Statement of Senator Chuck Grassley:
Finance Committee Hearing on Extension of 2001/2003 Bipartisan Tax Relief Plans
Wednesday, July 14, 2010

I've described this town of Washington, D.C., as an island surrounded by the reality of the rest of the country. We find that same metaphor applying to the discussion of today's hearing topic. Today's topic boils down to a discussion of the merits of extending current law levels of taxation. In the various layers of the D.C. establishment the discussion is framed solely from the perspective of an old phrase. The phrase is "tax cuts are not free."

Now, I'm not disputing the notion that extending these tax relief plans scores under the conventions of our budget process under the Congressional Budget Act. Take a look at the pamphlet prepared by the non-partisan official scorekeeper for taxes, the Joint Committee on Taxation, for today's hearing. Examine pages 42 and 43. These charts detail the multiple trillions of revenue at stake over the 10-year budget window. So, in that sense, tax cuts are not free.

But in the fantasy world of this town, the roughly trillion locked up in extending current law entitlements is off the table. Not subject to pay-go. Not really accounted for. Same goes for appropriated spending. It is ignored over the long-term, even though there's trillions of dollars in new spending baked into that fiscal cake. Not subject to pay-go. Not really accounted for. Last time I checked, a dollar spent equals a dollar of foregone revenue. This double standard doesn't make sense. It seems like fiscal fantasy to scrutinize to the "n-th" degree the revenue loss from extending current law tax policy and avoid trillions of dollars of increased spending.

Right now I want to display another difference between tax relief and new spending. I am now holding up the legislative text of the 2001 law, the "Economic Growth and Tax Relief Reconciliation Act of 2001," and the 2003 law, the "Jobs and Growth Tax Relief Reconciliation Act of 2003." This is a total of 130 pages of legislative text. Not exactly something you take on vacation to read, but certainly not insurmountable either. Now I am holding up the legislative text of the "American Recovery and Reinvestment Act of 2009," also known as the stimulus bill. I'm also holding up the legislative text, in a consolidated print, of the "Patient Protection and Affordable Care Act" and the "Health Care and Education Reconciliation Act." These are the bills through which health reform was enacted. These three massive spending bills, all from the 111th Congress and as I have them here, represent a total of 1,314 pages of legislative text. If you tried to take them on vacation to read, you would probably be charged an extra baggage fee.

The policy in these two tax bills was straight-forward. Cut rates for everyone. Enhance the child tax credit. Provide some marriage penalty relief. Enhance tax incentives for education. When we leave this island and venture back to our homes across America, we find that the tax increases that our constituents will pay are certainly not free. Let me repeat that. Outside of this town, the folks paying the 10% across-the-board tax increase tell us it is not free. Tax cuts aren't free. Tax increases aren't free.

Someone pays that additional tax. Whether it is a hard-working American family. Or a small business owner. Or a senior citizen who is relying on the dividends and capital gains from their retirement savings. Keep in mind, taxpayers, are literally the folks footing the bill. And they will respond to an across-the-broad tax increase. Today, we'll take a look at some of those consequences. We'll look at them short-term. We'll look at them long-term.

On both sides of the aisle we recognize the importance of this topic today. Namely, the topic of what to do about the looming expiration of the substantial tax relief adopted back in 2001 and 2003.

Let me remind everyone, these are not the "Bush" tax cuts. Of course, under the Constitution, only Congress has the taxing power, not the President. Indeed, the 2001 tax relief was bipartisan. My friend, the Chairman, and I were partners in this venture. It was shaped by the bipartisan efforts of the members of this Committee. The Conference Report was supported by 25% of the then-Democratic caucus. That bipartisan "glue" is why we are here today discussing growth and family tax relief.

A major theme of today's hearing is "growth." To address this topic, I would like to discuss the following topics: 1) marginal tax rates; 2*)* hidden marginal tax rates; and 3) uncertainty.

To illustrate the topics of marginal tax rates and hidden marginal tax rates, I would like to tell you the true story of a taxpayer I know of by the name of John. John is his real name.

In 2009, John had a low six-figure salary. In early April 2010, John accurately calculated his taxable income. John could see that he was in the "official" marginal tax rate bracket of 25%. That is, according to Section 1 of the Internal Revenue Code, for an additional $100 of taxable income, John would be $75 richer. It may -- or may not -- be the case that John would decide that to only be $75 richer would not be worth $100 of effort.

Perhaps John would have been willing to do $100 worth of effort if he became, say, $80 richer, but to only be $75 richer, he might decide it was better to engage in some other (and non-taxable) activity. Thus, there could be a loss of productive activity from this 25% official marginal tax rate bracket. That is, growth to the economy could be harmed.

At the end of 2010, however, the 25% tax bracket will become, under current law, the 28% tax bracket. So, the disincentive from earning that additional $100 of income will be somewhat greater. But it is actually worse than that. Although John was in the official tax bracket of 25%, there was a hidden marginal tax rate of an additional 5%. This was because some of his tax benefits began to phase out, at a 5% rate. So, John was in a hidden, or effective, marginal tax rate of 30%. (That is, 25% + 5%.) So, actually, for John to perform an additional $100 worth of effort would actually only make John $70 richer – not $75 richer as John's official marginal tax rate bracket would suggest.

And again, since in 2011, the official tax rate of 25% will become 28%, John would be, under currently scheduled law, in the 33% tax bracket. (That is, 28% + 5%.) The disincentives to productive activity will just be getting greater.

