AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

S. HRG. 113–88

LESSONS FROM REAGAN: HOW TAX REFORM CAN BOOST ECONOMIC GROWTH

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

JULY 31, 2013

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

82–471 WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

JOINT ECONOMIC COMMITTEE

[Created pursuant to Sec. 5(a) of Public Law 304, 79th Congress]

HOUSE OF REPRESENTATIVES
KEVIN BRADY, Texas, *Chairman*
JOHN CAMPBELL, California
SEAN P. DUFFY, Wisconsin
JUSTIN AMASH, Michigan
ERIK PAULSEN, Minnesota
RICHARD L. HANNA, New York
CAROLYN B. MALONEY, New York
LORETTA SANCHEZ, California
ELIJAH E. CUMMINGS, Maryland
JOHN DELANEY, Maryland

SENATE
AMY KLOBUCHAR, Minnesota, *Vice Chair*
ROBERT P. CASEY, JR., Pennsylvania
MARK R. WARNER, Virginia
BERNARD SANDERS, Vermont
CHRISTOPHER MURPHY, Connecticut
MARTIN HEINRICH, New Mexico
DAN COATS, Indiana
MIKE LEE, Utah
ROGER F. WICKER, Mississippi
PAT TOOMEY, Pennsylvania

ROBERT P. O'QUINN, *Executive Director*
NILES GODES, *Democratic Staff Director*

CONTENTS

Opening Statements of Members

Hon. Kevin Brady, Chairman, a U.S. Representative from Texas 1

Witnesses

Hon. James S. Gilmore III, President and CEO of the Free Congress Foundation and Free Congress Action and 68th Governor of Virginia, Alexandria, VA 4
Hon. Laura D'Andrea Tyson, Professor, Business Administration and Economics, Haas School of Business, University of California, Berkeley, CA 6
Dr. Kevin Hassett, John G. Searle Senior Fellow and Director of Economic Policy Studies, American Enterprise Institute, Washington, DC 8
Dr. Jane Gravelle, Senior Specialist, Government and Finance Division, Congressional Research Service, Washington, DC 10

Submissions for the Record

Prepared statement of Chairman Brady 26
Prepared statement of Hon. James S. Gilmore III 27
Prepared statement of Hon. Laura D'Andrea Tyson 29
Prepared statement of Dr. Kevin Hassett 34
Prepared statement of Dr. Jane Gravelle 49
Prepared statement of Vice Chair Klobuchar 60

LESSONS FROM REAGAN: HOW TAX REFORM CAN BOOST ECONOMIC GROWTH

WEDNESDAY, JULY 31, 2013

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 2:05 p.m. in Room G–50 of the Dirksen Senate Office Building, the Honorable Kevin Brady, Chairman, presiding.

Representatives present: Brady, Paulsen, Hanna, Maloney, and Delaney.

Senators present: Lee.

Staff present: Gabriel Adler, Gail Cohen, Connie Foster, Martha Gimbel, Niles Godes, Colleen Healy, Christina King, Robert O'Quinn, and Steve Robinson.

OPENING STATEMENT OF HON. KEVIN BRADY, CHAIRMAN, A U.S. REPRESENTATIVE FROM TEXAS

Chairman Brady. Good afternoon, everyone.

America's current tax code is too costly, too complex, and unfair—but mostly, unfair.

It is unfair to families. Whether you are single or raising children, starting your career or experiencing retirement, the tax code is impossible to understand. It is more time-consuming than ever, and you are always wondering: Is the next guy paying the same as me?

You can't possibly keep up with the 4,000 changes Washington has made in the past decade. That is a new change in the tax code every day. Few taxpayers even know the tax provisions to which they are entitled. For example, there are 15 different tax provisions for higher education, each with its own set of rules. The "simple guide" for these provisions in higher education is 90 pages long. And if you accidently make a mistake, the IRS is unforgiving.

Today's tax code is unfair to businesses. It costs too much for businesses to keep up with their taxes—especially if you are a small business. Most have to rely on outside tax preparers. It is not fair that many small businesses pay higher tax rates than big businesses. And it is not fair that American companies face the highest tax rate among developed countries.

Our outdated tax code often double-taxes American companies, forcing them to shift workers and research overseas just to try to compete on a level playing field against foreign competitors.

Today's tax code is unfair to America.

The complex and burdensome tax code drains over $160 billion out of America's economy each and every year. It makes it too hard to start up new businesses and create new jobs. America has fallen behind its global competitors in Europe and China—saddled with a tax code that costs us sales, contracts, and jobs when we compete.

Experts predict that a simpler, fairer, flatter tax code for families and businesses could create up to 1 million new jobs in the first year and make us competitive again in the 21st Century.

We need a simpler, fairer tax code that protects taxpayers, not special interests, and helps Americans compete and win.

So what can we learn from the last comprehensive rewrite of the American tax code?

When President Ronald Reagan took office on January 20th, 1981, the top individual income tax rate was 70 percent. The Economic Recovery Tax Act of 1981 reduced the top individual rate to 50 percent by the end of his first term. The Tax Reform Act of 1986 reduced the top individual rate further to 28 percent by the end of his second term.

Contrary to the claims of Reagan's critics at the time, these rate reductions neither starved the Treasury for revenue nor undermined the progressivity of the income tax.

Income taxes as a share of our economy remained virtually unchanged. The share of income tax paid by the richest Americans increased dramatically.

For example, the share of federal income taxes paid by the top 1 percent rose from 19.1 percent in 1980 to 27.6 percent in 1988.

In contrast, the federal income tax burden on the middle class fell. Indeed, the share of federal income taxes paid by the bottom 50 percent fell from 7.1 percent in 1980 to 5.7 percent 8 years later.

The Tax Reform Act of 1986 reduced the top corporate income tax rate from 46 percent to 34 percent. But the positive effects of lower corporate rates were largely offset by the repeal of the Investment Tax Credit, longer depreciation schedules especially for buildings, and the repeal of the 60 percent exclusion of capital gains from taxation, effectively raising the top tax rate on capital gains from 20 to 28 percent.

The tax reforms enacted under President Reagan were not perfect, yet collectively they boosted economic growth and employment. Tax changes in Reagan's first term increased real GDP by more than 10 percent, while tax changes in his second term partially offset these earlier gains by less than one percent.

The overall success of Reagan's tax policies brought about a worldwide revolution in taxation. Over the next two-and-a-half decades, nearly every developed country in the world reduced tax rates on both individuals and corporations.

The average combined corporate tax rate among the countries in the OECD declined from approximately 48 percent in the early 1980s to 25 percent last year. And after Japan recently cut its corporate income tax rate, the United States, regrettably, now has the highest combined corporate tax rate among our global competitors at 39.2 percent. It is the worst.

Despite President Obama's individual income and capital gains tax rate increases in January which have slowed the U.S. economic

recovery, the President still asserts the wealthy are not paying their fair share of federal taxes.

However, the facts just don't support this assertion.

An objective study by the OECD found that the highest earning 10 percent of the U.S. population actually paid the largest share among 24 countries examined, even after adjusting for their relatively higher incomes.

The richest 10 percent in the United States pay 1.35 times their share of income in taxes compared to the OECD average of just 1.11. "Taxation is most progressively distributed in the United States," the OECD study concluded.

Unfortunately, as other countries have moved forward in reducing their individual and corporate income tax rates, the United States has reversed course, undoing much of the earlier rate reductions. Including President Obama's latest tax increases, our top individual income tax rate is now nearly 44 percent.

The purpose of today's hearing is to review the lessons we should have learned from previous tax reforms. What worked? What didn't? And why?

And most importantly, given our anemic recovery from the current Recession—the weakest recovery since World War II—how can we improve our tax system to get the most economic bang for the buck.

What I have seen as a member of the tax-writing House Ways and Means Committee is that our current complex tax system diverts productive resources into wasteful lobbying and tax avoidance schemes. It favors consumption over investment, debt over equity, large businesses over small, and some industries over others.

Tax reform should eliminate these distortions and promote economic growth. Hopefully, today's hearing will help us identify the steps we need to take to achieve this goal.

I look forward to the testimony of our witnesses.

And I would note that the Vice Chair, Senator Klobuchar, is voting at this moment. When she returns, we will take a moment to have her read her opening statement, as well.

So let me introduce those who are here today.

Mr. James Gilmore currently serves as President and CEO of the Free Congress Foundation, an entity that offers bipartisan conservative solutions to various domestic and national security challenges. He also oversees operations in Gilmore Global Group, LLC, in which he consults with companies seeking to market goods and services throughout the world. Mr. Gilmore has served as the 68th Governor of Virginia, as Chairman of the Congressional Advisory Panel to Assess Domestic Response Capabilities for Terrorism Involving Weapons of Mass Destruction, known as "The Gilmore Commission." This panel was influential in developing the Office of Homeland Security. Governor Gilmore is a graduate of the University of Virginia and the University of Virginia School of Law. Welcome.

Dr. Laura D'Andrea Tyson is a Professor of Global Management at the Haas School of Business at the University of California, Berkeley. She is a member of the Brookings Institution's Hamilton Project Advisory Council, a member of the MIT Corporation. Dr. Tyson is a member of President Barack Obama's Economic Recov-

ery Advisory Board. Previously she served as President Clinton's National Economic Advisor, and the 16th Chairman of the White House Council of Economic Advisers. Dr. Tyson has a summa cum laude undergraduate degree from Smith College, and a Doctorate in Economics from MIT. Welcome, Doctor.

Dr. Kevin Hassett is the John G. Searle Senior Fellow and Director of Economic Policy Studies at the American Enterprise Institute. He was a senior economist at the Board of Governors of the Federal Reserve System, a policy consultant at the Treasury Department during the George H.W. Bush and Clinton Administrations. He has written a number of papers on fundamental tax reform, and has co-authored a book with renowned economist Glen Hubbard titled TAX POLICY AND INVESTMENT. He has a B.A. from Swarthmore and a Doctorate in Economics from the University of Pennsylvania. Welcome back, Dr. Hassett.

Dr. Jane Gravelle is currently Senior Specialist in Economic Policy in the Government and Finance Division of the Congressional Research Service. She specializes in economics of taxation, particularly the effects of tax policies on economic growth in resource allocation. She is the author of THE ECONOMIC EFFECTS OF TAXING CAPITAL INCOME and co-editor of the ENCYCLOPEDIA OF TAXATION AND TAX POLICY. She is also past president of the National Tax Association. I have told you everything I know about our four witnesses today.

Welcome. Thank you for being here. This will be an interesting hearing. Governor Gilmore, you are recognized for five minutes for your opening remarks.

[The prepared statement of Chairman Brady appears in the Submissions for the Record on page 26.]

STATEMENT OF HON. JAMES S. GILMORE III, PRESIDENT AND CEO OF THE FREE CONGRESS FOUNDATION AND 68TH GOVERNOR OF VIRGINIA, ALEXANDRIA, VA

Governor Gilmore. Mr. Chairman, thank you very much. And I want to thank the Committee and Ranking Members, and all the others who have invited us here to this distinguished panel today. I appreciate the opportunity to be a part of it.

We at Free Congress Foundation are focused on a number of public policy issues, but we think that this Committee today is addressing a genuine national crisis. Something has got to be done about growing and restoring the economy of this country, and emerging from the Great Recession. We are not emerging from the Great Recession, and something has got to be done about it.

Now this is as current as this morning's news, but first let me just say that as we look at our historic Free Congress Benchmarks, one of those is GDP. I made a note just recently that the Gross Domestic Product growth in this country in December of 2011 was 1.8 percent. The growth of the economy December of 2012 was 1.9 percent. This morning the report is that our economy is growing at 1.7 percent.

Now we are just standing still. We are just moving sideways in the same direction. The historic growth rate of the United States is 3.2 percent. The gap between 3.2 and 1.8 or 1.7 is dramatic. Always, in the history of this country, when we have gone through

a recession and dropped below the historic norm, we have always gone back and even above that norm so that we can return back to the proper trajectory of growth.

We are not doing it this time. We are not doing it. And everything we are doing is counter-growth in this country. So we should not be surprised that we are in this kind of position.

In the meanwhile, what is the direct impact of this? Well, in April of 2012 1.5 million, 53 percent of young people under 25 years of age with Bachelor's Degrees were either jobless or underemployed. We know the unemployment rate is about, what, 7.6 right now, Mr. Chairman? Unemployment in the African American community stands at 13.7. Young African Americans are facing unemployment at a rate of about 22.1 percent. Unemployment in the Hispanic community is likewise above the rate of the country at 13 percent. Women in the United States of America are at an unemployment rate of 11.6 percent.

I am going to take what little time I have and tell you, Mr. Chairman, a quick personal story. I went over recently to the Giant Food in Old Town, Alexandria, near where I have my office. I wanted to buy a salad for lunch. I'm trying to lose weight, like everybody else. I couldn't get through the line. I couldn't understand why I couldn't get up to the cash register. And I looked up at the front and there was a young African American woman up there about 23 years old, and she's got several items, and a cabbage, and a couple of things, and she's trying to pay for it with a plastic card, which I determined was a food stamp card.

And the cashier said—and I used to be a cashier when I got started in my career—said you don't have enough money on this card to pay this $5 bill. Whereupon, embarrassed, she put aside everything, picked up the cabbage, peeled off two singles out of her wallet and paid for the cabbage and went on.

Now, Mr. Chairman, this is an historic crime on the people of this country that this government is taking no action to bring us out of this Recession. We should have an economy that is so dynamic that even that young woman has a better opportunity in life than what I just described to you. And that is the responsibility of this Congress and of this Administration, and it is not being done.

We believe, and we think you should concentrate today on tax reform as a vehicle for growing the economy. We at Free Congress, at freecongress.org, have created a plan. We don't think it's the only plan. We think it could be subject to improvement. But the fact is that we have offered a plan that will grow the economy. And right now everything that is being done in the United States is counter-growth. So we should not be surprised that we are in this kind of position, and these kinds of impacts are being had on the people of the United States.

We believe the emphasis of the Congress, Republican and Democrat, Senate and House, ought to be on growing the economy and creating American opportunity. American opportunity is dependent on growth, growth, growth.

And you will not grow this economy through all the devices that we are seeing; of the Federal Reserve pumping up our currency, or stimulus spending that has not worked and will not work because

it's just like spinning a top. When you stop spinning the top, the top falls over.

We have to have organic growth, and that comes from investment. And that means that we have to do things in this country to create real investment, and the tax reform can in fact achieve that.

Well, Mr. Chairman, I believe in the 21st Century that the United States can continue to play the kind of role that it ought to play; that we can have the revenue necessary to be able to do what we have to do without these devices like a sequester, or a cutting, or increases of taxation which just reduces investment and the kind of policies that we are following right now.

We can have a strong economy, which was the foundation of America's strength in the 20th Century. We can do this again. We can have national security that is healthy and robust, and we can have a better quality of life for the American people, if the Congress does its job.

Thank you, very much.

[The prepared statement of Governor James S. Gilmore III appears in the Submissions for the Record on page 27.]

Chairman Brady. Thank you, Governor.

Dr. Tyson.

