



October 24, 2011

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To Members of Joint Select Committee on Deficit Reduction:

The National Small Business Association (NSBA) is America's oldest small-business advocacy organization. On behalf of the 150,000 small businesses the NSBA represents, I am pleased to provide our perspective on the steps necessary to recover from our present economic difficulties and lay the foundation for future prosperity.

The long-term fiscal outlook for the U.S. government is grave. Some of the problems that must be confronted are complex. We realize that it is probably unrealistic to expect the Joint Select Committee on Deficit Reduction to fashion a bi-partisan solution to the structural fiscal problems faced by this country in a matter of weeks.

The Committee, however, can play an important role in three ways. First, it should meet its obligations to recommend \$1.5 trillion in deficit reduction over ten years. Second, it should make such other specific proposals as it can agree upon to promote economic growth. Third, to the extent the committee can identify problems but does not have sufficient time to craft solutions acceptable to a majority of the committee, it should make specific recommendations to Congressional leadership about which problems should be taken up immediately by the standing committees of the Congress.

Our primary recommendations may be summarized as follows:

1. Reduce federal spending substantially;
2. Reform entitlement programs (especially Medicare and Medicaid);
3. Reform the tax system to promote economic growth;
4. Do not raise marginal tax rates or the cost of capital;

5. Reduce the regulatory burden and cap the regulatory costs imposed on businesses;
6. Contain health care costs by introducing proper incentives and by tort reform;
7. Improve small businesses' access to capital;
8. Make smart investments in infrastructure, and
9. Reduce restrictions on domestic energy development.

How to accomplish these goals is more fully discussed below.

The magnitude of the fiscal problems that the United States will face over the coming two decades is genuinely disturbing. Congress must address these problems and solve them in the very near future. Otherwise, we will all face, but particularly our young people, a future of declining living standards, high unemployment and limited opportunity. Such a future for America is not acceptable.

The Status Quo is Unsustainable and will Lead to Economic Disaster

Currently the federal government is spending 56 percent more than its revenues.¹ In other words, its revenues are only 64 percent of its spending. FY 2011 spending is expected to be \$3,630 billion and revenues are expected to be \$2,314 billion for a deficit of \$1,316 billion.² This deficit amounts to about 8.8 percent of the Gross Domestic Product (GDP). In FY 2010, the federal budget deficit was 9 percent of GDP.

Making the unrealistic assumption of 4.8 percent GDP growth, 1.8 percent inflation and ½ of one percent interest rates in FY 2012, the Office of Management and Budget (OMB) estimates that the budget deficit will be \$956 billion in FY 2012 or 6.1 percent of GDP. CBO's baseline estimate for FY 2012 is similar, \$973 billion. But as CBO routinely acknowledges, these projections are a convenient fiction because they assume that various tax and spending policies that are in current law but have routinely been waived or changed by Congress and Presidents of both parties will not be similarly waived or changed in the future. If the past is prologue, then the U.S. is facing federal budget deficits of about six percent of GDP indefinitely.³ In this scenario, the debt as a percentage of GDP will grow indefinitely. It is therefore, an unsustainable path and will lead to federal insolvency.

The federal budget deficit for the three-year period from FY 2009 to the most recent fiscal year (FY 2011) ranged from 9 to 11 percent of GDP.⁴ This is unprecedented except during world wars and is much higher than during the Great Depression. Federal spending in FY 2009, FY 2010, FY 2011 and FY 2012 (projected) as a percentage of GDP is higher than at any time since World War II and much higher than during the Great Depression.

¹ See, Budget of the United States Government, Fiscal Year 2012, Historical Tables, Table 1.1, p. 23.

² Mid-Session Review, Budget of the U.S. Government, Office of Management and Budget, Fiscal Year 2012, September 1, 2011.

³ The Budget and Economic Outlook: An Update, Congressional Budget Office, August, 2011. See, in particular, figure 2, p. ix.

⁴ Ibid, Table 1.2, p. 25.

Federal interest already consumes 1.4 percent of the GDP and about six percent of federal spending and is expected by the Congressional Budget Office to reach 4.1 percent of GDP and 15 percent of spending by 2035. Under more plausible alternative assumptions, by 2035 federal interest expense will reach 8.9 percent of GDP and 26 percent of federal spending.⁵

CBO Interest Expense Projections

| | Current Policies | | Plausible Alternative | |
|-----------------------|------------------|------|-----------------------|------|
| | 2011 | 2035 | 2011 | 2035 |
| % of GDP | 1.4 | 4.1 | 1.4 | 8.9 |
| % of federal spending | 6 | 15 | 6 | 26 |

Under current policies, the Congressional Budget Office projects that debt held by the public will grow from an estimated 69 percent of GDP this year to 84 percent by 2035. Under more plausible alternative assumptions, debt would exceed 100 percent of GDP by 2021, exceed its historical peak of 109 percent by 2023 and would approach 190 percent in 2035.⁶ To our knowledge, no country in history has ever recovered from debt levels even close to the projected 190 percent. Thus future debt levels will be either crushing or, under the plausible alternative scenario, cause the federal government to fail within 25 years. It is deeply troubling to contemplate the state of this country if we go down the same path as Greece. Of course, there will be no one in a position to bail out the United States. Given the imbalances in the current budget, the projected spending growth, ever-increasing interest payments and current political divisions, it is unlikely the country will ever recover if debt levels grow much beyond 100 percent of GDP. We will experience a very long period of pronounced economic stagnation, declining living standards and high rates of unemployment. It is also highly probable that we will experience high rates of inflation if, as is likely, the government attempts to evade its debt by monetizing large portions of its debt.⁷

We must act now to prevent this fiscal calamity from occurring.

⁵ CBO's 2011 Long-Term Budget Outlook, June 2011, p 8.

⁶ CBO's 2011 Long-Term Budget Outlook, June 2011, p xi. The budget outlook is much bleaker under the Alternative Fiscal Scenario, which incorporates several changes to current law that are widely expected to occur or that would modify some provisions of law that might be difficult to sustain for a long period. Most important are the assumptions about revenues: that the tax cuts enacted since 2001 and extended most recently in 2010 will be extended; that the reach of the alternative minimum tax will be restrained to stay close to its historical extent; and that over the longer run, tax law will evolve further so that revenues remain near their historical average of 18 percent of GDP. This scenario also incorporates assumptions that Medicare's payment rates for physicians will remain at current levels (rather than declining by about a third, as under current law) and that some policies enacted in the March 2010 health care legislation to restrain growth in federal health care spending will not continue in effect after 2021. In addition, the alternative scenario includes an assumption that spending on activities other than the major mandatory health care programs, Social Security, and interest on the debt will not fall quite as low as under the extended-baseline scenario, although it will still fall to its lowest level (relative to GDP) since before World War II.

⁷ Or, in more colloquial terms, starts to print large amounts of money as its taxing and borrowing capacity diminishes.

CBO Debt Projections

| | Current Policies | | Plausible Alternative | |
|----------|------------------|------|-----------------------|------|
| | 2011 | 2035 | 2011 | 2035 |
| % of GDP | 69 | 84 | 69 | 190 |

The Cause of the Crisis

There are several causes for this crisis. One is demographics and the unfunded nature of our entitlement programs. A second is the recession and very, very weak recovery and continued high unemployment. The recession was precipitated by poor monetary policy, poor management and regulation of the financial markets, poor housing policy, high federal spending growth rates, high energy prices and a number of other factors. Its depth and the lack of a robust recovery have been exacerbated by unnecessarily tight credit markets for small business, poorly targeted stimulus spending and over ongoing over-regulation. The recession and abnormally slow recovery, in turn, causes a third problem, insufficient revenues and contributes to, but by no means is the sole cause of, the fourth problem. Federal spending is too high.

Since the end of World War II, taxes have typically been around 17 to 20 percent of GDP.⁸ Taxes have been slightly under 15 percent for the past three years, primarily due to the weak economy but also due to legislative changes. Tax revenues are projected by both OMB and CBO to grow to 19 to 20 percent of GDP under current law.⁹ Federal spending has, however, grown to the 24 to 25 percent of GDP range since FY 2009 and is projected to stay well above historical norms for the indefinite future.¹⁰ Out-year entitlement spending will make the problem dramatically worse. According to CBO projections, Social Security, Medicare and Medicaid spending will increase from 10.4 percent of GDP in FY2011 to 12.2 percent of GDP in FY 2021 and 15.5 percent of GDP in 2035. This constitutes a 49 percent increase in the share of economy consumed by federal entitlements. State entitlement spending and state and federal pensions (both civilian and military) make the budgetary situation even more bleak.

