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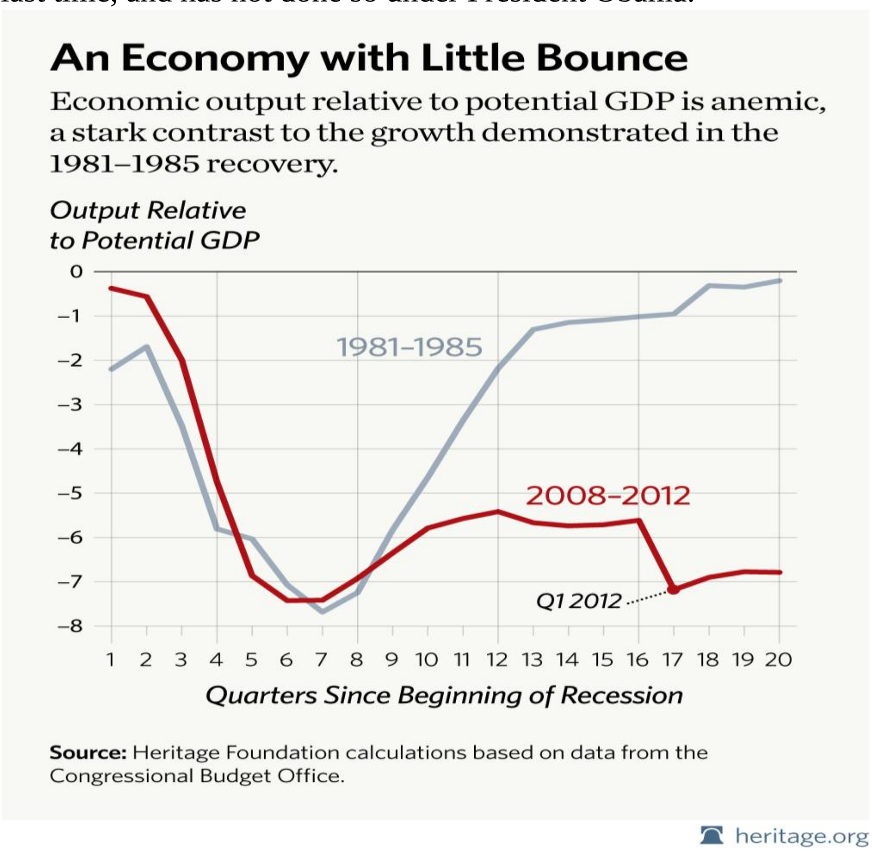
Chairman Baucus, Ranking Member Hatch, Members of the Senate Finance Committee, thank you for the opportunity to testify today. My name is J. D. Foster. I am the Norman B. Ture Senior Fellow in the Economics of Fiscal Policy at The Heritage Foundation. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

The risks to the economy remain great, and so too does the need to focus on jobs and economic growth. Last year, the economy grew at a pedestrian 1.7 percent, according to the latest estimates. Most private forecasts for 2012 are only slightly more optimistic. Even the Administration's otherwise remarkably rosy budget forecast shows only 2.7 percent growth for 2012.

Approaching three years after the end of the Great Recession, the economy should be accelerating smartly. It isn't. We have a couple decent quarters of growth, followed by worries of renewed recession. Speculation, argumentation, theorizing, and models are now irrelevant on this point. The President's stimulus policies failed. What recovery we now experience is demonstrably not attributable to his stimulus policies, but to the natural strengths of the United States economy operating despite, not with help from, the President's policies.

The unique weakness in the current recovery becomes most apparent when compared to the last recession of similar magnitude which began in 1981. As the chart below shows, the recent and earlier recessions were similarly deep and painful, yet the economy bounced back sharply the last time, and has not done so under President Obama.



I take no pleasure in pointing out this inescapable reality, nor in the fact that I predicted this policy failure three years ago. I would much rather have been wrong and for millions of my fellow citizens to be gainfully employed in all those jobs the President promised to create.

The federal government employed an impressive array of fiscal stimulants to the U.S. economy to soften the recession's blow and accelerate recovery. President George W. Bush started the effort with a mostly ineffectual $113 billion stimulus based on tax rebate checks and 50 percent expensing for business equipment investment. The economy didn't notice. President Barack Obama picked up the pace with his big stimulus bill and a succession of lesser efforts totaling in excess of a trillion dollars, featuring such creative ideas as the cash for clunkers program, the first-time home buyer's credit, the payroll tax holiday, and others.

