives is to encourage retirement saving behavior and ensure retirement security for older people. However, targeted tax reform policies that increase savings for only a small segment of the population could potentially create greater problems as the wealth distribution widens.

[37] See JCS-1-05, "Estimates of Federal Tax Expenditures, 2005 through 2009," Joint Committee on Taxation, January 2005.
[38] It is likely that a zero rate of tax on capital gains and dividends would have substantial behavioral effects on taxpayers.

IV. Impact on Retirement Saving—Conclusions And Recommendations

Retirement and personal savings, along with Social Security, are essential parts of the American retirement system. Policy changes that affect the ability to save or the composition of overall savings pose potential threats to retirement savings. Our present tax system already dilutes the demand for retirement savings by offering some favorable tax treatment for investments outside qualified retirement plans.

When considering such major reforms as consumption-style taxes or targeted approaches that eliminate the tax on capital gains and dividend income, it is important to consider the impact on qualified retirement savings. Consumption-style taxes, in general, would tax amounts consumed and would not tax amounts saved. Targeted tax preferences would exclude capital gains and dividend income from tax, thereby treating the majority of investment as if it were in a consumption tax system. While it may be true that major reform or targeted policies would increase aggregate savings, it is also true that such policies would not provide uniform savings across all income classes.

One of the most important features of qualified retirement plans is that they offer the opportunity to save to all eligible workers. In light of minimum participation and nondiscrimination rules, workers receive equitable treatment and receive comparable savings incentives. Without qualified retirement plans, most low-income individuals would not possess adequate resources to save outside of their qualified retirement plan. Reform and targeted relief does little to alter that fact. With tax reform and targeted tax preferences, the potential exists to exclude savings from tax, while threatening financial security and creating greater wealth disparities among retirees.

With the baby boom generation less than ten years away from retirement, tax policy and tax reform should consider carefully the impact that reform would have on qualified retirement savings. Changing demographics and lower personal savings rates suggest that retirement savings through qualified retirement plans is becoming increasingly more important over time. Increasing savings through consumption-style taxes or through targeted tax-favored investments would do little to ensure that individuals enter their retirement years with adequate savings. Given the costs of such reform policy changes and their significant distributional impacts, it is important to consider the effect on retirement savings. As tax reform proposals eliminate or dilute the incentives for qualified retirement plans, it is likely that many employers will cease to offer qualified retirement plans and the prospect for adequate retirement savings for the majority of Americans will diminish significantly.

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Testimony Presented to the Senate Committee on Finance Subcommittee on Taxation and IRS Oversight

Hearing on Encouraging Savings and Investment: Stay the Course or Change Direction June 30, 2005

Responses to Supplemental Questions From Brian Graff July 11, 2005

From Senator Hatch

The ASPPA study evaluated two proposals that could be included in fundamental tax reform – including one reducing to zero the tax rate on dividends and capital gains. Did the study consider these changes in isolation? Isn't tax reform likely to include other proposals that will also impact incentives to save and invest?

The ingredients of tax reform are the subject of speculation at this point, but one ingredient is common to all options being discussed by the President's Tax Reform Advisory Panel. This one ingredient is a zero tax rate on capital gains and dividends. All consumption based tax proposals by definition include a zero capital gains and dividend tax rate. Additionally, a zero capital gains and dividend tax rate as part of reform of the current system is being advocated by many policymakers. Whether or not other proposals to provide incentives for retirement savings are being considered is much less clear, but we certainly hope the members of the Finance Committee will consider additional retirement saving incentives under any tax reform scenario.

Given the lack of any obvious retirement saving incentive as part of tax reform, we thought it appropriate, and indeed urgent, to request a study from outside experts on the effect a zero tax rate on dividends and capital gains would have on tax-qualified savings without further incentives.

Most importantly, it is important to note that the study concludes that the effect of reducing to zero the tax rate on dividends and capital gains is likely to overwhelm the impact of any other retirement savings proposals. Of course, if any other retirement savings proposal is made public, we will incorporate the proposal into the analysis. However, the basis for the analysis will not change for small business owners, and we hope you will use this analysis to make sure that any new savings incentives for workers are sufficient to support our employer-sponsored retirement plan system.

Mr. Graff: the study you discussed today criticized proposals to eliminate the tax on dividends and capital gains because of the possible loss of tax-preferred savings options for low-income workers. But isn't it true that the study focused on the possible impact of the elimination of all taxes on dividends and capital gains and contained only a very slight mention of whether those risks might also be posed by an extension of current law? Are you worried about extending the current law in the same way you are concerned about the possible total elimination of the tax on dividends and capital gains?

The study shows that the present-law temporarily reduced tax rates on capital gains and dividends reduces the relative value of the intended tax preferences for long-term retirement savings. (Refer to pages 21 – 22.) As a general matter, ASPPA members have been able to rebut this when working with small business owners by arguing that the 15 percent rate is temporary whereas tax incentives for qualified retirement plans have been around for decades. It follows that a permanent extension of the 15 percent rate will make that rebuttal much more difficult, and a further reduction in the tax rates on capital gains and dividends will make it virtually impossible to convince a small business owner to adopt a retirement plan, since the owner would have to forego the significantly greater accumulations afforded by investing outside of a plan.

Importantly, the negative impact on retirement savings has a far reaching effect beyond just low-income workers. It would also hurt moderate-income workers making between $30,000 and $50,000 who are almost twenty times less like to save without a workplace retirement plan.

From Senator Bingaman

Can you point to any statistics which show any recent progress for small business plans?

Yes. The Congressional Research Service (September 10, 2004) reported that from 1994 to 2003, small businesses with less than 25 employees sponsoring a pension plan increased from 26.5 to 31.4 percent. In many respects, this substantial increase in retirement plan coverage is due to legislation enacted by Congress that was specifically designed to increase the number of small business retirement plans. The legislation included provisions to increase: contribution rates, new steam-lined plans for small businesses, and Savers Credits aimed at lower-income workers. This dramatic increase shows Congress can play a significant role in building a culture of saving in the workplace. It is progress we have worked hard to achieve. It would be a big mistake to walk away from it now.

What would be the most effective thing we could do to increase the American worker's retirement saving?

In 2001, the Senate-passed version of the tax bill that ultimately became the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) included a 50 percent tax credit for qualified retirement plan contributions on behalf of lower paid workers by new small business retirement plans for the first three years of the plan. The provision was dropped in conference for revenue reasons. ASPPA strongly feels that enactment of such a provision would dramatically increase small business retirement plan coverage and meaningfully increase the savings rates of small business workers.

ASPPA additionally suggests making the current law Saver's Credit permanent, and making the credit refundable so that it provides a real incentive to working families that have no tax liability. Finally, we recommend that the Saver's Credit be greatly expanded so that more middle-income families are eligible and that incentives are provided for greater levels of contributions. Specifically, we believe that households with adjusted gross incomes up to $75,000 should be eligible for some level of Saver's Credit and that the credit should apply to annual savings contributions up to $2,000 per individual.

We believe these Saver's Credit proposals would provide a meaningful savings incentives for almost 70 percent of American households as compared to the less that 10 percent of American households likely to benefit from the reduced tax rates on capital gains. We believe making permanent and expanding the Saver's Credit is much less costly from a revenue perspective than eliminating the tax rate on capital gains. Therefore, we strongly feel our proposal is a much more efficient and effective use of precious revenue dollars that will actually fulfill the priority of increasing moderate- and low-income workers' savings for retirement.

From Senator Kerry

During the hearing you mentioned your support for a tax credit for new retirement plan contributions for small businesses; I have been supportive of this type of credit in the past and believe that it is needed. How would you recommend that such a credit be structured?

When it comes to encouraging savings, the employer-sponsored retirement plan system has a proven track record. It is not surprising that one study showed that households covered by an employer-sponsored retirement plan are more than twice as likely to achieve retirement income adequacy as households not covered by a plan. As a result, ASPPA believes that any examination of our nation's savings policy must include consideration of new ways to expand coverage of the employer-sponsored retirement plan system.

In 2001, the Senate-passed version of the tax bill that ultimately became the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) included a 50 percent tax credit for qualified retirement plan contributions made on behalf of lower-paid workers, for the first three years of a new small business retirement plan. The provision was dropped in conference for revenue reasons. ASPPA strongly feels that enactment of such a provision would dramatically increase small business retirement plan coverage, thereby increasing the savings rates of small business workers.

Your testimony states that "according to the Employee Benefits Research Institute, low-to-moderate income workers are almost 20 times more likely to save when covered by a workplace retirement plan." Do you think improved access to employer-sponsored retirement plans would have a greater impact on the national savings rate than lowering the capital gains and dividend rate?

Whether lower capital gains and dividend rates will increase aggregate saving for our nation is a lofty debate over which economists have long battled and likely will continue to do so until the end of time. ASPPA members are not economists and will not enter into that debate.

However, ASPPA members do understand that lower capital gains and dividend rates will result in a dramatic change in the composition of saving – away from long-term retirement savings in workplace plans to unrestricted saving outside of workplace plans.

This matters because, in addition to the EBRI statistic you cite, all evidence we have shows that very few moderate- to low-income households have capital gains. In fact, a recent Joint Committee on Taxation report distribution chart shows that 84 percent of capital gains benefit goes to those making $200,000 or more, and 94 percent of capital gains benefit goes to those making $100,000 or more (JCX 50-05, page 6, June 27, 2005).

Joint Tax takes these statistics straight from taxpayers' returns. The best evidence shows that that low- to moderate-income workers do not benefit from low capital gains rate and invest very little, if any, outside of a plan. With no plans, our experience and these important statistics tell us that low- to moderate-income workers will not save for retirement. With more retirees, more retirees who live longer, and the strain on Social Security well evident, we must dedicate more resources to workplace plans – not drive them out of existence.

STATEMENT FOR THE RECORD OF CHAIRMAN CHARLES E. GRASSLEY FOR THE TAXATION & IRS OVERSIGHT SUBCOMMITTEE HEARING "ENCOURAGING SAVINGS AND INVESTMENT: STAY THE COURSE OR CHANGE DIRECTION?" JUNE 30, 2005

Today's hearing focuses on several very important capital formation provisions that are scheduled to expire under current law. These provisions are very popular and have already produced significant benefits for the U.S. economy. Before addressing these provisions, I would first like to thank Sen. Kyl, the Chairman of our Taxation and IRS Oversight Subcommittee, for focusing on these important provisions. Even though some of the provisions do not expire for several years, it is important that we recognize the effect of those future expirations on today's economy. Sen. Kyl should be commended for his forward thinking in addressing these provisions before their expiration damages the U.S. economy.

One of the most important provisions concerns small business expensing of $100,000 a year, which drops down to $25,000 in 2008. The farmers and small business people I have talked to in Iowa have told me over and over how important this provision is when they are considering equipment and other capital purchases. It also simplifies their recordkeeping and tax return preparation. We need to keep the annual expensing at the current $100,000 amount.

The current 15% tax rate on capital gains and dividends is set to expire at the end of 2008. We know that these provisions have resulted in a profound increase in stock values and dividend payouts to shareholders, many of whom are senior citizens. These rates have been a source of significant stimulus to our economy. If allowed to expire, the capital gains rate will increase to 20% and the dividends tax rate will increase to the taxpayer's highest marginal rate, which for some taxpayers, could be the top 35% rate. For them, expiration would represent a 233% increase in the rate of dividend taxation. We know that investors have a 3 to 5 year window for assessing their investment returns, and taxes are part of that assessment. We need to extend these provisions this year. If we delay extension until 2008, it will have a profoundly negative effect on our economy.

At the end of this year, a deduction for tuition and higher education expenses is set to expire. The deduction was enacted as part of the 2001 tax cut. We need to encourage Americans to seek further education and training, and we should assess whether this deduction has been successful in accomplishing that goal.

In addition, the Saver Credit, which was also enacted in 2001, is set to expire next year. The Saver Credit allows eligible taxpayers to claim a nonrefundable credit for certain retirement savings contributions. We all know that the savings rate is too low in our country. Once again ,we need to see whether this provision has been successful in enhance the rate of U.S. retirement savings.

I look forward to following up on these issues in the full Finance Committee later this year, and again I thank Sen. Kyl for focusing on these important issues.

Testimony before the United States Senate on behalf of the

TESTIMONY BEFORE THE UNITED STATES CONGRESS
ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

NFIB
The Voice of Small Business.

Testimony of

Scott Harding

before the

Finance Subcommittee on Taxation and IRS Oversight

on the date of

June 30, 2005

on the subject of

Section 179 Expensing

Good afternoon. I'm Scott Harding, President and CEO of F.B. Harding, Inc. Electrical Contractors in Rockville, MD. I'm proud to say that we have been in business since 1949. Thank you, Chairman Kyl and Ranking Member Jeffords, for giving me the opportunity to testify on behalf of the National Federation of Independent Business (NFIB) regarding Section 179 of the Internal Revenue Code. As a business owner, I am pleased to see that the committee is interested in addressing this important issue.

Small business owners do our jobs using hard earned experience and applied common sense. In business, we make many decisions daily that affect the life of our company and thus the livelihood of our employees and their families. Business, like life, can be complicated. But when it comes to complications in my company, the United States tax code ranks among the top. I'm sure most small business owners will say the same thing. So when I heard that Section 179 limits had been increased, I was eager to understand how my business could benefit from this legislation.

Working together with President Bush, Congress enacted into law the Jobs and Growth Tax Relief Reconciliation Act of 2003, which increased the limits on expensing from $25,000 to $100,000. This was a positive step to help small business owners and is one of the most significant changes to our tax code in years. The old threshold of a $25,000 dollar limit was restrictive, outdated and simply unfair.

Under current law, Section 179 allows small businesses to expense (fully deduct from taxable income) a limited amount of the cost of new business equipment in a year. This tax benefit is limited to small businesses by a provision stipulating that the expensing amount is phased out dollar for dollar for any amount of investment above $400,000 in a given year. However, in 2007, the law expires, and small businesses will only be able to expense up to

$25,000 in new investment per year. Additionally, the $400,000 limit will be reduced to $200,000, severely limiting the number of small businesses that can qualify for this important provision.

In order to assist small business owners as they make the investments necessary to grow and expand their businesses, I would suggest three proposals:

- Make permanent the current law of $100,000 in a given year;
- Make permanent the $400,000 investment limit; and
- Index for inflation both the $100,000 and $400,000 limits.

Allowing small business owners to expense immediately critical investments is a key component to the expansion of our economy. It will put money into the hands of small business owners so they can hire new workers. It will put money directly into the economy, as owners will be more likely to purchase new equipment. By indexing the limits to inflation, the bill provides stability for small business owners. It assures owners that they won't have to come back to Congress and ask for additional increases to keep up with inflation.

In my business, last year alone we spent $106,000 on our capital expenditures. We were able to purchase tools, computers, and four vehicles. This equipment is necessary to help operate my business and to stay competitive in the market. The expansion of 179 made this possible. Under the old rules, we would have only been able to expense $25,000. Which is paltry considering a new vehicle uses up nearly all of that limitation. Under the expanded rule, we were able to expense $100,000. This translated into a tax savings of approximately $ 27,000. In other words, because of the increased limits, we were not penalized but given the incentive to invest in our business.

As business people, we are risk takers. We do not take extra money and hide it under the mattress. When given the opportunity, we'll spend. When given the incentive, we'll invest. This is how you create more jobs and grow your business. In fact, according to the U.S. Small Business Administration, small business has generated 60-80 percent of net new jobs annually over the last decade. If small business benefits, the employee benefits, and the government ultimately benefits because more money is pumped into the economy. That is what makes America great.

I commend the Committee for holding this hearing. I look forward to working with the Congress and the President in the future to make Section 179 permanent.

Thank you for the opportunity to testify on this important issue, and I'll be happy to take any questions that you may have.

Statement of Senator Jim Jeffords
Finance Subcommittee on Taxation and IRS Oversight
Encouraging Savings and Investment: Stay the Course or Change Direction?
June 30, 2005

Chairman Kyl, thank you for calling today's hearing. And thanks to all of our witnesses for offering their views on how best to encourage savings and investment in our country.

The personal savings rate in our country is now close to zero. And perhaps even more troubling, that rate has been on a steady downward trend for the past two decades. Many households, of course, have experienced a growth in their net worth as a result of asset appreciation in stocks or real estate.

