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THE FUTURE OF INDIVIDUAL TAX RATES: EFFECTS ON ECONOMIC GROWTH AND DISTRIBUTION

HEARING

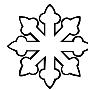
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

JULY 14, 2010



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CONTENTS

OPENING STATEMENTS

Page

Baucus, Hon. Max, a U.S. Senator from Montana, chairman, Committee on Finance 1
Grassley, Hon. Chuck, a U.S. Senator from Iowa 2

WITNESSES

Markman, Carol, certified public accountant, Feldman, Meinberg, and Company, LLP, Syosset, NY 7
Marzahl, David, president, Center for Economic Progress, Chicago, IL 8
Marron, Dr. Donald, director, Tax Policy Center, Urban Institute, Washington, DC 11
Holtz-Eakin, Dr. Douglas, president, American Action Forum, Washington, DC 12
Burman, Dr. Leonard, Daniel Patrick Moynihan professor of public affairs, Maxwell School of Syracuse University, Syracuse, NY 15

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Baucus, Hon. Max:
- Opening statement 1
- Prepared statement 51

Burman, Dr. Leonard:
- Testimony 15
- Prepared statement 53

Grassley, Hon. Chuck:
- Opening statement 2
- Prepared statement 66

Holtz-Eakin, Dr. Douglas:
- Testimony 12
- Prepared statement 70

Markman, Carol:
- Testimony 7
- Prepared statement 85

Marron, Dr. Donald:
- Testimony 11
- Prepared statement 93

Marzahl, David:
- Testimony 8
- Prepared statement 107

COMMUNICATION

Qualified Settlement Trusts for Asbestos Victims 111

THE FUTURE OF INDIVIDUAL TAX RATES: EFFECTS ON ECONOMIC GROWTH AND DISTRIBUTION

WEDNESDAY, JULY 14, 2010

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:10 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Bingaman, Wyden, Stabenow, Cantwell, Nelson, Carper, Grassley, Hatch, Snowe, Kyl, Bunning, Crapo, Roberts, Enzi, and Cornyn.

Also present: Democratic Staff: Bill Dauster, Deputy Staff Director and General Counsel; Lily Batchelder, Chief Tax Counsel; and Tiffany Smith, Tax Counsel. Republican Staff: Jim Lyons, Tax Counsel; Tony Coughlan, Tax Counsel; Nick Wyatt, Tax and Nomination Professional Staff Member; and Chris Condeluci, Tax and Benefits Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

Arthur Godfrey said, "I am proud to be paying taxes in the United States. The only thing is—I could be just as proud for half the money."

In 2001, the Congress enacted legislation to let American families keep more of their money. We lowered income tax rates for all taxpayers. We doubled the Child Tax Credit from $500 to $1,000 a child. We made the credit partially refundable so that more families could benefit. We increased the amount that families could get from the dependent care credit. That helps more working families make ends meet.

We eliminated the marriage penalty. That way, married couples do not get higher taxes as an added wedding present. We recognized the importance of higher education. We made it easier to deduct student loan interest. We made a lot of tax law changes in 2001 that have very broad support throughout the Congress.

But now we face a problem. These tax cuts are not permanent. They expire at the end of the year. The big questions before us now are whether we should make some of these tax cuts permanent and, if so, which ones.

But that is not the only challenge. There is another elephant in the room, and that is the budget deficit, and that elephant is growing. Last year, the budget deficit was the largest share of the economy since World War II. And the nonpartisan Congressional Budget Office expects the deficit to exceed $1 trillion in 2010. And the Congressional Budget Office projects that deficits will remain high for the rest of the decade.

That means that the Federal debt will keep growing. By the end of this year, economists expect Federal debt held by the public to reach 62 percent of the gross domestic product. That is also the highest share since right after World War II.

When we passed the 2001 tax cuts, the Federal Government was running a surplus. When we passed the 2001 tax cuts, economists projected big surpluses for years to come.

We face a different budget picture today. With today's budget picture, it is no longer clear that we can afford large tax cuts for the most well-to-do.

So today we will discuss the expiration of the 2001 and 2003 tax cuts. We will discuss the effect of these tax cuts on economic growth and on the distribution of income. We will consider whether these tax cuts should be made permanent and for whom.

And so, let us begin the work of addressing the 2001 and 2003 tax cuts; let us do so responsibly, with an eye on the budget picture; and let us endeavor to let working American families keep more of their money.*

Senator Grassley?

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Congress is in Washington, DC, and Washington, DC is an island surrounded by reality. 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 DC establishment, the discussion is framed solely from the perspective of an old phrase. The phrase is "Tax cuts are not free." Now, I am not disputing the notion that extending these tax relief plans scores, and emphasis on scores, under the conventions of our budget process under the Congressional Budget Act.

So take a look at the pamphlet prepared by the nonpartisan official scorer for taxes, the Joint Committee on Taxation, for today's hearing. Examine pages 42 and 43. These charts detail the multiple trillions of dollars of revenue at stake over the 10-year budget window.

So in that sense, and only in that sense, tax cuts are not free. But in the fantasy world of this town, the roughly trillions locked up in extending current law entitlements are off the table, not subject to PAYGO, not really accounted for.

*For more information, *see also,* "Present Law and the President's Fiscal Year 2011 Budget Proposals Related to Selected Individual Income Tax Provisions Scheduled To Expire Under the Sunset Provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001," Joint Committee on Taxation staff report, July 12, 2010 (JCX–36–10), *http://www.jct.gov/publications.html?func=startdown&id=3691.*

The same goes for appropriated spending. It is ignored over the long term, even though there are trillions of dollars in new spending baked into the fiscal cake; not subject to PAYGO, not really accounted for. The last time I checked, $1 spent equals $1 of foregone revenue.

This double standard does not make sense. It seems like fiscal fantasy to scrutinize to the nth degree the revenue lost from extending current law tax policy and, at the same time, avoid acknowledging 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 tax relief acts, called the "Economic Growth and Tax Relief Act of 2001" and the "Jobs and Growth Tax Relief Reconciliation Act of 2003." This is a total of 130 pages of legislative text, not exactly something that you take on a vacation to read, but certainly not an insurmountable task.

Now, I hold up the legislative text of the "American Recovery and Reinvestment Act of 2009," also known as the stimulus bill, along with 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 are 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 a vacation to read, you would probably be charged an extra baggage fee.

The policy in these two tax bills was very straightforward: cut rates for everyone, enhance the Child Tax Credit, provide some marriage penalty relief, and enhance tax incentives for education.

When we leave this island and venture back to our homes all across America, we find that the tax increases that our constituents will pay, from their point of view, are certainly not free.

Let me repeat that. Outside of this town, the folks paying the 10-percent across-the-board tax increase tell us it is not free. Tax cuts are not free. Tax increases are not free. Someone pays that additional tax, whether it is a hardworking American family or a small business owner or a senior citizen who is relying on 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-board tax increase.

Today, we will look at some of those consequences. We will look at them short-term, and there are long-term consequences. 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 tax relief adopted back in 2001 and 2003.

Let me remind everybody that these are not Bush tax cuts. Of course, under the Constitution, only Congress has taxing power, not the President. Indeed, in 2001, tax relief was bipartisan. My friend, the chairman, and I were partners in that venture. It was shaped by the bipartisan efforts of members of this committee.

The conference report was supported by 25 percent 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 marginal tax rates, hidden marginal tax rates, and, of course, the big issue out there of uncertainty. It was brought up to the President by all the CEOs that he called in last week to find out how come we are not creating jobs, and they listed 18 reasons why we are not increasing jobs, and most of those things are things that are on the President's agenda.

So, if you want to increase jobs, do away with the uncertainty.

To illustrate the topics of marginal tax rates and hidden marginal tax rates, I would like to talk about a man named John. John is a real taxpayer, and John is his real name. In 2009, John had a low 6-figure salary. In early April 2010, John accurately calculated his taxable income. John could see that he was in, quote-unquote, the "official" marginal tax rate bracket of 25 percent, 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 it may not be the case that John would decide that to only be $75 richer would not be worth $100 worth 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 nontaxable activity.

Thus, there could be a loss of productive activity from this 25-percent official marginal tax rate bracket. That is, growth to the economy could be harmed.

At the end of 2010, however, the 25-percent tax bracket will become, under current law, 28 percent. 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 percent, there was a hidden marginal tax rate of an additional 5 percent. This was because some of his tax benefits began to phase out at a 5-percent rate. So John was in a hidden, or effective, marginal tax rate of 30 percent, 25 percent plus the 5 percent.

So actually, for John to perform an additional $100 worth of effort would only make John 70 percent richer, not 75 percent, as John's official marginal tax rate bracket would suggest.

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

There are enormous quantities 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 phase-out, or 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, harming growth. The second is they significantly increase complexity. The third harmful effect is that they decrease transparency. John thought he was in the 25-percent tax

bracket, but was actually in the 30-percent effective tax bracket. Fourth, these problems have the cumulative effect of increasing the tax gap, and that is a concern to all of us, particularly the chairman. PEP and Pease do not exist in 2010, although numerous other phase-outs still exist. Both PEP and Pease are scheduled to spring back in full force in 2011; thus, in that year, the various harmful effects of PEP and Pease will be there.

Now, in my mind, I can already hear the objections. Those objecting might concede all these various problems I have 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 goes, 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 percent, which, in 2011, will be 33 percent.

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 of 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 is a pretty amazing stunt. You would at least hope that, if there are high marginal tax rates, there would be high amounts of tax paid to the government.

In case you are wondering how John could have been in a 30-percent tax bracket, but actually have negative tax, and actually receive a check from the IRS rather than pay any tax, that is possible because, had John made an additional $100 of income, the amount of the check John received from the IRS would have gone down $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 the current law of 2011. And in one very significant way, John's situation is actually less extreme than the problems 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 John does and even higher complexity than John does.

Finally, I will discuss uncertainty. There is a lot of uncertainty caused by the expiration of 2001 and 2003 tax relief. So, to the extent that taxpayers anticipate higher tax rates, this will itself create a disincentive to productive activity when people are planning their tax 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 to the Federal Government.

If you talk about extending some or all of the 2001 and 2003 tax relief only on a temporary basis, you still have the problem of uncertainty. The uncertainty is particularly relevant to small business, creating 70 percent of the new jobs.

As folks say it, this issue is all about jobs, jobs, jobs. All parties also agree small business creates 70 percent of those jobs. Small business health and expansion are 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 small business.

Where we disagree is on the effect of a substantial tax increase on the health and vitality of small business. Many of my colleagues on the other side do not believe that marginal rate increases of 17 percent will matter to small business.

On my side, we hear small business people loudly and clearly. They say they know their taxes are going up. They do not know how high the rates will go. They are reluctant to commit to expanding their business because of the hostile and uncertain environment related to a 17-percent marginal tax increase.

Since this significant tax increase is set to kick in in a few months, small business owners are clearly anxious. Maybe in the fantasy world of Washington, DC, taxes are not the cost of doing business. Maybe some folks think that they will just magically be made up somehow.

But the reality is, in the business world, that businesses must adjust. Increased tax costs need to be made up somehow, and that is a problem for creating jobs.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator. You are kind of worked up there. Thank you very much for your statement.

Now, I would like to introduce the panel. The first witness is Carol Markman. Ms. Markman is a certified public accountant with Feldman, Meinberg, and Company, LLP.

The next witness is David Marzahl, who is the president of the Center for Economic Progress. The center provides tax and financial counseling to low-income families.

The third witness is Dr. Donald Marron. Dr. Marron is currently the director of the Tax Policy Center with the Urban Institute. Dr. Marron previously served as a member of the President's Council of Economic Advisers, acting director of the Congressional Budget Office, and executive director of the Joint Economic Committee.

Our next witness is Dr. Doug Holtz-Eakin, who is the president of the American Action Forum and a former director of the Congressional Budget Office.

Finally, we have Dr. Len Burman, who is the Daniel Patrick Moynihan professor of public affairs at the Maxwell School of Syracuse University. Dr. Burman previously served as a Treasury Deputy Assistant Secretary for Tax Analysis.

As is our regular practice, I really want to encourage you to summarize your statements. We will put your statements in the record. They will automatically be included in the record, but I urge you to summarize your statements in the 5-minute neighborhood.

Please begin, Ms. Markman.

STATEMENT OF CAROL MARKMAN, CERTIFIED PUBLIC ACCOUNTANT, FELDMAN, MEINBERG, AND COMPANY, LLP, SYOSSET, NY

Ms. MARKMAN. Good morning, Senator Baucus, Senator Grassley, members of the committee. I am a tax preparer for a living. I have also served as president of the National Conference of CPA Practitioners. Accompanying me are two colleagues, the current chair of our tax committee, and the managing partner of Feldman, Meinberg, and Company, LLP and president of the Nassau chapter of the New York State Society of CPAs.

The membership of NCCPAP is also tax preparers. It consists only of CPAs in public practice all over the country. We estimate that our members serve more than half a million businesses and individuals throughout every State, and we appreciate very much the opportunity to speak with you today.

My topics, as Senator Grassley said, are the phase-outs of itemized deductions and personal exemptions. The rules for Pease and PEP do not exist for 2010, but will come back unless Congress acts to change the law.

The current situation, where tax preparers do not know if Congress will act or what the law will be in 2011, creates uncertainty and makes tax planning very difficult. Until the Tax Reform Act of 1986, any deduction or credit in the code was available equally to almost every taxpayer, without regard to his or her adjusted gross income.

TRA86 changed the rates from 15 brackets to two. The offset to this simple rate structure was the beginning of phase-ins and phase-outs of exemptions, deductions, and credits.

Since 1986, the rates have increased to a maximum of 35 percent and the phase-outs have proliferated, effectively raising this high marginal tax rate beyond the current stated rate. As new benefits have been introduced, many have been limited by adjusted gross income. The public's perception is that the tax code gives benefits, deductions, and credits with one hand and takes them away with the other.

There are many phase-outs in the current code. Most are based on adjusted gross income and filing status. Others are different only for married-filing separately taxpayers. Some phase-outs have kept pace with inflation; others have not. Some phase-out ranges are $10,000, $15,000, $25,000 and more. The phase-out range for the alternative minimum tax can be as much as $183,000.

And speaking of the AMT, this tax is the ultimate in phase-out provisions. The AMT first became effective in 1970 and was intended to target the rich: specifically, the 155 individuals with income over $200,000 who claimed so many benefits, like John, that they owed no tax. This was 1967.

The initial AMT rate was 10 percent, and the rates have inched up every few years. The annual adjustments in the AMT exemption, not knowing if Congress will act, and sometimes the fix being enacted very close to the end of the year, are another source of uncertainty and anxiety for taxpayers, tax professionals, and even the IRS. I know this because I serve on the Internal Revenue Service Advisory Council, and we have talked about it there.

It is NCCPAP's position that the AMT should be repealed. The AMT is too complex and it poses a large compliance burden, and still it does not tax the people for whom it was intended. The people who should pay the AMT are those who structure their lives to avoid tax, not those who have another child.

One of the most serious problems tax professionals have in dealing with phase-outs is that even a very seasoned professional cannot sit down with a taxpayer and prepare a tax projection using only a pencil, paper, and a calculator, if their income is above a nominal amount.

The code is so complex and provides for so many phase-outs, with different ranges, different beginning and ending points, that it is impossible to prepare a tax estimate and calculate the marginal tax rate without being armed with a series of worksheets, schedules, and charts.

Some phase-outs limit the change annually; others do not. So the preparer is never sure of the applicable limits for specific phase-outs without resorting to numerous reference materials.

The phase-outs have a corrosive effect on tax compliance and taxpayer confidence in the fairness of tax laws. Tax practitioners are forced to tell clients that many of the tax-saving provisions they read about in the press during tax season each year do not apply to them; they are rich, yet struggle to make ends meet, living an ordinary lifestyle.

My colleagues and I think it would be more prudent to permit taxpayers to utilize the deductions and credits currently available in the tax law before focusing on keeping lower tax rates. The elimination of the phase-outs will simplify the law and make it more equitable.

If the phase-outs must be continued, there should be uniform phase-outs for most provisions, and limits must be adjusted annually to reflect inflation and the costs in high-tax States.

Thank you so much for your attention.

[The prepared statement of Ms. Markman appears in the appendix.]

The CHAIRMAN. Thank you, Ms. Markman.

Mr. Marzahl, you are next.

STATEMENT OF DAVID MARZAHL, PRESIDENT, CENTER FOR ECONOMIC PROGRESS, CHICAGO, IL

Mr. MARZAHL. Thank you, Chairman Baucus, Ranking Member Grassley, and members of the committee. I am David Marzahl. I am president of the Center for Economic Progress in Chicago. And I put forth that we are no island; we do represent reality.

My organization helps hardworking families move from financial uncertainty to financial security by providing them with free, high-quality tax preparation and financial services. We operate entirely volunteer-driven tax sites in more than 30 Illinois communities, making our Volunteer Income Tax Assistance (VITA) program one of the largest programs in the country.

As a founder and current steering committee member of the National Community Tax Coalition, NCTC, I am pleased to offer the views of leading community-based tax preparation and asset-building organizations from throughout the country.

NCTC is comprised of over 1,700 members that provide free tax preparation and asset-building services. Our local partners help working families claim tax credits they might otherwise overlook, ensuring they receive the full refund to which they are entitled. And for many, I put forth, that refund provides a once-a-year opportunity to pay down debt, purchase necessities, and to actually start building assets.

Together, NCTC's members are the Nation's fourth-largest provider of tax preparation services, completing an estimated 3 million Federal tax returns each year for free.

On behalf of our programs and the taxpayers we serve, we thank the committee for their efforts in passing the 2009 Recovery Act provisions. The Recovery Act, despite its complexity, achieved many of the reforms we have supported, including expanding the Earned Income Tax Credit for married couples and families with three or more children, and ensuring more parents have access to the Child Tax Credit.

We are primarily concerned with the impact on the working families we serve if Congress fails to extend the 2009 Recovery Act provisions. The following provisions are scheduled to sunset this year and will have a direct impact on our constituency: the 10-percent tax bracket; the EITC with the 45-percent credit for families with three or more children and marriage penalty relief will sunset; the Child Tax Credit, as mentioned earlier, the maximum credit will fall from $1,000 per child to $500 per child, and the credit will no longer be refundable for the majority of tax filers; the American Opportunity tax credit, a partially refundable education credit with a maximum benefit of $2,500, will sunset; and the Making Work Pay credit.

With all these provisions at risk, we respectfully ask the committee to consider the following: permanent expansion of vital tax credits. We feel that parents who work full-time should be able to support their families and provide a standard of living that prevents their children from living in poverty.

The Recovery Act tax provisions targeting low-income taxpayers need to be made permanent to create sustainable economic growth and ensure a more equitable tax code. These provisions are helping build economic security through the EITC, the expansion of the EITC specifically for families with three or more children, which brought up an estimated $4.7 billion to those families; the Child Tax Credit, which, compared to 2008, meant 2.9 million more children in very low-income families were able to access the refundable portion of the credit—and, if I just may point out, nearly 100 percent of the $14.8-billion CTC credit goes to families making under $38,000 a year; and the American Opportunity tax credit, which makes college more accessible to workers.

Tax credits are indeed a work incentive. The expanded EITC and Child Tax Credit provide an incentive for parents to work, while giving them the financial boost they need to support themselves and their children.

Specifically, under the expanded Child Tax Credit, very low-income families are given a much greater incentive to work full-time to support their families. During the 2009 tax year, for example, a parent with two children who worked just 10 hours a week

at a minimum wage job received less than $100 from the Child Tax Credit. However, a parent with two children, working full-time at a minimum wage job, received a credit of $1,800.

At the Center for Economic Progress and the clients that we serve, the average Child Tax Credit this past year was $1,300, reflecting precisely this dynamic, this focus on low-income, hard-working families.

Other VITA sites and community programs around the country witness similar incentives at play. I want to highlight an organization in Pennsylvania that worked with a family of four, two parents, two children, both young preschool age, getting by on an income of $16,353. The father works as a cashier at a gas station, the mom stays at home with the children. Because of the stimulus-related changes to the Child Tax Credit, their Child Tax Credit was the maximum $2,000. Under the prior law, they would have only received $540, a $1,500 difference.

Tax credits also provide access to the financial mainstream. Thanks to changes that the Internal Revenue Service and Treasury have made to the tax form and the efforts of many of our programs, it is now becoming easier for clients to actually save a portion of their refund.

Many of our programs are offering year-round financial coaching and asset-building opportunities and working with financial institutions to help taxpayers actually save a portion of their refund.

A couple highlighted remarks here to close out. The typical taxpayer we serve has two to three W–2s. That means they are working several jobs in a given year. Despite their focus on securing and keeping work, 15 percent of our clients actually were unemployed at some point last year, 5 full percentage points above the national or the Illinois average.

In this tough economy, with falling wages the norm, many of our clients still benefitted from taking part-time or lower-paying jobs, because they qualified for the partial or the full Child Tax Credit. As more and more of our clients return to work, and as the economy recovers and the more people are moving toward full-time employment, they will have an incentive to stay employed and increase their salary.

A few final points as part of the hearing. I want to stress the importance of simplification, and that the complexity of the tax code causes many of our tax filers to pay hundreds and hundreds of dollars just to settle their tax bill with the Federal Government.

There are some unfortunate perverse incentives with the private market, that the more tax credits that people claim, the more they are going to pay to actually file their tax form.

And then just to close out, timely decision-making. One of the things that I put forward to this committee is to encourage you to move as quickly as possible and not wait until the very end of the year to make tax law changes. This causes—and I think my practitioner next to me, my fellow colleague, will tell you—delays in issuance of publications, problems in issuance of software, volunteers that work with our organizations struggling to correctly be trained and prepare tax returns, and taxpayers not fully understanding the tax code, because they do not have the information in a timely fashion.

I want to thank you very much for the opportunity to testify. I look forward to working with you so that all working families have access to the opportunities and resources necessary to sustain financial security.

Thank you.

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

The CHAIRMAN. Thank you, Mr. Marzahl.

Next, Dr. Marron?

STATEMENT OF DR. DONALD MARRON, DIRECTOR, TAX POLICY CENTER, URBAN INSTITUTE, WASHINGTON, DC

Dr. MARRON. Thank you, Chairman Baucus, Ranking Member Grassley, members of the committee. It is a pleasure to be here today to discuss the 2001 and 2003 tax cuts.

As this committee knows well, our Nation faces difficult economic and fiscal challenges. A year into the recovery, almost 15 million workers are unemployed, and millions more can find only part-time work.

At the same time, budget deficits have rocketed to 60-year highs. Those deficits should narrow in coming years, as the economy recovers and as policy responses to the recession wind down.

But our long-term fiscal outlook remains daunting. An aging population and rising health care costs will push up spending significantly faster than revenues over the next 25 years, putting our Nation deeper into debt.

Today's hearing thus comes at a time when you confront a challenging mix of economic weakness and fiscal imbalances. Against that backdrop, I would like to make six points.

First, tax revenues are remarkably low today relative to the size of the economy, indeed, their lowest since 1950, but they are scheduled to increase very sharply in coming years. Under current law, revenues from the individual income tax, the topic of today's hearing, will increase above record levels relative to the economy by 2020 and keep rising thereafter. And that is not just because of the expected economic rebound and the scheduled expiration of the 2001 and 2003 tax cuts.

Other factors driving individual taxes higher include the expansion of the alternative minimum tax, real bracket creep, demographic changes, and the recent health care legislation.

Second, full extension of the tax cuts and the AMT patch would slow the growth of Federal revenues, but not stop it. Individual income taxes would still rise to a projected 9.2 percent of GDP in 2020, a full percentage point above their 40-year average, but well below the level that would be implied by current law.

Third, full extension of the tax cuts and the AMT patch would provide larger tax reductions to higher-income taxpayers. At the Tax Policy Center, we have a model that basically tries to model all the different taxpayers at different income levels, and what that suggests is that, if you extend fully all the tax cuts, including the AMT patch, that the folks in the top fifth of income distribution, what we call a quintile, would see their effective tax rate decline by about 3 percentage points. The average cut in the middle quintile, right in the middle, 20 percent of taxpayers, would be about

2 percentage points, and then for folks in the bottom quintile, it would be about .6 of a percentage point, on average.

Fourth, some of the tax cuts have been characterized as middle-income tax cuts: rate reductions in the bottom four brackets, marriage penalty relief, and expanded credits. And I think it is important to point out that those provide significant tax reductions not just for what you might colloquially think of as middle-income taxpayers, but actually reach up fairly high into higher-income folks. The higher-income folks benefit from those tax cuts as well, whereas the things that are often characterized as upper-income tax cuts, in particular, the top two rates, and PEP and Pease we have heard about, the primary impact of those would really be on people at the tippy top, at the top 1 percent of income distribution.

Fifth, as you will hear from my colleagues on the panel here coming up in a moment, there is some disagreement about the potential economic effects of extending the tax cuts, both as a matter of stimulus and as a matter of long-run growth.

Before they get started, I would like to emphasize that, whatever path you ultimately choose, the economic benefits are ultimately going to be the largest if Congress chooses to pay for those tax cuts; not immediately, because we have a weak economy, and you would not extend tax cuts for next year and then offset them immediately. That would make no sense, from a stimulus point of view.

But whatever you choose to do, the best economic outcome would be if you then offset that by reducing unproductive spending or raising taxes in a way that does not undermine growth.

Sixth, and finally, regardless of what happens with the expiring tax cuts, my recommendation is that you look for opportunities to do fundamental tax reform. In principle, there are opportunities to both improve economic performance and, if necessary, raise more revenues.

For any given level of Federal spending that you are trying to hit, income tax rates can be lower if you take steps to broaden the tax base by limiting special credits and deductions and other tax expenditures. You can move to a more efficient tax system, even while raising more revenue.

Another possibility to consider would be broad-based consumption taxes or possibly greater use of environmental taxes.

Thank you.

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

The CHAIRMAN. Thank you.

Dr. Holtz-Eakin?

STATEMENT OF DR. DOUGLAS HOLTZ-EAKIN, PRESIDENT, AMERICAN ACTION FORUM, WASHINGTON, DC

Dr. HOLTZ-EAKIN. Chairman Baucus, Ranking Member Grassley, and members of the committee, it is a privilege to be here today. The impending sunsets of the 2001 tax law, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), and the 2003 tax law, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), are very important moments in the course of tax policy.

In my written testimony, I discuss four aspects of that: macroeconomic impacts; the budgetary impacts; impacts on the distribution, the income, and well-being; and then, lastly, implications for

tax reform. And I want to just say a few words about each of those areas briefly in my time.

First, on the macro impacts, I spend a fair amount of time encouraging the committee to frame this question correctly. The economy is now growing and has been. It is growing painfully slowly, and the millions of people looking for jobs know this.

We are no longer in a position where we have a falling economy, where one might want to intercede with commerce or fiscal policies or stimulus, in the political parlance. We should think about this as a situation where we need a ruthless attention to pro-growth policies, and look at the extensions of EGTRRA and JGTRRA from that perspective.

What is on the table there? Well, certainly, the recognition that, if you are going to get near-term economic growth, households have badly damaged balance sheets and weak income growth, and are too strapped to be the source. Governments are, arguably, in a worse position. We can belabor the budget issue.

That leaves, by process of elimination, the business community and net exports as the places where you can make a difference, and you ought to think about the implications of the extensions from those perspectives.

This is not a hearing about the corporate tax, which has a lot to do with international trade, so leave that aside. But there are a lot of small businesses taxed through the individual income tax, a lot of small business income. Marginal tax rates, and the low and equal treatment of returns to innovation and other capital investments, are important parts of economic growth. Capital cost recovery, section 179 expensing, things like that, are important aspects of economic growth.

And so the ability to extend EGTRRA and JGTRRA fully and permanently would eliminate uncertainty, does not raise marginal tax rates, is an important aspect of business tax policy, and thus contributes substantially to the possibility of more rapid economic growth.

The American Action Forum, where I work, teamed with Decision Economics to do some simulations of a temporary and partial extension of EGTRRA and JGTRRA, not extending it for those making more than $200,000, or $250,000 for joint filers, versus a permanent and full extension. And not only is the latter better long-run economic policy for growth, it has better short-run economic impacts, and the tables, I think, make clear that you get faster GDP growth and more employment. You get households' ability to save and repair their balance sheets, and thus put their finances and ability to consume over the long-term, on a more sustainable path. These are the elements of transitioning out of this weak economic period into stronger, more sustained growth, and that is the most important thing our Nation faces right now.

If we do not grow, our children will not get the economy we inherited. The burden of dealing with the outstanding debt will be harder, and I think there has to be an increasing attention to growing rapidly in the United States.

Now, the initial comment, "Oh, you cannot afford this, we have to pay for it budgetarily;" I think you have to be very clear about this. The budget problem is a spending problem, and, if you want

to fix your budget problems, you have to fix the growth in spending, and that is simply the reality.

I am concerned about two things. Number one, partial repeal, for example, is in the President's budget, and, if you look at that budget as priced by CBO, we are still running enormous deficits. So the notion that somehow we have a partial repeal and it solves our budget problems is very deceptive. I do not want people to get tricked in that, and understand the magnitudes.

And the second is, suppose you raise taxes a little bit, and somehow the budget pressures disappear temporarily. If you learn the wrong lesson and continue to try to repeat that trick, given the pace of spending growth, we will have taxes that will be extraordinarily high, 30 percent of GDP, and you do not have to be a Reagan supply-sider to know that is going to dramatically damage the economy.

So the top priority in the budget has to be to control the spending. We can come back to that.

The last two pieces are the distributional aspects. Chart 1 in my written testimony shows what happens to the effective marginal tax rates at each quintile, and there are a couple things to remember about this.

I mean, I understand that this is a political football, and we are not going to resolve the EGTRRA/JGTRRA tax cuts for the rich debate today. But distribution happens on both sides of the budget. So, if you want to think about it clearly, think about what you do on the spending and the tax side. I go through that.

Second is, who really pays differs from who sends in the check. And so, if you do distributional analysis from the point of who bears the effective economic burden, it looks very different, because of the shifting of tax on small business to workers through lower wages and less hiring—a lot of evidence on that front; because of the shifting of corporate taxes to individuals—corporations do not pay taxes; and a variety of things.