Spending Restraint is Pro-Growth

In principle, of course, some federal spending is pro-growth. Federal spending on infrastructure or the basic institutions of a free society may well have a rate of return higher than the all inclusive cost of securing the funds (although there are diminishing returns and at some point the spending can become excessive).¹¹ Most of the higher return projects have been or are being undertaken. Bridges to nowhere are not pro-growth.¹² Nonetheless, there almost certainly

⁸ Table 1.3—Summary Of Receipts, Outlays, And Surpluses Or Deficits In Current Dollars, Constant (FY 2005) Dollars, And As Percentages Of GDP: 1940–2016, Budget of the United States Government, Fiscal Year 2012, Historical Tables.

⁹ The Budget and Economic Outlook: An Update, Congressional Budget Office, August, 2011. Mid-Session Review, Budget of the U.S. Government, Office of Management and Budget, Fiscal Year 2012, September 1, 2011.

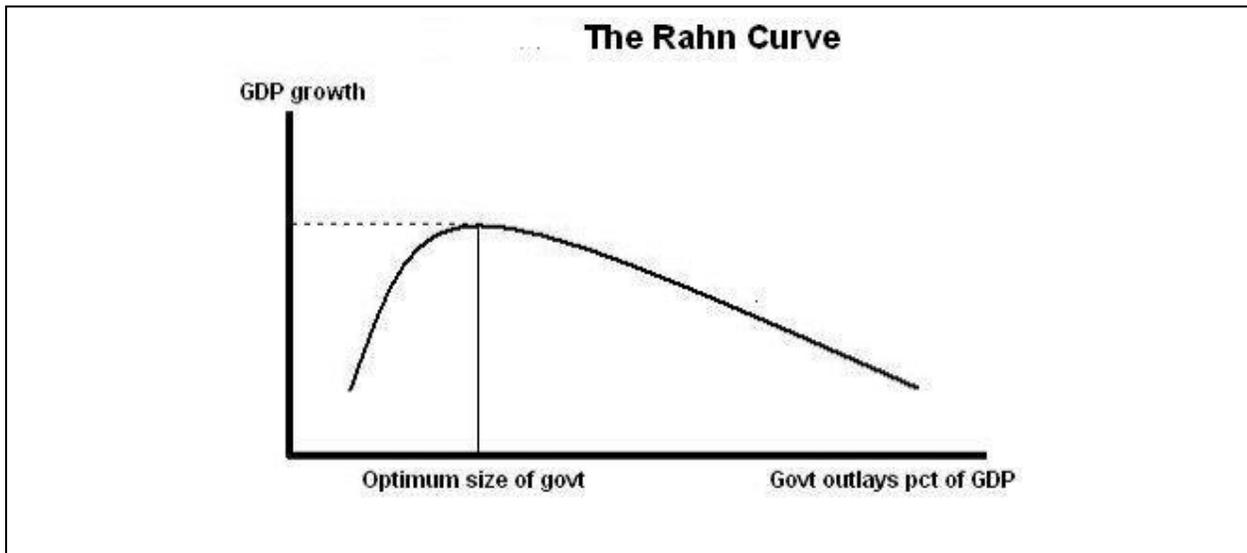
¹⁰ Table 1.3—Summary Of Receipts, Outlays, And Surpluses Or Deficits In Current Dollars, Constant (FY 2005) Dollars, And As Percentages Of GDP: 1940–2016, Budget of the United States Government, Fiscal Year 2012, Historical Tables.

¹¹ The direct cost plus indirect costs, most notably the deadweight loss (excess burden) of obtaining the revenue.

¹² Nick Jans, "Alaska Thanks You," USA Today, May 17, 2005.

remain infrastructure projects (roads and bridges, airports and ports, schools) that deserve to be funded.¹³ For example, having a modern, cost-effective passenger and freight transportation network with adequate capacity is pro-growth.

Initially, government spending on the basic institutions of a free society and on infrastructure that cannot reasonably be operated by the private sector is pro-growth. But there comes a point where government spending is counterproductive. Today, we are beyond that point. The figure below illustrates this concept.



In our current position, federal spending restraint is clearly pro-growth. Conversely, increasing federal spending harms economic growth and impedes job creation. The reason is relatively straight-forward. Funds spent by the federal government must come from one of three sources (taxes, borrowing or money creation) and obtaining money from these sources has a greater adverse economic impact than the positive impact of the spending. In more formal economic idiom, the income effects are equal and off-setting (the money spent is taken from someone else who therefore cannot spend it) but the substitution effects (incentive effects) are substantial and negative.¹⁴ Moreover, the majority of the additional federal spending being contemplated has a zero or negative rate of return rather than a substantial positive rate of return.

¹³ Although each of the following reports should be taken with a grain of salt since the parties have a strong interest in promoting infrastructure spending, they nonetheless demonstrate that there is a need for additional infrastructure spending. Well Within Reach: America's New Transportation Agenda, David R. Goode National Transportation Policy Conference, Norman Y. Mineta and Samuel K. Skinner, Conference Co-Chairs and former Secretaries of Transportation, Miller Center of Public Affairs, October 2010; Failure to Act: The Economic Impact of Current Investment Trends in Surface Transportation, by Economic Development Research Group, Inc. for the American Society of Civil Engineers, 2011.

¹⁴ Admittedly, money creation is a less obvious example. But money creation decreases the real purchasing power of other holders of money. Because money creation creates inflation, alters relative prices and distorts interest rates (especially real interest rates), it is probably a more damaging way to fund government spending than debt or taxes. Governments that resort to "printing money" and devaluing their currency to fund spending usually severely disrupt their economies and often virtually destroy them.

The fundamental point, obvious to most, is that federal spending must be paid for. It must be paid for with either taxes, borrowing or money creation and all of these sources of spending finance have an adverse economic effect. Securing the funds to pay for it has a substantial negative impact. If the cost of funding that spending is not outweighed by its benefits, it should not be undertaken.

Taxes reduce the incentive to work, save and invest and have well documented adverse economic effects. Money borrowed by the federal government is money that cannot be borrowed by companies to make productivity-enhancing investments or by consumers to spend on goods and services provided by the private sector.¹⁵ And money created under the rubric of “quantitative easing” devalues all existing money held by the private sector, increases prices over time, alters relative prices in a manner that makes planning difficult and reduces efficiency and reduces the value of the dollar on foreign exchange markets.¹⁶

Empirical studies have been conducted to find the growth maximizing rate of expenditure. They tend to find that the growth maximizing rate of government spending is in the 15 to 25 percent range.¹⁷ These studies suffer, however, from a lack of data from low spending jurisdictions, likely making the true figure lower.

Entitlement Reform is Mandatory

Medicare, Medicaid and, to a lesser extent, Social Security have massive unfunded liabilities and will place tremendous pressure on future state and federal budgets. They must be reformed and their expenditure growth paths brought under control. If not, the economic and fiscal future of this country is in peril.

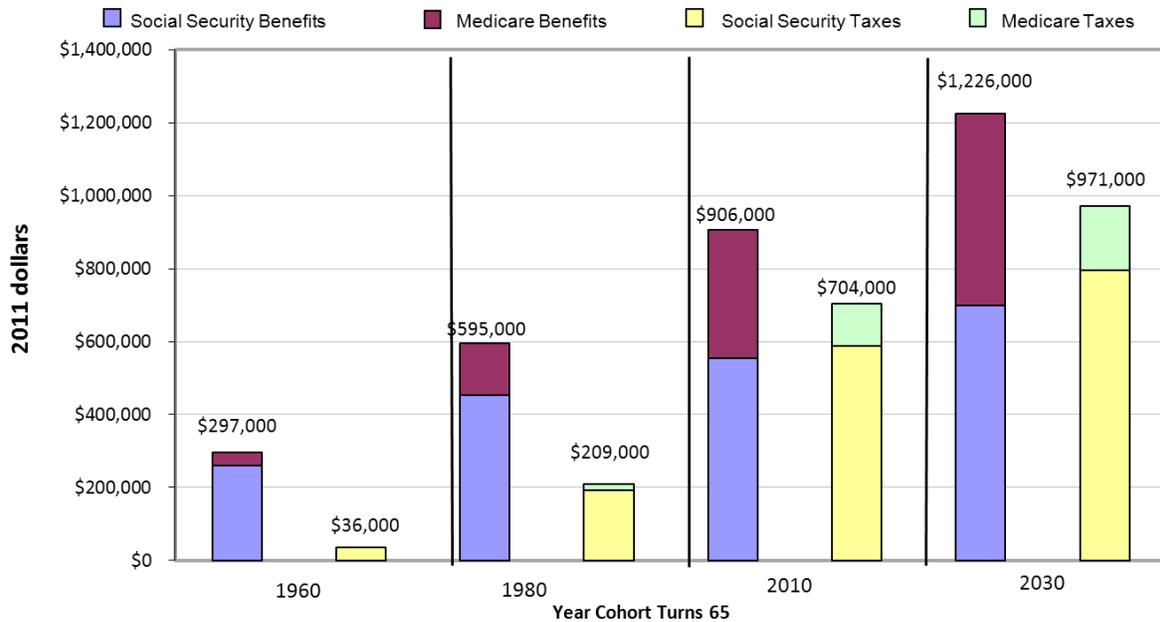
As a recent Urban Institute study shows, current recipients of Medicare and Social Security benefits are not paying anywhere near enough towards the programs to achieve fiscal balance (see graph on the next page). This remains true for the indefinite future and as the baby boom generation retires, the magnitude of the imbalances become severe for an extended period of time.

