

TAX RELIEF: THE REAL ECONOMIC STIMULUS FOR AMERICA'S ECONOMY

HEARING BEFORE THE SUBCOMMITTEE ON TAX, FINANCE, AND EXPORTS OF THE COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES ONE HUNDRED SEVENTH CONGRESS FIRST SESSION

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THURSDAY, DECEMBER 6, 2001

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TAX, FINANCE AND EXPORTS,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The subcommittee met, pursuant to call, at 10:07 a.m., in room 2360, Rayburn House Office Building, Hon. Patrick J. Toomey (chairman of the subcommittee) presiding.

Chairman TOOMEY. The hearing will come to order. I want to apologize for getting started a little bit late and thank our witnesses and invite them to take their respective seats at the witness table, if they would; and I will begin with a brief opening statement.

This morning, the House Small Business Subcommittee on Tax, Finance and Exports convenes to address a number of economic stimulus proposals and their possible impacts on our Nation's economy. Heightened concerns about an economic slowdown have spawned a number of proposals, ranging from tax relief to spending increases, all in an effort to stimulate the economy. Despite the passage of an economic stimulus package by the House, the Senate has yet to consider their own version of this legislation, so I think the input from the folks today is timely.

However, the delay, I think, has unfortunate consequences. Last week, it was announced the economy has now slowed to an annual rate of growth that is negative, negative 1.1 percent in the last quarter. The current economic downturn, which began, arguably, in September of 2000, was only accelerated by the events of September 11, 2001; and, since that time, over 400,000 jobs have been lost. The unemployment rate for October anyway has reached a 5-year high of 5.4 percent.

These job losses are impacting virtually every segment of our economy and all across our Nation, and we all know there is a heated debate on the approach that is most appropriate to resolve our current economic woes. Some think government spending is an appropriate stimulus. Others, including myself, believe that major, immediate tax relief will do much more good than even more government spending.

Much of the ongoing debate of an economic stimulus package has centered on the appropriate balance between spending and tax relief. Leaving aside the economic arguments for a moment as to which would better stimulate growth and job creation, it is important to note that Congress has already approved or agreed to ap-

prove spending increases that arguably approach \$100 billion. These cover everything from victims' compensation to airline assistance, the emergency supplemental as well as additional discretionary spending. The economic stimulus package passed by the House, for instance, contains \$12 billion to assist workers displaced as a result of the events of September 11.

However, at a time when the Nation is struggling to jump-start the economy, I believe the most viable remedy is to provide meaningful tax relief to stimulate long-term and short-term growth. At this time, more than any other, it is vitally important that we remove the barriers that working Americans face as they attempt to provide for their families, and one of the biggest barriers is the tax burden imposed by the Federal Government. The way to increase the wealth of working Americans is to encourage more work, saving, investment, risk-taking and entrepreneurship. That is why incentive-driven or supply-side economics has such a successful track record. When tax rates are reduced, people have more motivation to be productive and to create wealth; and when they earn more income, they are able to spend more, save more and invest more.

This hearing will focus on the impact meaningful tax relief will have on the Nation's immediate and long-term economic growth and, in particular, emphasizing the impact on small businesses.

I look forward to the testimony of the witnesses before us today. I want to particularly thank the subcommittee's ranking member, Bill Pascrell, who has been very flexible in scheduling this hearing and very helpful. While we may have somewhat differing views on the prescription for our economic woes, I certainly appreciate his commitment to resolving our current economic crises. No one is more dedicated to the well-being of the small business sector of our economy than my good friend and colleague, whom I will now recognize for his opening statement. Mr. Pascrell.

Mr. PASCRELL. Thank you, Chairman Toomey, and thank you for having this hearing today.

Yes, we do come at this issue from two different perspectives. Right now, we are about to commence the debate on the floor of the House of Representatives, an hour debate, no substitutes permitted. I thought I was in Red China for a moment this morning.

In a democracy attempting to air all ideas, we will be debating by any other term Fast Track. We will be cutting up the pie, so to speak. The debate has attempted to separate us into those who are for trade and those who are against, and that is pretty sophomoric, because we all know we live in a global economy. We see the effects of the global economy on American financial practices and visa versa. So to deny trade is to have our head buried in the sand.

I carry the Constitution around with me, Mr. Chairman, and I know what article 1, section 8 says, and I didn't come here from New Jersey to surrender my rights and my responsibilities and to file away and to bevel my responsibilities as a Congressman and to surrender the dust that accumulates in the executive office of government. That is not why I am here. Just so you know how I will vote later on this morning.

Mr. Chairman, recent announcements have confirmed that the economy is in recession, something you and I talked about 6 months ago. Unemployment has reached 5.4 percent. There is an

overall need for a stimulus bill. We hope there can be compromise so that we come up with something that not only looks nice but is, hopefully, effective.

For small businesses in particular, their most immediate need is working capital. We have said that in this committee many times discussing many different issues. Small businesses have few lines of credit or other financial sources that would provide them a self-sustaining source of support during this recession. Some tax relief is needed.

Mr. Chairman, it is not the only solution. A few weeks ago, we heard Grover Nordquist declare that even a bad tax cut is a good tax cut. Even Bill Safire would have a tough time on that one, but I find that it is often hard to have a good debate with people who harbor such blind allegiance to one philosophy or another, but I keep trying. Because of my naiveté, perhaps I will see the light some day.

This committee has the responsibility as representatives of small business—that is what it says outside on the wall—to focus on proposals that are targeted to small businesses, not corporate America. Many have used this committee's forum to argue for cutting the capital gains tax, accelerating the rate cuts, eliminating the corporate AMT, all of which are proposals benefiting big business.

In difficult economic times, economic theory from some is always the same, enact these proposals for large, established corporations and the wealth will trickle down to the minions. I just don't think that is right. Come to think of it, that may be the philosophy during any economic time for some. When the economy is good, we need tax cuts. When the economy is bad, we need tax cuts.

During periods of lower consumer confidence, the solution for small business is very different than that for corporate America. It is unfair and has frequently been the case to lump together the economic problems of two very different kinds of enterprise. Small businesses need working capital. I believe that a stimulus package must be responsible, targeted and temporary, must take effect immediately, that those who spend money on goods and services—we have enough data to see who are those folks—and last as long as the country needs it.

The economic stimulus bill that the House passed, Mr. Chairman, fails the test. Its tax relief provisions are not targeted primarily to those who will spend and boost the economy. They include a permanent reduction of the capital gains tax, which benefits the top 2 percent of earners, and a permanent repeal of the alternative minimum tax for 2001, which will cost \$25 billion to accomplish.

We were in deficit in June, long before September 11. It was pointed out time and time again that we would have to go into the Social Security and Medicare trust funds. And now, under the cover of a tragedy unlike we have ever seen before on September 11, we have decided that we are in a recession, and we understand the mounting unemployment ranks, we say.

Citizens for Tax Justice reports American corporations will receive \$7.4 billion in tax rebates from the House stimulus package. General Motors would receive \$833 million from a full repeal of the corporate AMT. According to a November 23 Washington Post arti-

cle, General Motors has roughly \$8 billion in cash, has no plans to increase its investments.

The Congressional Budget Office found that reducing the tax, quote, would make a relatively small change to a tax that applies to relatively little capital income, unquote. As for small businesses, this proposal would do nothing to help them, because the Tax Code already provides them an exemption.

Let me conclude on this point. Economist Joseph Stiglitz, the Nobel lawyer in economics for 2001, argues that accelerating the rate of reductions would benefit wealthy individuals only and thus would not have a significant effect on consumption but only increase their savings. He must know something about economics.

In short, contrary to some claims that even a bad tax cut is a good tax cut, not only are tax cuts not the only solution but the most effective tax cuts in a stimulus package would direct the largest share of benefits towards helping small businesses stay afloat in these tough, tough times.

Thank you, Mr. Chairman.

Chairman TOOMEY. Thank you, Mr. Pascrell.

At this time I would like to welcome and thank Mr. Chris Edwards, the Director of Fiscal Policy Studies from the CATO Institute. Thank you for joining us this morning, and I would welcome your testimony.

If we could try to keep the testimony to about 5 minutes. The red light will indicate when the time is out, and we will try to limit our questions accordingly.

STATEMENT OF CHRIS EDWARDS, DIRECTOR OF FISCAL POLICY STUDIES, CATO INSTITUTE

Mr. EDWARDS. Thank you, Mr. Chairman and members of the committee. Thank you for inviting me to testify today on proposals for economic stimulus.

The U.S. Economy is now in recession. The right tax policy can speed up the economy's return to growth. As large businesses are cutting jobs by the thousands now, we need small businesses and entrepreneurs to take up the slack and start new businesses and invest more. Let us make these risky decisions easier for them by cutting their tax burden.

Tax reforms can aid entrepreneurs in three ways—the decision to launch a new business, the ease of finding financing and the decision to expand. Let me run through each of these.

First, Congress can make the decision to start a new business more attractive by accelerating the already enacted income tax rate cuts. This will boost after-tax returns for sole proprietors, partnerships and S corporations. Treasury figures show that 63 percent of tax filers in the top 39 percent tax bracket have small business income, so cutting the top rate targets exactly the people who can get the economy moving again.

The capital gains tax rate is also very important to encouraging start-ups. This country has scores of so-called serial entrepreneurs, as we have seen particularly in high-tech in recent years. They start a new business which they grow for a few years and then, if it is successful, they sell their business, realizing a capital gain. Then they turn around and invest in a new start-up. Cutting the

gains rate makes successful start-up more valuable and allows entrepreneurs to keep more funds for reinvestment in new businesses.

As a side note on start-ups, there is a quirk in the Tax Code that would be very timely to fix right now. There is a requirement that new businesses write off start-up costs over 5 years, rather than allowing immediate deduction. These start-up costs include such items as market research and employee training. They may not be immediately deducted, so I recommend that the committee look into this disincentive and lower the tax hurdle to new businesses.

The second way that tax reforms can help is easing business financing. The committee is aware of the important role played by venture capital in the economy. So-called angel investment in start-ups is maybe even more important and, by some estimates, twice as large. Angel investors are usually wealthy individuals who are fully taxable. Microsoft billionaire Paul Allen, for example, has put his money into over 100 new companies. The return these investors receive is capital gains on the start-ups that succeed.

By the way, during the 1990s many large corporations became venture investors in new growth companies, particularly again in high tech. Corporate capital gains are taxed at a high 35 percent rate, so cutting the corporate capital gains rate may also increase investment flows to small companies.

Some have questioned what lowering the capital gains rate would do right now with the stock market down. But angel and VC investors know the market will rise again, and they are looking to realize gains in new investment perhaps 2 years or more in the future. So cutting the gains rate permanently will draw more investment into new high-growth firms right now.

Thirdly, accelerating the individual income tax rate cuts will stimulate existing small businesses to expand. A series of studies by four tax economists who are cited in my written testimony examined the effect of the 1986 tax rate cuts on sole proprietors. Their results show a 5 percentage cut in rates would increase capital investment by about 10 percent. They also found that dropping the top rate from 40 percent to 33 percent would increase hiring by about 12 percent. Those are substantial effects.

Other than tax rate cuts, liberalizing depreciation will lower overall or effective tax rates on new investment. The depreciation provision in the House bill is a step forward, but we need to do much more and make it permanent. The small business expensing limit, now \$24,000, should be raised substantially, and ultimately we should move to full capital expensing for all businesses. The Tax Executives Institute, which is a group of lawyers and accountants, testified before Congress this year that the depreciation rules are hopelessly outdated and needlessly complex. We should scrap them and move to expensing, which would eliminate many investment distortions. Workers would be the ultimate beneficiaries as more capital investment would raise worker productivity and produce higher wages.

Let me make a final note on the issue of broader tax reform. In the 1980s, the U.S. was a leader in tax rate cuts in the world. But the 1990s was a lost decade for tax reform in this country, while other countries have been moving ahead. The average corporate tax

rate for 25 OECD countries fell from 41 percent in 1986 down to 31 percent today. Our corporate tax rate is now 4 percentage points higher than the average of our trading partners. So we are a high tax country when it comes to corporate taxes. The average individual tax rate for OECD countries fell from 55 percent in 1986 down to 41 percent today. And regarding capital gains, a number of countries, such as the Netherlands, exclude it from taxation altogether.

A new study by Arthur Anderson compared 9 major countries as to how good their business environment is particularly for entrepreneurial growth companies, based on various tax and regulatory factors. As it turned out, the U.S. was not number one, as we would usually expect. We finished second behind Britain. Britain, by the way, has a 30 percent corporate tax rate. Let us not fall behind any further. We should pursue further tax reforms and create the best possible tax environment in the world for business and entrepreneurs.

Thank you for holding these important hearings, and I look forward to working with the committee on these issues.

Chairman TOOMEY. Thank you, Mr. Edwards.

[Mr. Edwards' statement may be found in the appendix.]

Chairman TOOMEY. At this time, I would like to welcome and invite Mr. William Beach, the Director for the Center for Data Analysis with The Heritage Foundation. Thank you for being with us today, Mr. Beach.

STATEMENT OF WILLIAM BEACH, CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION

Mr. BEACH. Thank you very much.

Mr. Chairman, Congressman Pascrell and members, my name is William Beach. I am director for the Center for Data Analysis at The Heritage Foundation. It is indeed a great privilege for me to be with you this morning to speak on this important topic. These remarks are my own and not necessarily those of The Heritage Foundation.

There is increasingly little doubt that the U.S. Economy currently is in recession. The visible and widely noted economic slowdown that began in the spring of 2000 worsened over the summer and fall. The service and financial sectors joined the manufacturing sector in contracting during the winter of 2001, and the recession officially began in March, as indeed Congressman Pascrell has noted in his remarks.

It is in this context that Congress now is debating the composition of an economic stimulus bill. The events of September 11 doubtless worsened the economic contraction and unnecessarily introduced into the debate proposals to ameliorate harm related to the terrorist attacks.

Perhaps the debate's most interesting feature is how it has helped clarify the economic differences between a demand-based approach to strengthening economic performance and the supply-based approach. Congressman, I appreciate your remarks very much in that regard. I suspect this additional clarity is not entirely evident to everyone involved, even those most closely involved in

the debate. The statistical and rhetorical record, however, should be very useful to future disputants.

What do I mean by additional clarity? While still too early to tell, the small boost to household disposable income that stems from the summer's tax rebate program, a key provision of the tax legislation signed into law by President Bush on June 7, appears to have had little effect on consumption expenditures. Not only do opinion surveys show that the households devoted the lion's share of their rebate checks to debt repayment and savings, new data from the Federal Reserve indicates a spike in savings commensurate with the size of the rebate and its timing. This additional information on the effects of tax rebates during economic slowdown reinforces findings about the disposition of earlier rebate efforts likewise intended to boost consumption expenditures during economically distressed times.

This additional evidence of how households will likely spend subsidies and one-off rebates is most welcome to analysts focused on stimulus measures that work on the deep structure of economic activity on incentives, investment and long-term expectations. It shows, I believe, the futility of efforts solely or mostly devoted on raising aggregate demand through spending. And while these lessons are hard for Washington policymakers to learn, the statistical record being made during this recession likely will guide a higher proportion of future lawmakers toward the more effective and economically sensible route of tax rate reduction in the future.

Our own work on various economic recovery proposals points to the greater importance of policy change directed at incentives, investments and long-term economic expectations. On November 9 this year, my colleagues, Mark Wilson and Ralph Rector and Rea Hederman, and I published an analysis of two leading stimulus proposals then pending in the United States Senate: a plan by Senator Grassley that reflected President Bush's recommendations and a plan associated with the Senate leadership, particularly with Senators Daschle and Baucus. We used a standard model of the U.S. Economy, the DRI/WEFA U.S. Macroeconomic Model in wide use in Fortune 500 companies and throughout the government, to estimate the economic effects of these two plans; and we also employed the CDA individual income tax model to estimate year by year changes in the fiscal effects.

In my written testimony, Mr. Chairman, I have outlined Senator Grassley's proposal and the proposal of the Senate leadership, I think which are all well-known to people who have been involved in this debate, and so I will skip that in my verbal remarks.

Every economic indicator in the DRI/WEFA model points to the superiority of an approach to economic recovery that depends on reducing the costs of work and investment. For example, over the period fiscal year 2002 through 2006, the Grassley plan produces seven times more jobs than the Senate leadership plan does, 283,000 per year versus 38,000 per year.

The inflation-adjusted disposal income of an average family of four would increase by \$1,060 per year under the Grassley plan and by \$236 per year under the Senate leadership plan.

Indeed, the Grassley plan increases inflation-adjusted consumption expenditures by \$45 billion, as opposed to the Senate leadership's plan of \$10 billion.

The Grassley proposal, which again closely reflected the plan advanced by the Bush administration, clearly would lessen the depth of the recession and shorten the time over which the economy would pass before returning to pre-recession growth levels. One question, however, remains. Just how much of these economic benefits stem from the acceleration of the individual income tax rates alone?

To answer that question, we estimated the economic effects of just the rate reductions using the same model of the economy over the same period. I am announcing these results for the first time today.

We found that the rate reductions alone of the Grassley-Bush plan, which again, Mr. Chairman, accelerated all of the rates from 2004 and 2006 into 2002, account for 59 percent of the gain in national output of the entire Grassley plan, which contained also consumption expenditures; 67 percent of the improvement in employment; 65 percent of the increase in disposable income; and 44 percent of the expansion of investment. Indeed, personal savings growth attributable to the rate reductions account for 68 percent of the total change in savings produced by the entire Grassley plan.

While it is possible to point to times in our history when spending programs made a significant difference to employment and output, these moments almost always are associated with extraordinary national mobilizations. Ours is not one of those times, even though the events of September 11 and since have produced a level of national resolve not seen since the beginning of World War II.

We have a recession produced by policy errors and aggravated by hostilities. The errors affected investment and incentives, and they call forth policy responses that are focused on investment and incentives. The hostilities devastated key elements of our economic superstructure and distressed the lives of hundreds of thousands of innocent and productive citizens. Those hostilities call forth responses that are compassionate and generous.

I thank you for the opportunity to appear before your committee.

Chairman TOOMEY. Thank you, Mr. Beach.

[Mr. Beach's statement may be found in the appendix.]

Chairman TOOMEY. At this time, I would like to recognize the Senior Fellow from the CATO Institute, Mr. Stephen Moore.

STATEMENT OF STEPHEN MOORE, SENIOR FELLOW, CATO INSTITUTE

Mr. MOORE. Thank you, Chairman Toomey, for holding these hearings and for inviting me to testify.

As the previous witnesses have documented, we clearly are in a recession; and, Mr. Pascrell, you are right that this recession began long before September 11. In fact, I think when the final figures come in it will indicate that the recession actually began around January of this year. So we have now been in a 9-month recession. Fourth-quarter growth must certainly be negative as well.

We do need an economic stimulus plan. We have lost somewhere in the neighborhood of \$300 billion in wealth this year, and the

growth path that we were on in the 1990s, the 3 and-a-half percent growth path, has been reduced to negative 1.1 percent. So clearly we do need an some type of economic stimulus plan.