But many others are living paycheck-to-paycheck, only one layoff or illness away from financial disaster. We all want to encourage people to save and invest. But we also want to be able to help those people who lack the means to do so, and give them the foundation for success.

I supported the tax cuts in 2001. I did so because taxes had reached almost 21 percent of GDP, and we thought we had a 10-year surplus on the order of $5 trillion. In my mind, a surplus of that magnitude gave us the room both to cut taxes and bolster Social Security -- with a healthy margin of error since we knew the projections might not materialize.

Of course they didn't come true. There is no need to rehash why -- it is enough to recognize that instead of a large surplus we are looking at about a $2 trillion deficit over the coming decade. In the face of these changed circumstances, Congress must decide whether the tax cuts begun in 2001, and accelerated in 2003, still make sense today.

I suppose I'm old fashioned, but I think deficits do matter -- $400 billion here, $300 billion there, and pretty soon you are talking real money. President Bush has warned that the Social Security system is on the road to bankruptcy, because in 40 years it will only be taking in 70 cents for every dollar it is supposed to pay out.

Well, if you accept that definition of the path to bankruptcy, the federal government has already arrived. Setting aside Social Security, the federal government took in just 70 cents for every dollar it spent last year. On-budget receipts were $1.3 trillion, but outlays were $1.9 trillion, almost $600 billion of red ink. And these are the good times. The Baby Boom is in its peak earning period and has not yet begun to retire. How will we cope from a fiscal standpoint in the next 10 or 20 years if we don't regain some fiscal discipline now?

All of the provisions we will discuss today are attractive for good reasons. There is not a politician alive who doesn't like to cut taxes. But I think it is time Congress stop digging ourselves into a deeper hole. The cost of extending the provisions that are the topic of today's hearing is more than $200 billion over the next 10 years. And we'll soon be considering proposals on the AMT, extenders, and the estate tax. All told, they could easily top a $1 trillion dollar loss of revenues.

Finally, beyond the cost of all of these items are the questions of equity. The Joint Committee on Taxation estimates Americans will realize $327 billion in capital gains this year. Of that, $307 billion – almost 94 percent -- will go to taxpayers making more than $100,000. Taxpayers with incomes under $50,000 will see less than $5 billion of those gains. I think those figures speak for themselves.

All of us would like to lower tax rates. But in a time of chronic deficits, cutting taxes just dumps more debt on our children.

Again, Mr. Chairman, I thank you and look forward to today's testimony.

Statement of Senator Kyl
Subcommittee on Taxation and IRS Oversight
Hearing on
"Encouraging Savings and Investment:
Stay the Course or Change Direction?"
June 30, 2005

In the coming years, Congress will be faced with an avalanche of expiring tax provisions; we must begin the process of deciding which provisions to keep and which should be allowed to expire. While most of the widely-used provisions—those that apply to broad classes of taxpayers—expire at the end of 2010, a handful of such provisions expire between 2006 and 2008.

Today's hearing is designed to review whether four particular policies that expire before the 2010 are accomplishing what Congress intended and if the cost is worth the economic benefit. This type of oversight is essential for Congress to undertake if we are to pursue sound tax policies and I hope we will do more of it in the Finance Committee.

Our first witness, Scott Harding, will talk about the importance of section 179 expensing to small businesses. This provision, which allows up to $100,000 worth of property to be expensed per year, expires at the end of 2007, at which time the amount will revert back to $25,000.

Our second witness, Robert Weinberger, will discuss the effectiveness of the Savers Credit in encouraging retirement savings by lower income taxpayers. This credit expires at the end of 2006.

The remainder of our witnesses – David Malpass, Eric Toder, Stephen Entin, and Brian Graff – will all speak to the 15 percent individual rate for most dividends and capital gains. While I expect we'll hear some disagreement over whether the lower rates should be continued or even made permanent, I think the trends we are seeing for revenues coming into the Treasury and the sustained economic growth we are experiencing argue strongly that these rates must be made permanent. In fact, the Republican leadership of the Senate is committed to extending the lower rates for dividends and capital gains as part of reconciliation later this fall, and to making these rates permanent as soon as possible.

Before we begin, I want to ask unanimous consent to put a survey conducted by the Securities Industry Association in the record.

And now, I look forward to hearing from all of our witnesses.

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EXECUTIVE SUMMARY -
Findings From Study Regarding Recent Changes to Corporate Dividend Tax Laws
May 12, 2005

Introduction

President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) in May 2003. This act reduces the double taxation of dividend income and equalizes this lower rate with a reduced rate of tax on long-term capital gains. Following passage, both forms of income are subject to a top tax rate of 15%. Prior to the law's passage, the maximum tax rate on dividend income was 38.6%, and long-term capital gains were subject to a maximum tax rate of 20%. This legislation is currently set to expire at the end of 2008. [1]

Much has been written about the reaction of businesses to the new law, including documentation of the number of companies that have increased or initiated dividend payments. Less is known about the impact the temporary nature of these lower rates have on key groups. Rivel Research Group conducted this survey at the request of the Securities Industry Association to explore such issues among three such audiences – individuals who invest in common stocks, professional investment advisors and finance executives in large US corporations.

Key Findings

The audiences examined in this study express keen, broad-based support for Congress taking action this year to make the lower rate on dividends permanent.

- A national sample of 350 individual investors indicates that most (64%) are not aware the lower rates expire at the end of 2008.
- But when told about the sunset and its potential impact on dividend tax rates, 51% say it is "very important" that Congress takes action this year and another 30% think it is "somewhat important". The cumulative total of 81% suggests a reservoir of support for short-term action.
    - 88% of female private investors say it is very or somewhat important compared to 78% of men.
    - 85% of private investors with household incomes less than $100,000 say it is very or somewhat important compared to 81% of investors with household incomes more than $100,000.
    - 83% of private investors aged 65 or older say it is very important or somewhat important compared to 81% of those under 50 years old.
    - Significantly, in the three sub-samples above, there is a corresponding difference among those who think action this year is "very important" (women 61%, men 45%; households under $100,000 59%, households over $100,000 43%; and aged 65 or over 59%, 50 or younger 45%).

- One in five individual investors (21%) reports that the temporary nature of the tax law change increases their uncertainty about their investment decisions.
    - 31% of these investors are unsure of long-term implications, must wait and see
    - 27% say they don't understand changing taxes/the whims of Congress
    - 17% say it would change their investment strategy
    - 4% are more likely to buy short term.

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[1] Public data supplied by the Securities Industry Association (SIA)

- 80% of the Treasurers and CFOs surveyed (from a cross-section of 20 large US corporations) say it is very important that action be taken this year to extend the current rates. Another 10% think action this year is somewhat important.

- Among a cross-section of 20 investment advisors, 85% support action this year (60% very important, 25% somewhat important). Sentiment is strongest among advisors who serve more than 100 clients. More than three in four of these large counselors (78%) think it is very important to act this year to preserve the changes.

Methodology
Rivel interviewed random samples of:
- Private investors
  - 350 individual investors with common stock investments in excess of $25,000, exclusive of mutual funds.
- Finance executives from large corporations
  - 17 treasurers
  - 3 chief financial officers
  - 12 are in companies with market capitalization under $5 billion
  - 3 are in companies with market capitalization of $5 billion to $9.9 billion
  - 5 serve in companies with market capitalization over $10 billion.
- Professional investment advisors
  - 10 with more than 100 clients, nine with less than 100 clients and one that would not divulge number of clients
  - 7 manage average assets per client of more than $1 million
  - 12 manage average assets per client under $1 million
  - One respondent would not divulge average assets per client.

All of the interviews were conducted by telephone from February 1 to 27, 2005. Questionnaires were used to ensure that questions were asked in a uniform manner and that all issues were covered with each respondent. Private investor interviews were completed by Greenwald Associates, under the direction of Rivel. Rivel executive interviewers completed the in-depth interviews with CFOs, Treasurers and investment advisors.

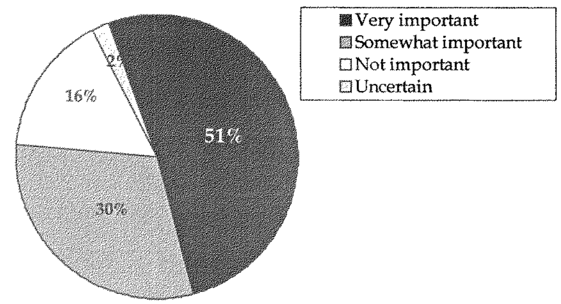
Conclusions
There is strong interest among individual investors, investment advisors, and corporate finance officials in seeing the Congress take action this year to extend the current tax rates on dividends and long-term capital gains.

The temporary nature of the dividend tax law change has helped undermine some individual investors' confidence in their investment strategies.

Question: How important is it that Congress takes action this year knowing the current top rate is 15% and this could increase to 35% in 2009?

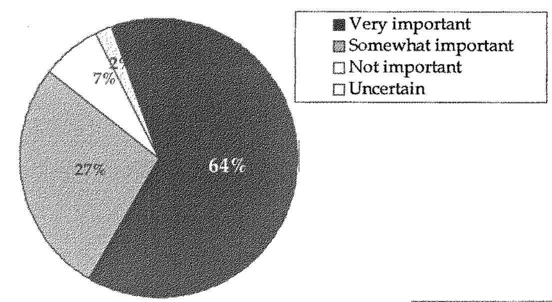
- **Total Private Investors**

  (N=350. Margin of error = ± 5%)



- **Among private Investors who say they now have a more favorable view of dividend-paying stocks due to change in tax rate**

  (N=150. Margin of error = ± 8%)

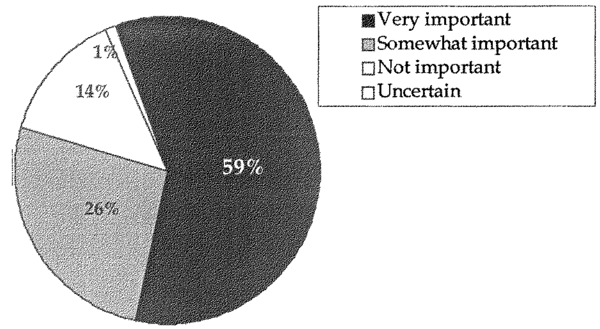


RIVEL THE VALUE OF INSIGHT

Question: How important is it that Congress takes action this year knowing the current top rate is 15% and this could increase to 35% in 2009?

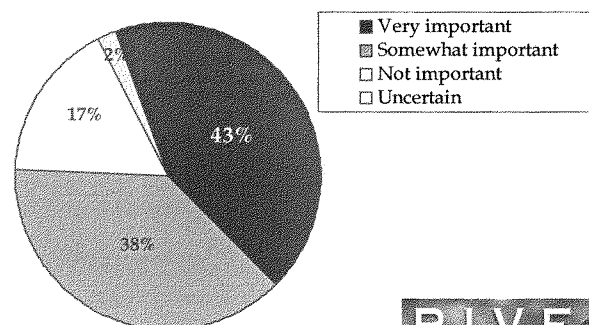
- **HH income under $100,000**

  (N=159. Margin of error = ± 8%)



- **HH income $100,000 or more**

  (N=163. Margin of error = ± 8%)

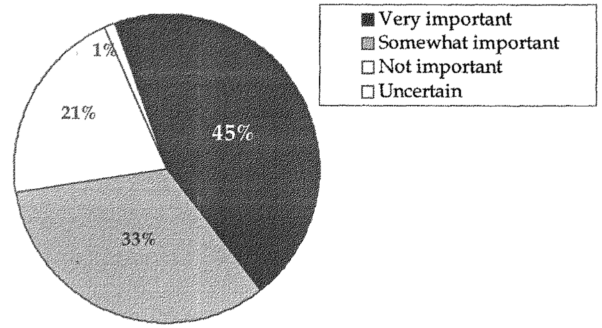


RIVEL
THE VALUE OF INSIGHT

Question: How important is it that Congress takes action this year knowing the current top rate is 15% and this could increase to 35% in 2009?

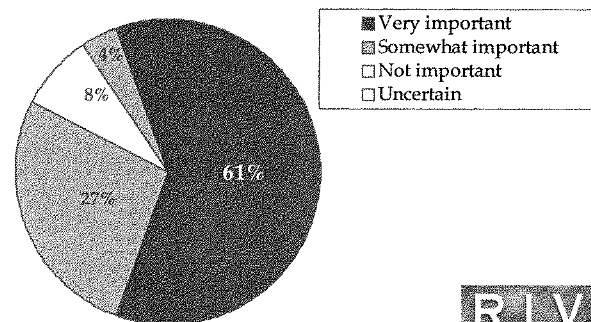
- **Total Male Private Investors**

  (n=207. Margin of error = ± 7%)



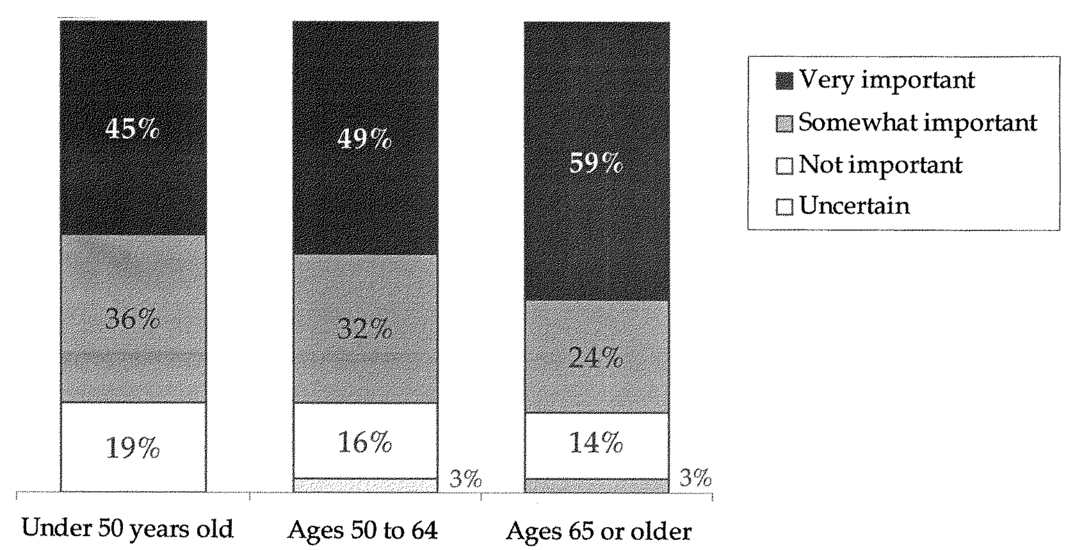
- **Total Female Private Investors**

  (n=143. Margin of error = ± 8%)



RIVEL THE VALUE OF INSIGHT

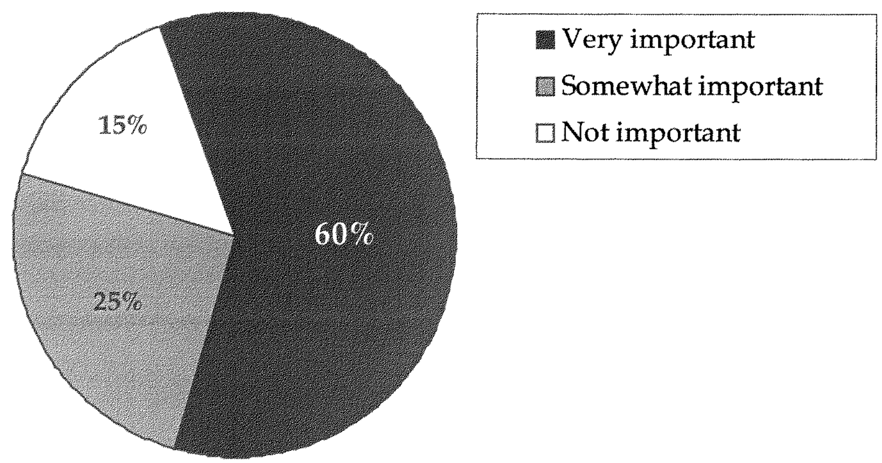
Question: How important is it that Congress takes action this year knowing the current top rate is 15% and this could increase to 35% in 2009?



- Under 50, n= 94, ± 10%. 50-64, n=130, ± 9%. 65+, n=121, ± 9%.