¹⁵ This effect is often colloquially called “crowding out.”

¹⁶ The increased money supply can find its way into almost any market, increases commodities prices, consumer prices, real estate prices, bond prices or stock prices.

¹⁷ For a recent survey of the empirical findings on the impact of government spending on growth, see Daniel J. Mitchell, “Supplemental Appendix” to “The Impact of Government Spending on Economic Growth,” *Heritage Foundation Backgrounder #1831*, March 15, 2005.

Social Security and Expected* Medicare Benefits and Taxes for Average-Wage, Two-Earner Couple (\$43.5k each)



* Expected rather than realized benefits. Notes: The “average” wage profiles are those hypothetical profiles used by the Social Security Administration in its analyses. Lifetime amounts are rounded and discounted to present value at age 65 using a 2 percent real interest rate and adjusted for mortality. Projections based on intermediate assumptions of the 2011 OASDI and HI/SMI Trustees Reports. Medicare benefits are net of premiums. Includes Medicare Part D. Source: Stephanie Rennane and C. Eugene Steuerle, 2011. Based on earlier work with Adam Carasso.

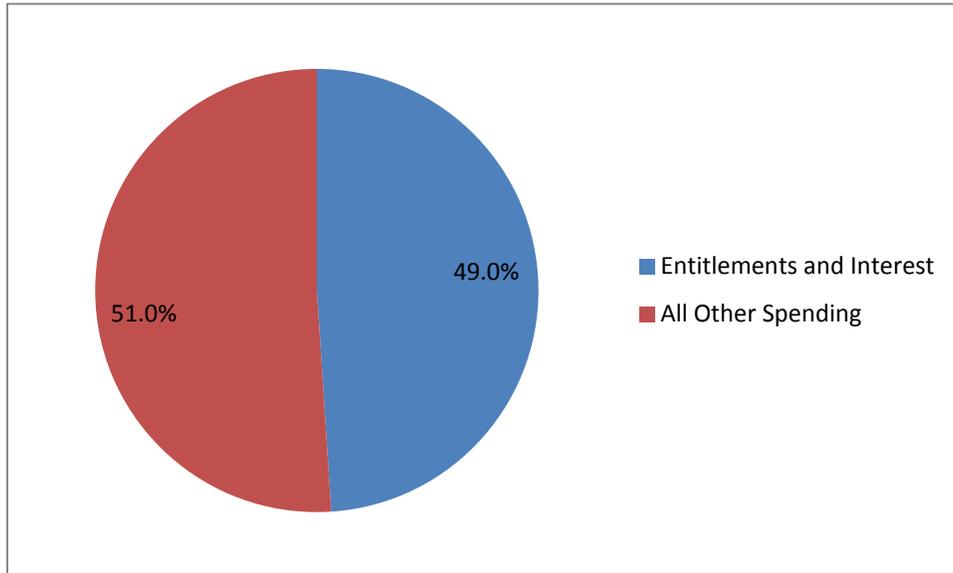
Source: Eugene Steuerle and Stephanie Rennane, Social Security and Medicare Taxes and Benefits Over a Lifetime, Urban Institute, June, 2011.

Young people are going to disproportionately pay the price of our current failed policies. They will live through the period of prolonged economic stagnation the policies will cause. They will be the most likely to be unemployed. They will receive an inadequate return on their savings. And as benefits are inevitably cut or taxes raised so that the entitlement programs do not fail, they will receive a negative return on the payroll taxes paid into the entitlement programs.

The CBO figures below show how entitlement spending (primarily spending on Social Security, Medicare and Medicaid) is going to soon totally dominate federal spending.¹⁸ Entitlement reform is therefore the central consideration when it comes to controlling future federal spending.

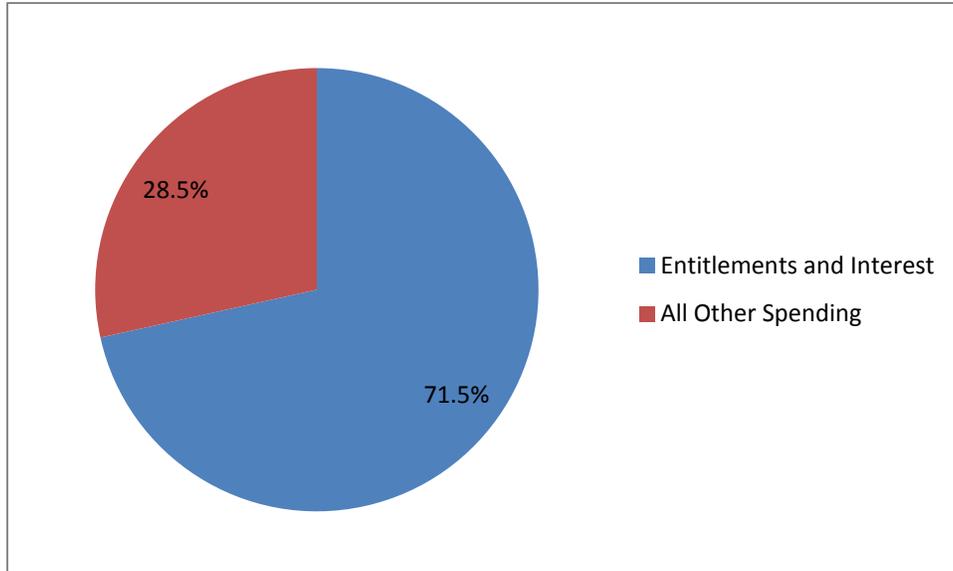
¹⁸ CBO’S 2011 Long-Term Budget Outlook.

2011 Entitlement Spending as a Share of All Federal Spending
CBO Baseline



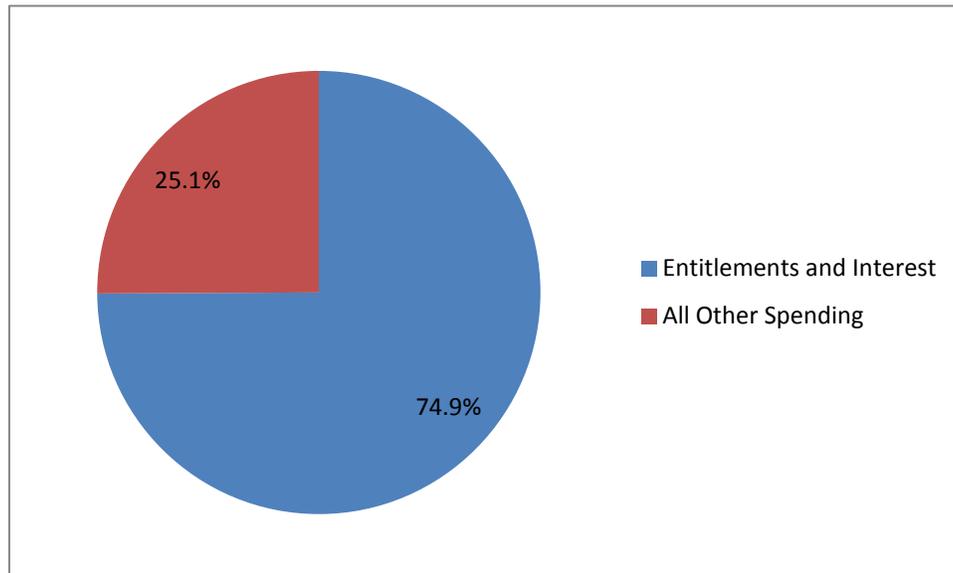
Note: Federal spending is 24.1 percent of GDP.

2035 Entitlement Spending as a Share of All Federal Spending
CBO Baseline



Note: Federal spending is projected to be 27.4 percent of GDP.

2035 Entitlement Spending as a Share of All Federal Spending
CBO Highly Plausible Alternative



Note: Federal spending is projected to be 33.9 percent of GDP.¹⁹

Medicare and Medicaid are the Major Problem

Over the past decade, Medicare expenditures have increased from 2.39 percent of Gross Domestic Product (GDP) in 2001 to 3.65 percent of GDP in 2011 or by 53 percent.²⁰ In another two decades, Medicare alone will consume 5.16 percent of GDP, an increase over 2001 of 116 percent.²¹ In nine years, the program will be running an annual deficit of \$92 billion and more than a trillion dollars over the typical 10 year budget window.²² The present value of Medicare's unfunded liabilities using the increasingly optimistic intermediate assumptions is now estimated to be \$34 trillion (or nearly four percent of projected GDP).²³ That corresponds to an annual deficit of \$600 billion in today's terms or \$6 trillion in a normal 10 year budget window.²⁴ It is also based on heroic assumptions that the very large provider reimbursement cuts²⁵ included in the Patient Protection and Affordable Care Act (PPACA) will actually occur. It is likely that these reductions are so high that, if implemented, providers will stop providing services to Medicare patients and that Congress will therefore waive these reductions as Congress has for

¹⁹ Thus, if state and local spending stay at 2010 levels of 14.5 percent of GDP, total government spending will reach 48.4 percent of GDP.

