Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

November 17, 2011

TESTIMONY OF CHAD STONE
CHIEF ECONOMIST, CENTER ON BUDGET AND POLICY PRIORITIES

Before the
Joint Economic Committee
United States Congress

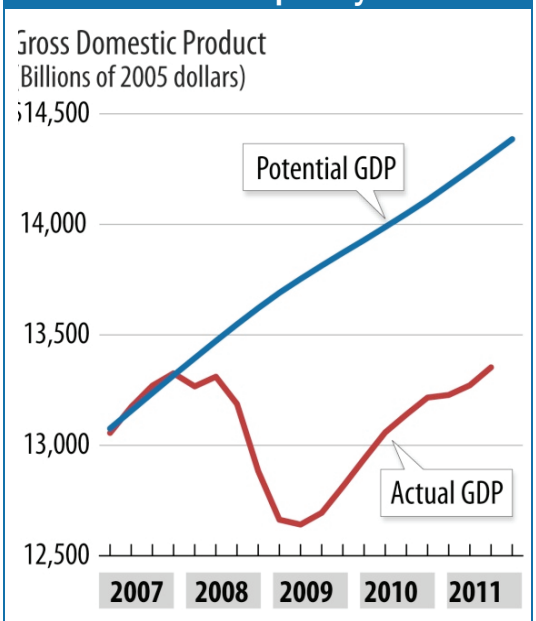
Hearing on "Could Tax Reform Boost Business Investment and Job Creation"

Chairman Casey, Vice Chairman Brady, and other members of the Committee, thank you for the opportunity to testify before this committee, which has been special to me since I first worked on the JEC staff in 1989. In my testimony, I want to make one overarching point about the question raised by the title of this hearing, "Could tax reform boost business investment and job creation?" and a couple of other specific points about repatriation of foreign earnings and small businesses.

A Framework for Analysis

My overarching point is that in framing the question "could tax reform boost business investment and job creation," it is critically important to distinguish between policies likely to boost investment, economic activity, and job creation in the short term and policies likely to increase the economy's potential for sustainable long-term growth with broadly shared prosperity. The distinction can be illustrated with the help of Figure 1, which shows the current gap between the quantity of goods and services actually being produced (actual GDP) and the quantity that could be produced if the available workforce were fully employed and the country's businesses were operating at their full productive capacity (potential GDP).

FIGURE 1: Economy Operating Well Below Full Capacity



Sources: Bureau of Economic Analysis and Congressional Budget Office

As the red line for actual GDP shows, the economy fell into a deep hole in the Great Recession of late 2007-2009. It started to come back following enactment of the American Recovery and Reinvestment Act of 2009 (ARRA), but growth has to be substantially faster than we have seen so far to close the gap and get the economy back on its long-run sustainable growth path (the blue line).

In evaluating the impact of tax reform we need to distinguish between two questions 1) would it be effective at stimulating economic growth in the short-term and erasing the output gap and jobs deficit (i.e., how would it affect the red line?) and 2) would it be effective at increasing the long-run capacity of the economy to produce goods and services (i.e., how would it affect the blue line?).

My reading of the economic evidence is that tax reform is unlikely to be an effective tool for speeding up economic growth in the short run. Tax reform *could* be a useful tool for enhancing growth in the longer run, but only in the context of a sound overall program for achieving long-term fiscal stabilization and not if it is used as an excuse to avoid the revenue increases that must necessarily be a part of any credible, sustainable deficit-reduction plan.

The Short-Term Problem: Inadequate Demand

With a huge output gap, high unemployment, and too much idle productive capacity, job #1 for policymakers should be jobs — putting people back to work and getting businesses back to operating at full capacity. Corporate tax reform, cutting top marginal tax rates, or reducing taxes on business income — none of these has anywhere near the short-term demand-creating, job-creating bang-for-the-buck of measures like those the President has proposed: extending federal emergency unemployment insurance, extending and expanding the payroll tax holiday, relatively quick acting infrastructure investments like repairing schools, and help to relieve pressure on state and local governments to lay off teachers, police, and firefighters.