RIVEL THE VALUE OF INSIGHT

*Importance of Making Lower Tax Rates on Dividends Permanent This Year **

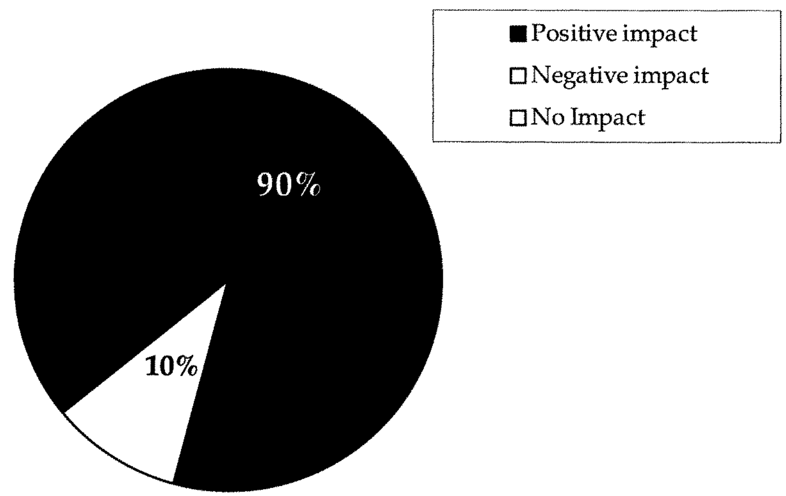


* Among 20 investment advisors managing investments for individual investors with portfolios ranging from $30,000 to over $1 million.

Interviewed between 2/1/05 and 2/27/05.

RIVEL THE VALUE OF INSIGHT

*Impact of Tax Law Change on Advisors' Views of Dividend-Paying Stocks**



* Among 20 investment advisors managing investments for individual investors with portfolios ranging from $30,000 to well over $1 million.

Interviewed between 2/1/05 and 2/27/05.

RIVEL
THE VALUE OF INSIGHT

Statement of
David R. Malpass before the
Subcommittee on Taxation
Senate Finance Committee
June 30, 2005

Chairman Kyl, Senator Jeffords, members of the Sub-Committee, thank you for the invitation to testify on the dividend and capital gains tax rates. The views I express today are my own and are not necessarily those of my employer.

The 2003 tax cut was a critical part of the recovery from the 2001 recession. One of the bill's most important features was the reduction in the tax rate on dividends and capital gains. This reduction in the cost of capital is a key to the economy's fast growth since then. When you tax something less, you get more of it – in this case more dividends, capital, capital gains and the associated jobs and economic growth. The cuts in the dividend and capital gains rates are also a structural improvement in the economy, allowing an improved allocation of capital which will provide increasing growth benefits over time.

S&P 500 Equity Price Index

Source: Haver; Bear, Stearns & Co. Inc.

If the existing rates are allowed to increase, I would expect a large negative reaction in the economy and equity market, reversing some or all of the gains from the tax cut. Higher dividend and capital gains taxes would unwind the improvement in the capital structure. It would likely lead to less economic growth, slower job creation and stock market losses. In my view, this impact would not drag out over a 10 year budget horizon, but would hit the economy and markets immediately.

As Congress considers extending the existing dividend and capital gains rates, I hope it will also consider the flaws in the 2003 tax scoring process. It completely ignored the growth and asset price benefits of the tax cut, leaving Congress to make a major tax decision based on extensive cost data (the federal government's assumed revenue loss), but no information on the benefits to the government and the private sector.

Positive Expected Impact of the 2003 Tax Cut

I supported the 2003 tax cut on the view that it would materially improve the economy by encouraging employment, investment, a more efficient use of capital, and higher equity prices.

From my May 22, 2003 research piece, *Tax Cut - Three-Quarter Loaf* (attached):

> "Our rough estimate is that the tax cut would add $600 billion (5% of market capitalization). This includes the added after-tax value of current dividends, the likelihood of an increase in the dividend payout, and some improvement in the capital structure. Congress estimates the 10-year deficit cost at $350 billion, not counting any economic benefits from the tax cut. Two important factors in the ultimate value of the tax cut will be: 1) when and how Congress clarifies whether tax rates will actually go back up at the end of the tax cut provision; 2) whether this tax cut is used as a step in broader tax or scoring reform. We note once again the unwieldiness of the Congressional budget and tax process and the extreme complexity of the outcome."

From my June 2, 2003 research piece, *Tax Cut Gains $750 Billion, ROI Already 150%* (also attached):

- "The tax cut is still being underestimated. The top marginal rate on federal income will decline from 38.6% to 35%, meaning taxpayers keep 65% of additional income, up from 61.4%. This is a 6% increase, not the widely cited 3.6% benefit. Those receiving dividends will keep 85%, up from 61.4%, <u>a 38% increase in after-tax dividend income</u>. Those earning capital gains will keep 85%, up from 80%, a 6% increase.
- "Since the tax cut suddenly became a reality beginning May 21, U.S. equities have gained some $750 billion. Comparing the $750 billion equity gain to the $300 billion net present value of the ten-year cost (5% discount rate), the gain is 2.5 times – a 150% ROI. *This doesn't count any GDP growth impact from the tax cut, which we expect to become material as the reduced obstacles to labor, capital and innovation spur the economy.*
- "Why didn't equity markets price in the tax cut earlier? Until the end, there was skepticism about the Senate finding the 50 votes needed to pass a growth-oriented bill. The surprisingly powerful solution was a tax cut that was bigger, more growth-oriented, and earlier than almost any expectations."

From my April 30, 2003 testimony to the House Committee on Financial Services:

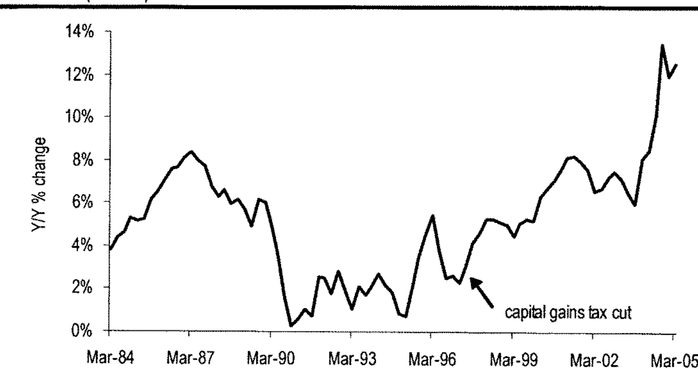
- We have a recent example of the impact of lower asset taxes on the value of assets and the related economic impact. In 1997, the government cut the capital gains tax rate on houses, losing a small amount of revenues but creating a tremendous gain in the national wealth. (By my rough estimate, the U.S. housing stock has increased roughly $4 trillion since the 1997 tax cut, though not all of that is attributable to the tax cut.) Jobs in residential construction surged.

- I would expect the same type of reaction to a dividend tax cut – a massive increase in national wealth and a surge in economic activity -- at a relatively small cost to the federal government.

- The current dividend tax distorts the capital structure. It creates an expensive wedge or toll gate between retained earnings and the shareholder, plus it encourages debt and unproductive acquisitions over equity capital and dividends. Its elimination would improve the allocation of capital, adding substantially to near-term and long-term U.S. economic prospects.

- A dividend tax cut offers a major, near-term addition to the value of equities due to: an increase in the after-tax value of current dividends; an increased dividend payout; faster dividend growth due to the reduction in the corporate cost of capital; and a pro-entrepreneur improvement in the corporate capital structure.

U.S. House Prices (OFHEO)



Source: Haver; Bear, Stearns & Co. Inc.

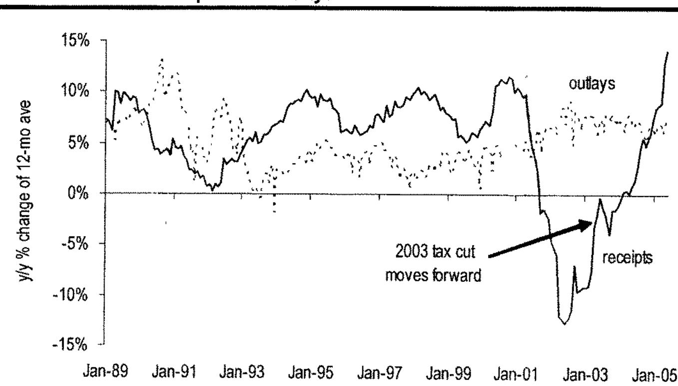
Positive Results of the 2003 Tax Cut

- **Faster growth.** On June 6, 2003, the Bloomberg consensus for third quarter 2003 economic growth was 3.2%, while the actual came in at 7.4%. For the two subsequent quarters, the June 2003 consensus was 3.5% while the actual growth averaged 4.4%. In total, GDP in the three quarters following the tax cut reached $11.47 trillion (annual rate) versus the June 2003 expectation of $11.31 trillion, an annualized gain of $160 billion in the immediate aftermath of the tax cut. Many of the tax cut's benefits accrue over time (in terms of capital formation, work incentives, entrepreneurship), helping U.S. GDP growth remain fast to date (an average 3.9% from the third quarter of 2003 through the first quarter of 2005.)

- **Higher stock prices**. Taxes on capital are a critical factor in the valuation of equities in two ways: the direct effect of taxes on the after-tax value of earnings, dividends and capital gains; and the effect on economic growth (and future earnings) of changes in the cost of capital. Simply put, if you cut the taxes on capital, you get more of it. Equities surged in May and June of 2003 when the 2003 tax cuts moved forward in Congress and then continued their gains as extra economic growth materialized. In the three quarters following the May 2003 announcement by the President and Congress of the tax cut deal, U.S. equities gained 24% and $3 trillion in market value.

- **Higher tax receipts**. Well-designed tax cuts like the 2003 cut cause more economic growth which in turn causes tax receipts to grow. The growth and asset price effects of tax changes are substantial, yet they are generally not taken into account in Congress's scoring process. Due to faster growth and higher stock prices, the year-over-year growth in tax receipts has reached 15%. Adjusting for inflation, this is the fastest real growth in federal receipts in more than 32 years.

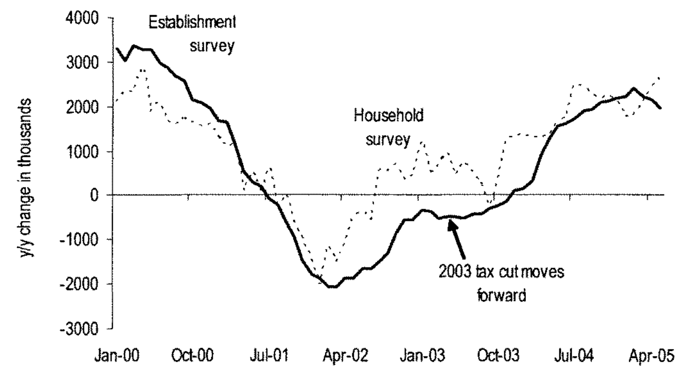
Growth in Government Receipts and Outlays



Source: Haver; Bear, Stearns & Co. Inc.

- **More jobs**. By helping re-energize the economy, the tax cuts also led to improved labor-market conditions. The pace of job growth picked up just after the enactment of the tax cuts.

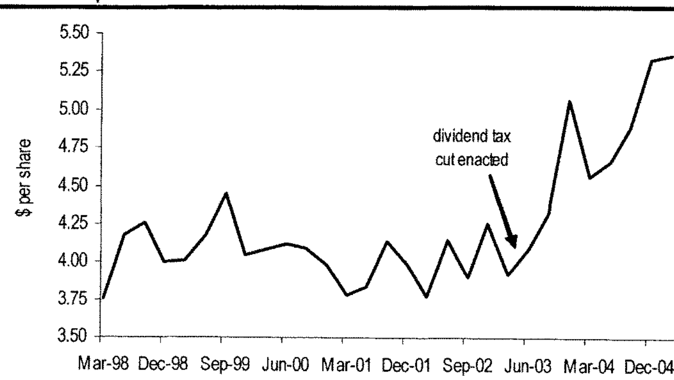
U.S. Employment Gains (000s)



Source: Haver; Bear, Steams & Co. Inc.

- **More dividends**. Since dividend tax rates were lowered, the incentive to shelter earnings has been substantially reduced. Businesses have responded by adding to dividends, making more and lower-cost capital available for other businesses.

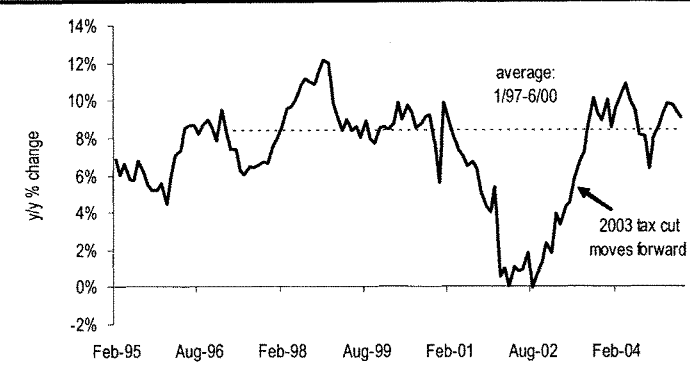
S&P 500 Dividends per Share



Source: Haver; Bear, Steams & Co. Inc.

- **More small business income**. As expected, small businesses have been one of the big beneficiaries of the tax cut. Non-farm proprietors' income (a proxy for income of smaller, unincorporated businesses) grew to a record $955 billion annual rate in April, up 9.1% year-over-year, even faster than the average growth during the 1997-2000 boom.

U.S. Non-Farm Proprietors' Income



Source: Haver; Bear, Steams & Co. Inc.

- **Adding it up.** In the three quarters following the 2003 tax cut, equities gained $3 trillion in market capitalization, GDP was $160 billion above the consensus expectation, employment grew by 1.3 million and dividends surged, helping free capital for smaller businesses. This compares favorably to the $350 billion scoring estimate for the ten-year cost to the federal government of the cut.

Risks of Allowing a Tax Hike on Capital

Financial markets assume a high probability that the 2008 expirations will be extended, so stocks would probably decline substantially if the dividend and capital gains rates were allowed to increase.

- Using the same modeling technique we used in 2003, we estimate that equities could decline some 7% (over $1 trillion in market capitalization at the market's current size) at the time an increase in the tax rates on dividends (to 35%) and capital gains (to 20%) became likely. This would reflect lower expectations for economic growth, the threat of higher taxes later, and the direct impact of the higher tax rates on asset prices.

- Additionally, a key strength of the US economy is its entrepreneurial nature. Allowing taxes on capital to rise would hurt small businesses, since a tax on capital is a tax on business formation and success.

- Over half of US households own equities in some form, so the benefits of rising equity valuation has had a far-reaching effect, and a reversal would too.

- The sooner that Congress makes the 2003 tax cuts permanent (rather than the cumbersome and uncertain extension process), the better for the economy. As the expiration date draws near every two years or so, uncertainty about tax rates will act like a partial rate hike, costing the economy in terms of a less dynamic capital structure and a loss of productivity.

Scoring System a Major Problem

The huge economic and equity gains from the 2003 tax cut on capital underscores the importance of reforming Congress's scoring system as a key first step toward a growth-oriented reform of the tax code.

- The current scoring system blocks effective tax reform by assuming tax changes won't improve the economy or asset prices. It imposes that faulty assumption on House and Senate voting procedures.

- **By itself, a better scoring system, one which recognizes that major tax changes impact the economy and asset prices, would constitute a major pro-growth structural reform, leading immediately to higher equity prices and the related increases in jobs and investment.**

- The static calculation of costs overstates the costs of a tax cut and ignores the benefits. I don't think it's possible to do an exact cost/benefit analysis of tax reform, but we know that simply looking at the cost to the government (the current approach) is incomplete and highly misleading.

- Most of the "cost" to the government is a straight benefit to taxpayers. From the standpoint of national well-being, the first-order effect is a wash, not a "loss".

- Taxing dividends reduces the value of corporations and encourages debt. Lowering the rate causes higher stock prices, more capital gains, more capital gains taxes, a lower cost of equity capital, a more efficient allocation of capital and a faster growth rate. None of these benefits was reflected in the 2003 scoring process.

- The scoring process presents a particular difficulty for making permanent the lower tax rates on dividends and capital gains. A primary goal would be to increase economic growth, but the added growth and rise in equity markets would not be scored.