²⁰ 2011 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, May 13, 2011, Table III.A2, p. 49.

²¹ Ibid.

²² Ibid, p. 233.

²³ Ibid, pp. 228-229.

²⁴ Four percent of today's \$15 trillion GDP is \$600 billion.

²⁵ Richard S. Foster, Chief Actuary, Centers for Medicare and Medicaid Services, "Estimated Financial Effects of the 'Patient Protection and Affordable Care Act,' as Amended," April 22, 2010, p. 2 and Table III (appendix).

years.²⁶ Without these cuts (and the payroll tax hikes made by PPACA), the unfunded liabilities are really in the neighborhood of \$50 trillion.²⁷

By way of comparison, the net worth of all households and not-for-profit organizations in the U.S. is only \$56 trillion.²⁸ Thus, the real unfunded liabilities of a single federal program, Medicare, are very nearly equal to the wealth of every American. Once the national debt, unfunded Social Security obligations, state and local debt, and unfunded state, local and federal pension obligations are considered, the U.S. is already insolvent because of government policies. These policies must change dramatically and soon.

Over the next 8 years, Medicaid expenditures are projected to increase at an average annual rate of 8.3 percent and to reach \$840.4 billion by FY 2019 compared to \$430 billion in FY 2011.²⁹ Federal expenditures on Medicaid will very nearly double in the next eight years from \$272 billion in FY 2011 to \$513 billion in FY 2019.³⁰ State Medicaid spending will more than double in those eight years.³¹ By 2019, Medicare will place an additional quarter of a trillion dollar burden on state and federal budgets each year.

According to the Congressional Budget Office, federal spending on health care today is 5.6 percent of GDP.³² In ten years it will be 6.9 to 7.1 percent of GDP or 23 to 27 percent higher.³³ By 2035 (24 years from now), federal spending on health care will consume 9.4 to 10.4 percent of GDP and be 68 to 86 percent higher than today.³⁴ By 2021, federal health spending combined with Social Security will account for about three-fifths of federal non-interest spending.³⁵ By 2035, combined entitlement spending will account for two-thirds of federal non-interest spending.³⁶

²⁶ See, Donna Smith, "U.S. Deficit Panel Weighs Medicare Doctor payments," Reuters, Oct 12, 2011. Even this panel (charged to reduce the deficit) is evidently considering reversing these payment reductions which will increase rather than decrease federal spending and the deficit.

²⁷ As estimated by Medicare trustees for years prior to the passage of PPACA.

²⁸ Statistical Abstract of the United States, 2012, Table 722. Board of Governors of the Federal Reserve System, Flow of Funds.

²⁹ 2010 Actuarial Report on the Financial Outlook for Medicaid, p. iii-iv.

³⁰ *Ibid.*, p. 19.

³¹ *Ibid.*

³² CBO'S 2011 Long-Term Budget Outlook, p. 8.

³³ *Ibid.*

³⁴ *Ibid.*

³⁵ *Ibid.*

³⁶ *Ibid.*

Historical and Projected Medicaid Enrollment and Expenditures for Medical Assistance Payments and Administration, Selected Years (Enrollment in millions of person-year equivalents, expenditures in billions of dollars)

| Fiscal Year | Enrollment | Total expenditures | Federal expenditures | State expenditures |
|------------------|------------|--------------------|----------------------|--------------------|
| Historical data: | | | | |
| 1966 | 4.0 | \$0.4 | \$0.2 | \$0.2 |
| 1970 | 14.0 | 4.7 | 2.6 | 2.2 |
| 1975 | 20.2 | 12.6 | 7.0 | 5.6 |
| 1980 | 19.6 | 25.2 | 14.0 | 11.2 |
| 1985 | 19.8 | 41.3 | 22.8 | 18.4 |
| 1990 | 22.9 | 72.2 | 40.9 | 31.3 |
| 1995 | 33.4 | 159.5 | 90.7 | 68.8 |
| 1996 | 33.2 | 159.6 | 90.7 | 68.9 |
| 1997 | 33.0 | 166.0 | 93.9 | 72.0 |
| 1998 | 32.5 | 177.3 | 100.1 | 77.2 |
| 1999 | 32.1 | 190.0 | 107.5 | 82.5 |
| 2000 | 34.6 | 206.2 | 117.0 | 89.2 |
| 2001 | 36.9 | 229.0 | 129.8 | 99.2 |
| 2002 | 40.5 | 258.2 | 146.6 | 111.6 |
| 2003 | 43.5 | 276.2 | 161.0 | 115.1 |
| 2004 | 45.2 | 296.3 | 175.0 | 121.3 |
| 2005 | 46.5 | 315.9 | 180.4 | 135.5 |
| 2006 | 46.7 | 315.1 | 179.3 | 135.8 |
| 2007 | 46.4 | 332.2 | 189.0 | 143.2 |
| 2008 | 47.6 | 351.9 | 200.2 | 151.7 |
| 2009 | 50.11 | 378.6 | 246.3 | 132.3 |
| Projections: | | | | |
| 2010 | 52.9 | 404.9 | 271.4 | 133.5 |
| 2011 | 54.3 | 429.5 | 271.9 | 157.6 |
| 2012 | 54.8 | 456.4 | 260.3 | 196.1 |
| 2013 | 55.1 | 490.2 | 281.3 | 208.9 |
| 2014 | 67.1 | 564.3 | 340.2 | 224.1 |
| 2015 | 73.0 | 621.1 | 378.5 | 242.6 |
| 2016 | 75.6 | 676.5 | 414.6 | 261.9 |
| 2017 | 76.7 | 729.6 | 445.9 | 283.7 |
| 2018 | 77.4 | 781.1 | 477.0 | 304.1 |
| 2019 | 78.0 | 840.4 | 512.9 | 327.6 |

Source: 2010 Actuarial Report on the Financial Outlook for Medicaid, Office of the Actuary, Centers for Medicare & Medicaid Services, United States Department of Health & Human Services

The table above shows the radical increases that have occurred in the Medicaid program. From 1980 to the 2009, the average annual growth rate was 9.8 percent. From 2000 to the 2009, the average annual growth rate was 7.0 percent. From 2000 to the 2019, in the absence of policy changes, the average annual growth rate will have been 7.7 percent (compounding annually).³⁷

Once the full implications of these numbers are absorbed, the staggering size of the problem the United States faces is genuinely disturbing. Major reforms to these programs are

³⁷ Calculations using Excel based on the figures in the above table.

mandatory and urgent.

Social Security Needs to be Addressed but Problems are Manageable

Social Security has serious problems but they are manageable and can be addressed through incremental changes in the program (if changes are made soon) or through more dramatic reforms.

In 2010, for the first time, Social Security benefit payments exceed payroll tax revenue.³⁸ By 2020, using intermediate assumptions, benefit payments will exceed payroll tax revenue by \$119 billion.³⁹ Once administration costs are included, Social Security will be contributing about \$124 billion to the deficit. When Disability Insurance is added, the annual deficit will be about \$155 billion in 2020.⁴⁰ The Trust Fund will not technically be insolvent, however, because the government pays interest to itself. The Trust Fund receives interest paid on bonds it holds. That interest is paid out of the general fund.

In 2010 there were 2.9 covered workers per beneficiary. In 2020, this ratio will fall to 2.5. By 2030, it will be only 2.1 covered workers per beneficiary. In contrast, in 1945 there were 41.9 covered workers per beneficiary, in 1960 there were 5.1 per beneficiary and as recently as 1980 there were 3.2 per beneficiary. Asking young people to support not only themselves and their families but almost pay half of the expense of a baby boomer's retirement years is asking a lot.⁴¹

The present value of Social Security's unfunded liabilities (using intermediate assumptions) is \$8 trillion over the next 75 years and \$17.9 trillion eventually.⁴² Social Security spending (OASDI) will be 4.85 percent of GDP in 2011. Using intermediate assumptions, it is expected to be 5.32 percent of GDP in 2020 and 6.12 percent of GDP in 2030.⁴³ Its deficits will

³⁸ The 2011 Annual Report of the Board of Trustees of the Federal Old-age and Survivors Insurance and Federal Disability Insurance Trust Funds, Table IV.A1.—Operations of the OASI Trust Fund, Calendar Years 2006-20, p. 36.

³⁹ Ibid.

⁴⁰ The 2011 Annual Report of the Board of Trustees of the Federal Old-age and Survivors Insurance and Federal Disability Insurance Trust Funds, Table IV.A3.—Operations of the OASI and DI Trust Funds, Calendar Years 2006-20, p. 42.