The charts in my testimony take account of that, and what they really show is that everyone's effective tax rates went down, it is true, but the one on the top, the effective tax rate in the top window, went down by something that is sort of typical of variations since 1979 when the CBO started putting these together.

In the bottom four quintiles, the effective tax rate fell to the lowest since 1979. So the real story here is that the bottom four quintiles are at record low levels of taxation, not that there was a record tax cut for the rich.

Then finally, on tax reform, I think you will get tremendous concurrence at this table that we dramatically need tax reform in the United States. The tax code is simply not up to the needs to raise revenue and promote economic growth.

In thinking about extensions, then, you should think about how half the tax reform gets effected. Tax reform is about lower rates and a broader base. My preference would be for a consumption base, and that is a good discussion to have. But the kinds of extensions we hear being discussed, raising marginal rates and preserving exemptions from tax, are exactly the wrong direction, from a tax reform point of view, and I think you should avoid that error. It will just make tax reform harder in the long run.

Thank you.

[The prepared statement of Dr. Holtz-Eakin appears in the appendix.]

The CHAIRMAN. Thank you very much.

Dr. Burman, you are the final witness.

STATEMENT OF DR. LEONARD BURMAN, DANIEL PATRICK MOYNIHAN PROFESSOR OF PUBLIC AFFAIRS, MAXWELL SCHOOL OF SYRACUSE UNIVERSITY, SYRACUSE, NY

Dr. BURMAN. Chairman Baucus, Ranking Member Grassley, members of the committee, thank you very much for inviting me to talk about extending the 2001/2003 tax cuts.

When the law was enacted in 2001, with a sunset in 2010, a lot of people, including me, were a little bit skeptical about that as policy and thought it might have been a cynical budget gimmick. But in retrospect, I think it turned out to be brilliant, because it provides us with an opportunity to reexamine the policy, and I am glad that the committee is doing that.

We have a very different fiscal environment now than what we had in 2001 or what we thought we had. In 2001, we were looking at a projection of $5.6 trillion of surpluses for the next decade. Right now, we are looking at projections of something like $10 trillion in deficits over the next decade.

The baby-boomers are about to retire—actually, they have started to retire—and it is going to put unprecedented pressures on the budget. Spending is going to increase, and continuing current policy, where spending increases and taxes are low, will lead to a disaster.

CBO projects that, when you account for the kinds of macroeconomic responses that would come from the rising national debt, the debt would be at 188 percent of GDP by 2027, 200 percent by 2028. That would be a disaster.

My colleague has said that low taxes are pro-growth, but low taxes, continuing current policies, is not pro-growth. It will lead to an economic catastrophe, and I actually think it could be worse than what CBO projected; that basically, we could become Greece, and nobody would want that to happen.

In my view, making the tax cuts permanent would be a mistake. One is, we cannot afford to do it without reneging on promises we have made to seniors. Now, you can talk about how cutting spending is a solution, but the kinds of spending cuts you would need, while keeping tax revenues at less than 20 percent of GDP, would be draconian.

Second, the income tax is a mess. As Dr. Holtz-Eakin said, everybody on this panel agrees that we need tax reform. It is complex, it is unfair, it is inefficient. Why would we want to carve that system in stone?

Finally, we think that we cut taxes in 2001 and 2003, but my view is that taxes were not cut at all. They were just deferred. They added something like $3 trillion to the debt over the last decade, because spending was not cut to offset them, and that is going to have to be paid back with interest.

All economists would agree that keeping tax rates stable at some level would be better than cutting them temporarily and then rais-

ing them to offset it in the future, because the higher the tax rate goes, the larger the economic cost is. So going from, say, 40 to 45 percent entails more economic costs than the benefit you got from cutting rates from 40 to 35.

That said, obviously, we are also in a recession, and a big tax increase now would be a mistake. What I propose in my testimony is extending the low- and middle-income tax cuts, but only for 3 years, and have a rock solid commitment to tax reform over that period.

Senator Wyden and Senator Gregg have been leaders in the tax reform effort. The one thing that I would encourage them to do would be, in the next step of tax reform, to come up with a plan that actually would raise enough revenue to pay for government.

What we have been trying to do over the last decade is this idea of, we will cut taxes and somehow spending will follow. It has not worked. Starve the beast does not work. What has actually happened instead is that, if deficits are okay for taxes, deficits also seem to be fine for paying for a new prescription drug benefit under Medicare, or a bridge to nowhere, or whatever. It has actually stimulated a huge growth in government.

I think the better thing to do would be to reform the tax system, design it so that it could actually pay for the government, and then take steps to control spending. Dr. Holtz-Eakin is absolutely right that the path of spending cannot go on as it is projected by CBO. But in my view, the solution is going to be a combination of more taxes and lower spending, and that is what we need to work on.

So why not just extend everything? Well, first of all, we cannot afford it. The second thing is that I think by only extending the middle-class tax cuts, it would help maintain support for tax reform. The idea of tax reform, as my colleagues have said, is a low rate and broad base.

Well, right now, we have a low rate and a narrow base, and the people who benefit from that think that is just a dandy system. I want to bring those people to the table and say that, if you want to lower rates, you want to have a tax system that is more conducive to growth, you have to participate in the tax reform debate.

There is an issue of, well, won't the higher top rate stifle the recovery? I would say no, and for a couple of reasons. One is that higher-income people do not spend more when you cut their taxes, and they are not going to spend less in the short-term if you raise their taxes. People with incomes over $200,000 spend about a third of their income, whereas lower-income people spend all of their income.

There is an issue about small businesses, and I am certainly sympathetic to the concern of the committee to not do things to discourage small businesses and entrepreneurship. In the short run, the effect of raising the top marginal tax rates would have very little, probably negligible effect on small businesses.

First of all, only 3 percent of small businesses—I know, a very broad definition—are in those top brackets. Second of all, when they are making decisions about things like hiring, if hiring an additional worker is profitable when you get to keep 65 percent of the profit, it is also going to be profitable if you get to keep 60 percent of the profit.

The Congressional Budget Office concluded that raising marginal tax rates would not have any effect on small business hiring in the short term.

The fact is, also, that the higher income taxes—higher income tax rates—actually encourage entrepreneurship. The reason is that entrepreneurs get to take deductions that regular people do not take, and those deductions are more valuable at a higher rate than a lower one. I am not arguing for high rates generally, but I am just talking about the short-term impact.

One very valuable thing that small businesses have is an option that, if their businesses turn out to be profitable, they can incorporate and benefit from the lower 15-percent corporate tax rate. And then there is risk-sharing between the government and the businesses. Basically, you get to deduct your losses and pay tax on the gains. That is actually a very valuable option. I would be happy to talk more about this in the Q and A.

My goal would be to try to repeat the trick of the 1986 tax reform: low rates, broad base. But the current system could not be farther from that ideal, and I think reform is necessary. And not extending the tax cuts permanently, but only doing it for a short time period over which you would commit to putting together a tax reform plan that could be voted on, would be the best option.

I look forward to your questions. Thank you.

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

Senator GRASSLEY [presiding]. Senator Baucus was called out, so I will go ahead with the first question. And I could direct this to everybody on the panel, but I think that will take too long. So I would like to have Dr. Holtz-Eakin, on one hand, and another point of view from Dr. Burman, to this question.

On page 10 of the pamphlet prepared by the Joint Committee on Taxation, we have this quote: "Fifty percent of the approximately $1 trillion of aggregate net positive business income will be reported on returns that have a marginal rate of 36 percent or 39.6 percent."

So 50 percent of flow-through business income will get hit with President Obama's proposed tax hike, since they have proposed to raise the top two tax rates. This is especially harmful to small businesses, because they operate on flow-through income.

Republicans and Democrats agree that small business creates 70 percent of the net new jobs. With unemployment at 9.5 percent, is it a good idea to raise taxes on half of the flow-through business income?

Let's start with you, Dr. Holtz-Eakin, then Dr. Burman.

Dr. HOLTZ-EAKIN. I think this is a bad idea, and I think there are a couple important points. First is it is the magnitude of economic activity that you are taxing that matters, not the number of tax returns that get filed. So the fact that there are only 3 percent of tax returns there does not mean anything.

If you look at the corporate tax, there are very, very many corporations that pay no tax, probably over half. There are a few corporations that get affected deeply by the corporation income tax, so we do not think the corporation income taxes are irrelevant, and

we know they have very big implications for our competitiveness and growth.

So counting tax returns is not the way to do this. Fifty percent of the $1 trillion is what matters.

The second thing is, it has very significant effects. My own research says that, if you raise the top rate from 35 to effectively 42 percent, given all the phase-outs, you are going to lower the probability of a small business hiring by about 18 percent; and, for those who already have people on the payroll, payrolls are going to grow 5 percent slower than they would otherwise.

The tax has to come from somewhere, and it is going to show up as less hiring and lower wages for workers, and, in that way, it gets shifted onto them. That is where the real burden is going to be.

Senator GRASSLEY. Dr. Burman?

Dr. BURMAN. It is absolutely true that you want to look at the amount of economic activity, but a lot of that income actually does not represent what we think of as small business, and it is probably relatively insensitive to taxes.

Lawyers, doctors, bond traders, members of corporate boards show up as small businesses on the tax data, but they are unlikely to be affected by the increase in the tax rate.

The second thing is, what would the effect on hiring be in the short term, and, as I said in my testimony, if somebody is going to be—if a new hire is profitable at a 35-percent tax rate, it would also be profitable at a 40-percent tax rate or a 42-percent tax rate.

The fact is that higher tax rates offer lots of incentives for people to choose to become small businesses.

One thing that the committee probably does not want to talk about, but it is true, is that small businesses are notoriously noncompliant. They have a 57-percent error rate. The amount of income they report to the IRS is off by 50 percent from what the actual income is.

The fact is a lot of people use small businesses as a tax shelter, and the value of the tax shelter goes up when the rate goes up.

Senator GRASSLEY. Dr. Burman, I want to challenge you on one of your—some of your testimony. In your testimony, regarding the top two tax rates, you said that, “Employers will hire a new worker if they expect the value of the worker’s output to exceed what he or she is paid.”

You went on to state, “If the hire is profitable before tax, it doesn’t matter whether the employer gets to keep 60 or 65 percent of that additional profit.”

So my question is, if it does not matter whether the employer gets to keep 60 or 65 percent of that additional profit, then would it also not matter whether the employer only gets to keep 10 percent of that additional profit? That is, would it distort employment decisions if we had a 90-percent tax rate?

Dr. BURMAN. As a practical matter, if you said that the next hire would be taxed—the profit on the next hire would be taxed at a 90-percent rate rather than a 35-percent rate, it would still be profitable after tax. Obviously, high marginal tax rates entail economic costs.

Actually, I came to Washington to work on the Tax Reform Act of 1986. I think low tax rates and a broad base, maintaining progressivity is a really good idea. The problem is we have a very porous tax system, and there are a lot of loopholes and deductions built into the tax, and those become more profitable at a higher rate. Those allow for all sorts of tax sheltering opportunities.

So the solution is to enact tax reform, to broaden the base and to cut the rates in a way that raises enough revenue to pay for the government, but does not create all sorts of tax shelter opportunities.

The CHAIRMAN [presiding]. Thanks, Senator. I regret I was out, was unable to listen to some of the earlier discussion. I want to get back to, I think, one of the subjects, and that is the assertion that so much of small business activity is in the top two rates. I say assertion, because the fact is, it is not.

It is true that 50 percent of business income is with respect to taxpayers at the top two rates. That is big business. It is not corporate big business, it is pass-through big business.

We are not talking about small business. We are talking about the top two rates. We are talking about big business, and big business is hedge funds, it is other professional corporations, it is large law firms, it is large accounting firms. And over 70 percent of the so-called 50 percent is big business, whereas 97 percent of small businesses, in terms of numbers, are not in the top two rates.

So I think we should make it clear what the facts are here. It is true that 50 percent of business income is the top two rates, but that is not the small business. By and large, that is big business. It is not corporate big business, it is individual big business, pass-throughs that organize themselves that way so that they can avoid the corporate income tax.

In fact, it is getting abused. A lot of, say, hedge funds are going public. They really should be corporations, because they are publicly traded. So, in effect, they are corporations, even though they take advantage of partnership law.

So I just want to ask anybody if I am accurate with my basic assertion. I will start with you, Dr. Burman. Is what I said, by and large, basically true?

Dr. BURMAN. It is absolutely true.

The CHAIRMAN. Thank you.

Dr. Marron, do you agree or disagree?

Dr. MARRON. I would agree and just elaborate that, right, in the top two rates, there is a lot of pass-through income, as you say. Some of it is from big businesses and some of it is from things that you would not really even recognize as being business activity, but it is just labor income that is characterized that way.

The CHAIRMAN. The figure I saw, that was accurate. I even think it is in the pamphlet. It is 70 percent of that 50 percent that is big business, and the remainder might be categorized as all business. But still, we are talking about 3 percent of businesses, which is a very small number.

My guess is that the real job creation is with the 97 percent of small businesses, and, with the smaller businesses, it might be up in that 50-percent category. That is the small business that creates jobs.

If you are truthful about it, all these law firms are letting people go. I do not know if accounting firms are, but I know a lot of law firms are letting a lot of their associates go. It is just you cannot—do not hire. There is not much job creation in these big law firms, which are partnerships.

I know you really want to speak, Dr. Holtz-Eakin, so I will let you speak.

Dr. HOLTZ-EAKIN. Thank you, Mr. Chairman. I am puzzled, actually, by your observations from the point of view of tax policy. Benchmarks for tax policy used to be that the tax code was designed to discriminate as little as possible among alternative activities, small or large business.

And so it seems odd, from a tax policy point of view, to somehow be aiming at the big business and not the small business, when——

The CHAIRMAN. That is not the point. No, no, no.

Dr. HOLTZ-EAKIN. And then the second——

The CHAIRMAN. Let us stop right there, and you can—that is not the point. The point is just trying to let the facts speak for themselves. And the facts do speak for themselves, and the fact is that it is true that 50 percent of business income is the top two brackets. That is true.

But it is also true that the vast majority of those are big, pass-through, professional organizations, not what one would ordinarily think of as a small business.

Dr. HOLTZ-EAKIN. The second point, just an observation about the debate on tax policy. And I think there is another benchmark we used to aim for and was heavily part of the 1986 reform, and that was the notion of integrating the corporate and individual taxes, because in the end, people pay all taxes, and pass-throughs were viewed as a desirable thing, because they allowed us to tax all business income, small and large, of an individual at the appropriate—at the individual's appropriate rate.

So I think that we ought to remember, since we need tax reform, that this issue of taxing small and large business income on the individuals was a goal of tax reform, and that we should recognize, as a result, the implications of individual taxes for business activity.

The CHAIRMAN. Well, clearly, we need reform. There is no doubt about that. You have all touched on that, and we will work on that soon. I do not think there will be significant tax reform this year.

If we could, frankly, I would like whatever action we take today on the 2001/2003 tax cuts to be at least a step toward reform, not backwards.

And I think one of you, it might have been you, Dr. Holtz-Eakin, or someone suggested—I am sorry. Can I have order, please, on the committee? To be courteous to our witnesses, please. Thank you very much.

One of you said that a step—it might be improper to just plain extend the rates and not do much else, because that might be a step backwards from reform. But I am hoping we can find some way to at least take a step towards reform in whatever we do.

Thank you very much.

We have enough Senators here, so we could conduct some business, actually, as minor as it is.

As is our usual practice, the committee plans to have meetings to discuss the committee's agenda. And I would like to, as is our customary practice, do that next week. And as is our usual practice, I ask consent that it be a closed meeting. Without objection, so ordered.

Senator Bingaman?

Senator BINGAMAN. Thank you all very much. Let me just simplify the discussion a little bit. As I understand, the argument that is being made for extending the tax cuts that were enacted in 2001 and 2003, the main argument is that this will contribute to economic growth and job creation.

I think, Dr. Holtz-Eakin, you made that point, and I think others might have, as well.

It is my impression that you get more bang for the buck from extending middle-class tax cuts than you do from extending the tax cuts for folks with higher incomes, because the middle class is more likely to spend the money that they obtain through those continued tax cuts.

Let me ask you, Dr. Burman. Is that an accurate way to think of it?

Dr. BURMAN. That is certainly the traditional way economists have thought about the effects of tax cuts on the economy in the short term.

Senator BINGAMAN. I guess the other concern I have is that if, in addition to extending the middle-class tax cuts, we also were to choose to extend the reduced top two rates or the tax cuts for folks with incomes over $200,000 or couples with incomes over $250,000, the loss of revenue to the Treasury over the 10 years is about $1 trillion.

Going forward, I can understand the philosophical argument that we ought to be trying to make that $1 trillion up through cuts in spending, but I do think it makes sense to recognize early in the process we are going to have to do both. We are going to have to cut some spending, just as we did in 1993 when President Clinton came into office, and we are going to have to raise some revenue.

And, if we cannot raise revenue in this way, I do not know where we will raise revenue. So I do not know. Again, Dr. Burman, do you have any thoughts on that?

Dr. BURMAN. It is absolutely right that, even if we limited the tax cuts to what is defined as low- and middle-income people up to $250,000, we would still be running substantial deficits over the next 10 years, and there is going to be a need for both more revenues and spending restraint.

The point I made in my testimony is that, if we cut taxes on high income people now, given the long-term budget projections, eventually taxes are going to have to go up anyway, and they will have to go up by more because of the tax cuts that are being granted in the short term.

The Congressional Budget Office, when Dr. Holtz-Eakin was the director, and the Treasury Department looked at the effect of tax cuts that are financed by deficits, and their conclusion was that they ultimately led to higher taxes; that they actually left the economy worse off than if the taxes had not been cut at all.

So I would say that, as a practical matter, unless you can accomplish some kind of spending reductions that we have never seen in our history, the effects of the tax cuts right now, at best, if there are any economic benefits, will be short-lived and that, over the long term, we would be worse off.

Senator BINGAMAN. Let me ask, Dr. Marron, do you have any thoughts on any of this? If you do, I would be anxious to hear them.

Dr. MARRON. Certainly. I guess the first is I would like to emphasize the traditional economists' distinction between the short run and the long run. As you said in your opening remarks, your opening question, in the short run, if you are worried about stimulus, tax cuts that are more oriented towards people who will spend the money rather than save it are likely to have a bigger bang per buck effect.

Over the long run, though, you have heard all of the economists on the panel here say that one of the key things to have for long run growth is lower rates. And so you have this tension, when you think about the top two tax brackets.

Those are ones that, in my view, are not crucially essential one way or the other when you are thinking about stimulus. But the rates in those are quite important when you think about long-run growth. And you have this tension that, for the economy, it would be good to have lower rates, but it would also be good to have a smaller deficit and to have greater revenue, and you would like to find a way to fund it.

In that regard, I would just like to point out that the tax reform proposal that Senators Wyden and Gregg have put forward, which has this attribute—my organization scored it. And we found, if you look at just the individual income tax component of it, what happens under it is that it raises somewhat more revenue relative to a baseline of extending all the tax cuts.

So it raises somewhat more revenue. It lets you keep the top tax rate of 35 percent, and it makes a more progressive tax system. And the way it does that is by trying to fill in some of the Swiss cheese of our existing system and broaden the base.

And I think from an economic growth point of view, if you want to do things on the tax side, that is the right direction to look: lower rates and then fill in the base.

Senator BINGAMAN. But if we are not going to this year fill in the Swiss cheese, then are you suggesting it still makes sense to cut the rates?

Dr. MARRON. I think it then becomes an issue of how concerned you are about the possibility that the economy may take another downturn in the next year or two, because there is this race between the fact that this would provide—extending them provides some additional stimulus, but not as much as the middle-income tax cuts or things like extending unemployment insurance, but it would provide some incremental stimulus.

Senator BINGAMAN. Thank you, Mr. Chairman.

Senator GRASSLEY [presiding]. Again, sitting in for the chairman, I call on Senator Hatch.

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

Dr. Holtz-Eakin, let me just ask you this question. In your testimony, you said that more rampant economic growth will be essential to minimizing the difficulty of slowing the explosion of Federal debt to a sustainable pace.

Would you elaborate on that idea and, also, discuss the role that tax rates have in dealing with the deficit and our overall debt?

Dr. HOLTZ-EAKIN. I think the first point is very simple. The projected growth of Federal debt is unbelievable. It is projected to be $20 trillion of debt in the hands of the public by 2020.

The larger is the economy by that time; thus, the more rapidly we grow, the easier it will be to carry the burden of both that debt and the interest payments on it, and provide a satisfactory standard of living.

So growth is paramount at this point in time. Tax policy is one, not exclusively, but one important part of the environment for rapid growth, and, in that regard, I think when Senator Bingaman was asking, geez, how do you get more revenue to make sure that you add up the budget, well, the answer is exactly what Dr. Marron said—broaden the base and keep rates low.

In terms of the language of this discussion, no one here has proposed—I do not think a tax cut is on the table for anyone. We are trying to keep rates where they are. And so this is a question about whether you do the wrong thing, from a tax policy point of view, raise taxes, marginal tax rates at the top, raise taxes on dividend income, provide unequal treatment of different kinds of equity investments. Those are all anti-growth provisions.

So tax policy is going to matter a lot.

Senator HATCH. Well, you mentioned that CBO is projecting that we will suffer a reduction in GDP growth of about 1.4 percent in 2011 if the 2001 and 2003 tax acts are allowed to sunset.

Now, would that likely also lead to further job losses?

Dr. HOLTZ-EAKIN. Yes, it would. It would be a large negative fiscal shock in the short term, and it would have detrimental long-run growth consequences.

Senator HATCH. In your testimony, you said that our dire long-term budget outlook is not the result of a shortfall of revenues. It seems to me that in the short run, however, we do have a shortfall of revenue, and it is from the economy not performing up to its potential.

Would not more economic activity generate more revenue simply because more of the unemployed would be earning again and paying taxes, and more capital gains and dividends and bonuses would be generated, which, in turn, would lead to higher revenue collections?

In other words, if we want more revenue in the near term, do we not need to enact the kind of policies that will lead to more economic growth? And finally, would not tax rate increases lead to just the opposite of this effect, which is less economic growth?

Dr. HOLTZ-EAKIN. Tax rate increases will not help economic growth; they are a mistake from that perspective. We do need the economy to recover not just for the Federal budget, but for the people who are unemployed. It is imperative that we focus on more rapid growth both in the near term and over the long term.

So I think there should be a ruthless attention paid to the growth prospects in this economy.

Senator HATCH. Beginning on page 7 of your testimony, you outline the difference between a permanent extension of the 2001 and 2003 tax acts compared with a 1-year limited extension.

Now, if we assume that Congress extends only the limited provisions of the acts a year at a time for 10 years or even longer, how would this compare in economic growth and other benefits to a permanent extension of the full acts?

Dr. HOLTZ-EAKIN. One-year extensions over that kind of period would retain the detrimental uncertainty that we have right now. People do not know the future of the tax code. They cannot do adequate tax planning. It would interfere with businesses' ability to make sensible investment decisions.

There is nothing good about having the tax code up for grabs year after year after year. Settling it and allowing people to plan appropriately is entirely desirable.

And if I could, I want to emphasize for the committee the nature of the experiment that I put in table 1. I am well-aware of the debate over stimulus and multipliers and all of that. It is important to recognize those are model-based debates. That is not about reality.

All of that discussion by Dr. Zandi and the others who have been featured so heavily are based on their, quote, "models." There is a lot of evidence those models are wrong. And there is a very nice piece by Greg Mankiw that summarizes that evidence.

My point was, even in the context of those models, and we used one like that, it is better to do the permanent full extension than the temporary and limited extension from a near-term economic growth perspective. So even in the context of stacking the deck against the policies I prefer, they come out ahead.

Senator HATCH. I just have a few seconds left. Well, at the end of your written testimony, you spend some time discussing the concept of who really pays the tax. Would you elaborate on the idea that the incidence of an increase in tax of the top two rates may not be borne by those whose names are actually on the tax returns that report the income that would be taxed at these new levels?

In other words, to what extent might employees or others who are not the business owners be affected by an increase in these tax rates?

Dr. HOLTZ-EAKIN. As I mentioned before, it was viewed as desirable to have business income taxed on the individual's returns. So individual rates matter for business decisions.

In the research I have done with a variety of coauthors, we find that increasing marginal tax rates lowers the probability that businesses will make a hire, lowers the size of payroll growth, lowers the probability they will buy new capital equipment, and lowers the amount they buy if they do buy it.

In each case, that reaction pushes the incidence of the tax, the economic burden, onto someone else, either onto laborers or onto their suppliers, and the real cost is not borne entirely by who sends in the return. It is borne elsewhere in the economy.

Senator HATCH. Mr. Chairman, I have to leave, but I want to come back. I have questions for the rest of the panel, as well. So I will try to get back, but, if I cannot, I will submit them.

Senator GRASSLEY. Senator Wyden?

Senator WYDEN. Thank you, Senator Grassley. It has been an excellent panel.

As you all know, tax compliance is one of the country's biggest industries. It comes to about $193 billion a year. The American people are, of course, furious about all this tax compliance water torture. Everybody in politics says it has to be fixed, and then what happens is people are skeptical that it will, and everybody goes back to tinkering with the tax system again.

There were 500 changes in tax law in 2008. It comes to more than one for every working day. This has been the case for years and years.

So here is my question. And I was very pleased about Chairman Baucus's comment about tax reform. Let us get you, Dr. Burman, and you, Dr. Holtz-Eakin, on this first and bring in others at the end.

What is going to force tax reform onto the agenda? In other words, I am not sure what the mechanism is to actually get this out there and with the bipartisan support you are going to need to get it done.

Now, to me, the best opportunity coming up is the Deficit Commission. That would give us a chance to bring Democrats and Republicans together around principals like real tax relief for middle-class folks, say, tripling the standard deduction, wiping out the alternative minimum tax, and also promoting the kind of growth you are talking about, Dr. Holtz-Eakin; for example, lowering the corporate rate so that we could get American manufacturing, high-skill, high-wage jobs in our country again.

What do you think is going to be the mechanism, the two of you, to force tax reform onto the agenda?

Dr. BURMAN. Well, as you know, Senator Wyden, it is very, very hard to do this. You have been trying for a long time, and I applaud you for your leadership on this.

I was thinking about what led to tax reform in 1986, and a big part of it was that the tax system was viewed by almost everybody as a total mess. Proliferation of tax shelters was a big factor. It is getting to that point again.

And the further problem we have now that we really did not have in 1986 was that tax revenues are clearly inadequate to pay for the promises that we have made, particularly to seniors through Medicare and Social Security.

So I agree that the Deficit Commission is a good opportunity. What I am hoping is—and the 1986 tax reform was revenue-neutral, and that made sense at the time.

I think, given that taxes have to increase, it would make sense to say that what we are going to do is throw out this irrational tax system that most people perceive to be unfair and replace it with one that people can understand, the practitioners can deal with, and that people perceive to be fair, so that there is an equal sacrifice going around.

So I think, actually, the need for more revenues could provide a big impetus for tax reform, or at least I hope it does.

Senator WYDEN. Dr. Holtz-Eakin, what gets tax reform on the agenda?

Dr. HOLTZ-EAKIN. Well, ultimately, it is a political question, and, since my track record in politics is pretty rotten, I do not know why you would ask me. But I do want to say that the first and most important ingredient is leadership, and you and Senator Gregg are to be commended for putting out a bipartisan plan that attempts to lower rates, broaden bases, make us internationally competitive. I view those as imperatives, as you know.

The second thing I would say is that I would concur that the deficit outlook is one that everyone recognizes is threatening and must be dealt with. I have strong feelings about sort of sharp tax increases in the near term, which ameliorate that deficit and delude people into thinking we do not have to deal with the spending side.

But, if I can be assuaged that that delusion does not take place, then that is the vehicle to make this happen.

Senator WYDEN. One last question. And thank you both, and I am looking forward to working very closely with you, as I know the chairman is.

Dr. Marron, let me get you into this. One of the most bizarre aspects of today's tax system is that, as long as you are tinkering, the Congress inevitably starts pushing permanent tax increases to solve temporary problems, like, particularly, the alternative minimum tax.

In other words, every year, the Congress comes in and tries to put another patch on the alternative minimum tax, which is a killer tax; talk about hitting the middle-class folks that Senator Stabenow does a great job of championing. That is just a killer tax.

Should Congress not get away from the idea of applying another permanent tax increase to solving a temporary problem? Because I think that alone is a pretty strong indictment of what happens today and why we ought to reform the system.

Dr. MARRON. That is a fine question. It is something you see in a lot of contexts. There is something similar that happens with the doc fix in Medicare, where you have basically temporary things, and the only way to deal with them is to pay for them, if you pay for them, as you described.

The answer to that is to solve your first question of having some forcing moment to get together and design a rational tax system, one that can eliminate the AMT, eliminate these other features, and raise the right amount of revenue, as Len says, and promote growth.

So I view the answer to that problem as being basically the answer to your first problem.

Senator WYDEN. Fair enough. Colleagues are all waiting. Mr. Chairman, Senator Bunning is next. Should we just recognize him?

Senator GRASSLEY. Yes.

Senator WYDEN. Senator Bunning?

Senator BUNNING. Thank you very much, Senator Wyden.

This question could be for Dr. Marron or Dr. Holtz-Eakin. I realize that this hearing is not supposed to be about capital gains and

dividend rates, but some of you mentioned them in your written testimony, and they certainly have an impact on economic growth.

I am already hearing from dividend-paying companies that stock analysts have downgraded their stock because of the likelihood of a 40-percent tax rate on dividends next year. This has already raised the cost of capital for them.

Dr. Holtz-Eakin, what impact does raising the cost of capital have on the economic growth and job creation? And the same question for Dr. Marron.

Dr. HOLTZ-EAKIN. There are two big impacts. Number one, you will see a higher cost of capital, diminishing investments in physical capital and new technologies, and that will diminish the productive capacity of the economy.

The second, and I think the one that has not been discussed enough, is the fact that, under the proposal, the dividend rate would now vastly exceed the capital gains rate, which we capped at 20 percent. That differential means that there are now big distortions in corporate financial policy between not only debt and equity, but within equity.

So dividend-paying firms will have an incentive to stop paying dividends—and most of those are going to be going to seniors—and instead will be holding on to retained earnings and distributing their returns in the form of a capital gain.