BEAR STEARNS

GLOBAL COMMENTARY

Equity Research
Global Economics
May 22, 2003

David Malpass
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Tax Cut - Three-Quarter Loaf

President Bush met with House and Senate leaders on Monday and urged them to finish the tax cut this week. Ways & Means and Finance worked out details and scoring on Tuesday. Final negotiations took place Wednesday with Vice President Cheney. We expect the full House to pass the compromise on Thursday or Friday, followed by Senate passage on Friday in time for the start of Congress's Memorial Day recess. In reaching 51 votes for passage, the 51 Senate Republicans would lose Senators McCain and Chafee, gain Democratic Senator Ben Nelson, and, if necessary, have Vice President Cheney add his vote.

We think the final bill will add to economic growth and equity values. The final deal reduces dividend taxes to 15% rather than 0%. As a result, we don't think it will be as beneficial to equity values or improve the U.S. corporate capital structure as much as the President's original proposal. Important growth provisions include the acceleration of the already-scheduled income tax cuts, a cut in the capital gains tax rate to 15%, a cut in the dividends tax rate to 15%, and expanded expensing of business equipment purchases.

Our rough estimate is that the tax cut would add $600 billion (5% of market capitalization). This includes the added after-tax value of current dividends, the likelihood of an increase in the dividend payout, and some improvement in the capital structure. Congress estimates the 10-year deficit cost at $350 billion, not counting any economic benefits from the tax cut. Two important factors in the ultimate value of the tax cut will be: 1) when and how Congress clarifies whether tax rates will actually go back up at the end of the tax cut provision; 2) whether this tax cut is used as a step in broader tax or scoring reform. We note once again the unwieldiness of the Congressional budget and tax process and the extreme complexity of the outcome.

BEAR STEARNS

GLOBAL COMMENTARY

Equity Research
Global Economics
June 2, 2003

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Tax Cut Gains $750 Billion, ROI Already 150%

We think the tax cut and its support for the ongoing reflation have been the driving force behind the recent $750 billion increase in U.S. equity market capitalization. It has helped extend the equity repricing that took place when Iraq uncertainty diminished, more than offsetting the damage from expensive oil.

Observations:

- For some time, reflation, the tax cut and Iraq repricing have been enough to lift equities. To sustain that process, we'd like to see lower oil prices, proof of future earnings growth, higher Treasury bond yields, and/or some improvement in the economic data. We expect all of these over time, as discussed in previous pieces. We note that the cost estimates done by Congress in evaluating tax cuts explicitly exclude any consideration of benefits from a tax cut, equity gains, added capital gains taxes, and faster economic growth due to the tax cut.

- The tax cut is still being underestimated. The top marginal rate on federal income will decline from 38.6% to 35%, meaning taxpayers keep 65% of additional income, up from 61.4%. <u>This is a 6% increase, not the widely cited 3.6% benefit</u>. Those receiving dividends will keep 85%, up from 61.4%, <u>a 38% increase in after-tax dividend income</u>. Those earning capital gains will keep 85%, up from 80%, a 6% increase. These figures don't take into account state and local taxes, which would subtract some, up to one-third, from the benefits. Our May 23 piece estimated an over 12% gain in disposable personal income over the next twelve months.

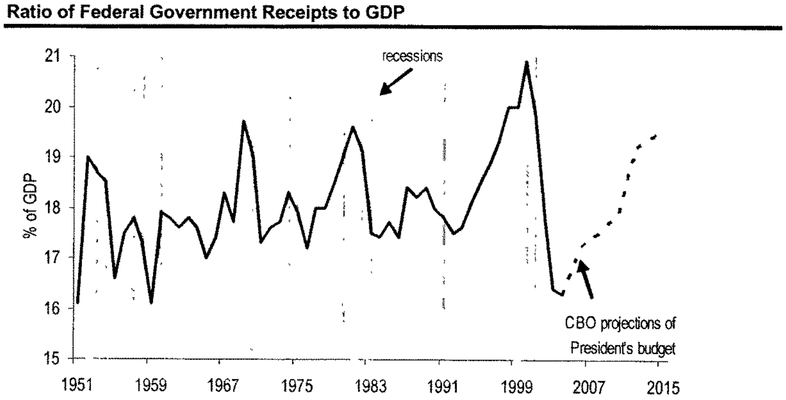
- Since the tax cut suddenly became a reality beginning May 21, U.S. equities have gained some $750 billion. Comparing the $750 billion equity gain to the $300 billion net present value of the ten-year cost (5% discount rate), the gain is 2.5 times – a 150% ROI. This doesn't count any GDP growth impact from the tax cut, which we expect to become material as the reduced obstacles to labor, capital and innovation spur the economy.

- Why didn't equity markets price in the tax cut earlier? Until the end, there was skepticism about the Senate finding the 50 votes needed to pass a growth-oriented bill. The surprisingly powerful solution was a tax cut that was bigger, more growth-oriented, and earlier than almost any expectations. It followed the same pattern as the Iraq war, depressing markets during the uncertainty phase and repricing them within weeks.

- In the past, we have emphasized the importance of oil prices in the growth outlook (for example, see *Oil Damage Mounts* on October 3, 2000). This still applies. However, the current damage from expensive oil is more than offset by the tax cut. U.S. oil usage (import and domestic) amounts to 7.1 billion barrels, $213 billion at $30 per barrel. A 30% decline would reduce that by $64 billion per year, about a quarter of the annual gain in disposable personal income from the tax cut. Expensive oil is also driving up the cost of other forms of energy. In addition, it is diverting investment to unproductive activities (i.e. Siberian exploration); however, the tax cut provides substantial incentives for new investment in the U.S., offsetting the oil price damage. We expect substantial additional stimulus to the economy if oil prices decline.

- In his June 1 New York Times piece critical of the tax cut, columnist Paul Krugman states that, as a share of GDP, "federal taxes will be lower than their average during the Eisenhower administration." This may be true for 2004, but is misleading. First, government receipts in 2004 will still suffer from unusually depressed capital gains, so it's not appropriate to compare 2004 to an *average* level in the 1950s. It's clear from the full data that tax receipts bubbled in the late 1990s and would only be brought back to normal by the three Bush tax cuts. Second, we're not sure federal tax receipts in this decade should be as high as in the Eisenhower administration. At that time, the U.S. was fighting the cold war, arguably more expensive than the war on terrorism. And state and local governments are bigger now, absorbing some of the federal burden for services.

Ratio of Federal Government Receipts to GDP



Source: Haver; Congressional Budget Office; Bear, Stearns & Co. Inc.

Some Related Pieces

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Responses to Questions From Mr. David Malpass
Hearing of June 30, 2005

From Senator Hatch:

Earlier this year, the Securities Industry Association commissioned a study of investors that, among other things found, of individual investors surveyed, 21 percent said the 2008 sunset of the current tax treatment of dividends and capital gains increased their uncertainty about their investment decisions. Given the relative volatility of the stock market in recent months, is this level of added uncertainty among investors something Congress should be concerned about?

> Congress should be concerned about financial market uncertainty. As uncertainty about after-tax earnings grows, it reduces the value of assets (by reducing the probability-adjusted after-tax earnings stream.) Taxes on dividends and capital gains are a critical factor in valuing equities. The risk of a tax increase after 2008 will reduce the value of the stock market, adding to the cost of capital and lowering the economic growth rate (and job creation) as the uncertainty increases. In effect, a delay in extending the current tax treatment beyond 2008, or uncertainty about doing it, would begin to reverse the growth and stock market benefits of the original tax cut.

The American Shareholders Association recently released an examination of the track record of the 2003 tax cut and found an interesting correlation between the timing of the tax cut and economic growth. They found that GDP growth, in the eight quarters prior to passage of the 2003 tax cuts, averaged just 1.6 percent. In the following eight quarters, however, GDP growth has averaged close to 4.4 percent. Do you think this faster pace of growth can be attributed to the reduced rates of tax on dividends and capital gains?

> I agree with the thrust of the American Shareholders Association examination. I think there was a direct cause-and-effect connection between the tax cut and faster GDP growth. As described in my testimony, our 2003 research predicted this impact. We placed heavy emphasis on the importance of the after-tax cost of capital (which declines with lower tax rates) for economic growth and job creation. Capital formation is vital to job creation and to the value-added potential of a job. Thus, when you tax capital less, you get more jobs, higher wages, and the extra GDP growth that goes with them.

From Democratic Members:

Your testimony highlights the need for dynamic scoring in order for Congress to better evaluate tax proposals. But Congress did have this information from Joint Tax, which prepared a macroeconomic analysis of the 2003 cuts. They concluded that the temporary stimulus from the cuts would be reduced over time, "because the positive business investment incentives arising from the tax policy are eventually likely to be outweighed by the reduction in national savings due to the increasing Federal government deficits." Do you disagree with this analysis?

> I think the 2003 cuts in the dividend and capital gains tax rates provided long-term stimulus to the economy, not just temporary stimulus. If you lower the cost of capital, you get more capital, which causes more growth and jobs, and therefore more ability to create capital in the future. The gains compound. I don't think national savings is reduced in the long run by a growth-oriented tax cut. The fiscal deficit might go up in the short run, but over time the increase in the size of the private sector should increase national savings.

Statement
Senator Rick Santorum
Hearing of the Subcommittee on Taxation and IRS Oversight
"Encouraging Savings and Investment: Stay the Course or Change Direction?"
June 30, 2005

I thank the Chairman and Ranking Member for holding this hearing and addressing these important issues.

As the cofounder of the bipartisan, bicameral Congressional Savings and Ownership Caucus, I am very interested in the topic of savings, investment and ownership. As recently as a decade ago, the national savings rate was about six percent of personal income. Historically, the savings rate has hovered between seven and ten percent. Over the past ten years, however, Americans' personal savings have plunged dramatically. Today, the savings rate is at less than one percent—a mere 40 cents is saved for every $100 earned. This is the lowest savings rate since the Great Depression.

The sad fact is that too many Americans don't have opportunities to save. According to the Federal Reserve, nearly 10 million households do not have a bank account of any kind. More than half of these families earn less than $15,000 a year. Other advanced nations are doing a much better job of encouraging their citizens to save money. Unfortunately, the United States currently ranks last among industrialized nations in terms of the amount of savings of its people. We must continue to open avenues to promote a savings and ownership society so this disturbing trend does not continue.

I have been actively involved in finding ways to encourage savings, investment and ownership policies that support hardworking Americans. I have cosponsored the Chairman's Jobs and Growth Tax Relief Act, S. 7, that would permanently extend the individual tax rate cut and the death tax repeal in the Economic Growth and Tax Relief Act (EGTRRA) of 2001 and the capital gains and dividend tax cut in the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003. S. 6, the Marriage Opportunity Recovery and Empowerment (MORE) Act, which I have sponsored, would make marriage penalty relief permanent.

Among the items we are discussing today is the effect that increasing the capital gains rate back to the old 10 and 20 percent rates would have on savings and investment. In my opinion, the U.S. tax code penalizes capital investment in the United States by taxing investment income more than once – first through individual income taxes, and then again through capital gains taxes. The current method of taxing capital gains multiple times hurts many Americans, including retired couples when they sell off assets and farmers and small business people when they attempt to collect the rewards of their life's work. Nonetheless, if this tax remains it should be as low as possible to reduce the harmful effects on savings and investment. Increasing capital gains tax rates would be destructive to a savings and investment society that we are trying to strengthen.

Another provision that promotes savings and retirement security for lower income individuals is the saver's credit. Single workers with adjusted gross incomes under $15,000 and families with incomes under $30,000 would receive a tax credit for 50 percent of their contributions to an IRA or employer-sponsored plan. Credits would be available for up to $2000 of contributions for a maximum credit of $1000. Encouraging savings by allowing low-income individuals to keep a little more of what they earned will hopefully help to develop habits crucial to their future.

Promoting a culture of savings and ownership has been an important issue to me, and while the provisions we are discussing today are helpful I believe that there are at least two other ways this committee should consider to increase savings and investment. This Congress, I introduced S. 922, the Savings and Working Families Act of 2005. This bill builds on existing Individual Development Account (IDA) programs by offering tax credit incentives for the creation an additional 900,000 accounts. The American Dream Demonstration, a 14-site IDA program, has demonstrated that low-income families, with proper incentives and support, can and do save for longer-term goals. The average participant saved 50% of their monthly savings target and made deposits in 6 of 12 months. The participants accumulated an average of $700 per year including matching contributions. Importantly, participants' deposits increased as their monthly savings target increased. This last result indicates that low-income families' saving behavior, like that of wealthier individuals, is influenced by the incentives they receive.

Additionally, key to the success of IDAs is the economic education that participants receive. Participants receive information about repairing credit, reducing expenditures, applying for the Earned Income Tax Credit, avoiding predatory lenders, and accessing financial services, all of which helps them reach savings goals and to integrate themselves into the mainstream economic system. The encouragement and connection to supportive services helps low-income individuals to keep early withdrawals to a minimum and overcome obstacles to saving. Banks and credit unions benefit from these new customer relations, and states benefit from decreased presence of check-cashing, pawnshop, and other predatory outlets. But more than income enhancement, asset accumulation affects individuals' confidence about the future, willingness to defer gratification, avoidance of risky behavior, and investment in community.

Under my bill, individuals between 18 and 60 who are not dependents or students and meet the income requirements would be eligible to establish and contribute to an IDA. For single filers, the income limit would be $20,000 in modified Adjusted Gross Income (AGI). The corresponding thresholds for head-of-household and joint filers would be $30,000 and $40,000, respectively. Participants could generally withdraw their contributions and matching funds for qualified purposes such as higher education expenses, first-time home purchase expenditures, and small business capitalization. President George W. Bush has supported IDAs and included this proposal for a national demonstration in his budget, which is estimated to cost $1.7 billion dollars over 10 years.

I also recently introduced, S. 868, the America Saving for Personal Investment, Retirement, and Education Act of 2005 – or ASPIRE Act with bipartisan support. This legislation creates a Kids Investment and Development Savings (KIDS) Account for every child at birth and creates a new opportunity for the children of low-income Americans to build assets and wealth.

Under this legislation, KIDS Accounts would be created after a child is born and a Social

Security number issued. A one-time $500 deposit would automatically be placed into a KIDS account. Children from households below the national median income would receive an additional deposit of $500 at birth and would be eligible to receive dollar-for-dollar matching funds up to $500 per year for voluntary contributions to the account, which cannot exceed $1,000 per year. All funds grow tax-free. Access to the account prior to age 18 would not be permitted, but kids--in conjunction with their parents--would participate in investment decisions and watch their money grow. When the young person turns 18, he or she can use the accrued money for asset building purposes such as education, homeownership, and retirement planning. Accrued funds could also be rolled over into a Roth IRA or 529 post-secondary education account to expand investment options.

This bill begins by giving younger individuals, especially low-income Americans, a sound financial start to their adult life. For example, a typical low-income family making modest but steady contributions can create a KIDS Account worth over $20,000 in 18 years. Additionally, and perhaps more importantly, KIDS Accounts create opportunities for all Americans to become more financially literate with a universal savings platform. The account holders and their guardians will choose from a list of possible investment funds and will be able to watch their investment grow over time. All Americans will have the opportunity to see firsthand that a smart investment now can grow over time into considerable wealth.

Once again, I commend the Subcommittee for focusing on savings, investment and ownership. It is important that we discuss the impact of tax policy on savings, investment and ownership initiatives as well as opening the debate on pending legislation.

Extension of Saving and Investment Incentives

Testimony Submitted to Subcommittee on Taxation and IRS Oversight
of the Committee on Finance
United States Senate

June 30, 2005

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Tax Policy Center

Chairman Kyl, Ranking Member Jeffords, and Members of the Subcommittee

Thank you for inviting me to testify today at this hearing on extension of the incentives for savings and investment that are scheduled to expire in the next few years. Major tax incentives enacted in 2001 and 2003 that are scheduled to expire and that the Congress may consider renewing include the special lower tax rates for capital gains and dividend income enacted in 2003, and the increase in the annual deduction amount for qualified section 179 property, the savers credit, and the above the line deduction for qualified post-secondary education expenses, all enacted in 2001. The education deduction and the increase in the section 179 deduction expire at the end of this year, the savers credit expires at the end of 2006, and the lower tax rates for capital gains and dividends expire at end of 2008.