⁴¹ The 2011 Annual Report of the Board of Trustees of the Federal Old-age and Survivors Insurance and Federal Disability Insurance Trust Funds, Table IV.B2.—Covered Workers and Beneficiaries, Calendar Years 1945-2085, p. 53.

⁴² The 2011 Annual Report of the Board of Trustees of the Federal Old-age and Survivors Insurance and Federal Disability Insurance Trust Funds, Table IV.B5.—Components of 75-Year Actuarial Balance Under Intermediate Assumptions, p. 64, and Table IV.B7.—Present Values of OASDI Cost Less Non-interest Income and Unfunded Obligations for Program Participants, Based on Intermediate Assumptions, p. 67.

⁴³ The 2011 Annual Report of the Board of Trustees of the Federal Old-age and Survivors Insurance and Federal Disability Insurance Trust Funds, Table VI.F4.—OASDI and HI Annual and Summarized Income, Cost, and Balance as a Percentage of GDP, Calendar Years 2011-85, p. 187.

be 0.3 percent of GDP in 2011, 0.43 percent of GDP in 2020 and 1.27 percent in 2030.⁴⁴ In today's terms, that means that the 2030 deficit will be about \$190 billion.

Social Security can be returned to balance and pose a minimal burden on young and middle aged workers if it is reformed now. This can be accomplished in the context of the current government system by taking two steps:

- Increase the retirement age to reflect longer life expectancy
- Index benefits to inflation rather than wage increases

Life expectancy at age 65 in 1940 was 77.7 for men and 79.7 for women. In 2034, it is expected to be 84.2 for men and 86.4 for women, an increase of 6.5 years for men and 6.7 years for women. Life expectancies at birth are, of course, much lower. In its early years, a large percentage of people did not even live to collect Social Security checks even though they had paid into the system for most of their working life. Now most do. Life expectancy at birth for those born in 1940 was an average of 63.6 years. In 1960, it was 69.9. In 2005, the average life expectancy at birth reached 78 years.⁴⁵

At the advent of the Social Security system, the average life expectancy at birth was less than the retirement age. Now, it is about 11 years past the retirement age and those that make it to 65 will on average receive benefits for about 18 years. It makes sense to raise the retirement age over time by "indexing" it to life expectancy.

Once a person retires, Social Security benefits are indexed to inflation. But the annual benefit for newly retired persons increases each year by the amount that wages increase. It is time to put a cap on benefits so that they increase only by the amount of inflation. This would effectively hold Social Security benefit constant in real terms rather than have them increase indefinitely.

These two steps would result in the current Social Security system achieving solvency.

If the system is reformed now, it can be made to work without gut-wrenching changes and without harming current retirees and still not be a major contributor to the coming fiscal train wreck. If, however, policy-makers continue to wait to reform the system, Social Security will either be a major contributor to our fiscal problems or major, job destroying tax increases are in our future or substantial and sudden benefit cuts for future retirees will be necessary.

Restraining Health Care Costs is Important to Economic Growth and Job Creation

The Economic Impact of Rising Health Care Costs

⁴⁴ Ibid.

⁴⁵ National Vital Statistics Reports, Vol. 58, No. 21, June 28, 2010, Table 11. Life expectancy by age, race, and sex: Death-registration states, 1900–1902 to 1919–1921, and United States, 1929–1931 to 2006, U.S. Department Of Health And Human Services Centers for Disease Control and Prevention p. 29.

Health care spending in the United States has increased from 12.5 percent of GDP in 1990 to 13.8 percent in 2000 to 17.6 percent in 2009. Nearly one in six dollars spent in the U.S. are spent on health care. This makes our country's health care system uniquely expensive. By almost any metric (life expectancy at birth or age 65, infant mortality, etc.), our system does not deliver materially better results than other advanced countries' health care systems.

International Comparison of Health Expenditures (Public and Private), 2008⁴⁶

| | |
|----------------|-------|
| United States | 16.0% |
| Canada | 10.4% |
| France | 11.2% |
| Germany | 10.5% |
| Italy | 9.1% |
| Netherlands | 9.9% |
| Switzerland | 10.7% |
| United Kingdom | 8.7% |

Rising health costs consume most of the real wage increases that ordinary Americans receive. They impose a huge expense on business and harm our international competitiveness. They will make our state and federal budget difficulties nearly intractable.

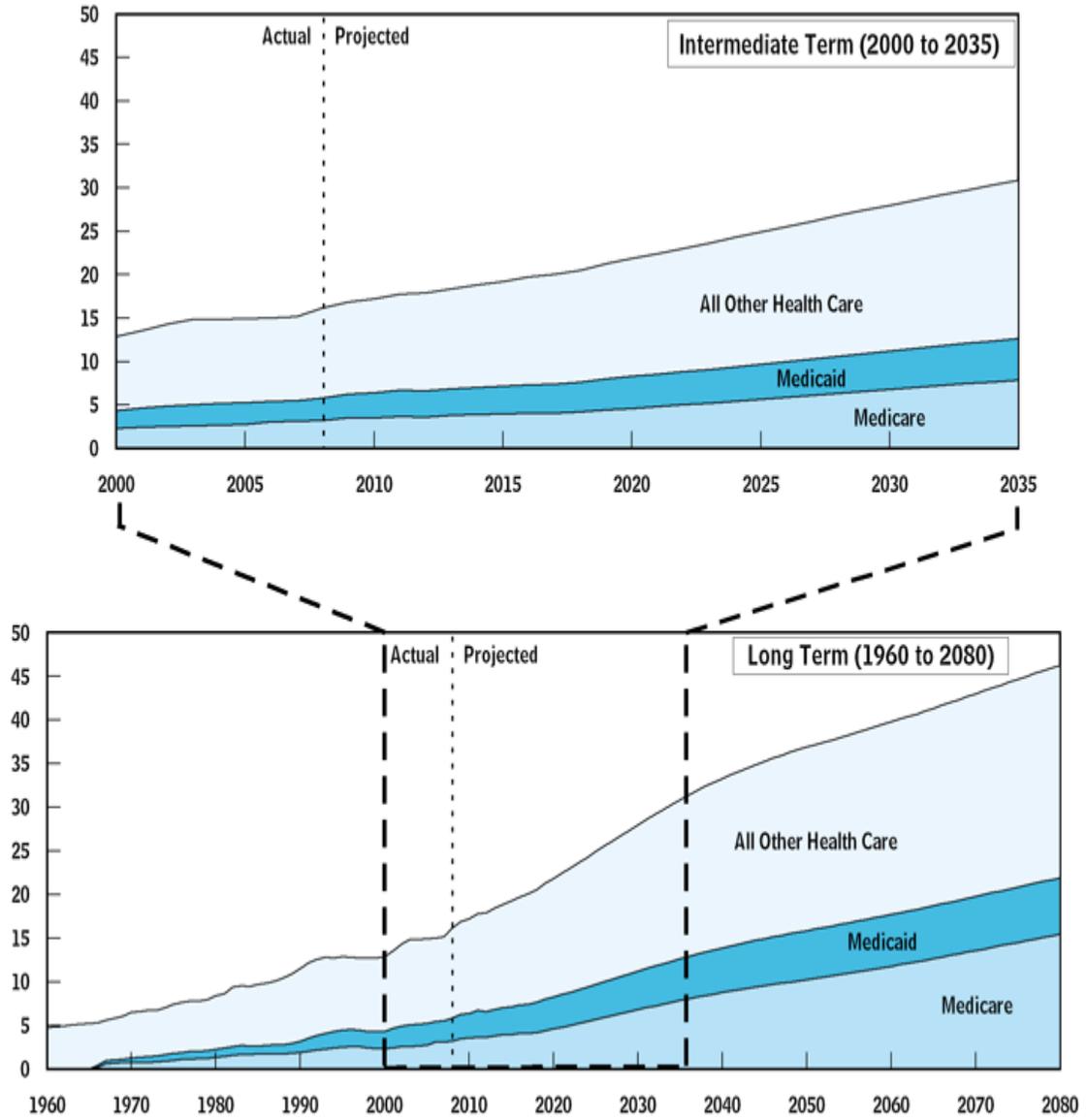
Restraining rising health costs will:

- Dramatically improve federal and state budgetary situation;
- Dramatically improve the cash compensation of working Americans; and
- Substantially improve the international competitiveness of U.S. businesses.

The CBO projections below show this problem getting steadily worse, with total health care spending reaching an absurd 25 percent of GDP by 2035. It is a problem that simply must be addressed. And one thing is certain. Simply making adjustments around the edges of the current system will not solve the problem.