Let me just spend a minute, if I may, and talk about why economic growth is important and why is it so critical that we get back on this 3 and-a-half percent potential output growth that we have in the United States.

Obviously, economic growth is important, because it leads to more jobs and higher wages and a better stock market and so on. But one of the areas where I think you all in Congress don't think enough about in terms of why economic growth is so important is that we cannot keep the budget in balance unless we have economic growth. And if I may just spend a minute referring to my testimony.

If you look on I think it is the third page of my testimony, we did an analysis of what would happen with revenues, Mr. Chairman, under three real growth—really output growth paths, 2 percent, 3 percent, and 4 percent, over the next 10 years. And the point I wanted to highlight to you all is that if we only have 2 percent real growth over the next decade, which I would describe is a low-growth path, we can't balance the budget. We will be running about a trillion dollars in deficits over the next decade if we have 2 percent real growth.

If we have 3 percent real growth, which I would describe as kind of a medium-growth path, we will have about \$750 billion in surpluses over the next decade.

And if we have 4 percent real growth, which I believe is very achievable, Mr. Chairman, with the right set of monetary and fiscal policies, we would have \$2.5 trillion in surpluses.

So the point I am trying to make here is, with respect to the question whether we can be afford to be cutting taxes in a pro-growth way, I would say we can't afford not do it. We have to do this if we want to have a strong fiscal environment, which I think we all agree we need to have.

So what do we do in terms of promoting growth?

I would argue, first of all, that I would agree with both the previous witnesses that we ought to look at accelerating the rate cuts. When we did that tax cut, Mr. Chairman, back in May, the idea was we would phase in these tax cuts 2005, 2006 and 2007. We need the tax cuts now. We are in kind of an economic emergency right now, and it makes no sense to phase in tax cuts later when the economic emergency is happening now.

I would argue that we ought to cut the capital gains tax. I think this would be one of the most important fiscal stimulus provisions in terms of dramatically having an immediate effect. And here is where why I think a capital gains cut would have a strong effect. If you cut the capital gains tax, what you will do is almost instantly raise asset prices in the United States. It has to happen. Because when you are cutting the capital gains tax, what you are doing is you are increasing the after-tax rate of return on those assets; and every time we have cut the capital gains tax over the last 30 years it has led to a rally on the stock market.

Now this is being described as a policy to help the rich. But I think if you look at the statistics now—and that was probably true

10 or 20 years ago. A capital gains tax cut would have primarily benefited rich people in terms of who had capital gains. It is not so true today. We are truly in a kind of new investor environment where we right now have about 80 million American households that own stock.

I would like to make one point in response to something that Mr. Pascrell said when he said this is a policy to help big business. I have been working on this policy for the last 15 years, and the thing that I found striking about this issue about capital gains tax cuts is big business doesn't want capital gains tax cuts. If you talk to people in the Chamber of Commerce they don't care about capital gains cuts because they realize that those are already big businesses that people already own their stocks. In fact, if you cut the capital gains tax, people may actually sell stock in some of the big businesses so they can move into these new emerging technologies which is so important.

One last point, as you decide what types of tax policies we should adopt, both in the short-term and the long-term, I just would like to offer one kind of principle that I think would be a great guiding principle for both the Republicans and Democrats. We all know we want to get to a simplified tax system, one-rate system that does not overtax and double-tax saving and investment. So I would urge you, as you look at tax policies, ask the question, does this tax change that we are looking at, will it move us in the direction of kind of a flat-tax model that doesn't double tax saving and investment that leads us to a single rate system? Because I think we would all agree that if we had that type of tax system in place it would be incredibly bullish for the American economy.

That argues against temporary tax cuts I think because I think temporary tax cuts only shift the timing of that economic activity. They do nothing to help the long-term growth rate. And I think it also argues against targeted tax cuts. I think the best type of tax cuts are ones that benefit everyone and not just one group over another.

Chairman TOOMEY. Thank you, Mr. Moore, for your testimony.

[Mr. Moore's statement may be found in the appendix.]

Chairman TOOMEY. At this time, I would like to recognize a man who comes to us from the small business world itself. As I look over Mr. Lauster's resume, it is an impressive resume with a number of impressive and distinguished projects in architecture, which is his profession. I would like to welcome you and thank you very much for joining us, Mr. Charles Lauster from New York.

**STATEMENT OF CHARLES M. LAUSTER, LAUSTER & RADU
ARCHITECTS, P.C., NEW YORK, NY**

Mr. LAUSTER. Thank you, Chairman Toomey.

I am indeed an architect. My partner and I have run a small firm of 12 people in New York City since 1983. Over the years we have seen a number of economic ups and downs and one war. We have never seen circumstances, however, quite like the ones we are seeing today—a recession, a war and a Nation holding its breath. Stimulus for small business is certainly needed, but it has to be the right stimulus. I would like to discuss those options that the Fed-

eral Government could take that would help businesses like mine and comment on those that would do no good at all for us.

What do I mean by small business? First, a firm that is 300 people or less. Most small businesses are much smaller, but even at several 100 the management can know the names or at least of all or at least most of the workers and thus has some personal relation with its staff. In terms of operations, such as accounting, human resources, advertising, a firm of 10 people and a firm of 300 are much more similar than either of them is to a company of 10,000.

Second, the business is not publicly traded. Capital is the key problem for small business. Meeting payrolls, running equipment, paying the rent—cash flow is what keeps most small businesses small. This is not to say that small businesses are poor. Most are quite successful. However, capitalization almost always comes out of the owners' pockets. You may have had a great year, but if the receivables were high for 6 months, it was probably a year of scrambling for cash.

So what can the Federal Government do to stimulate small business? There is a lot of discussion of cutting tax rates further. This makes sense to small business if it puts substantially more money in the hands of masses of consumers, the main market for small businesses. Big cuts for higher bracket taxpayers puts money into investments and not into the markets small business needs. There is a down side to simple rate cuts. As Federal, State and local governments cut their revenues, they cut services in capital projects. Government is an important customer for local small businesses and deficits means lost contracts. It also means the environment in which we do business deteriorates.

Again, the issue is capital. Big business has the money and the clout to make world fit its needs. If it doesn't like the world it is in, it moves. Small business lives in the world it has got. Crime, poor schools, inadequate mass transit make it harder and more expensive to do business, and there is nothing we can do about it as individual businesses. We rely on good quality of life as provided by government. That means adequate tax revenue.

For these reasons, capital gains cuts and the cut in the alternate minimum tax are largely harmful to small business. While we gain little from these cuts, the lost revenue means lost quality of life for our businesses and our lives. The AMT cut was especially galling to small business. No struggling small business is getting taxes back.

Focused stimulus can address real small business needs. Small business loans, tax credits for hiring, support of local efforts to provide manufacturing space and empowerment zones are programs that have worked and can serve as examples for new legislation. These sorts of efforts get contracts and money directly to small businesses, especially if aimed at areas that are particularly hard hit.

Right now, lower Manhattan is hard hit. The City is struggling to retain businesses, to keep small businesses from closing their doors and to rebuild. There are a lot of good ideas that Mayor Giuliani and others are advocating. Relocation assistance within the city, employee tax credits and special grants to businesses that stay in the recovery zone are a few of them. Simple rate cuts will

do nothing to help us in this regard. In fact, to the extent that the cuts reduced the City's revenue, our suffering will only increase.

To sum up, stimulus aimed directly at small business can help. Stimulus that meets big business needs will not necessarily help small business much. The differences in scale and practice are simply too great. Tax cuts at the highest brackets, capital gains cuts and the AMT cuts are no help at all. Government does not need to stimulate small businesses that have lots of capital already. Stimulus that creates access to capital and markets that assist in providing employee benefits and that broaden the horizon of business opportunities can make a real difference.

Small business is helping America fight the recession and thereby the terrorists who sought our ruin. A wide stimulus package can give small business a helping hand without weakening the country. We will all breathe easier.

Thank you very much.

Chairman TOOMEY. Thank you very much for your testimony.

[Mr. Lauster's statement may be found in the appendix.]

Chairman TOOMEY. Thank you all for joining us this morning and providing this testimony.

I would like to begin with a series of questions, and I would like to begin with Mr. Beach. My first question for you goes to the heart of this debate in some ways as to the appropriate economic stimulus. Some are arguing for taking measures that would enhance consumer spending, rebate checks, sending out checks to people who didn't receive them in the past, for instance, versus others who argue that it is all about encouraging investment. And I was wondering if you could comment on this, if you are familiar with the recent economic statistics.

It is my understanding that over the course of 2001, during the period during which the economy has slowed down and actually gone into negative growth, that consumer spending is holding quite well. In fact, consumer spending is not in and of itself in a recession but that investment has declined dramatically. Is that accurate? Is that your view? Is that empirical fact? Is that your theory? Could you just comment on what the real problem is, based on your understanding of what the empirical data suggests?

Mr. BEACH. Chairman Toomey, you are correct in your impression of what the data has shown. The data could be revised, but we don't expect a substantial revision. The data does indicate a strength in consumer spending, which is remarkable, to say the least.

It is apparent that the United States' economy continues to attract consumption from abroad. It continues to elicit good consumption spending from households. And though in the last several months and I think particularly after September 11 consumers have begun to cut back in their spending as they are hesitant to get involved with travel and any spending that involves that part of the industry, it is still the case that the consumer confidence hasn't fallen as much as we have seen in previous recessions, particularly if you have a recession starting in March.

But you are also right in saying that the source of this recession is in the investment. I say in my written remarks and I didn't say in my oral remarks that my view of what caused this recession is

really a series of policy errors that started actually back in 1997 as the Federal Reserve began to pump additional supplies of money and credit into the economy to prepare it to enable it to be liquid for the Y2K conversions, an enormous expansion in 1998 and 1999 of supplies of money and credit, some of which was no doubt used by small and large businesses to convert but was also used to create a whole new range of businesses, some of which had markets and many of which did not.

As the bubble began to burst, the Federal Reserve had another thing it was doing. It was actually raising rates to stop the inflationary pressures that were going on. Well, of course this created new tax burdens, and tax burdens rose almost to a point of 2 percent of GDP. So we had a combination of policy errors all related to investment.

I think the deep structure is there for a lot of policy changes. We need to cut the costs of capital, reduce the required rates of return for long-term investment in order to bring back that part of the economy.

Chairman TOOMEY. Thank you.

Moving on, I would like to follow up on a comment that Mr. Moore made. You emphasized the vital importance of economic growth. There are the obvious reasons, the benefit to all the people who live and work in America, but also the Government's perspective, the increase in revenue. And I think certainly most of us will agree with the merits of encouraging as much economic growth as possible. The question is, can we reasonably expect that to result from the prescription that you recommend? And to that I would ask again, is there empirical evidence? What is the correlation historically, globally, for greater economic freedom, economic freer trade and particularly lower taxes and prosperity? Is there a demonstrable correlation that we can point to that suggests empirically that when you have lower taxes you have greater growth?

Mr. MOORE. There is. And I would add just one thing to Bill Beach's comment about the economy, which is he is exactly right in terms of his explanation of what happened to the monetary policy. Something else was going on at that time, too, in the late 1990s that surprised a lot of people, especially when I tell Members of Congress about this. Between 1995 and the year 2000, the average Federal tax rate went from 17 percent of GDP up to about 21 percent of GDP. That was a huge increase. It was about a 3 and-a-half percent increase in GDP that was being taken in Federal taxes.

When I tell that to people in government, they say, how can that possibly be the case? We haven't raised any taxes in the last 4 or 5 years.

What was happening over that period, as people were making higher incomes, they were being pushed into higher tax brackets, something we described as this real income bracket creep.

The reason I mention that, if you look throughout the last 30 or 40 years, the post World War II period, if you track that Federal tax burden, any time it gets above about the 20 percent level, it is sort of a siren alarm that we may have a recession. In fact, many of the deepest recessions that we have had since World War II have been correlated with that tax burden ratcheting up. In fact,

the most recent example being the severe mini depression we had in the 1978 to 1982 period where taxes rose very dramatically because of both real and inflation-induced bracket creep.

So, clearly, the kind of historical evidence indicates that many times—not always, but many times when you get that tax burden up above that 20 percent level, you have got to bring them back down.

By the way, the normal of the post World War II period is about 18 percent, and if you take into account the Bush tax cut, that will bring us down to about 19 and-a-half percent of GDP. I think that is a little too high. We need to have a stimulus.

Just quickly in answer to your question about how economic growth affects—if you look at international comparisons, it is not only true that countries that have economic freedom are richer—in fact, economic freedom is generally lower taxes, small centralized government, freer trade policies, all these kinds of protection of private property rights which is very important to economic growth. But you also find countries that have these economic policies are countries that tend to be healthier. They tend to have longer life expectancies and so on.

So I do believe an economic stimulus plan now is necessary, if it is designed towards investment. And I think Bill Beach is exactly right. It is an investment drought that has really caused this economy to contract, not a consumption drought.

Chairman TOOMEY. Thank you very much.

I have run over my time, but I do have another question, and I will ask, can I do that now? Fine.

Mr. Edwards, I wanted to ask you to comment specifically about the corporate AMT. It strikes me that certainly this has been a much-aligned feature of the House-passed stimulus package. It has always struck me that the AMT is itself an extraordinary obsession of the absurdity of our Tax Code.

We basically say, if you follow the rules perfectly and do exactly what the law says and we don't like the consequence, we will make you redo it and pay more in taxes. As part of that, my understanding is that, in a manner of speaking, a corporation that pays the AMT has historically been given a credit to reduce future tax burden and that credit is carried on the balance sheet of a corporation and we would require that that be manifested that way. So elimination of the corporate AMT gets rid of an absurd feature of our Tax Code, but it requires that this credit be allowed to be cashed in because it is part of the very future. Perhaps you could clarify that and explain whether that is accurate or whether you have a different perspective.

Mr. EDWARDS. No. That is right. The modern version of the AMT was enacted in 1986. And basically the 1986 act really went overboard in trying to make sure every last company in the country paid some taxes. So they really broadened the general base, but in addition they threw on this parallel AMT tax system. What they did is they said any year that a company pays AMT, the amount that AMT was greater than the regular tax, they are allowed to take it as a credit in future years. So in current law, companies are taking about 3 or 4 billion dollars of credit every year against prior AMT payments made. So in the House bill, in a sense there would

be nothing—there would be no big change from the current law. Companies can already take these credits.

Chairman TOOMEY. Can I interrupt and ask you, would it be accurate to view that credit as equivalent to an interest-free loan that the company has made to the Federal Government?

Mr. EDWARDS. That is a good way of looking at it. I mean—a lot of the things in the corporate income tax are all timing. The Federal Government wants to get the money early. Companies want to delay it and pay it later. Accelerated depreciation is a good example of that.

I think there is a good compromise that we can work out that, by repealing the AMT itself, the Federal Government doesn't lose any money. Because the last few years companies have been paying about 3 or 4 billion dollars in new AMT and taking about 3 or 4 billion dollars of credit. The net effect has been zero. But when you repeal it, you have got about \$25 billion of built-up AMTs that we have to figure out what to do with. And I think a fair compromise would be to allow companies to take those built-up credits in current law maybe over 4, 5 years.

Chairman TOOMEY. Thank you very much.

Mr. Pascrell, thank you for your cooperation, and I am happy to recognize you.

Mr. PASCRELL. Mr. Moore—by the way, all of your testimony I found to be very interesting, and it is just too bad it doesn't have a wider audience, but that is the nature of the beast. I almost conclude that maybe this discussion should be brought to the Ways and Means Committee, because I thought you know that we are here to discuss small business.

But since you brought the subject up, you know, in your discussions, you mentioned about comparing tax rates. I have seen calculations that indicate that the effective tax rate is lower today than it was in 1985. You disagree with that, Mr. Moore?

Mr. MOORE. Well, depends on who you are talking about. The effective tax rate on investment actually has risen over the last 15 years or so. So I would disagree with the idea. And it also depends on whether you are talking about just Federal tax rates or you are talking Federal, State or local all together.

Mr. PASCRELL. Federal taxes.

Mr. MOORE. Federal taxes have actually been somewhat stable, slightly higher than they were in the mid 1980s.

Mr. PASCRELL. Any attempt to indicate, in defense of your arguments or support of your arguments, that the tax rate is higher now in terms of in relationship to the GDP is absolutely fallacious, do you agree?

Mr. MOORE. If you look at what has happened over the last 4 years, the Federal tax burden went from about 18 percent of GDP to about 21 percent of GDP. That is a fairly large increase over a 4, 5 year period. We are at an abnormally high level of Federal taxes or percent of GDP right now. Not the highest ever, but fairly close to being at peak levels.

Mr. PASCRELL. If we accelerate the tax cuts, which you are advocating, how much more of a deficit are we going to produce over the next 10 years?

Mr. MOORE. You know, that is a really difficult question.

Mr. PASCRELL. How much of a deficit are you going to produce over the next 5 years?

Mr. MOORE. My sort of rule of thumb on tax rate reductions is that you are going to roughly recapture about one-third of the static revenue loss. So if you are talking about a tax reduction that would be—let us say it is \$100 billion a year, you are going to recapture about one-third of that or \$33 billion in higher economic growth from the lower tax rates.

Mr. MOORE. So you will probably have some negative effect. But the point I was making about why economic growth is so important is that if we are right about how tax rate reductions help economic growth, then we can actually have increased revenues, not less.

If you look at my testimony, Mr. Pascrell, what you will find, for example, in the 1980s, when we did very dramatic reductions in tax rates, you know, the top tax rate went from 70 percent in 1980 down to 28 percent by the end of the 1980s, and yet over that period we almost doubled Federal tax revenues. And it was also—

Mr. PASCRELL. What did we do to the deficit?

Mr. MOORE. Well, the deficit went way up, but it was mostly—

Mr. PASCRELL. Well, that is the point. You want to rush over that point all the time. You even rush over it in your testimony and—you know, with all due respect.

Mr. MOORE. But it was because—

Mr. PASCRELL. The deficit is something we can't—it is something we cannot dismiss. It is not a phantom deficit. It had a lot to do with interest rates. You talk about the consumer. You talk about the average Joe out there. The consumer had to face the high rates due to, much of it, not all of it, to those deficits that you just wave your hand on.

Mr. MOORE. Well, but, Mr. Pascrell—

Mr. PASCRELL. You don't support deficit spending, do you?

Mr. MOORE. No, I don't. I—

Mr. PASCRELL. You don't support deficit government, do you?

Mr. MOORE. Not at all, but actually if you look at the 1980s—

Mr. PASCRELL. But that is what we had in the 1980s, and you keep on pointing back that that is the time when things were wonderful.

Mr. MOORE. Well, it was. We had very strong economic growth in the 1980s. By the way, we had lower interest rates, not higher interest rates. In fact, when I got out of college in 1981, the mortgage interest rate was 20 percent. So interest rates fell very dramatically in the 1980s. But one of the interesting things about the 1980s is that you did have a very big military buildup in the 1980s, I mean, and that was in large part a—

Mr. PASCRELL. It was needed.

