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“Joint Committee on Taxation Scoring of Tax Reform Legislation”

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My name is Todd McCracken and I am the president of the National Small Business Association (NSBA), America's oldest small-business advocacy organization.¹ The NSBA is pleased to provide its perspective on marginal tax rates, capital gains and dividends in the context of tax reform.

The NSBA strongly believes that the present tax system is irretrievably broken and constitutes a major impediment to the economic health and international competitiveness of American businesses of all sizes. To promote economic growth, job creation, capital formation, and international competitiveness, fundamental tax reform is required. Until fundamental tax reform is undertaken, reducing marginal tax rates and broadening the tax base in ways that do not exacerbate the tax bias against savings and investment is highly desirable

A major impediment to either incremental or fundamental tax reform is the current manner in which the Joint Committee on Taxation (JCT) estimates, or "scores" in Washington parlance, proposed legislation that would reform the tax system.² JCT staff ignore the well established "macroeconomic" impact that fundamental tax reform or other major tax changes would have.³ In order for a tax reform proposal to be revenue neutral, JCT staff estimates therefore require higher marginal tax rates than would actually be necessary in the real world. To be scored as "revenue neutral" by the JCT staff, a proposal must actually raise tax revenue in the real world and it becomes much more difficult to achieve the support necessary to overcome the entrenched interests that defend the current tax system.

People modify their behavior in response to major changes in tax policy. Revenue estimates should take these effects into account.⁴ Yet JCT revenue estimators continue to refuse to consider the impact of major tax changes on work, savings, investment and output. In their estimates, they assume that GDP will not change.⁵

Critics of taking these effects in account emphasize that doing so would require JCT to make judgments as to the effects' magnitude. But JCT routinely does that today with respect to so-called behavioral or microeconomic effects that can be quite large with respect to the revenue estimate. In the final analysis, it is better that JCT estimates be approximately correct than precisely wrong.

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² For a comprehensive discussion of the tax policy making process, including scoring issues, transparency, distributional analyses and the history of the Joint Committee on Taxation and the Treasury Office of Tax Analysis, see Dan R. Mastroarco, David R. Burton and William W. Beach, "The Secret Chamber or the Public Square? What Can Be Done to Make Revenue Estimation More Transparent and Accurate," Heritage Foundation, 2005.

³ Revenue estimates that ignore macroeconomic effects are often referred to as "static."

⁴ Revenue estimates that take macroeconomic effects into account are often referred to as "dynamic."

⁵ Joint Committee on Taxation, "Overview of Revenue Estimating Procedures and Methodologies Used by the Staff of the Joint Committee on Taxation," (JCX-1-05), February 2, 2005.

High marginal tax rates discourage work, savings and investment. They reduce productivity and real wages. Conversely, reducing marginal tax rates encourages work, savings and investment and will enhance productivity and real wages. Reducing marginal tax rates also increases entrepreneurial risk-taking because less of the potential reward from the risk-taking will be taken by government. Furthermore, lower marginal tax rates reduce the cost of capital and increase productivity-increasing investment. These effects are well established. There may be differences among economists about their magnitude but there is no doubt as to their sign and existence.

The economic loss associated with higher tax rates increases with the square of the tax rate increase.⁶ Thus, doubling the tax rate will result in a four-fold increase in the adverse economic effect of the tax system. This effect is equally true in reverse. Lowering marginal tax rates has a disproportionately positive impact on the economy. The deadweight loss (or excess burden) to the economy has been estimated to be as low as 17 cents to as high as \$2.75 per dollar of taxes raised.⁷ Part of the difference is attributable to the difference between average and marginal excess burden, with the latter, as expected, a higher figure. It is also the most economically relevant when scoring proposed changes.

The impact of replacing the current tax system with a consumption tax like the FairTax, for example, has been estimated to increase the overall economy over the baseline by something approaching 10 to 20 percent of GDP within 5 to 10 years.⁸ That means that marginal tax rates could be reduced by 9 to 17 percent and raise the same amount of revenue.

⁶ Alan Auerbach, "The Theory of Excess Burden and Optimal Taxation," in the Handbook of Public Economics, Alan Auerbach and Martin Feldstein, Editors, 1985; Harry Watson, "Excess Burden," Encyclopedia of Taxation and Tax Policy, Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, Editors, 2005; John Creedy, "The Excess Burden of Taxation and Why It (Approximately) Quadruples When the Tax Rate Doubles," New Zealand Treasury Working Paper 3/29, December 2003.