Congressional Budget Office Director Douglas Elmendorf provided new CBO estimates of the impact of different policies for increasing economic growth and employment in 2012 and 2013 in testimony before the Senate Budget Committee, November 15, 2011.[1] Policies like increasing aid to the unemployed, reducing payroll taxes, and increasing aid to state governments ranked considerably higher in terms of both GDP and jobs generated per dollar of total budgetary cost ("bang-for-the-buck") than keeping the Bush income tax rates in 2013 rather than letting them expire as scheduled and business tax cuts that merely pad companies' bottom lines.

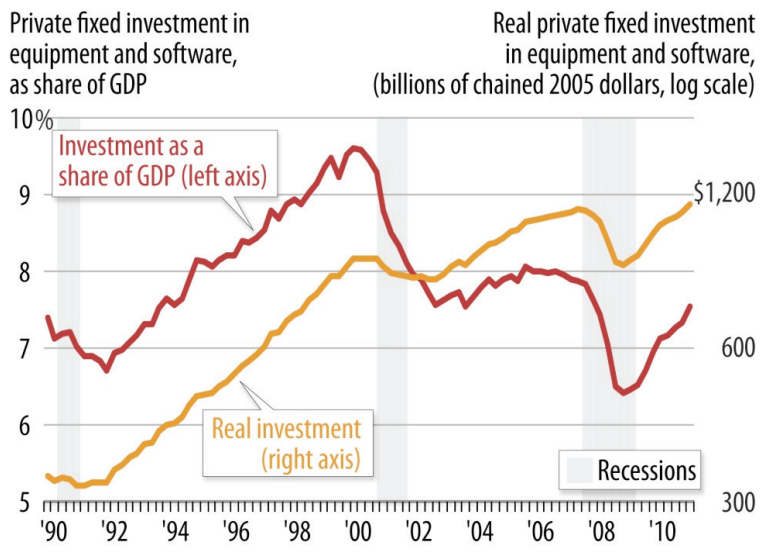
Almost by definition, excess unemployment and idle productive capacity mean the economy is suffering from inadequate aggregate demand for goods and services. I know there are some economists out there with models saying that all of the increase in unemployment since 2007 represents a structural mismatch between workers' skills and employers' needs or the sudden desire of large numbers of workers to take time off, but the most compelling explanation to most economists for why we have a 9 percent unemployment rate, tame inflationary expectations, and a large output gap is the textbook one: weak aggregate demand. Businesses are not able to sell all the goods and services they are capable of producing. Right now, putting more customers in their stores and giving those customers more money to spend is a far better way to encourage businesses to expand and hire more workers than giving them a tax break. After all, their stores are still half empty, and businesses are not going to produce more than they expect to sell.

---

[1] Douglas Elmendorf, "Policies for Increasing Economic Growth and Employment in 2012 and 2013," Congressional Budget Office, testimony before the Senate Budget Committee, November 15, 2011: http://www.cbo.gov/ftpdocs/124xx/doc12437/11-15-Outlook_Stimulus_Testimony.pdf

The pattern of overall business investment in recent years is obscured by the boom and bust in business structures (new factories, plants, office buildings, stores, etc.). However, business investment in equipment and software has been solid so far in this expansion. As shown in Figure 2, such investment fell sharply in the recession but has since grown faster than GDP (as evidenced by the rise in equipment and software investment as a share of GDP). This investment growth has been far better in the early stages of this recovery, for example, than in the comparable stage of the recovery from the 2001 recession, although we are not quite back to 2007 levels as a share of GDP, much less the levels achieved in the 1990s.