STATEMENT OF HON. LAURA D'ANDREA TYSON, PROFESSOR, BUSINESS ADMINISTRATION AND ECONOMICS, HAAS SCHOOL OF BUSINESS, UNIVERSITY OF CALIFORNIA, BERKELEY, CA

Dr. Tyson. Good afternoon, Chairman Brady, Members of the Joint Economic Committee. Thank you for the opportunity to testify about how carefully designed tax reform can improve growth.

I agree with the Governor. I am, as you heard a Professor at the Haas School of Business, University of California at Berkeley. The views in my testimony are my own, but I do serve as an Economic Advisor to the Alliance for Competitive Taxation, a coalition of American businesses promoting comprehensive corporate tax reform, and my remarks will focus on corporate tax reform.

As recently as 30 years ago, the American economy was the most competitive in the world. The U.S. could design its corporate tax code without considering the global economic environment.

We no longer live in that world. Emerging market economies, falling trade barriers, and leaps in technology have expanded opportunities for American companies, but they have also heightened global competition for American companies, and among countries—between the U.S. as a location for investment, and Germany as a location for investment, just as an example.

Today our corporate tax system is failing our country. It is reducing the competitiveness of the U.S. economy as a place to do business and create jobs.

For example, when a U.S. company sells shampoo in Asia, it competes with shampoos produced by foreign competitors. The price of the shampoo to the foreign consumer has to be competitive. The Dutch company providing the shampoo pays zero tax to the Netherlands on its sales of shampoo in Asia. The U.S. company is

subject to U.S. tax on those sales of its product in Asia whenever it chooses to repatriate its foreign earnings to the United States.

This system encourages American companies to hold their foreign earnings abroad in order to counter the competitive disadvantage of our current tax system.

Now the good news on corporate tax is there is widespread, bipartisan agreement that the system is flawed and needs fundamental reform.

After the 1986 overhaul, the United States had one of the lowest corporate tax rates among OECD countries. Since then, country after country has reduced its rate. Why? To attract investment.

They have left the U.S. with the highest corporate tax rate among developed countries. Cutting the U.S. corporate tax rate to a more competitive level would encourage more investment in the United States by both domestic U.S. companies and by foreign companies.

With capital becoming increasingly mobile, national corporate tax rates have a growing influence on where multinational companies locate their operations, locate their jobs, and report their income.

Higher investment in the U.S. by both domestic and foreign companies would foster growth, improve productivity, create jobs, and boost real wages over time. The pro-growth argument for reducing the U.S. corporate tax rate is compelling, but rate reduction by itself would reduce corporate tax revenues.

What to do? Like most economists I believe we can and should pay for a significant rate reduction in the corporate tax by broadening the corporate tax base to eliminate tax breaks and preferences.

This approach would reduce the complexity of the corporate tax code and would increase its efficiency by reducing distorting tax differences across economic activities.

With 95 percent of the world's consumers and an increasing share of the world's purchasing power outside of the United States, the U.S. also needs to reform the way it taxes the foreign earnings of U.S. companies.

Most other OECD countries have adopted a modern international tax system referred to as a "Participation Exemption or Territorial System." This system generally allows internationally engaged companies to compete globally and reinvest their foreign business earnings at home without paying a second tax.

The U.S., by contrast, taxes U.S. companies when they bring their foreign earnings to the U.S. And this approach lies far outside international norms of taxation.

To counter this disadvantage, U.S. companies have a strong incentive, as I said, to keep their foreign earnings abroad. And we know now that these companies are holding an estimated $2 trillion in accumulated foreign earnings.

These earnings are not financing investment and job creation in the United States. The U.S. companies are incurring efficiency costs from the suboptimal use of their balance sheets, and from higher debt levels than would be necessary if they could repatriate these earnings without incurring additional U.S. tax.

Preliminary results from a study I'm conducting suggest that adopting a 95 percent participation exemption system in the U.S.

would increase U.S. employment by about 150,000 jobs a year on a sustained basis. The up-front effect, the short-term employment gain would be nearly 10 times larger. And those gains come from the fact that there would be a significant increase in repatriated flows, and that money would be put to work on investment and consumption in the United States.

Tax reform also has to address the incentives which U.S. companies have to shift their income to low tax jurisdictions. These incentives exist in the U.S. tax system and they exist in foreign tax systems. By itself, lowering the rate in the U.S. would actually reduce income-shifting incentives. But more needs to be done.

Given the limits on my time, I will just mention two new proposals to address this. Chairman David Camp has proposed an innovative approach based on where products are sold.

The OECD is also working on a 15-point plan to deal with income-shifting and base erosion.

I believe we can move to a partial exemption system with serious base erosion protections. We need to reform our tax system to be more competitive internationally and to grow jobs at home.

[The prepared statement of Hon. Laura D'Andrea Tyson appears in the Submissions for the Record on page 29.]

Chairman Brady. Thank you, Doctor.

Dr. Hassett.

STATEMENT OF DR. KEVIN HASSETT, JOHN G. SEARLE SENIOR FELLOW AND DIRECTOR OF ECONOMIC POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. Hassett. Thank you, Chairman Brady, and Members of the Committee.

In my testimony I attempt to put the current circumstance in more of an historic perspective and analyze the case for tax reform not just by comparing our rates to other countries' rates, and so on, but comparing our current economic experience to our own in the past, and that of other countries.

I think, given that President Reagan's name is in the title of the hearing, that it was interesting at the beginning to look back on August 13th, 1981. President Reagan signed into law the Economic Recovery Tax Act of 1981, and it drastically reduced the tax burden on Americans. Those tax cuts were pared back some in 1982, but the majority of them survived. And the economic revival that followed was tremendous, as Senator Graham recently detailed in The Wall Street Journal.

Within 55 months of the start of the recession, the economy had created 7.8 million more jobs than at its start, and real per capita GDP grew by about $3,000. During the same time frame, the number of people on disability stamps fell 14.3 percent, or about 644,000 people; the number of food stamp recipients fell 13.4 percent, or by about 3 million people, and between 1981 and 1986 real median family income rose 7.7 percent.

In my testimony, I document how, while we don't know that all of those good statistics are related to the tax reductions, there is a mass of economic literature that supports that there is a positive link. But more troubling, I think that now that we are out of the area where we need to really be concerned about demand-side fac-

tors holding the economy down, in my testimony I start to look at where we are on the supply side factors that drive growth.

And my testimony discusses something that, as you know, the CBO, and the Fed, and other forecasters called "Potential GDP Growth," and the basic idea is that if you want to have long-term growth in output, then you need to have long-term growth in inputs.

And if we can project what is going to happen to the growth of inputs, then we have a good base for what output is going to be.

Now if you look at what has happened in the evolution of the growth in inputs, it is really quite troubling. Let's look at the labor force. Growth in the labor force is an important contributor to economic growth, but it has been shrinking in importance over the past decade.

At its peak in the 1970s, potential hours worked contributed 1.7 percentage points to potential GDP growth each year. Potential GDP growth is not exactly what is going to happen, but it is a key driving force of how the supply side is driving the economy forward.

From 2002 through 2012, however, hours worked only contributed 0.3 percentage points on average to potential GDP growth. And so if you wonder, are we in this new normal where we are going to have low growth, well, yes, the growth of labor input alone is contributing about 1.4 percentage points less growth per year going forward.

On the capital side, it is about a half a percent below where we were. And so what that means is that the underlying growth in inputs that drive the growth of the economy is contributing about two percentage points per year less than it used to to economic growth.

In my testimony, I connect these factors to our really often indefensible policies. We have spoken in this Committee before, and the other witnesses also speak quite a bit about corporate reform. And in my testimony I go into that in detail, but I think that as we are thinking about tax reform we also have to recognize that the big kahuna in terms of the disappointing new normal is that labor force growth is so disappointing.

And as my colleagues, Aspen Gorry and Sita Slavov have explained in a recent analysis, the structure of the tax code in the U.S., which is based on family units rather than individuals, has many disincentives for secondary workers.

In addition, our retirement programs like Social Security and Medicare have structures that very often discourage participation in the workforce. And if we are going to have a fundamental reform that increases the growth of inputs in a way that we could expect to have higher long-term output, then we need to focus on labor supply as well.

On the corporate side, I think that it is absolutely inexcusable that we are about the highest taxed place on earth—I think there are a couple of developing countries that are a little bit higher—and it has a massive negative effect I believe on capital stock growth; that firms right now, multi-national firms, in response to these high rates, and our somewhat liberal transfer pricing rules,

locate activity offshore rather than at home, contributing to the shortfall in capital stock growth.

I think that as members of this Committee discuss why tax reform is urgent—to conclude—that it is important to keep in mind the fact that if you look at the tax rate data and so on, we're out of whack; but if you look at the input growth data, the potential GDP calculations, and see that we have basically created a new normal for ourselves where we are going to growth 2 percent a year less, or 1.5 percent a year less, somewhere in there, because our policies are constraining input growth, then the urgency of tax reform becomes more apparent.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Kevin Hassett appears in the Submissions for the Record on page 34.]

Chairman Brady. Thank you, Doctor.

Dr. Gravelle.

STATEMENT OF DR. JANE GRAVELLE, SENIOR SPECIALIST, GOVERNMENT AND FINANCE DIVISION, CONGRESSIONAL RESEARCH SERVICE, WASHINGTON, D.C.

Dr. Gravelle. Thank you for inviting me. Comparing and contrasting the current effort with the 1986 Tax Reform Act [TRA], which is often considered a model, can help us to understand the expected effects.

TRA, like many current proposals, must be revenue and distributionally neutral, although currently some proposals propose a revenue gain.

The stated objectives of TRA were fairness, simplicity, and economic growth. But much of the initial analysis focused on neutrality or efficiency instead. While these terms are sometimes used interchangeably, each is a distinct concept.

Economic growth refers to responses that increase income and output. Efficiency refers to reallocating resources to maximize welfare. Many, indeed most, efficiency effects are not detectable as a change in output. They are generally small and may largely reallocate output or risk.

Economic growth generally arises from increases in labor supply, savings, and investment. Theory and evidence suggest, however, that TRA did not have much of an effect on growth. This limited effect was expected in part because supply responses are small, and in part because the revenue neutral tax reform that included base broadening offsets might have minimal aggregate effects on effective marginal tax rates.

For example, TRA reduced the corporate tax rate and repealed the investment credit. This tradeoff contributed to the neutrality of tax burdens across assets, but increased the overall cost of capital because the investment credit applied only to new investment, while the corporate rate reduction provided a windfall for old capital.

The same tradeoff would likely occur currently with the single largest corporate base-broadening provision commonly discussed: accelerated depreciation. Other corporate and individual base-broadening provisions would also offset cuts in statutory tax rates and limit the change in effective marginal tax rates.

In comparing TRA and current tax reform, some economic aspects such as concerns about deficits are similar. Two factors differ substantially, however, from 1986: a lower rate of inflation, and a more integrated worldwide economy.

Thus, some issues such as indexing capital income for inflation, may be less important today. However, the open economy and international investment flows, given relatively little attention in 1986, is now central to proposals to lower the corporate tax rate. Artificial shifting of profits to low-tax countries has also become a major compliance issue.

TRA is widely seen as a model for reform. And while TRA made major, dramatic changes on the corporate side, its individual base-broadening was actually somewhat limited.

Currently, the TRA corporate reforms, however, have left little low-hanging fruit. The repeal of the investment credit at that time financed almost all of the 12 percentage point rate reduction, but eliminating accelerated depreciation today would allow a rate reduction of 2 to 3 percentage points.

It would also increase the cost of capital. Rates could be reduced in the long run, steady state by only 5 percentage points, I estimate, if every corporate tax expenditure other than a deferral for in-source income were eliminated.

And without having a lot of time to talk about the individual side, the same issues occur on the individual side. When you change deductions that are marginal and trade them off for statutory tax rates, you may not accomplish very much.

Turning to the treatment of foreign source income, with current estimates eliminating the deferral, which has gotten larger, would offset a corporate rate reduction of almost 4 percentage points, increasing the capital stock in the United States somewhat through both the lower rate and the removal of the incentive for U.S. firms to invest abroad. It would also eliminate the benefit of profit shifting and of course the problem of repatriation restrictions.

Although these are traditional solutions, there is also a very strong interest in the Congress in moving in the other direction to a territorial tax. A pure territorial tax would make profit shifting more attractive, but these proposals have to contain anti-abuse provisions to address this issue. So a central issue is clear—how effective these anti-abuse provisions might be.

Although TRA increased corporate taxes in order to cut individual taxes, a significant share of that revenue gain was actually transitory in part because of timing effects. There is a similar issue with current tax reform, if provisions like accelerated depreciation are adopted, or if movement to a territorial tax is financed with transitory revenues from a one-time repatriation holiday.

Thank you.

[The prepared statement of Dr. Jane Gravelle appears in the Submissions for the Record on page 49.]

Chairman Brady. Thank you.

Dr. Hassett, you know thinking about the lessons from President Reagan's tax reforms and the impact, today we have a code that is actually more progressive. Even though the rate is lower, more and more people are paying on the upper earners side.

We have a low bracket, a 10 percent rather than 15 percent. But one of the biggest changes is how many businesses are filing as individuals, as corps, as pass-throughs, as partnerships, and all.

Some have suggested that we only do, as a country, for economic growth, corporate-only tax reform. But given your view of how much of your job growth occurs on the individual side, how critical is it that we do both?

Dr. Hassett. Thank you, Mr. Brady. The individual side is very important, as you know. There is an enormous share of aggregate business income now that goes through the individual code.

If we have, however, a very solid, smart corporate tax reform, then we would expect, based on the analysis in the literature by economists such as Roger Gordon and others, that there would be a lot of change of organizational form. If we made the corporate tax code really attractive, then people might decide to organize their business less through the individual side.

I think that is an important consideration if one starts to be constrained—and I am not an expert on this, and I know the members of the Committee are constrained by political realities that suggest that maybe you have to deal with the corporate reform all by itself. If you have a really good corporate reform the organizational form issues, I think most economists believe will kind of work themselves out.

Chairman Brady. From a job creation standpoint, and the role business investment plays—buildings, equipment, software—how critical is it that in addition to low rates that the after-tax cost of capital be also low from the standpoint of much of our economy, from energy on, the goal is to raise—it takes a large amount of capital invested, quickly recovered, and reinvested as well, very key to that job creation. What lessons should we keep in mind as we go forward?

Dr. Hassett. It makes me—and here I concur with Dr. Gravelle who by the way I first met when she discussed a paper of mine on this topic on the Investment Tax Credit Repeal of the 1986 Tax Act.

Dr. Gravelle. I remember that.

[Laughter.]

Dr. Hassett. But it is a concern that Dr. Gravelle and I both share that, if you are going to cut the corporate rate then the reduction in the corporate benefits both old capital, say a company that is making a lot of money today based on investments they made in the past, they'll pay less tax this year; and it will also benefit new capital, because if you make an investment that pays off then when you ultimately earn profits on it you will pay a lower rate.

But the depreciation is only available to somebody who invests in a new machine. Like at the margins, starting right now, it's the depreciation that I get if I buy a new machine that has an influence on my decision.