Mr. MOORE. It was needed, and it was one of the causes of the deficits. And yet I would say that those deficits were not inappropriate, at a time when you are trying to dig out of a big economic hole that we were in and win a war, and we are in a similar kind of situation to that right now.

Mr. PASCRELL. Mr. Chairman, I think Mr. Moore is very—is being very, very honest to his beliefs, but I do believe that his beliefs move towards the deficit spending being simply the fallout from specific economic policies, and I would really question, really

question it. I mean, I would like to debate you and discuss with you about the deficits and the effect that it has had on many aspects of this government.

I just want to ask one more question of Mr. Beach.

Chairman TOOMEY. Sure.

Mr. PASCRELL. We are in a dramatically different time right now than we were 10 months ago, 5 years ago. We realize that we are fighting this war, and it is going to have a tremendous effect abroad and at home. We have increased our intelligence apparatus. We have attempted to begin the process of education—it is costly—in terms of getting people to understand who we are as Americans and what we value. There is a tremendous stimulant package. If we do the things that Governor Ridge has asked us to do of protecting ourselves, in terms of bolstering specific targeted military, in terms of expanding intelligence and protecting our waterways and our water, protecting our food supplies, bioterrorism, if we do all of those things, somebody is going to have to spend money to do that. That is a stimulus unto itself. The numbers have ranged from 25 to \$50 billion. Aren't we saying that we—might not we say we could do two things at the same time? Stimulate the economy and protect ourselves? Or is that over simplistic?

Mr. BEACH. Not at all, Congressman, not at all. In fact the proposals that we have examined, and I think we have examined all of the proposals from both parties and indeed from some that were not even in a party, have combined an increase in homeland defense and the issues of infrastructure, which you quite properly raise, with what we would call true stimulus packages that go to the deep structure of the economy. The interesting thing about what we are finding is that many of the proposals for homeland defense go to preparing borders better, to maintain the security of the United States around its lakes and waterways and its highway systems, and the effect in that area of government spending will be stimulating. There will be more employment in Wichita, Kansas or El Paso, Texas.

But when we look at the entire economy, those measures, as much needed as they are, simply don't produce the employment and consumption and output changes, which a set of relatively simple moves do, and that is the rate reductions, particularly on labor. I am not particularly concerned on the capital side, because so many small businesses of course file their taxes through the 1040, and anything you are doing on rates there will help them. The overall effect of just the rate reductions, producing consumption expenditure growth and investment growth are truly remarkable, clearly indicating that the problem in this recession is in fact on the investment side.

So I would say, yes, let us have a stimulus package, a defense package that combines all of that spending, but let us not think in this particular episode that we are going to have the same effect on the economy that Franklin Delano Roosevelt, Republicans and Democrats, had in 1939, 1940 and 1941 as we prepared ourselves for war through massive government spending on the defense side.

Mr. PASCRELL. Thank you. Thank you, Mr. Chairman.

Chairman TOOMEY. Thank you. The gentleman from Ohio.

Mr. CHABOT. Thank you, Mr. Toomey. I share Mr. Pascrell's concern about deficit spending, and I am very much opposed to it. I would note that there was Democratic control of the House of Representatives for, like, 40 years up to 1994. I know that until—we had approximately 30 years of deficit spending up until the budget year of 1998, and it is my understanding that the budget years—basically we had the balanced budget agreement in 1997. We have had surpluses in the budget years 1998, 1999, 2000, 2001. It is my understanding that if you add up the surpluses of those 4 years, it is approximately \$600 billion of surpluses that we have had.

Now, I know a lot of my liberal colleagues—because of concern next year, it looks like we may very well have deficit spending again next year, which I am very much opposed to, but there are those projecting it.

Now, some of my liberal colleagues are blaming that projected deficit on President Bush's tax cuts. It is my understanding that of the \$595 billion of surpluses we have had over the past 4 budget years, that 94 percent of that went to reduce the debt that we built up in this Nation over those years when we didn't have balanced budgets, and only 6 percent of that surplus has gone for tax relief, only 6 percent.

Now, one could—one might say, well, you know, is that actually—you know, are those numbers accurate, because a lot of money went for additional spending, too? But the fact is if you spent the money, then, you know it isn't considered in the surpluses; and we did spend, in my view, far too much money.

This is kind of a longwinded question, but based upon that statement, those who would blame the deficits next year on the Bush tax cut, I would be interested to hear what the panel would have to say about that argument, which I personally disagree with that argument, but I would like to hear what the panel might have to say about that.

Mr. BEACH. Well, Congressman, if I could just weigh in, we need to keep in mind that the key elements of the Bush tax cut are not implemented until several years from now, and so we have to be patient before we make that argument. If we are eager to make the argument that the Bush tax cut is the source of deficits, we have to wait until the Bush tax cut is implemented. And next year we do get the first of the rate reductions in a very large way, but 2004—

Mr. CHABOT. Let me follow up before you go on. Some of it went back in the form of the rebates.

Mr. BEACH. That's right.

Mr. CHABOT. And I assume that is where the 6 percent figure is coming from, although I am not sure of that, and I would be happy to be enlightened by the panel.

Mr. BEACH. It is my understanding that that is where that number is coming from as well, and we have to be careful that we offset the economic growth attributable to the rebates and attributable to rate reductions before we make the argument. So we have to be balanced. We have to be fair.

The third thing I would like to say about this is that the Congress is currently considering an extraordinary growth in agricultural subsidies, and there are other challenges that the Congress

faces on the spending side. The projections that Mr. Daniels and others have made of deficits include an estimation, including our estimates, of what Congress is likely to do on the spending side. So we have to bring both sides of the ledger in when we began to think about deficits.

And then finally, the work that we are doing and I think others on this table have done indicates that there is a tenuous case at best between modest deficits and interest rate changes. The monetary handles that the Federal Reserve has at its disposal can accommodate small deficits in the neighborhood of probably less than 50 billion a year through the monetary means that Chairman Greenspan talks to you about all the time.

Mr. MOORE. Mr. Chabot, you asked the question about what happened to the surplus, and that is going to be a question throughout the next year that people are going to be asking, and basically the story I think is this. Clearly a lot of it was spent. This year you are looking at appropriations bills that will be up 8 or 9 percent, which is enormous, given that we are virtually at a zero inflation environment. So those are all real increases in spending in almost every area, and Bill Beach is right, one of the areas where you are saying the biggest spending increase is in the agriculture area.

So a lot of it was spent. You had the \$40 billion tax—I think it was about 40 billion on the tax rebates? What was it? 40 billion, which I would argue—Bill and I may disagree a little bit on this. I see no economic benefit whatsoever from tax rebates. In fact, I think tax rebates are probably the worst way to cut taxes, because they have no economic incentive effects whatsoever.

The other part, though, and this is the essence of what my testimony is about, the major reason you are possibly facing now a future of deficits again, and it swamps all of these other effects, is that we have gone from a 3.5 percent real GDP growth path to a negative growth path. And until you get that economy back up to 2, hopefully 3 to 4 percent growth, you are going to be—it is like a dog chasing your tail. You are never going to be able to produce enough revenues to balance the budget. And that is why, for example, Mr. Pascarell, we may disagree about what policies are best for economic growth, but hopefully the one thing we can all agree on is that unless we—that we have to pursue like a laser beam those growth policies, because, you know, you are going to be having these excruciating hearings over the next couple of years unless we get growth back up, and that is the primary explanation for why that surplus is shrinking so quickly.

Mr. CHABOT. Thank you.

Mr. EDWARDS. Can I make a very quick comment to follow up on something that Steve mentioned? In terms of the effect of the deficit, I think everyone believes that the Federal Government should not run large deficits just because of a basic honesty in Government argument. It shouldn't spend more than we take in. But economically, there is less and less relationship between the Federal deficit and effects on the economy, and the reason why that is, is capital markets these days are global. I came across a figure the other day from the IMF that shows the world debt markets, corporate and government debt around the world, are valued now at about \$25 trillion. The U.S. Federal debt is a small drop in the

bucket for that. Interest rates are set worldwide. There is less and less relationship between what we do with the Federal Government books here and interest rates on the United States, which are set globally.

Chairman TOOMEY. If everyone has time, I would like to have another round of questions. Did you want to follow up?

Mr. PASCRELL. I want to follow up with Mr. Edwards.

Chairman TOOMEY. Go ahead.

Mr. PASCRELL. If I may.

Chairman TOOMEY. Sure.

Mr. PASCRELL. You know how much comes out of every dollar to pay off the interest of the day. This is a large portion, and what we did—and the Congressman was absolutely correct—since we got here in 1997, we insisted that we have caps on spending, although of course they dissolved; both sides are guilty. But we wanted to reduce the amount of money that we have to take out of every tax dollar in order to pay the interest on the debt. I think that is critical. I think it is—regardless that it is part of a huge global financial situation, but the fact that we were able to do it for 4 years bodes well for the future.

Now, we were in deficit—going back to the original point, we were in deficit in terms of the stimulus package and some spending, all sides responsible, in June. And I can prove that. And we were hanging to the situation that has been exacerbated since the tragedy of September 11th. I believe that we should agree on those facts and move forward so that we get a stimulus package that is going to be effectively put to use immediately and not 2 or 3 years from now, and that helps the small business person.

That is why we are here, so that that small business person is the immediate recipient of the benefits that we think are necessary. I think that is critical. I think that is important, because we have been thinking corporate. We have been thinking global in that sense, and I think that it doesn't serve the majority of folks who have small businesses in this country. Haven't, Mr. Chairman, we been listening to these folks that have come before the general committee, small businesses that are hurting out there before September the 11th, after September the 11th? I think we need to respond to those needs. They are real needs.

Chairman TOOMEY. Well, I would like to follow up on this topic, too, and as a former small business owner myself, I was always very conscious of the percent of my operating budget that was going to debt service, and some have suggested that if we lower taxes, we may have at least in the short term a larger deficit and large deficits lead to high interest rates and that is very harmful for small businesses, as well as many others. But from what I have seen, at least in the post-war era, there is virtually no correlation whatsoever between the size of the Federal budget deficit and the level of interest rates. Am I wrong? Is there a correlation? Is there not a correlation?

Mr. EDWARDS. No. As I indicated, there is less and less relationship. I mean, you can graph interest rates in the Federal deficit over the last couple of decades, and there is very little relationship. Interest rates are set by things like inflation expectations and that sort of thing and—

Chairman TOOMEY. So this isn't a question of empirical fact. This isn't—the theory, you can look at the data; you know what interest rates were historically. You know how big the deficit was in any given year, and you can confirm that there simply is not a correlation anymore.

Mr. PASCRELL. Mr. Chairman, that is in utter contradiction to what Mr. Greenspan has been saying for the last 4 years, maybe one of the reasons why he thought he acted too early or too late in reducing interest rates. But that is contradicting basically what we—one of the foundations we have been moving on, and, you know, that is fine. I mean, there is no god—there is only one God, and there are no gods—

Mr. MOORE. He is not the God.

Chairman TOOMEY. Let me just respond quickly, and then I will yield to Mr. Moore. But I am simply making a point about objective historical fact, and if someone can show me the data that suggests that there is a historical correlation, then I will admit that I am then completely wrong, but I am saying that in—certainly in recent decades, there is no correlation, and I just don't think that is really disputable.

Mr. MOORE. Well, actually there is a correlation. It is actually government spending which is causing—there is a crowding-out effect of government, and it is not from the borrowing. It is from the government spending. And government spending can be financed in three ways, through higher taxes, through monetary policy or through running deficits. And what the evidence seems to indicate is that, you know, higher taxes also lead to a crowding-out effect. And so we should really be concentrating on the total size of the government spending.

One other interesting aspect about this, by the way, though, is not only in the 1980s did we have high interest rates and falling—I mean, high deficits and falling interest rates, but if you look at Japan today, Japan has the lowest interest rates in sort of recorded history, and yet they are running gigantic budget deficits. So it is just hard to find any relationship between deficits, and despite what God says about this.

Chairman TOOMEY. And that actually leads me right to the next topic which I wanted to ask Mr. Beach. Japan is an interesting example, not only because of their extremely low interest rates, but my understanding is that they have had an unprecedented wave of successive Federal Government, if you will, spending programs. And to those who suggest that, well, won't Federal spending, which has increased dramatically, won't that solve the problem, again, empirically, the evidence in Japan certainly doesn't suggest that. But is that a valid comparison? Is that useful to look at the decade of the 1990s in Japan?

Mr. BEACH. I think it is useful to look at large industrialized countries' recent history and see what pattern they have gone through. It is instructive, Mr. Chairman. Japan has got a very interesting problem. The average householder in Japan is so unconfident in the future that they are withholding their consumption. Prices fall and they withhold it even further. They say, well, I am going to wait to buy that refrigerator or that car or something

of that nature, and the government has tried one spending stimulus aggregate demand policy change after another.

Finally, after now 10 years—and today we will learn whether they are officially in their third recession of this decade—there is a set of proposals to actually cut taxes, and we are hopeful that that will now lighten the load on householders and stimulate that economy.

This deficit question is extraordinarily important, however, and we need to be real serious about it. I am a former small business person myself, so I have a great interest in these matters, but in fact if we were in a deficit in June, and I think that that is probably right, then we have a hard time explaining why we have had a succession month after month of major interest rates falling. You see, it is not so much the deficit that is the matter. It is the expectation of the future. The Japanese householder says, the future looks grim in Japan, I will behave in a rational way and withhold my economic investments and consumption. And that is what a lot of the people do in this country as well. If they think that the Federal Government is out of control, that its spending is too high, its taxes are on the way up, well, then interest rates are going to rise but not because of a deficit but because of a belief in the future.

Chairman TOOMEY. Thank you, and I will yield to Mr. Pascrell to ask the final question of the hearing.

Mr. PASCRELL. Thank you, Mr. Chairman. You know, in the 1980s we looked to Japan as the model.

Mr. BEACH. Wrongly.

Mr. PASCRELL. Well, we did. This is a fact of life. I didn't make it up on the way to the office this morning. You know, I don't have any problems supporting the government spending money, and I want to get Mr. Lauster's reaction and response to this. I don't have any problems, where needed, targeting money, unemployment insurance. It is government spending. Health benefits, a lot of folks are out of jobs. We stabilized the airlines. We did nothing for the 110,000 employees laid off. Bridge loans, increasing them, so we put off paying the tax—the loan back, I don't have any problems with that. When we look through the history of the 20th century, a lot of recessions, a lot of depressions, we saw government wisely spending money. I mean, it is not an either/or situation. It doesn't have to be. None of us should try to make it that.

And, you know, Mr. Lauster, you are like many other small business voices. You have heard back and forth here different philosophical bents. What do you think?

Mr. LAUSTER. Well, a lot of this discussion has been certainly outside of my zone of competence.

Mr. PASCRELL. Well, join us.

Mr. LAUSTER. The truth is I think most of us in business believe that the economy, you know, is like the sea. It is this powerful force, and that while you may be an aircraft carrier on the sea, you don't really control it. The Federal Government has an effect, that is clear. But I think most of us in business believe that the economy really has strong fundamentals, weak fundamentals, and it will do what it will do, and the Federal Government, through interest rates, fiscal policy, can exacerbate or help people, but it really

isn't going to control the economy. The economy is really a force of nature.

Consequently, my sense is that, especially from a small business perspective, my business perspective, when people in areas are suffering unduly, like workers who are losing, you know, their jobs and all of the companies that were referred to before by the chairman, these are people who will get back on their feet, but they are currently taking, as I said before, a hit. To the extent that the government can cushion them till they get back on their feet, that is really important. It is important to their morale. It is important to the prosperity of those communities, those communities that have large plants that shut down, small businesses that sell groceries, that sell all sorts of things, those businesses are going to suffer tremendously.

So you have a regional problem that comes from an individual/corporation's rational decision to cut back. To the extent that the government can cushion that kind of thing, it does a great job. I personally am dubious that the government really controls the economy as a whole. I believe that is beyond the power of Washington, but I think it can make life better for people and, hence, stabilize businesses and communities throughout the country.

Mr. PASCRELL. I thank you for all being here.

Chairman TOOMEY. Thank you very much. The hearing is adjourned.

[Whereupon, at 11:21 a.m., the subcommittee was adjourned.]

PAT TOOMEY, PENNSYLVANIA
CHAIRMAN

WILLIAM PASCRELL, JR., NEW JERSEY
RANKING MINORITY MEMBER

Congress of the United States
House of Representatives
107th Congress
Committee on Small Business
Subcommittee on Tax, Finance and Exports
2361 Rayburn House Office Building
Washington, DC 20515-6515

Remarks of Subcommittee Chairman Patrick J. Toomey

**“Tax Relief: The Real Economic Stimulus for
America’s Economy”**

December 6, 2001

This morning, the House Small Business Subcommittee on Tax, Finance, and Exports convenes to address a number of economic stimulus proposals and their possible impacts on the nation’s economy. Heightened concerns about an economic slowdown have spawned a number of proposals, ranging from tax relief to spending increases, to stimulate the economy. Despite the passage of an economic stimulus package by the

House, the Senate has yet to consider their own version of this legislation.

Unfortunately, this inaction has consequences. Last week, it was announced the economy has now slowed to an annual rate of negative 1.1 percent. The current economic downturn, which began in September 2000, was only accelerated by the events of September 11. Since that time, over 400,000 jobs have been lost. Consequently, the unemployment rate for October is at a five year high of 5.4 percent.

These job losses are impacting every segment of the nation. In the Lehigh Valley alone, employees from Kraft, Rodale, Laneco, Pabst, and Agere have been laid off. Nationally, industry giants such as Boeing, Gateway, IBM, and several Airlines, including Northwest and Delta have made significant layoffs.

As we all know, there is a heated debate on the approach necessary to resolve our current economic woes. Some think huge increase in government spending will solve economic problems. Others, including myself, believe major, immediate tax relief will do much more good than even more government spending.

Much of the ongoing debate over an economic stimulus package has centered on the appropriate balance between spending and tax relief. Leaving aside the economic arguments as to which better stimulates growth and job creation for the moment, it is important to note that Congress has already approved or agreed to approve spending increases of at least \$105 billion. These spending increases have gone for victim's compensation, airline assistance, the emergency supplemental, and additional discretionary spending. Additionally, the economic

stimulus bill passed by the House contains \$12 billion to assist workers displaced as a result of the events of September 11.

However, at a time when the nation is struggling to jump-start the economy, the most viable remedy is to provide meaningful tax relief to stimulate long-term growth. At this time, more than any other, it is important to remove the economic barriers working Americans face as they work to provide for their families. The only way to increase the wealth of working Americans is to encourage more work, saving, investment, risk-taking, and entrepreneurship. This is why incentive-driven supply-side economics has such a successful track record. When tax rates are reduced, people have more motivation to be productive and create wealth. And when they earn

more income, they are able to spend more and save more.

This hearing will focus on the impact meaningful tax relief would have on the nation's immediate and long-term economic growth, and for small businesses in particular.