Two years after the recovery began, the economy is stumbling along, and the unemployment rate remains well above 8 percent and threatens to climb once again. Like new jobs, real hope is in short supply. As some have argued, one might conclude from these facts that the problem with these stimulants on balance was that they were not aggressive enough. That is a tough argument to sell when the budget deficit jumped by almost $1 trillion, or about 7 percentage points as a share of GDP from 2008 to 2009. If Keynesian stimulus theory held any validity, the economy should be racing forward today, propelled by this onrush of debt. Instead, all we have is the debt.

Sadly, in the aggregate these policies were doomed to fail. They were similarly doomed to failure in their particulars. Rarely has a clunker of a plan been better labeled than "cash for clunkers." As expected, the first-time home buyers' credit made matters worse as it primarily shifted the timing of housing purchases while temporarily scrambling the process of price discovery essential to recovery. Both policies proved, once again, that incentives really do matter. But they also proved the benefits from artificial incentives applied temporarily are similarly fleeting.

Even the payroll tax holiday was of no effect because the tax does not fall on employers but on workers. The holiday temporarily increased workers' after-tax wages, which helped family finances and may have temporarily increased the supply of labor, but it did nothing to employers' costs and so did nothing for the demand for workers.

The point of this is not the painful recitation of failed policies, but to argue that the economy can recover and prosper only in a healthier economic environment in which government's role is shrinking and clarifying, not expanding and confusing through policy gimmicks that rarely help and more often hurt the recovery. This is how one should approach both the issue of tax incentives for business investment or otherwise and similar policy gimmicks outside the realm of tax policy considered as economic stimulus.

Tax Neutrality versus Tax Incentives for Business

Businesses do not need new tax incentive trinkets to encourage them to invest today. To contribute to a more rapid recovery, businesses need two fundamental changes in tax policy: tax certainty and a reduction in fundamental tax disincentives. The foremost threat to tax certainty today is the President's repeated insistence that individual income tax rates go up. These are the rates paid by all businesses that are not C chapter corporations.

Some will argue these rates fall on only a very small percentage of small businesses. While this is correct, one can scarcely imagine a less relevant statistic. A great many individuals report income on the side, income that means they are included in the ranks of "small businesses." What is relevant to the economy is the small business that actually engages in substantial trade or business and that hires workers. According to a recent study by the Obama Treasury Department[1], businesses that pay their taxes through the individual income tax and employ workers earn 90 percent of the income targeted by President Obama for higher taxes. President Obama's tax hike proposals could not target America's job creators—small businesses—for higher taxes more effectively with a GPS guidance system.

The federal income tax code is rife with distortions, so the growing interest in revenue-neutral tax reform is most welcome. Businesses do not need more tax distortions; they need a tax code that reduces the tax distortions to their economic decisions as to how much to invest, where to invest, what to produce, and how to finance their operations. In short, businesses need a neutral tax system, not a newly biased tax system.

Positive Forces for Growth – Expensing and Lower Tax Rates

President Obama is to be applauded for his support for broad expensing of capital purchases. This policy eliminates a clear tax bias against business investment and would help the economy in the long run. Unfortunately, expensing's effectiveness has been substantially diminished under current circumstances, specifically the current low levels of interest rates and the depth and duration of the recession.

Relative to the alternatives, expensing increases the present value of capital cost recovery. Very low interest rates reduce the time value of money, and so reduce expensing's economic benefit. However, as interest rates return to more normal levels in the coming years, and then continue to rise under pressures from the enormous increase in U.S. public debt, the importance of expensing will return in full.

Expensing's benefits have also been minimized by the depth and duration of the recession, and the pervasive unease of investors about the future. Substantial excess capacity and a lack of optimism about the future leave many businesses investing only as much as they have to, rather than as much as they could in more hopeful times. The well-advertised mountain of cash reserves on which America's corporations sit today testifies to the truth of this statement.

In contrast to fundamental changes like expensing, if Congress offers special tax goodies to preferred industries like the new wards of the state known as the renewable energy industry, then

[1] See Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitcher, James Pearce, and Richard Prisinzano, "Methodology to Identify Small Businesses and their Owners," *Technical Paper* No. 4, U.S. Department of the Treasury, Office of Tax Analysis, August 2011, at http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf.

to be sure those industries will provide the expected assurances as to what they will do with the tax relief and all the good that will follow from it. Few turn down an apparently free lunch.

