

Aspects of the Sunset of EGTRRA and JGTRRA

Testimony presented to the United States Senate, Committee on Finance

by

Douglas Holtz-Eakin
President, American Action Forum*

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

Executive Summary

1. Extending EGTRRA and JGTRRA is not about counter-cyclical “stimulus.” The U.S. economy is growing and needs stronger pro-growth policies in order to continue to do so. A permanent and full extension is shown to even have better *short-term* impacts than a temporary and limited extension. See Table 1.
2. The federal budget is on a dangerous and unsustainable course. The problem stems from federal spending and fixing it should focus on increasing economic growth and reducing growth in outlays. Relying on near-term tax increases may even undercut efforts to rein in spending.
3. The distributional implications of these Acts have been poorly understood and discussions ignore channels by which tax burdens are shifted. In particular, the well-documented impacts of higher individual tax rates on entrepreneurial and small businesses will tend to shift the real burden of higher taxes toward workers and other suppliers.
4. The U.S. income tax system desperately needs reform. Viewing extensions of aspects of EGTRRA and JGTRRA from this perspective places a premium on extending low marginal tax rates, low and equal rates on the cash-flow returns to innovation and investment, and allowing the anti-growth, tax-based subsidies to consumption to sunset.

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 JGTRRA 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 2010. 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 where it was in 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 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

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

budget. Over the next ten years, according to the Congressional Budget Office's (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 policies 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 known, 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 creates 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

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>

immediate economic benefits as businesses step up their spending to match the improved long-run outlook.

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 As a result of these phase-outs, the effective marginal tax rate could rise to 41 percent 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 this 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

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

rates on capital gains. However, the most striking blow on growth-oriented 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.

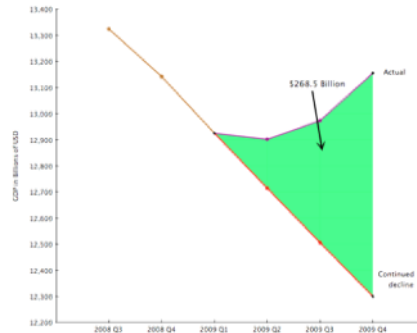
One can expect, nevertheless, that there will be a discussion of tax versus spending “multipliers.” For some this will be an argument for more spending, or at least to not cut spending, on the grounds that the negative multiplier effects will outweigh the benefits of tax policy. These arguments are often 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.

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. produce macroeconomic simulations of two policy options:

- Extend EGTRRA and JGTRRA for one year, but only for those earning less than \$250,000 (family) or \$200,000 (individual), versus
- Extend EGTRRA and JGTRRA 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 a weakened and slowly growing economy, 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

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, 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.

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 substantially 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

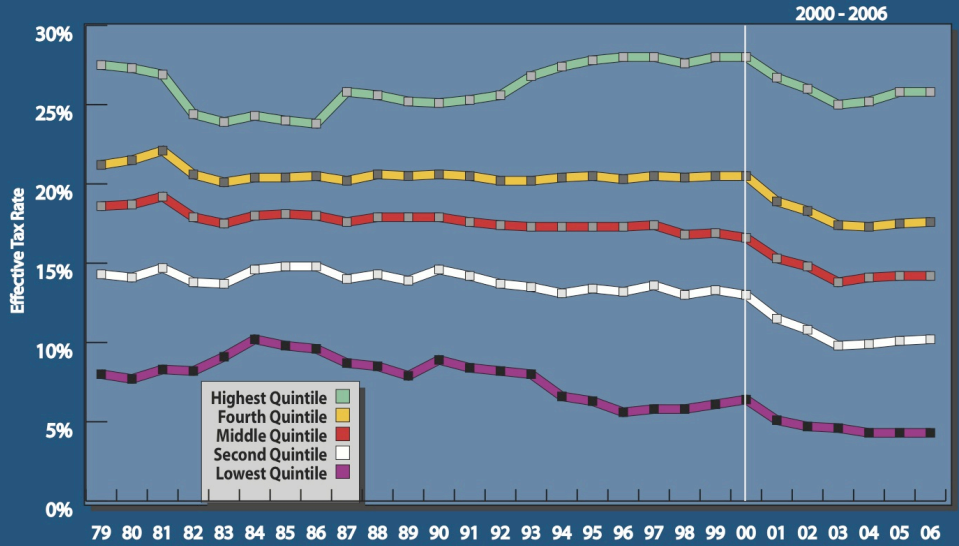
Chairman Baucus and Ranking Member Grassley, thank you for the opportunity to appear today. The sunsets of EGTRRA and JGTRRA are crucial moments in the evolution of U.S. tax policy. I believe that the focus should be on enhancing the growth potential of the U.S. economy and moving in the direction of 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



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.