I look forward to the testimony of the witnesses before us today. I want to particularly thank the Subcommittee's Ranking Member, Bill Pascrell, who has been very flexible in scheduling this hearing. While I suspect we will have differing views on the solutions to our economic problems, I do appreciate his commitment to resolving our current economic crisis. I now yield to my friend from New Jersey, Bill Pascrell for his opening statement.

Statement of Chris Edwards, Director of Fiscal Policy, Cato Institute

before the

**House Committee on Small Business,
Subcommittee on Tax, Finance, and Exports**

regarding

Economic Stimulus Proposals

December 6, 2001

Mr. Chairman and members of the Committee, thank you for inviting me to testify today on proposals for economic stimulus.

The U.S. economy is now in recession. The right tax policy can speed up the economy's return to growth. As large businesses are cutting jobs by the thousands right now, we need small businesses and entrepreneurs to take up the slack by starting new businesses and investing. Let's make these risky decisions easier for them by cutting their tax burden.

Tax reforms can aid entrepreneurs in three ways – the decision to launch a new business, the ease of finding financing, and the decision to expand. Let me run through each of these.

First, Congress can make the decision to start a business more attractive by accelerating the already enacted income tax rate cuts. This will boost after-tax returns for sole proprietors, partnerships, and S corporations. Treasury figures show that 63% of tax filers in the top 39% tax bracket have small business income, so cutting the top rate targets exactly the people who can get the economy moving again.

The capital gains tax rate is also very important to encouraging start-ups. This country has scores of so-called serial entrepreneurs, as we've seen in high-tech in recent years. They start a new business which they grow for a few years, and then if successful sell their business realizing a capital gain, then they turn around and invest in another start-up. Cutting the gains rate make successful start-ups more valuable, and allows entrepreneurs to keep more funds for reinvestment in new businesses.

As a side note on start-ups, there is quirk in the tax code that would be very timely to fix right now. That is the requirement that new businesses write-off start-up costs over 5 years, rather than allowing immediate deduction. These start-up costs include such items as market research and employee training. These may not be immediately deducted. So I recommend that the Committee look into this disincentive and lower this tax hurdle to new businesses.

The second way that tax reforms can help is easing business financing. The Committee is aware of the important role played by venture capital in the economy. So-called angel investment in start-ups is maybe even more important and about twice as large. Angel investors are usually wealthy individuals who are fully taxable. Microsoft billionaire Paul Allen, for example, has put his own money into over 100 new companies. The return these investors receive is capital gains on start-ups that succeed. By the way, during the 1990s many large corporations became venture investors in new growth companies, particularly in high tech. Corporate capital gains are taxed at 35%, so cutting corporate capital gains may also increase investment flows to small companies.

Some have questioned what lowering the capital gains rate would do right now with the stock market down. But angel and VC investors know that the market will rise again, and they are looking to realize gains in new investments perhaps in 2 years or more. So cutting the gains rate permanently will draw in more investment to new high-growth firms right now.

Thirdly, accelerating the individual income tax rate cuts will stimulate existing small businesses to expand. A series of studies by four top tax economists examined the effect of the 1986 tax rate cuts on sole proprietors.¹ Their results show that a 5 percentage point cut in rates would increase capital investment by about 10 percent. And they found that dropping the top tax rate from 40% to 33% would increase hiring by about 12 percent.² These are substantial effects.

Other than tax rate cuts, liberalizing depreciation will lower overall or effective tax rates on new investment. The depreciation provision in the House bill is a step forward, but we need to do much more, and make it permanent. The small business expensing limit, now at \$24,000, should be raised substantially, and ultimately we should move to full capital expensing for all businesses. The Tax Executives Institute testified before Congress this year that depreciation rules are "hopelessly outdated and needlessly complex."³ We should scrap them then and move to expensing which would eliminate many investment distortions. Workers would be the beneficiaries as more capital investment would raise worker productivity and produce higher wages.

Let me make a final note on the issue of broader tax reform. In the 1980s, the U.S. was a leader in tax rate cuts in the world. But the 1990s was a lost decade for tax reform in this country, while other countries have been moving ahead. The average corporate tax rate for 25 OECD countries fell from 41 percent in 1986 to 31 percent today. Our corporate rate is now 4 percentage points higher than the average of our trading partners.⁴ The average top individual tax rate for OECD countries fell from 55 percent in 1986 to 41 percent today.⁵ Regarding capital gains, a number of countries, such as the Netherlands, exclude it from taxation altogether.⁶

A new study by Arthur Anderson compared 9 major countries as to how good their business environment is for entrepreneurial growth companies, based on various tax and regulatory factors.⁷ As it turned out, the US was not number one, as we would usually

expect. We finished second behind Britain. Let's not fall any further behind, we should pursue further tax reforms and create the best tax environment in the world for business and entrepreneurs.

Thank you for holding these important hearings, and I look forward to working with the Committee on these issues.

¹ "Entrepreneurs, Income Taxes, and Investment," Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen, in *Does Atlas Shrug*, Joel Slemrod (editor), 2000. See also *Economic Policy and the Start-Up, Survival, and Growth of Entrepreneurial Ventures*, Douglas Holtz-Eakin and Harvey Rosen, Submitted to the Small Business Administration, May 2001.

² "Income Taxes and Entrepreneurs' Use of Labor," *Journal of Labor Economics*, Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen, April 1999.

³ Betty Wilson, Tax Executives Institute, Testimony before the Senate Finance Committee, 107th Congress, 1st session, April 26, 2001.

⁴ "Tax Rates Are Falling," *OECD in Washington*, March-April 2001. And email from OECD Washington with "OECD Tax Database" data.

⁵ Email from OECD Washington with "OECD Tax Database" data. Central government tax rate only.

⁶ *An International Comparison of Capital Gains Tax Rates*, Arthur Andersen LLP study completed for the American Council for Capital Formation, August 1998.

⁷ "Not Just Peanuts 2001," Growth Plus and Arthur Andersen, October 2001.

Testimony

Before the Subcommittee on Tax, Finance, and Exports
Of the Committee on Small Business
Of the United States House of Representatives

By

William W. Beach
Director
Center for Data Analysis
The Heritage Foundation

December 6, 2001

My Chairman, my name is William Beach. I am the Director of the Center for Data Analysis at The Heritage Foundation. It is a great privilege for me to be with you this morning and to speak on this important topic. You should know that my remarks today reflect my own views on this subject and not necessarily those of The Heritage Foundation.

There is increasingly little doubt that the U.S. economy currently is in recession. The visible and widely noted economic slowdown that began in the spring of 2000 worsened over the summer and fall. The service and financial sectors joined manufacturing in contracting during the winter of 2001, and the recession officially began in March. Why is the U.S. economy in a recession now after nearly a decade of economic growth?

I hold the view that recessions occur as a result of policy errors compounded by an external shocks to the economy. While we will have to wait several years for a thoughtful economic history of the 1990s, I imagine historians will point to two policy errors and the events of September 11 as important to the contraction of 2001.

First, they doubtless will note the unusually large expansion of money and credit in 1998 and 1999 that was intended to support the conversion of the nation's computer systems to Y2K compliance. No doubt the monetary expansion did just that, but it also allowed banks and venture capital firms to supply credit for new business startups. Again, I imagine history will show that a significant portion of the dot-com bubble was due to the Y2K monetary expansion.

The second policy error has two faces. First, the monetary loosening of 1998 and 1999 was followed by the monetary tightening of 1999 and early 2000. The Federal Reserve increased interest rates in an attempt to nip inflation in the bud (a bud which had been nurtured by their careless watering of the year before). The economy slowed; the speculative bubble began to burst; and the Fed loosened, but did so in vain.

The other face of this second policy error stems from the first: the expansion of the late 1990s increased the tax burden on labor and capital as incomes rose. Indeed, the weight of expansion-related taxes may well have been nearly two percent of Gross Domestic Product by 2000, or roughly equivalent to the federal surplus. This burden produced economic distress as the economy weakened. Required rates of return on long-term investments grew as the tax premium expanded, and grew further still as near- and medium-term economic prospects darkened.

It is in this context that Congress now is debating the composition of an economic stimulus bill. The events of September 11 doubtless worsened the economic contraction and have necessarily introduced into the debate proposals to ameliorate harm related to the terrorist attacks.

Perhaps the debate's most interesting feature is how it has helped clarify the economic differences between a demand-based approach to strengthening economic performance and a supply-based approach. I suspect this additional clarity is not entirely evident, even to those most closely involved in the debate. The statistical and rhetorical record, however, should be very useful to future disputants.

What do I mean by additional clarity? While still too early to tell definitively, the small boost to household disposable income that stemmed from the summer's tax rebate program (a key provision of the tax legislation signed into law by President Bush on June 7, 2001) appear to have had little effect on consumption expenditures. Not only do opinion surveys show that households devoted the lion's share of their rebate checks to debt repayment and savings, but new data from the Federal Reserve indicates a spike in savings commensurate with the size of the rebate and its timing. This additional information on the effects of tax rebates during economic slowdowns re-enforces findings about the disposition of earlier rebate efforts, likewise intended to boost consumption expenditures during economically distressed times.

This additional evidence on how households will likely "spend" subsidies and one-off rebates from the federal government is most welcome to analysts focused on stimulus measures that work on the deep structure of economic activity: incentives, investment, and long-term expectations. It shows the futility of efforts solely or mostly devoted at on raising aggregate demand through spending. And, while these lessons are hard for Washington policy makers to learn, the statistical record being made during this recession likely will guide a higher proportion of future lawmakers toward the more effective and economically sensible route of tax rate reduction.

Our own work on various economic recovery proposals points to the greater importance of policy change directed at incentives, investments, and long-term economic expectations. On November 9, 2001, my colleague, Mark Wilson, and I published an analysis of two leading stimulus proposals then pending in the United States Senate: a plan by Senator Grassley that reflected President Bush's recommendations and a plan associated with the Senate leadership, Senators Daschle and Baucus. We used a standard

model of the U.S. economy, the DRI/WEFA U.S. Macroeconomic Model, to estimate the economic effects of the two plans. We also employed the CDA Individual Income Tax Model to estimate the year-by-year changes in federal revenues stemming from the changes in tax law proposed by the two plans.

The proposal advanced by Senator Grassley consisted of the following seven major components:

- 1) acceleration into 2002 of all of the tax rate reductions that are currently scheduled for 2004 and 2006;
- 2) accelerating the depreciation of capital acquisitions for the next three years by enacting a 30 percent bonus depreciation for those years;
- 3) repealing the corporate alternative minimum tax on a prospective basis;
- 4) providing supplemental cash payments to taxpayers who were not qualified to receive the full amount of last summer's tax rebates;
- 5) establishing a temporary emergency extended unemployment compensation program to provide an additional 13 weeks of unemployment benefits to workers laid off as a result of the September 11 attacks;
- 6) providing states with \$3 billion in National Emergency Grants to pay for unemployment insurance benefits to laid-off workers not eligible for the temporary extended benefit program, to pay up to 75 percent of health insurance premiums covered by COBRA, and to strengthen job placement assistance; and
- 7) encouraging states to use \$11 billion in unspent State Children's Health Insurance Program matching funds to expand health insurance coverage for the uninsured.

The Senate leadership plan relied much less on tax cuts and more on spending programs. That plan contained the following nine provisions:

- 1) supplemental tax rebate checks for taxpayers who did not receive the full amount during the summer of 2001;
- 2) a 10 percent bonus depreciation for investment in capital and software placed in service over the next 12 months;
- 3) expansion of Section 179 expensing for small businesses;
- 4) expansion of the carryback period for net operating losses;
- 5) extension of expiring tax credits and tax incentives for New York City and distressed areas;
- 6) temporarily extending and expanding Unemployment Insurance;
- 7) subsidized COBRA coverage;
- 8) expansion of Medicaid to cover the unsubsidized portion of COBRA coverage; and
- 9) significant spending increases for agriculture, highway projects, transportation security, border security, bioterrorism prevention, and state and local anti-terrorism grants.

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Every economic indicator in the DRI/WEFA model points to the superiority of an approach to economic recovery that depends on reducing the costs of work and investment. For example, over the period Fiscal Year 2002 through Fiscal Year 2006,

- The Grassley plan produces seven times more jobs than the Senate leadership plan does (283,000 per year vs. 38,000 per year).
- The inflation-adjusted disposable income of an average family of four would increase by \$1,060 per year under the Grassley plan and by only \$236 per year under the Senate leadership proposal.
- The Grassley plan increases inflation-adjusted consumption expenditures by \$45.4 billion per year, compared with an increase of only \$10.3 billion under the Senate leadership plan.
- Personal savings (adjusted for inflation) would increase by \$27.3 billion per year under the Grassley plan and by only \$5.4 billion under the Senate leadership plan.
- The Grassley plan would increase inflation-adjusted investment by \$13.4 billion per year, while the increase under the Senate leadership proposal would be only \$1.1 billion per year.

The Grassley proposal (which, again, closely reflected the plan advanced by the Bush administration) clearly would lessen the depth of the recession and shorten the time over which the economy would pass before returning to pre-recession growth levels. One question, however: Just how much of these economic benefits stem from the acceleration of the individual income tax rates alone? After all, the Grassley plan contained a number of spending proposals advanced by the Senate leadership in their proposal.

To answer that question, we estimated the economic effects of just the rate reductions using the same model of the economy and over the same five-year time period. These results are being announced today for the first time. We found that the rate reductions alone in the Grassley-Bush plan account for

- 59 percent of the gain in national output,
- 67 percent of the improvement in employment,
- 65 percent of the increase in disposable income, and
- 44 percent of the expansion of investment.
- Indeed, personal savings growth attributable to the rate reductions account for about 68 percent of the total change in savings produced by the entire Grassley plan. A copy of these results is attached to this testimony.

While it is possible to point to times in our history when spending programs made a significant difference to employment and output, these moments almost always are associated with extraordinary national mobilizations. Ours is not one of those times, even though the events of September 11 and since have produced a level of national resolve not seen since the beginning of World War II.

We have a recession produced by policy errors and aggravated by hostilities. The errors affected investment and incentives, and they call forth policy responses that

are focused on investment and incentives. The hostilities devastated key elements of our economic superstructure and distressed the lives of hundreds of thousands of innocent and productive citizens. Those hostilities call forth policy responses that are compassionate and generous.

In neither case, however, are the needs of the injured or the weaknesses of the economy met through highway construction, park renovation, agricultural subsidies or the host of other spending programs that bear a weak connection at best to the economic slowdown and the terrorist attacks.

I thank you for the opportunity to appear before your committee.



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**How Only the Accelerated Rate Reductions in the Bush-Grassley Plan
Would Affect Selected Economic Indicators**

(Very Preliminary Results)

Economic Indicators	2001	2002	(Fiscal Year End)			2006	(Average)
			2003	2004	2005		2002 - 2006
Real Gross Domestic Product							
	In Billions of 1996 Dollars						
Forecast	9,350.9	9,526.3	9,947.1	10,330.4	10,671.3	11,000.8	10,295.2
Baseline	9,350.9	9,517.3	9,924.3	10,302.0	10,642.0	10,976.9	10,272.6
Difference	0.0	9.0	22.8	28.4	29.0	23.9	22.6
Real GDP Growth Rate							
	Percent Change from Year Ago						
Forecast	1.2	1.9	4.4	3.9	3.3	3.1	3.3
Baseline	1.2	1.8	4.3	3.8	3.3	3.1	3.3
Difference	0.0	0.1	0.1	0.1	0.0	0.0	0.1
Total Employment							
	In Thousands of Jobs						
Forecast	131,568	133,577	135,261	138,173	140,043	141,472	137,705
Baseline	131,568	133,441	135,038	137,953	139,827	141,317	137,515
Difference	0	136	223	220	216	155	190
Unemployment Rate							
	Percent of Civilian Labor Force						
Forecast	5.3	5.7	5.4	5.1	5.0	5.0	5.2
Baseline	5.3	5.7	5.4	5.2	5.1	5.1	5.3
Difference	0.0	0.0	0.0	-0.1	-0.1	-0.1	-0.1
Disposable Personal Income							
	In Billions of 1996 Dollars						
Forecast	6,847.5	7,069.5	7,231.5	7,503.9	7,715.8	7,907.0	7,485.5
Baseline	6,847.5	7,028.3	7,162.8	7,443.4	7,666.1	7,883.4	7,436.8
Difference	0.0	41.2	68.7	60.5	49.7	23.6	48.7
Disposable Income Per Person							
	In 1996 Dollars						
Forecast	24,709	25,292	25,667	26,416	26,943	27,393	26,342
Baseline	24,709	25,144	25,423	26,203	26,770	27,311	26,170
Difference Per Person	0	148	244	213	173	82	172
Difference for Family of Four	0	592	976	852	692	328	688
Consumption Expenditures							
	In Billions of 1996 Dollars						
Forecast	6,371.9	6,618.0	6,898.3	7,146.2	7,389.9	7,592.2	7,128.9
Baseline	6,371.9	6,604.1	6,868.0	7,110.2	7,353.9	7,564.3	7,100.1
Difference	0.0	13.9	30.3	36.0	36.0	27.9	28.8
Personal Savings							
	In Billions of 1996 Dollars						
Forecast	233.9	217.7	95.9	99.1	49.6	27.3	97.9
Baseline	233.9	191.1	58.9	76.0	37.4	32.9	79.3
Difference	0.0	26.6	37.0	23.1	12.2	-5.6	18.7
Investment							
	In Billions of 1996 Dollars						
Forecast	1,376.2	1,415.0	1,532.7	1,628.9	1,734.2	1,831.0	1,628.4
Baseline	1,376.2	1,412.5	1,527.7	1,622.6	1,726.4	1,823.3	1,622.5
Difference	0.0	2.5	5.0	6.3	7.8	7.7	5.9

Center for Data Analysis
The Heritage Foundation
Some numbers may not add due to rounding.

11/29/2001

A REPORT OF THE HERITAGE CENTER FOR DATA ANALYSIS

THE ECONOMIC EFFECTS OF
PRESIDENT BUSH'S AND SENATOR DASCHLE'S
ECONOMIC STIMULUS PLANS

WILLIAM W. BEACH, D. MARK WILSON,
REA S. HEDERMAN, AND RALPH A. RECTOR

CDA01-09

November 9, 2001



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THE ECONOMIC EFFECTS OF PRESIDENT BUSH'S AND SENATOR DASCHLE'S ECONOMIC STIMULUS PLANS

WILLIAM W. BEACH, D. MARK WILSON,
REA S. HEDERMAN, AND RALPH A. RECTOR

On November 6, 2001, Senate Majority Leader Thomas Daschle (D-SD) reaffirmed his intention to introduce a two-component economic stimulus package that would combine the plans of Senators Max Baucus (D-MT) and Robert Byrd (D-WV). It now appears likely that the upcoming Senate debate on economic stimulus legislation will center around Senator Daschle's plan and a plan proposed by Senator Charles Grassley (R-IA) that is strongly supported by President Bush.

