

Comments for the Record
House Committee on Ways and Means
The President's Fiscal Year 2013 Budget Proposal

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Center for Fiscal Equity

Chairman Camp and Ranking Member Levin, thank you for the opportunity to submit these comments for the record to the House Ways and Means Committee. The beginning of the budget debate for a new year brings with it the opportunity to rethink proposals. The Center for Fiscal Equity is using this opportunity to change our proposed fix for Social Security, which we will address in due course in our comments, which outline how Congress can respond to the President's Budget submission. Congress has four options in pursuing fiscal policy this year. It can do nothing, it can play small, it can play medium or it can go big. Our comments will address each possibility.

Doing nothing is a possible solution to almost every issue. At the end of the calendar year, the tax cuts of 2001, 2003 and 2010 expire automatically, as do the recently extended payroll tax cut, extended unemployment insurance benefits and the suspension of the "Doc Fix" for doctors serving Medicare patients. Allowing these provisions to expire essentially solves the nation's fiscal problems in the long term.

If the economy is more robust in December than current forecasts suggest, which is possible if ambitious solutions are pursued by the Federal Reserve on the underwater mortgage issue, this may be the most realistic option – although in our view it would be a lost opportunity for long term reform. This is not likely, however, as richest Americans (including doctors) who by and large fund the anti-tax movement, would be the hardest hit should permanent law come back into force, and would become the loudest voices for compromise to avoid this.

On the expenditure side, the Budget Control Act of 2011 contains within it spending caps which effectively serve as budget allocations for the purpose of enacting appropriations – making a concurrent budget resolution entirely unnecessary for the upcoming fiscal year. Voices who continue to claim that the Senate has not enacted a budget in 1000 days should be silent and if they continue to make this claim, held up to public ridicule because they should know better.

If the law included automatic enactment of the current service budget within these allocations, as we have suggested, then the only action required for this fiscal year would be extension of the debt limit, although some analysts, among them Bruce Bartlett, have suggested that the limit itself is unconstitutional and could be dispensed with, either in law or by Administration decree. Automatic enactment of the budget and dispensing with the debt limit would spur the Congress to enact timely compromise, which would end the impulse to gridlock.

There are two ways that Congress and the Administration can play small ball. Sadly, this is the most likely scenario given the state of the national economy. The most likely way is to delay action until after the election and, as a package, extend the debt limit through December 2013 in exchange for extending the expiring income, payroll, unemployment and medical payment provisions for an equal period of time, accepting the temporary pain of one year of sequestration.

A slightly more ambitious version of this scenario, which leaves less to chance as far as the impact of the election (as a lame duck President has no interest in any compromise at all) is to extend the debt limit, doc fix suspension, the payroll tax cut, extended unemployment and tax rates for middle class and wealthy taxpayers through July 2013 in exchange for making certain tax cuts for lower income Americans permanent, including the 10% tax rate and expanded Child Tax Credit – offsetting some or all of the spending cuts that have already been agreed to. This allows discourse on tax reform without holding our most vulnerable citizens hostage.

Should the President indicate that he is likely to let gridlock rule the day, a medium ball solution is more likely as opposition to a balanced solution evaporates as the likelihood of automatic tax cuts increases. The balanced solution is some combination of the cuts and tax reforms supported by the majority of the Fiscal Commission, also known as Bowles-Simpson, and the proposals of the Bipartisan Policy Center, also known as Rivlin-Domenici. Many of these proposals are similar and where they coincide seems like a fruitful place to start drafting legislation. Using the congressional budget process to begin enacting these provisions could occur in regular order, with the Department of the Treasury playing a supporting role in writing tax reform language.

The large ball game would be to actually balance the budget and enact radical reform in entitlement revenue and spending provisions, a shift from income taxes for most filers to consumption taxes and higher tax rates on those most ability to pay. The Center for Fiscal Equity proposes a large ball solution with four major provisions:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of \$100,000 and single filers earning \$50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves, with distributions from sales to a qualified ESOP continuing to be exempt.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

We have no proposals regarding environmental taxes, customs duties, excise taxes and other offsetting expenses, although increasing these taxes would result in a lower VAT. American competitiveness is enhanced by enacting a VAT, as exporters can shed some of the burden of taxation that is now carried as a hidden export tax in the cost of their products. The NBRT will also be zero rated at the border to the extent that it is not offset by deductions and credits for health care, family support and the private delivery of governmental services.

Some oppose VATs because they see it as a money machine, however this depends on whether they are visible or not. A receipt visible VAT is as susceptible to public pressure to reduce spending as the FairTax is designed to be, however unlike the FairTax, it is harder to game. Avoiding lawful taxes by gaming the system should not be considered a conservative principle, unless conservatism is in defense of entrenched corporate interests who have the money to game the tax code.

Our VAT rate estimates are designed to fully fund non-entitlement domestic spending not otherwise offset with dedicated revenues. This makes the burden of funding government very explicit to all taxpayers. Nothing else will reduce the demand for such spending, save perceived demands from bondholders to do so – a demand that does not seem evident given their continued purchase of U.S. Treasury Notes.