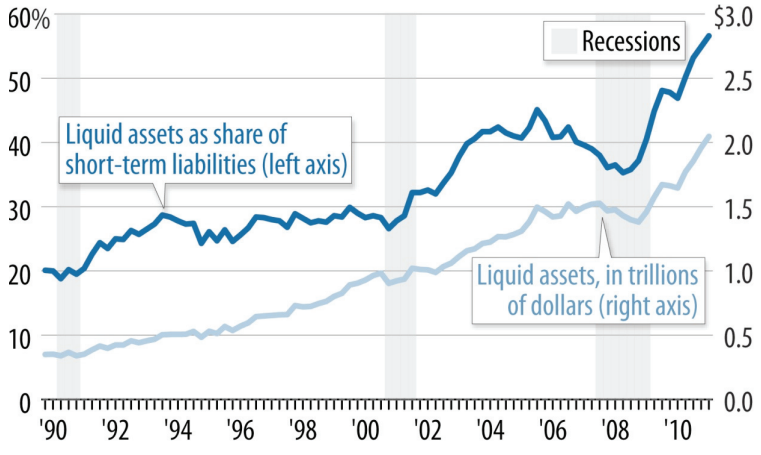
FIGURE 2:
Equipment and Software Investment Growing Faster Than GDP



Sources: Bureau of Economic Analysis and National Bureau of Economic Research

As Figure 3 shows, businesses are building up cash reserves relative to their short-term liabilities, as they did in the early stages of the previous two recessions while there was still excess unemployment and uncertainty about when sales would begin to pick up. Once it was clear a recovery was underway, cash reserves leveled off as a share of short-term liabilities. The magnitude of the current cash stockpiling is unprecedented, but the phenomenon is familiar. Firms are making profits, but as the current recovery struggles to gain traction, surveys show that firms continue to worry about weak economic growth and sluggish sales and so are building up cash until things pick up.

FIGURE 3:
Companies Are Flush With Cash



Sources: Federal Reserve and National Bureau of Economic Research

While the the cash reserves shown in Figure 3 are mostly held by large corporations, surveys of small businesses show a similar phenomenon. In National Federation of Business surveys of what concerns small business the most, taxes and regulation register at about the same level in both good economic times and bad, but weak sales quickly became the number one concern in the Great Recession and remain the number one concern of small businesses today.

To summarize, the major factor holding back investment and job creation in the current economy is weak sales due to inadequate aggregate demand and slow economic growth. Policies that increase aggregate *demand* are the best short-term policies for creating a more favorable environment for investment and job creation, and tax reform policies typically operate on the *supply* side of the equation. Measures like those in the President's American Jobs Act are likely to be much more effective at boosting aggregate demand and closing the jobs deficit — without adding to the long-term budget deficit, because they are temporary.

The Longer-Term Goal: Achieving Fiscal Stabilization and Promoting Shared Prosperity

Turning to the longer term, the question is how would tax reform affect the economy's potential to produce goods and services and its long-term growth path? This question needs to be addressed in the context of how we achieve long-term fiscal stabilization, which is critical to ensuring strong long-term growth and shared prosperity. In our judgment it is not possible to produce a credible, sustainable, long-term fiscal stabilization plan without acknowledging the need for more revenues.

As my colleague Kathy Ruffing showed in a recent paper,[2] revenue increases were a part of every major deficit-reduction package in the 1980s and 1990s until the Balanced Budget Act of 1997. In several cases — notably in 1982 and 1984 (where they offset a portion of President Reagan's large tax cuts of 1981) — they dominated the package. In several other cases — 1987, 1990, and 1993 — they contributed from one-third to more than one-half of the total savings (including the debt-service savings), and a larger share of the *policy* savings (i.e., if the debt service savings are set to the side rather than counted as a spending cut).

A key aim of fiscal sustainability is a stable or declining ratio of debt to GDP. To stabilize that ratio, we need to get deficits in the medium term down to about 3 percent of GDP. But under current policies, the deficit will be about 4 percent to 5 percent of GDP for the next decade even after the economy recovers and after we have phased down operations in Iraq and Afghanistan. So we need to cut the deficit by 1 percent to 2 percent of GDP in the coming decade — an amount that rivals the biggest deficit-reduction efforts of the past. Meanwhile, the nation faces a graying population and continued demands on government in the areas of defense, homeland security, veterans' care, infrastructure, and other needs; the amount of deficit reduction for future decades will need to be larger.