Although both plans are intended to ease the impact of the economic recession and improve the incentives to work, save, and invest (the real catalysts for economic growth), there are substantial fiscal policy differences between them. On the one side are those, led by the President and Senator Grassley, who believe that vigorous tax cuts combined with limited spending increases will do the most to lift the economy out of its current slump. On the other side are those, led by Senator Daschle, who believe that substantial spending increases combined with limited, targeted tax cuts will do the most to remedy the economic problems that have been exacerbated by the September 11 attacks.

This *Report* addresses the question of which approach—significant tax cuts with limited

spending or significant spending with limited tax cuts—would do more to boost the economy. It evaluates both of the Senate stimulus plans, using the same economic model, against the same baseline to determine which approach would produce the best economic results over the next five years.

To address this question, analysts in the Heritage Foundation's Center for Data Analysis (CDA) used the WEFA U.S. Macroeconomic Model, the Center's Individual Income Tax Model, and work by the staff of the Joint Committee on Taxation (JCT). Specifically, CDA economists estimated the economic effects of the Bush-Grassley and Daschle plans using the same model of the U.S. economy, one that contains a two-quarter recession beginning in the third quarter of 2001 and ending during the first quarter of 2002. This analysis shows that:

- In fiscal year (FY) 2002, the Bush-Grassley plan produces nearly twice as many jobs as the Daschle plan does (211,000 vs. 108,000). From FY 2002 to FY 2006, on average, the Bush-Grassley plan produces over seven times more jobs than the Daschle plan (283,000 per year vs. 38,000 per year).

 THE HERITAGE CENTER FOR DATA ANALYSIS

- From FY 2002 to FY 2006, the inflation-adjusted disposable income of an average family of four would increase by an average of \$1,060 per year under the Bush–Grassley plan and by only \$236 per year under the Daschle plan.
- In FY 2002, the Bush–Grassley plan increases inflation-adjusted consumption expenditures by \$27.9 billion—40 percent more than the Daschle plan's \$20.0 billion.
- By the end of FY 2002, the average savings for a family of four (adjusted for inflation) would increase by \$752 under the Bush–Grassley plan, compared with an increase of \$536 under the Daschle plan.
- From FY 2002 to FY 2006, investment (adjusted for inflation) would increase by an average of \$13.4 billion per year under the Bush–Grassley plan and by only \$1.1 billion per year under the Daschle plan.

Although both plans transfer income to low- and moderate-income taxpayers through rebates, and although both assist the unemployed, the fact that the economic outcomes produced under the Daschle plan fall far short of those produced under the Bush–Grassley plan raises serious questions about the utility of cash payments and increased government spending as the primary tools for boosting economic activity. The better approach would be to lower tax rates and the tax burden on labor and capital to improve incentives for workers and business owners, producing more jobs and generating higher incomes, which in turn translate into higher investment and consumer spending.

SUMMARY OF PLANS

CDA analysts evaluated two economic stimulus plans for this *Report*: the plan proposed by Senator Charles Grassley and strongly supported by President Bush, and the plan proposed by Senate

Majority Leader Thomas Daschle that would combine the plans of Senators Max Baucus and Robert Byrd.

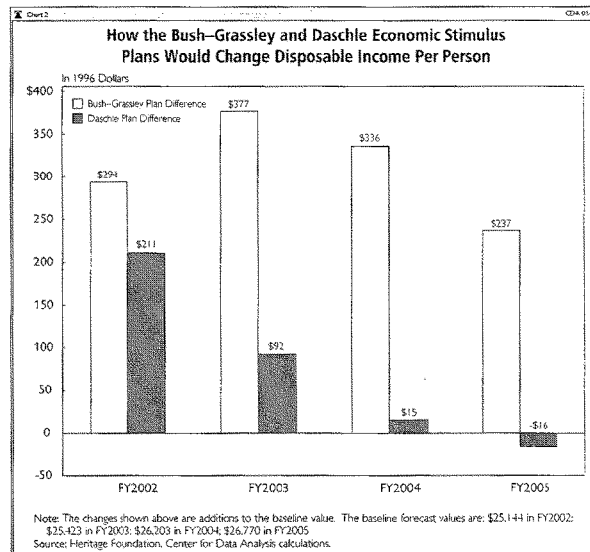
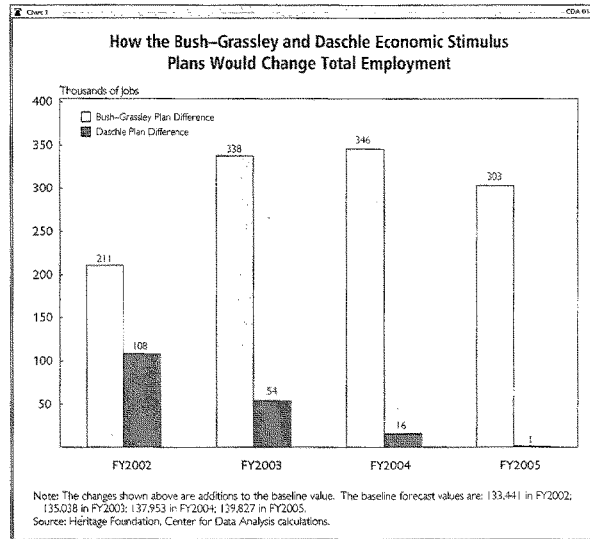
The Bush–Grassley plan consists of five elements: individual income tax reductions, tax policy changes that reduce capital costs, cash relief to low- and middle-income workers, extending and expanding unemployment insurance, and expanding health insurance coverage. The plan is expected to result in static federal revenue reductions and spending increases totaling \$248 billion over next five years.¹

Specifically, Senator Grassley and the President propose:

- Accelerating into 2002 all of the tax rate reductions that are currently scheduled for 2004 and 2006;
- Accelerating the depreciation of capital acquisitions for the next three years by enacting a 30 percent "bonus" depreciation for those years;
- Repealing the corporate alternative minimum tax on a prospective basis;
- Providing supplemental cash payments to taxpayers who were not qualified to receive the full amount of last summer's tax rebates (\$300 for singles, \$600 for married taxpayers, and \$500 for head-of-household taxpayers);
- Establishing a temporary emergency extended unemployment compensation program to provide an additional 13 weeks of unemployment benefits to workers laid off as a result of the September 11 attacks;
- Providing states with \$3 billion in National Emergency Grants to pay for unemployment insurance benefits to laid-off workers not eligible for the temporary extended benefit program, to pay up to 75 percent of health insurance premiums covered by COBRA,² and to strengthen job placement assistance; and

1. In scoring the President's tax and displaced workers provisions, The Heritage Foundation's Center for Data Analysis used the Center's Individual Income Tax Model and analysis by the staff of the Joint Committee on Taxation. For details, see Appendix A: Methodology. "Static" revenue reductions do not take into account the behavioral response of taxpayers to tax policy change. Such responses usually result in revenue changes that are significantly different from the estimates developed using accounting or static methods.

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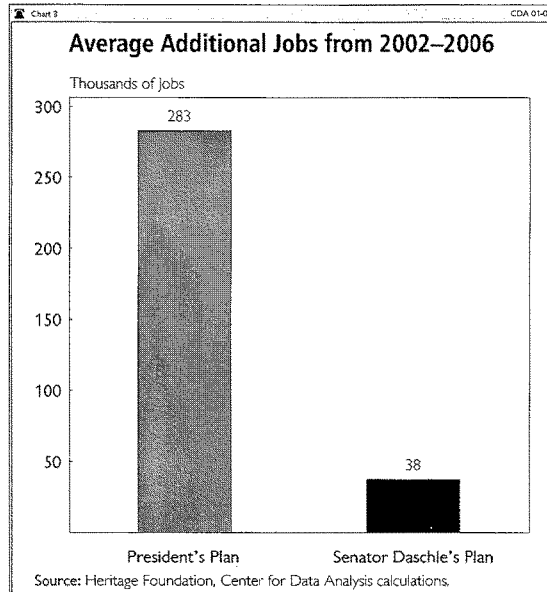
- Encouraging states to use \$11 billion in unspent State Children's Health Insurance Program (SCHIP) matching funds to expand health insurance coverage for the uninsured.

The Daschle plan consists of five elements: cash relief to low- and middle-income workers, tax policy changes that reduce capital costs, extending and expanding unemployment insurance, expanding health insurance coverage, and significantly increasing spending for infrastructure and national security projects. The key contrast between the Bush–Grassley plan and the Daschle plan centers on the amount of tax relief vs. the amount of increased spending that each provides.

Specifically, the Daschle plan would consist of:

- Supplemental tax rebate checks for taxpayers who did not receive the full amount during the summer of 2001;
- A 10 percent “bonus” depreciation for investment in capital and software placed in service over the next 12 months;
- Expansion of Section 179 expensing for small businesses;
- Expansion of the carryback period for net operating losses;
- Extension of expiring tax credits and tax incentives for New York City and distressed areas;
- Temporarily extending and expanding Unemployment Insurance;
- Subsidized COBRA coverage;
- Expansion of Medicaid to cover the unsubsidized portion of COBRA coverage; and
- Significant spending increases for agriculture, highway projects, transportation security, border security, bioterrorism prevention, and state and local anti-terrorism grants.

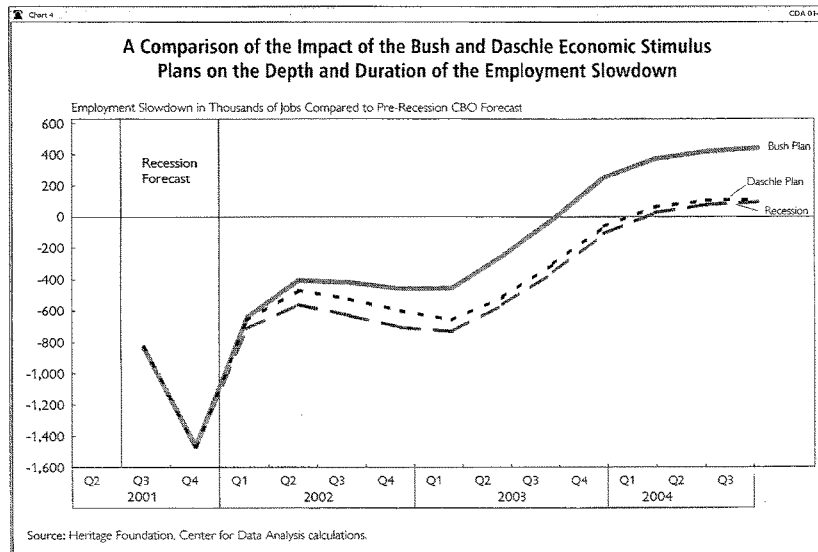
The Daschle plan would reduce federal tax revenue and increase spending by a total of \$88 billion over the next five years.³



2. The Consolidated Omnibus Budget Reconciliation Act of 1986 (Public Law 99–272).

3. U.S. Senate Committee on Finance, “Baucus Economic Recovery Proposal,” at <http://finance.senate.gov/102401leg.pdf>, and Cheryl Bolen, “Byrd Details \$20 Billion Spending to Put in Economic Stimulus Package,” Bureau of National Affairs *Daily Report for Executives*, October 25, 2001, p. A36.

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COMPARISON OF ECONOMIC EFFECTS

There may be many good political reasons for Congress to pass an economic stimulus package, but there is one overriding economic reason: The intervention should improve the incentives to work, save, and invest—the real catalysts of economic growth. Fiscal policy changes that focus on these economic incentives will lay the foundation for stronger economic growth and both reduce the depth and shorten the duration of the current slowdown. Indeed, the competing stimulus plans should be evaluated with respect to their effects on depth and duration of the recession as much as, or more than, with respect to any other criteria.

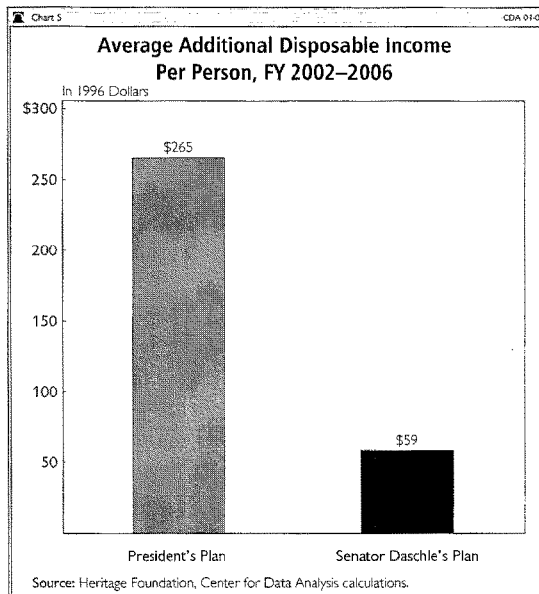
To determine how the two plans compare in terms of their effect on the expected depth and duration of the current recession, CDA analysts developed projections of the economic impact of each of the plans. Chart 4 shows how each plan will affect the change in employment between the

beginning of the recession (the end of the second quarter of 2001) and the time when total employment returns to the level it would likely have attained had there not been the recession of 2001 (i.e., the first quarter of 2004).

Chart 4 shows that, while both proposals lessen the depth of job loss, only the Bush–Grassley plan significantly shortens the time before employment regains the level it would have attained without a recession. As the chart demonstrates, the Bush–Grassley plan reduces the employment trough by nearly 33 percent and shortens the length of the job slowdown by six months.

Both plans affect economic activity, but the Bush–Grassley plan, which contains significant tax relief and limited spending, produces uniformly better economic results than would a plan based on substantial spending increases combined with limited tax cuts. For example, in FY 2002:

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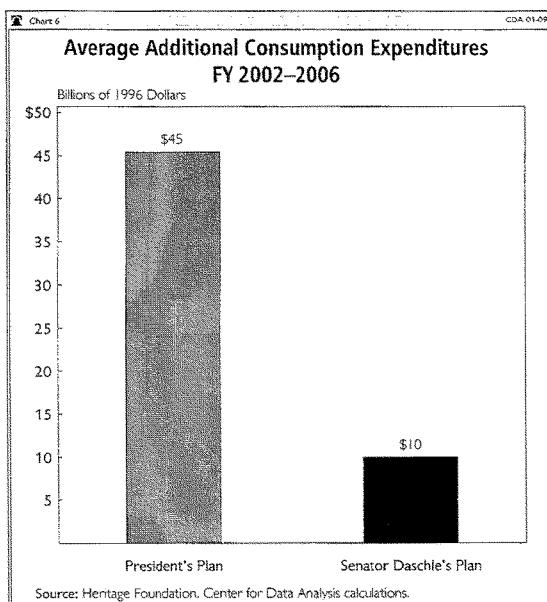
pared with \$4.9 billion under the Daschle plan.

Moreover, as Table 1 shows, the differences in the effects of the two plans will be even more pronounced in future years. The Bush–Grassley stimulus package creates more jobs, provides more income to families, and does a better job expanding economic activity than the Daschle plan.

These differences become more dramatic as the pro-growth elements of the Bush–Grassley plan take hold. On average, from FY 2002 to FY 2006:

- The Bush–Grassley plan would produce nearly two times as many jobs as the Daschle plan would (211,000 vs. 108,000).
- Under the Bush–Grassley plan, the inflation-adjusted disposable income of an average family of four would increase by \$1,176, compared with \$844 under the Daschle plan.
- The Bush–Grassley plan increases inflation-adjusted consumption expenditures by \$27.9 billion—40 percent more than the Daschle plan's \$20.0 billion.
- The average savings for a family of four (adjusted for inflation) would increase by \$752 under the Bush–Grassley plan and by only \$536 under the Daschle plan.
- The Bush–Grassley plan would increase inflation-adjusted investment by \$7.8 billion, compared with \$4.9 billion under the Daschle plan.
- The Bush–Grassley plan increases inflation-adjusted consumption expenditures by \$45.4 billion per year, compared with an increase of only \$10.3 billion per year under the Daschle plan.
- Personal savings (adjusted for inflation) would increase by \$27.3 billion per year under the Bush–Grassley plan and by only \$5.4 billion under the Daschle plan.
- The Bush–Grassley plan would increase inflation-adjusted investment by \$13.4 billion per year, while the increase under the Daschle plan would be only \$1.1 billion per year.

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On the other hand, Senator Daschle's demand-side approach relies primarily on cash transfers to displaced workers and distressed businesses to stimulate economic activity. While this plan produces some increase in employment and income, it fails to substantially increase the fundamental incentives for stronger economic activity. In fact, the Daschle plan never creates the large consumer response that would be needed for a demand-side, expenditure-based stimulus proposal to produce the job and income increases that are generated by supply-side proposals.

While both plans transfer income to low- and moderate-income taxpayers through rebates, and while both assist the unemployed, the fact that the economic outcomes produced under the Daschle plan fall far short of those produced

under the Bush–Grassley plan raises serious questions about the utility of cash payments and increased government spending as the primary tools for boosting economic activity.

—William W. Beach is Director of the Center for Data Analysis at The Heritage Foundation; D. Mark Wilson is a Research Fellow in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation; Rea S. Hederman is Manager of Operations for, and Ralph A. Rector is a Research Fellow in, the Center for Data Analysis.

CONCLUSION

The two economic stimulus plans analyzed in this *Report* clearly reflect the two major views of government's role in economic planning. On the one hand, the Bush–Grassley approach relies primarily on changes in the tax rates on capital and labor to boost economic performance. By lowering tax rates and the tax burden on investment and capital assets, this supply-side plan provides incentives for business owners and workers, producing more jobs and generating higher incomes, which translate in turn into greater investment and consumer spending.