It is a standard channel they use, and that means you would have a lot more buyback activities, and there is no value to that. That is a true waste.

Senator BUNNING. But what if the capital gains rate goes from 15 to 40?

Dr. HOLTZ-EAKIN. If you equalize the two treatments, you will get less of the pure financial engineering, but you will have even more dramatically bad impacts on overall economic growth, from the investment sense.

Senator BUNNING. Dr. Marron?

Dr. MARRON. The piece that I would particularly like to pick up on is the differential between the dividends and the capital gains, where I have been unable to come up with any rational tax policy reason why you would want to tax dividends higher than capital gains.

For a variety of reasons that Doug touched on, if you tax dividends a lot, it is basically an incentive for corporate management to hoard cash, and I am sufficiently cynical that I do not think that is a good thing for tax policy to do. At the margin, I think it is good for the profits to be redeployed to investors, who can then decide the best place for them to go.

And so, separating out from the level question, I would like to emphasize that, in my opinion, it is very important to have those rates be equalized.

Senator BUNNING. Does anybody here remember Dan Rostenkowski and Bill Archer? In 1992, Ron, we had a retreat on the Ways and Means Committee to do exactly what you are attempting to do presently with our colleague from New Hampshire, and we had maybe 40 really good suggestions come out of that retreat.

Do you know how many have been enacted? Zero. None of them. Now, what kind of incentives can you give us to change tax policy,

not incrementally, but significantly, to make it really—in other words, how can we get to the entitlements? How can we get to the things that really cost money without just incrementally changing?

Yes, go right ahead, anybody who wants to.

Dr. HOLTZ-EAKIN. The traditional obstacle to tax reform in the United States is the business community. That is the problem, because they have an enormous vested interest in rifle shot provisions, and some have old capital and others are startups and they would like to get expensing for new capital, and so they tear apart any attempt to broaden bases and lower rates.

So the best way to get to something like Wyden-Gregg or a tax reform that a tax economist would be proud of will be to lock the business community out of the room.

Ms. MARKMAN. One of the things I would really like Congress to consider——

Senator BUNNING. I have one more question, so let me make sure——

Ms. MARKMAN [continuing]. Is to eliminate the zero capital gain rate. It distorts income tax for people, and it does not make any sense. I have seen people with significant income, because it comes from dividends, qualified dividends, paying no tax, and that makes no sense.

Senator BUNNING. I have one more question, because I want to read something. Here is the significance of the estate tax. George Steinbrenner died yesterday, in 2010. If he had died in 2009 or 2011, there would have been a $500-million tax liability to his estate in 2009, and, in 2011, under the proposal that we have, there would have been $600 million. Because he was smart enough to die in 2010, there is zero tax liability to the estate.

Now, should that kind of estate tax exist presently, or should we propose it?

Dr. BURMAN. It does show that people respond to incentives. [Laughter.]

Senator BUNNING. Amen.

Dr. BURMAN. I think the estate tax serves as an important backstop to the income tax. There is actually a lot of income that is never taxed because of the various kinds of tax shelters that are available in the code.

I think actually extending something like the 2009 law and, generally, creating certainty would be a huge advantage. The fact that—I was actually amazed that the estate tax was allowed to lapse for at least part of the year and that——

Senator BUNNING. So far, it is the whole year.

Dr. BURMAN. In 2001, when the original legislation was passed, I made up this satirical timeline of what would happen as a result of the incentives in the law. And I suggested in 2007, the company that invented the artificial heart would come up with an estate tax saver, where they would keep people alive until 2010; and I said, of course, in 2010, they were all turned off, but the big surprise was then all these seemingly healthy people walked off into the sea, saying, "It's for the children."

You should fix this.

Senator BUNNING. I agree with you 100 percent.

The CHAIRMAN [presiding]. Thank you, Senator.

Senator Stabenow, you are next.

Senator STABENOW. Well, thank you, Mr. Chairman, for holding the hearing, and to all of our witnesses.

And I want to start by saying I wholeheartedly support our efforts on tax reform that I know we will be involved in over the long run, and the comments of Senator Wyden on the AMT and other issues that we need to address.

I do want to start with a couple of comments, though, that reflect what I believe the real world is for the majority of Americans and, certainly, the majority of the people who live in the State of Michigan.

We, a decade ago, saw the largest budget surpluses in the history of the country, coming off a time when actually rates were higher, but there was a real focus on economic growth and jobs and so on, in the 1990s.

A big question was what to do with the largest budget surpluses in the history of the country, when I came here in 2001 and sat on the Budget Committee, and the answer was that, because of policies, including the tax cuts that were passed, they turned into the biggest budget deficits in the history of the country. And that, unfortunately—and this is a comment, Dr. Burman, I think you made—left the economy worse off.

I know it left the economy worse off for the people I represent. I wish it had worked. I sincerely do. I think we have a different view on what works and what does not, what the reality is for the majority of Americans. I think we have very different views on this committee, and I respect the differences.

But I have to say that coupling a focus on supply-side economics with tax cuts at the top to trickle down—which did not, coupled with a number of things that happened in terms of two wars not being paid for and other spending not being paid for, and then, frankly, the recklessness on Wall Street, which, since that time, has cost 8 million jobs—has put the people that I represent and the majority of the country into a situation where they are looking at this debate, I believe, and saying, "What are you guys talking about?" in terms of what is happening to real people.

And to add insult to injury, we hear arguments that say we should not worry about deficits when extending the tax cuts in the top two rates, we should not worry about deficits then, but, if you are trying to help people out of work, then we have to worry about deficits.

So this just does not compute for the folks I represent. And when we look at the fact that extending the tax cuts will account for nearly 60 percent of the deficit in 9 years—and I am for, in fact, focusing on middle-class tax cuts and the things that affect the majority of Americans, including upper-income people who benefit by those.

But I just want to say for the record that at a time when people are losing their jobs, working part-time jobs, seeing their wages go down, and the incomes of the wealthiest 400 people in the country have gone up about 400 percent in the last decade and a half and their tax rates have been cut in half, for the majority of Americans, that does not compute. That is just not fair.

And so on the issue of fairness to people in this country, I believe one way to deal with that is the middle-class tax cuts, focusing on what has been talked about by many people here in terms of the family credits and child credits and so on, but not giving the extra help to the top 1 percent.

Dr. Burman, I wonder if you might speak to whether or not allowing the top two rates to expire would address some of the inequities that the majority of Americans feel today.

Dr. BURMAN. I certainly agreed with your statement that there has been this issue that incomes at the top have been exploding; and, obviously, they took a hit over the last few years, but at the same time, we have been cutting taxes disproportionately at the top.

I think that our tax system plays an important role in terms of mitigating some of the inequities that come out of the market system. Basically, the people at the bottom, working as hard as they can, have a hard time taking care of their families, and some of the tax credits that have been enacted helped them to be able to pay their bills.

Now, the debt, I think, should be a serious concern for the people of Michigan and everybody else, because one thing that we do not focus on is that a lot of our debt is—your debt is financed by foreigners. Basically, as a country, we are spending much more than we are producing.

People outside the United States lend us money, and we use it to buy their stuff. So basically, we are paying for imports. The imports directly track the growth of the debt.

So dealing with that, which I think means actually dealing with the middle-class tax cuts eventually, as well as the ones at the top, is really important, and the best way to do that would be in the context of a tax reform that preserved the fairness and made the tax system simpler.

Senator STABENOW. Thank you. I have other questions, but I see my time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Next is Senator Roberts.

Senator ROBERTS. Thank you.

Dr. Burman, I am struck by this—this is apart from my questions, and I am going to be wasting some time here, but maybe not. I did not know that you were that involved in the 1986 tax bill.

I was the only member of the Kansas delegation who voted no. I heard directly from Bob Dole after that. I thought he did that. I did not realize you had played such a large role in that.

That Tax Act put the real estate industry in the ditch, put agriculture in the ditch, the oil and gas industry in the ditch, put Kansas in the ditch, and, for 5 years after that, at town hall meetings, people were still complaining about it, and I could raise my hand proudly, and I said, "I voted no."

I do not know what all that means, except to say that I was very interested in your comments about that. And the way I view it, in terms of what happened in the real world, in Kansas, as opposed to what was proposed and what was hailed at the time as a historic tax measure—I am not asking you to reply, and I apologize if I have stepped on your toes.

Dr. Holtz-Eakin, can you discuss in greater detail which provisions of EGTRRA are most important to extend if you want to provide tax relief? Note, I did not say tax cut. Every time you say tax cut, our friends across the aisle say "for the rich." And so, if you say tax relief, there is a whole different connotation.

But I would like for you to say, if you can, which provisions of EGTRRA are most important to extend if you want to provide tax relief to the job creators and those who will contribute to economic growth? And you might touch on which aspects of EGTRRA are less effective.

Dr. HOLTZ-EAKIN. So from a pure growth perspective, the key elements are keeping marginal rates low, so not allowing the sunsets of the top two rates, in particular; keeping equal and low taxes on the return to innovation investments, dividends, capital gains; and capital cost recovery.

There are section 179 expensing provisions that came in actually in JGTRRA, as well, that allow small businesses, in particular, to fully expense the cost of their equipment in the year they acquire it. Those are all very important pro-growth policies.

There are many others that are there not for the purpose of growth. They were there for other tax policy objectives, whether it is fairness, marriage penalties, helping targeted constituencies, refundable child credits. And some of those actually end up imposing these very high implicit marginal tax rates on low-income workers as they acquire more income.

So it is a very hard tax policy question in that, if you care deeply about growth, and I, again, would argue that has to be the key consideration, you have to tailor your tax policy toward that at the expense of using it for other tools.

Senator ROBERTS. I appreciate that.

Ms. Markman, I think you said something about estate taxes and the fact that some people paid no taxes. It occurred to me that I was in California this past weekend meeting with all sorts of business leaders. One person pointed out that, in California, 49 percent of Californians do not pay any State or any Federal income tax—49 percent—and that is 16 percent of America's population.

My point is, I think everybody ought to pay at least some tax.

The CHAIRMAN. I think the national average is about 40 percent. So California may not be too far off.

Senator ROBERTS. At any rate, can you expand—and I am talking, again, to Dr. Holtz-Eakin—on the impact of the tax increase, and we are talking about capital gains and dividends increases that have been talked about here, and their impact on seniors? What do you think about the impact of this tax specifically on seniors? Are the seniors in the two top income tax brackets the only ones who would be impacted by this change, or would higher taxes on dividends also impact middle-income seniors?

Dr. HOLTZ-EAKIN. If the top rate goes to 39.6 percent and the second rate goes up, as well, dividends will be taxed at that rate, and the clear evidence is that firms will pay fewer dividends, and they pay fewer dividends to everyone. They do not discriminate on which shareholder gets them.

So you will see a reduction in dividend payments. Dividends are disproportionately received by the elderly, and so all elderly would

see fewer dividends—that sort of regular dividend income—and instead they would have to realize their—somehow manage their cash flow while they waited for firms to do buybacks and other ways to get cash out, if firms took the effort to get the cash out.

And I want to echo Dr. Marron's comment that I do not think it is a good idea to have a tax policy that incentivizes corporations and their executives to sit on hoards of cash.

Senator ROBERTS. I appreciate your answer.

Mr. Chairman, I am way over time, but I would point out that I think you have created a new or at least a different definition, perhaps more restrictive, of what a small business is.

The SBA definition of a small business is somebody with 500 or fewer employees. Even if there are larger businesses in the top two brackets, small businesses would still be harmed, it seems to me, would still be subjected to higher taxes if the top two tax rates are increased.

So I think this is the wrong approach. We just have a difference of opinion.

I thank everybody for their patience.

The CHAIRMAN. Senator Enzi, you are next.

Senator ENZI. Thank you, Mr. Chairman.

I particularly want to thank Ms. Markman for her testimony and her expertise. And I will not have time to ask you all the questions that I would like to. I want to take advantage of that, so I will provide some of them in writing.

Very seldom do we have anybody appear before our committees who has actually been in business, and, as the accountant of the Senate, I know that you are in a lot of businesses, because you do the accounting for them, and that gives you a little different perspective.

I know when we are talking about tax reform, I have often been accused of trying to protect accountants so they would have more work. And when we talk about reform, I know that accountants would like to have reform, because they have so much liability hanging out with all the complexities.

But they do not urge reform because, every time we have tried reform, what we have done is made it more complicated. And so we need expertise from people like you so that, when we do reform, we make it simpler and fairer.

I just wish we had more accountants working on that sort of thing. But one of the things that concerns me is the health care reform bill that we passed, because one of the provisions in that is a new requirement on filing form 1099s. And that probably does not seem like a big deal to most people, but now, instead of just services, we are going to have to file on goods.

And so probably we are going to go from 10 1099s a year for a business to 200 or 2,000; I am not sure.

Do small businesses understand the paperwork burdens that are coming down the road, even if Congress does not increase taxes?

Ms. MARKMAN. No. I do not believe that they do. I think that this 1099 issue is hidden. It is sort of the gorilla in the room, because a lot of small businesses, particularly the very smallest, do not keep their records contemporaneously. They should, but they do not.

And at the end of the year, they will add up their payments for various things and provide us with information. But they are not in a position, and they do not pay attention to the fact that before you would have—under the bill, they would have to keep track contemporaneously.

Before they paid someone, they would have to get their relevant information, and I do not believe that they do understand that at all.

I know that there is a bill before Congress to undo that provision. I do not know where it is going. But I do not believe small business understands that at all. The CPAs do. We have been talking about it at great length, and it is really a question of what is the right thing to do, because many small businesses deal with other small businesses, and they do not want the reporting.

The recipients do not want it. There are many clients who will come to their preparer with their 1099s, particularly if they are professionals who sell their services, they will come to their preparer with their 1099s, and we will say to them, "Well, is this all your income?" "It's all I have 1099s for; it's all I have to report."

I say, "No, that's not the answer." But many times, that is all they—if they got small payments for less than $600, that is sort of ignored because there is no record of them having received it.

Senator ENZI. It is my impression that most of us have the feeling that every business is simple, but we do not really get the chance to kind of scratch below the surface some of the decisions that they have to make. And I think there are probably a lot of other things in the health care reform bill that are going to add a few accounting expenses, whether they are meeting the Federal mandate or not.

But I want to get to a topic that we have talked about a little bit here, whether it is 3 percent of small businesses that will have to pay a higher tax or 50 percent of businesses that will have to pay a higher tax, a lot of that is definitional.

I know that the truly rich whom we keep talking about can afford tax and investment planning and have done that to reduce their taxes.

But I know, having been a small businessman—we were in the shoe business—that, if I am in that 3 percent, I would feel that it was the 100 percent. It would affect me very, very drastically.

And I also know that when you are in small business, although you are showing great income, if you do not put that back into the business pretty quick, you do not have a business. So it provides an extra burden there. And should we not be expecting the same reinvestment by small business owners across the country?

Raising taxes is going to provide some uncertainty for them and, also, eliminate reinvestment that they might make in their business.

With the businesses that you work with, the small business definition, whether it is $50 million or 500 employees, you work with a lot of small businesses and——

Ms. MARKMAN. Much, much smaller. Our typical clients might have 10, 15, or 20 employees. The American Institute of CPAs calls people who work with businesses like that "micro" businesses.

Senator ENZI. Yes.

Ms. MARKMAN. And I think that there, where they are operated as partnerships or S corporations and the income is tax at the individual level, many of the business owners, if they reinvest in a business, have what we call phantom income. They are paying tax on money that they cannot take out of the business. It is invested in inventory. It is invested in property, plant, and equipment.

That is why the section 179 is important, if the businesses have the money to buy the equipment.

But the answer is, yes, I think it will. But the businesses we deal with are not in those top two brackets.

Senator ENZI. Is the uncertainty that we are providing keeping them from expanding their businesses or hiring additional people?

Ms. MARKMAN. I think right now, it is cash flow, it is funding, it is not having the ability to have the funds available, and not being able to get credit.

The CHAIRMAN. Senator Carper?

Senator CARPER. Thank you, Mr. Chairman.

To our witnesses, welcome, one and all. It is nice to see you come by and share your insights with us today.

Today, we are discussing whether or not it is the right thing to do to extend all or at least a part of the series of tax cuts that were enacted almost a decade ago, I think in my first year in the Senate.

So I think it makes sense to take a look at the history of these tax cuts. We have done some of that already, but I would like to go down that road just a little bit further.

So I recall between 1993 and 2000, when I was Governor of Delaware, we created a lot of new jobs not just there, but all over the country. I think maybe 20 million new jobs were created during that period of time.

And the 8 years, we balanced our budgets, we balanced the Federal budget I think a couple years in a row near the end of the Clinton administration. But we began, I think, almost every year of the Clinton administration, starting 1993, 1994, 1995, almost each of those years began with the expectation and ultimately with the realization we were going to have budget deficits of about close to $200 billion, and we did.

Fast-forward to 2000. The estimate is that we are going to have budget surpluses for as far as the eye could see. In fact, I remember having a hearing my first year in the Senate on what we ought to do about tax cuts, and one of the witnesses raised the alarm that we faced a real threat by reducing deficits, paying off our debt too soon. It is kind of ironic, sitting here today, is it not?

And in response, to reduce a surplus that some considered too large, tax cuts were enacted in 2001, as we know, that provided tax relief to all ends of the income spectrum, particularly those at the high-end brackets.

And in the years following these tax cuts, we experienced 8 years of subpar economic growth, weak job creation, low savings rates, and, as we know now, exploding deficits. I think we racked up as much new debt between 2001 and 2008 as we did in the previous history of our Nation.

I want to invite the entire panel, if you would, but particularly Dr. Marron, Dr. Burman, and Dr. Holtz-Eakin, to comment on whether and how can we possibly justify extending all of those tax

cuts in light of the dismal economic and budget results that I just outlined?

Do you want to go first, please?

Dr. BURMAN. Thank you, Senator. I think it would be a mistake to extend all the tax cuts, because there is not any way we can come close to paying for the government. And this is a basic factor, that we are looking at $10 trillion of deficits over the next decade and then exploding beyond that.

You are right that the effects of taxes on the economy are actually pretty subtle. I would not say necessarily that the 2001/2003 tax cuts were responsible for subpar economic growth, but the history, as you note——

Senator CARPER. I would concur with you. So there was a housing bubble in there somewhere.

Dr. BURMAN. And I think one of the big things behind the 1993 act, which was so hard to get enacted, but which ultimately led to the balanced budgets at the end of the decade, was Chairman Alan Greenspan, who said—who understood that the debt was a huge threat to the economy. It tends to push up interest rates, raises the cost of capital for businesses, and I think it is very important to deal with that.

Senator CARPER. Thank you.

Dr. Holtz-Eakin?

Dr. HOLTZ-EAKIN. Well, as you know, I believe we should keep rates low, including the top rates, for growth purposes, because that is our real obligation to out-of-work Americans and for the children. I think at this point, we are dangerously close to handing them an economy that is broken and a lot of debt along with it, and I think we should have a real focus on growth.

The other thing we need to reestablish, which was present in the 1990s and which has been absent for a decade, is real spending discipline. If you look back to that era, with PAYGO rules, discretionary spending, I mean, we had real PAYGO rules that were much tougher.

Yes, it helped to have the dot-com bubble; yes, it helped to have the peace dividend; but there was also an ethic toward controlling spending that needs to be reinstated.

Senator CARPER. Thank you.

Dr. Marron?

Dr. MARRON. I guess what I would add to that is I think—I mean, I have the liberty of doing big think from the think tank world—that really the discussion we need to ultimately have is a question about how big a government we want, and then how are we going to finance it.

Earlier in my testimony, I mentioned the trajectory we are on is that, if we do nothing, so if we do nothing on taxes, taxes are going to rise very rapidly relative to the size of the economy, up to levels we have not seen before.

That might be the right decision, it might be the wrong decision, but I do not think we have yet had that discussion about where do we actually want to end up, and then, conditional on that, what is the right way to design the tax code around that.

So obviously, actually, the priority—as we have heard through several lines of questioning today—is really to make decisions

today that put the Congress and the American people in as good a posture so that, whenever it is the time to make those decisions, there is a forcing event, so we actually confront those issues, answer them, and design a plausible tax system to finance what we want to do.

Senator CARPER. Thank you. Most of you probably know Mark Zandi, founder of Moody's *economy.com*. I updated, last year, his estimates of what he calls his "bang for the buck" chart of different economic recovery ideas—I guess, for every $1 of cost to the Treasury, how much economic growth is expected.

His calculations suggested that the 2001 and 2003 tax cuts, particularly the top two brackets, would generate something like 29 percent of economic growth for every $1 of lost revenue.

In contrast to his analysis, other studies, I am told, show that tax cuts that would primarily benefit the middle-income and low-income Americans produce a significantly higher bang for the buck.

Dr. Zandi's findings suggest that there is an economic case for extending the middle-income and middle-class portion of the tax cuts, but at the same time, a strong case against extending the tax cuts that benefit the most affluent 3 percent of Americans.

If possible, I would like for each of you to just comment on that. If we could, start with Dr. Burman and just walk our way down, and that will be it for me.

The CHAIRMAN. Briefly, please. Thank you.

Dr. BURMAN. I completely agree with Dr. Zandi. In terms of bang for the buck, the middle-class tax cuts, in the short term, are going to have the biggest effect.

Senator CARPER. All right. Thank you.

Dr. HOLTZ-EAKIN. I want to point out, first of all, I am the man who made Mark Zandi famous. So let me just say that I hired him for the McCain campaign, and he is a wonderful data analyst, but this is not a finding. This is not going into the real world and discovering an economic truth.

This is what he puts into his model, and this is exactly what he gets out. So it is not a finding. It is an assumption. And as I laid out in great detail in my written testimony, there is good reason to question whether those models are well-formulated and whether to place a lot of policy reliance on using them for this purpose.

Senator CARPER. I would like to thank you for making him famous. Go ahead, please.

Dr. MARRON. So I guess I will agree with both Len and Doug, which is to say that I think the mainstream conventional economic view is as you described and as Mark describes it. But again, Mark is not discovering that. He is just reporting that using models.

And then ultimately, the decision that you all face is going to be, if you line everything up in terms of bang per buck, as Mark would suggest, you would start with extending unemployment insurance. You would work through middle-class tax cuts, and then you would have the question about whether to do the upper-income tax cuts. And the question you really face is, well, how much stimulus is appropriate?

The CHAIRMAN. Thank you very much.

Senator Cantwell?

Senator CANTWELL. Thank you, Mr. Chairman.

The CHAIRMAN. I am going to have to leave. Senator Wyden, would you mind sticking around and chairing? Thanks.

Senator CANTWELL. Mr. Chairman, thank you. I wanted to ask— I know we are talking about individual tax rates and the effect on growth and distribution. But one of the things, it seems to me, that is looming out there that is going to affect incomes across America is this issue of EPA's action on climate and the regulation of pollutants under the Clean Air Act, and that is going to take effect in January.

Companies are going to have to start looking at best available control technology, and that is going to be an expense. Later, in July, they are going to have the full scope of covering facilities that are going to have to make upgrades on emissions, and that cost is going to get passed on to the individual consumers, and that is an expense. That is an expense that is going to affect people moving forward.

And I wondered, Dr. Holtz-Eakin, I know you have talked about proposals like we have proposed that would help to try to lessen the impact on consumers. Do you think legislation is a better path to reducing the cost on the consumer as opposed to just letting EPA act?

Dr. HOLTZ-EAKIN. Regardless of one's views on the merits of climate legislation, it is widely recognized that to have the EPA go back to a command and control regime, with as many point sources as there are for carbon emissions, is economically irrational and destructive.

There is not one good reason to do this. If you want to take care of carbon emissions, then you should use market forces, as your bill with Senator Collins does, so that there is a price on carbon and people will respond appropriately to innovate with new technologies that do not emit carbon and substitute away from those that do. That is a much more rational course.

Senator CANTWELL. And is there not a way to help keep consumers whole during that process?

Dr. HOLTZ-EAKIN. I think, personally, my opinion is you should not use this as an excuse to grow government. So you should set the price, and the literature says you should cut other taxes, pay old taxes or corporation income taxes or, in your case, return the funds to as great an extent as possible back to the American people.

Senator CANTWELL. What do you think that the cost of this will be moving forward? I mean, just letting EPA regulate without acting.

Dr. HOLTZ-EAKIN. Regulation is a disguised tax, and getting the price tag on this is impossible at the moment, because it carries with it, first, the burden of uncertainty: when will the EPA actually be able to finish rulemaking and impose this? It is being litigated, as you know.

So there is a real uncertainty cost to businesses. They have no idea what investment choices to make, and they are standing there as a result.

Second is, if we go this route, become certain that they will do the rulemaking, there will be tremendously inefficient choices

made about how to deal with this problem, and that will bear a big cost on the economy.

I do not even know how to calculate it, but it is a terrible idea, and it is harming the business outlook.

Senator CANTWELL. I am one who has talked to many attorneys about this, and I think the Supreme Court's ruling is pretty definitive on what has to happen.

And so the fact is that there are two choices: one that is command and control, as you say, or something that allows the market to make better decisions for us. I think there are some estimates that an auction could generate somewhere between $80 billion and $100-plus billion a year. I would assume that that would be revenue that could be better allocated to, again, lessen the impact on consumers.

Dr. HOLTZ-EAKIN. I guess the number I can come up with is, you could auction and you could return to consumers, and so the net of that would be zero. The alternative—I mean, that is just a transfer.

But the real question is, if you did the command and control, how much would you impair growth; how much would you lower, as a result, wages and incomes in the economy; and that is, I think, a potentially very large number that we should know.

Senator CANTWELL. I think definitely there is a more predictable path. So, thank you very much.

Thank you, Mr. Chairman.

Senator WYDEN [presiding]. Thank you, Senator Cantwell.

I believe Senator Crapo is next.

Senator CRAPO. Thank you very much, Mr. Chairman.

I would like to go for a moment into the question—in fact, Dr. Holtz-Eakin, I am going to focus on you. I apologize to the others. It is primarily because I know you best, and I do not really have time in my 5 minutes to go through 5 witnesses.

But I want to focus on the issue—really, the big pressure that we are seeing here in Congress is to raise taxes. It is one of the big issues that we are dealing with right now, because of the explosion in spending, the explosion in debt, and the fiscal circumstances that we face.

The question is, what role does tax policy play in our response to that, and should we raise taxes? And the first thing I want to make clear, just as a statement, is we keep talking about the 2001 and 2003 Bush tax cuts, but the issue here is whether we are going to allow taxes to spring back, in other words, to go up.

And I think a lot of the time, in the discussion, we think that we are talking about a tax cut here. What we are really talking about is whether to extend current tax law and keep taxes where they are or whether to have yet, again, another tax increase in response to our fiscal circumstances.

I understand generally, Dr. Holtz-Eakin, that you do not believe that an increase in taxes at this time is the proper response to our economic circumstances. Is that correct?

Dr. HOLTZ-EAKIN. That is correct.

Senator CRAPO. I did not intend to do this when I came in, because I have a number of other questions about the 2001 and 2003 tax cuts, but there is so much being said about the fact that the

Bush tax cuts are the cause of our current economic malaise and that the deficits that we face right now and the national debt are all a result of these terrible tax cuts, most of which went to the wealthy.

There was an article in the *Wall Street Journal* yesterday in which the author went through literally about an $11.7-trillion swing that we had seen from proposed surpluses in the neighborhood of $5.6 trillion in 2001 to now deficits that are being looked at in the neighborhood of $6.1 trillion.

And this author's point was that, even if you do not give any dynamic scoring to the tax relief of 2001 and 2003, it still is only 15 percent of those numbers. There is something else and a lot more going on here, and this author says that what is going on—by the way, I do not agree that tax cuts are static. In other words, I think that they do have a positive impact on the economy.

And so it will be a much smaller number than that in terms of their actual impact on deficits. But this author indicated that he thought that—well, he actually gave percentages to the numbers.

The economic and technical revisions that we have seen were 33 percent of that new deficit; other new spending, 32 percent of it; increasing interest on the debt, 12 percent of it; and the 2009 stimulus bill all by itself was 6 percent of it, with other tax cuts amounting to 3 percent of it.

So my question to you is, really, could you comment on these numbers and this analysis and give us your perspective on what really is the cause of this huge swing that we have seen since 2001 from projected surpluses in the $5-plus trillion range to now projected deficits over $6 trillion?

Dr. HOLTZ-EAKIN. So there are several components. Component number one is simply the original forecasts were wrong, and I spent a lot of time as CBO director explaining how could we be so badly wrong, and the answer was always that about half of the swing was pure economic and technical changes.

So my predecessors implicitly extended the dot-com bubble as far as the eye could see, which was bad forecasting.

Senator CRAPO. But it was not caused by the tax cuts.

Dr. HOLTZ-EAKIN. No. And then the rest was caused by legislative changes on the tax or spending side, and the minority was on tax. In my time, it broke about 20 percent tax and 30 percent spending. Since then, there has been more spending.

So those numbers are in the range of the kinds of exercises we did at CBO during my tenure.

Now, the other way to look at it going forward is, we have known that we were going to end up, if we went on current law, at a debt-to-GDP of 62 percent; we just thought it would take longer to get there. We were going to go off on this unsustainable course no matter what.

All that really happened is we spent a decade not fixing the problem, and then with the financial crisis and recession, we ate up our cushion. And so it is here now.

Senator CRAPO. So just to make sure that I am summarizing your testimony accurately, those causes of the swing that you talk about and the incorrect projections, that was not caused by the 2001 and 2003 tax cuts.

Dr. HOLTZ-EAKIN. No. They contributed, but were not a majority, by any means.

Senator CRAPO. And in terms of our current policy moving forward, would you agree that now is not the time to allow the taxes to spring back to a higher level?

Dr. HOLTZ-EAKIN. I would agree both from the short-run perspective, but also from the longer-run notion that we are going to need a tax reform. I believe that tax reform will have to be markedly pro-growth if we are going to meet all our obligations, and that the kinds of things being proposed in letting this sunset are exactly the wrong direction from both of those perspectives.

Senator CRAPO. And if Senator Wyden will allow me one more quick question. Senator Wyden, in fact, earlier mentioned that we do have a President's commission dealing with these fiscal policies. I happen to be one of the Senators appointed to that commission.