And so if we have a revenue-neutral reform that increases the tax on new capital, and then reduces the tax on new and old capital, then it necessarily on net has to increase the tax on new capital. And in the kind of models that I have used throughout my career, the kind of model that Dr. Gravelle used throughout her ca-

reer perhaps as well, at least the career since we started interacting, that could be a negative for growth if you're not careful.

Chairman Brady. All right. Thank you, Doctor.

Dr. Tyson, given the competitive climate we are in worldwide, is it possible to remain competitive and have a pro-growth tax code retaining a worldwide form of taxation for corporations?

Dr. Tyson. I do not think we should. I think we have a worldwide system which has a lot of particular features which have encouraged and allowed our companies to overcome the competitive disadvantage associated with the worldwide system essentially by taking advantage of deferral and other options to keep money outside.

Chairman Brady. We tied ourselves in knots.

Dr. Tyson. So we get no revenue. We don't get the money for financing investment and employment in the United States. So we get none of the benefits.

Moving to a partial exemption system with some serious base erosion protections—and Dr. Hassett and I agree on this—gets rid of the competitive disadvantage our firms face. We get rid of the competitive disadvantage of locating here. And we get the benefits of competitive advantage vis-a-vis the rest of the world.

Chairman Brady. It just seems in this world, when our companies compete and win overseas and have profits, that we have a tax gate preventing them from bringing them back and reinvesting in U.S. jobs, U.S. research, U.S. growth.

Dr. Tyson. Absolutely.

Chairman Brady. It makes no sense at all.

Dr. Tyson. It makes no sense.

Chairman Brady. Thank you. Governor, I want to ask you. The lesson to us from your experience as we go forward in tax reform, is there one key message we ought to keep in mind as we pursue this?

Governor Gilmore. Yes, sir. First of all, I happen to agree with Dr. Tyson about this issue of the repatriation of capital. I have been personally involved with corporations that have been very proud of the fact that they've moved their capital overseas so that they can increase their reports to their shareholders, and they are rather happy about it because they understand that they are tax-advantaged by going overseas.

That is something that has to be changed. It has to be repaired. If we can bring the money back for our companies to get them invested in the United States, why do we insist on penalizing that? I agree with Dr. Tyson.

Now secondly, you asked me a question—oh, let me also mention also that as part of our Growth Code, we think an innovation would be to break up this distinction between small businesses and individuals and corporations.

You can tax all people on business activity the same, and eliminate this pass-through where a small business is just disadvantaged in passing through to higher individual tax brackets, as part of an overall program which we have developed called "The Growth Code" on our website.

You asked me a question, Mr. Chairman, and I congratulate you, by the way. I think you are one of the Congressmen who actually

understands what is going on around here, and we appreciate very much your having this hearing to push this forward and to do this.

If there's one question, one point, it is this: Net growth must become the national goal of the United States of America, and we should not do anything that discourages it. We should do everything we can do to encourage it, at least until we get the revenue going again.

And what have we done? Well, we've raised taxes on the higher brackets to make sure that the people don't invest—even though you won't see the revenue, because they can get away from that.

We have increased the taxes on capital gains to make sure nobody will create any capital gains. You are not going to see any revenue from that, but we are discouraging the investment.

We have done a sequester. We have done an Obamacare, which makes sure small businesses can't increase their employees over 49 people.

And amazingly, we have allowed a payroll tax on every wage earner in the United States to make sure that consumption goes down.

We have done everything as a national policy to discourage growth, and we have done nothing to encourage growth. My message is that that must become the national challenge.

Chairman Brady. Thank you, Governor.

Representative Delaney.

Representative Delaney. Thank you, Chairman Brady, for holding this important hearing. And I want to thank all of our guests for their testimony and for their work on behalf of these issues.

I think at this point the testimony is very clear around the need for corporate tax reform, which I almost view as unassailable at this point. The case is so persuasive. The case is so obvious. The debate to whether it is 25 or 28, everyone has agreed on what the standards should be, which is revenue-neutral, and we should get on with getting it done.

And it is really an important issue for U.S. competitiveness. It also seems to be there are two components, particularly around the international system. The first is: How do we change the tax code, which we always do on a prospective basis so that the unintended outcomes that currently exist with all this cash accumulating overseas does not continue. And let's assume we agree on that, at some point.

The second thing is: What do we do with the money that's over there? How do we create ways of bringing that money back in a way that is consistent with a pro-growth agenda, which is one of the reasons I have put forth bipartisan legislation to have that money used to invest in our infrastructure as a way of investing in a pro-growth economy that does not cost the taxpayers money, because that money is not coming back now.

And I do care a lot about this competitiveness issue that this country faces. And I think we have to think of it not necessarily through the lens of what has happened across the last 20 or 25 years—although it should inform the way we think about the world. We really have to think about what is going to happen in the next 20 or 25 years.

The macro trends in the world, globalization and technology, are going to continue to put pressure on the United States from a competitiveness standpoint.

There are many things we need to do there. I touched on infrastructure, but this notion of investment is really, really important.

Switching now to our capital gains tax, because I want to drill down on that for a minute or two, and maybe, Dr. Tyson, I will put the question to you first:

It seems to me that right now there are two types of investments that professional investors make. They make investments in companies that by and large don't need them, which is the largest companies in this country who are all awash in cash; they have more liquidity than they have ever had; they are all increasing their dividends and buying back stock, which is terrific. But we do not necessarily need to create an incentive for people to invest in those types of transactions because they are not really capital formation transactions.

Put more directly, someone buying Apple stock, holding it for 12 months, and selling it is not really necessarily stimulative to the economy. It is in a nuanced way because if they make money they have more money to spend, et cetera. But then there is the whole category of the investments that really create jobs in this country, investing in start-up businesses, mid-sized businesses which actually create all the jobs, infrastructure, things like that, they are long-tail investments.

You typically need to have a long-term investment horizon on those investments because of the nature of what they do.

Would you be in favor of a capital gains system that actually raised taxes for short-term capital gains but lowered it as the investment horizon was deferred 3, 5, 7 years, potentially down to zero, so that we really have a game-changing view of how people allocate capital and are much more focused on allocated capital to start-ups, to fast-growing mid-sized businesses, to other long-dated assets like infrastructure? Maybe, Dr. Tyson?

Dr. Tyson. Well I did say that I was focusing primarily on corporate tax reform, so let me start by at least linking that question to your question. Because I have observed in past things that I have written that countries around the world, as they have shifted and reduced their corporate tax rates, have tended to offset some of the revenue losses in two different ways.

One way is by adjusting their treatment of capital gains and dividends and the taxation of that, by moving taxation from the level of the business entity, the corporation, to its owners. Countries around the world have done that. We have been moving in the opposite direction.

We raised the rate on corporations, and lowered the rates on individuals.

Representative Delaney. Yes.

Dr. Tyson. The second thing is, countries have—to go to the accelerated depreciation point—observed that for large multi-national companies looking for big investments around the world accelerated depreciation doesn't matter as much as statutory corporate rate differences.

So companies are saying, get rid of all the deductions, including accelerated depreciation. We are going to be able to deal with being competitive. All of our competitive disadvantages will go away if we have a lower competitive corporate rate with territoriality.

On the issue of capital gains, it has long been discussed among economists, and I remember discussing it in the Clinton Administration, that if you're looking at capital gains, it is perfectly reasonable to think about adjusting the rates with the duration of holding the assets.

This is an argument which I will turn over to Kevin, but basically economists have looked at this and thought this might be something to do to encourage longer holding periods.

Representative Delaney. Dr. Hassett, very quickly?

Dr. Hassett. I am wary of the term "differences in rates," because you don't want to have the government make people hold stuff for a given amount of time. Everybody should be making the decision based on the economic optimality of going here versus there.

And so I think whatever rate you decide should apply pretty much across the board. I think that the lock-in effect is pretty well established, and that it's not necessarily something that supports economic efficiency.

Representative Delaney. Thank you, Mr. Chairman.

Chairman Brady. Thank you.

Representative Hanna.

Representative Hanna. Thank you, Mr. Chairman.

Dr. Gravelle, the conversation is simple around here and long in the tooth. We want to level the tax field, eliminate deductions, and lower the rate. But clearly you don't think that the rate we may want to lower it to, whoever "we" are, is possible, inasmuch as you said that eliminating all deductions is someplace between 3 and 5 percent.

So—and I will ask anybody this—does this mean our mission is impossible already?

Dr. Gravelle. Well, you know, I think it is pretty tough. I mean, I think when you start with "I want this rate" instead of "I want these tax changes," and what that rate will lead to, that is when you get yourself to something that you want that can't happen.

Now there are some things outside of tax expenditures that you could consider. One of them I mentioned in my testimony was restricting deductions for interest, or disallowing the part that reflects inflation.

There are other sort of nontax-expenditure base broadeners like capitalizing advertising. There are things like that that you could think of. But even with those, it seems to be very hard.

If you—you could do what the Wyden-Gregg bill did, but they had—you know, they ended deferral. Without ending deferral, if that's off the table, then it's very hard to imagine, for me, to see a combination of provisions that will let you have a 25 percent corporate rate that's revenue neutral.

Representative Hanna. Dr. Tyson. Thank you.

Dr. Tyson. I think it is very difficult, but I do think that one of the reasons I agreed to be an economic advisor to this Alliance, and actually Doug Holtz-Eakin, my Republican counterpart, also

agreed, is because we were convinced by work that is ongoing in the Congress that Congressman Camp and Senator Baucus are leading to determine whether it is possible to achieve a 25% rate that is revenue-neutral.

And if we can get to it, are we willing to give up all the things that we need to give up to get to it?

And I have been struck by the fact that there is a very strong view in the business community that indeed there is a path to get to a reform which leads to a significant rate reduction that is revenue neutral—and revenue neutral in two senses. It is revenue neutral on the domestic rate reduction, by eliminating credits and preferences. It's also revenue-neutral internationally. By dealing with the transition tax on the repatriated earnings that are sitting outside right now and going forward, you can actually get rid of deferral and move to a territorial exemption system with base erosion protection, which does not lose revenue.

Now I think we should work hard. This is the challenge. Those are ideal features of a corporate tax reform you would want. Let's see if we can get there. Many, many people in the United States who work on these issues regularly believe that we can. That is the challenge to the Congress, to work to see if we can.

Representative Hanna. Thank you. Go ahead, Governor.

Governor Gilmore. Congressman, just very quickly. We at Free Congress put together a program, working with an economist, we call "The Growth Code." I would encourage your staff to look at it at freecongress.org. It's got five elements: Plan, comprehensive, revenue neutral. You buy down the rate on the corporate side to 15 percent, and you reform the personal exemptions. The elimination of double Taxation is a key element.

And then the repatriation issues and others. And then finally, a refundable tax credit. It's revenue neutral, but the consequences of it on the dynamic side would be an explosive growth.

Representative Hanna. Is anyone here able to assume anything about compliance, and the multiplier effect of being willing to say within capital gains, to Mr. Delaney's point, that the 15 percent rate allows people to—or at least makes it easier for people to accept that rate and reinvest that same money, that amount of money in a much shorter period of time where higher rates cause people to perhaps delay decisions?

Dr. Gravelle. There's a vast literature on that that suggests that it varies quite a bit, but it suggests that the revenue maximizing tax rate is above the rates we have right now. So you could raise revenue. At least that's the assumption that the Joint Committee on Taxation would make, if they were scoring a capital gains tax increase.

Dr. Hassett. May I interject, just that I think that, you know, sometimes the perfect is the enemy of the good. But in this tax reform debate, it seems like the mediocre is the enemy of the good; that we have to face up to the fact—Dr. Gravelle mentioned the literature that we are on opposite sides of.

The Joint Tax Committee, frankly, does not have a clue how to score a bill that is changing the international tax code because the transfer pricing and everything is so complex. If we reduce the rate 3 percentage points, I tell you revenue is probably going to go up.

Okay? But the point is that what's going on right now is the Joint Tax Committee is trying to give you a revenue-neutral bill based on scoring calls that are essentially impossible for a trained economist to make.

And we are tying ourselves in knots to get it to add up to zero, rather than just trying to do the right thing and get the rate down. And so my suggestion is: Cut the rate a little bit for three years and see what happens.

And if your revenue is too low, then do something about it. But to tie yourselves in a knot over these scores that have absolutely no scientific merit seems to me extremely illogical, especially given——

Representative Hanna. And we do that pretty well, don't we. Thank you. Thank you, my time has expired, thank you, Chairman.

Chairman Brady. Thank you. Former Chairwoman Maloney is recognized.

Representative Maloney. Thank you. Thank you, Mr. Chairman, and welcome to all of our panelists. I enjoyed very much your testimony.

The title of today's hearing is lessons learned from Reagan, and several of my colleagues have referenced his record. But it seems to me, if we are going to look at a successful record that turned our economy around and gave us record surpluses, we should be looking at the record of Former President Clinton.

I know that Dr. Tyson you were the head of the Council of Economic Advisers under that Administration, and played a part in the success that happened for our country. During his Administration, we achieved record surpluses, the largest in recent history.

We also achieved tax relief for the middle class families: Economic growth of almost 4 percent a year. The creation of over 22 million new jobs. And the lowest unemployment rate this country had seen since 1969.

So as a member of that Administration, Dr. Tyson, I would like to know if you would like to comment on that success. And it seems to me that if raising individual tax rates inhibited economic growth, it did not seem to do so during the Clinton years.

So I would like to ask you: Do you have any evidence that raising rates on individual rates inhibits economic growth? And could you comment on the success that you were part of achieving, the best economy in my lifetime, during the Clinton years?

Dr. Tyson. Well I would certainly love to take credit for that, but—and I think we did some very sound and wise things. I think it was part of convincing the country that we had a credible, long-run plan to bring the deficit down. It was a balanced plan. It had spending cuts as well as revenue increases.

Indeed, I remember the concerns about the increase in the top rates that occurred around the deficit reduction plan. Clearly, I don't think the evidence from what happened afterwards supports those concerns.

I want to note, however, because again I am focusing now on the future rather than the past, even though this is a lesson from the past, but I think we really do have to look to the future and the changing environment that we live in.

I remember President Clinton talked a lot about globalization, and he talked a lot about falling trade barriers, and he talked a lot about the importance of exports for the U.S. economy.

And, if you ask him now, he has made it very clear that he thinks the corporate tax rate in the United States should be reduced to 25 percent.

Representative Maloney. Well actually we were in a meeting earlier today with President Obama, and President Obama was appealing really to the Democratic Caucus that we needed to lower the corporate tax rate to 28 percent, and an even lower one for manufacturing, 25 percent. And he felt that this would grow our research and development, innovation, and be a driving force.

So I would like to——

Dr. Tyson. Indeed.

Representative Maloney [continuing]. To hear your response to his proposals that were in his economic speech recently. And also, how does it compare to what is happening internationally with our global competitors?

Are they moving to this territorial system you were describing earlier where there is no taxation? Could you give an overview of the competition that we are competing with?