Put no confidence in these assurances. On balance, the economy will not be strengthened thereby, the nation's resources of labor and capital will be put to less productive uses, and yet another industry will become more attentive to Washington's goodybag than to their customers and workers.

Reforms that would simplify the tax system while reducing the biases against economic growth center on reducing the tax biases against personal saving and investment and involve reducing effective marginal tax rates. The tax code is far less punitive in terms of personal saving today than it was a couple of decades ago, but there is still far to go. Moreover, the issue is as much a matter of saving to ensure a degree of economic security while working and in retirement as it is a matter of increasing the amount of domestic saving available to finance domestic investment.

In addition to moving toward a neutral tax base, business investment would accelerate over time if tax rates for both C corporations and all other businesses were reduced substantially. Again, President Obama is to be applauded loudly for his framework for corporate tax reform featuring a 28 percent top corporate income tax rate. This may well prove a landmark event in the history of American tax policy. While there was much else in his framework that would do enormous harm to the economy, the centerpiece of the proposal, which should not be lost in these details, is a drive to lower the corporate income tax rate.

Lower statutory tax rates are important because they would lower the hurdle rate on investment, or cost of capital. Businesses would increase their investment, despite today's dismal economy and high levels of excess capacity, because lower rates would signal a sea change for the better in Washington thinking about corporate tax policy.

The President's framework to reduce the corporate tax rate, while welcome, is nevertheless curious when considered alongside his proposal to increase significantly the tax rates paid by all other businesses. One might easily surmise that the President has a high regard for the importance of large companies, and little or no real appreciation of the importance of small businesses to job creation and economic dynamism.

A common refrain today is that tax reform should "broaden the base and lower the rates." This is close but not quite correct. One could, for example, have a very broad base by taxing every dollar of business receipts and every dollar of individual income. This massive tax base would permit a very low tax rate, but it also would substitute one set of distortions for another and likely produce a nasty recession and a weaker economy in the long run. Broadening the tax base is fine as long as the goal is not simply a broad tax base but a neutral tax base where, again, neutrality means the definition of what is taxed creates neither artificial incentives nor disincentives. This is essentially where the President's corporate tax reform framework runs off the tracks. His framework broadens the base to the point of overstating taxable income and thus losing much of the benefit he would obtain from lower rates.

Finally, with respect to tax policies that would help the economy, one must acknowledge something of a conflict between the goals of tax certainty and pro-growth revenue-neutral tax reform designed to achieve a neutral tax base and lower rates. Perfect tax certainty precludes any tax changes, including positive changes from tax reform. No one can say, once started, where tax reform will end. For policymakers and economists, this is a source of concern. It is much worse for businesses facing difficult decisions. Given the current weakened state of the economy, any ill-defined move toward tax reform would increase the uncertainty in the economy, adding substantially to the economy's headwinds.

To Help the Economy Today, Do Less Harm

There is much more the federal government could do to help the economy today, a list that need not fall back on policy gimmicks. To understand which policies might be helpful today and which would be harmful, it is important to assess why the economy is not yet recovering. The fundamentals of our economy remain sound. The natural productive tendencies of America's workers, investors, and entrepreneurs remain undiminished. The economy is poised to grow. Why, then, does it still hold back?

There are, of course, the unusual headwinds, such as the ongoing weakness in the domestic housing sector, with prices still falling and stagnant new construction, but the economy faces and overcomes such headwinds even in the best of times. Headwinds there are, to be sure, but they do not explain the economy's lethargy.

The economy suffers from two categories of troubles. The first are structural, which today primarily reflect a housing sector still in deep disequilibrium in many areas of the country. There is very little substantively that government can do to restore housing markets , and heaven knows Congress and the President have tried just about everything.

And that is part of the problem: Government's well-intentioned meddling has delayed and distorted the essential requirement for normalization—price discovery. On balance, these policies have set back the housing recovery by months, perhaps a year or more. There is an important lesson here.

The second category of trouble is what might be termed environmental—not the natural environment, but the economic environment. Missing from most economics textbooks are the true animating forces of prosperity. Most relevant for our discussion is, alternatively, a shortage of confidence or an excess of bad uncertainty.