And the question I have for you is, leaving aside the question of trying to just raise or lower taxes, do you believe that reform of our code could be a helpful exercise for us, a helpful action for us to take, that would actually generate a stronger and more dynamic economy and a more competitive economy for our country and, thereby, obviously, increase revenues?

Dr. HOLTZ-EAKIN. Absolutely. We have a tax code that is just really a disgrace, by modern standards, and interferes with our ability to succeed as an economy.

So tax reform is essential, but the level of taxes that will ultimately be raised is going to be determined by the spending side, and we know the difficulties there.

So I think one of the things to make very clear is that suppose, for example, from the other House, you drop Congressman Ryan's plan—even under his plan, spending is at 20 percent of GDP and it is hard to get it down to that.

If you are going to balance the budget, it means you have to raise 20 percent of GDP, and I would stipulate I do not think anyone thinks it is a good idea to use this tax system to raise 20 percent of GDP in taxes. So it would interfere badly with the economy.

Senator CRAPO. Thank you very much.

Senator WYDEN. Thank you, Senator Crapo.

Senator Grassley is next.

Senator GRASSLEY. Thank you, Senator Wyden.

Dr. Holtz-Eakin, your testimony on macroeconomic simulations that you cite reached different conclusions than Dr. Zandi's "bang for the buck" analysis. Could you explain why your data indicates a permanent extension of the 2001/2003 tax relief plans provides more bang for the buck than a temporary extension of a portion of the 2001/2003 tax relief plans that apply to taxpayers earning under $200,000 and $250,000?

Dr. HOLTZ-EAKIN. So both of these exercises, Mr. Zandi's and the one that I did with Decision Economics, used fairly conventional macroeconomic models. The difference here is that there are actually present, in our analysis, households with real balance sheets, and those balance sheets are badly damaged at the moment. Many of the homes are under water.

In the course of the financial crisis, they lost $11 trillion in net worth. And it is important to them to repair their balance sheets and put themselves in the capacity to spend on a sustained basis.

Our exercise captures that and, as a result, our households save more, and that savings stimulates more investment. Then Mr. Zandi would get his pure cash flow model. If you throw money at a household, they spend it, in his model. That is not what is going to go on out there in these circumstances.

Senator GRASSLEY. I have another question for you. If the tax rates are allowed to expire, then this would mean that, come January 2011, people will notice their paychecks will be smaller, because their employer will be withholding more. They will not notice for the first time that 2011 taxes went up when preparing their returns in April 2012. Do you think that this could cause a fairly immediate "tax shock" to the economy, or would any harmful growth effects be more gradual?

Dr. HOLTZ-EAKIN. I think a full sunset would be a tremendous tax shock. The CBO estimate is it would cut economic growth by 1.4 percentage points. That is an analysis that does not have any sort of forward-looking effects.

So businesses who look at the full sunset and realize that their business environment is worse as far as the eye can see might react even more strongly than that. So I think it is a highly detrimental prospect.

Senator GRASSLEY. And I would end, Senator Wyden, with just a statement I would like to make to follow-up on Senator Roberts's comment on the more restrictive definition that was put forward earlier today in a discussion of the impact of the margin rate increases on small businesses.

The definition was tied to the small business bill that was before the Senate earlier this week. Everyone should know that there is no single definition of small business in the Internal Revenue Code.

As Senator Roberts noted, the generally accepted definition of small business is 500 or fewer employees. If our bipartisan focus is to do the least harm to small business, then we ought to use the most comprehensive definition. If all small business creates 70 percent of new jobs, why would we cut back on the universe of job creating units? Also, as I said earlier, small businesses are dependent on owners for capital, whether debt or equity. The owners are sensitive to tax rates on their activity. If we care about jobs, we should be careful.

Senator WYDEN. Thank you, Senator Grassley.

Let me ask a few questions of all of you about the tax reform issue, and I want to get, again, just some principals. I think you all have already heard my hope that the Deficit Commission will come forward with a bipartisan kind of effort. And I want to just—and any panel member who chooses to get into it can participate in this.

In 1986, Ronald Reagan, a big group of Republicans, and a big group of Democrats, essentially agreed on a theory, and it strikes me that theory is still sound, and I want to assess your views on it.

What they said is, let us keep progressivity, because that ensures fairness; let us hold down marginal rates, because the tax on the

last dollar of income that is earned is a big deal; and, if we do those things, Democrats and Republicans can come together and take a machete to the preferences, this blizzard of deductions and exemptions and credits.

That strikes me as still a very sound theory today. You can debate which bill, whose idea, and the rest. But the theory that, in my view, would promote growth—Dr. Holtz-Eakin talked about it—is the fairness that I and other Democrats feel so strongly about. These kinds of principals are still valid today, and we had a lot of discussion off and on about the 1986 bill.

Just in terms of the principals, I would be interested, Dr. Burman, Dr. Holtz-Eakin, Dr. Marron, and the other two are welcome to chime in, as well.

Do you think the theory behind it is still sound? Dr. Burman?

Dr. BURMAN. I think the theory behind it is sound. I think the thinking that happened in 1986 that made it easier was that most people do not think like economists, and there was a big corporate tax increase that made it possible to cut taxes for individuals. So a lot of people thought they were getting tax cuts who probably were not.

Taking a machete to the preferences, I think, I say great idea, but you know better than I do how hard that is, because there is such a strong constituency for every one of those.

I think the thing you need to get across to people is that the system we have now is that, right now the tax system takes a lot of your money to start, and then you have to do a whole lot of paperwork to get it back.

It would be a lot simpler to say, well, we will take a little bit less to start, and you will not take all those deductions, so you will not have to jump through the hoops.

Ms. MARKMAN. One of the flaws, I think, in the 1986 Tax Act was a failure to deal with AMT. It was calculated in that AMT would raise money that the ordinary rates would eliminate.

And so what happened is that you had a shifting, which we have seen clearly now, that more money is raised by AMT, in some estimates, almost certainly at the higher income levels, than the ordinary tax. And the failure to index it, the failure to deal with it at that level, I think, in my opinion, was the biggest flaw in the 1986 Tax Act.

Senator WYDEN. Dr. Holtz-Eakin? Any others?

Dr. HOLTZ-EAKIN. I think that, first of all, I agree with the basic premise. The settings are, again, similar. The 1986 act came after a period of extended poor economic performance, and it was widely perceived that the tax code was, at least in part, responsible for that, and it was interfering with America's ability to grow and, in a bipartisan way, people got together to fix that.

We are at that position again. We have had subpar economic performance on a sustained basis, and people are seeing it.

In the interim, when the economy was growing more rapidly, it became easy to toss another tax credit here, throw a special exemption there, and it became littered with things which now are interfering with our ability to grow.

We need to go back to the notion that the job is way more important than any tax credit could possibly be and clean up the code and have low rates.

The second thing that I think ought to be recognized is that Dr. Burman's observation is correct. The 1986 act was built on cuts for individuals, increases for corporations, and that is why they do not want to have tax reform, because the last time, they were viewed as the guys to pay for it. And so that is the key political obstacle that I mentioned earlier.

The last piece is, the 1986 reform did not survive long. It was unwound very rapidly, and I think there is a lesson there, which is that we went for the wrong kind of reform. Its effort to tax capital income comprehensively at the moment it was earned, adjusted for inflation, is too hard, and it became administratively impossible to reach that objective.

So we need to think smart about reforms that I think go to consumption bases, because they are easier to enact and fit my philosophical underpinning, which is people should be taxed on the basis of what they take out of this economy, not what they contribute in the way of their labor, their energies, their innovation, and their capital.

Senator WYDEN. Other panel members who would like to chime in?

Mr. MARZAHL. I will jump in very quickly here. I think your principals are absolutely correct. I think the concept—if you go back to 1986, if we just want to look at the refundable credits, all there was was the earned income credit. Everything else has been added since then, and the core premise of many of our other credits, in some ways, is the same as the Earned Income Tax Credit.

It is to reward work; it is to provide an incentive to families with children; and it is to ensure general progressivity. We have added all these other credits and, from the perspective of the consumer, of the taxpayer, I think we would both agree there is absolute rampant confusion. It creates distrust in government. It creates enormous problems for all of you to defend when you are running for office in terms of talking about things.

I think the concept of simplicity, having a core set of principals, and finding a way to weave some of these elements that reward work, that provide the kind of refunds that low-income working families deserve, but to simplify it and to couple it with corporate tax changes and other treatments that are more fair, I think, definitely would pass muster with the American people.

Dr. MARRON. So, just to round up by echoing what other folks have said. The usual mantra is, there are three principals for tax reform, which are pro-growth, fair, and simple. So pro-growth would be primarily lower rates; fair would be suitable progressivity; and simple would be (A) using the machete and then (B) getting rid of things like the AMT, which I think are both—they are problematic. From a simplicity point of view, it is a nuisance to deal with them, and I think, frankly, they also undermine some Americans' faith in the tax system, that there are sort of surprises when they discover things that apply to them or they thought apply to them do not apply to them.

Then, if you can make the system more simple, it will be both better economically and better from a fairness point of view.

Senator WYDEN. The second question is, how would reformers use radical simplification as a way to jumpstart tax reform?

What is striking about all this is virtually every reform proposal comes in with a 1-page 1040 form. Comes in with a 1-page 1040 form.

The Bush proposal during President Bush's terms, I think, was 32 lines. Everybody is between 30–34 lines, close enough for government work, to say everybody is on the same page.

How might reformers use radical simplification to jumpstart reform? Because it is an area people agree on and, inevitably, to get to radical simplification, you have to start making some of these changes that are being discussed here.

Any thoughts on that, Dr. Burman?

Dr. BURMAN. I completely agree that simplification ought to be a part of anything that qualifies as reform. And I also echo the copanelists that getting rid of the AMT, which your plan would do, is clearly essential.

One thing that I actually proposed in a paper, in the *Virginia Tax Review*, is to go with a system where most people would not have to file tax returns; where the withholding that is taken from their income by their employers and maybe withholding by banks on interest would be final, and that there would not have to be this reconciliation at the end of the year.

I think that would get a lot of people's attention. It would be a radical change in the way the tax system worked. Michael Graetz has a proposal where most people would just pay a value-added tax and would not pay an income tax. I have some issues with that, but it certainly would get—I think it has gotten a lot of attention.

So I think a level of simplification that real people can perceive is important, and just going to a 1-page tax return will not do it. If you just start telling people how to fill out their taxes by now putting in all the detail, that does not make things simpler; but getting rid of all the things that go in on those lines, it is important and a real contribution.

Senator WYDEN. Any thoughts on how radical simplification might jumpstart a bipartisan effort? I have been struck—if you think about the applause George Bush got at one of those presidential conventions, the crowd went berserk, the same thing is true for every Democrat, and, particularly, ideas on how radical simplification might jumpstart bringing the parties together.

Any panelist can chime in on this. Yes, go ahead.

Dr. HOLTZ-EAKIN. So it will be a shock for you to find out I disagree with Len, and here is why. This has always been a Nation whose tax compliance is voluntary, and that is an important part of the way we should think about this problem.

If people saw a very simple tax form that they could fill out and did fill out to file their taxes, they would be much more confident in the tax system being fair, because they were filling out the same thing as the other person, and they could do those comparisons. And Americans have a deep fundamental sense of fairness, and they like progressive tax systems. They want to see that.

If you do not make them fill it out, if you hide it, they will be more suspicious and less willing to support the reform than if they see it is fair, and I think visibly demonstrating the fairness is important.

So all these notions of having people not fill out their taxes, I do not think that works. I think you jumpstart reform by demonstrating that, by having people be able to fill out their taxes, not people filling out their taxes and afraid they are getting a better break because they can hire tax preparers and things like that. I do not think that works.

We really need to have the public care about this issue, and it is a compliance issue at its core. They want to support this tax system.

Senator WYDEN. Any other panelists want to chime in? You are not required to do it, because I have a couple of other questions.

Mr. MARZAHL. I actually would agree with, in some ways, Dr. Holtz-Eakin. I do not think that the issue of removing the filing obligation or removing filling out the paperwork is necessarily the starter. I think a starter is creating the simplicity, and I think putting forward a radical set of core concepts, maybe saying, let's get it all on the 1040, makes a lot of sense.

I go back to—I think all of the refundable credits have enormous value to them, but from a practitioner perspective, when you sit down and you try to even begin to explain to a taxpayer what these mean, their eyes glaze over. They have no way of understanding it, and I think that does, again, feed into this just absolute core distrust of IRS, of government all together.

So I think there are some huge opportunities here, but someone has to have the political courage to move forward on it.

Senator WYDEN. Let me ask one other one. If you think back to 1986 and what happened, one of the aspects that has been most troubling to reformers is, as soon as you get to a tax reform bill, everybody says, "Fine, let's start unraveling it. Let's come back and make this change and that change," and you can go back and add all kinds of exemptions and deductions and start, once again, having a huge lobbying bonanza, because every one of those exemptions and deductions has a lobbyist.

What might be done as part of tax reform to say, when you get tax reform this time, you will make it harder to unravel it?

Now, given the fact that no current Congress can ever bar a future Congress from acting, I am not trying to suggest some absurd kind of drill that would in any way address that, but it seems to me that, as part of tax reform this time, everybody ought to learn from 1986 and at least try to see if there are some sensible ideas for figuring out how you can make sure that, once the bill was passed, as soon as the ink is dry, everybody is not out trying to unravel it again.

Any panelist member have some thoughts on that? Dr. Burman?

Dr. BURMAN. Martin Feldstein had a paper in the 1980s called "On the Theory of Tax Reform," and what he said was that frequent tax reforms, whatever your tax system is, just raise costs. They create a lot of uncertainty and, of course, there is huge pressure on policymakers to come up with new tax breaks to show—new tax changes to show they are working for their constituents.

What Feldstein suggested was that maybe you should have a limit for some period of time, 5 years or something like that. All you could do would be to adjust rates, if you need to adjust revenues. You could not enact new deductions or credits or whatever.

And you are right that current Congresses cannot bind future Congresses, but the Senate has done a pretty good job of making rules that future sessions agree to. And you could have a supermajority requirement for changes other than changes in rates and then have a jubilee every 10 years or something or every 6 years, where you might look at the tax code and think about it in a systemic context rather than just having a lot of rifle shot provisions.

Senator WYDEN. Let us finish this question. I see my friend and colleague has come, and let us finish this one, and then I want to recognize Senator Hatch.

Others on the question of how you might make it tougher to unravel a tax reform bill that picked up bipartisan support and was signed into law by the President, big signing ceremony? How do you make sure that 4 weeks later, everybody is not starting to plot to unravel it?

Dr. HOLTZ-EAKIN. So, you have a menu to choose from. You have process-style reforms, rules, and things that Len mentioned, and then you have the substance of the reform. And I think the simpler it is, so it is really clear what the tax code is, so that once one changes it, you notice, is step number one.

Step number two, one of the reasons I favor things that look like cash flow taxes, consumption-based cash flow taxes, is that everything happens this year, and you cannot hide preferential tax treatment in, for example, depreciation allowances and other things that are about timing so that you can always hide them.

That is a great way for a lobbyist to get what they want, and you just do not see it. So turn everything into cash flows, have some bright lines, make it simple. Then when someone else gets a break, everyone knows it.

Senator WYDEN. Any others? Dr. Marron?

Dr. MARRON. Yes. Just building on Dr. Holtz-Eakin's last point, I think one of the structural issues you face is what tax base to choose, and I think what we have learned is, if you go with an income tax base, which has a lot to suggest it, you create all these difficulties of coming in saying, "Well, measure my income differently and give me a tax break."

If you go with something like a broad-based consumption tax, I am not going to say you cannot tweak that, but my suspicion is that it is a harder thing to tweak and get special treatment in.

Certainly, if you go with a carbon tax or something like that, it is clear if you are emitting carbon or if you are not. We have long experience in this country with the payroll tax. The payroll tax has very few strange exemptions from it, unlike our income tax.

I am not saying we should increase the payroll tax, but I am saying it is an example that, if you choose your base well, you can protect it from a lot of these special pleadings.

Senator WYDEN. Others? We will let you pass.

Senator Hatch?

Senator HATCH. Well, thank you, Senator Wyden. I appreciate it.

Dr. Marron, you discuss in your testimony the six factors why revenues from individual income taxes are expected to increase over the next 10 years. The first, as I viewed it, was the recovery of the economy.

Compared with the other factors, how significant is that first point that you made?

Dr. MARRON. So here I should emphasize I am quoting numbers from the CBO's most recent long-term projections. Over the short term, it is relatively significant. Over the long term, actually, only moderately.

Over the 25 years, CBO sees individual income tax revenues rising by about 6.5 percentage points of GDP, in geek speak, and the recovery of the economy is about 10 percent of that.

Senator HATCH. In your testimony, you mention that, if both the tax cuts and the AMT patch were extended permanently, revenue growth would be slower. What would be the effect of a permanent extension of the tax cuts on economic growth, if you could tell me?

Dr. MARRON. So, a permanent extension of the tax cuts, on the one hand, would reduce marginal rates, which would promote growth and, on the other hand, would, all else equal, lead to bigger deficits and a growth of debt. And my best guess of what the net of that is is that, in the first few years, you would see, on net, more growth, but that the growing debt and the growing deficit would eventually undermine that as you get into later years.

Senator HATCH. Dr. Holtz-Eakin, do you agree with that?

Dr. HOLTZ-EAKIN. I agree that the best thing you can do is keep rates low and then do the spending reductions so that you do not run into the deficit. In fact, that is the best economic growth policy.

Senator HATCH. What about his point that we might increase the deficit by keeping the—by a permanent extension of the tax cuts?

Dr. HOLTZ-EAKIN. I do not believe tax cuts pay for themselves instantly, so, yes, the deficit will be larger. But in this case, the top priority has to be on growth, and, in the end, the deficit problem is a spending problem. So, if you want to solve that, go to the spending side and solve it.

Senator HATCH. I see.

Now, Dr. Marron, in your testimony, you state that extending the tax cuts would provide some demand-side stimulus to the economy. Could you elaborate on how much stimulus that might provide, and would it provide more stimulus than government spending, for instance?

In other words, does a $1 tax cut stimulate the economy more than $1 of spending?

Dr. MARRON. Sorry, I do not have specific numbers in front of me, but the numbers I have looked at most recently are ones that were, again, put out by CBO earlier this year.

It did basically a benchmark scoring of various types of provisions you might use in order to stimulate the economy. And the one that appeared the highest on that was extending unemployment insurance, just on the premise that you are giving money to people who would be likely to spend it; and, again, in the short run, that provides stimulus, whereas the various tax provisions came somewhat lower down the list, but clearly provided some stimulus.

Senator HATCH. You also note that the amount of stimulus would be greater if the tax cuts were extended on a permanent basis rather than just a year or two. Now, would you explain why this would be so?

Also, how would you compare the effectiveness of a permanent extension to a series of, say, temporary extensions?

Dr. MARRON. So, if you do it on a permanent basis, the beauty of that, from a short-term growth point of view, is that, first of all, the classic Keynesian demand-side effects would be larger, because people will perceive that the money they are getting from lower taxes will be something that is going to be persistent and they can spend. So they do not have this issue about how much do I save, because it is just a temporary tax rebate.

Then in addition, to the extent that you get some positive supply-side effects from the tax cuts being permanently lower, you would be likely to see those, as well. If you are just kind of cutting and slicing a year at a time with tax cut extensions, the supply-side story about how the lower tax rates are going to encourage working, saving, and investment do not work very well. That argument works best when those things are permanent.

Senator HATCH. There has to be some consistency and some ability to rely on what is going on.

Dr. MARRON. Exactly. So, if you are making an investment or saving decision, you have some sense about what the trajectory of taxes is. But again, you have to weigh against that the fact that, if we did permanent extension of the tax cuts and did not do anything on the spending side or on other taxes to offset it, we would have larger debts in the future, and that would start to weaken our economy down the road.

Senator HATCH. Dr. Burman, I do not mean to keep you. I know that you have been here a long time. But let me just ask a couple more, and then I will get out of your hair.

Dr. Burman, thank you for your very interesting testimony. I appreciate all of you being here. I have enjoyed your testimony. It has been very good.

Now, a major thing, Dr. Burman, in your remarks, which fairly screams because of its prominence, is that our tax system is not producing nearly enough revenue.

Now, is it your belief that we should raise revenues to match the spending levels of Congress and the President, no matter how profligate the Congress and/or the President may be?

Dr. BURMAN. We have tried the other way, which is keeping revenues low and hoping that spending would follow. I do not think that has worked out very well.

I think if we actually raise taxes to pay for the level of spending, that that would actually build support for doing sensible things to slow spending.

Right now, people have the sense that we can wage wars, we can have a massive expansion of Medicare, we can do all sorts of things, and taxes only go down. It makes it sound like government is free or even better. And I agree that we have to restrain spending.

But just this idea that—this kind of field of dreams theory that, well, we build this edifice that is suitable for a small government, and eventually a small government will come, is not working.

Senator HATCH. Well, how do we control spending when we have Medicaid, Medicare, Social Security, et cetera, et cetera, that are basically entitlements that go on and on and on and generally increase and increase and increase?

Dr. BURMAN. It is going to be a challenge, obviously. You are going to have to come up with ways to slow the rate of growth, more with Medicare and Medicaid. There are various options. One is, you could budget for it. You could set up something like a voucher, where if you pay—actually, Congressman Ryan has proposed something like this.

I think the voucher is probably at too low a level to actually provide adequate health insurance. But the concept that you just mandate benefits and then come up with however much money is needed to pay for them, that is not sustainable either.

But I think most people who look at this see the long-term problem as one that is a combination of too much spending and too little revenue. So you are going to have to deal with it on both sides.

Senator HATCH. Is it true that one of the strongest turbines of our economic engine is consumer spending? You indicated in your testimony that a tax increase would result in less spending, which would ripple through the economy, costing jobs and threatening the recovery.

Would our economy recover faster if we extended these expiring tax cuts?

Dr. BURMAN. I think it is a good idea to extend most of the expiring tax cuts. Where I disagree with Dr. Holtz-Eakin is that I think there would be relatively little cost to letting the high-end tax cuts sunset as scheduled, and I think it would actually build some impetus for tax reform. And actually, if more stimulus was needed, you could do some of the other things on CBO's list, like extending unemployment benefits, or maybe providing some more aid to States, which are engaging in a lot of tax increasing and spending cuts right now, which is threatening the recovery.

Senator HATCH. Dr. Burman, you indicated in your testimony that a major tax increase would slow the economic recovery, at least that is the way that I interpreted it.

Does this mean that you believe that higher taxes affect economic growth and, if so, how would allowing the tax cuts to expire affect the economic growth over, say, the next 10 years?

Dr. BURMAN. Over the short term, just allowing the tax cuts to expire would certainly have a negative effect. It would reduce consumption and could very well prolong the recession.

Over the long term, we have talked about whether we should have permanent tax cuts or temporary tax cuts. I do not think permanent tax cuts are even plausible if we do not radically cut spending.

One of the things Dr. Holtz-Eakin talked about was the critique of the standard economic model, which does not take into account how people perceive the effects of current policies, what future consequences of those policies will be.

I think anybody who is rationally looking at a tax system that was raising 19 or 20 percent of GDP and spending was running much, much higher than that would see that future taxes were coming, and probably at a much higher level than the tax rates were before.

So over the long term, if we make permanent the tax cuts and we cannot radically cut spending, I think that would actually leave the economy in a much worse position than you would be if they were allowed to expire.

Senator HATCH. And one more for you, Dr. Holtz-Eakin. On the question of narrowing the definition of small businesses, some on the other side of the table suggested restricting the definition of small business in terms of the impact of the marginal rate increase. If we want more jobs, and small business is the source of 70 percent of the new jobs, why would we employ a narrower definition?

Dr. HOLTZ-EAKIN. I am not in favor of a narrow definition. I am mystified by the notion that somehow it is desirable to raise these taxes, in any event, and, if somehow there are tax analysts who believe that you can draw a line in the tax code and identify job-creating tax returns versus non-job-creating tax returns and an appropriately designed policy, I have yet to meet that person.

Senator HATCH. Well, I want to thank the whole panel. I apologize to you folks on the end of the table, because I had some questions for you, too, but I just feel like we have gone on long enough. And I just want to thank you all for your testimony. It has been very enlightening, as far as I am concerned.

Thank you.

Senator WYDEN. Thank you, Senator Hatch. You all have been very patient, been with us for 3 hours or thereabouts. And it seems to me, what you have helped to highlight, at least for me, is that this tax debate is, in effect, at a fork in the road, and there is a choice.

One approach involves more tinkering and nipping and tucking here and there, which will inevitably add to scores of additional provisions, 500 I mentioned; 500 tax changes in 2008 alone, and I think that will inevitably be a partisan debate.

The alternative path is to try to come up with a bipartisan approach where, in effect, Democrats can secure changes that they have long sought: relief for the middle class and fairness; and Republicans can look to a number of the incentives for business, a number of incentives for American industry; and you can marry principals that both sides feel strongly about.

What I come away with is that that second approach, bipartisan and an opportunity to bring the country together, would also help deal with the uncertainty in the economic inefficiency of continuing to tinker, which is going to put the brakes on economic growth.

So I think you have helped give us additional ammunition for that point of view. Unless you all feel particularly strongly at this point about adding anything else, we will excuse you at this time.

The Finance Committee is adjourned.

[Whereupon, at 12:50 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Hearing Statement of Senator Max Baucus (D-Mont.)
Regarding the Impending Expiration of the 2001-2003 Tax cuts

Arthur Godfrey said: "I'm proud to be paying taxes in the United States. The only thing is — I could be just as proud for half the money."

In 2001, Congress enacted legislation to let American families keep more of their money.

We lowered income tax rates for all taxpayers.

We doubled the child tax credit from $500 to $1,000 a child. And we made the credit partially refundable, so that more families could benefit.

We increased the amount that families could get in the dependent care credit. That helps more working families to make ends meet.

We eliminated the marriage penalty. That way, married couples don't get higher taxes as an added wedding present.

We recognized the importance of higher education. We made it easier to deduct student loan interest.

We made a lot of tax law changes in 2001 that have very broad support, throughout the Congress.

But now we face a problem. These tax cuts are not permanent. They expire at the end of the year.

The big questions before us now are whether we should make some of these tax cuts permanent. And if so, which ones?

But that's not the only challenge. There's another elephant in the room — the budget deficit. And, that elephant is growing. Last year, the budget deficit was the largest share of the economy since World War II.

And the nonpartisan Congressional Budget Office expects the deficit to exceed $1 trillion in 2010. And CBO projects that deficits will remain high for the rest of the decade.

That means that the Federal debt will keep growing. By the end of this year, economists expect Federal debt held by the public to reach 62 percent of the GDP. That's also the highest share since right after World War II.

When we passed the 2001 tax cuts, the Federal Government was running a surplus. When we passed the 2001 tax cuts, economists projected big surpluses for years to come.

We face a different budget picture today.

With today's budget picture, it's no longer clear that we can afford large tax cuts for the most well-to-do.

So, today we'll discuss the expiration of the 2001 and 2003 tax cuts. We'll discuss the effect of these tax cuts on economic growth, and on the distribution of income. We'll consider whether these tax cuts should be made permanent, and for whom.

And so, let us begin the work of addressing the 2001 and 2003 tax cuts. Let us do so responsibly, with an eye on the budget picture. And let us endeavor to let working American families keep more of their money.

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Statement of

Leonard E. Burman
Daniel Patrick Moynihan Professor of Public Affairs
Maxwell School
Syracuse University

Before the
Senate Committee on Finance

The Future of Individual Tax Rates: Effects on Economic Growth and Distribution

July 14, 2010

Chairman Baucus, Ranking Member Grassley, Members of the Committee: Thank you for inviting me to share my views on whether and how to extend the 2001 and 2003 tax cuts. I am speaking for myself alone. My views should not be attributed to any of the organizations with which I am affiliated.

The expiration of the "Bush tax cuts" at the end of 2010 creates a number of decision points for the Congress: Should all or some of the tax cuts be extended? If so, should they be made permanent? If not, how long should they be extended for? And, if only some of the tax cuts are to be extended, which ones?

In short, I believe it would be a serious mistake to make any of the tax cuts permanent now. The income tax is a mess and is badly in need of an overhaul. It doesn't raise close to enough revenue to pay for current governmental expenditures and is needlessly complex, unfair, and inefficient. A system-wide reform along the lines of the Tax Reform Act of 1986, but with the goal of eventually raising enough revenue get the national debt out of the red zone should be a top priority for the Congress. Permanent extension of the tax cuts would make such a reform far more difficult and would signal to markets that our budget problems are only going to get worse.

However, I also think it would be a mistake to allow all of the tax cuts to expire as scheduled in 2011. The economy is in a very precarious state and a major tax increase would slow the economic recovery. With credit still in very short supply, low- and middle-income households are facing serious cash flow constraints. A tax increase would result in less spending, which would ripple through the economy, costing jobs and threatening the nascent recovery.

This is not true for the tax cuts affecting high-income households. As the CBO noted in a recent report on stimulus options, the "consumption [of higher-income households] is unlikely to be constrained by their income in a given year."[1] Some have argued that lower income tax rates are necessary to encourage "pass through entities" whose owners pay individual income taxes to hire, but the CBO also was skeptical of that claim: "increasing the after-tax income of businesses typically does not create much incentive for them to hire more workers in order to produce more, because production depends principally on their ability to sell their products."

Allowing the high-income tax cuts to expire will save $125 billion through FY 2013 compared with a full extension. Those savings could make a small dent in our ballooning debt, or they could fund more effective fiscal stimulus measures such as extending unemployment benefits or aiding the states.

The duration for the temporary tax cut extension should match a commitment to produce and vote on a major tax reform. As President Reagan did in his 1984 State of the Union Address, the Congress should instruct the Treasury Department to produce a tax reform blueprint to be released after the presidential election in 2012. The tax reform should aim to simplify the tax system enough so that ordinary Americans understand it and perceive it as fair. A major goal should be to broaden the base and lower tax rates while raising enough revenue to pay for government by a set date. With luck, the President's Bipartisan Debt Reduction Task Force will come up with a plan that could serve as a useful starting point. Other good models also exist, including the Wyden-Gregg Bipartisan Tax Fairness and Simplification Act of 2010 and the proposals of President Bush's tax reform panel, although both of those plans would need significant adjustment to produce adequate revenues. Congress should commit to producing its own plan and bringing it up for a vote before the expiration of the temporary tax cut extension in 2013.