Dr. Tyson. So an overview, in my longer written testimony I do talk about the overview. And I can just summarize in the following way:

Every other developed country has moved to what you can call technically a partial exemption system, what you can call generally as a territorial system. As I described in my remarks, if you are a U.S.-headquartered company selling a product abroad, you have set up a subsidiary to sell abroad, and most of the sales of foreign subsidiaries are actually to sales abroad. They're not to sales in the United States. You pay the tax in the country. If you repatriate the earnings, you would not pay the tax here in a territorial system.

There is an exclusion—there is a small percent of your income that would be taxed. The rest of it would not be taxed. The rest of the countries in the OECD are there. They are just like us, though, with a different system.

They confront the reality that we've got a world economy where a lot of the profits are based on intangible income. Very difficult to price. And can be located pretty easily any place in the world.

So we do have what you would call base erosion going on, income shifting going on. You can see this in the numbers. You can see that for American multi-national companies like foreign multi-national companies, there's more income in certain places than there's production in certain places.

So what's going on? So we have to deal with that. And as I said in my remarks as I was running out of time, Congressman Camp has a very interesting set of options to deal with that. President Obama has also suggested an approach similar to one of Congressman Camp's options.

The new Commission the OECD is putting together is also working on base erosion protections. We've got to get it done right, but I think we have the opportunity now to do a corporate tax reform which gets it done right and is forward-looking.

A year ago, more than a year ago, in February of 2012, President Obama's Administration put out a business tax reform framework. And the idea there was, as the President said yesterday—and I haven't had a chance to review all the proposal, so I can't give you detail—but I know the basic rubric. It called for bringing the corporate rate down to 28, to try to bring it down to 25 for manufacturing, and to make that revenue-neutral.

Now he has other ideas about territorial. He would not agree with my position on territorial, and that is something that has to be negotiated. But the point is that I think there is broad based, bipartisan recognition that we are on a path that can get us to a well-designed corporate tax reform. And it would be, to my mind, a real lost opportunity if we let this die because we can't work out other things.

Why let impasse on other things be the enemy of the good, the perfect be the enemy of the good. Why not go after the good? I believe we can get meaningful corporate tax reform. Very important for the future. Very important for jobs and investment in the future. Let's do that. And there I see commonality, a lot of commonality with what President Obama said yesterday, and Former President Clinton is saying about the need to do this. We should get going and do it.

Representative Maloney. My time has expired. Thank you. Good to see you again.

Dr. Tyson. Nice to see you.

Chairman Brady. Thank you.

Representative Paulsen.

Representative Paulsen. Thank you, Mr. Chairman, also for holding this hearing. As was mentioned earlier, both from I think your outsetting statement, as well as from the folks that testified today, the economic numbers that came out today if anything show that the economy is not on solid enough footing. Our anemic growth levels are such—they are such anemic growth levels that there's a lot more we can be doing to jumpstart our economy and put people back to work.

And certainly tax reform, I think many of us really do believe that tax reform is the vehicle to getting the economy back on track and on solid footing. It's not about doing tax reform for tax reform's sake; it is definitely about making the tax code simpler and fairer and more competitive. That is the one word that has really stood out.

As the topic of the hearing talks about, looking at past history in terms of, you know, the Reagan Tax Reform, and with the Democratic Congress' successes, and no tax reform is perfect. And certainly there were strengths and weaknesses in both the 1981 and the 1986 Tax Acts.

So I am wondering if maybe you can just reflect a little bit, Dr. Hassett to start with you. What were some of the major strengths, and what were some of the major weaknesses? And then, Dr. Tyson, you can comment also because you referenced in 1986 we were at the lowest, the U.S. had the lowest corporate tax rate, and everyone has adjusted since then.

You know, how did our actions create sort of a worldwide revolution in tax policy?

Dr. Hassett.

Dr. Hassett. I'll begin. I think that the biggest strength of the 1986 Act was the reduction in the individual side marginal rate. I think there were two weaknesses that Dr. Gravelle alluded to one of them, that on the corporate side that basically increased the tax on new capital in order to reduce the tax on old capital.

There were also a number of technical changes to things like passive loss rules that many people attribute, or think might have caused a real collapse in the nonresidential real estate market, that I think was like a bigger mess than people anticipated when they wrote the bill. But I would say that those are the pluses and minuses that are the headliners for me.

Representative Paulsen. Dr. Tyson.

Dr. Tyson. So I would like to point out that I think that at the time it would not have been clear exactly how the world was going to change. And what I want to emphasize is, we had a pretty good—it had pros and cons, and you've heard a couple of them—pretty good tax reform in 1986. But the world is so different now.

And it is different because the share of the world's purchasing power out of the United States is so much larger, because in every sector of the economy, or practically every sector of the economy, there are serious new competitors, not just from developed countries but from developing countries.

So the U.S. companies have had to in many cases, just to serve those foreign markets, have had to move production there, have had to move employment there. Sometimes it's to jump tariff walls. Sometimes it's because countries condition their sales to their customers by being there. Sometimes it's just because you have to design the product better by being close to the customers you are selling to.

So what has happened here is that U.S. companies, multi-national companies, still to this day locate most of their activity in the United States, but a large part of their markets have shifted abroad. And so now they are in a situation where they look at the tax rate in the United States and the tax rate in the other location, and the large difference becomes an additional reason to go to the other location.

Then they look at the fact that their earnings from the other location are becoming a much larger share of their total earnings, and they can't bring their foreign earnings back to the United States without paying that additional tax.

So we have got to change the system. I use in my testimony the word "modern." Let's just say it's realistic. We have to say this is the world as it is. We can't re-engineer the world. We have to reform our tax system to deal with this world.

Representative Paulsen. Governor.

Governor Gilmore. Congressman, if I could add just two quick things. Once again, I continue to support Dr. Tyson and her idea of the repatriation of assets, because I have seen it in the real world.

What is the rate in Europe? The blended rate in Europe, all these experts, it's 20 percent, isn't it? Yes, it's 20 percent.

Dr. Tyson. The blended OECD rate is in the order of 25, actually. But let's say—it depends on how you weight it.

Governor Gilmore. And we are at a maxium rate of 35 percent. So the point is this. We have got to go below that. That has got to be our goal, and our aim, and our national objective.

And second of all, I am getting increasingly uncomfortable with this discussion here about siloing the corporate tax rate. We in Free Congress think you have to look at the entire tax code in order to be able to put enough components together to get to your goals and objectives. If you just silo the corporate tax rate, then you get into some argument about how you're going "to pay for it," and the next thing you know you don't do anything.

Representative Paulsen. And knowing that many small businesses, obviously, are paying under that individual rate, and that is where a lot of jobs come from. There are a lot of us that do believe that we cannot leave one off the table without making sure we get our economy back on solid footing without helping small business.

So I yield back.

Chairman Brady. Thank you. First I want to—the Senate is voting, and I see Senator Lee is here now, but I would like to insert Vice Chairman Klobuchar's statement into the record.

[The prepared statement of Chair Klobuchar appears in the Submissions for the Record on page 60.]

Chairman Brady. And with perfect timing, I would like to recognize Senator Lee for five minutes.

Senator Lee. Thank you, Mr. Chairman, and thanks to all of you for being with us today.

Professor Tyson, I've got a question for you. In your testimony that you submitted to the Committee, you state that, quote, "Scoring conventions ignore the stimulative effects of a cut in rate on future growth," close quote.

Do you think it would be appropriate for Congress to consider dynamic scoring of corporate tax reform packages?

Dr. Tyson. I'm afraid I have to leave this up to the Congress. We are all dealing, economists are dealing, and the Congress is dealing with models of corporate tax effects which are out of date relative to corporate reality, relative to the mobility of capital income, relative to competitive conditions around the world.

So I do believe that the competitive effects of the kind of corporate tax reform that I have been discussing are significantly larger than traditional economic models, and dynamic scoring models would allow.

What is important for me to emphasize here is that the Alliance for Competitive Taxation, and a lot of members of the business community and the corporate sector believe that we can get to a rate that we think significantly improves our competitive situation, paying for it by getting rid of preferences and credits, without dynamic scoring. We believe it is going to be better than that, but we aren't proposing that you do that.

And I think that is an important point. I mean, if you want to try alternative models, I think that is great. But I think that the proposal is we can get a competitive tax rate that is paid for by base broadening without making assumptions about the dynamic effects, even though I personally believe in the dynamic effects.

Senator Lee. Okay. And you personally believe in them such that if we were to use them we would probably get more accurate scoring, but you are saying we don't have to get there with what you are talking about, as much as it would be good, much as you would welcome seeing that. Okay.

Dr. Hassett, any thoughts you have on dynamic scoring that you would like to share along those lines?

Dr. Hassett. Well, sure. I think that ideally we would be basing our judgments on the best estimate of what might happen, and we are not doing that.

And as I said a little bit earlier, before you arrived, that I think that it ends up creating almost a theater of the absurd where we are using scores that we do not think really have much to do with reality to tie ourselves into knots.

And for me, I think that, absent having a new scoring debate and establishing new procedures, I think exercising humility on both sides, and being willing to learn is something else that you could do. And make a small, temporary tax change and then watch what happens to revenue, and then start to learn how tax changes affect revenues, and then collectively decide what the right thing to do is.

Instead, what we are doing is tying ourselves in knots because we cannot come up with something that pleases the scoring models that have nothing to do with reality. And that gridlock has been with us really since President Clinton made a very, very small change in the corporate rate while the rest of the world has been cutting its rate.

And so I think we have to fix the system of scoring because it has become an obstacle to competitiveness.

Senator Lee. Back to Dr. Tyson for a minute. In a piece you recently wrote in Project Syndicate, I think it was in March, you discussed, among other things, the difficulty of doing corporate tax reform comprehensively, absent any changes to the treatment of pass-throughs, LLCs, or other businesses that pay—other businesses as to which taxes are typically paid through the individual side of the code.

Do you think corporate-only tax reform is a viable option? And how do you think this would change the competitive position of small businesses relative to large corporations due to the tax code?

Dr. Tyson. Let me say that I did preface that statement in Project Syndicate with the observation that I think it is not desirable to have a corporate tax code which distorts choice of organizational form, when everything is similar about the organization except whether it checks an "S corp" or a "C corp" box.

So that is an inefficiency from an economist's point of view. I actually think that the best answer to this was again given by my colleague, Dr. Hassett, who said: If we had the right, well-designed corporate tax reform with an appropriate rate, a lot of businesses that are currently choosing other organizational forms would choose the corporate form.

This is an organizational choice. And it depends upon the tax system. We could get rid of this organizational form distortion by a comprehensive corporate tax reform with an appropriate rate. As

a result of such a reform, a lot of companies would choose to organize as corporations.

I think that therefore what I prefer is to focus on getting the corporate tax reform right. And then that will allow businesses to choose the form of organization and taxation which is the most appropriate for them.

Senator Lee. Okay. You are saying corporate form is itself a dynamic response.

Dr. Tyson. I guess I think that. And, by the way, the Governor and I have agreed on a lot of things. Since I think we are on the road to possible, meaningful, sensible corporate tax reform, and I can see the political way to do that I would hate to see it get blocked because we are trying to get comprehensive tax reform and then therefore get no tax reform.

Senator Lee. Thank you. I see my time has expired.

Governor Gilmore. Mr. Chairman, may I answer the Senator's question?

Chairman Brady. Very quickly, yes, sir.

Governor Gilmore. Senator, the answer is: Yes, we should consider dynamic scoring. Now when we put together our program at Free Congress, I asked my economists to do a revenue-neutral static approach because I didn't think politically it would be acceptable otherwise. But we all know there's going to be dynamic pluses.

And Kevin Hassett's right. Try it. You will see that it will work. And then we will learn something about economics.

Senator Lee. Thank you, Governor.

Chairman Brady. Thank you. On behalf of Vice Chair Klobuchar and myself, I want to thank our witnesses. I get the sense of enough is enough with this tax code. It is time to make the tough changes and become competitive again. It is not easy. That's why it is not done but once a generation, but this really is an opportunity in I think a bipartisan way to get this done.

So I want to thank the witnesses for their insight, their thought, and past experience that is just hugely helpful for us at this Committee. So again, thank you for being here.

The hearing is adjourned.

(Whereupon, at 3:18 p.m., Wednesday, July 31, 2013, the hearing was adjourned.)

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF HON. KEVIN BRADY, CHAIRMAN, JOINT ECONOMIC COMMITTEE

America's current tax code is too costly, too complex, and unfair, but mostly unfair.

It's unfair to families. Whether you're single or raising children, starting your career or experiencing retirement, the tax code is impossible to understand. It's more time-consuming than ever. And you're always wondering—is the next guy paying the same as me?

You can't possibly keep up with the 4,000 changes Washington has made the past decade. That's a new change in the tax code every day. Few taxpayers even know the tax provisions to which they are entitled. For example, there are 15 different tax provisions for higher education—each with its own set of rules. The "simple guide" for these provisions is 90 pages long! And if you accidentally make a mistake, the IRS is unforgiving.

Today's tax code is unfair to businesses.

It costs too much for businesses to keep up with their taxes—especially if you're a small business. Most have to rely on outside tax preparers. It's not fair that many small businesses pay higher tax rates than big businesses. And it's not fair that American companies face the highest tax rate among developed countries.

Our outdated tax code often double-taxes American companies—forcing them to shift workers and research overseas just to try to compete on a level playing field against foreign competitors.

Today's tax code is unfair to America.

The complex and burdensome tax code drains over $160 billion out of America's economy each year. It makes it too hard to start up new businesses and create new jobs. America has fallen behind its global competitors in Europe and China—saddled with a tax code that costs us sales, contracts, and jobs when we compete.

Experts predict a simpler, fairer, flatter tax code for families and businesses could create up to 1 million new jobs in the first year and make us competitive again in the 21st century.

We need a simpler, fairer tax code that protects taxpayers—not special interests—and helps Americans compete and win.

So what can we learn from the last comprehensive rewrite of the American tax code?

When President Ronald Reagan took office on January 20, 1981, the top individual income tax rate was 70 percent. The Economic Recovery Tax Act of 1981 reduced the top individual rate to 50 percent by the end of his first term. The Tax Reform Act of 1986 reduced the top individual rate to 28 percent by the end of his second term.

Contrary to the claims of Reagan's critics at the time, these rate reductions neither starved the Treasury for revenue nor undermined the progressivity of the income tax.

Income taxes as a share of our economy remained virtually unchanged. The share of income taxes paid by the richest Americans increased dramatically.

For example, the share of federal income taxes paid by the top 1 percent rose from 19.1 percent in 1980 to 27.6 percent in 1988. In contrast, the federal income tax burden on the middle class fell. Indeed, the share of federal income taxes paid by the bottom 50 percent fell from 7.1 percent in 1980 to 5.7 percent in 1988.

The Tax Reform Act of 1986 reduced the top corporate income tax rate from 46 percent to 34 percent. But the positive effects of lower corporate rates were largely offset by the repeal of the Investment Tax Credit, longer depreciation schedules especially for buildings, and the repeal of the 60 percent exclusion of capital gains from taxation, effectively raising the top tax rate on capital gains from 20 percent to 28 percent.