There is an enormous quantity of phase-outs of various tax benefits. One of our witnesses, Ms. Carol Markman, will discuss that in a more in-depth way. The best known of these phase-outs are the Personal Exemption Phaseout (known as "PEP") and the limitation on itemized deductions (better known as the Pease limitation, after the member of the House, Don Pease, who came up with the limitation).

There are several harmful effects from PEP, Pease, and other phase-outs.

- The first harmful effect is that they increase the marginal effective tax rate – thus increasing the disincentive to perform productive activity. Thus harming growth.
- The second is that they significantly increase complexity.
- The third harmful effect is that they decrease transparency – John thought he was in the 25% tax bracket, but was actually in the 30% effective tax bracket.
- Fourth: These problems have the cumulative effect of increasing the tax gap – a concern to all of us.

PEP and Pease do not exist for 2010 – although numerous other phase-outs do still exist for 2010. Both PEP and Pease are scheduled to spring back with full effect for 2011. Thus, in 2011, the various harmful effects of PEP and Pease will spring back.

Now, in my mind, I can already hear the objection. Those objecting might concede all these various problems I've just mentioned are indeed real, but would say that those problems are worth it so that we can get John to pay a high tax to help the nation confront its significant deficit problems. That trade-off, so the argument will go, is worth it.

But here is my response to that potential objection: I never said that John paid any tax. I told you that for 2009 he was in an effective marginal tax rate bracket of 30%, which in 2011 will be 33%. The truth of the matter is that in 2009, John lawfully did not pay any Federal income tax. In fact, not only did he get all the income tax his employer withheld from his paycheck back in a refund, but he actually got even more, additional money in his refund check from the IRS. This was made possible because of the expansion of refundable tax credits in recent years.

So, in fact, the tax code has created the worst of all possible worlds in the case of John: It has significant disincentives from productive activity (as well as complexity problems) and does not raise one dime of revenue for the Federal Government. That's a pretty amazing stunt. You would at least hope that if there are high marginal tax rates, there would be a high amount of tax paid to the government.

In case you are wondering: How could John have been in a 30% tax bracket, but actually have a negative tax, actually receive a check from the IRS, rather than pay any tax? That's possible because, had John made an additional $100 of income, the amount of the check John received from the IRS would have gone down by $30. So, John still only got $70 of net benefit from $100 worth of productive activity.

While John's situation is more extreme than that of most, his situation does illustrate a number of problems with the tax code. And, again, these problems will only get significantly worse under current law for 2011. And, in one very significant way, John's situation is actually less extreme than the problem faced by many. Namely, the problem faced by taxpayers with more income than John. These upper-middle income taxpayers and above will face even higher disincentives from additional productive activity than does John, and even higher complexity than does John.

Finally, I want to discuss how uncertainty harms growth. There's a lot of uncertainty caused by the expiration of the 2001 and 2003 tax relief measures. So, to the extent that taxpayers anticipate higher tax rates, this will itself create a disincentive to productive activity when people are planning their affairs. And yet, to the extent tax relief is ultimately adopted, the nation will again face the unfortunate "two-fer" of high disincentives to productive activity, but low tax receipts for the Federal Government.

There's a lot of talk about extending some, or all, of the 2001 and 2003 tax relief on only a temporary basis. I question whether that really addresses the problem of uncertainty. Perhaps it just kicks that problem down the road a bit.

The uncertainty is particularly relevant to the small business owners of this country. Why does the uncertainty matter? Here's why. President Obama, Congressional Democrats, and Congressional Republicans agree that job creation is our number one policy priority. As folks say, it's "jobs, jobs, jobs." All parties also agree small business creates 70% of the new jobs in America. Small business' health and expansion are the key to getting our unemployed constituents back to work. We all agree that we should not do anything to impair the health and vitality of our small business sector. Where we disagree is on the effect of a substantial tax increase on the health and vitality of our small business sector. Many of my colleagues on the other side don't believe that a marginal rate increase of up to 17% on small business owners will matter one wit.

On this side, we hear the small business people loud and clearly. They say they know their taxes are going up. They don't know how high the rates will go. They are reluctant to commit to expanding their businesses in what they perceive to be a hostile and uncertain environment relationship of an up to 17% marginal rate increase on small business owners that is coming. Since this significant tax increase is set to kick in a few months, small business owners are clearly anxious.

Maybe in the fantasy world of Washington, D.C., taxes aren't a cost of doing business. Maybe some folks think they'll just magically be made up somehow. But the reality of the business world is that businesses must adjust. Increased tax costs need to be made up somehow.

Small businesses are not like Big Fortune 500 companies. Unlike publicly-traded entities, they are financed solely from the owner's capital contributions and retained earnings. On the debt side, the owner's assets are looked to as backing for the loans. The impact of an increased cost, like higher taxes, on the owner of a small business cannot be ignored.

It will affect decisions on whether the business expands or contracts. It will affect whether a business hires or lays off workers. Those of us on our side will lay out the case for the impact of the higher rates. Some on the other side dispute the impact of higher marginal rates on small businesses. And we'll have a discussion on that point. But, to those who are pushing the higher marginal rates, I say the burden is on you to show that you are not harming our primary job creators, small business. Thank you again, Mr. Chairman, for putting together this hearing. It's incredibly important and not a moment too soon.