My remarks will focus mainly on the effects of extending lower rates for capital gains and dividends. I will also comment briefly on the savers credit and the education deduction.

<u>Lower Rates for Capital Gains and Dividends</u>

Prior to 2003, dividends of individuals were taxed at the same rate as ordinary income. Long-term capital gains were subject to a maximum tax rate of 20 percent for taxpayers in the 25 percent tax rate bracket and above and of 10 percent for taxpayers in the 15 percent tax rate bracket and below.

Between 2003 and the end of 2007, dividends and capital gains will both be subject to a maximum rate of 15 percent for taxpayers in the 25 percent rate bracket and above and 5 percent for taxpayers in lower brackets. (The lower rate on dividends was effective January 1, 2003; the lower rate on capital gains for sales of assets after May 6, 2003). In 2008, the rates drop to zero for taxpayers in the 15 percent income tax rate bracket and below. The lower rates for dividends and capital gains expire at the end of tax year 2008.

The lower rates for dividends and capital gains have been justified on two grounds: 1) relief of the double taxation of corporate income, so that all income is taxed once, and 2) promotion of saving and economic growth. I will comment on the extent to which the current provisions promote these goals and discuss their effects on economic efficiency and income distribution.

Does it Tax Corporate Income Once?

Under current law, income from corporate equity is potentially subject to tax at both the corporate and individual level. Because corporations cannot deduct dividends paid to shareholders, dividends can be taxable to both corporations and individuals. In the case of individuals and corporations that are both in the 35 percent bracket, $100 of pre-tax corporate income is subject to $35 of corporate tax, leaving $65 to be distributed to shareholders or retained and reinvested by the corporation. If the $65 is paid as a dividend to shareholders in the top bracket (35%), the total tax under pre-2003 tax law on the $100 of income would be $57.75 -- $35 of corporate income tax and $22.75 of individual income tax on the dividend payment. In contrast, interest paid to creditors is deductible from income subject to corporate tax, so that $100 of corporate net revenues that are paid as interest payments give rise to a maximum individual income tax of $35 and no corporate-level tax.

Retained earnings also result in two levels of tax to the extent that corporate retentions raise the value of shares and result in taxable capital gains. The second level of tax on corporate retained earnings is lower than the tax on dividends, however, because tax on capital gains is deferred until the gain is realized by sale or exchange and because capital gains held until death escape income tax entirely. In addition, even before the 2003 Act, the tax rate on capital gains was lower than the tax rate on ordinary income.

In general, it is desirable that effective tax rates be equalized across types of investments and forms of saving, so that business investment decisions are driven by economic productivity and not tax considerations and individual portfolio decisions achieve a balance between maximization of yield and minimization of risk that is consistent with investor preferences. The double taxation of corporate income, however, produces a number of biases that distort investment decisions and financing choices:

- It penalizes corporate enterprises compared with non-corporate businesses because the latter face only one level of income tax. This bias discourages businesses from choosing the corporate form of organization and shifts investment and output away from industries characterized by a high reliance on the corporate form of organization.

- It favors debt over equity finance, which could lead some corporations to become over-leveraged and assume too much risk.

- It encourages retained earnings over dividends, which weakens shareholder control over corporate policies and could contribute to problems in corporate governance.

It is important to note that the existence of *two* levels of tax does not necessarily mean that the overall tax burden on corporate source income is too high. Many corporations pay low effective tax rates on their income, either because of the use of legislated tax incentives or through international income shifting and other sophisticated tax avoidance techniques (McIntyre 2003, Desai 2002, Sullivan 2004). And a significant portion of corporate-source income pays no income tax at the shareholder level or tax at reduced rates even when paid out in the form of dividends or share repurchases or accrued as capital gains by shareholders. This includes income accrued in employer-funded pensions, individual retirement accounts, 401k plans, life insurance policies, and other tax-deferred vehicles and income accruing to tax-exempt organizations. For example, Gale (2002) reports that just under half of dividends paid out of the corporate sector were subject to taxation at the individual level in 2000 and a similar share in prior years going back to 1982.

Proposals to eliminate the double taxation of corporate income by integrating individual and corporate income taxes have been advanced a number of times since the 1970s. These include the income tax reform option in *Blueprints for Basic Tax Reform*, published at the end of the Ford Administration (Bradford and U.S. Treasury Tax Policy Staff, 1984) the first version of the Reagan Treasury's tax reform proposal in 1984 (U.S. Treasury, 1984), and a Treasury Department Report in the administration of the first President Bush (U.S. Treasury, 1992). In 2003, the current Administration proposed a version of corporate integration in which dividends from previously taxed corporate income would be exempt to individual shareholders.

The current partial exemption of dividends and capital gains, however, differs from previous proposals in two important ways:

- Tax relief on dividends and capital gains is provided, without regard to whether any tax was actually paid at the corporate level. In contrast, the prior proposals, including the current Administration's original 2003 proposal, sought to provide credits or exemptions only to offset corporate taxes actually paid.

- It increases the Federal budget deficit and provides disproportionate tax relief to high-income taxpayers. In contrast, the Ford and Reagan integration proposals were included as part of overall tax reform proposals that were revenue neutral and roughly maintained the existing distribution of the tax burden, while the Treasury report in the first Bush Administration included an option (the Comprehensive Business Income Tax, or CBIT) that actually raised revenue by eliminating interest deductibility at the corporate-level. (U.S. Treasury, 1992).

These differences are important because, instead of moving towards a system in which all capital income is taxed once, the current provisions create new distinctions among taxation of different forms of income. Taxable shareholders of fully taxable corporations continue to pay two levels of tax on dividend income, but shareholders of corporations that pay zero or low effective tax rates at the corporate level receive an additional benefit because their distributions are lightly taxed as well.

The partial exemption of capital gains and dividends raises the benefits of corporate shelters and increases incentives for corporate tax avoidance behavior because fewer of the benefits of shelters are recaptured upon payment of dividends or realization of capital gains. It also increases the incentive for individual tax shelters that work through techniques that convert ordinary income to capital gains. In addition, while the capital gains cut offsets in part the double taxation of corporate income, a substantial share of capital gains comes from sales of assets not subject to corporate-level tax, including real estate, land, and non-corporate businesses.[1]

The provisions do reduce the *net* bias towards corporate debt finance by lowering the combined tax rate at the corporate and individual levels on corporate equity income. But they do not provide equal treatment of corporate debt and equity finance, as would earlier proposals for corporate tax integration. Instead, they move towards a tax structure that taxes returns from debt at the individual level only and returns from equity mostly at the corporate level. This provides incentives for portfolio reshuffling among individuals. It encourages individuals in high tax brackets to hold more corporate equity, and tax-exempt investors (including 401k plans and pension funds) to hold more debt than they otherwise would under both pre-2003 law and a neutral corporate integration system.[2]

Finally, on balance, the 2003 changes do appear to have increased dividend payouts by corporations with large taxable institutional owners or independent directors with large shareholdings (Chetty and Saez, 2004). Whether or not the same increase in dividend payouts will persist if the tax cut becomes permanent will become evident over time.

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[1] IRS Statistics of Income reports that for tax year 1999 capital gains less losses on corporate stock and mutual funds other than tax-exempt funds and capital gains distributions accounted for 57 percent of all capital gains less losses. The corporate share of gains was higher than usual in 1999; in some prior years the share has been less than 50 percent. Burman (1999) reports that capital gains on corporate stock and mutual funds accounted for 47 percent of realized capital gains in 1993.

[2] A corporate integration system that taxes debt and equity the same way can be accomplished either by allowing corporations to deduct qualified dividend payments or by requiring shareholders to gross up dividend income for corporate taxes paid and allowing them to claim a credit for the corporate tax (the credit imputation method). The latter method is equivalent to treating the corporate tax as a withholding tax on dividends. Under both methods, corporate tax associated with distributed corporate income is eliminated and shareholders pay tax on dividends at their individual marginal tax rate. OECD countries that have provided relief of double taxation use either the dividend deduction or credit imputation method. Alternatively, the single level of tax could be shifted to the corporate level by eliminating taxation of dividends and capital gains on corporate shares, eliminating tax on corporate interest payments, and eliminating deductibility of interest by corporations. (U.S. Treasury Department, 1992)

Under an imputation system, it is also possible to provide relief for the double taxation of retained earnings by allowing corporations to declare stock dividends instead of paying out cash to shareholders. Shareholders would have to report the stock dividends and associated tax as income, but would receive a credit for the corporate-level tax paid and raise their basis for computing any subsequent capital gains tax upon sale of the stock by the amount of income reported.

Will it Increase Savings and Economic Growth?

Reducing the tax rate on income from capital may stimulate more saving and thereby increase investment and economic growth. This could happen because raising the after-tax return on saving increases the amount of future consumption that an individual can obtain by sacrificing an additional dollar of consumption today. But tax cuts that raise the rate on saving also make it possible for people to accumulate more wealth for retirement or other future purposes without saving as much. When taxes on income from capital are reduced, *without offsetting increases in other taxes or cuts in government benefits*, economic theory does not predict whether private saving will increase, decrease, or remain the same. And studies of the relationship between after-tax returns and saving by economists have produced no clear conclusion that higher after-tax returns increase saving.[3]

Moreover, the higher deficits that will result from extending the cut in capital gains taxes and dividend taxes will reduce national saving on balance, unless private saving rises enough to offset the cut in public saving. The higher deficits will raise interest rates unless foreign savers are willing to finance the additional U.S. borrowing without demanding higher yields. Most likely, the additional deficits will result in both higher interest rates and increases in our already large dependence on foreign sources of funding for the needs of both the public sector and an expanding private economy.

A number of economists have simulated models in which replacing an income tax with a consumption tax that removes the tax on the return to capital will improve economic efficiency and raise GDP in the long run (See discussion in Gale and Orszag, 2004). But the conclusion that growth will increase is based on the implicit assumption in the models that implementing a new consumption tax will impose a lump-sum tax on current wealth. This lump sum tax, unlike taxes on wages and new saving, has no adverse economic effects because it cannot be avoided; the wealth has already been accrued. Without the wealth effects, however, some of the same models that show economic gains from replacing an income tax with an *equal revenue* consumption tax show a much smaller benefit from reducing the tax rate on income from capital. (Altig *et. al, 2001*). And the current proposal to reduce tax rates selectively on capital gains and dividends provides large windfall benefits to existing wealth holders by reducing income taxes on the return to wealth that has been accumulated in the past.

Who Benefits from the Tax Cut?

The distribution of taxable capital gains and dividends is highly skewed towards upper-income tax returns. Simulations with the Urban-Brookings Tax Policy Center (TPC) micro-simulation model show that 48 percent of qualifying dividends and 69 percent of capital gains accrue to taxpayers with annual cash income over $200,000 and 22 percent of dividends and 59 percent of capital gains are received by taxpayers with cash income

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[3] These studies are reviewed in Congressional Budget Office (1997). According to CBO, "existing empirical studies provide a bewildering range of estimates. Some find that saving responds markedly to changes in after-tax rates or return; others find no response."

over $1 million. (Table 1). Taxpayers with income over $1 million represent 0.3 percent of all tax returns with 11.5 percent of pre-tax income. Taxpayers in the top 1 percent of the income distribution receive 9 percent of pre-tax income, but receive 33 percent of qualifying dividends and 72 percent of capital gains. (Table 2).

The benefits of extending the tax cut on capital gains and dividends would also accrue mostly to upper-income taxpayers. The TPC estimates that, in 2010, taxpayers with cash income of $200,000 or over in 2005 dollars would receive 72 percent of benefits from the extension of the tax cut and taxpayers with income of $1,000,000 or over would receive 46 percent of the benefit. The increase in after-tax income would be 1.6 percent for taxpayers with income over $1,000,000, 0.7 percent for taxpayers with income between $500,000 and $1,000,000, 0.5 percent for taxpayers with income between $200,000 and $500,000 and 0.2 percent or less on average in all income groups with income below $200,000. (Table 3). When taxpayers are ranked by percentile of the income distribution, taxpayers in the top 1 percent receive 58 percent of the tax benefit and taxpayers in the top 0.1 percent receive 39 percent of the tax benefit. (Table 4). While taxpayers on average receive a tax cut of $209, taxpayers in the top 1 percent receive an average tax cut of over $12,000 and taxpayers in the top 0.1 percent receive an average tax cut of over $80,000.

Can the Provisions be Improved?

Cutting taxes on capital income of individuals disproportionately benefits high-income individuals not only because high-income individuals hold a large share of total wealth, but also because much of the wealth of most Americans is already held in the form of assets, such as homes and pensions, that do not generate taxable income from capital. Cuts in taxes on capital gains and dividends do not directly benefit the vast majority of Americans who either have not accumulated much savings or hold most of their wealth in the form of homes, pensions, and tax-deferred savings plans.

Nonetheless, the distortions resulting from the double taxation of corporate income remain a major flaw in the U.S. income tax system. Proposals to reduce or eliminate double taxation of corporate income, if designed properly, could be an important part of a broader tax reform that eliminated and reduced some tax preferences, simplified the structure of remaining preferences, and adjusted rates to maintain revenue and keep the tax system from becoming less progressive. The President has endorsed the goals of revenue neutrality and maintaining a progressive system in his instructions to the Tax Reform Commission that is planning to produce options by the end of September.

With the retirement of the baby boomers and the accompanying fiscal pressures on the Federal retirement program coming soon, it is also important to think how we can use the tax system to help Americans save for retirement. To do so, it is important to re-design savings incentives to make them more effective in increasing net saving of average Americans. The saver's credit is one type of incentive that, with some modifications, has the potential to promote more saving by low and middle-income taxpayers who are currently not saving enough for their future retirement needs. I now turn to a brief discussion of the saver's credit.

The Saver's Credit

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) included a new tax credit for qualified retirement savings contributions of taxpayers with income below certain thresholds. A 50 percent tax credit is available for single filers with adjusted gross income (agi) below $15,000. The available credit rate is reduced to 20 percent for single filers with agi between $15,000 and $16,500 and a 10 percent credit for single filers with agi between $16,500 and $25,000. The agi thresholds are 1.5 times the individual threshold amounts for head of household filers and twice the individual threshold amounts of joint filers, so that joint filers receive some credit for agi up to $50,000. The credit is reduced dollar for dollar for any distribution from the account during the taxable year, including up to the due date for filing the return for that year, and for the two preceding taxable years or for any distribution received by a spouse if the couple files a joint return. The credit is not refundable, so it is limited to the income tax liability the taxpayer would otherwise have.

By providing a larger subsidy rate for lower income taxpayers, the credit differs from other savings incentives in the Federal income tax. Because they reduce or defer income subject to tax, IRAs and 401k plans are relatively more valuable to taxpayers in higher tax brackets. Research results are ambiguous as to whether these traditional incentives raise net private saving or merely cause people to shift assets to tax-preferred accounts.[4] But some research results do suggest that deposits to tax-preferred accounts by low-income individuals (without other sources of wealth) are more likely to come at the expense of current consumption instead of other saving or borrowing as compared with deposits of high-income individuals.

A recent research study from a carefully designed controlled experiment with H&R Block clients in St Louis found that higher match rates on contributions to IRAs induces more low-income taxpayers to deposit their tax refunds in IRAs and induces participants to deposit more on average than those with a lower match rate or no match (Dullo *et. al* 2005). The same study found the existing savers' credit to be less effective than the matching program in the experiment. Three possible reasons for the greater effectiveness of the matching program are that: 1) taxpayers in the matching program were informed by a tax preparer of the availability of the subsidy and counseled on how to use it, 2) the match was designed as an 100 percent add-on to the net amount contributed instead of a 50 percent offset to the gross contribution, so it may have appeared larger even though it was not, and 3) the subsidy was not limited to tax liability.

Several modifications to the savers' tax credit could make it more effective, although it would add to the budgetary cost. The credit could be made refundable, so that low-income taxpayers without tax liability could benefit from it (Gale, Iwry and Orszag, 2005). To ease concerns about ineligible people filing returns just to claim the credit,

[4] For opposing perspectives, see Engen, Gale, and Scholz (1996) and Hubbard and Skinner (1996).

availability could be limited to individuals with a minimum amount of reported earnings. The maximum credit amount could be phased out gradually as income increases over a threshold, instead of having the credit rate drop precipitously when income passes a certain point. That would avoid the higher marginal tax rate on earnings that some taxpayers may face because they would lose a big amount of credit if they earn an additional dollar above a threshold amount.

