WRITTEN TESTIMONY OF

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Chairman Camp and Ranking Member Levin, I want to thank you for the opportunity to appear before you today. It is a pleasure to be back in a very familiar room, but in an unaccustomed role. I appear today in my personal capacity, and my remarks represent my personal opinions.

I strongly support the idea that the tax legislative process would benefit from more information on the macroeconomic impact of major tax legislation. The current House Rule requiring the inclusion of macroeconomic effects of tax legislation in the Committee Report may have been well intentioned, but it is ineffectual. It provides relevant information but only after this Committee has made the critical decisions on the substance of legislation. Reviewing the methodology used by the staff of the Joint Committee on Taxation in analyzing the macroeconomic effects of changes in tax policy is certainly appropriate. But, I believe that this Committee should do more than that to ensure that it is aware of the potential impact of tax reform on our economy.

JCT MACROECONOMIC MODELS

It is impossible for any economic model to fully reflect the complex economy that we have today with global flows of goods, services and capital. All macroeconomic models have simplifying assumptions and therefore limitations for analyzing the impact of tax changes on our economy. The JCT staff appropriately presents multiple models "when analyzing tax

proposals because no one model framework can provide complete information about the broad array of anticipated effects of tax policy on the economy."[1]

The models used by the JCT staff differ in basic assumptions. Two of the models assume full utilization of labor and capital (i.e., no unemployment). One model assumes that we have a closed economy with no international flows of capital, goods, or services. Another assumes an open economy and the third is somewhere between those assumptions. In one model, individuals are assumed to have "perfect foresight" about economic conditions over their lifetimes. In other models, individuals do not have that level of clairvoyance.

The impact of tax policy changes that could change the distribution of the tax burden among important sectors like housing, health care, insurance, financial services, retail, and manufacturing is either not modeled at all or in a way that does not completely address all the possible effects. Winners and losers are not identified as such.

None of this is intended to be critical of the JCT staff's work in this area. Their work represents some of the best economic analysis in the country. But, they cannot overcome a simple fact: it is impossible to develop an economic model that accurately reflects our complex economy, or accurately measures the impact of a comprehensive tax reform on that economy.

The JCT analysis provides important, theoretical insights as to how our economy works. It provides useful supplemental information to inform Members on the potential impact of tax policy changes. But, it should not be the only economic information that this Committee uses in developing a tax reform plan.

Based on economic studies and simple observations of economic performance after the enactment of major revenue legislation, I would also note that the economic projections based on these models have consistently overstated both the positive and negative impacts of the legislation involved.

EXAMINATION OF ECONOMIC IMPACT OF TAX REFORM ACT OF 1986

If you believe, as I do, that the economic models are imperfect guides for tax reform, the question remains: what should the Committee do to prepare for tax reform? I would suggest an examination of the real world impacts of the Tax Reform Act of 1986, the last time that the Congress enacted a tax reform that substantially reduced rates and broadened the tax base.

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[1] Macroeconomic Analysis of a Proposal to Broaden the Individual Income Tax Base and Lower Individual Income Tax Rates, JCX-53-06, December 14, 2006, page 7

Many economists predicted that the Tax Reform Act of 1986 would increase economic efficiency and contribute to increased economic growth. Those predictions seemed especially warranted since most of the base broadening was accomplished through eliminating clearly distortive, nonproductive, tax-shelter activities. Others warned that the removal of investment incentives, like the investment tax credit, would lead to the deindustrialization of America.

The University of Michigan commissioned a study of the economic impact of the 1986 reforms by a group of prominent economists, which included both proponents and opponents of the 1986 reforms. The published results of that study reflect an almost unanimous consensus that the real world effects of the 1986 reforms, both good and bad, were substantially less than predicted. "Most of the papers presented at this conference reinforce casual observation that TRA86 has had little effect on the broad measures of real economic activity in which most economists are interested."[2]

The fact that the Tax Reform Act of 1986 may have produced little real economic benefit does not detract from its merits. It eliminated abusive and nonproductive tax shelters, and the elimination of such tax shelters did not impose large costs on the economy. The widespread use of individual tax shelters has been eliminated. Any future tax reform will involve the elimination of "long-term features of our system embedded in the fabric of our society."[3] Elimination of those benefits will result in dislocations in important sectors like housing and healthcare. The Committee should carefully examine the benefits of broad-based reform before imposing those costs.