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Table 1

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How the Bush-Grassley and Daschle Economic Stimulus Plans Would Affect Selected Economic Indicators (Preliminary Results)

Economic Indicators	2001	2002	Fiscal Year End		2005	2006	(Average) 2002 - 2006
			2003	2004			
Real Gross Domestic Product			In Billions of 1996 Dollars				
Baseline	9,350.9	9,517.3	9,924.3	10,302.0	10,642.3	10,976.9	10,272.6
Bush-Grassley Plan Difference	0.0	20.1	44.3	49.6	46.6	31.2	38.4
Daschle Plan Difference	0.0	16.5	14.4	2.3	0.1	0.4	6.7
Real GDP Growth Rate			Percent Change from Year Ago				
Baseline	1.2	1.8	4.3	3.8	3.3	3.1	3.3
Bush-Grassley Plan Difference	0.0	0.2	0.2	0.0	0.0	0.0	0.1
Daschle Plan Difference	0.0	0.2	-0.1	-0.1	0.0	0.0	0.0
Total Employment			In Thousands of Jobs				
Baseline	131,568	133,441	135,038	137,953	139,827	141,317	137,515
Bush-Grassley Plan Difference	0	211	338	346	303	217	283
Daschle Plan Difference	0	108	54	16	1	12	38
Unemployment Rate			Percent of Civilian Labor Force				
Baseline	5.3	5.7	5.4	5.2	5.1	5.1	5.3
Bush-Grassley Plan Difference	0.0	-0.1	-0.1	-0.2	-0.2	-0.1	-0.1
Daschle Plan Difference	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Disposable Personal Income			In Billions of 1996 Dollars				
Baseline	6,847.5	7,028.3	7,162.8	7,443.4	7,666.1	7,883.4	7,436.8
Bush-Grassley Plan Difference	0.0	82.1	106.0	95.3	67.9	23.9	75.0
Daschle Plan Difference	0.0	58.8	25.8	4.3	-4.5	-2.7	16.3
Disposable Income Per Person			In 1996 Dollars				
Baseline	24,709	25,144	25,423	26,203	26,770	27,311	26,170
Bush-Grassley Plan Difference	0	294	377	336	237	83	265
Daschle Plan Difference	0	211	92	15	-16	-9	59
Consumption Expenditures			In Billions of 1996 Dollars				
Baseline	6,371.9	6,604.1	6,868.0	7,110.2	7,353.9	7,564.3	7,100.1
Bush-Grassley Plan Difference	0.0	27.9	50.7	57.9	53.7	37.0	45.4
Daschle Plan Difference	0.0	20.0	17.8	9.4	3.3	1.1	10.3
Personal Savings			In Billions of 1996 Dollars				
Baseline	233.9	191.1	58.9	76.0	37.4	32.9	79.3
Bush-Grassley Plan Difference	0.0	52.5	52.9	34.7	11.6	-15.0	27.3
Daschle Plan Difference	0.0	37.5	7.2	-5.6	-7.9	-4.2	5.4
Investment			In Billions of 1996 Dollars				
Baseline	1,376.2	1,412.5	1,527.7	1,622.6	1,726.4	1,823.3	1,622.5
Bush-Grassley Plan Difference	0.0	7.8	13.2	17.1	16.6	12.5	13.4
Daschle Plan Difference	0.0	4.9	0.6	-0.4	0.0	0.5	1.1

Note: Some numbers may not add due to rounding.

Source: The Heritage Foundation, Center for Data Analysis.

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Source: The Heritage Foundation, Center for Data Analysis.

APPENDIX A: METHODOLOGY

Heritage Foundation economists in the Center for Data Analysis (CDA) followed a two-step procedure in analyzing the budgetary and economic effects of the two stimulus plans evaluated in this *Report*.

- First, preliminary static tax revenue estimates for the economic stimulus plan were either generated by the Center's Individual Income Tax Model or obtained from the Joint Committee on Taxation (JCT). The CDA and JCT tax revenue estimates are based on a static methodology that generally does not account for the macroeconomic effects that would result from a reduction in tax rates.⁴ These effects include changes in gross domestic product (GDP), interest rates, employment, personal income, and inflation that can significantly affect tax revenues. Therefore, the static estimates provide a very limited analysis of the economic and budgetary impact of any policy change. To forecast the change in federal tax revenue, spending, and the economy more accurately, a dynamic model must be used.
- Second, the static revenue changes were introduced into the WEFA U.S. Macroeconomic Model.⁵ The WEFA model is a dynamic model of the U.S. economy designed to estimate how the general economy is reshaped by policy reforms, such as tax law and spending changes. Heritage economists developed a revised WEFA model for Heritage work that embodies the economic and budgetary assumptions published by the CBO in August 2001, the recent increases in federal spending, and the latest Blue Chip forecast for economic growth following the September 11 terrorist attacks.⁶ This specifically adapted WEFA model produces dynamic responses from the modified CBO baseline as a result of the proposed policy changes.

Static fiscal year revenue estimates for tax rate changes were computed using the CDA Individual Income Tax Micro-simulation model. This model estimates the change in tax liability for a national sample of over 100,000 tax filers. The sample contains tax return data from the Public Use Tax File that is produced by the IRS. In addition, the sample contains demographic and other information from the

U.S. Bureau of the Census Current Population Survey. Economic data from the Congressional Budget Office (CBO) August 2001 forecast were used to project the sample data forward to 2011.

THE SIMULATION

The WEFA model contains a number of variables that are used to simulate proposed policy changes. The following sections describe how the CDA static estimates were introduced into the WEFA model to estimate the dynamic economic and budget results.

4. The JCT's estimates for changes in tax law reflect some behavioral responses, but not possible changes in macroeconomic variables. For example, while the JCT would take into account how tax changes increase the amount of itemized deductions or shift compensation from taxable to tax-exempt or tax-deferred forms, its estimates do not take into account how tax changes affect work effort and saving that could affect gross domestic product.
5. The Heritage Foundation's Center for Data Analysis used the Mark 11 U.S. Macro Model of WEFA, Inc., formerly Wharton Econometric Forecasting Associates, to conduct this analysis. The model was developed in the late 1960s by Nobel Prize-winning economist Lawrence Klein and several of his colleagues at the Wharton Business School of the University of Pennsylvania. It is widely used by *Fortune* 500 companies, prominent federal agencies, and economic forecasting departments. The methodologies, assumptions, conclusions, and opinions herein are entirely the work of Heritage Foundation analysts. They have not been endorsed by, and do not necessarily reflect the views of, the owners of the model.
6. Diana I. Gregg, "High Probability of Recession Now; Recovery Next Year, Says CEA Chairman," Bureau of National Affairs *Daily Report for Executives*, October 3, 2001, p. A23.

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Average Effective Personal Income Tax Rate. The WEFA model contains a variable that measures the total amount of all federal taxes on individual income as a percentage of the nominal personal income tax base. Heritage economists adjusted this average effective tax rate downward for each of the forecast years to reflect the static revenue decrease estimates.

Average Effective Corporate Tax Rate. The WEFA model contains a variable that measures the total amount of federal corporate tax revenue as a percentage of nominal corporate profits. Heritage economists adjusted this average effective tax rate downward for each of the forecast years to reflect the static revenue decrease estimates.

Labor Force Participation and Average Weekly Hours. Small adjustments were made in the model's exogenous labor force participation rate and in the number of hours worked to account for the dynamic effects of accelerating the marginal income tax rate reductions.

Business Sector Price Index. The business sector price index was reduced to reflect the lower effective tax rates on business income.

Corporate AAA Bond Rate. The corporate AAA bond rate was reduced to reflect the lower effective tax rates on business (capital) income in the two plans.

Government Transfers. The WEFA model contains variables that measure the amount of federal transfers to persons. Heritage economists increased these amounts to reflect the tax rebates, unemployment insurance benefits, and any other transfers to persons in the two plans.

Government Grants to States. The WEFA model contains variables that measure the amount of federal grants to states. Heritage economists increased these amounts to reflect any increased spending on medical insurance and other state grants in the two plans.

Government Spending. The WEFA model contains variables that measure the amount of federal defense and non-defense spending. Heritage economists increased these amounts to reflect any increased spending in the two plans.

Monetary Policy. The model assumes that the Federal Reserve Board will react to this policy change as it has historically. This assumption was embodied in the Heritage model simulation by including the stochastic equation in the WEFA model for monetary reserves.

A REPORT OF THE HERITAGE CENTER FOR DATA ANALYSIS

HOW THE ECONOMIC STIMULUS PROPOSALS
OF THE ADMINISTRATION, THE HOUSE, AND
THE SENATE WOULD AFFECT THE ECONOMY

WILLIAM W. BEACH, D. MARK WILSON, REA S. HEDERMAN,
AND RALPH A. RECTOR

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WILLIAM W. BEACH, D. MARK WILSON, REA S. HEDERMAN,
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Congress and the President are debating economic stimulus legislation to ease the economic recession and to improve the incentives to work, save, and invest—the real causes of economic growth. Although Congress has shown a great degree of unity following September 11, the economic stimulus package has created strong disagreements.¹ On the one side are those, led by the President, who believe that vigorous tax cuts combined with limited spending increases will do the most to lift the economy out of its current slump. On the other side are Members who believe that substantial spending increases combined with limited, targeted tax cuts will do most to remedy the economic problems worsened by the September 11 attacks.

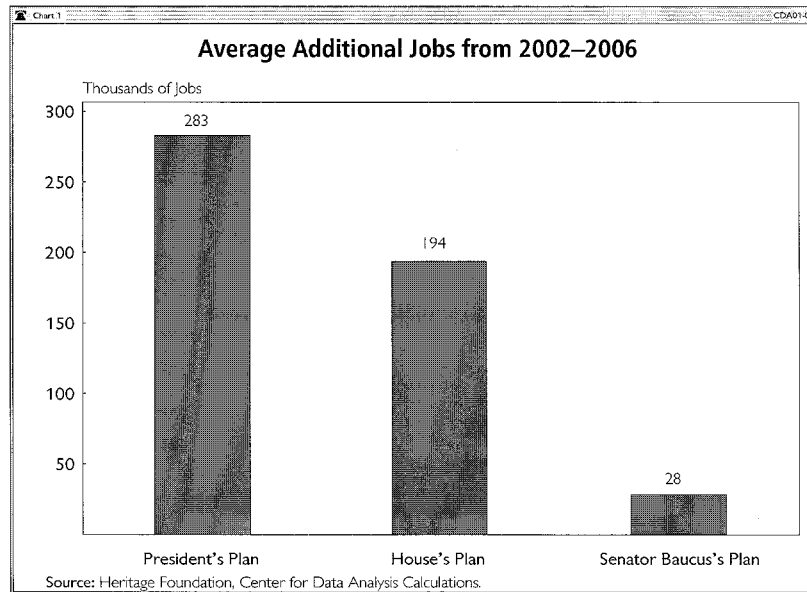
This *Report* addresses the question of which approach—significant tax cuts with limited spending or significant spending with limited tax cuts—would do more to boost the economy. It evaluates each of the three leading approaches—the President's, the House's, and the Senate's—using the same economic model, against the same baseline, to determine which would produce the best economic results over the next five years.

Analysts in The Heritage Foundation's Center for Data Analysis (CDA) used the WEFA U.S. Macroeconomic Model, the Center's Individual Income Tax Model, and work by the staff of the Joint Committee on Taxation to make their projections. (See Appendix A.) Specifically, CDA economists estimated the economic effects of each plan using the same model of the U.S. economy, one that contains a two-quarter recession beginning in the third quarter of 2001 and ending during the first quarter of 2002. This analysis shows that:

- In fiscal year (FY) 2002, the President's plan would produce nearly three times the number of jobs that the Senate plan would, while the House plan would produce more than twice the Senate's projection. From FY 2002 to FY 2006, on average, the President's plan would produce 10 times more jobs than the Senate plan. (See Chart 1.)
- Under President Bush's plan, the inflation-adjusted disposable income of a family of four would increase by an average of \$1,060 per year from FY 2002 to FY 2006, compared with just \$176 per year under the Senate plan and \$708 under the House plan. After-tax, disposable income per per-

1. See H.R. 2926, The Air Transportation and Security Act, which provided financial support for the airline industry; and S. 1447, The Aviation Security Act, which dealt extensively with anti-terrorism issues.

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son grows by an average of \$265 per year under President Bush's plan, by \$177 under the House plan, and by \$44 under the Senate's plan. (See Chart 2.)

- In FY 2002, the President's plan would increase inflation-adjusted consumption expenditures by almost \$28 billion. The House plan would increase consumption spending by just over \$22 billion in FY 2002, while the Senate plan would increase spending by nearly \$19 billion (33 percent less than the President's plan).
- By the end of FY 2002, the average personal savings from income after taxes for a family of four (adjusted for inflation) would increase by \$752 under the President's plan and by only \$502 under the Senate plan.
- Under President Bush's plan, inflation-adjusted investment would increase by an average of \$13.4 billion per year from FY 2002 to FY

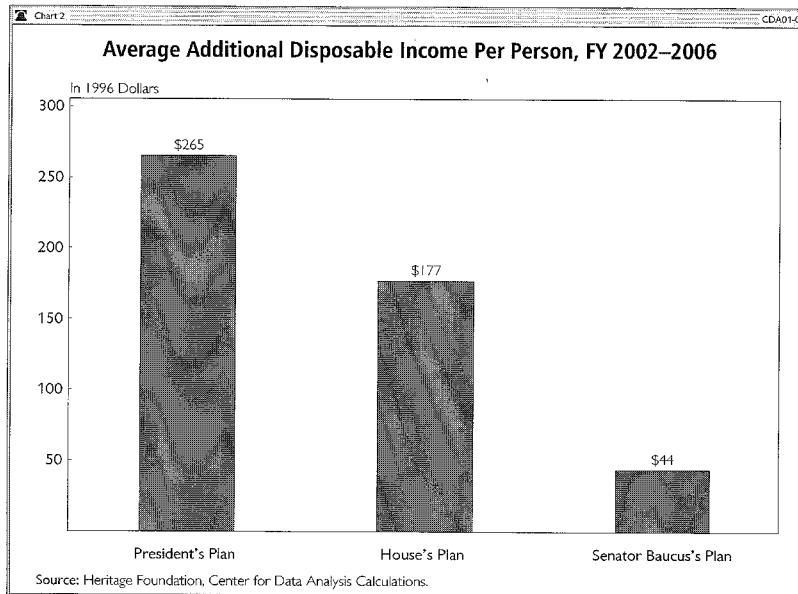
2006, compared with just \$1.2 billion per year under the Senate plan and \$9.5 billion per year under the House plan.

THE ECONOMIC JUSTIFICATION FOR STIMULUS LEGISLATION

President Bush's earlier tax cut plan, a 10-year measure signed into law on June 7, 2001, set the tax policy context for the current work of Washington economic policy makers. That plan's substantial change to tax law was intended, in part, to address the sluggish economy and produce stronger long-term economic growth by reducing tax burdens on labor and capital. In an early effort to boost the slowing economy, the U.S. Treasury sent nearly \$40 billion in tax rebates to taxpayers this summer as the first installment of the Bush tax cut.

The terrorist attacks of September 11, however, dealt a damaging blow to these nascent efforts to encourage greater economic activity. Though esti-

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mates of how deeply terrorists harmed the U.S. economy remain highly uncertain, recent estimates indicate that the attacks in New York City resulted in direct costs of \$11 billion in lost wages and \$45 billion in property damage. The indirect costs may fall somewhere between \$45 billion and \$60 billion over the next two years, which would bring the total losses to the New York City metropolitan area to somewhere between \$90 billion and \$105 billion.² Damage to the Pentagon is estimated at \$1 billion, and losses to the economy of metropolitan Washington, D.C., may be greater than \$360 million.³

These regional economic effects quickly spread throughout the general U.S. economy. The airline industry slashed 20 percent of its domestic flights,

laid off nearly 100,000 employees, and appealed to Congress for a \$15 billion emergency bailout.⁴ The economic shock of September 11 probably pushed the general economy into recession. On September 20, DRI-WEFA, the nation's premier economic forecasting company, lowered its forecast for 2001 from an already anemic 1.6 percent annual growth rate to 1.0 percent, including a negative growth rate for the third and fourth quarters of this year. For 2002, DRI-WEFA lowered its estimated growth rate from 2.3 percent to 1.3 percent.⁵

Recent economic news has reinforced the pessimism that followed September 11. The Conference Board's Leading Indicators fell 0.5 percent in September, the largest one-month decline since

2. Office of the Comptroller, The City of New York, Alan G. Hevesi, Comptroller, "The Impact of the September 11 WTC Attack on NYC's Economy and City Revenues," October 4, 2001, p. iii.

3. Michael Grunwald, "Terror's Damage: Calculating the Devastation," *The Washington Post*, October 29, 2001, p. A12.

4. *Ibid.*

January 1996.⁶ Sales of existing homes fell by a dramatic 11.7 percent in September to a slow 4.9 million annual sales rate.⁷ The number of Americans claiming unemployment insurance benefits rose to an 18-year high of almost 3.7 million, an increase of 1.5 million from a year ago.⁸ Given all of this bad news, it is little wonder that a recent survey found that 52 percent of Americans now believe that the events of September 11 are pushing the economy into recession and that 90 percent of consumers have postponed major purchases.⁹

On October 31, the Commerce Department's Bureau of Economic Affairs added to this widespread sense of economic crisis when it announced that, in the third quarter of 2001, the GDP shrank by 0.4 percent.¹⁰ The unemployment estimate for October underscored this clear signal of a recession: 415,000 workers lost their jobs in October, the largest one-month employment decline since May 1980.¹¹ If the subsequent revisions to the third-quarter results support this initial signal of contraction, and if the next quarter also is negative, then the United States will have entered its first general recession since 1990.

It is against this background of economic crisis that Congress and the President have framed their respective economic stimulus packages.

SUMMARY OF PLANS

CDA analysts evaluated three economic stimulus proposals: the President's, the legislation passed by the House of Representatives on October 24 (H.R. 3090, the Economic Security and Recovery Act of 2001), and a plan proposed by Senator Max Baucus (D-MT), chairman of the Senate's Committee on Finance.

The President's Proposal. President Bush's economic stimulus package, sponsored in the Senate by Senator Charles Grassley (R-IA), consists of three elements: individual income tax reductions, tax policy changes that reduce capital costs, and cash relief to low- and middle-income workers. The President's plan is expected to result in a static reduction in federal revenues of \$242.5 billion over the next five years.¹² Specifically, the President proposes:

1. Accelerating to 2002 all of the tax rate reductions that are currently scheduled for 2004 and 2006;
2. Accelerating the depreciation of capital acquisitions for the next three years by enacting a 30 percent "bonus" depreciation for those years;
3. Repealing the corporate alternative minimum tax on a prospective basis;
4. Providing supplemental cash payments to taxpayers who were not qualified to receive the full amount of last summer's tax rebates (\$300

5. Nariman Behravesht, "U.S. and Global Economic Prospects: A Deeper Recession and a S-Recovery," www.dri-wefa.com/media/index.cfm?page=press4.cfm.

6. The Conference Board, "U.S. Composite Indexes for September 2001," October 22, 2001. See <http://www.tcb-indicators.org/US/LatestReleases/index.cfm>.

7. National Association of Realtors, "September Existing-Home Sales Slow in Response to Attack," <http://narealtor.com/>.

8. U.S. Department of Labor, Unemployment Insurance Weekly Claims Report, November 1, 2001, available at www.dola.gov/news/whclaim.asp.

9. The Conference Board, "More American See U.S. Heading Into Recession," October 26, 2001: <http://www.conference-board.org/search/dpress.cfm?pressid=4668>.

10. U.S. Department of Commerce, Economics and Statistics Administration, Bureau of Economic Analysis, "Gross Domestic Product: Third Quarter 2001 (Advance)," News, BEA 01-33 (October 31, 2001).

11. U.S. Department of Labor, *The Employment Situation: October 2001*, November 2, 2001, available at <http://www.bls.gov/news.release/pdf/empst.pdf>.

12. Scoring of the President's tax and displaced workers provisions was made by the Center for Data Analysis, which used the Center's Individual Income Tax Model and analysis by the staff of the Joint Committee on Taxation. See Appendix A: Methodology for details. "Static" revenue reductions do not take into account the behavioral response of taxpayers to tax policy change. Such responses usually result in revenue changes that are significantly different from the estimates developed using accounting or static methods.

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for singles, \$600 for married taxpayers, and \$500 for head-of-household taxpayers).