Value Added Taxes can be seen as regressive because wealthier people consume less, however when used in concert with a high-income personal income tax and with some form of tax benefit to families, as we suggest as part of the NBRT, this is not the case.

The shift from an income tax based system to a primarily consumption based system will dramatically decrease participation in the personal income tax system to only the top 20% of households in terms of income. Currently, only roughly half of households pay income taxes, which is by design, as the decision has been made to favor tax policy to redistribute income over the use of direct subsidies, which have the stink of welfare. This is entirely appropriate as a way to make work pay for families, as living wage requirements without such a tax subsidy could not be sustained by small employers.

The income surtax is earmarked for overseas military, naval sea and international spending because this spending is most often deficit financed in times of war. Earmarking repayment of trust funds for Social Security and Medicare, acknowledges the fact that the buildup of these trust funds was accomplished in order to fund the spending boom of the 1980s without reversing the tax cuts which largely benefited high income households.

Earmarking debt repayment and net interest in this way also makes explicit the fact that the ability to borrow is tied to the ability to tax income, primarily personal income. The personal or household liability for repayment of that debt is therefore a function of each household's personal income tax liability. Even under current tax law, most households that actually pay income taxes barely cover the services they receive from the government in terms of national defense and general government services. It is only the higher income households which are truly liable for repayment of the national debt, both governmental and public.

If the debt is to ever be paid back rather than simply monetized, both domestically and internationally (a situation that is less sustainable with time), the only way to do so without decreasing economic growth is to tax higher income earners more explicitly and at higher rates than under current policy, or even current law.

The decrease in economic class mobility experienced in recent decades, due to the collapse of the union movement and the rapid growth in the cost of higher education, means that the burden of this repayment does not fall on everyone in the next generation, but most likely on those who are living in high income households now.

Let us emphasize the point that when the donors who take their cues from Americans for Tax Reform bundle their contributions in support of the No Tax Pledge, they are effectively burdening their own children with future debt, rather than the entire populace. Unless that fact is explicitly acknowledged, gridlock over raising adequate revenue will continue.

Unlike other proposals, a graduated rate for the income surtax is suggested, as at the lower levels the burden of a higher tax rate would be more pronounced. More rates make the burden of higher rates easier to bear, while actually providing progressivity to the system rather than simply offsetting the reduced tax burden due to lower consumption and the capping of the payroll tax for Old Age and Survivors Insurance.

One of the most oft-cited reforms for dealing with the long term deficit in Social Security is increasing the income cap to cover more income while increasing bend points in the calculation of benefits, the taxability of Social Security benefits or even means testing all benefits, in order to actually increase revenue rather than simply making the program more generous to higher income earners. Lowering the income cap on employee contributions, while eliminating it from employer contributions and crediting the employer contribution equally removes the need for any kind of bend points at all, while the increased floor for filing the income surtax effectively removes this income from taxation. Means testing all payments is not advisable given the movement of retirement income to defined contribution programs, which may collapse with the stock market – making some basic benefit essential to everyone.

Moving the majority of Old Age and Survivors Tax collection to a consumption tax, such as the NBRT, effectively expands the tax base to collect both wage and non-wage income while removing the cap from that income. This allows for a lower tax rate than would otherwise be possible while also increasing the basic benefit so that Medicare Part B and Part D premiums may also be increased without decreasing the income to beneficiaries.

If personal accounts are added to the system, a higher rate could be collected, however recent economic history shows that such investments are better made in insured employer voting stock rather than in unaccountable index funds, which give the Wall Street Quants too much power over the economy while further insulating ownership from management. Too much separation gives CEOs a free hand to divert income from shareholders to their own compensation through cronyism in compensation committees, as well as giving them an incentive to cut labor costs more than the economy can sustain for purposes of consumption in order to realize even greater bonuses. Employee-ownership ends the incentive to enact job-killing tax cuts on dividends and capital gains, which leads to an unsustainable demand for credit and money supply growth and eventually to economic collapse similar to the one most recently experienced.

The NBRT base is similar to a Value Added Tax (VAT), but not identical. Unlike a VAT, an NBRT would not be visible on receipts and should not be zero rated at the border – nor should it be applied to imports. While both collect from consumers, the unit of analysis for the NBRT should be the business rather than the transaction. As such, its application should be universal – covering both public companies who currently file business income taxes and private companies who currently file their business expenses on individual returns.

In the long term, the explosion of the debt comes from the aging of society and the funding of their health care costs. Some thought should be given to ways to reverse a demographic imbalance that produces too few children while life expectancy of the elderly increases.

Unassisted labor markets work against population growth. Given a choice between hiring parents with children and recent college graduates, the smart decision will always be to hire the new graduates, as they will demand less money – especially in the technology area where recent training is often valued over experience.