The Bush Tax Cuts

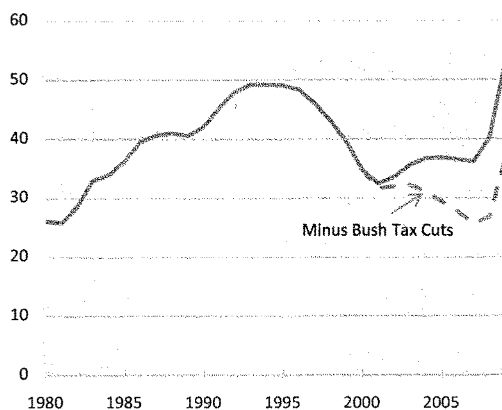
The large deficit-financed tax cuts enacted between 2001 and 2006 had many unfortunate consequences. While they had some good elements, including cuts in marginal tax rates, a phaseout of the complicated tax surcharges known to tax geeks as PEP and Pease, and important support for low-income working families through expansion of the child and earned income tax credits, they added enormously to the public debt while failing to address the major shortcomings of the income tax. Notably, the tax cuts actually exacerbated the problem of the ultra-complicated AMT by cutting regular income tax rates with no permanent change to the design of the AMT. As a result, a series of costly temporary stopgaps have been required to prevent tens of millions of middle class households from facing that incomprehensible levy.

If the Bush tax cuts had never been enacted, debt held by the public at the end of 2009 would have been reduced by 30 percent, to about $5.2 trillion or 37 percent of GDP. (See Figure 1.) This was less than the level of the debt at the end of 1999. With the tax cuts, however, the debt ballooned to $7.5 trillion (53 percent of GDP) and is now over 60 percent of GDP. While the

[1] Congressional Budget Office, "Policies for Increasing Economic Growth and Employment in 2010 and 2011," working paper, January 2010. http://www.cbo.gov/ftpdocs/108xx/doc10803/01-14-Employment.pdf

cost of two wars, enhanced homeland security, the TARP, several rounds of economic stimulus and an expensive new prescription drug benefit under Medicare have clearly also contributed to the run-up in debt, the fact remains that the debt would likely be at relatively manageable levels had it not been for the tax cuts.

Figure 1. Debt as a Share of GDP, With and Without Bush-Era Tax Cuts, 1980-2009



Source: Kathy A. Ruffing and James R. Horney (http://www.cbpp.org/files/12-16-09bud.pdf) and author's

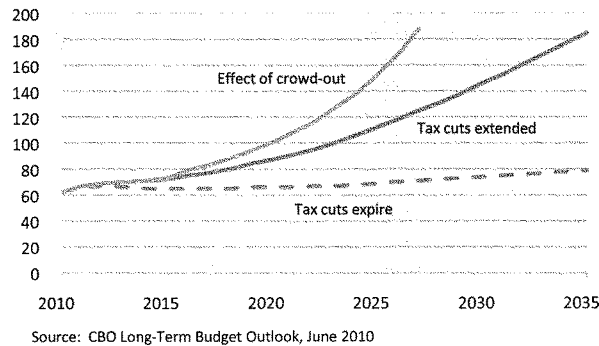
Will Rogers said, "If you find yourself in a hole, the first thing to do is stop digging." Permanently extending the tax cuts would dig the hole much, much deeper. The CBO projects that if the tax cuts are allowed to expire and the cost containment measures in the new healthcare bill are allowed to take effect, the debt will actually decline over the next decade, although it will trend up after that. (See Figure 2.) If the tax cuts are extended and the healthcare cost containment measures in the new health reform bill prove unsustainable, however, the debt explodes, reaching 100 percent of GDP by 2023. Even this grim scenario is optimistic because it assumes no response of interest rates to the higher debt levels. If interest rates increase as the government's demand for capital grows, public borrowing will crowd out private investment and the economy will suffer. The CBO estimates that, under that scenario, debt could reach 188 percent of GDP by the year 2027.

As my Tax Policy Center colleagues and I have explained, the debt explosion could have far worse consequences than a gradual erosion of the economy.[2] It is possible that interest rates will remain low for years, creating a kind of debt bubble: our ballooning debt appears affordable to

[2] Leonard E. Burman, Jeff Rohaly, Joseph Rosenberg, and Katherine C. Lim, "Catastrophic Budget Failure," *National Tax Journal,* 63(3): 561–584, September 2010.

us and our lenders as long as interest rates stay low. At some point, investors perceive a risk of default on the debt (or inflation, which would devalue it). This pushes up interest rates, which in turn raises the risk of default, creating a vicious cycle. When the bubble bursts, the United States is an insolvent, heavily indebted superpower, with disastrous consequences for ourselves and the rest of the world. The possibility of such a "catastrophic budget failure" should be avoided at all costs.

Figure 2. CBO Projection of Debt Held by the Public Under Alternate Fiscal Scenarios, 2010-2035



Source: CBO Long-Term Budget Outlook, June 2010

<u>Rationales for permanent tax cuts</u>

Advocates of permanent tax cuts make at least three arguments for them: (1) limiting federal revenues is the only way to restrain government spending, (2) permanent tax cuts are much more effective than temporary ones at boosting the economy, and (3) tax cuts pay for themselves because they lead to higher growth and thus boost future tax revenues.

The first argument is sometimes known as the "starve the beast" theory. Under this theory, figure 1 is naïve because it assumes that spending would have been the same even if the government had collected trillions in additional revenues. Instead, it is argued, more revenues just enable more (wasteful) government spending. If the Bush tax cuts had not been enacted, policymakers would have spent more.

On its face, this argument appears plausible, but it is hard to imagine that spending could have been higher as revenues were slashed by the Bush tax cuts. Government grew much faster from 2001-2009 than during the Clinton Administration. While some of that was war-related, nondefense discretionary spending also sped up and, as noted, a major expansion in Medicare was enacted.

It appears that instead of constraining spending, deficit financing was contagious. If deficits don't matter when considering tax cuts, why should they be considered when evaluating a new drug benefit or a "bridge to nowhere?"

William Niskanen, president of the libertarian Cato Institute, posited a public choice critique of "starve the beast."[3] If deficits finance 20 percent of government spending, then citizens perceive government services as being available at a discount. Services that are popular at 20 percent off the listed price would garner less support at full price.

He found statistical support for his theory in a time series regression of revenues against changes in spending. He hypothesized that higher revenues could constrain spending, and found strong support for that conjecture based on data from 1981 to 2005. Another Cato researcher, Michael New, tested Niskanen's model in different time periods and using a more restrictive definition of spending (non-defense discretionary spending) and found the earlier results to be robust.[4]

I think that Niskanen and New might have understated the effect of deficits on spending. The message during the last decade seems to have been not that spending and tax cuts were available at a discount, but that they were free. Spending for wars, Medicare expansion, and "no child left behind" happened at the same time that taxes were falling. Citizens could be forgiven for forgetting that there is *any* connection between spending and taxes.

My guess is that if President Bush had announced a new war surtax to pay for Iraq or an increase in the Medicare payroll tax rate to pay for the prescription drug benefit, both initiatives would have been less popular. Given that the prescription drug benefit only passed Congress by one vote after an extraordinary amount of arm-twisting, it seems unlikely that it would have passed at all if accompanied by a tax increase.

Starve the beast doesn't work. Conservative Bruce Bartlett called it "the most pernicious fiscal doctrine in history."[5]

The notion that permanent tax cuts are more effective than temporary ones has a stronger pedigree, dating back to Milton Friedman's "permanent income hypothesis." The basic notion is that prudent consumers will spend only part of a temporary windfall and will save the rest, whereas a permanent increase in income will translate immediately into permanently higher spending. Ample empirical evidence supports the hypothesis.

Nonetheless, this insight is not a very useful guide to tax policy. While permanent tax cuts may be more effective as anti-recession tools than temporary cuts, an endless series of permanent tax cuts would bankrupt the nation and is thus infeasible as policy.

Deficits are simply deferred tax increases or spending cuts. The Bush tax cuts will have to be paid back (with interest) and given the retirement of the baby boomers and the continued growth in health care costs, they will surely be offset with higher taxes rather than lower spending.

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[3] William A. Niskanen, "Limiting Government: The Failure of 'Starve the Beast'," *Cato Journal*, 26(3):553-558, Fall 2006.
[4] Michael J. New, "Starve the Beast: A Further Examination," *Cato Journal*, 29(3): 487-495, Fall 2009.
[5] Bruce Bartlett, "Tax Cuts And 'Starving The Beast'," *Forbes.com*, May 7, 2010.
http://www.forbes.com/2010/05/06/tax-cuts-republicans-starve-the-beast-columnists-bruce-bartlett.html.

This means that anti-recession tax cuts will be temporary—whether advertised as such or not—and thus will have diminished effectiveness.[6] Thus, to produce a given level of stimulus, any temporary tax cut has to be bigger. Alternatively, the money might be spent on direct expenditures—such as investment in infrastructure—which guarantees that all of it will be spent and produce income for the recipients.

Finally, some supply-side theorists have contended that cuts in marginal tax rates could pay for themselves because the economy would grow faster and generate more tax revenues. Serious analyses of supply-side tax cuts, even by those very sympathetic to the premise that tax cuts can boost economic growth, have all concluded that deficit-financed tax cuts do not pay for themselves over the long run.[7] In fact, if the resulting deficits are ultimately offset by higher tax rates, the ultimate effect is likely to be lower GDP.

This occurs because the cost of taxation grows disproportionately with the tax rate. Thus, if top tax rates are cut from 40 percent to 35 percent for a while, but then raised to 45 percent to pay back the resulting debt, the 5 percentage point increase in rates reduces growth by much more than the temporary 5 percentage point rate cut boosted it.

As a general rule, stable tax rates impose less economic cost than volatile ones. For that reason, it would be far better to raise taxes soon to reduce the deficit than to postpone action for many years. The longer we wait, the higher tax rates would have to be to restore balance. And income tax rates of 50 or 60 or 70 percent would entail huge economic costs compared with a 40 percent rate.

A Strategy for the Short- and the Long-Term

I suggest three goals for tax and budget policy over the next few years:

- Do not stifle the nascent economic recovery.
- Implement a credible plan to get the debt down to a sustainable level within the next decade.
- Reform the tax system to make it simpler, fairer, and more conducive to economic growth.

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[6] There are exceptions. Temporary investment credits or deductions can be very effective at shifting the timing of expenditures. If taxpayers know that they have to spend money this year to get a tax credit or deduction, they will be inclined to accelerate spending. The home buyers' credit and bonus depreciation are both in the category of timing tax incentives; however, experience with the home credit suggests that proper timing can be a challenge. While the credit sped up home purchases among those who qualified, its expiration appears to be creating a significant dip in home sales while the housing market is still very weak.

[7] The Congressional Budget Office, Joint Committee on Taxation, and the Treasury all conducted studies in the early 2000s. They concluded that tax rate cuts could boost the economy in the short-run, but not by nearly enough to offset the direct revenue loss. The long-run effect depended on how the deficits were closed. If the deficits ultimately led to higher tax rates, GDP would be lower than without the tax cuts. If the deficits ultimately led to spending cuts, GDP would increase permanently. In all cases, the effects were small. See Jane Gravelle, "Issues in Dynamic Revenue Estimating," CRS Report for Congress RL31949, U.S. Congressional Research Service, 2007, for an excellent survey.

Temporarily Extending the Middle-Class Tax Cuts

The goals of addressing the debt crisis without retarding the economic recovery are directly in conflict. The traditional fiscal policy recipe for addressing a severe economic downturn calls for spending increases and/or tax cuts with resulting deficits in the near term to boost aggregate demand and stimulate economic activity. The other avenue for boosting the economy is expansionary monetary policy, but the Federal Reserve's traditional toolkit is unlikely to provide much additional support with interest rates barely above zero.[8] Thus, the Fed's ability to offset the effect of contractionary fiscal policy with monetary easing may be especially limited.

For that reason, traditional fiscal policy would call for continuing all or most of the tax cuts, but, as noted, that path will eventually lead to ruinous deficits. The balance between the two objectives can be reached by extending the most expansionary of the tax cuts, but only temporarily. This would limit the increase in the debt.

The most effective way to boost aggregate demand (and thus the economy) is to raise the incomes of those whose spending is constrained—that is, those with low incomes. Lower-income households spend virtually all of their income while those with high incomes are able to save. During normal times, middle-income households can smooth their consumption by borrowing—for example, by using a credit card or tapping a home equity line of credit—but the financial market meltdown has sharply curtailed access to credit. This increases the likelihood that targeted tax cuts would boost spending (rather than simply reducing debt or increasing saving).

In contrast, high-income households spend only a fraction of their incomes. In 2003, households with incomes over $200,000 spent less than 40 percent of their incomes.[9] The rest goes to saving and taxes. Tax cuts for such households are likely to have little effect on spending.

Temporarily extending only the provisions affecting low- and middle-income households would dramatically reduce the cost of extending the tax cuts. Excluding the high-income provisions, as proposed by the Obama Administration, would reduce the 10-year cost of full extension by about 25 percent—nearly $1 trillion—based on Treasury estimates. Further limiting the tax law extension to three years (through 2013) would reduce the revenue cost of extension by roughly 80 percent—or about $3 trillion. Including savings in interest payments, the national debt could be reduced by close to $4 trillion by 2020 under a temporary targeted extension of the middle-class tax cuts.

In addition, a smaller budgetary commitment to tax cuts could make more resources available for other possibly more effective economic stimulus measures, such as an extension of unemployment benefits—which ranks at the top of CBO's list in terms of bang for the buck—or

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[8] The Fed can also print money (technically, using its currency reserves to buy Treasury bonds and other assets, increasing the stock of cash in circulation). Until the economic meltdown, the Fed primarily relied on its control of interest rates to expand or tighten access to credit because it is easier to quickly open or close the spigot at the discount window.

[9] Leonard E. Burman, Jane G. Gravelle, and Jefffrey Rohaly, "Towards a More Consistent Distributional Analysis." *National Tax Association Proceedings of the 98th Annual Conference*, 2005.

aid to states to forestall some of the spending cuts and tax increases they are undertaking under tremendous budgetary pressure.

Tax Reform

The other part of the program would be a commitment to comprehensive tax reform that would stabilize the debt at about 60 percent of GDP by the end of the decade.[10] A good place to start this effort could be the recommendations of the bipartisan National Commission on Fiscal Responsibility and Reform if it produces a recommendation for tax and budget reform. Alternatively, the Treasury might take the lead as it did in producing the first draft of what became the Tax Reform Act of 1986 in the Fall of 1984, after the presidential election. Following that precedent, the Treasury report would be completed by the end of 2012. A three-year extension of the middle-class tax cuts would give Congress until the end of 2013 to craft and pass a tax reform bill.

The ideal reform would broaden the tax base and lower tax rates. Both the Wyden-Gregg Bipartisan Tax Fairness and Simplification Act of 2010 and the proposals of President Bush's tax reform panel took this approach and would significantly reduce top income tax rates. The problem with both proposals, however, is that they would substantially add to the public debt. The Wyden-Gregg plan is designed to be revenue neutral compared with a full extension of the expiring tax provisions, including the AMT patch. The Bush proposals would raise more revenue because they did not assume an AMT fix in the baseline. But both options would fall far short of revenues needed to get deficits under control.

To meet revenue targets, a new more efficient tax such as a carbon tax or value-added tax could be enacted to complement the income tax and facilitate lower individual and corporate income tax rates while maintaining a suitable degree of progressivity.[11]

This would be far better than simply raising top income tax rates under the current flawed system. Tax rate increases harm the economy and cannot, by themselves, close the budget gap.[12] In contrast, base broadening can boost tax revenues and make the income tax more efficient, fair,

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[10] Two careful bipartisan plans for debt reduction chose the 60 percent target. See National Research Council and National Academy of Public Administration, *Choosing the Nation's Fiscal Future,* Washington, DC: National Academies Press, 2010; and Peterson-Pew Commission on Budget Reform, "Red Ink Rising: A Call to Action to Stem the Mounting Federal Debt," Washington, DC: Peterson-Pew Commission, 2009. Economists Carmen Reinhardt and Kenneth Rogoff provide one rationale for such a threshold: Half the nations that experience debt crises had debt-to-GDP levels below 60 percent of GDP. See Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly*. Princeton: Princeton University Press, 2009.

[11] For example, I have suggested enacting a VAT dedicated to paying for health care, which would allow a major reform and simplification of the individual and corporate income taxes at much lower rates than the current system. See Leonard E. Burman, "A Blueprint for Tax Reform and Health Reform," *Virginia Tax Review* 28: 287-323, 2009.

[12] See Rosanne Altshuler, Katherine Lim, and Roberton Williams, "Desperately Seeking Revenue," *National Tax Journal*, forthcoming. They calculate that raising only the top three tax rates would require a top rate of more than 76 percent to get the deficit down to down to an average of two percent of GDP from 2015 to 2019; and raising only the top 2 rates—the policy most consistent with the President's promise to spare the middle class—would require a top rate of almost 91 percent, a level not seen since the Kennedy Administration. In fact, the resulting tax avoidance would reduce the revenue take at these very high tax rates. Thus, rate increases alone could not possibly close the budget gap.

and comprehensible.[13] Loopholes and preferences in the income tax complicate tax preparation and create opportunities for tax avoidance and evasion. For example, long-term capital gains face a 15-percent top rate compared with a 35 percent rate for ordinary income. The capital gains preference has created a whole tax shelter industry designed to convert highly taxed ordinary income into lightly taxed capital gains. The lower rate can distort investment and occupation choices. For example, finance experts who work in the private equity arena are taxed at less than half the rate of bond traders who may work down the hall and do very similar work. Taxing capital gains at the same rate as other income would eliminate those distortions.[14]

Issues and Concerns

Several critiques have been raised with respect to extension of only the low- and middle-income tax relief. One is that high income tax rates would discourage entrepreneurship and slow employment, threatening the economic recovery. In addition, some analysts have raised concerns that the refundable tax credits, which were significantly expanded as part of the 2001 and 2003 legislation (and also by the recently enacted health reform legislation), can discourage work.

Income tax rates and entrepreneurship

Entrepreneurship is a key component of economic growth. Entrepreneurs take risks and, when successful, create jobs, profits for shareholders, and innovations that other firms can imitate.[15] If high individual income tax rates discouraged entrepreneurship, that would be undesirable. The conventional argument for why high tax rates might have such an effect is simply that potential entrepreneurs won't do the hard work or take the risks necessary for success unless they can keep a large share of potential returns. A somewhat more subtle argument is that progressive tax rates discourage risk taking since successful entrepreneurs end up in high tax brackets where much of their profits go to the tax collector, whereas the unsuccessful entrepreneur faces low tax rates which reduce the value of loss deductions.[16]

In fact, it is unlikely that higher income tax rates on entrepreneurs would reduce hiring in the short term. For one thing, less than 3 percent of tax returns with business income are in the top

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[13] See Emmanuel Saez, Joel B. Slemrod, and Seth H. Giertz, "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review," NBER Working Paper 15012, 2009. They conclude that rate increases entail significant economic costs while base broadening reduces the cost of taxation. Conservative icon Martin Feldstein made the same argument in a *Wall Street Journal* op ed, arguing that additional revenues are needed and eliminating tax breaks would be far better than raising tax rates. See Martin Feldstein, "ObamaCare's Crippling Deficits," *Wall Street Journal*, September 7, 2009.
[14] Numerous other arguments are made for a lower tax rate on capital gains. See Leonard E. Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed,* Washington, DC: Brookings Institution Press, 1999, for a discussion and critique.
[15] Julie Berry Cullen and Roger H. Gordon, "Taxes and Entrepreneurial Risk-Taking: Theory and Evidence for the U.S," *Journal of Public Economics*, 91(7-8): 1479-1505, 2007.
[16] William M. Gentry and R. Glenn Hubbard, "'Success Taxes,' Entrepreneurial Entry, and Innovation," in *Innovation Policy and the Economy. Volume 5*, edited by Adam B. Jaffe, Josh Lerner and Scott Stern, 87-108, Cambridge and London: MIT Press, 2005.

two tax brackets, so the vast majority would be protected from tax rate increases by the extension of middle-class tax cuts proposed by the President.[17]

But even those who might face higher tax rates would not have an incentive to change hiring decisions. Employers will hire a new worker if they expect the value of the worker's output to exceed what he or she is paid. If the hire is profitable before tax, it doesn't matter whether the employer gets to keep 60 or 65 percent of that additional profit. The new worker will also be profitable after tax. And if the worker cannot produce enough to justify his or her costs, income tax rate cuts cannot make the new hire profitable.

As for the effect of individual income tax rates on the decision to become an entrepreneur, it is likely that higher individual income tax rates encourage entrepreneurship for several reasons. First, successful entrepreneurs can choose to incorporate to take advantage of the 15-percent tax bracket that applies to small corporations. According to economists Julie Cullen and Roger Gordon, "The option to choose the organizational form ex post based on the outcome reduces the effective tax rate on profits without affecting the tax rate on losses, thereby encouraging risk taking. *The higher are personal relative to corporate tax rates, the larger is the encouragement to risk taking arising from this option.*" (p. 1480, emphasis added)

Self-employed people may also fully deduct expenses that wage and salary workers cannot deduct. And, to the extent that self-employed people work at low wages, investing their labor into their business (that will ultimately be repaid in the form of lightly taxed capital gain if the business is successful), they save the taxes they would have paid if they had remained in a wage-paying job. The value of those tax savings grows with the individual income tax rate. Cullen and Gordon estimated the empirical effect of all of these factors on entrepreneurial activity and concluded that "contrary to conventional wisdom, ... a cut in personal tax rates can substantially reduce entrepreneurial risk taking." (p. 1501)

In addition, self-employed people are notoriously non-compliant. The IRS estimates that sole proprietors misreported income by an average of 57 percent in 2001.[18] The tax sheltering aspects of self-employment become more attractive at higher income tax rates.

Thus, the evidence suggests strongly that higher marginal income tax rates on high-income entrepreneurs are unlikely to result in significantly less employment or risk-taking. There may, however, be a much more important indirect effect. If rising debt levels pushed up interest rates, that would have a very deleterious effect on investment and hiring decisions of all businesses, including entrepreneurs. By sharply curtailing the revenue loss attributable to the Bush tax cuts, a targeted, temporary extension could help keep interest rates low and boost economic activity and entrepreneurship.

[17] William G. Gale, "Small Businesses and Marginal Income Tax Rates," *Tax Notes*, 471, April 26, 2004.
[18] See Susan C. Nelson, "Tax Policy and Sole Proprietorships: A Closer Look," *National Tax Journal*, 61(3): 421-443, September 2008.

Refundable tax credits and work incentives

The Bush-era tax cuts significantly expanded the amount of tax credits that could be claimed by households with no income tax liability. The new laws raised the maximum child tax credit from $500 to $1,000 per child and created a refundable child tax credit of 15 percent of earnings above $3,000 up to the maximum of $1,000 per child. The refundable earned income tax credit (EITC) was also increased. Prior to 2001, households with one child received a refundable credit equal to 34 percent of earnings up to a maximum level; the phase-in rate was 40 percent for households with two or more children. The credit phased out at higher income levels. Married couples and singles were subject to the same phase-in and phase-out schedule for the credits, creating potentially substantial marriage penalties. (Marriage could push family incomes into the phase-out region for the EITC, reducing or eliminating the credit.)

The American Recovery and Reinvestment Act of 2009 (ARRA) added a third tier for the EITC—a 45 percent phase-in rate for families with three or more children—and increased the EITC marriage penalty relief that was created as part the 2001 tax cut. The EITC now phases out at a higher income level for couples than for singles.

The combined credits can now be quite substantial. In addition, the making work pay tax credit, enacted in 2009, is another refundable wage subsidy, and the only substantial work incentive for households without children.[19] In total, the subsidies are designed to encourage work and help lower-income families with children.

Although some conservatives are uneasy about the large refundable tax credits, sometimes calling them "welfare," well designed work subsidies would seem to epitomize conservative values. They reward work over welfare and make it possible for families in low wage entry level jobs to earn a decent after-tax income. By encouraging an attachment to the work force, the subsidies encourage the development of human capital and promote upward economic mobility.

While most economists believe that a well-functioning free market system may maximize aggregate income, there is no guarantee that the distribution of income is equitable. Indeed, between 1979 and 2007, average real incomes at the bottom of the income distribution stagnated while incomes at the top exploded. At the same time, the share of income earned by top earners more than doubled while low earners saw a dwindling share of total income. (See Figure 3.)

Refundable tax credits play an important role in mitigating rising economic inequality. I view this as a good thing in its own right, but even those who believe that it is fine for a small number of people to control more and more of society's resources might have an interest in using the tax system to diminish inequality. Growing inequality could lead to a populist revolt against factors thought to be implicated, such as free trade and relatively unfettered markets. Increasing trade barriers and increased regulation could diminish the incomes of those at the top by much more than a modestly progressive tax system (and might not help those at the bottom either). The progressive income tax might be viewed as a mechanism to buy the support of ordinary working people for a system that disproportionately benefits a few high earners.

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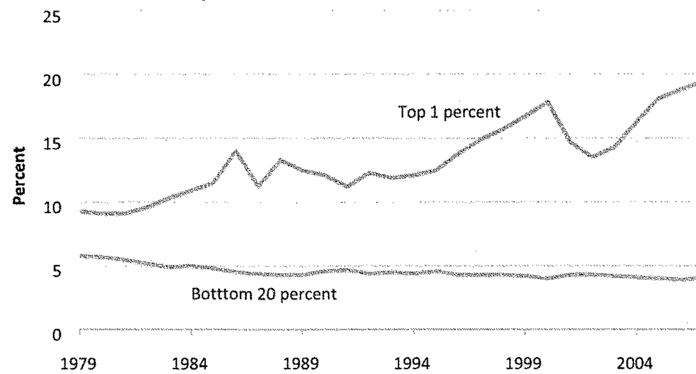
[19] The Affordable Care Act (health reform) will include refundable credits that dwarf the existing work and child subsidies for households with low incomes when it is fully phased in.



Source: Congressional Budget Office, *Average Federal Taxes by Income Group*, June 2010.

The other line of criticism levied at refundable tax credits is that they are poorly designed and discourage work. While it is true that the phase-out of the EITC combined with payroll taxes and income taxes can create relatively high effective marginal tax rates for low-income households, the evidence suggests that, on balance, the EITC encourages work. The credit creates conflicting incentives. For a single parent (the vast majority of EITC recipients), the credit encourages participation in the labor force because earnings are necessary to qualify for the credit. For very low-income workers whose earnings fall entirely in the phase-in range, the credit raises the after-tax (after credit) wage, which rewards working more hours. However, many workers' earnings are in the phase-out range, where each additional dollar of earnings can cost as much as 21.06 cents in lost credits (for workers with two or more children). These workers might decide to cut hours to avoid the high implicit taxes.

Empirical research suggests that the participation effect is the more important of the two conflicting incentives.[20] The EITC encourages single parents to work and has little or no effect on hours worked in that group. Among married couples with income in the EITC phase-out range, there is a small negative effect on participation and hours of second earners. On balance, the EITC encourages work.

[20] See, e.g., Eissa, Nada, and Hillary W. Hoynes, "Behavioral Responses to Taxes: Lessons from the EITC and Labor Supply," in Poterba, James M. (ed.), *Tax Policy and the Economy, Volume 20*, 73–110, Cambridge, MA: National Bureau of Economic Research, 2006; Steve Holt, "The Earned Income Tax Credit at Age 30: What We Know," The Brookings Institution Research Brief, February 2006; V. Joseph Hotz, Charles H. Mullin, and John Karl Scholz, "Examining the Effect of the Earned Income Tax Credit on the Labor Market Participation of Families on Welfare," NBER Working Paper 11968, January 2006.

While research on the empirical effects of the refundable child tax credit and making work pay tax credits on labor force participation and work hours is not yet available, those programs were designed to provide a positive subsidy to meager wages and they do not phase out until fairly high income levels. It is thus likely that those credits would reinforce work incentives for low-wage workers.

The credits could, of course, be improved. For example, the various tax subsidies for work and children could be consolidated and simplified. If phase-outs and the resultant high marginal tax rates are deemed undesirable, they could also be addressed as part of tax reform. However, the refundable credits mitigate some of the harshest features of the free market, encourage work and economic mobility, and provide essential aid to low-income working families with children.

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

Thank you, Mr. Chairman.

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 dollars 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 dollars 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's 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 are all from the 111th Congress and, as I have them here, represent a total of 1314 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 straightforward. 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-board 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's worth of effort.

Perhaps John would have been willing to do $100's 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's 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 are 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 330%.

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 for 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's 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 1 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 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.

Aspects of the Sunset of EGTRRA and JGTRRA

Testimony presented to the United States Senate, Committee on Finance

by
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July 14, 2010

*The views presented here are my own and not necessarily those of the American Action Forum

Chairman Baucus, Ranking Member Grassley and distinguished members of the Committee. I am honored to have the chance to appear before you to discuss the important issue of the future of federal income tax policy, notably policy options regarding the sunset of the Economic Growth Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

The future of EGTRRA and JGTRAA raise important issues of tax policy. Collectively, these Acts are substantial enough to have important macroeconomic consequences in both the near term and over longer horizons. As a corollary, the decisions made about their future have significant budgetary consequences. In weighing the options regarding their future, policymakers will wish to consider who bears the burden of each shift in the tax burden. Hopefully they will do so by looking past the superficial metric of measured tax liability to the deeper question of understanding who bears the economic consequence of each policy decision. Lastly, the tax code will need deep reform regardless of which near-term options are chosen regarding the sunsets of EGTRRA and JGTRRA. Thus, it is useful to examine the near-term policy options from the perspective of whether they move the tax code closer to, or away from, desirable long-run reforms. I will discuss each in turn.