The tax reforms enacted under President Reagan were not perfect, yet collectively they boosted economic growth and employment. Tax changes in Reagan's first term increased real GDP by more than 10 percent, while tax changes in Reagan's second term partially offset these earlier gains by less than one percent.

The overall success of Reagan's tax policies brought about a worldwide revolution in taxation. Over the next two and a half decades, nearly every developed country in the world reduced tax rates on both individuals and corporations.

The average combined corporate tax rate among the countries in the Organization for Economic Cooperation and Development (OECD) declined from approximately 48 percent in the early 1980s to 25 percent in 2013. After Japan recently cut its corporate income tax rate, the United States now has the highest combined corporate tax rate in the OECD at 39.2 percent—the worst.

Despite President Obama's individual income and capital gains tax rate increases in January which have slowed the U.S. economic recovery, the President still asserts the wealthy are not paying their fair share of federal taxes.

However, the facts don't support his assertion.

An objective study by the OECD, found that the highest-earning 10 percent of the U.S. population actually paid the largest share among 24 countries examined, even after adjusting for their relatively higher incomes.

The richest ten percent in the United States pay 1.35 times their share of income in taxes compared to the OECD average of 1.11. "Taxation is most progressively distributed in the United States," the OECD study concluded.

Unfortunately, as other countries have moved forward in reducing their individual and corporate income tax rates, the United States has reversed course, undoing much of the earlier rate reductions. Including President Obama's latest tax increases, our top individual income tax rate is now nearly 44 percent.

The purpose of today's hearing is to review the lessons we should have learned from previous tax reform efforts. What worked, what didn't, and why?

And most importantly, given our anemic recovery from the current recession—the weakest recovery since World War II—how can we improve our tax system to get the most economic bang for the buck?

What I've seen as a member of the tax-writing House Ways and Means Committee is that our current complex tax system diverts productive resources into wasteful lobbying and tax avoidance schemes. It favors consumption over investment, debt over equity, large businesses over small, and some industries over others.

Tax reform should eliminate these distortions and promote economic growth. Hopefully, today's hearing will help us identify the steps we need to take to achieve this goal.

I look forward to the testimony of our witnesses.

PREPARED STATEMENT OF JAMES S. GILMORE III, PRESIDENT & CEO, FREE CONGRESS FOUNDATION AND FREE CONGRESS ACTION

Good afternoon. Thank you for the opportunity to speak at this hearing today. As a former alternate delegate for presidential candidate, Ronald Reagan, at the 1976 Kansas City Republican Convention, I like the title of this hearing. But we cannot simply look to the past. John F. Kennedy and Ronald Reagan lived in different times and rose to the occasion to lift our spirits—but also our economic growth through their policies. Millions of unemployed and underemployed Americans need today's leaders to look forward and create a sense of purpose for our new national goal—which is economic growth. Currently, our leaders are not proposing bold, new ideas.

We here at the Free Congress Foundation have focused on economic recovery for the United States for more than three years. We have participated in numerous panel discussions and written op-eds to promote an economic program that most Republicans and Democrats can agree on. At the end of 2011 we offered the "Growth Code," a specific program of tax reform that if enacted would spur growth, get the economy moving, and create jobs that would get us out of this recession.

The truth is that this country has not yet recovered from the "Great Recession." Historically, this country grows at 3.2%. We are not growing anything like that rate. All estimates show growth in the near future at less than 2%. No estimates show recovery at 3.2% or the higher rate it will take to make up the ground we have lost in recent years. Unemployment is historically 5.7% (or better) in the U.S. We have been over 7.5% unemployment FOR FOUR YEARS NOW.

Current economic trends show the following:

- 1.5 million or 53% of young people (under 25 years of age) with bachelor degrees are jobless or underemployed. (April 2012)
- Unemployment in the African-American community currently stands at 13.7%; Young African-Americans (ages 18–29) are facing an unemployment rate of 22.1%. (Jan. 2013)
- Unemployment in the Hispanic community (ages 18–29) stands at 13%. (Jan. 2013)
- All women in the United States of America (ages 18–29) are staring at an unemployment rate of 11.6%. (Jan 2013)

The consequences of this situation are not simple economic numbers. It means lower wages as more workers chase fewer jobs. It means gross unemployment in the black community. It means no jobs for our bright young people coming out of school

and getting started. It means that long time workers are being laid off, and not being able to get reemployed. It means family strife. It means an endangered national security.

This is a historic crime against the citizens of our country, and no government benefit program will make up for lost opportunity. The only answer, as we have said for years, is to focus on growing our economy. A growing economy has more business opening and existing businesses expanding, creating more jobs. More jobs means a better life for our citizens. It also increases tax revenue organically, making high taxes unnecessary and eliminating deficit spending.

We should control government spending, but it gets a lot easier when you have more tax money coming in.

President Obama's current slate of proposals is not going to erase the economic, psychological and political damage done to date by a long-held, misplaced faith in excessive government spending and bureaucratic problem solving. Americans see this clearly. They can see that conventional government programs will not advance our nation beyond its current stagnation.

What our country needs instead is an unambiguous and actionable way forward for the new political dynamic. The problem with the current national dialogue is the confusing mashup of conflicting policy signals from our political leadership. As if uncertainty about our economy were not enough, Washington creates even more uncertainty by, in some cases, proposing to give with one hand and take back with another. In other cases, it shows reluctance to offer any hand at all.

Americans are tired of the talk. Tired of the gamesmanship of politics. They want results. I agree with President Obama that Washington is out of touch. I agree that we need to invest in our future. This week at Knox College the President asked for ideas. The President said in his speech "I will welcome ideas from anyone from across the political spectrum."

OK Mr. President, we have a suggestion:

The nation needs to set a new national goal. That goal should be to grow the economy of this nation and far beyond the historial 3.2% rate of economic growth. All other national objectives should be subordinate to this goal of growth. We as a nation should only implement national economic policy and laws that lead to growth. The reverse is also true: we should avoid at all cost actions that discourage growth.

As we watch the debate between the House of Representatives, controlled by the Republicans, and the White House, controlled by the Democrats, we need to understand that judging by the new national standard, neither party is furthering the national goal. Cutting spending is a laudable objective, but it is not the best immediate way to obtain national growth. Raising taxes is the exact opposite of what is necessary to achieve national growth. Growth must become the new touchstone.

The national discussion right now is all wrong. The loudest theme is "tax the rich." This is not a growth strategy, and isn't even a debt/deficit reduction policy. The national debt today is about 16 trillion dollars. Put another way, the debt is 16,000 billion dollars. The annual deficit is about one trillion, ninety billion dollars. This amount equals 1,090 billion dollars. Tax increases on the "rich" promise to bring in between 20 and 45 billion dollars: a drop in the bucket.

While raising 20 to 45 billion extra dollars of new revenue is arguably better than nothing, it is clearly no strategy for taxing our way out of debt, and won't make a dent in the nation's deficit. Also, these proposals assume that the "rich" won't take steps to reduce their taxable incomes or otherwise shelter their incomes, including investing overseas instead of here at home. It's still a free county, and money is our most easily movable asset.

In other words, we'll never see the 20 to 40 billion dollars from the tax increases. Meanwhile, investment will be discouraged, and we will have fewer jobs and less revenue on our economic activity. No one wants to become the advocate for the "rich." The real point is different: The real question is: What actions will increase growth, employment, and real careers for all Americans, young or old, rich or poor, who want to get ahead?

The point is that nothing about "taxing the rich" or "compromise" or "lets all work together" has anything to do with the new national goal of growing the economy. While the "fiscal cliff" was avoided earlier this year, the only national policy that offers any real hope for the future is national growth. If the country grows, there will be more people employed. There will be more income for the government to tax. The country will get more revenue. The percent of spending as a percent of Gross Domestic Product, will go down automatically as our economic activity goes up. Pressure on entitlements and benefit programs will be reduced. Investment will be encouraged. National defense can be preserved. In fact, growth as the national policy should be the objective of both Democrats and Republicans, conservatives and

liberals, and all Americans. Everybody wants more money to support the nation's aspirations, however each of us defines it.

This is why we at the Free Congress Foundation have been consistent advocates for growth as a national policy, and why we created the "Growth Code," to propose a specific tax reform with predictable growth results. The "Growth Code" proposal can be found on the Free Congress Foundation website at FreeCongress.org and we hope you will read our specific five point plan and join us in our efforts to save the nation. The good news is that eventually we, as a nation, will do what is necessary to grow the economy because we have no other choice. The question is: How many people will have to suffer until we figure it out?

What we should take away from President Obama's Knox College speech is what he does not mention: He has proposed no bold program that will incentivize investment, job creation, and growth. The country desperately needs a growth plan to save the livelihoods of the people of the United States, but the President does not want growth to be a focus of the economic debate. It may be that the philosophy of this President makes it impossible for him to see the path forward that will bring us out of recession. We can only ask how many lives must be ruined, how much loss must be endured by the people of this country before a positive program comes forward? The emergency is now. The need for action is now. We look forward to the day when we can complement the President on a new program to renew our economy and our country.

We invite all of our friends to read "The Growth Code" proposal in full at *www.freecongress.org*

THE GROWTH CODE

Made up of five steps, The Growth Code is simply, squarely and precisely focused on the taxcode and restoring America to a sustainable economic growth trajectory:

- A simple unified 15% rate on all business income, regardless of the type of entity;
- Tax rates of 10%, 15% and 25% on individual income is currently defined under the IRC;
- Immediate expensing of capital equipment;
- Elimination of the abhorrent practice of double taxation;
- Any household living in poverty will receive a family tax credit of $4,300.

Full Report of the Growth Code *http://www.freecongress.org/wp-content/uploads/2011/11/The-Growth-Code-Final-Product.pdf*

James S. Gilmore III is the President and CEO of the Free Congress Foundation. He was Governor of Virginia from 1998–2002.

PREPARED STATEMENT OF DR. LAURA D'ANDREA TYSON

Chairman Brady and Vice Chair Klobuchar, thank you for the opportunity today to address the issue of tax reform and specifically how carefully designed tax reform can improve the economy's performance. My name is Dr. Laura Tyson and I am a professor at the Haas School of Business at the University of California Berkeley. I served as the Chair of the Council of Economic Advisers and as Chair of the National Economic Council under President Clinton. I was a member of President Obama's Economic Recovery Advisory Board and his Council on Jobs and Competitiveness. I am currently an economic adviser to the Alliance for Competitive Taxation, a coalition of American businesses that are promoting comprehensive corporate tax reform. The views in this testimony are my own.

My remarks will focus on corporate tax reform. Fifty years ago under President Kennedy and perhaps as recently as 30 years ago under President Reagan, the American economy was the most competitive in the world, and the U.S. could design its corporate tax code without considering the global economic environment. American companies derived most of their income from their domestic operations and to the extent they were engaged globally, they were typically larger than their foreign-based counterparts.

But we no longer live in that world. Emerging market economies, falling trade barriers, and remarkable leaps in information and communications technology have expanded opportunities for U.S. companies abroad, but have also heightened global competition among companies to gain market share and lower production costs, and among countries to attract investment and jobs.

Our current corporate tax system makes it harder for U.S. businesses—small and large—to compete with foreign companies, and reduces the competitiveness of the U.S. economy as a place to do business and create jobs. As a result of numerous

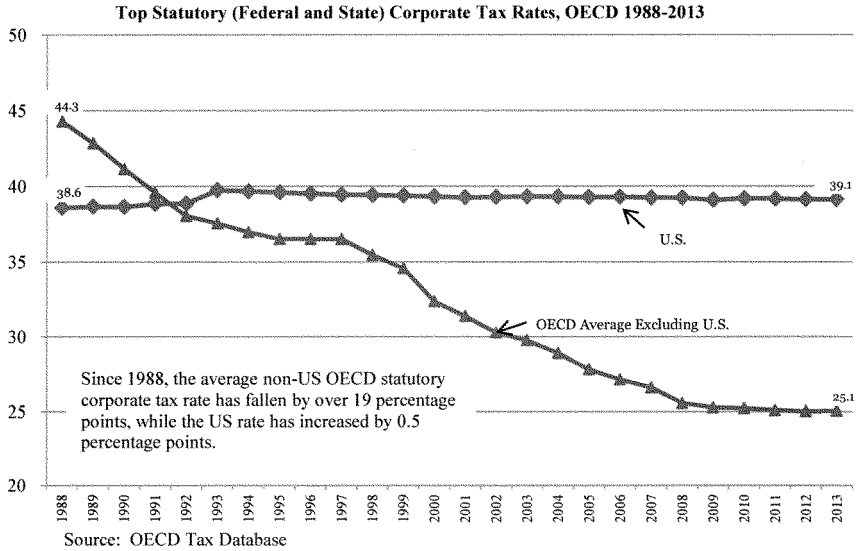
credits, deductions and exclusions, the current system also results in high compliance costs for businesses—estimated at $148 billion in 2005—and undermines the efficiency of business decisions in numerous ways. There is widespread bipartisan agreement that our corporate tax system is deeply flawed and in need of fundamental reform.

I believe there are ways to reform the corporate tax system that will strengthen the competitiveness of U.S. companies, make the U.S. a more attractive location for investment, and promote simplicity and efficiency in the tax code without increasing the deficit. In the remainder of my remarks, I will suggest changes to current tax rules affecting both the domestic and the foreign-earned income of U.S. corporations to achieve these objectives.

Before turning to these changes, I want to use an example to illustrate how the current system undermines the competitiveness of U.S. companies. When a U.S. company sells shampoo in Asia, it is competing with shampoos made by its foreign competitors. The price of the shampoo to the consumer has to be competitive. However, a Dutch company pays zero tax to the Netherlands on the sale of its shampoo in Asia, whereas the U.S. company is subject to tax on its Asian income when repatriated. This puts foreign subsidiaries of U.S. companies at a competitive disadvantage among foreign competitors.

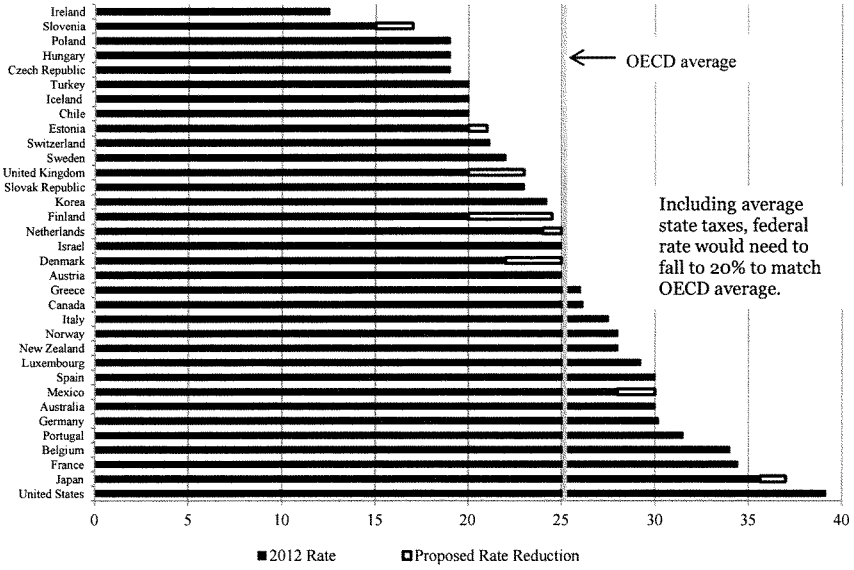
DOMESTIC TAX REFORM

After its 1986 tax overhaul, the United States had one of the lowest corporate tax rates among OECD countries. Since then, these other developed countries have been slashing their rates in order to attract foreign direct investment and discourage their own companies from shifting operations and profits to low-tax foreign locations. In the most recent and audacious move, the British government has embarked on a plan to reduce its corporate tax rate from 28% to 20%—one of the lowest in the OECD—by 2015. And this year the British government instituted a special 10% tax rate on income from patents.