Given the size of that challenge, and the need to phase in any entitlement changes gradually, the next round of deficit reduction must include substantial revenue increases. Plans that rely on spending cuts alone do not acknowledge the changing realities of the U.S. economy and U.S. society or the preferences of the American people as revealed in poll after poll.

The tax reform mantra is: we can broaden the base, which will allow us to lower the rates, without any adverse effect on revenue. That's not good enough in the current budget situation, because we need to raise revenue. The fact that tax reform is not a panacea for our budget problems does not mean, however, that we should abandon the principle that *if we have enough revenue* to fund the size and role of government we want to have, broadening the tax base allows us to have

---

[2] Kathy Ruffing, "The Composition of Past Deficit-Reduction Packages — and Lessons for the Next One," Center on Budget and Policy Priorities, November 14, 2011: http://www.cbpp.org/files/11-14-11bud2.pdf

lower tax rates. It means that we still have to make tough choices about taxes and spending. Taking a hard look at spending that occurs through the tax code —"tax expenditures," which are defined as revenue losses attributable to provisions of the tax code that provide special benefits to particular taxpayers or groups of taxpayers — should definitely be on the table.

A key point to keep in mind when discussing tax reform in the context of fiscal stabilization and long-term growth is that deficit reduction is much more critical to long-term growth (once the economy is back closer to full employment) than reducing taxes. As my colleague Paul Van de Water discussed in a recent paper,[3] even if revenue-neutral tax reform might produce some small economic growth benefits, it would be far more economically beneficial to use the additional revenues gained from limiting tax preferences to reduce budget deficits rather than cut marginal tax rates. When the economy is operating near or at its capacity, federal budget deficits reduce total saving in the economy, crowd out capital investment, and reduce the economy's potential rate of growth. Most economists believe that the adverse effect of higher deficits dominates the effect of higher tax rates.

For example, the Congressional Budget Office finds that permanent extension of the 2001 and 2003 tax cuts and AMT relief would *reduce* output in the long run if the extension is deficit-financed. Conversely, reducing the deficit once the economy is stronger will spur economic growth even if it requires higher tax rates. In other words, putting a dollar of budget savings into deficit reduction would do more to boost the economy's capacity to produce goods and services (potential GDP) than using that dollar to cut marginal tax rates, and any hit to the economy's capacity to produce goods and services from raising a dollar of taxes would be more than offset by the gain from reducing the deficit by a dollar.

In summary, in the longer run, the goal is to achieve the maximum sustainable growth rate in potential GDP. That comes from capital investment (including investment in infrastructure), investment in people in order to produce a well-trained, well-educated, adaptable workforce, and technological progress. Tax rates in the range we are talking about as part of a credible and sustainable debt stabilization plan are less harmful to growth than budget deficits of the kind we are projecting in the absence of such a plan. It's hard to be serious about long-term deficit reduction without recognizing that revenues have to be part of the solution. Supply side fantasies and dynamic scoring pipedreams won't cut it. So it makes sense to embrace an enduring principle of tax reform — that a broader tax base allows rates to be lower than a narrower tax base, but we also have to ensure we have enough revenue to pay for the things we want government to do — ranging from national defense to an adequate safety net. The debate should be about what we want government to do and how should we pay for it, not what can we squeeze into some arbitrarily determined limit on how much revenue we are willing to collect.

Other Observations

In the remainder of my testimony, I would like to touch on a couple of specific topics: the repatriation of foreign earnings and the impact of increases in the top marginal tax rate on small businesses.

---

[3] Paul Van de Water, "Supercommittee Should Reject 'Dynamic Scoring': Estimates Are Uncertain and Subject to Manipulation," Center on Budget and Policy Priorities, October 18, 2011: http://www.cbpp.org/files/10-18-11bud.pdf

The Perils of Another Repatriation Tax Holiday

In 2004 policymakers were seduced by the idea that giving U.S. multinational companies a window in which they could repatriate overseas profits and pay a greatly reduced U.S. corporate income tax on those profits would be a boon to U.S. investment and job creation. But researchers have found scant evidence that the 2004 repatriation legislation produced such effects. Instead of expanding their operations and creating more jobs, most companies appear to have used their tax-favored repatriated income to pay dividends or buy back stock.