⁷ See, e.g., Robert Carroll, "The Excess Burden of Taxes and the Economic Cost of High Tax Rates," Tax Foundation, Special report No. 170, August 2009; William A. Niskanen, "The Economic Burden of Taxation," Proceedings, Federal Reserve Bank of Dallas, October 2003, pages 93-98; Don Fullerton, "Reconciling Recent Estimates of the Marginal Welfare Cost of Taxation," The American Economic Review, March 1991, p. 302-308; Charles L. Ballard, John B. Shoven and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States, The American Economic Review, March 1985, p. 128-138.

⁸ David G. Tuerck, Jonathan Haughton, Keshab Bhattarai, Phuong Viet Ngo, Alfonso Sanchez-Penalver, "The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model, The Beacon Hill Institute at Suffolk University, February 2007; Kotlikoff, Laurence J. and Sabine Jokisch, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," National Bureau of Economic Research, Working Paper No. 11858, December, 2005; Arduin, Laffer & Moore Econometrics, "A Macroeconomic Analysis of the FairTax Proposal, Americans For Fair Taxation Research Monograph, December, 2005; Dale W. Jorgenson and P. J. Wilcoxon "The Long-Run Dynamics of Fundamental Tax Reform," American Economic Review, Vol. 87, No. 2, May 1997, pp. 126-132; Dale W. Jorgenson, "The Economic Impact of Taxing Consumption," in Committee on Ways and Means, United States House of Representatives, Replacing the Federal Income Tax, Vol. II, One Hundred Fourth Congress, Second Session, 1996, pp. 105-113; reprinted in Joint Economic Committee, Congress of the United States, Roundtable Discussion on Tax Reform and Economic Growth, One Hundred Fourth Congress, First Session, 1996, pp. 79-97; Jorgenson, Dale W., "The Economic Impact of the National Retail Sales Tax," November, 1996.

Raising marginal tax rates will also increase the user cost of capital, reduce productivity-enhancing investment and reduce economic growth and real wages. Reducing marginal tax rates will have the opposite effect. Lower marginal tax rates will reduce the user cost of capital, increase productivity-enhancing investment, economic growth and real wages.⁹

Although the tax base should be broadened and marginal tax rates on business reduced, the tax base should only be broadened to the extent that can be accomplished without imposing multiple levels of taxation on savings and investment. Lower tax rates should either be undertaken for their own sake or by reducing tax preferences that do not exacerbate the tax system's bias against savings and investment.

Lowering tax rates and replacing the lost revenue by repealing loopholes that do not raise the cost of capital and tend to eliminate discrimination among types of investment is pro-growth. Lowering tax rates and replacing the lost revenue by changing provisions such that the cost of capital is increased has a much more ambiguous impact and may actually harm the economy. The revenue estimates should reflect this very different economic effect and the fact that pro growth proposals will not require as high a marginal tax rate because of the positive impact on the economy and the magnitude of the taxable base.

We urge the Committee to move towards so-called dynamic or reality based scoring. This will have a salutary impact on tax policy and ease the road toward badly needed tax reform.

Also see, Bachman, Paul, Jonathan Houghton, Laurence J. Kotlikoff, Alfonso Sanchez-Penalver, and David G. Tuerck. "Taxing Sales Under the Fair Tax: What Rate Works?" NBER Working Paper No. 12732. Cambridge, MA: National Bureau of Economic Research, 2006; Kotlikoff, Laurence J., and David Rapson.

"Would the FairTax Raise or Lower Marginal and Average Taxes?" NBER Working Paper No. 11831. Cambridge, MA: National Bureau of Economic Research, 2005; Marco Fantini, "Macroeconomic Effects of a Shift from Direct to Indirect Taxation: A Simulation For 15 EU Member States, presented at the 72nd meeting of the OECD Working Party No. 2 on Tax Policy Analysis and Tax Statistics, Paris, 14-16 November 2006. See also, Joint Committee on Taxation, "Tax Modeling Project and 1997 Tax Symposium Papers," JCS-21-97, November 20, 1997. Symposium participants: Alan J. Auerbach, Charles L. Ballard, Michael J. Boskin, Roger E. Brinner, Eric Engen, William Gale, Jane G. Gravelle, Dale W. Jorgenson, Laurence J. Kotlikoff, Joel L. Prakken, David Reifschneider, Robert D. Reischauer, Aldona Robbins, Gary Robbins, Diane Lim Rogers, Harvey S. Rosen, Joel Slemrod, Kent Smetters, Jan Walliser, Peter J. Wilcoxon, John G. Wilkins.

⁹ See Hall, Robert E., and Dale Jorgenson (1967): "Tax Policy and Investment Behavior," *American Economic Review*, vol. 57, No. 3 (June), pp. 391-414 for the basic user cost of capital analysis with taxes.