Those who could make the decisions and take the actions that would grow the economy lack the confidence to do so. Even today, the economy abounds in opportunities for growth, but turning potential into reality requires action, and action requires confidence—confidence in the future, confidence in the specific effects in government policy, and confidence that government can properly carry out its basic functions, like agreeing to a budget. America suffers a confidence shortage, and Washington is overwhelmingly the cause.

Confidence, in turn, is lacking because of an excess of uncertainty: uncertainty about the future, but also uncertainty about the effects of government policies—tax policies, regulatory policies, monetary policies, and trade policies.

Uncertainty is natural, of course. The future is always uncertain. But there is good uncertainty and bad uncertainty, much as there is good cholesterol and bad cholesterol. Good uncertainty, for example, presents opportunities for profit. Bad uncertainty arises largely when investors and entrepreneurs have very real questions about the potentially harmful consequences of government policy.

Tax policy provides a good example of bad uncertainty. The President's repeated insistence on raising taxes on high-income workers and investors slows the economy even without the policy being enacted. It does so by raising the uncertainty about the tax consequences of various actions. It does not stop all such actions, but it stops some, and therein lies the difference between stagnation and real prosperity.

Moreover, the President's insistence is a "twofer" in terms of bad uncertainty. The specific is that taxpayers don't know what their tax liability will be. The general is that suggesting raising taxes on anyone in the face of high and possibly rising unemployment suggests a gross lack of understanding about how an economy works. That's a source of bad uncertainty that afflicts the entire economy, not just those threatened with higher taxes. In this environment, Congress need not enact bad policy to weaken the economy. Threats are enough to do real damage.

The federal government should adopt a very simple guiding principle for deciding what to do next. That principle is to do less harm. There is very little in terms of concrete actions government can do at this stage that would help and a great deal of intended help that would harm, either by raising the deficit to no good effect or by creating more uncertainty and slowing the economy's natural healing process.

Do less harm means getting spending under control and thereby cutting the budget deficit. Americans are worried about spending and the deficit. That worry, by itself, is holding us back.

Do less harm means that policymakers should stop threatening higher taxes. We can have debates about who should pay what when we're at full employment. In the meantime, this threat is debilitating.

Do less harm means stop the onslaught of new regulations. The pending regulatory consequences of Dodd-Frank and Obamacare weigh heavily on the economy because even the threat of new regulations creates bad uncertainty for those affected, freezing them in place. Again, we can work through these regulations when Americans are back to work.

Do less harm means that policymakers should stop meddling with the economy. There is almost no limit to the harm Washington can do *to* the economy in its efforts to do something *for* the economy. The patient is in recovery, slowed by the incessant proddings and procedures of Washington's policy doctors. The patient doesn't need another procedure or a new nostrum. Let it heal. Do less harm.

Keynesian Alchemy

What policies meet this criterion? Under the circumstances, very few. Consider, for example, the policy of increasing the budget deficit to spur the economy. The argument is fairly simple: The economy is underperforming, demand is too low, the government deficit is part of aggregate demand, so just increase the deficit. It's an equation. How can it be wrong?

The answer, of course, is that the economy is more complicated than this simple equation. Government borrows the money, so every deficit dollar spent by the government is a dollar less that is available to the private sector. The answer, in other words, is that the macroeconomic model ignores financial intermediation, which is the bread and butter of financial markets.

Proponents will counter by saying that people are saving more, and corporations are sitting on mounds of cash. True, but it changes nothing. All this saving is not lying dormant in some vault or stuffed in some mattress. Ironically, even if it were, irresponsible deficit spending would surely not draw it out. On the contrary, this saving is deposited with the financial system, which then takes the resources from those who do not currently need them and makes them available to those who do need them. In terms of aggregate flows, this process works just as well today in recession as it does at full employment.

Thus, Keynesian demand-side stimulus does not help. It is fiscal alchemy. And by adding to the deficit and thus fears about the future, it surely adds to the economy's headwinds.

Infrastructure

Increased infrastructure spending, as the President and others have advocated, is an example of a double folly. To be clear, the issue here is not whether the nation needs more or less infrastructure spending. I am not expressing an opinion on that one way or another.

The issue is whether it acts as a short-term stimulus. It does not. First, assuming the additional spending was financed by additional borrowing, the policy runs afoul of the Keynesian fallacy. To be sure, once a project is underway, one can point to the people working, but just as surely, the borrowing that made that project possible reduced employment elsewhere.