Studies by academic researchers, the Congressional Research Service (CRS), and others have found no convincing evidence that the 2004 holiday had any of the promised positive economic effects.[4] To the contrary, there is strong evidence that firms primarily used the repatriated earnings to benefit owners and shareholders, and that the restrictions Congress imposed on the use of the repatriated earnings — aiming to ensure that firms invested them in the United States — proved ineffective. In fact, many of the firms that repatriated large sums during the holiday actually laid off workers.

With most companies likely to be affected by a repatriation tax holiday flush with cash and enjoying ready access to capital markets, there is every reason to expect that the results from a second tax holiday would be at least as disappointing as those from the failed 2004 legislation. In its analysis of recent repatriation proposals, Goldman Sachs concluded, "The short-term economic benefits of such a policy would likely be minimal."[5] Goldman Sachs explained, "we would not expect a significant change in corporate hiring or investment plans: most firms with large amounts of overseas profits are likely to have adequate access to financing, so the availability of cash on hand is unlikely to be a constraint on investment at the present time." In its latest analysis of policies under consideration for boosting economic activity and jobs, the Congressional Budget Office ranks a repatriation tax holiday like that enacted in 2004 dead last in effectiveness and estimates that it would have minimal impact.[6]

The Joint Committee on Taxation (JCT) estimates that a proposal like the 2004 proposal would reduce revenues over the next 10 years by almost $80 billion, even though about $700 billion would be repatriated and tax revenues would be higher in the window opened by a temporary tax holiday. Without the legislation, some of these earnings would have been repatriated at a higher rate later in the 10-year budget period covered by the estimate or outside the budget window. More significantly, enactment of a second repatriation holiday in less than a decade would create the expectation that more such holidays will occur in the future. That would give companies an incentive to shift the location of future investments abroad to escape higher U.S. tax rates on earnings with the expectation that those earnings will be repatriated in the *next* tax holiday.

In the JCT estimate, during the first three years, revenues would be higher as the large volume of repatriation dominates the lower tax rate. Subsequently, however, the proposal would lose an even

---

[4] Chuck Marr, Brian Highsmith, and Chye-Ching Huang, "Repatriation Tax Holiday Would Increase Deficits and Push Investment Overseas," Center on Budget and Policy Priorities, October 12, 2011. http://www.cbpp.org/cms/index.cfm?fa=view&id=3593

[5] Alec Phillips, "U.S. Daily: Profit Repatriation Tax Holiday: Still an Uphill Climb," Goldman Sachs, October 5, 2011

[6] Elmendorf, November 15, 2011.

larger amount of revenue because the earnings that would have been repatriated at a higher rate were already repatriated during the window and because the increased investment abroad induced by the expectation of further holidays generates more tax-sheltered earnings abroad and less taxable earnings in the United States.

A policy that would do little to stimulate investment in the current weak economy but would lose tax revenue in the future when deficit reduction should be kicking in doesn't make sense. That is why Mark Zandi, Chief Economist of Moody's Analytics, has urged lawmakers not to regard repatriation as a stimulus measure but rather to consider it in the broader context of corporate tax reform.[7] I would reiterate, however, that many proposals for corporate tax reform would likely further diminish the shrinking amount of revenue coming from the corporate income tax, which would make it harder to achieve our deficit reduction goals.

I believe the best policy is not to enact a second repatriation tax holiday. But if the momentum behind such legislation seems unstoppable, I would certainly encourage Congress to try to limit the uses to which repatriated earnings can be put better than they did last time.

Small Businesses

The claim that raising marginal tax rates at the top of the income distribution would severely harm small businesses has little factual basis. The most basic reason is that few small business owners pay taxes at the top rates. According to a recent Treasury analysis, when you look at a definition of small business that captures what people usually mean by the term, only 2.5 percent of small business owners who are taxed at the individual rather than corporate rates are in the top two income-tax brackets.[8] In addition, the best research on small firms as job creators indicates that it is important to distinguish between young firms (startups), which are the main source of job creation in the small business sector, and other more established small businesses.