The House Proposal. The Economic Security and Recovery Act of 2001 (H.R. 3090) that passed the House on October 24 is similar to the President's current plan, but contains several important differences. The staff of the Joint Committee on Taxation estimated a static reduction in revenues of \$195.4 billion over fiscal years 2002 through 2006.¹³ H.R. 3090 calls for:

1. Providing 30 percent expensing over the next three years for capital assets and cost recovery expansion for small businesses (Section 179 filers);
2. Repealing the corporate alternative minimum tax;
3. Providing supplemental rebates to tax filers in 2000 who did not receive the full value of the rebate last summer;
4. Accelerating the implementation of the 25 percent rate bracket;
5. Reducing the tax liability of Net Operating Losses;
6. Extending the provisions of certain expiring tax credits.

The Senate Finance Committee Chairman's Proposal. A sharp contrast exists between two plans that are emerging in the Senate—the Republican proposals and the plan taking shape in the Senate Finance Committee.¹⁴ Under the direction of Senator Baucus, chairman of the Committee, the likely Senate plan will consist of:

1. Supplemental tax rebate checks for taxpayers who did not receive the full amount during the summer of 2001;
2. A 10 percent "bonus" depreciation for investment in capital and software placed in service over the next 12 months;
3. Expansion of Section 179 expensing for small businesses;
4. Expansion of the carryback period for Net Operation Loss carrybacks.
5. Extension of expiring tax credits;
6. Temporarily extending and expanding unemployment insurance;
7. Subsidized COBRA coverage, or continuation of health benefits by workers who have separated from the employer through whom they had received health insurance;
8. Expansion of Medicaid to cover the unsubsidized portion of COBRA coverage.

Senator Baucus estimates a 10 year reduction in revenues of \$56 billion.¹⁵

PROJECTED ECONOMIC EFFECTS OF EACH PROPOSAL

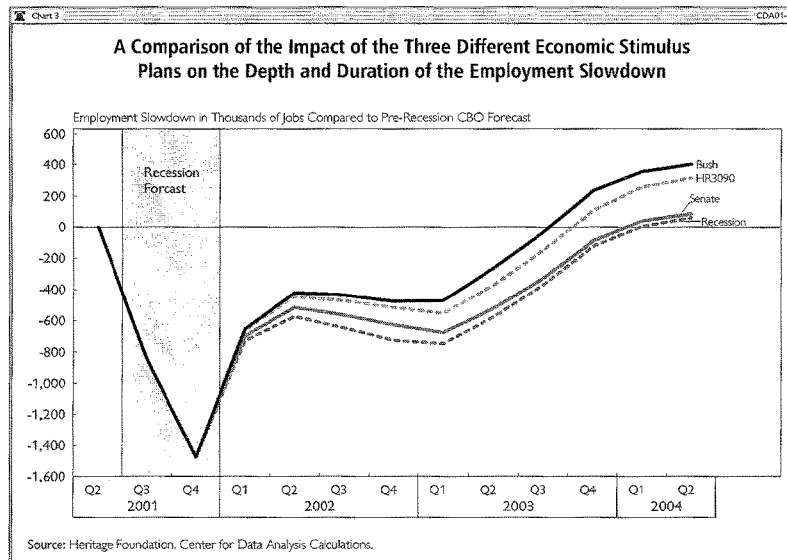
There may be many good political reasons for Congress to pass an economic stimulus package, but there is an overriding economic reason: The intervention should lessen the depth of the slowdown and shorten its duration. Indeed, the competing stimulus packages should be evaluated with respect to their effects on the depth and duration of the slowdown as much, or more, than with respect to any other criteria.

13. Joint Committee on Taxation, "Estimated Budget Effects of a Modified Chairman's Amendment in the Nature of a Substitute to the Revenue Provisions Contained in H.R. 3090, the 'Economic Security and Recovery Act of 2001,' Scheduled for Markup by the Committee on Ways and Means on October 12, 2001," JCX-70-01, October 12, 2001.

14. As of this writing, the Senate Finance Committee had several economic stimulus plans before it. Indeed, the Senate may debate legislation other than the proposal by Senator Baucus. However, the Senator's proposal closely resembles legislation presented by the Democrat leadership in the House during debate over H.R. 3090. CDA analysts decided to publish the Center's analysis of the Senator's package now, rather than wait for any changes he or others would make to it. If those changes are extensive, the Center will revise its analysis and make the results available upon request.

15. CDA analysts assumed a \$16 billion, 10-year expenditure on unemployment insurance. U.S. Senate Committee on Finance, "Baucus Economic Recovery Proposal," <http://finance.senate.gov/102401leg.pdf>. See also "Statement by Senator Max Baucus on October 23, 2001," Bureau of National Affairs, *Daily Report for Executives*, October 24, 2001, p. L-1.

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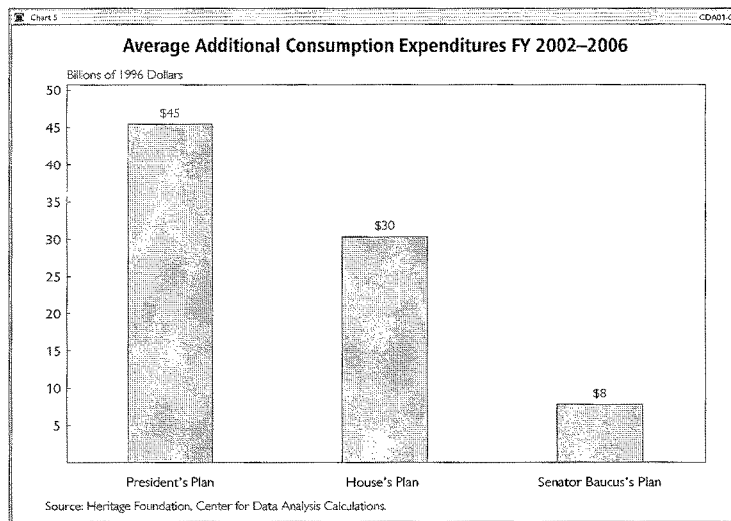
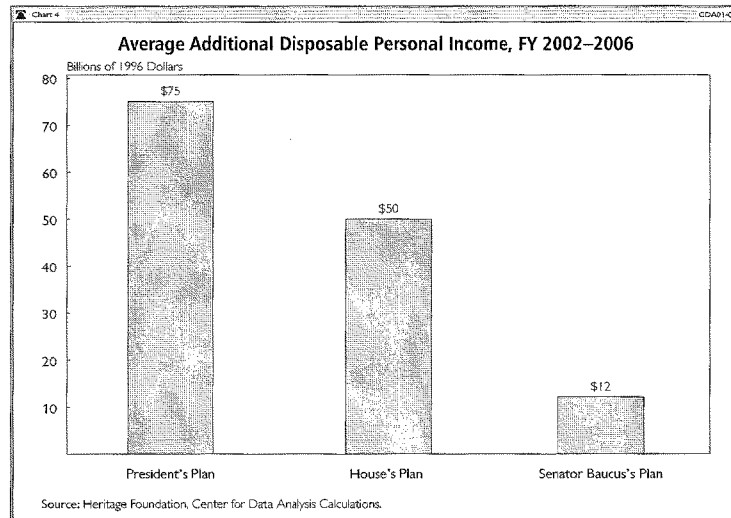


To determine how the three proposals compare in terms of their effect on the expected depth and duration of the current recession, CDA analysts developed projections for economic effects under each of the plans. Chart 3 shows how each plan would affect employment between the beginning of the recession (the end of the second quarter of 2001) and the time when total employment returns to the level it would likely have attained had there not been the recession of 2001 (i.e. in the first quarter of 2004). This chart shows that, while each proposal lessens the depth of job loss, only the President's plan and the House plan significantly shorten the time before employment regains the level it would have attained without a recession. In fact, Chart 3 shows that the President's plan lessens the employment trough by nearly 33 percent and shortens the length of the job slowdown by six months.

Although all three plans affect economic activity through job creation, expansion of output, and increases in disposable income, in FY 2002:

- The President's plan produces almost three times more jobs than the Senate plan (211,000 vs. 79,000) and significantly more jobs than the House legislation would produce (175,000).
- Under President Bush's plan, the inflation-adjusted disposable income of an average family of four would increase by \$1,176, compared with \$964 under the House legislation and just \$788 under the Senate plan.
- The President's plan increases inflation-adjusted consumption expenditures by \$27.9 billion in FY 2002, whereas the House legislation would increase consumption spending by \$22.1 billion and the Senate plan would increase spending by \$18.6 billion (33 percent less than the President's plan).
- The average savings for a family of four would increase by \$752 (adjusted for inflation) under the President's plan, compared with \$630

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under the House legislation and \$502 under the Senate plan.

- President Bush's plan would increase inflation-adjusted investment by \$7.8 billion, compared with \$6.1 billion for the House legislation and just \$4.8 billion for the Senate plan.

As Table 1 shows, the differences in the effects of the three plans will be even more pronounced in future years. The President's stimulus package creates more jobs, provides more income to families, and does more to expand economic activity than either the House plan or the package advanced by the Senate Finance Committee Chairman. These differences become more dramatic as the pro-growth elements of the House plan and the President's proposal take hold.

On average, from FY 2002 to FY 2006:

- The President's plan produces 10 times the number of jobs that the Senate plan does (283,000 per year vs. 28,000 per year) and more than double the number of jobs that would be produced under the House legislation (194,000 jobs per year).
- Under President Bush's plan, the inflation-adjusted disposable income of an average family of four would increase by \$1,060 per year, compared with \$708 per year under the House legislation and just \$175 per year under the Senate plan.
- The President's plan increases inflation-adjusted consumption expenditures by an average of \$45.4 billion per year, compared with \$30.3 billion per year for the House legislation and just \$7.8 billion per year for the Senate plan. (See Chart 5.)
- Personal savings (adjusted for inflation) would increase by an average of \$27.3 billion per year under the President's plan, compared with \$18.1 billion under the House legislation and \$3.9 billion under the Senate plan.
- President Bush's plan would increase inflation-adjusted investment by an average of \$13.4 billion per year, compared with \$9.5 billion

per year under the House legislation and just \$1.2 billion per year under the Senate plan.

CONCLUSION

The three economic stimulus plans analyzed in this *Report* clearly reflect the fundamental difference in two major views of the government's role in economic planning. On the one hand, the approaches by the President and the House generally emphasize reductions in the tax rates on capital and labor to boost economic performance. By lowering tax rates and the tax burden on investment and capital assets, these supply-side plans help business owners and workers, producing more jobs and generating higher incomes—which translate, in turn, into greater investment and consumer spending.

On the other hand, Senator Baucus's demand-side approach principally relies on cash transfers to displaced workers and distressed businesses to stimulate economic activity. While this plan produces some increase in employment and income, and is better than doing nothing, it fails to achieve the level of stronger economic activity that will be attained under the other two approaches. In fact, the Senator's plan never creates the large consumer response that would be needed in order for a demand-side, expenditure-based stimulus proposal to produce the job and income responses that are generated by supply-side proposals. While all three plans transfer income to low- and moderate-income taxpayers through rebates that supplement those of this past summer, this provision plays a much more central role in the Senator's plan. The fact that this mechanism will not produce the economic benefits generated by the other plans brings into serious doubt the utility of cash payments as a tool for boosting economic activity.

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Table 1							
How the Various Economic Stimulus Plans Would Affect Selected Economic Indicators							
Economic Indicators	Fiscal Year End						(Average)
	2001	2002	2003	2004	2005	2006	2002 - 2006
In Billions of 1996 Dollars							
Real Gross Domestic Product							
Baseline	9,350.9	9,517.3	9,924.3	10,302.0	10,642.3	10,976.9	10,272.6
President's Plan Difference	0.0	20.1	44.3	49.6	46.6	31.2	38.4
House's Plan Difference	0.0	14.3	32.0	30.7	26.9	15.2	23.8
Senate's Plan Difference	0.0	12.4	11.3	-0.2	-1.0	0.2	4.5
Percent Change from Year Ago							
Real GDP Growth Rate							
Baseline	1.2	1.8	4.3	3.8	3.3	3.1	3.3
President's Plan Difference	0.0	0.2	0.2	0.0	0.0	0.0	0.1
House's Plan Difference	0.0	0.1	0.2	0.0	0.0	-0.1	0.0
Senate's Plan Difference	0.0	0.1	0.0	-0.1	0.0	0.1	0.0
In Thousands of Jobs							
Total Employment							
Baseline	131,568	133,441	135,038	137,953	139,827	141,317	137,515
President's Plan Difference	0	211	338	346	303	217	283
House's Plan Difference	0	175	220	256	191	127	194
Senate's Plan Difference	0	79	42	22	-6	4	28
Percent of Civilian Labor Force							
Unemployment Rate							
Baseline	5.3	5.7	5.4	5.2	5.1	5.1	5.3
President's Plan Difference	0.0	-0.1	-0.1	-0.2	-0.2	-0.1	-0.1
House's Plan Difference	0.0	-0.1	-0.1	-0.2	-0.1	-0.1	-0.1
Senate's Plan Difference	0.0	-0.1	0.0	-0.1	0.0	0.0	0.0
In Billions of 1996 Dollars							
Disposable Personal Income							
Baseline	6,817.5	7,028.3	7,162.8	7,443.4	7,666.1	7,883.4	7,436.8
President's Plan Difference	0.0	82.1	106.0	95.3	67.9	23.9	75.0
House's Plan Difference	0.0	67.4	75.3	62.6	36.0	8.6	50.0
Senate's Plan Difference	0.0	54.9	11.9	-0.1	-4.9	-0.9	12.2
In 1996 Dollars							
Disposable Income Per Capita							
Baseline	24,709	25,144	25,423	26,203	26,770	27,311	26,170
President's Plan Difference	0	294	377	336	237	83	265
House's Plan Difference	0	241	268	221	125	30	177
Senate's Plan Difference	0	197	43	0	-18	-3	44
In Billions of 1996 Dollars							
Consumption Expenditures							
Baseline	6,371.9	6,604.1	6,868.0	7,110.2	7,353.9	7,564.3	7,100.1
President's Plan Difference	0.0	27.9	50.7	57.9	53.7	37.0	45.4
House's Plan Difference	0.0	22.1	37.1	39.3	32.6	20.4	30.3
Senate's Plan Difference	0.0	18.6	12.9	5.6	1.2	0.6	7.8
In Billions of 1996 Dollars							
Personal Savings							
Baseline	233.9	191.1	58.9	76.0	37.4	32.9	79.3
President's Plan Difference	0.0	52.5	52.9	34.7	11.6	-15.0	27.3
House's Plan Difference	0.0	44.0	36.3	21.5	1.7	-12.9	18.1
Senate's Plan Difference	0.0	35.0	-1.4	-6.0	-6.3	-1.8	3.9
In Billions of 1996 Dollars							
Investment							
Baseline	1376.2	1412.5	1527.7	1622.6	1726.4	1823.3	1,622.5
President's Plan Difference	0.0	7.8	13.2	17.1	16.6	12.5	13.4
House's Plan Difference	0.0	6.1	9.9	12.4	11.2	7.9	9.5
Senate's Plan Difference	0.0	4.8	0.8	-0.1	0.0	0.5	1.2

APPENDIX A: METHODOLOGY

Heritage Foundation economists in the Center for Data Analysis (CDA) followed a two-step procedure in analyzing the budgetary and economic effects of the three stimulus proposals evaluated in this *Report*.

First, preliminary static tax revenue estimates for the economic stimulus plan were either generated by the Center's Individual Income Tax Model or obtained from the Joint Committee on Taxation (JCT).¹⁶ The CDA and JCT tax revenue estimates are based on a static methodology that generally does not account for the macroeconomic effects that would result from a reduction in tax rates.¹⁷ These effects include changes in gross domestic product (GDP), interest rates, employment, personal income, and inflation, all of which can significantly affect tax revenues. Therefore, the static estimates provide a very limited analysis of the economic and budgetary impact of any policy change. To forecast the change in federal tax revenue, spending, and the economy more accurately, a dynamic model must be used.

Static fiscal year revenue estimates for tax rate changes were computed using the CDA Individual Income Tax Micro-simulation model. This model estimates the change in tax liability for a national sample of over 100,000 tax filers. The sample contains tax return data from the Public Use Tax File that is produced by the Internal Revenue Service. In addition, the sample contains demographic and other information from the Census Bureau's Cur-

rent Population Survey. Economic data from the Congressional Budget Office (CBO) August 2001 forecast were used to project the sample data forward to 2011.

Second, the static revenue changes were introduced into the WEFA U.S. Macroeconomic Model.¹⁸ The WEFA model is a dynamic model of the U.S. economy designed to estimate how the general economy is reshaped by policy reforms, such as tax law and spending changes. Heritage economists developed a revised WEFA model for Heritage work that embodies the economic and budgetary assumptions published by the Congressional Budget Office in August 2001, the recent increases in federal spending, and the latest Blue Chip forecast for economic growth following the September 11 terrorist attacks.¹⁹ This specifically adapted WEFA model produces dynamic responses from the modified CBO baseline as a result of the proposed policy changes.

THE SIMULATION

The WEFA model contains a number of variables that are used to simulate proposed policy changes. The following sections describe how the CDA static estimates were introduced into the WEFA model to estimate the dynamic economic and budget results.

Average Effective Personal Income Tax Rate.

The WEFA model contains a variable that mea-

16. Joint Committee on Taxation, "Estimated Budget Effects of a Modified Chairman's Amendment in the Nature of a Substitute to the Revenue Provisions Contained in H.R. 3090," JCX-70-01, October 12, 2001.

17. While the JCT's estimates for changes in tax law reflect some behavioral responses, they do not reflect possible changes in macroeconomic variables. For example, while the JCT would take into account how tax changes increase the amount of itemized deductions or shift compensation from taxable to tax-exempt or tax-deferred forms, its estimates do not take into account how tax changes affect work effort and saving that could affect gross domestic product.

18. The Heritage Foundation's Center for Data Analysis used the Mark 11 U.S. Macro Model of WEFA, Inc., formerly Wharton Econometric Forecasting Associates, to conduct this analysis. The model was developed in the late 1960s by Nobel Prize-winning economist Lawrence Klein and several of his colleagues at the Wharton Business School of the University of Pennsylvania. It is widely used by *Fortune* 500 companies, prominent federal agencies, and economic forecasting departments. The methodologies, assumptions, conclusions, and opinions herein are entirely the work of Heritage Foundation analysts. They have not been endorsed by, and do not necessarily reflect the views of, the owners of the model.

19. Diana I. Gregg, "High Probability of Recession Now; Recovery Next Year, Says CEA Chairman," Bureau of National Affairs, *Daily Report for Executives*, October 3, 2001, p. A-23.

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asures the total amount of all federal taxes on individual income as a percentage of the nominal personal income tax base. Heritage economists adjusted this average effective tax rate downward for each of the forecast years to reflect the static revenue decrease estimates.

Average Effective Corporate Tax Rate. The WEFA model contains a variable that measures the total amount of federal corporate tax revenue as a percentage of nominal corporate profits. Heritage economists adjusted this average effective tax rate downward for each of the forecast years to reflect the static revenue decrease estimates.