1. Macroeconomic Issues

The United States' economy has endured a severe recession and is currently growing slowly. Over the course of the past several years, Administrations and Congresses have engaged in a number of counter-cyclical fiscal measures, , or in the parlance of the political world, "stimulus": checks to households (the Economic Stimulus Act of 2008), the gargantuan stimulus bill in 2009 (American Recovery and Reinvestment Act), "cash for clunkers" (the Car Allowance Rebate System), and tax credits for homebuyers (the Federal Housing Tax Credit). As this Committee is well aware there is an ongoing debate regarding the effectiveness of these measures in mitigating the natural course of the business cycle downturn.

Regardless of the ultimate resolution of that debate, I believe it would be a mistake for policymakers to evaluate the sunsets of EGTRRA and JGTRRA from that perspective. The U.S. economy *is* growing, albeit slowly, not declining. Gross Domestic Product (GDP) has been rising since the third quarter of 2009, and employment is up from its trough in December 2009. NFIB's small business confidence index was 92.2 in May 2010, up from 81.0 in March 2009. Consumer confidence is up from 26 in March 2009 to 63.3 in May. The ISM manufacturing and non-manufacturing indices are above 50, signaling growth. There is substantial and widespread evidence of an ongoing economic expansion. Accordingly, this is not the time for counter-cyclical "stimulus".

The Need for Pro-Growth Policies

The pace of expansion remains solid and unspectacular. In many ways this is not surprising. As documented in Rogoff and Reinhart (2009), economic expansions in the aftermath of severe financial crises tend to be more modest and drawn out than recovery from a conventional recession.[1] Nevertheless, at this juncture it is imperative that policy be focused on generating the maximum possible pace of economic growth. More rapid growth is essential to the labor market futures of the millions of Americans without work. More rapid growth will be essential to minimizing the difficulty of slowing the explosion of federal debt to a sustainable pace. More rapid growth will generate the resources needed to meet our obligation to provide a standard of living to the next generation that exceeds the one this generation inherited.

Drivers of Economic Growth

Policies focused on more rapid economic growth are the most important priority at this time. In light of this, it is useful to reflect on the four basic sources of growth in final demand for GDP: households, businesses, governments, and international partners.

Households are caught in a double bind of badly damaged balance sheets and weak income growth. As is well known, the collapse of the U.S. housing bubble left many households in mortgage distress, and more broadly diminished the net worth of the household sector. In addition, the financial crisis itself destroyed additional household wealth, with the result that household net worth is now $11 trillion below 2007. The pace of the expansion thus far has yielded modest income growth.

It would be surprising, or even unwise, to expect households to be a robust source of final demand growth. Instead, the best course for households would be to repair their damaged balance sheets as quickly as possible. Policies that support the ability of households to do so while otherwise maintaining their consumption patterns will be the most beneficial. One-time "stimulus" in the form of tax cuts or transfers contribute little to these goals. In the other direction, the prospect of a large tax increase would force households to undertake even more balance sheet repair in anticipation of higher taxes and lower future income growth. For example, the Congressional Budget Office ("CBO") projects a reduction in GDP growth of at about 1.4 percent in 2011 if the Acts sunset.

Similarly, federal and sub-federal governments also face enormous budgetary difficulties, largely due to long-term pension, health, and other spending promises coupled with recent programmatic expansions. Consider the federal budget. Over the next ten years, according to the Congressional Budget Office's

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[1] See *This Time Is Different: Eight Centuries of Financial Folly*, by Carmen M. Reinhart and Kenneth Rogoff, 2009.

(CBO's) analysis of the President's Budgetary Proposals for Fiscal Year 2011, the deficit will never fall below $700 billion. Ten years from now, in 2020, the deficit will be 5.6 percent of GDP, roughly $1.3 trillion, of which over $900 billion will be devoted to servicing debt on previous borrowing.

The dire long-term budget outlook is not the result of a shortfall of revenues. The CBO projects that over the next decade the economy will fully recover and revenues in 2020 will be 19.6 percent of GDP – over $300 billion more than the historic norm of 18 percent. Instead, the problem is spending. Federal outlays in 2020 are expected to be 25.2 percent of GDP – about $1.2 trillion higher than the 20 percent that has been business as usual in the postwar era.

As a result of the spending binge, in 2020 public debt will have more than doubled from its 2008 level to 90 percent of GDP and will continue its upward trajectory. Traditionally, a debt-to-GDP ratio of 90 percent or more is associated with the risk of a sovereign debt crisis. Indeed, there are warning signs even before the debt rises to those levels.

As outlined in a recent report, the credit rating agency Moody's looks at the fraction of federal revenues dedicated to paying interest as a key metric for retaining a triple-A rating. Specifically, the large, creditworthy sovereign borrowers are expected to devote less than 10 percent of their revenues to paying interest. Moody's grants the U.S. extra wiggle room based on its judgment that the U.S. has a strong ability to repair its condition after a bad shock. The upshot: no downgrade until interest equals 14 percent of revenues. This is small comfort as the CBO analysis shows 2015 as the year when the federal government crosses the threshold and reaches 14.8 percent, and continues to rise to 20.1 percent in 2020.

The federal government needs to reduce spending growth, control its debt, and do so dramatically. No sensible growth strategy can be built around greater federal spending, or greater government spending more generally.

With households and governments repairing balance sheets, this leaves the business sector spending and net exports at the heart of badly-needed pro-growth policies. Policies toward international trade are not the focus of this hearing, so I will put this aside and merely mention that the United States has been on the sidelines of international trade agreements for far too long. Pro-trade polices should be a bipartisan approach to raising growth and increasing jobs.

Tax Policy Considerations for Pro-Growth Policy

To be effective in the current environment, tax policy should support not only household consumption, but also household saving and repairing their balance sheets so that consumption gains can be permanent. It should support business expansions in the form of spending for innovation, workers and their compensation, repairs, and new plant and equipment. Because this hearing focuses on EGTRRA

and JGTRRA, the corporation income tax code is not a topic of discussion, and beneficial policies like cutting the corporation income tax are not on the table. But as is now well know, a large swath of U.S. economic activity is organized in sole-proprietorships, partnerships, and other pass-thru entities that are directly affected by the individual income tax.

The Joint Committee on Taxation projects that $1 trillion in business income will be reported on individual income tax returns in 2011. Notably, of that $1 trillion, nearly one-half, $470 billion, will be reported on returns that will be subject to the top two rates of 36 percent and 39.6 percent if EGTRRA and JGTRRA are allowed to sunset.[2]

This has direct effects on employment. According to the Small Business Administration, there are almost 120 million private sector workers in the United States. Slightly more than half those workers, 60 million, work for small business. About two-thirds of the nation's small business workers are employed by small businesses with 20 to 500 employees. According to Gallup survey data conducted for the National Federation of Independent Business (NFIB), half of the small business owners in this group fall into the potential 36 percent and 39.6 percent tax brackets. This means there is a pool of more than 20 million workers in those firms directly targeted by the higher marginal tax rates. This is likely a conservative estimate as it ignores flow-through entities with one to 19 workers.

The future of EGTRRA and JGTRRA is central to business tax policy.

The first consideration is the uncertainty over the future course of the tax law itself. It has been widely noted that uncertainty over the policy environment itself may contribute to a desire by businesses to hoard cash instead of spending. A particularly vivid expression of this view is in the June 2010 *NFIB Small Business Economic Trends:* "But Congress continues to pass and propose legislation that increases the cost of running a business and create huge uncertainty about future costs. The small business sector of the economy is improving, there is a pulse, but it is weak. Washington is applying leeches and performing blood-letting as a cure."[3]

A temporary extension of EGTRRA and JGTRRA will merely defer resolving the uncertainty over the tax policy outlook. In the other direction, a permanent extension would set expectations, permit long-range business planning, and support long-term economic growth. Notice that at the same time, there would be *immediate* economic benefits as businesses step up their spending to match the improved long-run outlook.

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[2] The Joint Committee on Taxation analysis does not take into account the impact on small, non-publicly-traded "C" corporations. There are several million of these entities, which will likely be adversely affected by the marginal rate increases on ordinary and capital income.

[3] See http://www.nfib.com/Portals/0/PDF/sbet/sbet201006.pdf

In thinking about permanent extensions of EGTRRA and JGTRRA, it is useful to recognize that not all the components are equal from a growth perspective. Innovation, investment, and saving decisions are directly affected by structure of marginal tax rates, the taxation of returns to equity investment in the form of dividends and capital gains, and provisions for capital cost recovery (e.g., Section 179 expensing). In contrast, provisions for refundable tax credits, marriage penalty relief, and other targeted incentives make no contribution to growth incentives.

Indeed, the impact of phase-outs of refundable credits may have even more perverse growth consequences. As noted in Brill and Holtz-Eakin (2010), some provisions (exacerbated by the phase-outs in the recently-passed Patient Protection and Affordable Care Act (PPACA)) contribute to high marginal tax rates.[4] The effect is to raise to as high as 41 percent the effective marginal tax rate on some of the lower-income U.S. workers. This has implications for the ability of families to rise from the ranks of the poor, or to ascend toward the upper end of the middle class. This growth and mobility is the heart of the American dream and is the most pressing issue at this time.

In addition, a broad spectrum of provisions creates more complexity that is costly for small businesses and individuals. In some other cases they effectively raise marginal rate hikes: Ways and Means GOP tax staff calculate that the net effect of these non-rate provisions is to raise effective marginal tax rates by 2 percentage points.

A picture emerges in which preserving permanently certain aspects of the tax code – low marginal tax rates, low taxation of dividends and capital gains, etc. – is central to a successful growth strategy. In contrast, making permanent other provisions in the Acts is less central to growth imperatives – they are present for other policy objectives – and may even diminish incentives. In light of the clear need for more rapid growth the issue facing policymakers is how to resolve the tradeoffs among multiple policy objectives.

What is at stake? If the top rates are permitted to rise the marginal tax rate on the return to small business will rise to roughly 42 percent (39.6 plus the roughly 2 percent hidden marginal rates. Note that his excludes the 3.9 percent tax in the PPACA.). This will diminish incentives to expand payrolls and establishment size, as well as tilt the playing field in favor of corporate investments that will face a 35 percent rate. Less dramatic effects in the same direction are posed by higher tax rates on capital gains. However, the most striking blow on growth-oriented

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[4] Brill, Alex and Holtz-Eakin, Douglas, "Another Obama Tax Hike." *Wall Street Journal*, February 4, 2010. See also, Douglas Holtz-Eakin and Cameron Smith, "Labor Markets and Health Care Reform, 2010.
http://americanactionforum.org/files/LaborMktsHCRAAF5-27-10_0.pdf

investment is the increase in taxation of equity returns in the form of dividends from 15 percent to the top effective rate of 42 percent.

Growth versus Stimulus

Many will choose to frame the extension of EGTRRA and JGTRRA as an issue of "stimulus." As noted above, I believe this is deeply misplaced and a laser focus should be placed on a growth strategy that gives good incentives for business spending, net exports, and sustainable household consumption. In that setting, expectations and uncertainty regarding future tax rates are part of the calculus of current business hiring and investment decisions. It is a false dichotomy to suggest that long-term incentives are unrelated to current economic activity.

One can expect, nevertheless, that there will be a discussion of tax versus spending "multipliers." For some this will be an argument for more spending, or at least to not cut spending, on the grounds that the negative multiplier effects will outweigh the benefits of tax policy. These arguments are often couched within the context of a formal economic model, such as that used by Administration officials Christina Romer and Jared Bernstein to tout the ARRA. It is important to note that in basic Keynesian models, spending multipliers are assumed to be larger than tax multipliers. As a result, adopting these models presumes this result. In contrast, recent empirical work on both sides of the budget suggest that tax impacts are larger – perhaps much larger – than spending impacts.[5]

For these reasons, it is important to take model-based predictions about the impact of alternative budget policies with an appropriate grain of salt. It is equally important to be skeptical of the use of these same models to show that stimulus is "working" – depending on the model, they could find nothing else.[6]

In the end, this will be decided on the basis of the evidence. The chart below shows actual GDP during 2009. It also shows what *would* have happened if the trajectory at the start of 2009 had continued the entire year (labeled "Continued Decline"). This is the graphical version of "the economy was falling off a cliff" and shows a continued decline at the 6.4 percent rate that was present in the last quarter of 2008. The shaded area is the difference – the *additional* GDP from not continuing to decline – and totals $268 billion.

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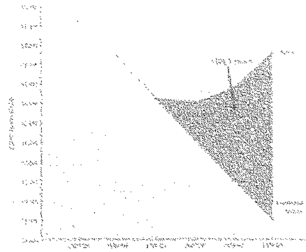
[5] Greg Mankiw has a nice discussion of these issues. See http://nationalaffairs.com/publications/detail/crisis-economics

[6] John Taylor makes this point quite effectively. See "Perspectives on the U.S. Economy: Fiscal Policy Issues", Testimony before the Committee on the Budget U.S. House of Representatives, July 1, 2010.



Stimulus (outlays and reductions in receipts) in 2009 was roughly $260 billion. Thus, if one attributes all improvement in GDP to the stimulus – that is, no role for the Federal Reserve's policy efforts, no role for mortgage relief programs, no role for worldwide economic improvements, and so forth – then the stimulus bill essentially broke even. That is, it provided no multiplier effects.

Of course, these assumptions may be too pessimistic, as there doubtless would have been some impact from other policy efforts, the natural recovery mechanisms in the economy, and the benefits of recovery abroad. Using the same logic, if the economy had been flat in 2009, stimulus would be responsible for $63 billion in additional GDP – a payoff of only 25 cents on the dollar. These simple computations suggest that one should not place model-based, short-run multipliers as the center of the policy debate.

With that as prelude, I turn now to some illustrative investigations of the options facing the Congress. The American Action Forum paired with Decision Economics, Inc. to produce macroeconomic simulations of two policy options:

- Extend EGTRRA and JGTRAA for one year, but only for those earning less than $250,000 (family) or $200,000 (individual), versus
- Extend EGTRRA and JGTRAA permanently.

The simulations of these options are a subset of a larger study that will be forthcoming. Obviously, one option is explicitly short-term, while the other is permanent. To put these on an even playing field, I focus only on the effects in 2011 and 2012 and ignore the long-term growth aspects.

In doing so, we employ a conventional macroeconomic model in which short-run spending multipliers are larger than short-run tax multipliers, and in which the role of forward-looking expectations are not central. Thus, these simulations stack the deck against the very kind of policy that I would believe most beneficial.

Nevertheless the results in Table 1 are illuminating. Beginning with top-line GDP growth, permanent extension is estimated to raise growth by 1 percentage point in the first year and 0.2 percentage points in 2012. In contrast, a one-year and

limited extension has a smaller, 0.8 percentage point impact in 2011 and reduces growth in 2012 as the negative impact of poorer tax policy hits the economy.

These differences are mirrored in labor market outcomes as the limited and temporary extension cumulatively creates fewer jobs (551,000 versus 883,000) and reduces unemployment by less. Not surprisingly, fewer discouraged workers return to the labor force. Under the permanent extension the labor force is cumulatively larger by 341,000 workers in 2012 compared with 216,000 in the limited, temporary extension.

Finally, there are important differences in key areas for growth. As shown in the next panels, domestic investment is 5 percent larger in the first year, and 46 percent larger in the second year, under the permanent policy. Also, household saving rises by a net $206 (in year 2000 dollars) and the saving rate averages 0.8 percentage points higher under the permanent extension.

These latter results are evidence that the permanent extensions permit households to save, repair balance sheets, and then raise their consumption in the future. In contrast, under the temporary and limited extension, there is a very modest rise in the overall saving rate.

2. Fiscal Policy Impact

The fiscal outlook for the federal government is dire. In these circumstances, some argue that it is imperative to permit the Acts to sunset, thereby reducing deficits. However, as noted above, the fundamental budgetary problem is excessive spending, not a paucity of tax receipts. Receipts are projected to rise to 19.6 percent above GDP – above historic norms – only to be offset by spending at 25 percent of GDP. Spending is the fiscal problem.

Thus, focusing on the impacts of the sunsets EGTRRA and JGTRRA as the top budgetary priority is misplaced as a matter of priorities. In addition, it may be true that sunsets of the Acts in the near-term would reduce deficits and perhaps could ameliorate any emerging financial market distress from the budgetary outlook. Unfortunately, any such fiscal progress would be quickly unwound due to rising federal spending. When that happens, would Congress be tempted simply to raise taxes again? If so, then a sunset to the Acts may actually undercut incentives to rein in excessive federal spending.

Just as tax policy must be focused on growth, fiscal policy should be oriented to a pro-growth philosophy. To grow more quickly, the Nation must be willing to forego current consumption to finance innovation, additional education and skills, and investment in plant and equipment. To the extent that budget deficits are driven by consumption subsidies trimming the growth in these program will shift the balance to greater growth and prosperity.

Lastly, it remains important to gauge budgetary impacts *inclusive* of growth feedbacks. Based on CBO's January estimate, the budget impact of extending both Acts for 2011 is roughly $115 billion, while the full 10 years is over $2.5 trillion. Based on the simulations above, the growth effects reduce the deficit impact by roughly 10 percent for a 1-year extension, meaning the dynamic deficit effect is roughly $100 billion. In contrast the feedbacks from growth reduce the deficit impact by 22 percent over 10 years, thus lowering the deficit impact to $1.95 trillion.

3. Distributional Impacts of Policy Options

Much of the history of the debate over EGTRRA and JGTRRA has been a debate over fairness in tax policy. Those dedicated to "taxing the rich" for the sake of taxing the rich, and at all costs, should skip the remainder of this section. Those interested in understanding how distribution issues fit into the policy options should consider four points.

First, taxes are an incomplete measure of the impact of federal policy on the distribution of income. Much of federal redistributive efforts take place via the spending side of the budget. Recent research at the Tax Foundation, while preliminary, makes vivid the large amount of net redistribution from more affluent to less affluent when the budget as a whole is evaluated.[7] Going forward, it is equally important to keep one's eye on the overall impact of tax and spending policy.

Second, perhaps the greatest unfairness is that being visited upon future generations who are threatened with inheriting both an economy weakened and growing too slowly, as well as the burden of servicing enormous federal debts. Policies that raise economic growth and control the growth of spending that fuels debts must be considered a fundamental improvement of fairness.

Third, the debate must be informed by magnitudes. How much is the progressivity of the tax code affected by policies desirable from the perspective of economic growth? A lot? A little? In this regard, consider the attached chart, which shows the effective tax rates by quintile over time. The chart highlights the periods prior to 2000 and that since the passing of EGTRRA, and subsequently JGTRRA. (The chart stops in 2006 so as to avoid the impacts of the recent recession.)

As the chart makes clear, the Acts lowered the effective tax rate for the highest-earning quintile. However, the net impact was to keep the effective tax rate

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[7] See, for example, The Tax Foundation, "Accounting for What Families Pay in Taxes and What They Receive in Government Spending," http://www.taxfoundation.org/news/show/25195.html

well within the range of rates since 1979. That is, the Acts changed the effective tax rate on the top quintile by an amount that is common in U.S. tax policy history.

The second aspect of the history displayed by the chart is that the remaining four quintiles benefitted from reductions in effective tax rates that were of a magnitude *comparable* to that experienced by the top quintile. Extreme characterizations of the Acts as "tax cuts for the rich" are inconsistent with these facts. Moreover, the end result of the Acts was to reduce the effective tax rates for the bottom 4 quintiles to their *lowest* levels since 1979. From the strict perspective of the history of the distribution of effective tax rates, the reductions for the lowest 4 quintiles are the unprecedented aspect of EGTRRA and JGTRRA.

The fourth and final perspective on distributional aspects is the importance of understanding the economic burden of taxes. Importantly, the person bearing this burden often differs from the person who sends the tax payment to the U.S. Treasury. When higher taxes cause a business owner to lay off a worker, the business owner sends in the tax payment. But the worker bears at least part of the burden in the form of spells of unemployment, the costs of changing jobs, and lower wages and other compensation.

The computations presented in the Chart attempt to incorporate economic incidence by recognizing, for example, that corporation income taxes are paid by individuals and that employer-paid payroll taxes are borne by workers. (These are not controversial economic assumptions; rather accepted facts as to how the world works.) However, the computations assume that all business taxes in the upper two tax brackets are paid by the owners. There is substantial evidence that personal income taxes affect the desire of entrepreneurs and small firms, thereby shifting some of the tax burden. Using results from my previous research, for example, suggests that letting the top two tax rates sunset would have a substantial impact on the workers of small businesses.[8]

For example, an increase in the top effective rate from 35 percent to 42 percent would lower the probability that a small business entrepreneur would add to payrolls by roughly 18 percent. Similarly, for those that do manage to hire, the growth in payrolls would be diminished by over 5 percent. Put differently, the heavier burden of taxation would be shifted toward workers by hiring less, paying less, or some combination of both. Other things being the same, this is neither a progressive shift nor supportive of growth.

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[8] Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. 2000. "Income Taxes and Entrepreneurs' Use of Labor." Journal of Labor Economics 18(2) (April):324-351. Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen. 2000. "Entrepreneurs, Income Taxes, and Investment." In Joel Slemrod (ed.), Does Atlas Shrug? The Economic Consequences of Taxing the Rich. NY: Russell Sage Foundation, pp. 427-455.

In the same way, the same tax hike also affects incentives for capital expenditures, reducing the probability that a small business undertakes expansion by nearly 15 percent, and reducing the capital outlays of those that do by almost 20 percent. As these expansionary incentives are muted, the demand for capital goods is diminished – thereby shifting the burden to workers and investors in those firms.

This discussion suggests two main conclusions. First, when evaluating the role of distributional impacts on the future of tax policy, it is important to do so from the perspective of economic incidence – who will *really* pay the higher tax burden of any proposed increase. Second, magnitudes matter. Distributional issues are a matter of tradeoff and must be quantitatively informed, both with respect to their setting within the larger budgetary redistribution and with respect to the tradeoff between distribution and other objectives.

4. The Road to Tax Reform

The U.S. income tax is in need of fundamental reform. The existing corporation and individual income taxes are rife with phase-outs, carve-outs, and other distortions. The corporation tax is high relative to many of our competitors and the U.S. remains unique in its anti-competitive dedication to taxing worldwide income of its multinationals. The individual income tax provides subsidies for the excessive consumption of debt-financed housing, gold-plated health insurance, and myriad other activities. Its combination of refundable tax credits and phase-outs creates strikingly high effective marginal tax rates on working Americans of modest means. The income tax system in the United States is in desperate need of fundamental reform. For purposes of this hearing, I will simply assume that this need is widely recognized and focus my remarks on how the sunsets of the Acts fits into the movement to a more efficient tax code.

The most important thing to recognize is that tax reform is built around the objective of permanently lowering marginal tax rates while broadening the tax base to ensure sufficient revenues. Any plan that does not seek to permanently maintain or lower marginal tax rates is moving in the wrong direction from the perspective of tax reform. Specifically, permitting the Acts to sunset for those making more than $250,000 (family) or $200,000 (individual) would raise substantial more revenue without broadening the base.

How should the base be broadened? A premium should be placed on base-broadeners that reduce subsidies to consumption. A consumption-oriented tax places burdens on the amount that individuals take out of the economy. In contrast, an income tax places the tax burden on the amount of labor hours, effort, skills, capital, and risk-taking that individuals supply. To my eye, at least, the former is ethically superior. A consumption-based tax would also equalize the effective tax on all forms of investment – investment in technologies, human skills, and innovation would compete equally with physical capital. Investment in small and large business would be on a level field.

The same insight applies to extensions of temporary, tax-based policies enacted as part of the Recovery Act. To the extent that permitting provisions to sunset lowers effective marginal tax rates (especially including those on lower-income workers) and reduces specific subsidies to consumption, it will be consistent with using tax policy to enhance the growth prospects for the U.S. economy.

A final point is that tax reform does not mean adding whole new tax systems on top of a broken U.S. income tax. Some recent discussion has featured adding a value added tax (VAT) to the U.S. system, in part because of the putative efficiency of a VAT. But the efficiency effects of a free standing VAT are quite different from the effects of a VAT that would be added onto the existing tax system. Indeed, because deadweight losses rise non-linearly, the total distortion associated with an add-on VAT would be worse than the sum of the two systems. In the context of the sunsets of the Acts, the key is to undertake effective reform of the existing system before contemplating new tax systems.

5. Conclusion

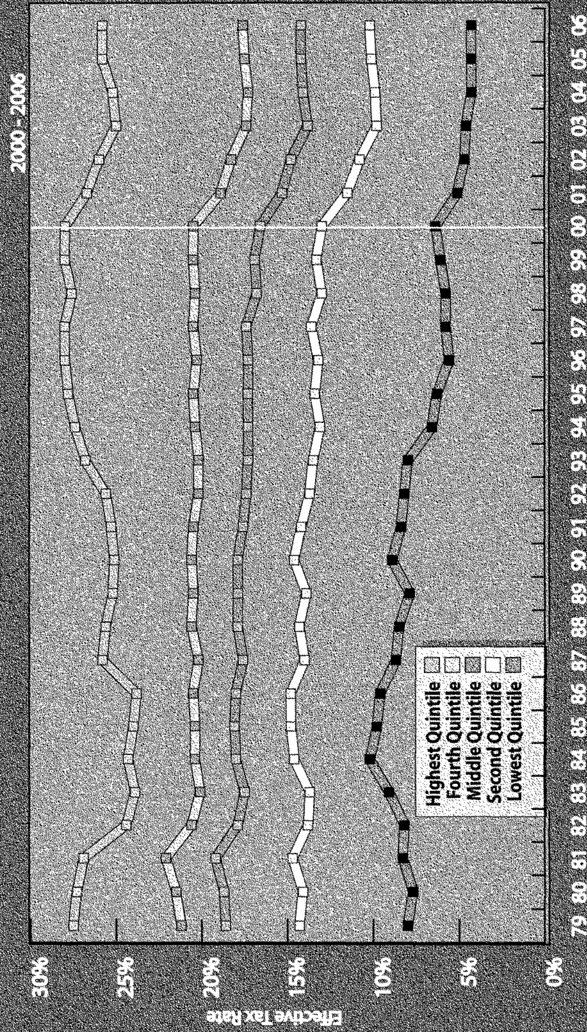
Chairman Baucus and Ranking Member Grassley, thank you for the opportunity to appear today. The sunsets of EGTRRA and JGTRRA are crucial moments in the evolution of U.S. tax policy. I believe that the focus should be on enhancing the growth potential of the U.S. economy and moving in the direction of fundamental tax reform. This places a premium on permanently low marginal tax rates, encouraging investment in innovation and capital, broadening the tax base, and using spending controls to provide a sustainable fiscal future.

I look forward to answering your questions.

Table 1
Simulated Impact of Policy Alternatives
(Entries show deviation from baseline projection)

	2011	2012
GDP Growth (percent growth rate)		
1-Year Extension Under $250k/$200k Only	0.8	-0.2
Permanent Extension Everyone	1.0	0.2
Employment (thousands of jobs)		
1-Year Extension Under $250k/$200k Only	515	551
Permanent Extension Everyone	613	883
Unemployment Rate (percent)		
1-Year Extension Under $250k/$200k Only	-0.1	-0.3
Permanent Extension Everyone	-0.2	-0.4
Labor Force (thousands)		
1-Year Extension Under $250k/$200k Only	107	216
Permanent Extension Everyone	130	341
Gross Private Investment (billions of 2000 dollars)		
1-Year Extension Under $250k/$200k Only	20.3	27.5
Permanent Extension Everyone	23.8	40.2
Household Saving (billions of 2000 dollars)		
1-Year Extension Under $250k/$200k Only	184.0	-124.3
Permanent Extension Everyone	225.8	-19.8
Household Saving Rate (percent)		
1-Year Extension Under $250k/$200k Only	1.4	-1.0
Permanent Extension Everyone	1.8	-0.2

Source: Decision Economics, Inc. Preliminary results.


Total Effective Federal Tax Rate:
1979-2006
2000 - 2006
30%
25%
20%
15%
10%
5%
0%
Effective Tax Rate
Highest Quintile
Fourth Quintile
Middle Quintile
Second Quintile
Lowest Quintile
79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06
Source: Congressional Budget Office, "Historical Effective Federal Tax Rates: 1979 to 2006."
Note: Total effective tax rate includes individual income taxes, social insurance (payroll) taxes, corporate income taxes, and excise taxes.

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Opening Comments

Senate Finance Committee Hearing

July 14, 2010

My name is Carol Markman. I am a partner of Feldman, Meinberg & Co. LLP of Syosset, New York and a member of the Internal Revenue Service Advisory Council. I have served as President of the National Conference of CPA Practitioners, NCCPAP, the only professional organization representing only Certified Public Accountants in Public Practice, and as Chairperson of its Tax Policy Committee. I am a member of the American Institute of CPAs and the New York State Society of CPAs. Accompanying me is Neil Fishman, CPA, principal of Fishman Associates CPAs PA of Boynton Beach, Florida, currently the Chairperson of the NCCPAP Tax Policy Committee and Mark Meinberg, CPA, managing partner of Feldman Meinberg & Co. LLP, currently the President of the Nassau Chapter of the New York State Society of CPAs.

The membership of NCCPAP consists of Certified Public Accountants in public practice located throughout the United States with a concentration of chapters in the Northeast. We have several chapters in New York and New Jersey and a chapter in Florida. The members of NCCPAP deal with the Internal Revenue Code on a daily basis directly with the public and sort through its complexities constantly. We estimate that our members serve more than 500,000 businesses and individual clients throughout every state of our country. We appreciate the invitation to participate in this hearing.

My topic today is the phase-out of itemized deductions and personal exemptions, the so-called Pease and PEP provisions, and other phase-out provisions. The Pease provisions are named after the late Representative Donald J. Pease (D-Ohio) and PEP stands for Personal Exemption Phase-out. The phase-out rules for Pease and PEP do not exist for 2010 tax returns but will come back in full force in 2011 unless Congress acts to change the law. The current situation, where taxpayers and tax preparers do not

know if Congress will act or what the tax law will be in 2011 creates uncertainty and makes tax planning very difficult. Many of the financial publications have recently included articles on what to do if the PEP and Pease phase-outs return but this advice may not be correct if the phase-outs do not return.