DETAILS MATTER

Details matter when it comes to the economic impact of major tax policy like comprehensive tax reform. A meaningful discussion of the economic impact of tax reform can only occur in the context of a detailed proposal. Mr. Chairman, earlier this year you laid out an ambitious agenda on tax reform. Like you, I strongly believe that our tax laws need reform. I also believe that more than abstract discussions of reform are necessary to start the tax reform process.

Most economists asserting the economic benefits of tax reform are modeling their vision of an ideal tax system. Most often, it is a vision that would have little political viability and unrealistically low rates because of the omission of items like transition relief. They cannot analyze the impact of reform without a specific plan, nor can this Committee.

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[2] Do Taxes Matter?, edited by Joel Slemrod, MIT Press, 1990, page 322.
[3] Testimony of Jonathan Talisman before the Senate Finance Committee, March 1, 2011.

The tax reform process in the 1980's began with the introduction of legislation by Senator Bradley and Congressman Gephardt. The introduction moved the process from abstract discussions of reform to the more important task of analyzing the impacts of specific approaches. I will use two examples to show why I believe that a detailed proposal is required.

The first example is tax benefits for owner-occupied housing: the mortgage interest deduction and the real property tax deduction. A tax reform plan with low rates and a broad base probably would eliminate or sharply restrict both of those deductions. I, along with many economists, believe that the value of those benefits is capitalized in the price of homes. Therefore, reducing or eliminating those benefits could threaten further reductions in home prices.

The second example is what many people see as the outline of a potential corporate tax reform plan. Such a plan would include a significant reduction in the overall corporate tax rate and a tightly constructed, revenue neutral, territorial system overseas. The rate reduction would be funded by repeal of tax benefits such as accelerated depreciation and the section 199 deduction for domestic manufacturers. A plan of this type could easily result in a net tax increase on the domestic manufacturing sector. A territorial system by itself repeals current law benefits for exports from the United States and for royalties for the product of research conducted in the United States. Accelerated depreciation and the section 199 deduction also are large benefits for domestic manufacturers.

In principle, I can see the arguments for a neutral tax system with an even playing field. But, many other countries take a different approach. As a result, I tend to favor an even playing field that tilts in favor of promoting jobs in the United States.

An economic analysis of the impact of tax reform on the housing sector or manufacturing sector can be analyzed only in the context of a comprehensive, detailed tax reform proposal with transition relief. These are only two examples of many such issues.

SHOULD MACROECONOMIC ANALYSIS AFFECT BUDGET EXTIMATES?

Finally, Mr. Chairman, I want to urge you and other Members to resist the temptation to use these uncertain economic models to determine the budgetary effects of tax legislation. Today, we have a serious budget problem, but our estimates of the costs (whether foregone revenues or direct government spending) of policy changes have credibility in the markets because they are based on generally accepted cost accounting rules.

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Businesses, like governments, incur costs with the expectation that those costs will yield a positive return. In the case of businesses, those costs can come in the form of investments in plant and equipment, research and employee training. Businesses are required to reflect the full cost of those investments on their books without any reduction for their potential benefits. The anticipated benefits are recognized if and when they occur.

Currently, our budget score-keeping rules roughly conform to business practice. The costs are recognized up-front and the benefits are recognized if and when they occur. I know from personal experience that those rules frustrate Members from both sides of the aisle. But, I think that a departure from those rules would threaten the credibility of our budget numbers and create the unavoidable perception that political considerations affect budget numbers. The loss of that credibility could have serious consequences.

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