Recent research suggests that individuals may be very responsive to the way incentives are delivered as well as the actual financial benefit. For example, there is evidence that the take-up rate on 401k plans is much higher when employers automatically deposit money in the plan, with an option for the employee to opt out, than when the employee is simply offered an opportunity to contribute (Choi *et.* al 2004). This does not mean that the tax incentives are ineffective, but merely that they are more effective when they work in coordination with institutional arrangements that make it easier for employees to contribute to savings plans.

Deduction for Expenses of Post-Secondary Education

EGTRRA also created an "above the line" deduction for post-secondary education tuition and fees. The maximum deduction was $3,000 in 2002 and 2003 for taxpayers with modified adjusted gross income (magi) less than $50,000 for single and $100,000 for joint returns. (Modified adjusted gross income is agi less the tuition and fees deduction for purposes of the deduction and agi plus excluded foreign earned income for purposes of the Hope and Lifetime Learning credits.) Smaller deductions were available for single filers with magi less than $65,000 and for joint filers with magi less than $130,000. In 2004 and 2005, the deduction increased to a maximum of $4,000 for single taxpayers with magi less than $65,000 ($130,000 for joint returns). Single taxpayers with magi between $65,000 and $80,000 ($130,000 and $160,000 for joint returns) can deduct up to $2,000 in tuition and fees. The deduction for tuition and fees is scheduled to expire after tax year 2005.

The deduction adds to the Hope and lifetime learning credits that are permanent features of the tax law. The Hope credit is available for the first 2 years of post-secondary education only and can be claimed for any student in a family. It is equal to 100 percent of the first $1,000 of qualified expenses (tuition and fees) and 50 percent of the next $1,000, for a maximum credit of $1,500. The lifetime learning credit (LLC) is available for undergraduate, graduate, and professional students and for people upgrading skills or changing careers. It equals 20 percent of expenses up to $10,000 per household, a maximum credit of $2,000. Only one LLC may be claimed per return.

A student cannot take advantage of both the Hope credit and the LLC in the same year. Both credits phase out for taxpayers with magi of $42,000 if single or $85,000 if married at a rate of 20 cents on the dollar for single returns and 10 cents on the dollar for joint returns. Taxpayers cannot claim a credit for any expenses paid for with certain tax-free funds, including scholarships, Pell grants, employer-provided educational assistance, Coverdell Education Savings Accounts, or Section 529 plans.

Deciding which credit or deduction to use for higher education is a complicated calculation for taxpayers. In cases where there is only one student in the tax unit, the HOPE credit is most advantageous for the first 2 years of higher education at institutions with tuition below $7,500 and the LLC may be more advantageous if tuition is above $7,500. However, if there is more than one student in the household, the choice between these credits becomes more complicated because the Hope credit is available per student and the LLC is available per return. The deduction benefits primarily taxpayers in the 25 percent rate bracket or higher because for these taxpayers the matching rate is higher than with the LLC, but this also depends on the level of expenses. If expenses are $3,000 or less, the deduction is more beneficial than the LLC for any taxpayer in the 25 percent bracket or above. If expenses are higher, however, the choice depends on the trade-off between the higher match rate and higher income limits of the deduction and the higher amount of match-able expenses for the LLC.

The Tax Policy Center simulated the distributional effects of the deduction under the assumption that taxpayers choose the incentive most favorable to them. Compared with the other incentives, the deduction is relatively more favorable to higher-income taxpayers. Taxpayers with annual cash income between $100,000 and $200,000 receive 51 percent of the benefits of the deduction and receive the largest increase in after-tax income of any income group. (Table 5) Less than 20 percent of the benefits go to taxpayers with income less than $50,000. The other tax incentives are also relatively more favorable to upper middle-income than to lower-income taxpayers, but less so than the deduction. In contrast, the distribution of the Pell Grants, which depend on measures of family ability to pay, is highly progressive.

The distributional effects of the deduction should not be surprising because the deduction, when added on top of the other incentives, benefits only taxpayers in the 25 percent bracket or above or with incomes above the thresholds for the Hope or lifetime learning credits. In 2002, more than 60 percent of taxpayers had marginal rates below 25 percent. (IRS Statistics of Income).

The main goal of the tax incentives is to increase enrollment in higher education. A number of studies have found that reducing college costs increases college attendance (Dynarski 2002). There is little direct evidence on the effect of tax incentives on enrollment, but a simulation study by Long (2004) suggests there is no overall impact on enrollment because of the inability of low-income families to access the credits. It is questionable, therefore, whether a deduction focused on upper-middle income families will have any significant effect on enrollment. Consideration should be given to simplifying the tax incentives for higher education and focusing them more effectively on families with financial need who are most likely to respond to incentives.

Conclusions

A number of tax incentives for savings and investment enacted in 2001 and 2003 are scheduled to expire in the next few years. These incentives are being considered at a time when the United States is experiencing large budget deficits and faces the prospect of growing fiscal problems once the baby boom generation begins to retire. At the same time, the private saving rate is very low and many Americans are confronting the prospect of reaching retirement age with inadequate saving. In this context, it is important that tax benefits be paid for and that they be designed to be effective in encouraging additional saving and investment in productive assets and human capital.

The special rates on capital gains and dividends address in part the problem of double taxation of corporate equity income. But they fail to achieve the goal of corporate integration of taxing all capital income equally because they provide benefits to shareholders regardless of whether tax is paid at the corporate level. Unless the lower tax rates on capital gains and dividends were offset by lower spending or increases in other taxes, extending them is likely to reduce instead of to increase national saving and economic growth The lower rates on capital gains and dividend income provide disproportionate benefits to taxpayers in the highest income groups, who receive most dividend and capital gain income.

Elimination of the double taxation of corporate income remains a worthy goal of tax reform, but should be considered only in the context of a broader reform that is revenue neutral or revenue increasing and distributes the overall tax burden fairly among income groups. Double tax relief should be designed to make the tax treatment of different forms of income received by shareholders and lenders more equivalent and to ensure that shareholder relief for taxes at the corporate level is provided only if the taxes are actually paid.

The Saver's Credit is an alternative approach that provides an incentive for new saving and, in contrast with other saving incentives in the tax law, provides a larger matching grant to low-income than to high-income taxpayers. Recent research suggests that matching grants can increase contributions to retirement accounts by low and middle-income Americans. This is a promising approach to help low and middle-income Americans save more and reduce their future dependence on government retirement programs. Congress should consider ways of modifying the Saver's credit to make it accessible to more people and increase its effectiveness.

The deduction for education is one component of a very complex set of tax incentives for spending on higher education. With the other incentives in place, the additional benefits of the deduction go mostly to upper middle-income taxpayers and probably have little effect on college enrollment. Congress should consider combining and simplifying the current complex set of tax incentives for education and targeting their benefits more to students from families that are more likely to need assistance to finance higher education.

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Responses to Questions for the Record
Testimony Before the Subcommittee on Taxation and IRS Oversight
Committee on Finance, United States Senate
June 30, 2005

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From Senator Hatch

Question

In a recent column in Investors' Business Daily, *Mallory Factor and Jack Kemp singled out an often-overlooked benefit of the 2003 tax cut – improved corporate governance. They noted that, "in the midst of uncertainty and concerns over accounting practices, investors demand sustainable and visible earnings from companies.... Companies can fake their earnings reports, but they can't fake cold hard cash. Do you agree that the 2003 tax cuts have enhanced the "discipline of the dividend" and resulted in improved corporate governance?*

Answer

The 2003 tax cuts reduced the relative preference for retained earnings over corporate distributions by reducing the tax rate on dividends to the same as the rate on capital gains. (There is still some preference for retained earnings because taxes on accrued gains on corporate shares are deferred until realization and exempted completely if the shares are transferred at death.) As I noted in my written statement, there is some evidence (Chetty and Saez 2004) that dividend payouts increased in response to the tax change, at least in the short run, among corporations with large institutional owners or independent directors with large shareholdings

I am not aware of any studies that show that corporate governance has improved as a result of the 2003 tax cuts, but that would be difficult to observe if it had happened. As the statement by Factor and Kemp implies, in theory improved corporate governance in the interest of shareholders could result from removal of the tax bias against dividend payouts. Shareholders may consider dividend payments to be a more reliable indicator of corporate profitability than reported corporate earnings because they are less subject to manipulation and that is one reason they may want dividends even if they result in additional tax. In addition, dividend payouts in some circumstances force corporations to go to the market to raise more capital instead of financing investment through retained earnings. The argument that dividend tax cuts unlock capital can be overstated, however, because corporations can and do also pay out profits through stock repurchases, which are subject to capital gains tax, not dividends tax. In addition, non-taxable investors (pension funds and individuals investing through 401k plans) have been holding an increasing share of corporate equity over the past quarter century and they are not affected by the tax rate on dividends.

Most economists would probably agree that neutrality among sources of corporate finance (as between payouts and retentions and between debt and equity) is a desirable feature of the tax system. But, as I discussed in my testimony, previous proposals for relief of double taxation advanced this goal through proposals that moved towards taxing all capital income once and that were included as part of overall reforms that were revenue neutral and maintained the existing burden of the tax distribution.

From Democratic Members

<u>Question</u>

I noticed that you feel a continuation or further cut in the capital gains and dividends rates may be unfair as it rewards existing wealth holders for wealth they accumulated in the past. You cite studies showing economic growth and efficiency are only possible when switching to a consumption tax where there is a "lump sum" tax on current wealth. Can you detail how this "lump sum" tax would work exactly?

<u>Answer</u>

Introducing a new consumption tax, such as a value added tax, effectively imposes a "lump sum" tax on existing wealth. The term "lump sum" refers to the fact that imposition of a new consumption tax would reduce the value of all existing wealth because the same dollar of wealth would buy fewer consumer goods. This could happen either through an increase in the price level or, if the price level is held constant, a decline in the market value of existing wealth. In contrast, an income tax includes in the tax base the return from wealth, but does not tax the spend-down of wealth because the funds used had already been taxed as earned or accrued through investment income. Put another way, an income tax is imposed on earnings and returns from saving, while a consumption tax is imposed when those earnings and/or returns from saving are spent.

Here is an example of how that might work. Suppose the U.S. Congress enacted the Hall-Rabushka (1995) flat tax plan. Under this plan, all wages would be taxable (above a fixed exemption amount for taxpayers and dependents), but interest, dividends and capital gains would be tax-exempt. All business would pay tax on their sales of goods, less purchases from other firms, including purchases of capital goods, and wages. The base of this tax would be exactly the same as a value-added tax, except that tax on the portion of value-added contributed by labor would be taxed to wage earners directly instead of to businesses. This would occur because, unlike in a traditional VAT, businesses would be allowed to deduct wages, which would then be subject to an individual tax. The tax would be a consumption tax because all business investments would be expensed and, with intermediate purchases from other firms and labor netted out, the tax base would simply be the sum of value added by all firms, which equals the value of sales of final goods to consumers.

Suppose the new tax rate is 25 percent. If, when the new tax is imposed, businesses were allowed no further depreciation on assets placed in service under the prior income tax and were fully taxable on the sales of those assets, then the value of old assets would decline. If, for example, a business installed a new capital asset at a cost of $1,000 just prior to the new tax, it would get no deduction for the purchase of that capital. But an equally productive asset would be eligible for a $250 deduction the day after the new law is enacted. This would make the value of the "used" asset drop immediately to $750. Overall, the enactment of the new rules, *without transition relief* would reduce the value of old assets and effectively tax any owner who wishes to sell the asset to finance consumption. The key feature of the tax law change that creates this lump sum tax is a reduction in the tax basis of existing assets to zero, even if those assets were purchased with after-tax dollars under the prior income tax.

Whether this lump sum tax will exist in practice depends on transition rules. Transition relief could take the form of maintaining basis on old assets, allowing businesses either to depreciate them under the old rules or to deduct basis immediately. In the absence of transition relief, there would be significant concerns about the unfair treatment of older people, who are consuming their life savings in retirement, and about losses imposed on businesses that made large investments within a few years before the new law took effect. But transition relief significantly reduces the efficiency gains that economists have estimated would result from replacing an income tax with a consumption tax. For example, Altig *et. al* (2001) estimate that transition relief significantly lowers the net benefit of replacing the current income tax with a flat rate consumption tax. By requiring higher tax rates to make up the lost revenue, transition relief would leave all income groups except the lowest (who benefit from a large exemption on wages) and the highest (who benefit from elimination of graduated rates) worse off under the flat tax than under the current tax system.

The cut in taxes on dividends and capital gains in 2003 does not impose a tax on consumption from existing assets and would not be associated with most of the benefits economists have estimated. It is a move towards replacing the income tax with a wage tax, not a tax on consumption. Moreover, it provides windfall gains to people who had accumulated wealth in the past, under the expectation that dividends would be taxed at the same rate as wage income. These wealth holders experience a large tax cut without any change in their behavior and the resulting revenue loss will eventually have to be financed by higher tax rates on labor income.

Question

In Mr. Malpass' testimony, he noted that equity prices rose following the 2003 tax cuts. Correlation is not causation, of course, and the 2003 rise in stock prices followed an almost unprecedented three-year decline in the S&P 500 as well as monetary policy that resulted in a real federal funds rate below zero. Is there any empirical evidence of the relative contribution of tax policy to the subsequent rise in equity prices and economic growth?

Answer

No, there is no empirical evidence establishing that the 2003 tax cuts, were the cause of the subsequent rise in equity prices. Equity prices fluctuate widely from month to month for a variety of reasons. The Standard and Poor's index increased 5.2 percent between April and May 2003, the month that JGTRRA was enacted. But it also rose 5.1 percent between March and April. The monthly S&P index increased steadily from its trough of 837.62 in February 2003 to 1143.36 in February 2004 and then dropped almost every month through the end of August, before rising again to 1199.21 in December 2004. As the question suggests, the S&P today is still significantly below its average for 2000. Obviously, many factors are at play in these movements and it is hard to tease out the effect of the 2003 cut in the tax rate on dividends.

In theory, lower tax rates on dividends and capital gains should increase the market value of corporate equity in the short run, assuming all other influences held fixed. At a given discount rate, the market value of any stream of before-tax dividends and anticipated future capital gains realizations will rise if the tax rates on dividends and capital gains are lowered. Gravelle (2005) cites an estimate by Professor James Poterba of MIT that the Bush 2003 dividend and capital gains tax cut proposals would raise the value of the stocks by between 5 and 6 percent and shows how that figure could be arrived at by capitalizing the value of the tax cut to U.S. equity holders, assuming a fixed discount rate. Gravelle also suggests that this estimate is an upper bound, because as U.S. taxpayers shift out of debt and into corporate equity, the interest rate will rise. The higher interest rate will raise the rate at which stock returns are discounted, lowering the present value of returns to shareholder equity and potentially wiping out most of the initial gain in stock prices.

The above analysis assumes a closed international equity market; only U.S. investors buy shares of U.S. corporations and U.S. investors buy only shares of U.S. corporations and no foreign equity. If the market value of both U.S. and foreign corporations were used in the denominator of the calculation instead of the equity value of the U.S. share market (since the tax cuts apply to gains on U.S. individuals holdings of both U.S. and foreign equity), then the calculated percentage increase in U.S. share prices would be much smaller, but there would also be an increase in foreign share prices from the U.S. tax cut. While international equity funds have been growing and many financial advisors recommend that people hold some share of their portfolio in international funds, it is likely that investors consider U.S. and foreign shares to be less than perfect substitutes. This means that, while assuming no international flows of equity finance probably overstates the impact on the U.S. share market, assuming a single world-wide equity market with perfect substitutability between U.S. and foreign equities would understate the effect of the tax cut on the U.S. stock market.

In conclusion, any positive impact of the cut in capital gains and dividends on equity prices is likely to be very small in comparison to short-term price swings that occur frequently when no tax change is being enacted or considered.

Question

During the questions and answers following the hearing testimony, we discussed the benefits of reduction in capital gains and dividends for low- and middle-income taxpayers, most of whom hold little or not stocks, or do so in tax-deferred retirement accounts. It was generally agreed that there have been some notable dividend payments in the wake of the cut in the rate of taxes on dividends. What impact do such payments have on the value of a stock or mutual fund held in a retirement account, and what is the net effect of such dividend payments?