Labor Force Participation and Average Weekly Hours. Small adjustments were made in the model's exogenous labor force participation rate and in the number of hours worked to account for the dynamic effects of accelerating the marginal income tax rate reductions.

Business Sector Price Index. The business sector price index was reduced to reflect the lower tax rates on business income that would be reported on personal income tax forms.

Corporate AAA Bond Rate. The corporate AAA bond rate was reduced to reflect the lower tax

rates on business (capital) income in the three plans.

Government Transfers. The WEFA model contains variables that measure the amount of federal transfers to persons. Heritage economists increased these amounts to reflect the tax rebates, unemployment insurance benefits, and any other transfers to persons in the three plans.

Government Grants to States. The WEFA model contains variables that measure the amount of federal grants to states. Heritage economists increased these amounts to reflect any increased spending on medical insurance and other state grants in the three plans.

Government Spending. The WEFA model contains variables that measure the amount of federal defense and non-defense spending. Heritage economists increased these amounts to reflect any increased spending in the three plans.

Monetary Policy. The model assumes that the Federal Reserve Board will react to this policy change as it has historically. This assumption was embodied in the Heritage model simulation by including the stochastic equation in the WEFA model for monetary reserves.

Policies to Increase Economic Growth

**Stephen Moore
Senior Fellow in Economics
Cato Institute
Washington, DC**

**Testimony Before the
House Small Business Committee
Subcommittee on Tax, Finance, and Exports
December 6, 2001**

Thank you very much, Chairman Toomey for the opportunity to address the Small Business Committee on the issue of policies to promote economic growth. In compliance with the Truth in Testimony Act, I will note that the Cato Institute receives no federal grants, loans, or subsidies--nor do we want any.

With the economy officially slipping into recession in 2001, it is crucial to concentrate public policy in Washington on getting back on the high growth rate path of the previous expansion. From 1982-2000 the economy grew at an annual average rate of 3.5%. Over this period, family incomes increased by 15% in real terms, poverty rates fell--particularly for black Americans--and real assets owned by Americans increased in value by some \$15 trillion. This was not just a period where the rich got richer and others got left behind. The average family that was poor in the late 1970s was more likely to be in the highest income group by the 1990s than to still be poor. Twice as many middle-income families rose up the income ladder into the high-income group than fell down into the low-income group.

In this testimony I wish to address two issues. First: why is economic growth important? And second, what are the fiscal policy changes that are likely to expand economic growth and opportunity.

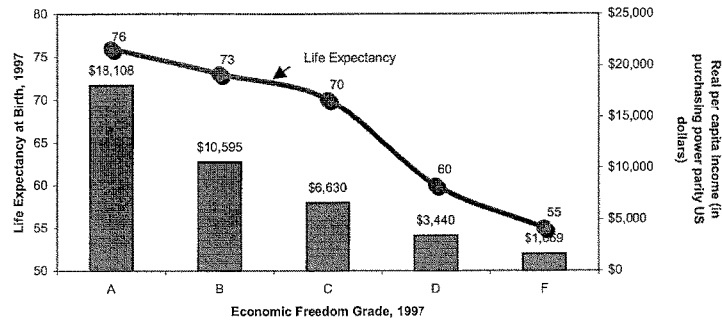
The answer to the first question of why economic growth is important may seem self-evident. Growth leads to higher living standards, more jobs at higher wages, and the production of more goods and services that people want.

But growth has two often underappreciated benefits that I wish to emphasize to this committee. First, economic growth is strongly correlated with other social improvement. A recent Cato Institute study entitled *Economic Freedom of the World, 2000*, rates 120 nations on the degree of economic freedom. Countries receiving an A grade, such as the U.S. and Hong Kong, have relatively low taxes, small centralized government, low tariffs, protection of private property rights, the rule of law, and so on. Countries receiving an F grade are those nations like Afghanistan and African nations that have high taxes, big centralized government, a heavy load of regulation, protectionist trade policies, and so on.

The study found, not too surprisingly, that nations with a high level of economic freedom have much higher standards of living than the unfree countries. The per capita income is 10 times higher in economically free (\$18,000) than economically unfree nations (\$1,600). See chart.

But what was much more surprising is that wealth leads to health. The free and prosperous nations had a life expectancy that was 20 years longer than in the centrally planned unfree economies. This means that economic growth leads to more income and better health. Wealthier nations are healthier nations.

Free Countries are Wealthier and Healthier

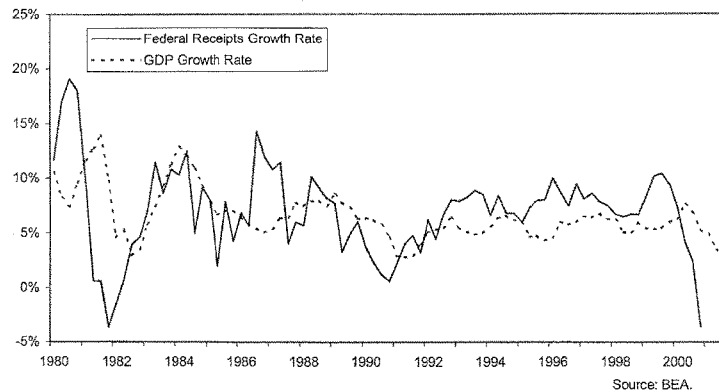


Source: DKT International; James Gwartney and Robert Lawson, *Economic Freedom of the World 2000*; and World Bank, *1999 World Development Indicators*.

The second underappreciated dividend from economic growth is that growth is what balances the budget. And the absence of growth is what leads to budget deficits.

Growth drives the entire process when it comes to revenues, deficits, and debt. Take this past year as a textbook case study. Economic growth has fallen from 3.5% to about 0.5% for the year. What was the revenue and deficit impact? The revenue growth from FY1999 to FY2000 was 9 percent. The revenue growth from FY2000 to FY2001 was 0.5% (after subtracting out the \$35 billion tax rebate).

GDP Growth Drives Revenue Growth



No amount of fiscal root canal budget surgery and no amount of tax increases can make up for that kind of Niagara Falls impact on revenues. We lost \$100 to \$150 billion of expected revenues this year because of the growth anemia this year.

In the late 1990s we averaged 4% real economic growth. Federal tax receipts soared by about 8 per year. This growth dividend converted a \$200 billion deficit in 1994 into a \$200 billion surplus by 2000. Ronald Reagan and Jack Kemp had it right all along: we grew our way out of deficits.

Now, let's gaze forward. Let us assume 3 growth path scenarios. Slow growth, modest growth, and rapid 1980s-90s style growth. We assume a revised growth path of expenditures that has federal spending growing more rapidly than is assumed by the latest CBO forecast. We assume a federal spending baseline of 5% nominal growth per year, which is the average pace of federal spending since 1980. We assume a \$50 billion a year higher annual baseline for national defense spending, as a result of the war on terrorism.

Revised Spending Baseline, 2001-2011												
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total
Outlays	1,913	2,009	2,129	2,257	2,392	2,536	2,688	2,849	3,020	3,201	3,394	28,389

The slow growth scenario is 2% from 2002-2011. Under this scenario we get federal tax receipts of \$27 trillion over the 10-year period. Assuming spending grows at 5% per year, which was the average over the past 20 years and that defense is increased by \$50 billion a year above the baseline, this 2% real growth rate would yield a deficit of just under \$1 trillion over ten years. Trying to balance the balance budget with a 2% growth rate is about as eating chicken broth with a fork. It can't be done.

2% Real Growth Scenario – Federal Revenue Projections, 2001-2011												
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total
Revenues	1,988	2,083	2,176	2,272	2,373	2,479	2,586	2,698	2,815	2,937	3,064	27,471
Surplus/Deficit	75.0	74.4	46.4	15.4	-19.1	-57.1	-101.9	-151.2	-205.2	-264.5	-329.4	-917.2

The medium growth path is 3% for 2002-2011. This gives Congress \$29 trillion in revenues. That's about \$1.75 trillion more money into the federal coffers over the next decade just by elevating growth by 1 percentage point. Under this economic growth scenario, keeping the budget balanced is a piece of cake. We'd run surpluses of about \$75 billion a year with a 3% real growth rate.

3% Real Growth Scenario – Federal Revenue Projections, 2001-2011												
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total
Revenues	1,988	2,105	2,223	2,346	2,477	2,615	2,757	2,908	3,066	3,233	3,410	29,128
Surplus/Deficit	75.0	96.8	93.4	89.4	84.6	78.9	69.3	58.4	46.0	31.9	16.2	739.8

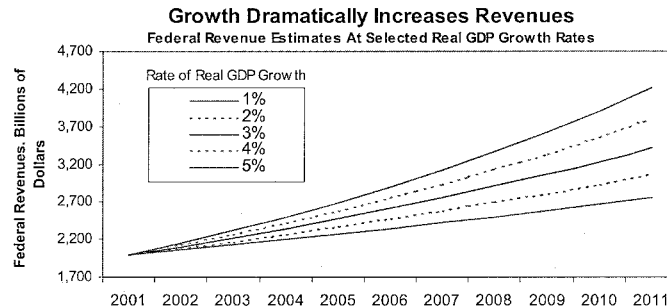
The high growth path is 4% for 2002-11. This is achievable. We had 4% growth with no inflation from 1996 through 2000. What does that give us in revenue streams? More than \$30.5 trillion in tax receipts. That's about \$3.5 trillion more revenues from high growth than from low growth. JFK had it right when he said in 1963, "high tax rates will never

produce enough revenues to balance the budget.” Congress would have budget surpluses equaling \$2.5 trillion even with the higher spending baseline we assume. Congress would almost have to cut taxes.

4% Real Growth Scenario – Federal Revenue Projections, 2001-2011

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total
Revenues	1,988	2,128	2,270	2,422	2,584	2,757	2,938	3,131	3,337	3,556	3,790	30,900
Surplus/Deficit	75.0	119.1	140.9	165.0	191.6	220.8	249.9	281.7	316.6	354.7	396.4	2,511.8

By the way, the difference between a 2 and 4% growth path means a world of difference in terms of the size of the U.S. economy ten years from now. A 4% growth path nearly doubles GDP in 10 years time. A 2% growth path increases GDP by a little less than 60%.



10 Year Revenue Totals, 2001-2011

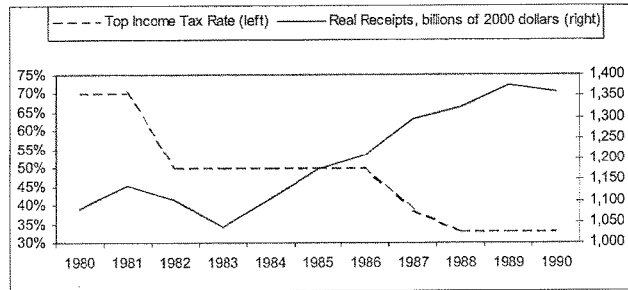
Real GDP Growth Rate	1%	2%	3%	4%	5%
Revenue, billions of dollars	25,922	27,471	29,128	30,900	32,795

What we have at play here is the impact of what Albert Einstein once called “the most powerful force in the universe.” He was referring to compound interest. Two percent growth gets you an annual struggle to keep the budget in balance. Four percent growth gets you revenue riches that would create mountainous surpluses. So, growth is everything when it comes to fiscal health.

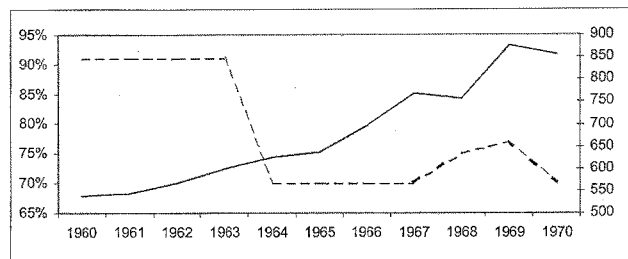
Now one problem is that many economists and politicians regard fiscal policy (particularly tax policy) as an exogenous variable having no effect on the economic growth rate. These economists regard growth as akin to the weather: you can complain about it but you can’t do much to change it. The Congressional Budget Office, for one, believes that tax changes have no impact on growth rates. This is why the CBO truly casts a curse on the U.S. economy with its interminable “static revenue analysis.” Tax rate changes under this model impact the economy not at all.

We respectfully disagree. Our analysis indicates that the profound tax rate reductions of the 1960s and 80s had a giant impact on economic growth and revenues, as shown in the graphs below.

Federal Revenues Following Tax Cuts 1980s



1960s



So this is why the balanced budget hawks in both parties are wrong when they say that we cannot afford to cut taxes now or that tax cuts would be fiscally irresponsible. The truth is the opposite: in this no-growth economic environment, Congress cannot afford not to cut taxes in ways that enhance the growth potential of the U.S. economy.

This brings me to the second question: what tax policies will stimulate growth? A number of prestigious economists, including Professor Dale Jorgenson, Chairman of the Economics Department at Harvard University have found that a single flat rate consumption tax system is the model that would optimize potential economic growth. The two key components of this ideal tax system are: 1) it does not double tax savings and investment, and 2) it applies just one low uniform tax rate to all economic activity. Jorgenson finds that a single rate flat tax system would increase annual production by as much as 10% over the long term trend. A flat tax or sales tax would be like rocket fuel for the economy. This is the model we should strive toward. We may not get there soon or in one grand tax reform action.

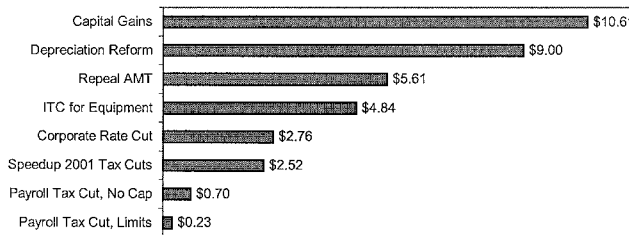
Herein lies the critical point for Congress as it addresses tax changes to enhance economic growth. The standard of measurement should be as follows: Does this tax change under congressional consideration move us closer toward or further away from a single rate consumption tax model? If the tax change does move in the direction of a flat rate tax system, then the tax change promotes economic growth. If the tax change moves us in the opposite direction, it should probably be rejected.

Tax changes such as the elimination or lowering of the capital gains and death tax are advisable, because under a flat consumption tax model there would be no capital gains or death tax at all. Tax changes that increase tax-free savings keep the faith of tax reform, because savers should not pay a tax on income that has already been taxed. A lowering of tax rates is consistent with tax reform, because lower tax rates leads to a low uniform tax rate system. Allowing businesses to write off business investment expenses is consistent with a reformed tax system. Under the ideal tax system, businesses would be permitted to write off all capital expenses in the year the expenses were incurred.

Tax rebates, tax credits, and temporary tax cuts generally do not move the IRS tax code in the direction of growth and simplicity and generally should be avoided.

Given this guideline, I finally will review some of the short-term anti-recession economic stimulus options that Congress is now considering. The best research on this issue was conducted earlier this year in a study for the Institute for Policy Innovation. Two former Treasury tax experts, Gary Robbins and Aldona Robbins, ranked the various tax policy options on the basis of which would provide the greatest bang for the buck. Below, I reprint a table prepared by these two scholars. Clearly, you can see that a capital gains tax cut, accelerated income tax rate reductions, and business tax cuts for investment purposes are the options on the table that provide us with the greatest bang for the buck.

Ranking Tax Proposals
(Long run added GDP per \$1 of Tax Cut)



In sum, an economic stimulus plan that cuts income tax rates, cuts the capital gains tax rate in half, and spurs business investment would provide a real and quick stimulus to the economy. Whether these tax policy changes would be enough on their own to pull the U.S. economy out of recession is not clear, but they are far more likely to succeed than the alternatives.

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House Committee on Small Business — Testimony by Charles M. Lauster

6 Dec 01

I am an architect. My partner and I have run a small firm of twelve people in New York City since 1983. Over the years we have seen a number of economic ups and downs and one war. We have never seen circumstances, however, quite like those we see today — a recession, a war and a nation holding its breadth. Stimulus for small business is certainly needed. But it has to be the right stimulus. I would like to discuss those actions that the federal government could take that would help businesses like mine and comment on those that would do us no good at all.

What do I mean by a small business? First, a firm that is 300 people or less. Most small businesses are much smaller but even at several hundred, the management can know the names of all or at least most workers and thus has some personal relation with its staff. In terms of operation, such as accounting, human resources and advertising, a firm of ten people and a firm of 300 are much more similar than either of them is to a company of 10,000. Second, the business is not publicly traded. Capital is the key problem for small business. Meeting payrolls, running the equipment, paying the rent — cash flow is what keeps most small businesses small. This is not to say that small businesses are poor. Most are quite successful. However, capitalization almost always comes out of the owners' pockets. You may have had a great year, but if receivables were high for six months, it was probably a year of scrambling for cash.

So what can the Federal Government do to stimulate small business? There is a lot of discussion on cutting the tax rates further. This makes sense to small business if it puts substantially more money in the hands of masses of consumers, the main market for small businesses. Big cuts for the higher bracket tax payers puts money into investments and not into the markets small business needs. There is a down side to simple rate cuts. As federal, state and local governments cut their revenues they cut services and capital projects. Government is an important customer for local small businesses and deficits mean lost contracts.

It also means the environment in which we do business deteriorates. Again the issue is capital. Big business has the money and clout to make the world fit its needs. If it doesn't like the world it is in, it moves. Small business lives in the world it's got. Crime, poor schools and inadequate mass transit make it harder and more expensive to do business and there is nothing we can do about it as individual businesses. We rely on good quality of life as provided by government. And that means adequate tax revenue.

For these reasons, capital gains cuts and the cut in the alternate minimum tax are largely harmful to small business. While we gain little from these cuts, the lost revenue means lost quality of life for our business and our lives. The AMT cut was especially galling to small business. No struggling small business is getting several years of taxes back.

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Focused stimulus concepts can address real small business needs. Small business loans, tax credits for hiring, support of local efforts to provide manufacturing space and empowerment zones are programs that have worked and can serve as examples for new legislation. These sorts of efforts get contracts and money directly to small businesses, especially if aimed at areas that are particularly hard hit.

Right now, lower Manhattan is hard hit. The City is struggling to retain businesses, to keep small businesses from closing their doors and to rebuild. There are a lot of good ideas that Mayor Giuliani and others are advocating. Relocation assistance within the city, employee tax credits and special grants to businesses that stay in the Recovery Zone are a few of them. Simple rate cuts will do nothing to help us in this regard. In fact to the extent that the cuts reduce the city's tax revenue, our suffering will be greater.

So to sum up. Stimulus aimed directly at small business can help. Stimulus that meets big business needs will not help small business much, the differences in scale and practice are simply too great. Tax cuts at the highest brackets, capital gains cuts and the AMT are no help at all. Government does not need to stimulate small businesses with lots of capital. Stimulus that creates access to capital and markets, that assists in providing employee benefits and that broadens the horizon of business opportunities can make a real difference.

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Small business is helping America fight the recession and thereby the terrorists who sought our ruin. A wise stimulus package can give small business a helping hand without weakening the country. We will all breathe easier.

Thank you