Until the Tax Reform Act of 1986 (TRA86) was enacted, any deduction or credit in the tax code was available equally to almost every taxpayer without regard to his or her Adjusted Gross Income (AGI). TRA86 changed the tax rates, from 15 brackets ranging from 11 to 50 percent to two brackets, 15 and 28 percent. The offset to this simple rate structure was the beginning of the phase-ins and phase-outs of exemptions, deductions and credits.

Subsequent laws changed the tax rates to four tax brackets in 1989, three in 1990 ranging from 15 to 28 percent, five in 1993 ranging from 15 to 39.6 percent, and six brackets in 2002, ranging from 10 to 35 percent. The 2002 brackets are still in effect for 2010. But these changes do not tell the whole story. The phase-out of itemized deductions and personal exemptions effectively created many more brackets for higher income taxpayers in all of these periods except 2010 when there are no PEP or Pease phase-outs. If Congress does not act, the five brackets in effect in 2000 ranging from 15 to 39.6 percent will return.

The phase-out rule for personal exemptions was enacted as part of the TRA86. The phase-out of itemized deductions was enacted as part of Omnibus Budget Reconciliation Act of 1990 (OBRA'90).

In 1988, for the first time, the personal exemption, then $1,950, began to be phased out when the AGI of joint filers was $149,250. The exemptions were completely eliminated when AGI exceeded $171,650.

One of the earliest phase-out provisions of itemized deductions has to do with medical expenses. The phase-out of medical expenses first became part of the tax law in 1942

with a five percent phase-out and a $2,500/$1,250 maximum deduction. Beginning in 1954, the itemized deduction for health insurance and medical expenses was subject to a three percent of AGI phase-out. The Equity and Fiscal Responsibility Act of 1982 changed the floor to five percent of AGI and TRA86 set the floor at 7.5 percent of AGI with no maximum deduction. The phase-out is scheduled to increase to ten percent of AGI for most taxpayers beginning in 2013 and all taxpayers beginning in 2017 due to the 2010 health care reform legislation.

Beginning in 1991, the first year a phase-out of itemized deductions was in effect, taxpayers with AGI above an "applicable amount" ($100,000 for all taxpayers except married filing separately "MFS") began to lose a portion of their itemized deductions. This limitation is calculated after all the other limitations. Up to eighty percent (80%) of itemized deductions can be lost as a result of this provision. In 2009 the phase-out range began for taxpayers with AGI above $166,800 ($83,400 for MFS).

The itemized deductions for charitable contributions and home mortgage interest were included in the phase-out. Most miscellaneous itemized deductions including un-reimbursed employee business expenses, which were deductible only to the extent that they exceeded two percent of adjusted gross income, were also included in the phase-out.

Since that time, tax rates have increased to a current maximum rate of 35 percent and the phase-outs have proliferated, effectively raising this marginal tax rate beyond the current stated rate of 35 percent. As new tax benefits have been introduced, many are limited by AGI. The public's perception is that the tax code gives benefits, deductions and credits with one hand and takes them away with the other.

The Taxpayer Relief Act of 1997 and subsequent laws established a proliferation of education incentives in the form of tax credits and deductions for qualified tuition and related expenses paid to eligible post-secondary educational institutions by the taxpayer. These credits and deductions were designed to benefit low and middle-

income taxpayers. Income limits were established for single taxpayers with the phase-out beginning at $80,000 of AGI and ending at $90,000 of AGI. For married taxpayers filing jointly, these phase-out levels are doubled. The laws do not differentiate between a single taxpayer and a single taxpayer with dependent children (Head of Household). The cost of living is significantly different when an individual must pay expenses for additional family members yet they are subject to the same phase-out limits as a single taxpayer. An expense such as child-care so that the single parent can go to school is not considered.

Code Section 25A should be expanded to permit taxpayers claiming Head of Household status a higher income phase-out than single taxpayers, in order to allow more single parents to claim tuition tax credits. Alternatively, the phase-outs for education credits should be made uniform or eliminated.

For the first time, starting in 1987, only taxpayers who were not active participants in an employer pension plan and those with very limited incomes could make tax-deductible IRA contributions. The deductibility of an IRA contribution was phased out for employees with employer-sponsored retirement plans with income above $35,000 for single filers and above $50,000 for married filing joint filers. The limitation for joint filers applies if either spouse is covered by a pension. Some taxpayers who would prefer to make an IRA contribution early in the year to take advantage of the tax deferral may not be able to do so because an unexpected event at the end of year may render them ineligible to make the IRA contribution due to the phase-out.

There are many other phase-outs in the current tax law. Most are based on modified AGI and filing status. Others are different only for MFS taxpayers. Some phase-outs have kept pace with inflation and others have not. Some phase-out ranges are $10,000, others are $15,000 and still others are $25,000 or more. The phase-out range for personal exemptions is $122,500 for all taxpayers except MFS. The phase-out range for Alternative Minimum Tax (AMT) can be as much as $283,800.

Speaking of the Alternative Minimum Tax – this tax is the ultimate in phase-out provisions. This tax first became effective in 1970 and was intended to target the rich, specifically 155 individuals with incomes over $200,000 who claimed so many tax benefits that they owed no income tax in 1967. The initial AMT rate was 10 percent. The AMT tax rate inched up every few years. The AMT was significantly changed in the 1986 Tax Act and the exemption amount, which is subject to a phase-out, was not indexed for inflation and has been adjusted by Congress annually since 2000. The current AMT rates are 26 and 28 percent.

The recent annual adjustments in the AMT exemption amounts, not knowing if Congress will act or not and sometimes the "fix" being enacted very close to the end of the year is another source of uncertainty and anxiety for taxpayers, tax professionals and the Internal Revenue Service.

It is NCCPAP's position that the AMT should be repealed. The AMT is too complex and imposes a large compliance burden. Taxpayer Advocate Nina Olson, in her December 2004 report, stated that the AMT now functions "randomly and no longer with any logical basis in sound tax administration." She believes that the AMT impacts the "wrong" taxpayers. We agree with Ms. Olson in this regard. The record keeping requirements for two sets of records is burdensome and unfair. Tax simplification can be achieved by an immediate repeal of this tax.

The National Taxpayer Advocate has recommended repeal of the AMT in her annual report to Congress every year since 2001. In addition, former President Bush's select committee on tax reform also advocated for repeal of the AMT. The rules for AMT are unnecessarily complex and result in affecting taxpayers not originally targeted when the AMT was first enacted. Rather than a provision to prevent high-income taxpayers from avoiding tax through tax planning, the AMT has become a tax on the middle class, burdening certain regions of the country more than others. Repeal, adjustment or reorganization is desperately needed to restore equitable taxation to the middle class taxpayer.

In 1980 Form 6251, the form used to calculate AMT was one page with 22 lines and one page of instructions. It began with AGI and allowed the subtraction of only some itemized deductions and required the add-back of certain amounts deemed "tax preference items". The 2009 Form 6251 is two pages with 55 lines and 12 pages of instructions. It begins with taxable income and adds back all personal exemptions and most itemized deductions and tax preference items and requires other adjustments and it still does not tax the people for whom the tax was intended. The people who should pay the AMT are those who structure their lives to avoid tax, not those who have another child.

One of the most serious problems for tax professionals dealing with the phase-outs is that even a very seasoned professional cannot sit down with a married taxpayer and prepare a projection using only a pencil, paper and calculator if the client's income is above a nominal amount. The code is so complex and provides for so many phase-outs with different ranges, and different beginning and ending points, that it is impossible to prepare an estimate of projected taxes and marginal tax rates without being armed with a series of worksheets, schedules and charts. Some phase-out limits change annually; others do not, so the preparer can never be sure of the applicable limits for specific phase-outs without resorting to numerous reference materials.

An example, identified by one of our members, concerns Qualified Performing Artists. Code section 62(b)(1) and (3) of the 1986 Tax Act defines the term "qualified performing artist" as a person who performed services in the performing arts as an employee for at least two employers during the tax year and received wages of $200 or more per employer.

This code section permits a deduction before arriving at AGI for the professional expenses of a performing artist, but only if the individual's AGI is below $16,000. This amount was not indexed for inflation and has remained the same since 1986. If the taxpayer is married, the $16,000 threshold applies to the couple's combined AGI. The

constraints of this provision are so narrow as to preclude any benefit to almost all low-income performing artists who live in high cost areas such as California, Massachusetts, Texas, New Jersey or New York. This is a perfect example of giving with one hand and taking away with the other.

Another phase-out that began in 1987 limited the deduction of business meals and entertainment expenses to eighty percent of the amount paid. The Omnibus Budget Reconciliation Act of 1993 (OBRA '93) reduced the deduction of business meals and entertainment to fifty percent of the amount paid.

A related issue previously identified by NCCPAP is the treatment of all employee business expenses including business meals and entertainment. Internal Revenue Code section 67(a) requires an employee who incurs ordinary and necessary business expenses in the performance of his/her duties, and is not reimbursed by his/her employer, to list those expenses on Form 2106. This total is transferred to Form 1040, Schedule A, as a miscellaneous itemized deduction, which is required to be reduced by two percent (2%) of the taxpayer's AGI. The deduction for these expenses can be further reduced if the phase-out of itemized deductions returns. In many cases, these reductions cause the expenses to be eliminated and the employee is denied these legitimate deductions for tax purposes. In addition, employee business deductions are not an allowable expense for AMT purposes.

In contrast, "Statutory Employees" and businesses in all forms, i.e., corporations, partnerships, LLC's, LLP's and sole proprietorships are allowed to deduct all business expenses in full against gross income (subject to certain limitations such as 50% of business meals and entertainment that affect all taxpayers equally). The only business expenses that cannot be deducted in full are those incurred by employees. This is unfair to the typical wage earner who is required to make expenditures to earn a living.

The total of all employee business expenses listed on Form 2106 should be allowed as a deduction before arriving at AGI. It should not be listed on Form 1040, Schedule A,

as a miscellaneous itemized deduction subject to a two percent reduction, or be an addback for the Alternative Minimum Tax.

The phase-outs have an erosive effect on tax compliance and taxpayer confidence in the fairness of tax laws. Tax practitioners are forced to tell clients that many tax saving provisions that they read about in the press during tax season each year do not apply to them. They are considered "rich," yet struggle to make ends meet living an ordinary life style.

My colleagues and I think it would be more prudent to permit taxpayers to utilize the deductions and credits currently available in the tax law before focusing on lower tax rates. The elimination of the phase-outs will simplify the tax law and make it more equitable.

If the phase-outs must be continued, there should be uniform phase-out limits for most provisions and these limits must be adjusted annually to reflect inflation and the costs in high tax states.

Respectfully submitted,

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On behalf of the National Conference of CPA Practitioners

Statement of

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Before the
Senate Committee on Finance

The Future of Individual Tax Rates:
Effects on Economic Growth and Distribution

July 14, 2010

Chairman Baucus, Ranking Member Grassley, and Members of the Committee: Thank you for inviting me to appear today to discuss our individual income tax system.

As this committee knows well, our nation faces difficult economic and fiscal challenges. In the aftermath of the worst financial crisis since the 1930s, almost 15 million workers are unemployed, about one-tenth of our work force. Almost 7 million of those workers have been unemployed for six months or longer. And millions more lack jobs but don't count in the statistics because they're too discouraged to look for work. Moderate economic growth is expected to lower those figures only gradually over the next few years.

At the same time, budget deficits have rocketed to 60-year highs because of the financial crisis, the weak economy, and subsequent policy responses. As a result, the federal debt has grown from about 40 percent of gross domestic product (GDP) at the end of 2008 to about 60 percent of GDP today, the highest since just after World War II.

Deficits should narrow in coming years as the economy recovers and as policy responses to the recession wind down. Our long-term fiscal outlook remains daunting, however, because of a fundamental imbalance between spending and revenues. Because of an aging population and rising health care costs, spending is expected to grow significantly faster than revenues over the next 25 years, pushing our nation deeper into debt.

Today's discussion of the 2001 and 2003 tax cuts, which are scheduled to expire at the end of the year, thus comes at a challenging time when policymakers confront both near-term economic weakness and long-term fiscal imbalances. Against that backdrop, my testimony makes six points:

[1] My testimony draws heavily on the work of numerous Tax Policy Center colleagues. However, the views expressed are my own and should not be attributed to the Tax Policy Center, the Urban Institute, its board, or its funders.

1. **Tax revenues are remarkably low today, relative to the size of the economy, but are scheduled to increase sharply in coming years.** Under current law, revenues from the individual income tax will increase above record levels, relative to the economy, by 2020 and keep rising thereafter. That increase reflects a variety of factors, including the scheduled expiration of the 2001 and 2003 tax cuts, the expansion of the alternative minimum tax (AMT), real bracket creep, demographic changes, the recent health care legislation, and the expected economic rebound.

2. **Full extension of the 2001 and 2003 tax cuts and indexation of the AMT would slow the growth of federal revenues substantially relative to the current law baseline.** Individual income taxes would rise to a projected 9.2 percent of GDP in 2020, rather than 10.9 percent under current law. Over the 10-year budget window, that reduction would correspond to about $2.9 trillion in forgone revenue.

3. **Full extension of the tax cuts and the AMT patch would provide larger tax reductions to higher-income taxpayers.** Almost all taxpayers in the top half of the income distribution would receive a tax cut, compared with only a quarter of taxpayers in the bottom quintile. Taxpayers in the top quintile would see their effective tax rate decline by 3.1 percentage points on average; the average cut for the middle quintile would be 1.9 percentage points, and that for the bottom quintile would be 0.6 percentage points.

4. **The "middle-income" tax cuts (rate reductions in the bottom four brackets, marriage penalty relief, and expanded credits) provide significant tax reductions not only to middle-income taxpayers, but also to most higher-income taxpayers.** The "upper-income" tax cuts (rate reductions in the top two brackets and elimination of the phaseouts of personal exemptions and itemized deductions), in contrast, primarily benefit taxpayers in the top 1 percent of the income distribution.

5. **The potential economic impact of extending some or all of the tax cuts involves four related issues: stimulus, long-term growth, economic efficiency, and fiscal impacts.** Analysts disagree on the degree to which extending the tax cuts would provide stimulus, promote long-term growth, and improve efficiency. Most analysts believe, however, that the economic benefits of extending some or all of the tax cuts will be maximized if we offset the forgone revenue by reducing unproductive spending or raising offsetting revenues in a more efficient manner.

6. **Regardless of what happens to the expiring tax cuts, policymakers should look for opportunities to pursue fundamental tax reforms that could simultaneously improve economic performance and, if necessary, raise more revenue.** For any future level of government spending, income tax rates could be lower if policymakers take steps to broaden the tax base (by limiting special credits, deductions, and other tax expenditures), introduce a new broad-based consumption tax (e.g., a value-added tax), or rely more on environmental taxes (e.g., a carbon tax).

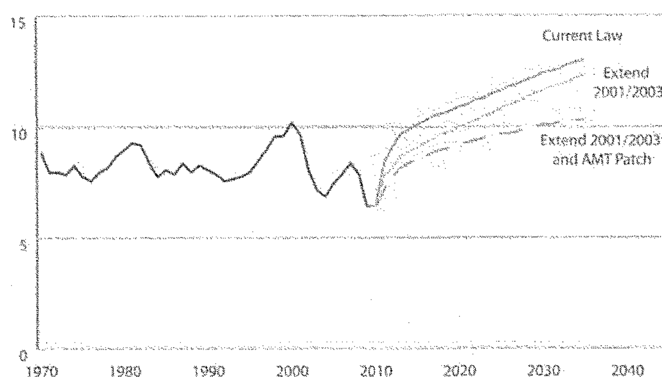
The Revenue Outlook

It is well known that federal spending is projected to increase rapidly in coming years due to an aging population and rising health care costs. The Congressional Budget Office (CBO) projects, for example, that under current law spending would be 23.5 percent of GDP in 2020 and 27.6 percent of GDP in 2035.[2] Federal spending averaged only 20.7 percent of GDP during the four decades from 1970 to 2009.

Less well known is that federal revenues are also projected to increase rapidly. CBO estimates, for example, that revenues will rise to 20.7 percent of GDP in 2020 and 23.3 percent in 2035 if current law remains in place. To put those figures in context, note that federal revenues have averaged about 18.1 percent of GDP over the past 40 years. Because of the recession and stimulus measures, tax revenues today are remarkably low—14.9 percent of GDP in 2010. Indeed, they are the lowest they've been since 1950. But that would quickly reverse under existing law. By 2020, revenues would near their all-time record (20.9 percent of GDP in 1944) and by 2035, revenues would be more than 25 percent higher than historical levels.

Much of that increase would come from individual income taxes. CBO projects that under current law they will increase from 6.5 percent of GDP in 2010 to 10.9 percent in 2020 and 13.0 percent in 2035 (figure 1). That growth would take individual income taxes from their lowest level in 60 years, relative to the economy, to well above the record high of 10.2 percent in 2000.

Figure 1
Individual Income Tax Revenues (Percent of GDP)



Source: Congressional Budget Office

[2] All figures in this section come from Congressional Budget Office, "The Long-Term Budget Outlook," July 2010.

Revenues from individual income taxes would increase for six reasons. First, the economy will likely recover, lifting revenues from currently depressed levels. Second, both the 2001 and 2003 tax cuts[3] and the tax cuts enacted in the 2009 stimulus are scheduled to expire. Third, the alternative minimum tax, which is not indexed for inflation, will boost taxes for millions more taxpayers. Fourth, retiring baby boomers will make more taxable withdrawals from tax-deferred retirement accounts. Fifth, in a phenomenon known as real bracket creep, growing real (inflation-adjusted) incomes will push taxpayers into higher tax brackets and will reduce their eligibility for various credits, exemptions, and deductions. Finally, the excise tax on "Cadillac" health plans enacted in the recent health legislation and scheduled to take effect in 2018 will increase the portion of employee compensation that is taken in the form of taxable wages and salaries.

Revenues would rise more gradually if Congress permanently extends some or all of the 2001 and 2003 tax cuts and the AMT patch. But individual income tax revenues would still increase faster than the economy because of the other factors. If the tax cuts alone were permanently extended, for example, revenues would rise to 10.0 percent of GDP in 2020 and 12.3 percent in 2035. If both the tax cuts and the AMT patch were extended permanently, revenue growth would be slower, with individual revenues rising to 9.2 percent of GDP in 2020 and 10.3 percent in 2035.

CBO's projections indicate that permanent extension of the 2001 and 2003 individual income tax cuts alone would reduce revenues by about $1.7 trillion over the 10-year budget window (2011–2020). Permanent extension with an AMT patch would reduce revenues by about $2.9 trillion.[4] As these figures demonstrate, there is an important interaction between the tax cuts and the AMT. The revenue cost of extending the tax cuts, by themselves, is moderated by the fact that an increasing number of taxpayers would be pushed onto the AMT. The revenue cost would be much larger if both the tax cuts and the AMT patch were permanently extended.

The Tax Cuts

The 2001 and 2003 tax laws made numerous changes to individual income taxes.[5] Expiring at the end of the year are those that

[3] These two laws were the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

[4] Throughout this testimony, I use current law as the baseline for measuring policy impacts. I thus treat as a tax cut any policies that extend some or all of the 2001 and 2003 tax provisions. Another approach would be to treat current policy—the tax law that applies in 2010—as the baseline. Under that approach, allowing any of the 2001 and 2003 tax cuts to expire would amount to a tax increase. The figures in this testimony can be recast in those terms with an appropriate sign change. For example, if current policy is the baseline, then allowing all the tax cuts and the AMT patch to expire would amount to a $2.9 trillion tax increase over the budget window.

[5] The 2001 law also reduced estate taxes—expanding exemptions and lowering rates—leading to full repeal (as of this writing) in 2010. Those changes are outside the scope of this testimony.

- *Lowered rates on ordinary income.* The 28, 31, 36, and 39.6 percent tax rates were reduced to 25, 28, 33, and 35 percent, respectively. In addition, a new 10 percent tax bracket was carved out of the 15 percent bracket.

- *Reduced the marriage penalty.* The standard deduction and the width of the 15 percent tax bracket for married couples filing jointly were both increased to be twice those for single filers; they had previously been only 1.67 times as large.

- *Reduced tax rates on capital gains and dividends.* The tax rate on long-term capital gains was reduced from 10 to 0 percent for taxpayers in the 15 percent bracket and below and from 20 to 15 percent for filers in higher tax brackets. The tax rate on qualified dividends was lowered from ordinary tax rates to the lower long-term capital gains rates.

- *Increased the child credit.* The credit doubled from $500 to $1,000 per child and eligibility for refundable credits expanded.

- *Increased other credits.* The maximum child and dependent care credit increased, and the phaseout range for the earned income tax credit for married couples expanded, boosting the value of the credit for some families.

- *Eliminated the phaseout of personal exemptions and limitation on itemized deductions that occur at high incomes.* Those provisions are known as PEP and Pease (after the congressman who proposed the latter), respectively.

- *Expanded tax incentives for education.*

The 2001 and 2003 laws also temporarily increased the exemption level for the AMT. A series of subsequent laws increased the exemption level through the end of 2009.

The Distributional Effects of Extending the Individual Income Tax Cuts

Individual income taxes are the single largest source of federal revenues. Other important sources include payroll taxes, corporate income taxes, and estate taxes. Under current law, the revenues from these federal taxes would average 23.5 percent of taxpayers' cash income in 2012 (table 1). If the individual income tax cuts that originated in 2001 and 2003 were extended, along with the AMT patch, federal taxes would average 20.9 percent of cash income in 2012. Extending the individual income tax cuts would thus reduce the average tax rate by 2.6 percentage points or about 11 percent.[6]

If all the 2001 and 2003 individual income tax cuts and the AMT patch were extended, nearly three-quarters of taxpayers would receive a tax cut compared with current law, but that likelihood varies with income. Only a quarter of taxpayers in the bottom quintile

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[6] As noted earlier, this analysis ignores any extension or reform of the estate tax. For purposes of calculating the figures in table 1, we have assumed that the estate tax remains at its 2009 level.

would receive a tax cut, while 99 percent of taxpayers in the top two quintiles would.[7] A key reason for this disparity is that many low-income taxpayers already have little or no income tax liability.[8] Some low-income taxpayers with no tax liability would nevertheless benefit from extending the increases in the refundable child credit and earned income credit that began with the 2001 law.

Table 1

Extension of the 2001 and 2003 Individual Tax Cuts and AMT Patch
Distribution of Federal Tax Change by Cash Income Percentile, 2012 [1]

Cash Income Percentile[2,3]	Average Effective Tax Rates[4]			Percent of Tax Units with Tax Cut[5]	Average Federal Tax Change ($)	Percent Change in After-Tax Income[6]	Change in Share of Total Federal Taxes (% points)
	Current Law	Tax Cuts Extended	Change (% points)				
Lowest Quintile	5.2	4.6	-0.6	24.7	-66	0.6	0.0
Second Quintile	12.2	10.2	-2.0	78.3	-572	2.3	-0.3
Middle Quintile	18.2	16.3	-1.9	93.2	-963	2.3	0.1
Fourth Quintile	21.6	19.3	-2.3	98.6	-2,077	3.0	0.1
Top Quintile	28.3	25.2	-3.1	99.4	-8,672	4.3	0.1
All	23.5	20.9	-2.6	73.8	-1,975	3.4	0.0
Addendum							
80-90	24.8	21.9	-2.9	99.4	-3,944	3.8	-0.1
90-95	25.9	23.2	-2.7	99.3	-5,283	3.6	0.1
95-99	27.7	25.2	-2.6	99.3	-8,897	3.6	0.3
Top 1 Percent	32.7	28.8	-3.9	99.3	-70,700	5.8	-0.2
Top 0.1 Percent	35.6	31.2	-4.4	99.3	-370,486	6.9	-0.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

(1) Calendar year. Baseline is current law, proposal is the extension of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) plus the extention of the 2009 AMT Patch which indexes the AMT exemption, rate bracket threshold, and phase-out exemption threshold for inflation after 2009.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

(3) The cash income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2009 dollars): 20% $19,356, 40% $37,493, 60% $65,656, 80% $111,659, 90% $161,739, 95% $226,402, 99% $599,181, 99.9% $2,727,123.

(4) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

(5) Includes both filing and non-filing units but excludes those that are dependents of other tax units.

(6) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

The reductions in average tax rates show a similar pattern. The average tax rate would fall by 0.6 percentage points for taxpayers in the bottom quintile, but by 3.1 percentage points in the top quintile. That difference is primarily driven by the fact that so few taxpayers in the bottom quintile would receive a tax cut. Among those who would receive a tax cut, the differential still exists, but is smaller: an average tax cut of 2.3 percentage points for taxpayers in the bottom quintile who receive a tax cut versus 3.1 percentage points in the top. The size of the tax cut also varies significantly within the top quintile.

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[7] The appendix provides similar information by cash income level rather than income quintiles.

[8] Roberton Williams, "Why Nearly Half of Americans Pay No Federal Income Tax," *Tax Notes*, June 7, 2010. The share that pays no income tax will decline as the economy recovers and the temporary stimulus tax cuts, especially the Making Work Pay Credit, expire.

The average tax rate in the 80th to 95th income percentiles would fall by 2.8 percentage points, while the average tax rate in the top 1 percent would fall by 3.9 percentage points.

In dollar terms, the largest tax reductions would go to taxpayers with the highest incomes and the highest tax burdens. Bottom-quintile taxpayers would receive an average cut of about $70 (a 0.6 percent increase in after-tax income), middle-quintile taxpayers about $970 (a 2.3 percent increase), and top-quintile taxpayers about $8,700 (a 4.3 percent increase). But, because current law tax rates increase with income, the tax cut as a share of taxes paid would be largest in the second quintile of the income distribution. As a result, those in the second quintile of taxpayers would pay a slightly smaller share of income taxes than they pay under current law, while the top three quintiles would pay a slightly larger share of federal taxes.

Table 2

Change in Average Effective Tax Rates from Specific Provisions
Distribution of Federal Tax Change by Cash Income Percentile, 2012 [1,2]

Cash Income Percentile[3,4]	Average Effective Tax Rate under Current	Change from Provision (% points)								Average Effective Tax Rate if All Cuts Extended
		AMT Patch	Lower Marginal Rates	Marriage Penalty Relief	Credits Expansion	Lower Rates on Dividends	Lower Rates on Capital Gains	PEP and Pease Repeal	Top Marginal Rates	
Lowest Quintile	5.2	0.0	-0.3	0.0	-0.2	0.0	0.0	0.0	0.0	4.6
Second Quintile	12.2	0.0	-0.9	-0.2	-0.9	0.0	0.0	0.0	0.0	10.2
Middle Quintile	18.2	-0.1	-1.0	-0.2	-0.5	0.0	-0.1	0.0	0.0	16.3
Fourth Quintile	21.6	-0.5	-1.1	-0.3	-0.3	0.0	-0.1	0.0	0.0	19.3
Top Quintile	28.3	-0.4	-0.9	-0.3	-0.1	-0.2	-0.5	-0.3	-0.5	25.2
All	23.5	-0.3	-0.9	-0.3	-0.2	-0.1	-0.3	-0.2	-0.3	20.9
Addendum										
80-90	24.8	-0.5	-1.3	-0.7	-0.2	0.0	-0.2	0.0	0.0	21.9
90-95	25.9	-0.5	-1.4	-0.5	0.0	-0.1	-0.2	0.0	0.0	23.2
95-99	27.7	-0.6	-1.0	-0.2	0.0	-0.2	-0.4	-0.3	-0.1	25.2
Top 1 Percent	32.7	0.0	-0.2	0.0	0.0	-0.6	-0.9	-0.7	-1.4	28.8
Top 0.1 Percent	35.6	0.0	-0.1	0.0	0.0	-0.8	-1.3	-0.6	-1.7	31.2

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).
(1) Calendar year. Baseline is current law, proposal is the extension of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) plus the extention of the 2009 AMT Patch which indexes the AMT exemption, rate bracket threshold, and phase-out exemption threshold for inflation after 2009.
(2) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of
(3) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm
(4) The cash income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2009 dollars): 20% $19,356, 40% $37,493, 60% $65,656, 80% $111,659, 90% $161,739, 95% $226,402, 99% $599,181, 99.9% $2,727,123.

Table 2 shows how the various provisions in the tax laws combine to reduce average effective tax rates. In interpreting these figures, keep in mind that the provisions interact with one another; as a result, the order in which the provisions are analyzed matters. In this case, the analysis proceeds from left to right. Starting with current law, the table first considers an AMT patch,[9] followed by the changes that benefit lower- and middle-income taxpayers as well as high-income ones (the 10 percent bracket and the 25 and 28 percent rates, marriage penalty relief, expansion of the child credit and credits for child

[9] The most recent patch applied to 2009. The analysis assumes that Congress extends that patch with the exemption amount, rate bracket threshold, and exemption phaseout all indexed to inflation.

and dependent care and for education), and the changes that primarily benefit high-income taxpayers (lower rates on qualified dividends and long-term capital gains, eliminating PEP and Pease, and extending the top marginal rates of 33 and 35 percent).

As one example of the potential interactions, the AMT patch would appear to have a larger effect if it came at the end of the stacking order rather than at the beginning, as in table 2. If the AMT patch came at the end, the reductions in the regular income tax would push more people onto the AMT. The effect of patching the AMT would then be larger, and the effect of the other tax cuts would be correspondingly smaller.

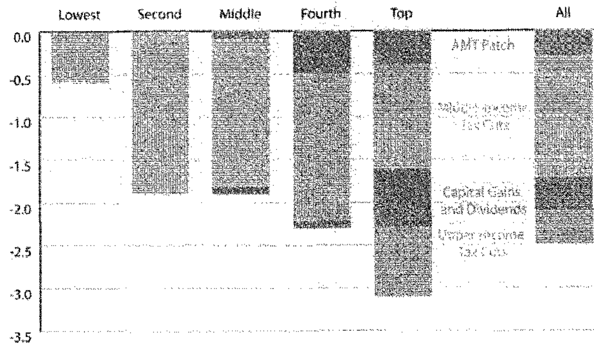
The provision-by-provision changes cumulate to the total changes shown in table 1. For example, the 2.0 percentage point reduction in the average tax rate for the second quintile is explained by the reduction of tax rates in the lower brackets (0.9 percentage point), marriage penalty relief (0.2 percentage points), and the expansion of credits (0.9 percentage points).