Separating out pay for families allows society to reverse that trend, with a significant driver to that separation being a more generous tax credit for children. Such a credit could be “paid for” by ending the Mortgage Interest Deduction (MID) without hurting the housing sector, as housing is the biggest area of cost growth when children are added. While lobbyists for lenders and realtors would prefer gridlock on reducing the MID, if forced to choose between transferring this deduction to families and using it for deficit reduction (as both Bowles-Simpson and Rivlin-Domenici suggest), we suspect that they would choose the former over the latter if forced to make a choice. The religious community could also see such a development as a “pro-life” vote, especially among religious liberals.

Enactment of such a credit meets both our nation’s short term needs for consumer liquidity and our long term need for population growth. Adding this issue to the pro-life agenda, at least in some quarters, makes this proposal a win for everyone.

The expansion of the Child Tax Credit is what makes tax reform worthwhile. Adding it to the employer levy rather than retaining it under personal income taxes saves families the cost of going to a tax preparer to fully take advantage of the credit and allows the credit to be distributed throughout the year with payroll. The only tax reconciliation required would be for the employer to send each beneficiary a statement of how much tax was paid, which would be shared with the government. The government would then transmit this information to each recipient family with the instruction to notify the IRS if their employer short-changes them. This also helps prevent payments to non-existent payees.

Assistance at this level, especially if matched by state governments may very well trigger another baby boom, especially since adding children will add the additional income now added by buying a bigger house. Such a baby boom is the only real long term solution to the demographic problems facing Social Security, Medicare and Medicaid, which are more demographic than fiscal. Fixing that problem in the right way definitely adds value to tax reform.

The NBRT should fund services to families, including education at all levels, mental health care, disability benefits, Temporary Aid to Needy Families, Supplemental Nutrition Assistance, Medicare and Medicaid. If society acts compassionately to prisoners and shifts from punishment to treatment for mentally ill and addicted offenders, funding for these services would be from the NBRT rather than the VAT.

The NBRT could also be used to shift governmental spending from public agencies to private providers without any involvement by the government – especially if the several states adopted an identical tax structure. Either employers as donors or workers as recipients could designate that revenues that would otherwise be collected for public schools would instead fund the public or private school of their choice. Private mental health providers could be preferred on the same basis over public mental health institutions. This is a feature that is impossible with the FairTax or a VAT alone.

To extract cost savings under the NBRT, allow companies to offer services privately to both employees and retirees in exchange for a substantial tax benefit, provided that services are at least as generous as the current programs. Employers who fund catastrophic care would get an even higher benefit, with the proviso that any care so provided be superior to the care available through Medicaid. Making employers responsible for most costs and for all cost savings allows them to use some market power to get lower rates, but not so much that the free market is destroyed. Increasing Part B and Part D premiums also makes it more likely that an employer-based system will be supported by retirees.

Enacting the NBRT is probably the most promising way to decrease health care costs from their current upward spiral – as employers who would be financially responsible for this care through taxes would have a real incentive to limit spending in a way that individual taxpayers simply do not have the means or incentive to exercise. While not all employers would participate, those who do would dramatically alter the market. In addition, a kind of beneficiary exchange could be established so that participating employers might trade credits for the funding of former employees who retired elsewhere, so that no one must pay unduly for the medical costs of workers who spent the majority of their careers in the service of other employers.

Conceivably, NBRT offsets could exceed revenue. In this case, employers would receive a VAT credit.

The Center calculates an NBRT rate of 27% before offsets for the Child Tax Credit and Health Insurance Exclusion, or 33% after the exclusions are included. This is a “balanced budget” rate. It could be set lower if the spending categories funded receive a supplement from income taxes. These calculations are, of course, subject to change based on better models.

In testimony before the Senate Budget Committee, Lawrence B. Lindsey explored the possibility of including high income taxation as a component of a Net Business Receipts Tax. The tax form could have a line on it to report income to highly paid employees and investors and pay surtaxes on that income.

The Center considered and rejected a similar option in a plan submitted to President Bush’s Tax Reform Task Force, largely because you could not guarantee that the right people pay taxes. If only large dividend payments are reported, then diversified investment income might be under-taxed, as would employment income from individuals with high investment income. Under collection could, of course, be overcome by forcing high income individuals to disclose their income to their employers and investment sources – however this may make some inheritors unemployable if the employer is in charge of paying a higher tax rate. For the sake of privacy, it is preferable to leave filing responsibilities with high income individuals.

Dr. Lindsey also stated that the NBRT could be border adjustable. We agree that this is the case only to the extent that it is not a vehicle for the offsets described above, such as the child tax credit, employer sponsored health care for workers and retirees, state-level offsets for directly providing social services and personal retirement accounts. Any taxation in excess of these offsets could be made border adjustable and doing so allows the expansion of this tax to imports to the same extent as they are taxed under the VAT. Ideally, however, the NBRT will not be collected if all employers use all possible offsets and transition completely to employee ownership and employer provision of social, health and educational services.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

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