The U.S. now has the highest corporate tax rate of these countries. Even after accounting for various deductions, credits, and other tax-reducing provisions, the effective average and marginal corporate tax rates in the United States are higher than the OECD averages.

Corporate Tax Rates (Federal and State) in OECD Countries, 2013



Source: OECD Tax Database

Cutting the corporate rate to a more competitive level would encourage more domestic investment by U.S. and foreign investors. Capital has become increasingly mobile, and differences in national corporate tax rates have a growing influence on where multinational companies locate their operations and report their income.

Higher investment in the U.S. by both domestic and foreign companies would boost economic growth, while the resulting increase in capital—new businesses, factories, equipment, and research—would improve productivity. That should, in turn, boost real wages over time.

The pro-growth rationale for reducing the U.S. corporate tax rate is compelling. But rate reduction—at least as estimated under the conventions used by the Joint Committee on Taxation and by Treasury—is costly, perhaps on the order of $100 billion or more per percentage point over the next 10 years. By scoring conventions, such calculations ignore the stimulative effects of a cut in the rate on future economic growth. Although I believe these effects are significant, I am not convinced that they would alone be sufficient to offset the lost revenues from a reduction in the rate to a level comparable to that in other OECD countries.

So how should we finance a rate reduction large enough to have a significant effect on the competitiveness of U.S. companies and on the competitiveness of the U.S. as a location for investment without increasing the deficit? Like most economists, I believe that we can and should pay for such a rate reduction by broadening the corporate tax base through the elimination of tax breaks and preferences. This approach would also reduce the complexity of the tax code and increase its efficiency. The current system of deductions and credits not only reduces corporate tax revenues, it also results in large differences in effective tax rates across economic activities and these differences affect investment decisions, often with harmful effects on productivity and growth.

Combining rate reduction with base broadening is the approach adopted in the 1986 corporate tax reform enacted under President Reagan and it is the approach advocated by numerous independent commissions on competitiveness and deficit reduction and by the Obama Administration.

Given the importance of the statutory corporate tax rate in influencing the location of highly profitable and mobile capital, a significant reduction in this rate paid for by broadening the corporate tax base can achieve meaningful efficiency gains and boost economic growth. And over time as growth increases a revenue-neutral corporate tax reform will increase corporate tax revenues and reduce the deficit.

INTERNATIONAL TAX REFORM

In addition to reducing its corporate tax rate, the U.S. needs to reform the way it taxes the foreign earnings of U.S. companies.

With 95% of the world's consumers located outside of the United States, American companies need to have a presence in foreign markets in order to be able to compete there. For companies trying to sell and service escalators, most of the growth potential exists in areas where construction is robust, such as Asia. If a U.S. company wants to be selected to install and service an escalator in a building abroad, it must have maintenance and engineering staff on the ground in the country where the building is located. And if the U.S. company isn't established in the foreign jurisdiction, a non-U.S. competitor will likely win the business.

Every other G–8 country and 28 of the other 33 OECD member countries have adopted modern international tax systems that generally allow their internationally engaged companies to compete globally and reinvest active foreign earnings at home without paying a second tax. This approach, referred to as a participation exemption or territorial tax regime, is grounded in the principle of capital ownership neutrality—that is, the ownership of a foreign company by a domestic company should not result in greater taxation of its active income than ownership of that company by a foreign competitor.

The United States, by contrast, taxes U.S. multinational companies when they repatriate active income earned abroad by their foreign subsidiaries, with a credit for foreign taxes imposed on this income. With the adoption of territorial tax systems by the United Kingdom and Japan in 2009, and by thirteen other OECD member countries since 2000, the U.S. international tax system now lies far outside of international norms. Indeed, of the companies that appeared on the Global Fortune 500 list in 2012, 93 percent of the foreign companies that compete with U.S. companies were headquartered in territorial countries. Only two OECD countries have ever switched from exemption to foreign tax credit systems—Finland and New Zealand—and both subsequently reinstated exemption systems.

The current worldwide approach to corporate taxation in the U.S. puts globally engaged U.S. companies at a competitive disadvantage. They cannot bring profits from their foreign affiliates home without paying the high U.S. corporate tax rate, while foreign-based competitors pay only the local tax rate on such profits. The combination of a high corporate tax rate and a worldwide approach to taxing the foreign active earnings of companies reduces the attractiveness of the U.S. as a place to locate the headquarters of global companies.

As a consequence of both U.S. taxation of repatriated foreign earnings and the high U.S. corporate tax rate, U.S.-based multinational companies have a strong incentive to keep their foreign earnings abroad. Indeed, their non-U.S. affiliates currently hold an estimated $2 trillion in accumulated foreign earnings.

These earnings are "locked out" and unavailable to finance investment and job creation in the United States without incurring significant additional U.S. taxes. Moreover, U.S. companies incur efficiency costs from the suboptimal use of these earnings and from higher levels of debt than would be necessary if their foreign earnings could be repatriated without incurring additional U.S. tax. Treasury economist Harry Grubert and Rutgers economics professor Rosanne Altshuler estimate that the hidden efficiency costs of the U.S. international tax system averages about five percent of the trapped foreign cash of mature U.S. multinational companies. These costs are a drag on their competitiveness.

A participation exemption or territorial system similar to those in other developed countries would allow U.S. multinationals to put their foreign earnings to work in the United States and to compete more effectively in foreign markets, which today represent 75 percent of the world's purchasing power and which will become even more important in the future.

Preliminary results from a study I am conducting at the Berkeley Research Group, an independent research and consulting group, with financial support from the Alliance for Competitive Taxation, suggest that exempting 95-percent of the active foreign income earned by the foreign subsidiaries of U.S. companies from U.S. corporate taxation would increase U.S. employment by about 150,000 jobs a year on a sustained basis, with a short-term employment gain nearly 10 times larger. These gains in employment are the result of a significant increase in the repatriation of income by foreign subsidiaries. Repatriated funds would boost U.S. employment and growth through an increase in the parent companies' economic activities in the U.S. and through distributions to their U.S. shareholders, who in turn would increase their investment and consumption.

Adopting a hybrid participation exemption or territorial system similar to those in other developed countries would address the competitiveness disadvantages, the

"lock-out" effect, and the inefficiencies of the current U.S. worldwide approach. However, such a system would not reduce the incentives for U.S. multinational companies to structure the transactions between their U.S. operations and the operations of their foreign affiliates in ways that shift their profits abroad to low tax jurisdictions. Recent Congressional hearings have focused on the incentives that U.S. companies face under present law to shift reported profits to lower tax foreign jurisdictions, in some cases through the transfer of intangible property and risks to foreign affiliates.

Income-shifting incentives exist in both the current U.S. system and in territorial systems and have become stronger over time as a result of several factors including: the increasing globalization of business activity; the rising importance of intangible capital that is difficult to price and relatively easy to move; competitive cuts in corporate tax rates; and the availability of tax havens. As a result, income shifting and the resulting erosion of domestic corporate tax bases have become major policy concerns throughout the OECD. In response to such concerns, OECD countries with both worldwide and territorial systems have developed a variety of techniques to curb base erosion including transfer-pricing rules based on OECD guidelines, "exit" taxes on outbound transfers of appreciated property, limits on interest deductibility, and domestic taxation of passive and certain types of mobile income earned by foreign subsidiaries. Territorial systems with such features are referred to as hybrid territorial systems. The current U.S. worldwide system already has all of these features.

The OECD recently announced a 15-point action plan to develop coordinated national measures to further restrict opportunities for multinational companies to reduce or avoid taxation on cross-border income.

As part of comprehensive corporate tax reform that includes a revenue-neutral rate cut, the House Ways and Means Committee is currently considering a hybrid international reform that would follow the participation exemption or territorial systems of other OECD countries and would include additional measures to counter tax-base erosion and income shifting. Lowering the high U.S. corporate tax rate by itself would reduce the incentives for both U.S. and foreign-based companies to shift income from their U.S. operations and erode the U.S. corporate tax base.

Among the anti-base erosion options included in Ways and Means Committee Chairman David Camp's international tax reform discussion draft is an innovative proposal that rests on the "destination principle," with the tax rate on intangible property income based on where products are sold. This option would significantly reduce incentives to move intangible property or manufacturing abroad for tax reasons by offering a low 15-percent rate on income from intangible property owned in the United States and used in connection with providing goods and services sold in foreign markets. This is a form of the "patent box" regimes recently put in effect by seven EU member countries and China.

CONCLUSION

The U.S. last reformed its business tax code in 1986, when it had one of the lowest corporate tax rates in the world and the competitive dynamics of the global economy were very different. It is time for another comprehensive corporate tax reform that, without increasing the budget deficit, reduces the tax rate, broadens the tax base, makes the corporate tax system simpler and more efficient, and adopts a hybrid international system with effective safeguards to protect the U.S. tax base.

American Enterprise Institute for Public Policy Research

Testimony before the Joint Economic Committee

Lessons from Reagan: How Tax Reform Can Boost Economic Growth

Kevin A. Hassett

John G. Searle Senior Fellow

Director of Economic Policy Studies

American Enterprise Institute

July 31, 2013

The views expressed in this testimony are those of the author alone and do not necessarily represent the views of the American Enterprise Institute.

Chairman Brady, Vice Chair Klobuchar, and Members of the Committee, thank you for inviting me to discuss the issue of tax reform with you today. In the testimony that follows, I will discuss the success of previous tax reforms, problems with the tax code today, and which tax policies could be used to promote economic growth.

In 1982, Ronald Reagan presided over a devastated economy. The unemployment rate hit 10.8%. Reagan advocated a firm prescription for our nation's economic woes. In his first inaugural address, he said to the nation that, "It is time to reawaken this industrial giant, to get government back within its means, and to lighten our punitive tax burden. And these will be our first priorities, and on these principles, there will be no compromise." When the US officially entered recession in July 1981, the President was prepared.

On August 13th, 1981, President Reagan signed into law the Economic Recovery Tax act of 1981 that drastically reduced the tax burden on Americans. And while these cuts would be pared back in 1982, the majority of cuts survived. The economic revival that followed was tremendous, as Senator Gramm recently detailed in the Wall Street Journal.[1] Within fifty-five months of the start of the recession, the economy had created 7.8 million more jobs than at its start and real per capital GDP grew by $3,091. During the same time frame, the number of people on disability stamps had fallen 14.3 percent, or by 644,000 people, and the number of food-stamp recipients had fallen 13.4 percent, or by three million people. Between 1981 and 1986, real median family income rose 7.7 percent a year.

While the anecdotal evidence is compelling, it requires rigorous theoretical and empirical analysis to determine whether this anecdotal experience linking the Reagan approach temporally is supported by hard science. In this testimony, I examine whether tax reform can drive growth, and whether it is the right policy for today's environment.

In the recovery following the 2007-2009 recession, the return to normal levels of employment and economic growth has been notably slow. Many factors have contributed to this slow recovery, including the nature of the financial crisis that accompanied it, policy uncertainty, and weakened economic performance internationally, especially in the Eurozone. Though growth has improved since the end of the recession, there is more that the federal government can do to foster a robust economy. Following in Reagan's footsteps, reforming the tax code is one place to start.

Expanding output requires expanding inputs. Indeed, a primary factor driving American economic growth in the past two centuries has been the growth of the stocks of capital and labor. In recent decades, the country's economic success has been driven more by innovative currents and the expansion of entire new industries with high growth potentials. This evolution surely, in part, reflects the acceleration of technological change, but it also is the result of a more uncomfortable truth: that the steady and predictable growth of the normal inputs of production, capital and labor, has slowed. That brings the United States to a strange new world where healthy growth is no sure thing, depending more and more on the presence or absence of technological good fortune. A

[1] http://online.wsj.com/article/SB10000872396390444812704577609863412900388.html

key objective of policy should be to return the United States to a path that can post steady and predictable growth of inputs and outputs, and take advantage of technological opportunities as they arise.

There are three primary problems with our tax code in this regard. The first is its needless complexity, in the form of hundreds of credits and cutouts for different types of people or activities. The second is the tendency for the code to discourage labor supply. The third is the heavy tax we impose on capital formation. Economists generally agree that each of these issues limits economic growth by creating distortions in the economic choices that people in the U.S. make today. The good news is that our tax code is so bad that the opportunity from fundamental tax reform is significant.

The distortions created by these fundamental problems are serious, and economists agree that a well-designed reform could have a significant effect on growth. For example, a survey of 69 public finance economists conducted by Victor Fuchs, Alan Krueger, and James Poterba (1998) found that, at the median, respondents believed that the 1986 tax reform President Reagan signed into law produced about one percentage point higher growth over a long period,[2] a conclusion that my review of the broader tax reform literature with Alan Auerbach supports with respect to a prospective sweeping fundamental reform, if not for the likely impact of the 1986 reform specifically.[3] If tax reform could add even a small amount of growth per year, this growth could compound, having a large long-term effect on the size and health of the economy.

In 2005, Alan Auerbach and I reviewed numerous tax reform proposals from different economists, and identified three characteristics that they had almost universally in common: reducing the marginal tax rate on corporate investment; improving incentives to save; smoothing out differing treatment of different industries and assets while minimizing economic distortions; and finally, improving incentives to work.[4] A sound reform should not only address marginal tax rates, but should reform the definition of the tax base as well. Through comprehensive tax reform, the system could be streamlined to improve taxpayers understanding (helping them make rational choices) and remove distortions that hamstring economic growth.

Taxes and the Labor Force

Growth in the labor force is an important contributor to economic growth, but one that has been shrinking over the past decades. At its peak in the 1970s, potential hours worked contributed 1.7 percentage points to potential GDP growth each year. Potential GDP is a theoretical measure of the output that an economy is capable of if all its factors of production were employed. From 2002-2012, however, hours worked only contributed

[2] Victor R. Fuchs, Alan B. Krueger, and James M. Poterba, "Economists' Views about Parameters, Values, and Policy: Survey Results in Labor and Public Finance," Journal of Economic Literature 36 (3): 1387-1425.

[3] Alan J. Auerbach and Kevin A. Hassett, Toward Fundamental Tax Reform, (Washington, DC: AEI Press, 2005), 150

[4] Alan J. Auerbach and Kevin A. Hassett, eds. *Toward Fundamental Tax Reform.* (Washington, DC: AEI Press 2005).