The second folly is just as plain. Infrastructure spending on projects is capital-intensive and stretches over years. It cannot, even if enacted, swiftly affect employment in the next year plus.

Payroll Tax Holiday

The irony of a payroll tax holiday to create jobs is that reducing payroll taxes would increase employment when the economy is at full employment, yet it cannot accelerate hiring in periods of high unemployment. The key to this irony is incidence—who bears the tax.

The payroll tax is borne by workers. It subtracts from their total compensation, leaving them less after-tax wage income. This is equally true of the "employer's share" because, of course, the employer has no share. The tax is all paid by the worker, but the worker unfortunately is aware of only half the tax, so extending the tax relief to the invisible part of the tax would not improve the outcome. Nor are weak labor markets the environment in which workers would gain a new ability to force employers to bear part of the tax.

Thus, a reduction in the payroll tax rate does not reduce the employer's costs, but rather raises the worker's after-tax wage. During periods of full employment, this means an additional supply of workers to be absorbed into the economy, thereby raising output. During periods of high unemployment, the increase in labor supply resulting from a payroll tax cut, temporary or otherwise, results in an increase in the number of unemployed workers. Thus, a policy intended to reduce the ranks of the unemployed is likely to produce an increase in the unemployment rate.

Repatriation Tax Holiday

Another policy under consideration that does not create jobs is a repatriation tax holiday. The issue here is not whether tax cuts are good or bad *per se*, but whether this particular tax cut would increase domestic employment and domestic jobs. Again, the answer is that it would not.

A repatriation tax holiday would result in a sizable influx of corporate profits from abroad. Tax policy does matter. Companies have responded and would again to this extent. But no new jobs would result. The key to understanding why this policy and its undoubted influx of capital would not increase investment and jobs at home lies in the following question: Are these repatriating companies capital-constrained today?

No, with perhaps one or two exceptions, they are not. These large multinational companies have enormous sums of accumulated earnings parked in the financial markets already, and those few, if any, that might need additional financing have ready access to the capital markets at remarkably low prices. Thus, they can meet all of their financing needs out of available domestic resources. Adding to those resources will not increase the extent of their investment opportunities. Parallel to the payroll tax holiday that would increase the supply of workers without increasing the number of jobs available, the repatriation tax holiday would increase the supply of saving without increasing the range or amount of investments to which the saving could be applied.

Having seen their primary argument wither, repatriation holiday proponents have pivoted, acknowledging that companies will mostly pay out the extra cash in the form of dividends and share buybacks. But, they argue, this would put more "money in people's pockets" which would spur consumption and thus the economy. This, of course, is just a Keynesian demand-side echo policy.

Worse, it ignores the fact that what has occurred is simply a portfolio shift on behalf of the shareholders. If a shareholder wanted more cash and less investment, he or she could simply sell shares. Faced with extra cash that was previously invested, overwhelmingly shareholders are simply going to reinvest the dividends, perhaps even in the same company. This is most striking in the context of pensions and other institutional investors. What would a pension do with the additional cash flow, but reinvest it? Ultimately, the repatriation tax holiday has nothing to do with domestic jobs, and all to do with a retroactive tax cut for profitable companies to improve the appearance of their balance sheets.

Unemployment Benefits

Yet another ineffective or even counterproductive policy for increasing employment is extension of unemployment benefits. This policy may be defended on humanitarian grounds, but not as economic stimulus because it, too, runs afoul of the Keynesian fallacy. The extension of benefits will certainly increase the purchasing power and purchases of the recipients, but the borrowing needed to fund these benefits will, with equal certainty, reduce other areas of private spending.

Further, to the extent that the resulting increased budget deficit adds to the depth of the bad uncertainty, it adds to this important economic headwind. And the research on the issue strongly suggests, as recent papers by both The Heritage Foundation and the Brookings Institution have made clear, that extending unemployment benefits actually raises the unemployment rate.

Conclusion

In light of the ongoing high unemployment, policymakers should be keenly focused on what they can do to help the economy recover, but they must also recognize the limitations of policy initiatives. Tax gimmicks are of value only in slaking politicians' natural desire to be seen as doing something. Even fundamental tax reforms can be problematic if they are not well-defined from the outset. Though it may require a difficult discipline to implement, government's guiding principle today should be: Do less harm.

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