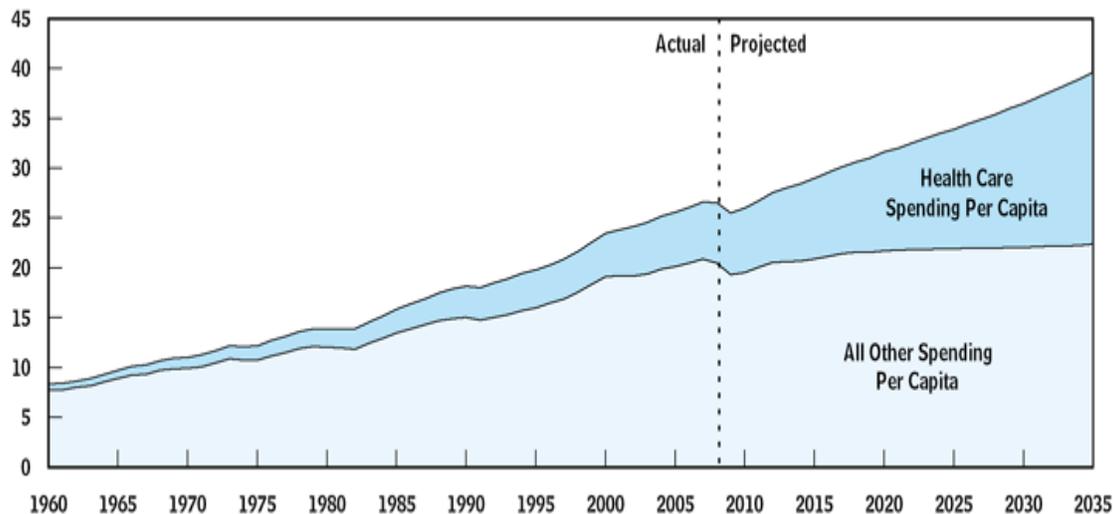
Total Spending for Health Care Under CBO's Extended-Baseline Scenario
(Percentage of Gross Domestic Product)

⁴⁶ Statistical Abstract of the United States, 2012, Table 1346.



Source: Congressional Budget Office, Long-Term Outlook for Health Care Spending, 2009.

Total Health and Nonhealth Spending Per Capita
Under CBO's Extended-Baseline Scenario
(Thousands of 2009 dollars)



Source: Congressional Budget Office, 2009

Principles of Health Care Cost Constraint

The current health care marketplace is thoroughly broken and bears no resemblance to a normal market. There is virtually no competition on the basis of price. Information about quality regarding providers is very difficult to obtain. Neither providers nor consumers have a meaningful incentive to economize and a third party pays for the decisions made by consumers and providers of health services. In fact, almost all of the incentives in the current system are to spend more money.

Consumers, although they have some first dollar cost-sharing, have no incentive at the margin to economize on health care costs. Generally, the marginal cost to consumers under private insurance and under Medicare and Medicaid is zero. This must change. We must move the private and government health systems toward positive marginal costs to consumers. As has been almost universally understood by economists since the 1870s, it is at the margin that decisions are made. If there is a marginal cost to the consumer of ordering an additional test or choosing a more expensive treatment, then consumers will have some incentive to economize. The current flat deductive and flat co-pay system means that there is no marginal costs to consumers for electing more expensive health care.

Another reason for high hospital costs are mandates on hospitals to treat those that arrive at the emergency room for free if necessary. By this mechanism, a large number of uninsured persons received free medical care. Providing this care, however, is not free and the hospitals recover it in the end by higher bills to paying patients.

Moreover, the employer-provision of health insurance (driven by the tax exclusion for employer provided health insurance) further breaks the link between health care expenditures by

consumers and the cost of providing those expenditures. Generally, a consumer's health care costs consist of a deductible (which is so low it is almost always exceeded) and minor co-payments. There is little to no variance in a consumer's health care costs depending on the degree to which health care services are used.

Providers, meanwhile, have every incentive to provide more health care because by providing more services they make more money. They are under no pressure to compete on the basis of price because the health care consumer generally faces a zero marginal cost. Very little information is available or provided regarding quality. Artificial limits are placed on the number of newly minted doctors each year. Medicare, Medicaid and private insurers are under tremendous pressure to simply pay the medical bills presented to them and are treated as pariahs by politicians and the media if they attempt to push back on health care provider costs.

There is one obvious exception to the forgoing analysis: the case of elective procedures such as corrective eye laser surgery or cosmetic surgery. In these medical fields, competition on the basis of price and quality is commonplace. The reason, of course, is that the consumer is footing the bill.

Neither does the current system possess the cost containment features of a government run system. The government is not in a position to dictate prices and salaries to health care providers. It cannot use monopoly power to dictate to suppliers.

In short, we have the worst of both worlds. A private market without any of the normal market mechanisms that lead to efficiency, cost control and quality gains. A government insurance system that has almost none of the cost containment features that a single-payer, monopoly, socialized system would have. Thus, we have the most expensive health care system in the world. We cannot afford it.

The health care system must be changed so that:

- Consumers have substantial marginal costs when consuming health care services;
- Consumers benefit financially when they economize on health care services;
- Health care providers compete on the basis of price;
- Health care providers compete on the basis of quality and outcomes;
- Health care providers have a substantial incentive to economize; and
- Genuinely unwarranted medical malpractice claims or excessive awards are limited.

Maintaining the present system will accomplish none of these goals. Both President Obama's PPACA and Rep. Paul Ryan's Medicare reform proposal move towards a premium support system (where government subsidizes the purchase of private insurance). They retain the basic structure of the current health care system with no meaningful consumer costs at the margin and little incentive for consumers or providers to economize. In Rep. Ryan's case, the plan may succeed in shifting costs from government onto private citizens, but it can be expected to do little to reduce overall health care costs.

Ensuring that consumers bear meaningful marginal costs and that therefore providers in competing for those consumers have a reason to compete on the basis of price and quality can be accomplished without harming the poor or lower middle class. Instead, however, of subsidizing insurance premiums, government funds could be used to provide individuals with a stipend for health care expenses that if not used for health care expenses because the consumer effectively economized can eventually be used by the consumer for whatever they want. In this way, there is a real incentive for everyone involved in the system to economize.

Tort reform can also contribute to health care cost containment. The Congressional Budget Office estimates that a modest medical malpractice reform law would save over \$50 billion through 10 years. However, those savings would continue to increase as the cost of medical malpractice litigation in the U.S. continues to grow, steadily increasing at almost 12 percent annually since 1975. Moreover, according to the Harvard School of Public Health, 40% of malpractice suits filed in the U.S. are “without merit.” In general, studies place the direct and indirect costs of malpractice between 5 percent and 10 percent of total US medical costs.

Beyond traditional medical malpractice laws, NSBA supports some kind of safe harbor for physicians, as well as the use of health courts. Any safe harbor rule would have to be in conjunction with federally-defined, evidence-based medical procedures. Physicians, who abide by those standards and report outcomes, would be allowed a certain level of protection from medical liability. Health courts would allow for the establishment of specialized courts for dealing with medical malpractice claims. NSBA surveys show 83 percent of small businesses support monetary caps in medical malpractice cases. That survey also found that a majority support addressing the issue federally. Tort reform traditionally has been dealt with at the state level; however, the National Conference of State Legislatures cites 17 states where there are no stipulations whatsoever on medical malpractice lawsuit caps. The broad variance in states’ laws encourages attorneys to forum shop, which simply increases the need for a federal solution.

Tax Reform Helps Solve the Problem

Tax Reform is Pro-Growth and Will Increase Revenues and Reduce Spending

The impact of replacing the current tax system with a consumption tax (for example, the FairTax) 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.⁴⁷ That means that marginal tax rates could be reduced by 9 to 17 percent and raise the same amount of revenue.

⁴⁷ 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

Tax Reform Will Reduce Wasteful Compliance Costs

Compliance costs are the costs incurred by taxpayers complying with the tax system. The compliance costs incurred by businesses are estimated to be about \$95 billion annually but may be as much as 50 percent higher.⁴⁸ Individual and not-for-profit compliance costs are, of course, quite substantial as well. In the case of small businesses these costs include the time of small business owners and their accounting staff devoted to collecting necessary information and filling out IRS forms and the costs incurred hiring outside accountants and lawyers for advice about how to comply with the tax law. Small business compliance costs relative to income or revenues are disproportionately high. A recent SBA study quantifies this disproportionate impact, showing that the impact on small firms in terms of per employee costs is three times that of larger firms.⁴⁹

| Cost per Employee | All Firms | Firms with <20 Employees | Firms with 20-499 Employees | Firms with 500+ Employees |
|--------------------------|------------------|------------------------------------|------------------------------------|----------------------------------|
| Tax Compliance | \$800 | \$1,584 | \$760 | \$517 |

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. Also see, Bachman, Paul, Jonathan Haughton, 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.