0.3 percentage points on average to potential GDP growth.[5] From the supply side, then, labor force growth could be expected to deliver a steady significant boost to growth. Today, the base case starts 1.4 percentage points lower.

If labor force participation were higher, GDP would have the potential to be higher as well. The income tax system unfortunately discourages labor force participation in many cases, especially for older workers and second earners.

As my colleagues Aspen Gorry and Sita Slavov explain in a recent analysis, the structure of the tax code in the U.S. is based on family units rather than individuals, and in many cases this leads to disincentives for secondary earners to work.[6] This is because married couples face a higher average tax rate when a second earner starts to work, and that secondary earner (usually a woman) faces a higher marginal tax rate as well. A review of the literature surrounding workers' responsiveness to marginal tax rates by Michael Keane[7] finds that women are very responsive to marginal tax rates, and the effect on their decision to work or not is especially large. A review of the 1986 tax reform by Nada Eissa[8] found that the reduction of the top marginal rate from 50 to 28 percent increased the labor supply of women with family incomes in that bracket, and had an especially strong impact on whether a woman worked or not (as opposed to the number of hours worked by these women).

In addition, the tax code combines with Social Security and Medicare structures to discourage older workers from participating in the labor force. Once a worker reaches retirement age, in many cases he receives little further benefit from working an extra year in terms of social security payments, but he still pays the same payroll taxes of 12.4 percent into Social Security. This decreases the returns to working for older workers, as described by Gorry and Slavov in a separate recent analysis.[9]

An efficient tax code would work to minimize disincentives for work. Where workers are especially responsive to marginal tax changes, the income tax system should be adjusted to take this into account, perhaps eliminating payroll taxes for older workers or changing the way a second earner is treated by the income tax system. Overall lower marginal tax rates also reduce the disincentives for joining the labor force or increasing the number of hours that someone works, so lowering overall marginal tax rates may increase labor force participation and encourage economic growth as well.

---

[5] "Key Assumptions in Projecting Potential GDP-February 2013 Baseline," Congressional Budget Office. February 5,2013. http://www.cbo.gov/publication/43910

[6] Gorry, Aspen and Sita Slavov. "The Tax Treatment of the Family." AEI Economic Perspectives, May 2013.

[7] Michael P. Keane, "Labor Supply and Taxes: A Survey," *Journal of Economic Literature* 49, no. 4 (2011): 961–1075.

[8] Eissa, Nada. "Taxation and Labor Supply of Married Women: The Tax Reform Act of 1986 as a Natural Experimnet." NBER Working paper No. 5023, February 1995.

[9] Gorry, Aspen and Sita Slavov. "Financing Entitlements and Promoting Work: Does Policy Encourage Early Retirement?" AEI Economic Perspectives, December 2012.

Taxes on Capital

This nation employs several methods for taxing capital income, including the corporate income tax, capital gains tax, and tax on dividends, both at the individual and the corporate level. There is a large economic literature that documents strong theoretical and empirical support for reforms that would reduce capital taxes in the United States, but the consensus amongst economists on these issues has not always been reflected in a political consensus. While there has previously been a strong bipartisan consensus regarding capital gains taxes, which were cut dramatically by Jimmy Carter in 1978, and again by Bill Clinton in 1997, they have recently grown more contentious. Dividend taxes were also low until the beginning of this year, having been increased from 15% to 20% for taxpayers in the top bracket during the fiscal cliff negotiations at the end of 2012, with the addition of a 3.8% Medicare tax on dividends for those same taxpayers. There has been less of a political consensus regarding the corporate tax, and the U.S.'s currents status as the highest tax country in the developed world is likely the most pressing tax policy issue of the day.

In addition to labor, capital is the other main driver of production, and increasing investment and utilization of capital leads to economic growth. High taxes on capital reduce saving and investment, and therefore lead to lower long-run growth. Capital is not only beneficial to those who own it; an increase in capital improves the productivity of workers as well, and they benefit from wage increases as they become more productive. A goal of tax reform should be to decrease distortions in the tax code that disincentivize investment in order to promote growth of the capital stock, which would lead to greater productivity and economic growth.

As mentioned above, the economic literature has explored the area of capital taxation in detail. One of the first models which was used to show how an optimal tax on capital is zero was created by Auerbach and Kotlikoff. Over several decades, this model was subsequently used by authors who modified and added complexity to it in order to understand the long-run interactions of fiscal policy and economic decisions of people in their life cycles. Numerous studies — including Chamley (1985, 1986)[10] and Judd (1985, 1999)[11] – have used the Auerbach-Kotlikoff model to show that the optimal capital tax is zero after the initial period in the model. Later studies by Jones, Manuelli, and Rossi (1993, 1997)[12] and Erosa and Gervais[13] added in certain constraints (such as an

[10] Christophe Chamley, "Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives," *Econometrica* 54, no. 3 (1986): 607-22. Christophe Chamley. "Efficient Taxation in a Stylized Model of Intertemporal General Equilibrium," *International Economic Review*, vol. 26(2) (1985): 451-68.
[11] Kenneth Judd, "Redistributive Taxation in a Simple Perfect Foresight Model." *Journal of Public Economics* 28, no. 1 (1985): 59-83; Kenneth L. Judd, "Optimal Taxation and Spending in General Competitive Growth Models," *Journal of Public Economics* 71 (1999): 1-26.
[12] Larry E. Jones, Rodolfo E. Manuelli and Peter E. Rossi, *Journal of Political Economy* , Vol. 101, No. 3 (Jun., 1993), pp. 485-517. Jones, L.E., R.E. Manuelli, and P.E. Rossi, "On the Optimal Taxation of Capital Income.," *Journal of Economic Theory* 73 (1997): 93-117.
[13] Andrew Erosa, Martin Gervais, "Optimal Taxation in Life-Cycle Economies," *Journal of Economic Theory* 105 (August 2002): 338-369.

exogenous determination of government spending, or the inability to tax by age) and found that the inclusion of a capital tax was optimal under certain conditions. However, their results showed that the optimal capital income tax was small, and supported the idea that wage and consumption taxes were preferable for efficiency in the economy.

Kenneth Judd provides a useful explanation for these results in a chapter from a volume edited by Glenn Hubbard and myself.[14] A capital tax introduces a distortion into the return on saving and investment, a distortion that "explodes" over time. Even a small capital tax will not be optimal because the damage it causes will eventually grow without bound. The intuition of this result is quite straightforward. Recall that an efficient tax system will cause individuals to change their behavior as little as possible. A huge tax on apples and a small tax on bananas would cause an enormous shift away from apples and toward bananas. A small uniform tax on both would not. Think of consumption today as being represented by apples and consumption ten years from now as bananas. If you give up an apple today, you get a number of bananas ten years from now that depends on the interest you got on the money you saved after not eating the apple. At 10 percent interest, a dollar saved today becomes $2.60 ten years from now. If we tax that interest at 50 percent, a dollar saved today only yields $1.63 ten years from now. Clearly, a tax on interest can have a very large effect on how much money you have ten years from now, a very big effect on the rate at which you can trade apples today for bananas tomorrow. Indeed, this distortion grows bigger and bigger over time because of compounding. One dollar saved today produces $17.45 thirty years from now at 10 percent interest. If the interest is taxed at 50 percent, then a dollar saved yields only $4.32 over the same time period.

It is easy to dismiss these implications as theoretical, with little relevance to how capital taxes work in the world today. But the high tax rates on capital income in the U.S. stand in strong contrast not only to the implications of optimal tax theory described in the economics literature, but also to the policies of our trade partners. Not only do high capital taxes in the U.S. today distort the incentives for investment, but they have implications for U.S. competitiveness as well.

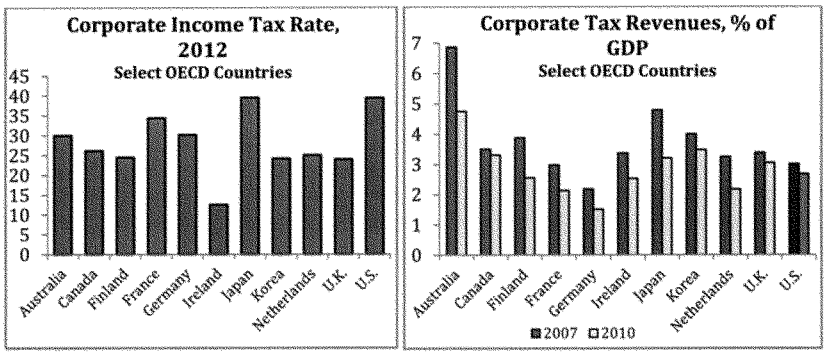
Corporate Tax Rates

The corporate income tax has been levied in the United States since 1909, when it was introduced at the rate of 1 percent. Today, the U.S. federal tax rate for most corporations is 35 percent; on average, state taxes add another 4.2 percent tax. With a 39.2 percent combined corporate tax rate, we earned the honor of highest tax rate in the developed world last year when Japan lowered its rate from 39.5 to 38 percent. In lowering its corporate income rate, Japan followed a wave of reforms that began in the mid to late 1980s and has continued through the 2000s. The OECD average corporate tax rate fell almost 9 percent in the first decade of the 21st century; overall, top combined statutory rates amongst OECD countries have fallen from an average of about 48 percent in the

[14] Judd, K.L. (2001), "The Impact of Tax Reform in Modern Dynamic Economics," in K.A. Hassett and R.G. Hubbard, eds., *Transition Costs of Fundamental Tax Reform.*

early 1980s to a little over 25 percent in 2011.[15] The U.S., however, has not changed its top statutory rate since 1993.

A common argument is that even though the statutory corporate tax rate is extremely high, the significant number of loopholes in our tax code allows firms to escape much of the apparent tax burden in the U.S. In truth, when looking at effective rates rather than statutory rates, the U.S. does not rank much better compared to other OECD countries. In a 2011 study with my AEI colleague Aparna Mathur, I computed the Effective Average Tax Rate (EATR) and Effective Marginal Tax Rate (EMTR) for corporations in OECD countries, and our results suggest that the effective rates have followed a similar trend to statutory rates.[16] In 1996 the U.S. EATR was slightly below the OECD average – 29.2 versus 30.2 – but in 2010, while the U.S. EATR remained largely constant at 29 percent, the OECD average (excluding the United States) had fallen to 20.5 percent. The United States fares slightly better when looking at the EMTR, but remains above the average. In 2010, the U.S. EMTR was 23.6 percent, compared to the non-US OECD average of 17.3 percent.



The relatively unfavorable position of the U.S. compared to the rest of the world creates a significant competitive disadvantage. The harm caused from suboptimal taxation is magnified significantly when capital is mobile, and when alternatives to locating in the U.S. exist.

Lowering the corporate income rate may be especially beneficial to boosting U.S. competitiveness in the manufacturing sector. Manufacturing has been especially mobile over the past two decades, and the U.S. has seen manufacturing employment and output decrease dramatically, a phenomenon that accelerated following the normalization of U.S. trade relations with China in 2000, according to research by Pierce and Schott.[17]

---

[15] "OECD Tax Database," http://www.oecd.org/ctp/taxdatabase.

[16] Kevin A. Hassett and Aparna Mathur, *Report Card on Effective Corporate Tax Rates: United States Gets an F*, Tax Policy Outlook No. 1 (Washington, DC: American Enterprise Institute, February 2011), http://www.aei.org/docLib/TPO-2011-01-g.pdf.

[17] Pierce, Justin R., and Peter K. Schott. 2012. "The Surprisingly Swift Decline of U.S. Manufacturing Employment." NBER Working Paper No. 18655.

Today, however, it may be possible that the U.S. is improving as a location for the manufacturing industry in comparison with China, whose labor costs have steadily increased over the last decade. As energy costs and productivity have improved in the U.S., many observers see an opening for a broadening of the U.S. manufacturing sector – but a recent study by Thomas Duesterberg of the Aspen Institute emphasizes that lowering the corporate rate and moving to a territorial tax system are key to improving the environment for investment in capital and manufacturing in the U.S.[18] It will be difficult for the U.S. to attract foreign direct investment, especially if its corporate tax rate remains well above the OECD average.

Since capital is mobile in the long-run and other countries have relatively lower levels of capital taxation, there are several implications for the U.S. economy. First, the United States would likely draw more capital by lowering its corporate tax rates. It is possible that it is also on the wrong side of the "Laffer curve", and may be able to raise more revenue from a lower tax rate. In addition, the gains from a corporate tax cut would likely flow through to labor. As capital returns to the American economy, each worker will have a relatively larger stock of capital to work with, and the marginal product of labor will rise. Reforming our corporate income tax system has the potential to bring numerous benefits.

When corporate tax rates are high in an open economy, then investors and firms are free to move capital to other countries with more favorable taxes. If an American firm locates a plant in the U.S., for example, it will keep only 61 cents of every dollar the facility earns after federal, state, and local taxes. If it locates the new plant in Ireland, it keeps 87 cents of unrepatriated earnings. There is a large literature that finds that firms are incredibly skilled at moving money around to minimize their taxes. A classic paper by Roseanne Altshuler, Harry Grubert and T. Scott Newlon finds investment location is highly responsive to differences in tax rates (with elasticities ranging from 1.5 to 2.8).[19] In addition, Harry Grubert has written a large number of papers with various coauthors documenting massive income shifting behavior of U.S. multinationals.[20]

The Laffer curve represents the tradeoff between tax rates and revenue. When tax rates are 0, revenues is also zero, and as tax rates increase, so does revenue. But at a certain point, tax rates increase to an amount where revenue actually decreases because people shift behavior to avoid the tax. Economists will tell you that Laffer curve phenomena – that is, situations when tax rates go down and revenue goes up – are rare and unlikely, requiring high elasticities. It is true that they are rare, but it is not surprising given the

---

[18] Duesterberg, Thomas. "The Manufacturing Resurgence: What it Could Mean for the U.S. Economy." The Aspen Institute, Manufacturing and Society in the 21st Century. March 2013.

[19] Rosanne Altshuler, Harry Grubert, and T. Scott Newlon. "Has U.S. Investment Abroad Become More Sensitive to Tax Rates?" *International Taxation and Multinational Activity* edited by James R. Hines. Pg. 9-38 (January 2000)

[20] Examples include Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location." *National Tax Journal*, 56.1 (March 2003); Harry Grubert and John Mutti, "Do Taxes Influence Where U.S. Corporations Invest?" *National Tax Journal*, 53.3 (December 2000); Harry Grubert and Joel Slemrod, "The Effect of Taxes on Investment and Income Shifting to Puerto Rico." NBER Working Paper No. 4869 (September 1994) http://www.nber.org/papers/w4869.pdf.

elasticities described above that a number of authors have supported the idea that the U.S. is on the wrong side of the Laffer curve with regards to corporate income taxes.