Answer

In general, if someone is accumulating assets within a tax-deferred retirement plan, an increased in the dividend payout rate will have no effect on the value of her portfolio. If the corporation reinvests a dollar of profit, it will on average increase the value of the stock by a dollar. If the corporation instead pays out the dollar, it will have one less dollar to invest, but the account holder will be able to reinvest the dividend either in the same stock or in some other asset. Note that because there is no tax on either dividends paid or realized capital gains within the account, the account holder is not locked in to a particular stock and gains no additional flexibility in portfolio allocation from a change in the payout ratio. Ultimately, when the account holder withdraws funds in retirement, the proceeds will be taxable at ordinary income rates without regard to how the funds were accrued within the account.

As I noted in the answer to the previous question, the increased demand for corporate stock by taxable investors could in theory produce a modest increase in the value of corporate equities, which would by itself also raise the value of equities within tax-deferred retirement plans. But if national saving does not increase, the rise in the value of equities would be offset by a decline in the value of other assets, including long-term bonds and housing. The net effect on any individual who does not hold stocks outside of a retirement account would depend on her portfolio allocation. The only clear winners from the cut in taxes on dividends and capital gains are people who hold large amounts of corporate equity outside of tax-deferred accounts.

From Senator Kerry

Question

Do the higher deficits that would result from extending the lower rates for capital gains and dividends negate any of the benefits that lower rates would have on the national savings rate?

Answer

If extension of the lower rates for dividends and capital gains is not paid for by other taxes increases or lower spending, it is likely that the national saving rate will fall. Any increase in private saving that may occur, and that increase is uncertain and likely to be small, will in all probability be more than offset by the reduced public saving associated with a larger deficit.

Question

In your testimony, you mentioned that the partial exemption of capital gains and dividends increases incentives for corporate tax avoidance behavior because fewer of the benefits of shelters are recaptured upon payment of dividends or realization of capital gains. Do you think that the 2003 capital gains and dividends changes have resulted in increased corporate tax avoidance?

Answer

I believe that not taxing corporate income at the individual level does increase the incentive for avoidance of tax at the corporate level for the reasons stated in my written testimony. The avoidance behavior I cited referred both to legal tax avoidance, through use of tax incentives and benefits intended by Congress, and use of abusive tax shelter transactions and other under-reporting of tax. But I have no information on whether or not the amount of tax avoidance through abusive transactions actually did change after 2003. Even if we did know that avoidance increased, we would not know the extent to which the tax law changes may have been a factor

Measures of the corporate under-reporting tax gap – the difference between corporate tax liability and the what corporations report on their tax return – are dated and subject to considerable error. The latest IRS estimates are that the corporate under-reporting tax gap in 2001 was $30 billion, or a little over 17 percent of corporate tax liability for that year, and includes both tax shelter transactions and other sources of under-reporting. The IRS estimates are based on projections from audit data in earlier years.

In short, the exemption of dividends and capital gains raises the benefit to shareholders of avoidance and evasion of corporate tax, but there are no quantitative estimates on what has actually happened to corporate tax sheltering since 2003.

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H&R BLOCK

STATEMENT OF
ROBERT WEINBERGER, VICE PRESIDENT, H&R BLOCK
"ENCOURAGING SAVINGS AND INVESTMENT:
STAY THE COURSE OR CHANGE DIRECTION?"
SUBCOMMITTEE ON TAXATION, SENATE FINANCE COMMITTEE
JUNE 30, 2005

Mr. Chairman, thank you for the invitation to share H&R Block's experience in helping low- and middle-income Americans save.

H&R Block serves nearly 20 million taxpayers at 11,000 offices across America (including 249 offices in Arizona and 21 in Vermont) and via online and packaged tax preparation software.

In our 50th year, we are evolving from a firm devoted to helping families deal with their tax filing responsibility to one that provides help with a broader range of financial issues, including advising our clients on how to save for college, home ownership, and retirement.

Americans face serious challenges in saving for retirement. Many are without work-related defined benefit pension plans and have little or no savings in tax-advantaged IRAs, 401(k)s, and other personal retirement accounts. Social Security benefits alone may be insufficient. With savings rates declining, the gap between what is needed and what is actually being saved is growing. The problem is particularly acute for low- and middle-income Americans.

The "Saver's Credit"

As the Subcommittee considers ways to close the savings gap, it may find our recent experience with the Retirement Contributions Savings Credit, or "Saver's Credit," useful.

Enacted in 2001, the Saver's Credit provides a tax credit of up to 50% for contributions to 401(k), IRAs, and similar retirement plans. It covers more than 60 million taxpayers with incomes up to $50,000, to the extent of their income tax liability.

While its coverage is limited, the Saver's Credit has been very successful in encouraging retirement savings for at least five reasons:

- First, the credit relies on personal responsibility. People can't claim it unless they are willing to make a substantial commitment to their futures through their own contributions.
- Second, it uses tax time to promote savings. One hundred million tax filers have refunds averaging $2,100. With nearly 60% using professional tax preparers, the run-up to April 15 is a once-a-year opportunity for a family financial check up and a chance to turn good intentions and savings advice into action.
- Third, it supports the existing private retirement system, leveraging the well-known structure of IRA, 401(k) and other vehicles and encouraging eligible taxpayers with low and moderate incomes to use them.

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- Fourth, the credit rate of up to 50% (which can be an effective after-tax match of up to 100%) provides a large enough incentive both to strengthen savings and to encourage new savings behavior.

- Finally, the higher credit rate for those with lower incomes targets benefits at those who most need incentives to save. In contrast, the tax benefits from traditional retirement savings incentive formulas favor those in the highest tax brackets.

Saver's Credit effective matching rates by income

Adjusted Gross Income		Credit rate (percent)	Tax credit for $2,000 contribution	After-tax cost of $2,000 contribution	Effective after-tax match rate (percent)
Married filing jointly	Singles and married filing separately				
0-30,000	0-15 000	50	1,000	1,000	100
30,001-32,500	15,001-16,250	20	400	1,600	25
32,501-50,000	16,251-25,000	10	200	1,800	11

Polls taken shortly after enactment showed that more than 80% of Americans had no idea what the Saver's Credit was. Because many of our tax clients are eligible, we provided extra training for our preparers. We also created a low-cost, low-minimum-deposit "Express IRA" to enable more clients use the credit to save. The results have been very positive.

- We have facilitated 1.2 million Saver's Credits yearly, about a quarter of the national total. Over the last three years, our clients who used the credit received more than $603 million to help them save, an average of $167 each per year.

- While most used the Saver's Credit to match contributions to an existing 401(k), IRA or other retirement plan, over 243,000 opened a new IRA through us. Among these tax clients, a majority are first-time retirement savers, average income is $27,000, half have no bank account, and about two-thirds are Earned Income Tax Credit recipients.

As helpful as the Saver's Credit is, it also has limitations.

- First, it is somewhat complex, partly because Congress created three different credit rates and they, in turn, have different effective match rates. This can make the credit difficult to understand and claim.

- Second, benefits fall in steep cliffs as income rises, which substantially reduces the power of the incentive as a result of very small changes in income.

- Third, the credit is unavailable to many income-eligible taxpayers because it is not refundable: at the 50% credit rate, for example, five out of six taxpayers who would otherwise be eligible based on income cannot use the credit because they do not have income tax liability. Families of four with incomes as high as $41,000 may be shut out.

- Finally, families who use the credit to save may be penalized when their savings goes over about $2,000, since that can trigger the denial of many Government benefits that have asset tests.

St. Louis Matched Savings Test

To test alternative ways to encourage savings by low- and moderate-income families, H&R Block joined in a 2005 study initiated by scholars from University of California at Berkeley, Harvard University, the Massachusetts Institute of Technology's Poverty Lab, and the Brookings Institution.[1]

At 60 H&R Block offices in metro St. Louis, our tax professionals presented low- and moderate-income taxpayers with Block-funded matching incentives to open and save in a low-cost "Express IRA" account. About 15,000 clients were randomly offered no match (the control group), a 20% match, or a 50% match.

The match rate had a significant effect on savings and participation, with especially strong results among low- and middle-income married filers and those receiving an Earned Income Tax Credit:

- Take-up rates were 3% in the control group, 10% in the 20%-match group, and 17% in the 50%-match group – nearly six times the rate with no match. In addition to increasing the level of savings participation, the study also found larger amounts were saved as incentives increased. Average IRA contributions (excluding the match) for the 20% and 50% match groups were 4 and 8 times higher than in the control group, respectively.

- The study found that savings incentives are most effective if they are understandable and coupled with easily accessible savings vehicles, the opportunity to save using part of a tax refund, and encouragement and guidance from a knowledgeable tax professional.

Options to Increase Savings by Low- and Moderate-Income Families

Based on our experience, we encourage the Finance Committee to consider extending the Saver's Credit beyond its 2006 expiration and expanding it to include more taxpayers. Because recent tax cuts have increased to 40% the number of American households who do not have income tax liability (families of four with incomes up to $41,000), many low- to moderate-income families cannot take advantage of the Saver's Credit as it is currently structured. Making it refundable would extend important incentives to these taxpayers and is likely to provide a significant boost to retirement savings.

The Committee may also want to consider an option based on the results of the St. Louis study. It would provide a savings match for taxpayers with incomes under $50,000. Savers could deposit between $1,000 and $2,000 in a 401(k) plan or IRA and receive a 50% matching contribution

[1] Full results are at https://www.brookings.edu/dybdocroot/views/papers/20050509galeorszag.pdf.

from employers or financial institutions, which would be reimbursed through a tax credit equal to the match and a small administration fee.

This "Saver's Match" could have several advantages: it is based on what someone saves, not what he or she earns; its audience is broader than that of the Saver's Credit but still under the same ceiling to ensure low- to moderate-income focus; the match is immediate and put into the savings account rather than delivered later as a tax refund that might be used for other purposes; and it encourages employer involvement and can combine with employer 401(k) matches.

We applaud the Committee's efforts to help Americans achieve more security in retirement. Our experience shows that a combination of factors – available assets in the form of a tax refund, a financial match from the Federal Government, a low-cost savings vehicle, and professional guidance – can have a significant impact on retirement savings, especially at lower income levels.

We look forward to assisting the Committee as it considers the best means to encourage savings by all American families.

Celebrating its 50th anniversary in 2005, H&R Block is the world's largest tax services provider, having served more than 400 million clients since 1955 The sixth largest retailer in the world, H&R Block has more than 12,500 locations serving taxpayers in the United States, Canada, Australia and other countries. Headquartered in Kansas City, H&R Block served more than 19 million U.S. clients during fiscal year 2004 at approximately 11,000 H&R Block U.S. retail offices and through software and online services. Over 167,000 company and franchise employees deliver tax services including preparation of one out of seven individual tax returns filed with the IRS. H&R Block tax schools trained 250,000 students including 84,000 enrolled in our 66-hour basic tax course. H&R Block served 3.2 million tax clients through its *TaxCut®* software and through online tax preparation services.

H&R Block's subsidiaries also deliver financial advice, investment and mortgage services, and business accounting and consulting services. H&R Block Financial Advisors Inc., headquartered in Michigan, offers investment services and securities products. With approximately 1,000 financial advisors serving clients at approximately 270 branch offices, H&R Block Financial Advisors is a member NYSE, SIPC, a registered broker-dealer and investment advisor. H&R Block Inc. is not a registered broker-dealer and is not a registered investment advisor. H&R Block Mortgage Corp offers a full range of retail mortgage services. Option One Mortgage Corp., headquartered in California, provides mortgage services and offers wholesale mortgages through large financial institutions and a network of 24,000 independent mortgage brokers. RSM McGladrey Business Services Inc., headquartered in Minnesota, and its subsidiaries serve mid-sized businesses and their owners with tax, accounting and business consulting services, as well as personal wealth management services. H&R Block Small Business Resources, operating in 14 U.S. cities, serves the tax, financial and business needs of small business owners. H&R Block Small Business Resources is not a licensed CPA firm.

ROBERT A. WEINBERGER
ANSWERS TO FINANCE COMMITTEE QUESTIONS

From Senator Hatch:

Q: Mr. Weinberger, what are the main reasons Americans do not save more for their retirement? Is it a cultural thing? Would more and better education about the importance of saving make a difference? Do you think easy access to a retirement account with the promise of a strong match would make a big difference in the overall saving rate?

A: Culture is a factor. Consumption receives more attention than savings. People also tend to focus on immediate needs and, if they do plan, often underestimate future health and retirement needs. Better financial education can make a difference. Schools, employers, community groups, businesses, and government can all play a stronger role. H&R Block, for example, has increased the financial education we provide to our nearly 20 million tax clients even as we facilitated retirement savings.

Easier access to retirement accounts and financial incentives in the form of a match could make a real difference for middle- and low-income families' retirement savings, as our experience and the recent study done with many of our clients show.[1]

We see five main reasons that low-income families don't save enough for retirement.

First, many households lack available funds on a week-to-week basis to begin regular saving. Tax filing and resulting tax refunds can provide those resources in lump sums, which may not be available week to week. Tax refunds –averaging $2,100 in 2005 – are often the largest single payment that low-income families receive during the year. This makes many of our clients more comfortable with diverting a portion of this income into savings for the future. In addition, IRA deposits can be made for a given tax year up to April 15 of the following year. This enables many taxpayers, who receive year-end bonuses but cannot make a 401(k) contribution after December 31, to still save. Taxpayers who learn of a coming refund and the tax advantages available for savings can also use the opportunity. In contrast, many who want to save regularly during the year may be reluctant because they do not have a clear picture of their full financial situation until tax time.

Second, many are not able to take full advantage of existing savings incentives. While our tax system encourages work-related and personal retirement accounts, tax deductions provide the greatest financial incentives to those in the highest tax brackets and, because savings tax credits are not refundable, they don't reach over a third of tax filers who have no income tax liability. Thus, many middle- and low-income families, who need the most incentive to save, receive little or no tax benefit for savings. The St. Louis study done with H&R Block's clients demonstrates that a match for amounts saved, either through a direct deposit or a tax credit, can substantially increase a client's propensity to save.

Third, asset tests for many means-tested federal benefit programs penalize savings by making ineligible those who have accumulated assets of $2,000 or more. Taxpayers should not have to choose between

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[1] The Retirement Security Project, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," N° 2005-5 (May 2005), at http://www.pewtrusts.com/pdf/RSP_save_Incent.pdf (the "St. Louis study").

savings and food stamps. These tests need reasonable exceptions if we are to encourage savings and connect more low-income taxpayers to the banking system.

Fourth, many Americans lack knowledge of their real retirement needs and therefore under-save for the future. Here our experience shows that the advice of a trained professional can make a difference. By illustrating the benefits of compound interest on long-term savings, and guiding an individual through the process, they can be "wealth coaches," contributing strongly to improved savings behavior.

Finally, a lack of appropriately priced or structured savings vehicles can serve as a barrier. Many IRAs have high minimum deposit requirements or high annual fees that place them out of reach of lower-income savers. Products designed with low-minimum deposits, low-fees, high security (for example, in FDIC-insured accounts), and easy availability as a tax return is prepared and a refund is calculated can be more helpful.

From Democratic Members:

Q: How do you think it would influence your client's behavior if the credit were deposited to their IRA or 401(k) plan as a kind of matching contribution instead of going to the client?

A: There is some debate about this. On the one hand, evidence from other fields suggests that a matching contribution may be more effective in generating new contributions than an equivalent tax credit that goes directly to the client. Furthermore, funds deposited into the account seem likely to "stick" there and be saved. On the other hand, for some savers, barriers to saving can be overcome by showing a tax benefit as a "pain reliever" or reward. If they feel that depositing $1,000 in an account will only "cost" them $500 in a reduction in their refund due to a tax credit, they may be more inclined to save. In this sense the structure of the existing Saver's Credit can work for both types of savers in a way that requiring deposit of the full credit may not – it accommodates both goals. Thus, the effects of such a restriction could be mixed: it may increase the amount saved for those who do save, but it may discourage some potential savers from making a deposit due to the impact on their tax refunds. We will be exploring this specific question in more detail during the next phase of our work with the St. Louis project research team.