⁴⁸ Nicole V. Crain and W. Mark Crain, "The Impact of Regulatory Costs on Small Firms," U.S. Small Business Administration, Office of Advocacy, September, 2010, p. 29. See also, United States Government Accountability Office, "Summary of Estimates of the Costs of the Federal Tax System," August 2005, GAO-05-878 (business compliance costs are \$40 to \$85 billion annually); J. Scott Moody, Wendy P. Warcholik, and Scott A. Hodge, "The Rising Cost of Complying with the Federal Income Tax," Tax Foundation Special Report No. 138, December 2005 (business compliance costs are \$148 billion annually).

⁴⁹ Nicole V. Crain and W. Mark Crain, "The Impact of Regulatory Costs on Small Firms," U.S. Small Business Administration, Office of Advocacy, September, 2010, Table I, p. 7.

There will always be some compliance costs in any tax system. But today these costs are very high. And if there is one thing the NSBA membership is almost universally agreed on, it is that the current compliance costs are too high and that the tax system needs to be simplified.

We should aim to raise the revenue needed by the federal government in the least costly way. The costs of the current system represent a huge waste of resources that could be better spent growing businesses, creating new products, conducting research and development, or purchasing productivity enhancing equipment.

These costs also represent a significant drag on the economic growth, job creation and international competitiveness of U.S. businesses. Compliance costs must be recovered by businesses in the sales price of their goods or services. Otherwise, the businesses will fail. Reducing these costs is within our control and it should be a priority of Congress. Furthermore, there is strong reason to believe that U.S. costs are substantially higher than those of most other developed nations.

What Tax Reform Is and Is Not

Tax reform is not a tax increase. And tax reform is not just repealing deductions credits and exclusions. Meaningful tax reform is a coherent set of reforms designed to promote economic growth, reduce complexity, reduce administrative costs, increase transparency and voluntary compliance in an equitable manner. In order to promote economic growth, tax reform must reduce marginal tax rates without raising the cost of capital.

All “Base-Broadeners” Are Not Created Equal

Adequate capital cost recovery allowances, preferably expensing, are critical to maintaining a reasonable cost of capital and to firms of all sizes being able to afford the capital investment necessary to compete in the international marketplace.⁵⁰ It is hard to overstate this point. Capital formation is critical to maintaining long-term competitiveness and preserving relatively high U.S. wage rates. Unless U.S. firms invest in productivity-enhancing or innovative cutting-edge equipment that provides new capabilities, U.S. firms will only be able to compete by accepting lower returns and by paying workers less. If, of course, they fall far enough behind their domestic and foreign competitors, the firms will simply fail.

Section 179 expensing is of vital importance for smaller firms, particularly those in more capital intensive industries. It should be retained or expanded. For now, section 179 eliminates the tax bias against savings and investment for firms that can take advantage of it. It reduces the user cost of capital considerably for small firms. For 2011, up to \$500,000 of investment purchases may be deducted.⁵¹ In 2012, the figure falls to \$125,000. Thereafter, unless Congress acts, the amount deductible will fall to \$25,000. This latter limitation dramatically limits the number of firms that can appreciably benefit and dramatically reduces the economic effect of the provision. Retaining the current \$500,000 threshold should be high on the Congressional agenda.

Tax Reform should Place Foreign and Domestic Manufacturers on an Even Footing and Remove Impediments to Exporting

An origin principle tax system taxes goods and services based on where they were produced or originated rather than where they were purchased or consumed. In an origin principle tax system, the production of goods and services in the taxing country is taxed no matter where the goods and services are sold, used or consumed. In a destination principle consumption tax, goods consumed in the taxing country are taxed whether the goods or services were produced domestically or abroad. Exported goods are not taxed.

⁵⁰ Expensing is always the correct answer in a consumption tax where either (i) interest is neither taxable nor deductible or (ii) debt proceeds are includible in the taxable base and principle and interest are deductible. In a hybrid system, such as the current U.S. system, some limits on debt financed investment in expensed property may be appropriate. As a practical matter, this will only be important in the case of large enterprises with large borrowing capacity.

⁵¹ The section 179 deduction is not available to firms investing \$2.5 million or more.

The individual and corporate income tax and payroll tax raise well over 90 percent of the revenue collected by the federal government. These taxes are origin principle taxes. Most consumption taxes (including sales taxes⁵², European style credit-invoice type value added taxes, Canadian and Australian goods and services taxes⁵³ and proposed business transfer taxes⁵⁴) are destination principle taxes. The Flat Tax and various proposed consumed income taxes⁵⁵ are, however, origin principle systems.

It is a common fallacy that having a destination principle tax like a VAT or a GST helps domestic exporters and hurts foreigners importing goods into the taxing country. This is not the case because both domestic and foreign goods are subject to the same tax when consumed domestically. This is why VATs and GSTs are legal under World Trade Organization rules.

What **will** help U.S. producers and impose a greater effective tax burden on foreigners importing goods into the U.S. would be to **replace** the current origin principle taxes with a destination principle consumption tax. There are two reasons for this. First, exports will no longer bear a U.S. tax burden and imports, for the first time, will bear the same tax burden as U.S. goods. Second, as discussed below, a consumption tax reduces the U.S. user cost of capital and will increase the U.S. capital stock and hence the productivity of U.S. businesses.

The current tax system taxes U.S. producers whether they are selling in U.S. or foreign markets and imposes no appreciable tax on foreign producers selling goods into the U.S. It, therefore, places U.S. producers at a considerable disadvantage.⁵⁶ Were the U.S. to replace the current tax system with a destination principle consumption tax (such as the FairTax) then, for the first time in nearly a century, the U.S. government through its tax system would no longer be according a major advantage to those who produce goods abroad over those that produce goods in the U.S.

The FairTax

There are many ways to improve the tax system. To improve on the current system doesn't take a lot. But NSBA regards the FairTax (S. 13, H.R. 25) as the best fundamental tax reform proposal. It would have a dramatic positive impact on economic growth, job creation, real wages, investment and international competitiveness. A summary of why:

1. The FairTax would be simple and dramatically reduce compliance costs have a disproportionate negative impact on small firms. The resources currently used to comply with the present tax system can be better used growing businesses,

⁵² Including U.S. state sales taxes and proposed national sales tax such as the FairTax.

⁵³ GST is essentially just another name for credit-invoice type VAT.

⁵⁴ These are subtraction method value added taxes.

⁵⁵ A consumed income tax is sometimes called an expenditure tax (Kaldor), cash flow tax (Aaron-Galper) or inflow-outflow tax (Ture) depending on the author or analyst. The only significant difference among the various proposals is the inclusion (or not) of the proceeds from debt in the tax base and the deduction from the tax base of principal payments.

⁵⁶ There is an argument sometimes made that exchange rates will adjust to compensate for this effect. It is beyond the scope of this short statement to address that subject. Suffice it to say that the tax system alters costs, relative prices and rates of return and therefore alters behavior, in this case, just like other better understood cases.

creating new products, conducting research and development, purchasing productivity enhancing equipment or reducing prices to customers.

2. The FairTax would be neutral toward savings and investment and reduce the user cost of capital substantially. The capital stock would therefore grow. Productivity, innovation and real wages would increase.
3. The FairTax has much lower marginal tax rates than the current tax system and has virtually the lowest possible marginal tax rate consistent with a neutral tax treatment of savings and investment.⁵⁷ It would dramatically reduce the tax disincentive to work, save and invest. The double taxation of corporate income (i.e. dividends and individual capital gains that are a function of retained corporate earnings) would be eliminated.
4. Entrepreneurial risk-taking and innovation would increase because more investment capital would be available and the tax on capital gains would be zero.
5. The U.S. would attract capital from throughout the planet. Investment in the U.S. whether by Americans or foreigners would not be taxed. The U.S. would, in effect, become the largest tax haven in the world. The “giant sucking sound” you would hear, to paraphrase Ross Perot’s memorable metaphor, would be the U.S. attracting capital from throughout the world. Having adequate capital is important for all businesses but particularly important for small and start-up businesses.
6. For the first time, the tax system would impose the same tax burden on foreign produced goods and U.S. produced goods. The FairTax would eliminate the current origin principle system that places U.S. based firms at such a large disadvantage. This is because the FairTax is a destination principle tax (i.e. it is, in effect, border adjusted).

Tax Increases are Anti-Growth and Will Harm Job Creation

Overall Economic Impact of Tax Increases

Tax increases that raise marginal tax rates reduce the incentive to work, save and invest. Marginal tax rate increases have well understood and well documented adverse economic effects. Tax increases that raise the cost of capital (including rate increases, reductions in section 179 allowances or capital cost recovery allowance or capital gains tax rate increases) will reduce investment, productivity, international competitiveness, growth and real wages.

⁵⁷ The only reason it does not have the lowest possible rate theoretically possible is the rebate that prevents the poor from paying any federal income or payroll tax and reduces middle class effective tax rates substantially.