As the table demonstrates, several provisions often considered middle-income tax relief also provide benefits to taxpayers high in the income distribution. The rate reductions in the lower brackets, for example, reduce average tax rates by about a percentage point for taxpayers not only in the middle three quintiles of the income distribution, but in the top quintile. Marriage penalty relief similarly provides a sizable tax reduction in the top quintile.

In contrast, the impacts of the provisions that are considered high-income tax relief are concentrated at high incomes. Eliminating PEP and Pease, for example, benefits taxpayers in the top 5 percent of the income distribution, while extending the two top marginal rate reductions primarily benefits the top 1 percent.

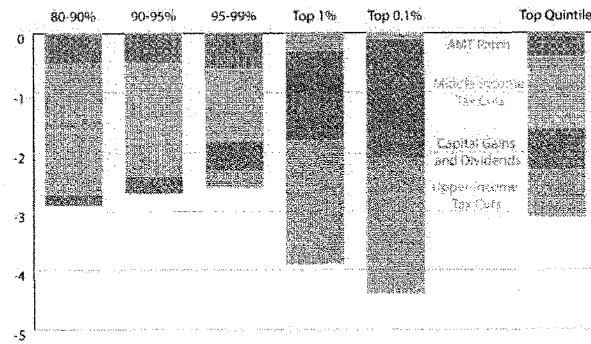
To illustrate these differences, figures 2 and 3 condense the tax cuts into four groups: the AMT patch, the "middle-income" tax cuts (the lower brackets, marriage penalty relief, and expanded credits), the dividend and capital gains rate reductions, and the "upper-income" tax cuts (the two highest brackets and the elimination of PEP and Pease). Figure 2 shows the results by quintile, and figure 3 shows greater detail within the top quintile.

Figure 2
Change in Average Tax Rates from Extending Tax Cuts
(Percentage Points)
by income quintile



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

Figure 3
Change in Average Tax Rates from Extending Tax Cuts
(Percentage Points)
by percentiles within top quintile



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

As these figures illustrate, the "middle-income" tax cuts (in blue) account for most of the tax reductions for taxpayers up to the 95th percentile of income and about half of the reductions in the 95th to 99th percentiles. The "upper-income" tax cuts (purple) and the rate reductions for capital gains and dividends (green) account for nearly all of the tax reductions for the top 1 percent of taxpayers.

Economic Growth

In considering the potential economic impacts of the tax cuts, policymakers should consider four related issues: whether extending them would provide helpful stimulus at a time of economic weakness; whether they would encourage long-run economic growth; whether they would reduce inefficiencies created by the tax system; and whether and how the resulting revenue reductions would be paid for.

Stimulus. The U.S. economy clearly remains fragile. Although the overall economy has been growing for a year, the unemployment rate remains near 10 percent, and when one factors in the number of workers who are discouraged or cannot find full-time work, the underemployment rate is about 16 percent. History suggests that it takes a long time for economies to heal after financial crises,[10] and the recent crisis was particularly severe. As a result, most forecasters expect that it will take at least several years for the unemployment rate to decline to levels consistent with full employment.

Given that outlook, it is reasonable to ask whether extending the tax cuts would provide near-term stimulus for the economy or, equivalently, would prevent any "anti-stimulus" that would occur from their expiration. The short answer to that question is clearly yes: extending the tax cuts would provide some demand-side stimulus to the economy.

But that conclusion comes with several caveats. First, the amount of stimulus varies across the different tax provisions. All else equal, the cuts that go to middle- and low-income taxpayers are likely to provide more demand-side stimulus in the near term, because they are less likely to be saved.

Second, only some of the stimulus would show up in 2011, when it is presumably most beneficial. The remainder would show up in the first few months of 2012, when families file their tax returns and most receive tax refunds. When CBO examined this issue earlier in the year, it concluded that extending the tax cuts would provide some stimulus in 2011, but significantly less, on a bang-per-buck basis, than other options, such as extended unemployment benefits.[11]

Third, the amount of stimulus would be greater if the tax cuts were extended on a permanent basis, rather than just for a year or two. Families would spend more of their

[10] See, for example, Carmen M. Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton University Press, 2009).

[11] Congressional Budget Office, "Policies for Increasing Economic Growth and Employment in 2010 and 2011," January 2010.

reduction if they believed it to be permanent. Moreover, permanent reductions in the tax rates on dividends and capital gains could lift the value of stocks and other assets, providing a wealth boost to consumer spending. Both of those effects would increase the demand-side stimulus from an extension. In addition, the potential supply-side responses would be enhanced if the tax cuts were perceived to be permanent. That additional stimulus would, of course, require a much larger reduction in future revenues (relative to the rising path implied by current law) than would a temporary reduction.

Long-term growth. Over the long run, the key economic issue is whether extending the tax cuts would encourage work, saving, and investment and thereby boost economic growth. Such supply-side effects would primarily result from reductions in marginal tax rates on wages, salaries, investment income, and business income.

Analysts disagree on the extent to which extending the tax cuts would have such beneficial effects on growth. On one hand, extending the tax cuts would indeed reduce marginal tax rates; those reductions would encourage work and investment.[12] On the other hand, many of the provisions do not reduce marginal tax rates (e.g., the increase in the child tax credit). All else equal, extending those provisions would tend to weaken supply-side incentives. The potential economic gains from extending the tax cuts would also be offset, at least in part, by the resulting increase in deficits and debt. Over time, deficits crowd out private-sector investment and thus reduce the productive capacity of the economy. For tax cuts to boost long-run growth, their positive supply-side effects would have to be large enough to overcome the drag from crowding out.

Efficiency. A related issue is whether the tax cuts would improve economic efficiency. Our current tax system creates many undesirable distortions in economic activity. The deduction for mortgage interest, for example, encourages homeowners to take on larger mortgages. The exclusion for employer-provided health insurance encourages excessively broad insurance plans. The taxes on dividends and capital gains encourage businesses to finance themselves with debt rather than equity and to avoid corporate form, and the favorable treatment of capital gains relative to dividends encourages them to hoard cash rather than distribute it to shareholders. Higher marginal tax rates amplify all of these distortions.

Fiscal impacts. Finally, there is the issue of whether and how any extension would be paid for. Given the revenue increases that will occur under existing law even if the tax cuts are extended (as noted in figure 1), some analysts argue that the tax cuts should be extended without offsets. Given the current imbalance in our budget, that is effectively arguing that unspecified future spending reductions or revenue increases would have to bridge the gap or that the United States should run up its debt even more quickly. But that latter course would eventually undermine private investment and weaken economic growth. For that reason, most analysts believe that the potential long-run economic

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[12] For one recent analysis, see Congressional Budget Office, "An Analysis of the President's Budgetary Proposals for Fiscal Year 2011," March 2010.

benefits of a permanent extension would be maximized if policymakers offset the resulting deficit increases by spending reductions or less-distortionary tax increases.

Some analysts have also argued that a temporary one- or two-year extension, without any offsets, would be appropriate to provide stimulus to our weak economy. Given extremely low borrowing rates (the 10-year Treasury rate is currently about 3 percent), the costs of financing the resulting increase in debt would likely not be a major immediate problem, but the additional borrowing would, of course, add to the debt burden in coming years.

However, another strategy for near-term stimulus would be to pair a temporary extension of most or all of the tax cuts with offsetting spending reductions or revenue increases several years in the future. Most analysts believe that this approach would provide the greatest economic benefit, since it would combine short-term economic stimulus with a commitment to greater fiscal responsibility in the future.

The Need for Fundamental Tax Reform

As a closing note, I should emphasize that our current tax system is already highly inefficient and will not scale well if there are higher revenue demands in the future. Regardless of any near-term decisions they make about extending the tax cuts, policymakers should also begin to consider more fundamental reforms.

In principle, there are substantial opportunities to reduce the economic burdens created by our tax system while raising the same or more revenue. One option would be to limit the numerous special credits, exclusions, and deductions that narrow our income tax base. Reducing such tax expenditures would allow for the economic benefits of lower rates and reduced distortions from the tax system. A second option would be to introduce a new, broad-based tax on consumption, such as a value-added tax, rather than to increase more-distortionary income taxes. Finally, the nation could raise additional revenue by taxing behaviors we want to discourage—such as carbon emissions—rather than behaviors that we would prefer to encourage—such as working, saving, and investing.[13]

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[13] For a longer discussion of the role of revenue options in addressing our fiscal challenges, see Donald B. Marron, "America in the Red," *National Affairs*, March 2010.

Appendix: Distributional Analysis by Cash Income Level

Table 3

Extension of the 2001 and 2003 Individual Tax Cuts and AMT Patch
Distribution of Federal Tax Change by Cash Income Levels, 2012 [1]

Cash Income Level (thousands of 2009 dollars) [2]	Average Effective Tax Rates [3]			Percent of Tax Units with Tax Cut [4]	Average Federal Tax Change ($)	Percent Change in After-Tax Income [5]	Change in Share of Total Federal Taxes (% points)
	Current Law	Tax Cuts Extended	Change (% points)				
Less than 10	5.4	5.3	-0.1	1.0	-4	0.1	0.0
10-20	5.3	4.5	-0.8	41.9	-119	0.8	0.0
20-30	10.7	8.7	-2.0	74.7	-504	2.2	-0.2
30-40	14.8	12.8	-2.0	86.9	-734	2.4	-0.1
40-50	17.3	15.5	-1.8	91.4	-845	2.2	0.0
50-75	19.5	17.6	-1.9	96.5	-1,202	2.3	0.2
75-100	21.6	19.3	-2.3	98.8	-2,074	2.9	0.1
100-200	24.7	21.9	-2.8	99.3	-3,951	3.7	-0.1
200-500	27.4	24.8	-2.6	99.4	-7,826	3.6	0.3
500-1,000	28.6	25.8	-2.8	98.7	-19,652	3.9	0.1
More than 1,000	33.8	29.7	-4.2	99.5	-129,318	6.3	-0.3
All	23.5	20.9	-2.6	73.8	-1,975	3.4	0.0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

(1) Calendar year. Baseline is current law, proposal is the extension of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) plus the extention of the 2009 AMT Patch which indexes the AMT exemption, rate bracket threshold, and phase-out exemption threshold for inflation after 2009.

(2) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

(3) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

(4) Includes both filing and non-filing units but excludes those that are dependents of other tax units.

(5) After-tax income is cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); and estate tax.

Table 4

Change in Average Effective Tax Rates from Specific Provisions
Distribution of Federal Tax Change by Cash Income Levels, 2012 [1,2]

Cash Income Level (thousands of 2009 dollars) [3]	Average Effective Tax Rate under Current	Change from Provision (% points)								Average Effective Tax Rate if All Cuts Extended
		AMT Patch	Lower Marginal Rates	Marriage Penalty Relief	Credits Expansion	Lower Rates on Dividends	Lower Rates on Capital Gains	PEP and Pease Repeal	Top Marginal Rates	
Less than 10	5.4	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	5.3
10-20	5.3	0.0	-0.4	-0.1	-0.3	0.0	0.0	0.0	0.0	4.5
20-30	10.7	0.0	-0.8	-0.2	-0.9	0.0	0.0	0.0	0.0	8.7
30-40	14.8	0.0	-1.0	-0.2	-0.8	0.0	-0.1	0.0	0.0	12.8
40-50	17.3	-0.1	-1.0	-0.2	-0.5	0.0	-0.1	0.0	0.0	15.5
50-75	19.5	-0.2	-1.1	-0.1	-0.4	0.0	-0.1	0.0	0.0	17.6
75-100	21.6	-0.5	-1.1	-0.3	-0.3	0.0	-0.1	0.0	0.0	19.3
100-200	24.7	-0.5	-1.3	-0.6	-0.2	0.0	-0.2	0.0	0.0	21.9
200-500	27.4	-0.6	-1.1	-0.2	0.0	-0.1	-0.3	-0.2	0.0	24.8
500-1,000	28.6	-0.1	-0.5	-0.1	0.0	-0.3	-0.5	-0.6	-0.7	25.8
More than 1,000	33.8	0.0	-0.1	0.0	0.0	-0.6	-1.1	-0.7	-1.6	29.7
All	23.5	-0.3	-0.9	-0.3	-0.2	-0.1	-0.3	-0.2	-0.3	20.9

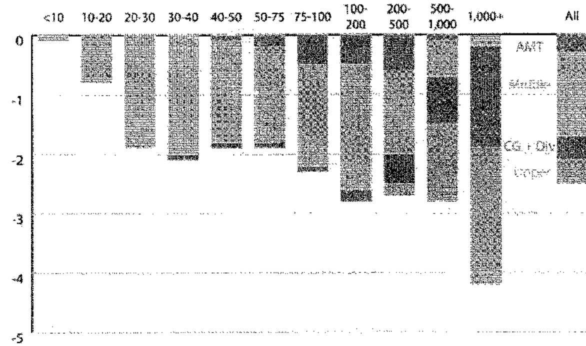
Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

(1) Calendar year. Baseline is current law, proposal is the extension of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) plus the extention of the 2009 AMT Patch which indexes the AMT exemption, rate bracket threshold, and phase-out exemption threshold for inflation after 2009.

(2) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, and the estate tax) as a percentage of average cash income.

(3) Tax units with negative cash income are excluded from the lowest income class but are included in the totals. For a description of cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

Figure 4
Change in Average Tax Rates from Extending Tax Cuts
(Percentage Points)
by cash income levels ($thousands)



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5).

Testimony of

David Marzahl
President
Center for Economic Progress

Before the

Committee on Finance,
United States Senate

Regarding

The Future of Individual Tax Rates: Effects on Economic Growth and Distribution

July 14, 2010

Thank-you, Chairman Baucus, Ranking Member Grassley, and Members of the Committee. My name is David Marzahl and I am the President of the Center for Economic Progress (CEP). CEP helps hard-working families move from financial uncertainty to financial security by providing them with free, high quality tax preparation and financial services. We operate volunteer-driven tax sites in more than 30 Illinois communities – making CEP's Volunteer Income Tax Assistance (VITA) program one of the largest and oldest statewide programs of its kind. As a founder and current Steering Committee Member of the National Community Tax Coalition (NCTC), I am pleased to offer the views of leading community based tax preparation and asset building organizations across the country.

NCTC is comprised of over 1,700 members that provide free tax preparation and asset building services to low- and moderate-income families. Our local partners help families claim tax credits they might otherwise overlook, ensuring they receive the full tax refund to which they are entitled. For many, that refund provides a once-a-year opportunity to pay down debt, purchase necessities and start building assets. Together, we are the nation's 4th largest provider of tax preparation services, completing an estimated 3 million federal tax returns each year.

On behalf of these VITA programs and the 3 million taxpayers that we serve each year, we thank the Committee for their efforts in passing the 2009 American Recovery and Reinvestment Act (ARRA / the Recovery Act). The Recovery Act achieved many of the reforms we have supported, including expanding the Earned Income Tax Credit (EITC) for married couples and families with three or more children and ensuring more parents have access to the Child Tax Credit (CTC).

As a non-profit organization and a VITA Program we are primarily concerned with the impact on the working families that we serve if Congress fails to extend the 2009 ARRA provisions. The following provisions are scheduled to sunset this year and will have a direct impact on our constituency:

- **10 percent tax bracket:** The 10 percent tax bracket will sunset, making 15% the lowest marginal tax rate.
- **Earned Income Tax Credit**: The 45% credit for families with three or more children and marriage penalty relief will sunset. Marriage penalties are often an unintended consequence of tax complexity. Thanks to changes to the tax code since 2001 that adjusted the 10% and 15% tax brackets, the standard deduction, and the EITC phase-out ranges to reduce or eliminate the marriage penalty for many taxpayers. The Recovery Act provided additional marriage penalty relief for EITC recipients.
- **Child Tax Credit:** The maximum credit will fall from $1,000 per child to $500 per child and the credit will no longer be refundable (with an exception for some families with three or more children).
- **American Opportunity Tax Credit:** The partially refundable education credit with a maximum benefit of $2,500 will sunset. The non-refundable HOPE and Lifetime Learning education credits will remain.
- **Making Work Pay Tax Credit:** The $400 ($800 for married couples) refundable credit will sunset.

With these provisions at risk, we respectively ask the Committee to consider the following:

Permanent Expansion of Vital Tax Credits

Building Financial Security
Parents who work full time should be able to support their families and provide a standard of living that prevents their children from living in poverty. The 2009 ARRA provisions need to be made permanent in order to create sustainable economic growth and ensure a more equitable tax code. These provisions are helping to build economic security through:

- **The EITC:** The expansion of the EITC for families with three or more children and for married couples. This change brought an estimated $4.7 billion to hard-working families, many who have been impacted by the recession.
- **The CTC:** Compared to tax year 2008, 2.9 million more children in very low-income families are able to access the refundable portion of the CTC. Nearly 100 percent of this $14.8 billion tax benefit goes families earning less than $38,000.
- **The American Opportunity Tax Credit**: This education credit makes college more accessible to American workers and their children by providing access to refundable tax credits.

Tax Credits as a Work Incentive
The expanded EITC and the Child Tax Credit provides an important incentive for parents to work while giving them the financial boost they need to support themselves and their children. Under the expanded CTC, very-low-income families are given a much stronger incentive to work full-time to support their families. During the 2009 Tax Year, a parent with two children who worked just 10 hours a week at a minimum wage job received less that $100 from the CTC. However, a parent with two children, working full-time, received a credit of about $1,800.

VITA sites across the country witnessed this work incentive at play in a number of our clients' lives. This past tax season, Just Harvest, a Coalition member organization in Pittsburgh, PA, served a family of 4 (two parents, two kids) getting by on an income of $16,353. The Dad works as a cashier at a gas station and the mom stays home with the kids. Because of the stimulus-related changes in the Child Tax Credit, their CTC this year was the maximum $2000. Under the previous law, they would have received only $540.

Thanks to the changes that the IRS and Treasury have made to the tax form and the efforts of many VITA programs to provide asset building services at the tax sites, it has becoming easier for clients to save a portion of their refund. It is now easy for taxpayers to split their refund or purchase a U.S. savings bond through the tax return.

Meanwhile more VITA programs are offering year-round financial coaching and asset building services. Many programs across the country are also working with financial institutions and local credit unions to help taxpayers open checking or savings accounts and access various savings and money management products at tax time. Not surprisingly, the size of the refund often provides an incentive to the taxpayer to make a decision to constructively use the dollars they receive

The typical taxpayer we serve has two to three W2's, meaning they work at least that many jobs in a given year. Despite their focus on securing and keeping a job, 15% of our clients were unemployed at some point last year, five full percentage points above the Illinois average. In this tough economy, with falling wages the norm, many of our clients still benefited from taking part-time or lower-paying jobs because they qualified for the partial or full child tax credit. As more of our clients return to

work, and, hopefully full-time employment, they will have more incentive to stay employed and increase their salary.

Simplification

As practitioners we hope that the Committee streamlines the existing tax code to ensure that it promotes economic stability and opportunity for *all* Americans. A simplified tax code will not only increase the quality of tax returns but it will also decrease the cost burden imposed on taxpayers.

Due to our complicated tax code, many American workers are spending hundreds of dollars each year just to settle their tax bill with the federal government. The more complex the tax return, the more a paid preparer charges for that tax return as most paid preparers charge per form. The CTC, ACTC, Child and Dependent Care Credit, and EITC, all require separate forms, and provide a perverse incentive to commercial preparers to make more money.

Timely Decision-Making

In addition to building a tax code that works for all, as practitioners we ask that the Senate make timely decisions about tax law changes. The timing of these decisions has a tremendous effect on our program's ability to serve our communities. If Congress delays making tax law changes until very late in the year it has the following impacts:

1. **The IRS** is delayed in producing necessary publications.
2. **Tax return software companies** are not able to update their software accordingly in time for the kick-off of the tax season.
3. **Certified volunteers** are not able to adequately prepare for the upcoming tax season. Our practitioners are trained in November or December. If tax law changes are implemented close to or after the kick-off of tax season, our volunteers need to retrain. From a quality assurance stand point, this is problematic.
4. **Taxpayers** who wish to file their return at the beginning of tax season, may not be able to access a free community VITA program due to delays in the tax season.

As outlined in the testimony above, we support the permanent expansion of the EITC for married couples and families with three or more children and increased support through the Child Tax Credit for parents working to raise their children. Increased simplification of the tax code and timely decisions from Congress will only improve our efforts to provide a tax system that works for all taxpayers.

Thank you for the opportunity to testify. The Center for Economic Progress and the National Community Tax Coalition look forward to working with you to ensure that the all working families have access to the opportunities and resources necessary to gain and sustain financial security.

COMMUNICATION

Statement for the Hearing Record
Qualified Settlement Trusts for Asbestos Victims

Senate Committee on Finance
The Future of Individual Tax Rates:
Effects on Economic Growth and Distribution
July 14, 2010

As part of the Senate Finance Committee's deliberations on whether to extend marginal income, capital gains and dividend tax rates and other provisions enacted in the Economic Growth Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003, we are submitting this statement to encourage you also to reevaluate an inequity that exists in our current tax system – the high tax rates that are applied to "qualified settlement funds" (QSFs) that have been established to compensate individuals who have suffered injuries or death due to exposure to asbestos.

We serve as court appointed trustees to five qualified settlement trusts established to compensate individuals who have suffered personal injuries or death as a result of exposure to asbestos[1]. We have fiduciary duties to represent both current and future claimants who are entitled to be compensated for their injuries due to asbestos.

Background on Asbestos Litigation and QSF Formation

Asbestos is a fibrous mineral that was formerly used in many industries due to its resistance to fire, heat and corrosion. It was a component of products that included insulation, roofing, flooring, brake and boiler linings, gaskets and ship building materials. Following the widespread use of asbestos, it was discovered to cause irreparable harm and health risks to individuals who worked with and around the material. Use of asbestos peaked in 1973, the year in which the United States Court of Appeals for the Fifth Circuit issued a ruling that allowed workers injured by exposure to asbestos to hold manufacturers of those products and others strictly liable for failure to warn that the products were unreasonably dangerous.

The volume of asbestos litigation increased following the 1973 ruling, and in 1982, Johns-Manville Corporation ("Manville"), the principal asbestos defendant at that time, filed for bankruptcy as a result of the insufficiency of its assets to pay the asbestos claims being filed against it. After a lengthy bankruptcy proceeding, a trust was established in 1988 to pay qualifying asbestos claims against Manville. This was the first asbestos trust. Asbestos claims continued to increase through the 1990s, and other asbestos defendants also filed for bankruptcy.

[1] We serve as trustees to trusts established by court order pursuant to the bankruptcies of the following companies: Armstrong World Industries, Inc., The Babcock & Wilcox Company, Mid-Valley, Inc. et al., Owens Corning et al., and USG Corporation.

In 1994, Congress amended the Bankruptcy Code to create Section 524(g) to specifically address asbestos-related bankruptcies. Among other things, the provision allows a bankruptcy court to bind future asbestos injury claimants to a plan of reorganization through the appointment of a futures representative to represent their interests in the negotiation of the plan. Because of the long latency period between exposure to asbestos and manifestation of a disease, Congress recognized that provisions must be made for the compensation of future asbestos victims and determined that a trust would be the best vehicle for handling asbestos claims against a bankrupt defendant. Section 524(g) basically codified the approach to dealing with asbestos claims that the court had approved in the Manville bankruptcy.

A trust that is created under Section 524(g) assumes the asbestos-related liabilities of the debtor company and must use all of its assets and income to pay qualifying asbestos claims. If all of the requirements of Section 524(g) are met, the court will issue a channeling injunction directing that asbestos claims may be brought only against the trust.

Description of Asbestos Victims

The majority of asbestos victims are lower-to-middle income, blue-collar workers. According to the National Institute for Occupational Safety and Health, the leading occupations for deaths due to asbestos exposure are plumbers, pipefitters and steamfitters. Many were exposed to asbestos while serving in the U.S. military. Others were exposed as a result of working in an industry in which asbestos was utilized. Examples of such industries are construction, shipbuilding, asbestos mining and processing, chemical manufacturing and metalworking. Approximately one million victims have filed claims against existing asbestos trusts and defendants. Because the latency period between the first exposure to asbestos and diagnosis of clinical disease is typically 20 to 40 years, many asbestos victims have not yet been identified.

The types of diseases that the victims experience range from mesothelioma, a fatal cancer caused by asbestos, to non-malignant asbestosis, a disease that impairs the victim's lung function. Victims of mesothelioma typically only live for 9 to 14 months after their diagnosis. Other types of cancer that persons exposed to asbestos sometimes develop are lung, colorectal, laryngeal, esophageal, pharyngeal and stomach. Lung cancer is the most common of these other types of cancer.

Insufficiency of Assets Available to Compensate Asbestos Victims

Even though existing asbestos trusts established to pay asbestos victims hold in the aggregate approximately $20 billion, this amount is far short of the amount that would be necessary to fully compensate the victims for the bankrupt defendants' liabilities. When a trust is established, the Bankruptcy Court and the District Court approve a schedule of values for the payment of asbestos claims based upon the historical several share of the bankrupt defendant's liability to asbestos victims in different disease categories. These values exclude punitive damages.

An asbestos trust must invest and manage its assets in a manner that will allow it to pay qualifying claimants equitably over a 40-year period. The trust pays claimants, who submit qualifying claims to the trust, values based upon the court-approved schedule. The trust,

however, will in almost every case only be able to pay a qualifying claimant a minor percentage – well below half -- of the scheduled value for his or her claim as a result of the underfunding of the trust.

Taxation of Asbestos Victims and Asbestos Settlement Funds

The tax treatment of asbestos trusts further diminishes the amounts that victims could receive. Under current regulations, asbestos settlement funds are considered "qualified settlement funds." Section 468B(b)(1) provides that the gross income of a qualified settlement fund is taxed at the maximum rate applicable to an estate or trust under section 1(e), that is, equal to the highest individual income tax rate. This rate applies even to dividends and to capital gains earned by the trusts.

Compensatory payments to asbestos victims and their survivors, as with all personal injury tort victims, are excluded from taxable income under section 104 of the Internal Revenue Code, which applies to payments received "on account of personal physical injuries or physical sickness." However, because asbestos QSFs are subject to very high taxation, asbestos victims are indirectly subject to the highest individual tax rate since the trusts' income is taxed at such rates.

The policy that underlies the tax treatment of QSFs under section 468B is that corporations should not be able to establish nontaxable trusts that could be used as a means of corporate income tax deferral. That would be possible if a corporation were able to satisfy a potential financial obligation by accelerating excess payments to a tax-favored fund in which it has a reversionary interest once all obligations have been satisfied. To prevent such tax arbitrage, section 468B and the regulations impose high tax rates on such funds. However, as noted below, the corporations that fund asbestos settlement trusts have no reversionary interests in the assets placed in the trusts.

Unlike other section 468B QSFs, asbestos settlement funds must produce income and manage their assets to be in existence for 30 to 40 years, due to the nature of the disease, which can be latent for decades before it begins to affect the health of the person exposed. Asbestos trusts deal with unknown future claimants and while estimates of such future claims are periodically performed to ensure that present and future claimants are treated the same, these estimates can be understated. Therefore, the earnings of asbestos trust assets are essential to maintain parity for all claimants.

Furthermore, the long-term nature of these trusts makes it more important that they be able to generate income without paying the maximum individual ordinary income tax rate on interest, dividends and capital gains income. This is made even more critical by virtue of the fact that almost all of the asbestos trusts pay only a percentage of the amount the claimant is entitled to; earnings on the trusts' assets are essential to the ability to make uncertain future payments. As a practical matter, high tax rates on every form of income, and fiduciary duties to invest conservatively to preserve trust assets, compel the trusts to be largely invested in municipal obligations. This minimizes returns to the trusts and erodes their ability to pay compensation to current and future claimants.

Reasons for Eliminating Tax on Asbestos Settlement Funds

Asbestos QSFs benefit only asbestos claimants. The timing and amount of contributions to the trusts are dictated by bankruptcy courts. The corporations that fund the asbestos settlement funds have no reversionary interest in the assets placed into the trusts. Thus, the policy considerations that underlie the tax treatment of QSFs are inapplicable in the case of asbestos trusts. The tax imposed under section 468B should not apply to asbestos settlement funds since asbestos QSFs cannot be manipulated to provide tax advantages to contributing corporations.

This hidden tax on asbestos victims also conflicts with both general tax policy principles and Federal priorities. General tax policy exempts from taxable income payments received by victims for physical injury or sickness. Taxing asbestos QSFs at the highest individual rate is effectively a tax on asbestos victims, the large majority of whom are lower middle-income, blue-collar workers and are now effectively being taxed at the highest individual income tax rate, 35% currently and scheduled to rise to 39.6% in 2011, if marginal tax rates for high-income individuals are not extended.

The taxation of the QSFs subjects asbestos victims to dramatic rate increases that have affected few other taxpayers. When section 468B was enacted in 1986, the maximum individual income tax rate was 28% on ordinary income, dividends and capital gains. Since then, the maximum individual rate on ordinary income has increased to 35% and, as noted, would rise again to 39.6% beginning in 2011 – an effective 41% tax increase on the income of asbestos QSFs since the enactment of section 468B. During that same period, the rate on capital gains income and dividends has been reduced to 15%, except in the case of QSFs where capital gains and dividends are treated the same as all other income and are therefore subject to the increased tax rate of 35%. The top tax rate on ordinary income applies only to the highest-income taxpayers, who, unlike the QSFs for asbestos victims, benefitted from an offsetting cut in the tax rates on capital gains and dividends over that time. QSFs pay a flat tax rate at the highest individual income level on all their income, including dividends, capital gains and ordinary income.

In 2006, Congress recognized the unfairness of subjecting certain QSFs to the highest marginal tax rates by amending section 468B to exempt from taxation QSFs that were established to clean up Superfund sites. This exemption also should be made available to QSFs established for asbestos victims, given the similarities between the two types of QSFs. In both cases, the contributing corporations have no reversionary interest in the assets placed in the funds. In addition, both types of QSFs are created as the result of a federal court order or decree.

Indeed, the case for exempting the income of asbestos QSFs is even more compelling since trust income is a critical factor for our ability to manage compensatory payments to future claimants. As you consider whether to extend the 2001 and 2003 tax rates, we urge the Committee to eliminate this unfair treatment of asbestos QSFs.