Q: The Saver's credit currently applies to the first $2,000 of contributions. Based on your experience with low to moderate income taxpayers, would it generate more or less savings if we increased the size of the credit and reduced the maximum amount of contribution eligible for the credit? For example, instead of 50% of the first $2,000 of contributions the credit might be 100% of the first $1,000 of contributions. Do you have other suggestions for redesigning the credit to increase utilization?

A: The available evidence does not allow us to determine definitively which version would be more effective at boosting contributions in the aggregate. Some believe that the 50% version up to $2,000 would generate more contributions in total (even though the 100% version up to $1,000 would likely a larger number of contributors). A 100% credit, furthermore, may raise concerns about potential gaming For this reason, the 50% version on the first $2,000 may be preferable.

A related issue is whether the incentive should be provided in the form of a matching contribution or a credit. The Saver's Credit maximum is 50% but the true effect is a 100% after-tax savings match: a $1,000 savings contribution "costs" $500 because a tax credit for $500 is provided. In other words, an after-tax-credit contribution of $500 (the $1,000 contribution minus the $500 tax credit) corresponds to a $1,000 account contribution, the same outcome as under a 100% match on a $500 contribution. Our experience suggests that how the incentive is presented to the taxpayer can make a big difference in the willingness to save. The St. Louis study showed that a saver's match can be a more powerful incentive than the Saver's Credit, but it is not clear whether all tax professionals were presenting the Saver's Credit in the most compelling way, so the full potential of the Saver's Credit may not be entirely clear. We hope further research will clarify whether a matching contribution is more effective than a credit.

The redesign that could have the most significant impact on savings is refundability. Currently only about 15% of those eligible for the maximum Saver's Credit on an income basis can take advantage of it because they have tax liability to offset. Making the credit refundable would make it available to the other 85% of low-income families, and the St. Louis matched savings test shows that many of them will save.

Another redesign worth considering would be smoothing the "cliffs" between the 50%, 20% and 10% credit rates, or simplifying the credit by having one rate of 50%. Currently very small increases in income can have a major effect decreasing the power of the incentive provided. As the St. Louis test confirmed, a 50% matching incentive is more powerful than a 20% match: While 17% of clients contributed with a 50% match, only 10% contributed with a 20% match.

From Senator Kerry:

Q: From H& R Block's experience with the St. Louis Matched Savings Test, do you think that one of the best ways to encourage individuals to save is by providing a match rather than a tax credit?

A: Both a tax credit and a direct match can increase savings. In the study itself, the match seemed to have a stronger effect but that may relate to the manner and context of presentation. The advantage of the type of match used in the test was its simplicity – clients were simply told of its availability and made a decision, and it was not necessary to perform extra calculations to claim the match. Much of this simplicity could be incorporated in a revised and expanded Saver's Credit. For example, making the credit refundable would make it available to all who qualify on the basis of income, eliminating the uncertainty surrounding eligibility, minimizing calculations necessary to determine eligibility, and reducing the amount of explanation needed. These types of changes could make the credit easier to grasp and increase utilization.

We intend to explore this critical question further in future research as noted in other responses to the committee.

Finally, the St. Louis study showed the value of drawing specific attention to savings incentives, be they direct matches or tax credits. A public education campaign to accompany a revived Saver's Credit (whether strengthened in its current form or revamped into a matching contribution), and improved tax professional training based on our learning, could have similar effects.

COMMUNICATIONS

"Encouraging Savings and Investment:
Stay the Course or Change Direction?"

a hearing by the

United States Senate Committee on Finance,
Subcommittee on Taxation and IRS Oversight

June 30, 2005

Statement for the Record of Michael J. Esser, Principal,
on behalf of
Edward D. Jones & Co., L.P.
12555 Manchester Road, St. Louis, MO 63131

Submitted July 13, 2005

Thank you for holding this important hearing on savings and investment and for providing me with the opportunity to make this statement for the record on behalf of Edward D. Jones & Co., L.P. Edward Jones is one of the largest investment firms in the country and a leader in the financial services industry. We have over 8,500 offices throughout the country, more than any other investment firm in America. We take a personal approach to serving our nearly 6 million clients, and attribute a great deal of our success to our principles and personal, long-term approach to investing.

The focus of our statement for the record is the federal income tax treatment of capital gains and dividends. Specifically, we urge Congress to make permanent the reduced tax rates for capital gains and dividends that were enacted on a temporary basis as part of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "2003 Act"). As explained in more detail below, Edward Jones believes that making these reduced tax rates permanent will benefit individuals and families by reducing their tax burdens and encouraging them to invest and save, which in turn will benefit the capital markets and the overall economy.

Background

Under our federal tax system, the return on equity invested in corporations generally is taxed twice – once as corporate profits and again as dividends or capital gains received by investors. This double tax encourages corporations to finance more of their investments by selling bonds rather than stock and by retaining earnings rather than by paying dividends. This, in turn, discourages the most efficient use of corporate capital and interferes with the allocation of corporate investment to the use with the highest economic return. (Congressional Budget Office)

The 2003 Act went a long way towards mitigating the inefficiencies in our economy that result from the double taxation of corporate profits and has encouraged more savings and investment by individuals. Specifically, for capital gains that had been taxed at a 20 percent rate, the 2003 Act reduced the rate to 15 percent. In addition, for capital gains that had been taxed at either an

8 or 10 percent rate, the 2003 Act reduced the rate to 5 percent until 2007, after which the rate is scheduled to drop to zero. The 2003 Act also significantly improved the tax treatment of dividends by applying the lower capital gains rates to dividends, which under prior law were taxed at much higher ordinary income tax rates.

Millions of American families have benefited from these tax reductions, and the changes have proven to be a huge success in promoting investment and savings. However, the changes made by the 2003 Act will expire at the end of 2008 unless Congress enacts additional legislation to make them permanent. If Congress does not act, investments made after 2008 will not benefit from the reduced rates at all, and many investments made before that time will benefit only partially because some of their returns will be earned after 2008. Hence, unless Congress acts soon, the benefits we already have seen from the 2003 Act will be lost.

Moreover, the uncertainty regarding the future of the rate reductions is causing unnecessary conservatism and caution in long-term planning by individual investors and companies alike. Investors are not sure whether the lower tax rates will continue to apply to their capital gains and whether they should purchase dividend-paying stocks as part of their long-term investment strategies. Likewise, because capital investments by companies typically require long-term planning, the temporary and uncertain nature of the 2003 Act's provisions hinder such planning. Furthermore, because companies normally set their regular dividend levels so they can be maintained for the foreseeable future (since the market typically responds negatively to a reduction in regular dividends), they necessarily exercise conservative judgment in doing so – a conservatism that is increased due to the temporary and uncertain nature of the 2003 Act's rate reductions. Absent this uncertainty, the rate reductions could result in even more dividend payments than already have occurred thanks to the 2003 Act.

Finally, the temporary nature of the 2003 Act's provisions could result in unnecessary volatility and instability in the financial markets, as individuals and businesses artificially accelerate the timing of their activities to realize returns prior to the Act's sunset. All of this leads to the clear conclusion that Congress not only needs to take action to make the 2003 Act permanent, but it needs to take that action now.

<u>The Success Story of the 2003 Tax Rate Reductions</u>

The clear response to the 2003 reductions to the tax rates for investments was that corporations began declaring more and larger dividends to investors. For example, in 2004 the number of publicly traded corporations that began paying dividends increased by 500% over prior years' averages (113 companies began paying dividends in 2004, compared to an average of 22 in prior years). (Securities Industry Association)

Many other companies significantly increased the size of their dividend payments. For example, in each of the three quarters after the 2003 Act was enacted, an average of 65 companies that were already paying dividends increased the size of those dividends by 20 percent or more, compared to an average of only 25.5 companies per quarter in 2002 and 32 companies per quarter in prior periods that had an increase of this magnitude. (National Bureau of Economic

Research) In addition, the Securities Industry Association recently found that dividend increases since the beginning of 2004 equaled all dividend increases between 1994 and 2002 combined.

Furthermore, Treasury Department data shows that the lower tax rates on capital gains and dividends saved 24 million households an average of almost $950 on their 2004 taxes. The reduced tax rates have particularly benefited seniors, seven million of whom saved in excess of $1,230 on their 2004 tax returns thanks to the rate reductions. Moreover, based on historical demographics of Americans who have stock and receive dividend income, the tax savings for Americans has been distributed across income groups. In this regard, among taxable returns reporting dividend income in 2002, nearly 60% had adjusted gross incomes below $75,000.

In addition, the lower rates play an important role in improving corporate governance and increasing investor confidence. Prior tax laws created an incentive for companies to reinvest their earnings and thereby increase their stock prices in order for shareholders to benefit from capital gain rates, and a disincentive for companies to distribute their earnings as dividends taxed at ordinary income tax rates. By equalizing the treatment of dividends and capital gains, the 2003 Act removed the disincentive to pay dividends, and the increased dividend payments have left companies with less cash on hand to reinvest in their businesses. This, in turn, has created an incentive for managers to be more efficient by investing only in the best capital projects available to their companies.

Moreover, the 2003 Act's changes to dividend taxation have made it easier for companies to raise capital through dividend-paying stock, when they previously might have turned to debt or other forms of financing. Furthermore, as seen in some of the recent and widely publicized corporate scandals, stock prices can be subject to manipulation when questionable accounting practices are used to overstate profitability or understate losses. Because dividends can be paid only out of actual cash on hand, they provide a more tangible and reliable way than accounting statements to measure profitability. (American Shareholders Association) This improved corporate governance and correspondingly more reliable measure of profitability boosts investor confidence and encourages more investment and savings.

<u>The Need to Make the 2003 Rate Reductions Permanent</u>

The need to make the capital gains and dividend tax rate reductions permanent has already been acknowledged by the Administration and Members of Congress. The Administration included a permanent extension of the lower rates in its fiscal year 2006 budget proposal. In addition, Senators Jon Kyl (R-AZ) and Bill Frist (R-TN) introduced legislation (S. 7) that would make the reduced rates permanent, and Rep. Eric Cantor (R-VA) introduced similar legislation in the House (H.R. 809).

These proposals, which Edward Jones strongly supports, recognize that the temporary nature of the rate reductions has started to cause investors to become increasingly uncertain about investing in dividend-paying stocks. Similarly, capital investments by companies take time to plan and implement, and firms are less likely to fully adjust their long-term plans to take into account the lower rate in light of the uncertainty of how long those rates will be available. This uncertainty will only increase as the 2008 sunset of the rate reductions approaches, which will erode the positive effects that these provisions of the 2003 Act have had on investing and saving and our overall economy.

Moreover, companies and individual investors may accelerate the timing of their activities in order to realize returns prior to the sunset. Such decisions could add volatility and potential instability to the financial markets. **In short, as the Congressional Budget Office said in a recent report, "many of the gains in efficiency that could result from the effects of the lower rates on the allocation of investment will not be realized unless [the rates are] perceived to be permanent."**

Making the dividends and capital gains tax rate reductions permanent would eliminate the uncertainty that threatens to undo the success that the rate reductions have had since their temporary enactment. Permanence would benefit individuals and families by making it more advantageous to invest and by providing them with more confidence that they can do so wisely. Likewise, increased investment would benefit the overall economy by boosting long-term growth and productivity, and would benefit the capital markets by improving efficiency and reducing financial costs by lowering the cost of capital so that it can be put to more productive uses. However, to achieve these goals and preserve the positive impact that the rate reductions have had to date, Congress needs to act now.

For these reasons, Edward Jones urges Congress to make permanent the capital gains and dividend tax rate reductions that were enacted as part of the 2003 Act.

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We appreciate the opportunity to provide this statement for the record. If there is any additional information that Edward Jones can provide to your subcommittee, please do not hesitate to contact Michael J. Esser at Edward Jones Investments, 12555 Manchester Road, St. Louis, MO 63131 or (314) 515-4991.

ESCA

EMPLOYEE-OWNED S CORPORATIONS OF AMERICA

STATEMENT OF THE
EMPLOYEE-OWNED S CORPORATIONS OF AMERICA

BEFORE THE

SENATE COMMITTEE ON FINANCE

HEARING ON

ENCOURAGING SAVINGS AND INVESTMENT: STAY THE COURSE OR CHANGE DIRECTION?

JUNE 30, 2005

Background

The Employee-Owned S Corporations of America (ESCA) speaks exclusively for America's employee-owned Subchapter S corporations, which successfully reflects current pension and retirement savings policies. We appreciate the opportunity to submit a statement to the Committee in the context of its efforts to review the state of U.S. savings and investment policies and assess proposed modifications to current law.

As the Chairman and members of the Committee may already know, thousands of private S corporation businesses across the country are owned by their employees through ESOPs, or employee stock ownership programs – making hundreds of thousands of American workers owners of the S corporations for which they work. Subchapter S ESOP companies, in fact, operate in virtually every state in the nation, in industries ranging from groceries to general contracting, pizza parlors to printing, health care suppliers to heavy manufacturing.

As the Chairman and Members of the Committee work to identify the most pressing challenges in our current national savings and investment policies, we wish to take this opportunity to highlight something that is working under the current system, and which creates tremendous retirement savings benefits, through ownership, for working Americans: the S corporation ESOP.

Employee-Owned Companies Reflect America's "Ownership Society"

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Because they are employee-owned, private ESOP companies offer their employees perhaps the ultimate retirement savings opportunity: the availability to directly benefit from their employers' growth through an equity stake in the businesses where they work.

It is not a surprise that employees who own stock in their companies tend to be more productive; these employees understand that their work will generate economic benefits to them as owners of the business. Indeed, academic analysis has demonstrated over and over again that employee ownership translates into measurable economic gains for ESOP companies, not to mention enhanced job security for the employee-owners of these businesses. Employee ownership generates, on average, productivity increases of 4 to 5 percent compared to non-ESOP companies; it also tends to enhance employment stability and the long-term survival of companies that are employee-owned.[1]

Among S corporation ESOPs, which Congress created in 1996, another impressive and important trend has emerged: Workers in these closely held, employee-owned companies are amassing significant wealth by virtue of their equity interests in their firms. Today, employee-owners across the country have amassed enormous retirement savings through their stakes in S-ESOPs, allowing them to retire early in many cases, while limiting or eliminating their dependence on other federal or federally insured retirement benefits in others. In Minnesota, an administrative worker at a church photography company who never earned more than $35,000 in annual salary retired not long ago with more than $1 million in her ESOP account. In Ohio, a 55-year-old line worker at a book products manufacturer -- whose current salary is around $30,000 – boasts an S-ESOP account balance of nearly **$12 million**.

While these particular instances of success stand out, the circumstances that gave rise to them are the rule, not the exception, for S corporation employee-owners. These and thousands of other workers in S corporations – not just upper management, but workers on the line, on the shop floor, on the receiving bay -- are building wealth and savings in their ESOP accounts, and at a rate that outpaces by far what they are able to accumulate in personal savings, or even in other qualified retirement accounts.

Sub S ESOP accounts are funded distributions made by the company and, according to law, these accounts cannot be accessed until workers meet diversification eligibility requirements wisely adopted by Congress. Because S corporation ESOP accounts are allowed to grow and compound; because they can be funded at higher levels than many other qualified plans; and because the value of an ESOP company is often enhanced by the commitment of its employee-owners to the company's bottom line, S corporation ESOP accounts often become substantial retirement savings vehicles for working Americans. Through S corporation ESOP accounts, moreover, these workers have something no other qualified retirement plan can offer them: a direct ownership stake in their company.

S corporation ESOPs are indeed qualified retirement plans, but they are superior relative to other retirement savings vehicles because the investment that these employee-owners make is a knowledgeable one. They know the company. They know the management.

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[1] *See "Sharing Ownership via Employee Stock Ownership," James Sesil, Douglas L. Kruse and Joseph R. Blasi, United Nations University, July 2001.*

They have a voice in the business through the ESOP. Most importantly, however, they are investing in themselves, their own hard work and dedication.

That is why it is not surprising, only a decade later, to see the proliferation of real wealth among S corporation ESOP participants. And that is also why these plans are hallmarks of America's ownership society.

Conclusion

As this Committee assesses ways in which it can promote fair and effective retirement savings opportunities for working Americans, ESCA and the thousands of employee-owners for whom we speak urge that the rules enabling and encouraging S corporation ESOPs be preserved and promoted. We thank the Chairman and the Committee for their consideration of our views, and welcome any questions that may ensue.

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