Individual Tax Rates and the Taxation of Pass-through Entities are Key for Small Businesses

Most small businesses are sole proprietorships, subchapter S corporations or limited liability companies. Most of the remainder are partnerships (either limited or general). There are also some business trusts. All of these businesses are pass-through entities that are subject to individual tax rates not the corporate tax rates. Some small businesses are C corporations that are subject to the corporate income tax, but these are a relatively small percentage and a large portion of these companies' net income before compensating the owners' is usually consumed by paying the owners' salary.⁵⁸ This salary is also subject to the individual tax rates.

Thus, for the overwhelming majority of small businesses, individual marginal tax rates are much more important than corporate marginal tax rates. Since small businesses disproportionately contribute to job creation, raising individual marginal tax rates can be expected to have a disproportionate negative impact on job creation.

Major Tax Increases Will Inevitably Harm the Middle Class and Small Businesses

Abstracting away from the adverse economic effects it would have, raising marginal tax rate to tax the rich can only accomplish so much. Today, assuming an average marginal state tax rate of six percent, the top marginal tax rate is 43.9 percent. In 2013, it will be 50.3 percent. Once the rate gets much above 60 percent or so, raising the rate further should not be expected to raise revenue. Rates above 60 percent have been shown to have such a significant adverse impact on the incentive to work, save or invest that they reduce the tax base so much that further rate increases raise little or no revenue.

The bottom line is this. The deficit cannot be closed by taxing rich people. It is not simply questionable policy. It is arithmetically impossible. If the deficit is to be closed by tax increases, the middle class (including small business owners) will have to bear the burden because that is still where the money is.

Senate Majority Leader Reid and others have proposed raised the tax rate on those earning over \$1 million annually by 5.6 percent. This proposal has been scored as raising \$453 billion over ten years, an average of \$45 billion per year.⁵⁹ An increase of twice that amount (11.2 percent) then would be scored as raising about \$90 billion per year. Such an increase, however, would put the top marginal tax rate at 61.5 percent in 2013. Any further rate hikes cannot be expected to raise revenue but just harm the economy. Yet \$90 billion is only six percent of last year's deficit. In short, the deficit problem cannot be solved by tax increases on the rich.

Looked at another way, taxpayers with incomes over \$1 million have taxable incomes totaling \$623 billion.⁶⁰ They pay federal income taxes of \$177 billion. They probably pay state

⁵⁸ For data on the composition of small business entities, see "Present Law and Background Relating to Selected Business Tax Issues," Joint Committee on Taxation, Part III, September 19, 2006, JCX-41-06.

⁵⁹ See CBO letter of October 7, 2011 from Douglas W. Elmendorf to Sen Harry Reid.

⁶⁰ IRS Statistics of Income, "Table 1.1 Selected Income and Tax Items, by Size and Accumulated Size of

income taxes on the order of five percent or \$31 billion. Thus, assuming they pay no other taxes (payroll, real estate, sales), they would have \$415 billion. If the federal government simply confiscated this money by imposing a 100 percent tax, it would only reduce last year's deficit by one-third. Two things would follow in quick succession. First, the economy would enter a tail spin and in the second year the government would collect zero revenue from rich people since there would be no point to them earning any money. Yet the government would still have a deficit approaching a trillion dollars.

Regulatory Reform Helps Solve the Problem

The Economic Impact of Regulations

Estimates of the total cost of regulation in the economy as a whole are quite high. The study entitled "The Impact of Regulatory Costs on Small Firms" by Nicole V. Crain and W. Mark Crain, September 2010, commissioned by the Small Business Administration, appears to be the best work on the economy-wide costs of regulation. It estimates that the total cost of federal regulations in 2008 was \$1.75 trillion or about 12 percent of GDP.⁶¹ This represents a substantial increase over time and given the current regulatory environment it is virtually certain that costs are higher relative to GDP now than in 2008.

Regulatory Reform

The current system of placing constraints on regulation by the federal government is both complex and ineffective. The Administrative Procedure Act, Executive Orders 13258, 13422 and 13563, Office of Management and Budget Circular A-4, the Regulatory Flexibility Act of 1980, the Small Business Regulatory Enforcement Fairness Act of 1996 and the Paperwork Reduction Act all have had some positive effect. On the whole, however, agencies have become quite proficient at evading their strictures when they wish to pursue a regulatory agenda. The scope, cost and intrusiveness of federal regulations continues to grow. That needs to change.

A National Regulatory Budget

It is clear that the current system of constraints on the costs that federal agencies may impose on society is ineffectual. A new system is required. The potential savings and positive impact on economic growth and living standards of imposing meaningful restraint on the regulatory actions of federal agencies is large.

Establishing a National Regulatory Budget (NRB) would impose strict, enforceable constraints on the ability of the federal government to impose regulatory costs on the public.

Adjusted Gross Income, Tax Year 2009."

⁶¹ See also, "Analysis of an Estimate of the Total Costs of Federal Regulations, Curtis W. Copeland, Congressional Research Service, April 6, 2011. This analysis reviews various critiques of the Crain study but still places the overall figure very high.

A National Regulatory Budget would entail the following:

1. Obtain independent, rigorous, fact-based estimates of the cost of all existing regulations by agency. This could be accomplished by the formation of an independent agency (e.g. a National Economic Laboratory) or assigning the task to an existing agency with a record of independence (e.g. the Bureau of Economic Analysis at the Commerce Department). This need not be terribly costly. It would probably require about \$30 million annually⁶² and these costs could be offset by terminating all of the existing positions throughout the government that, in principal, conduct cost-benefit analyses currently.
2. Providing the independent estimating agency with the authority to compel all agencies to provide relevant information.
3. Congress would then establish a National Regulatory Budget setting a cap on the cost that each agency's regulations could impose.
4. If the agency was imposing costs above the NRB cap, it would be required to withdraw regulations until it was below the NRB cap.
5. If issuing a new regulation would place the agency over the cap it would be prohibited from issuing the new regulation unless it withdrew other regulations so that it remained under the NRB cap.
6. All new regulations would be required to receive an estimate from the independent estimating agency before they could be implemented.
7. Non-compliance by the agency would be subject to judicial review and the courts would be required to invalidate regulations that caused agencies to exceed their NRB caps.

Improve Small Businesses' Access to Capital

Access to debt and equity financing is a critical problem for small businesses. Improving small business access to capital will have a substantial positive impact on economic growth. The NSBA supports increase the cap on credit union business lending from 12.25 percent of a credit union's assets to 25 percent of total assets.⁶³

We are developing detailed proposals to reform existing SEC regulations. We are also developing proposed statutory changes to improve small businesses' access to capital. Our proposals will address both the private equity markets, initial public offerings and the burdens placed on small capitalization public companies. Our proposals will be designed to substantially reduce the administrative burden on small private and public businesses while maintaining needed protections for the investing public.

The Annual SEC Forum on Small Business Capital Formation has routinely made constructive suggestions, almost none of which have ever been acted upon by the SEC. It is our hope that President Obama's recent initiative on retrospect regulatory review will change this.

⁶² The entire BEA budget for FY 2011 was \$97 million. U.S. Department Of Commerce, Economics And Statistics Administration, Economic and Statistical Analysis Budget, Budget Estimates, Fiscal Year 2012, As Presented to Congress, February 2011.

⁶³ 12 USC 1757.

We specifically propose maintaining the current level for accredited investors, making it clear that small offerings below a specified offering amount and a specified number of investors are *per se* private placements, simplifying Regulation D, making it clear that paying a commission to finders who help to raise capital is not a violation of the Broker-Dealer regulations, substantially limiting the scope of section 404 of Sarbanes Oxley so that it does not apply to small capitalization firms.

We want to stop bank examination practices that treat small business loans as inherently more risky than other types of loans for the simple reason that they are not and doing so reduces small businesses' access to bank loans.

These steps will improve small companies' access to capital and enhance economic growth and job creation.

Reduce Restrictions on Domestic Energy Development

Reducing or eliminating regulatory barriers to domestic energy exploration will produce jobs, reduce our dependence on foreign energy suppliers, reduce our trade deficit and reduce energy costs. All of these effects would have a positive impact on the economy and on small businesses (both those involved in the energy business and those in communities that would see an increase in employment and economic activity). It is much better for the U.S. economy for energy value added to be added here rather than abroad.

Obviously the oil industry has a stake in this occurring and their estimates should be taken with grain of salt. An American Petroleum Institute study estimates that liberalizing the regulation of oil and gas exploration would create one million jobs by 2018 and generate \$800 billion in tax revenue between now and 2030. Even if we reduce these estimates substantially, the economic gains are likely to be very substantial. There are currently about 14 million unemployed persons in the U.S. If the API is correct, then energy regulatory reform could reduce unemployment by 7 percent.

The U.S. needs more, reasonably priced, domestic energy production. Alternative energy sources are a part of the solution. Conventional fuels, however, are a key component as well and we should reduce the regulatory barriers to exploring and developing these energy sources.

Sincerely,

A handwritten signature in black ink, appearing to read "Todd McCracken", with a long horizontal line extending to the right.

Todd McCracken
President
National Small Business Association