With respect to the impact of taxes on small businesses, Tax Policy Center co-Director William Gale has noted that "the effective tax rate on small business income is likely to be zero or negative, regardless of small changes in the marginal tax rates," because of the valuable array of tax subsidies that small businesses receive.[9] As CRS notes, the subsidies with the broadest reach include:

> "the taxation of small firms as pass through entities, the graduated rate structure for the corporate income tax, the expensing allowance for equipment …, the exemption of some small corporations

---

[7] Response by Mark Zandi at Senate Budget Committee hearing on "Policy Prescriptions for the Economy," September 15, 2011

[8] Matthew Knittel, Susan Nelson, Jason DeBacker et al., "Methodology to Identify Small Businesses and Their Owners," Treasury Department Office of Tax Analysis, August 2011: http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf

[9] The Congressional Research Service has found that "current federal tax law contains a number of provisions bestowing preferential treatment on small firms." Gary Geunther, "Small Business Tax Benefits: Overview and Economic Rationales", Congressional Research Service, revised September 18, 2007, p. 3.

from the corporate alternative minimum tax, cash basis accounting, and the exclusion from taxation of capital gains on the sale or disposition of certain small business stock."[10]

The imagined impact of high marginal tax rates on small businesses is a weak justification for extending the current top two rates or for shielding very high-income individuals from making a significant contribution to deficit reduction.

Policymakers have justified channeling a large volume of tax breaks to small businesses, primarily on the assumptions that small businesses are the primary creators of jobs and that tax policy strongly affects small business job creation. Both assumptions bear closer examination. The claim that small businesses are the primary creator of jobs is based on research conducted in the 1980s; as CRS notes, "more recent research has revealed some methodological deficiencies in these original studies and suggests that small businesses contribute only slightly more jobs than other firms relative to their employment share. Moreover, this differential is not due to hiring by existing small firms, but rather to start-ups, which tend to be small."[11]

Similarly, a 2010 National Bureau of Economic Research study finds no systematic relationship between firm size and job growth after controlling for firms' age.[12] This indicates that it is particularly important to distinguish between young businesses (startups), which the study finds "contribute substantially to both gross and net job creation," and other small businesses.[13]

The evidence that tax rates strongly affect small business growth and job creation is also thin. Only one study exists that directly addresses the question of whether cutting the marginal tax rates of small business owners leads to increased hiring in existing firms. That study, by Douglas Holtz-Eakin and others, finds a statistically significant increase in small business hiring following the deep cuts in tax rates from the 1986 tax reform.[14] But CRS notes that the study may overstate the extent to which high-income entrepreneurs respond to tax changes. CRS also cautions that "given only one study, it is premature to conclude that raising taxes of the owner would decrease hiring in existing firms."[15]

Unlike large corporations, which are, for the most part, flush with cash, small businesses appear to still face difficulty financing expansions. That may justify short-term measures that target job creation in small businesses, but it does not justify a costly and poorly targeted measures like keeping the current very low top marginal tax rates from expiring as scheduled.

---

[10]Gary Geunther, "Small Business Tax Benefits: Overview and Economic Rationales", Congressional Research Service, revised September 18, 2007, p. (i).

[11]Jane Gravelle, "Small Business and the Expiration of the 2001 Tax Rate Reductions: Economic Issues," Congressional Research Service, September 3, 2010: http://assets.opencrs.com/rpts/R41392_20100903.pdf

[12] John Haltiwanger, Ron Jarmin and Javier Miranda, "Who Creates Jobs? Small vs. Large vs. Young," NBER working paper, August 2010: http://papers.nber.org/papers/w16300

[13] Haltiwanger et al, August 2010, pg. 30

[14] Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, "Entrepreneurs, Income Taxes, and Investment," Chapter 13 in *Does Atlas Shrug?* edited by Joel B. Slemrod, Russell Sage Foundation, 2000.

[15]Gravelle, September 3, 2010