A 2007 paper by Kimberly Clausing examines OECD countries over the period 1979-2002.[21] Analyzing the variation in the countries tax rates and their tax revenues, she concludes that the revenue-maximizing corporate tax rate is 33 percent for the sample. Michael Deveraux examines the same relationship and finds evidence, although weak, that the revenue- maximizing rate might be rather low.[22] Focusing on Canada, a study by Jack Mintz estimated that a corporate rate at 28 percent would bring in the most revenue. Lastly, my work with AEI colleague Alex Brill also finds strong evidence that a Laffer curve exists in the corporate sphere and that the revenue maximizing rate has fallen from about 34 percent in the 1980s to 26 percent in the early 2000s.[23] If you take the Brill-Hassett estimates seriously, then the U.S. could increase tax revenue by $767 billion over the next ten years if it reduces its rate to 26.4 percent, and it would have to cut the rate all the way to 17.8 percent if it wanted to enact a revenue neutral reform.

This result is fully consistent with the large literature documenting how mobile capital income is internationally. Laffer curve results depend on high elasiticities, and high elasticities are independently documented as well. A recent CRS report respecifies this analysis and argues that the Laffer curve effect is not present in the data. However, even this CRS report provides strong evidence that corporate rate reductions would not cost a large amount of revenue, finding that, "Once appropriate estimation methods are used to correct problems arising with panel data, there appears to be no statistically significant relation between corporate tax rates and corporate tax revenues as a percentage of GDP." While this report has severe methodological problems, it suffices to say that even after aggressive specification search, the authors find that a reduction in the corporate rate would not be expected to have any effect on revenue, that is, a straight rate reduction should not be expected to reduce revenues.[24]

A final argument in favor of cutting the corporate tax rate is that it would benefit workers. This channel was recently discussed in a Senate Budget Committee testimony by the former director of the Brookings-Urban Tax Policy Center Roseanne Altshuler, who wrote, "Moreover, any increase in the corporate income tax rate will reduce domestic income and lower wages (through an outflow of capital) and adversely affect economic efficiency."[25]

---

[21] Clausing, Kimberly A. "Corporate Tax Revenues in OECD Countries," *International Tax and Public Finance* 14:115-133 (2007).

[22] Michael P. Devereux, *Developments in the Taxation of Corporate Profit in the OECD Since 1965: Rates, Bases and Revenues*. Oxford University Working Paper. (May 2006)

[23] Alex Brill and Kevin Hassett, *Revenue Maximizing Corporate Income Taxes: The Laffer Curve in OECD Countries"* AEI working paper # 137, American Enterprise Institute, July 31, 2007.

[24] Gravelle and Thomas L. Hungerford, "Corporate Tax Reform: Should We Really Believe the Research?"Tax Notes, Oct. 27, 2008, p. 419, Doc 2008-18748, or 2008 TNT 209-18.

[25] Rosanne Altshuler, "Testimony of Dr. Rosanne Altshuler Before the Senate Committee on the Budget." Hearing on Tax Reform: A Necessary Component for Restoring Fiscal Responsibility. February 2, 2011. Pg. 3. http://www.budget.senate.gov/democratic/ index.cfm/files/serve?File_id=d86dd771-f895-48f4-abf7-1e1f79dc319b

The benefits to American workers have been documented in a number of recent studies such as a 2007 paper by Alison Felix,[26] work done by Mihir A. Desai, C. Fritz Foley, and James R. Hines,[27] and my own research with my colleague Aparna Mathur.[28] They all conclude that labor bears much, if not all, of the burden of the corporate tax. The idea that workers may bear a portion of the corporate income tax is neither surprising nor new. Basic incidence analysis suggests that the burden of the tax will always be larger on the side of the market that is more inelastic. In the short run, the incidence will necessarily be borne out of the earnings of fixed capital since the supply of capital is fixed. However, it is the long run effects which are of greatest theoretical and practical interest. Since capital is relatively more mobile in the long-run than labor (which is relatively inelastically supplied), labor could bear a larger portion of the tax burden.

In one of the first empirical studies on the topic, (Hassett and Mathur, 2006, revised 2010) my colleague Aparna Mathur and I use a unique, self-compiled dataset on international tax rates and explore the link between taxes and manufacturing wages for a panel of 65 countries over 25 years.[29] We find that wages are significantly responsive to corporate taxation, controlling for other macroeconomic variables. Our evidence shows that higher corporate tax rates depress wages. My colleagues Aparna Mathur and Matt Jensen summarize these results concisely,[30] "the results suggest that a 1 percent increase in the corporate tax rates leads to a 0.5 percent decrease in wage rates. For example, if the corporate tax rate increases from 35 percent to 35.35 percent, a 1 percent increase, a 10 dollar per hour wage rate will decrease 0.5 percent to $9.95. Using information from the United States wage bill and tax revenues, this implies that every additional dollar of tax revenue leads to a $4 decrease in aggregate real wages. Examining the effects of tax rate changes one year later, rather than five, we find that a $1 increase in tax revenues leads to $2 decrease in wages." We also find that tax characteristics of neighboring countries, whether geographic or economic, have a significant effect on domestic wages. The study uses a standard specification drawn from the existing literature on wage variation across countries.

Other subsequent studies have supported this finding. R. Alison Felix[31] uses cross-country data over the period 1979-2002 to estimate the effect corporate tax rate changes on annual gross wages. She finds that a 1 percentage point increase in the corporate tax

---

[26] Rachael Alison Felix, "Passing the Burden: Corporate Tax Incidence in Open Economies." (October 2007) http://www.kc.frb.org/Publicat/RegionalRWP/RRWP07-01.pdf

[27] Mehir A. Desai, C. Fritz Foley, and James R. Hines, Jr., "Labor and Capital Shares of the Corporate Tax Burden: International Evidence," Prepared for the International Tax Policy Forum and Urban-Brookings Tax Policy Center conference on Who Pays the Corporate Tax in an Open Economy?, December 18, 2007.

[28] Kevin A. Hassett and Aparna Mathur, "Spatial Tax Competition and Domestic Wages" *AEI Working Paper* (December 2010).

[29] The original paper was updated in 2010. The 2010 version is described here. Kevin A. Hassett and Aparna Mathur, "Taxes and Wages," *AEI Working Paper 128* (June 2006); Kevin A. Hassett and Aparna Mathur, "Spatial Tax Competition and Domestic Wages" *AEI Working Paper* (December 2010).

[30] Matthew H. Jensen and Aparna Mathur, "Corporate Tax Burden on Labor: Theory and Empirical Evidence," *Tax Notes*, June 6, 2011, p. 1083, *Doc 2011-10018*

[31] Rachael Alison Felix, "Passing the Burden: Corporate Tax Incidence in Open Economies." (October 2007) http://www.kc.frb.org/Publicat/RegionalRWP/RRWP07-01.pdf

rate decreases annual wages by 0.71 to 1.21 percent. Another example is a study by Mihir A. Desai, C. Fritz Foley, and James R. Hines, who use data on foreign activities of U.S. multinationals to create a panel of more than 50 countries between 1989 and 2004.[32] They investigate the effect of corporate taxes on labor and capital. Their estimates show that 45 and 75 percent of the burden of corporate taxes is borne by labor with the remainder (out of a 100 percent) borne by capital. Lastly, a European study by Wiji Arulampalam, Michael Devereux and Giorgia Maffini on corporate taxes, which uses firm level data in 9 countries over the period 1996-2003.59 They conclude that an exogenous rise of $1 would reduce the wage bill by 49 cents.

A different study focusing on the incidence across states is Tax Foundation Working Paper by Robert Carroll, who also finds that corporate taxes negatively affected wages during the 1970 and 2007 period.[33] The paper estimates that a 1 percent increase in the average state and local corporate tax rate can be expected to lower real wages by 0.014 percent.

Some have critiqued the empirical techniques employed in the Hassett and Mathur study. Gravelle and Hungerford (2008)[34], for example, argue that purchasing power parity conversions would be preferable to exchange rate conversions and that omitted variable bias could lead to artificially high estimates of the corporate tax burden on labor. However, most of the studies in the literature, including Hassett and Mathur use standard techniques employed in empirical economics. Many of the critiques leveled by Gravelle and Hungerford could be applied to any study that involves data. Furthermore, an accurate assessment of this matter would recognize that the preponderance of empirical papers and a great many theoretical papers all support the same conclusion that much of the burden of corporate taxation falls on labor. For those who would like an overview, my colleagues Aparna Mathur and Matt Jensen reviewed this literature in the June 2011 issue of Tax Notes[35].

These results are consistent with the frequently employed assumptions in the public finance literature that capital is highly mobile, but labor is not. Under these conditions labor will bear the burden of capital taxes after some lag, while firms observe productivity gains and workers renegotiate fixed wage contracts.

Dividend Taxes

In addition to the corporate income tax, the United States also taxes dividends paid out to shareholders and capital gains at the individual level. This extra layer of capital taxation

---

[32] Mehir A. Desai, C. Fritz Foley, and James R. Hines, Jr., "Labor and Capital Shares of the Corporate Tax Burden: International Evidence," Prepared for the International Tax Policy Forum and Urban-Brookings Tax Policy Center conference on Who Pays the Corporate Tax in an Open Economy?, December 18, 2007.
[33] Carroll, Robert. "The Corporate Income Tax and Workers' Wages: New Evidence From the 50 States," Tax Foundation Special Report No. 169 (Aug. 2009).
[34] Gravelle and Thomas L. Hungerford, ''Corporate Tax Reform: Should We Really Believe the Research?''Tax Notes, Oct. 27, 2008, p. 419, Doc 2008-18748, or 2008 TNT 209-18.
[35] Mathur, Aparna and Matthew H. Jensen. "Corporate Tax Burden on Labor: Theory and Empirical Evidence." *Tax Notes*, June 6, 2011, p. 1083-1089.

increases the overall effective tax rate that burdens new investment. On the other hand, depreciation and expensing provisions lower the effective tax rates on business income, and numerous loopholes and other tax expenditures lower the rate for industries that happen to be favored in Washington.

The double taxation of corporate income discourages investment in equipment and structures. The dividend then tax raises the cost of funds to firms, increasing the hurdle rate for new projects. The accompanying reduction in capital spending reduces economic growth and interferes with the creation of new jobs.

The literature on dividend tax policy and investment has had a rather contentious history. Theoretically speaking, it is possible to derive cases where dividend taxes have a large effect on investment, but other cases exist that are equally plausible that suggest that dividend taxes have a smaller effect. An early and path-breaking study by Poterba and Summers (1985) concluded, "our results suggest that dividend taxes reduce corporate investment and exacerbate distortions in the intersectoral and intertemporal allocation of capital".[36] A more recent study that I coauthored with Alan Auerbach of the University of California at Berkeley found evidence that supported somewhat smaller economic effects of dividend tax reductions (or increases),[37] which seems to be supported by other recent analyses of the effects of dividend tax cuts. This is not to say, however, that increasing the dividend tax rate at the beginning of 2013 did not have an effect on firm behavior, however. In fact, a 2010 study by Gourio and Miao[38] found that a decrease of the dividend and capital gains taxes from 25 and 20 percent to 15 percent each would lead to an increase of 4 percent in long-run capital stock. Lower capital accumulation in the long-run means lower growth and productivity.

Other Capital Tax Issues

In addition to corporate taxes, other forms of capital income taxes are ripe for updating, and many smaller changes would improve efficiency and encourage investment in the U.S. One such change to the current system would be the implementation of permanent business expensing. In other words, allowing firms that purchase new machines and other capital goods to be able to write them off immediately, instead of over many years.

A well-developed body of research by economists provides support for something that people in business will readily confirm: firms are much more likely to expand their capital stock when the cost of capital is low. Implementing full expensing can reduce the cost of capital significantly. Future deductions are not as valuable as current deductions because of the time value of money, and because these deductions are not indexed for inflation. Expensing gives firms the entire deduction up front, and with full expensing,

---

[36] Poterba, J.M., and L.H. Summers, "The Econonomic Effects of Dividend Taxation", (1985) in E. Altman and M. Subrahmanyam, eds., *Recent Advances in Corporate Finance*, pp. 227-284.
[37] Auerbach, A.J., and K.A. Hassett (2003), "On the Marginal Source of Investment Funds," *Journal of Public Economics*, 87, pp. 205-232.
[38] François Gourio and Jianjun Miao, 2010. "Firm Heterogeneity and the Long-Run Effects of Dividend Tax Reform," *American Economic Journal: Macroeconomics*, vol. 2(1), pages 131-68, January.

the value of the deduction will exactly offset the present value return on the investment over its lifetime, so the effective marginal tax rate on investment will be zero.

Although much of the recent economic literature on expensing has focused on the merits of temporary provisions enacted as stimulus, there is wide agreement in the economics profession that permanent measures can have significant long-run growth effects. Many researchers actually agree that expensing provisions provide more growth per dollar of foregone revenue than reductions to other capital taxes. This is because full expensing offers tax benefits to new investment only, whereas cuts to corporate, dividends, or capital gains tax rates offer tax benefits to old capital as well. The Treasury Department, for example, estimates that cuts to the corporate, capital gains, or dividends rates are only about 60% as effective in terms of "bang-for-the-buck" investment growth as expensing provisions.[39]

In addition to inefficient expensing provisions, another problem with the current structure of capital taxes is the asymmetric treatment of debt and equity, which encourages heavy debt loads and increases the overall level of risk in the corporate sector. Firms that borrow to finance investments are allowed under current law to deduct interest payments associated with that debt. Dividend payments are not deductible. This encourages firms to use debt finance over raising equity whenever possible. When firms have large debt loads, they are much more likely to enter bankruptcy during difficult times.

Consumption Taxation

The best solution for tax reform that encourages investment and growth is to move from our income tax system to a system that taxes consumption. Consumption-based taxes have been explored in research that exploded in the 1970s and 80s and has continued to this day. As I previously mentioned, an important result of the tax-reform literature is that, in the long run, an efficient tax system must not tax capital income.

Increasingly sophisticated economic models have attempted to predict the impact of a wholesale change to a consumption tax on the American economy. Some such models find the gain from a switch to a consumption tax to be enormous. For example, Larry Summers, President Obama's first director of the National Economic Council, wrote in 1981, "The results suggest that the elimination of capital income taxation would have very substantial economic effects. For example, a complete shift to consumption taxation might raise steady-state output by as much as 18 percent and consumption by 16 percent."[40] These large gains occur because an income tax discourages capital formation, and the increase in capital formation leads to a higher level of economic growth for some length of time.

Summers' paper was one of the first glimpses of this result, and, in retrospect, it is a bit

[39] U.S. Department of the Treasury, "Background Paper." Paper presented in the Treasury Conference on Business Taxation and Global Competitiveness, U.S. Department of the Treasury, July 23, 2007.
[40] Lawrence H. Summers, "Capital Taxation and Accumulation in a Life-Cycle Growth Model." *American Economic Review* 71 (September 1981): 533-44.

of an outlier. Models of increasing complexity today generally find effects smaller than those described by Summers. Nonetheless, economists have consistently found large positive output effects from fundamental tax reform. Pecorino (1994)[41] estimated the hypothetical effect on the growth rate of replacing the 1985 US income tax structure with a consumption tax to be of the order of 1 percent per capita per year. Over the course of several years, this result would closely correspond with the estimates found in other studies that mostly focus on long-run increases in output. An OECD study by Arnold (2008) provides an empirical analysis of the effect of the tax structure on long-run GDP. The main findings include "Property taxes, and particularly recurrent taxes on immovable property, seem to be the most growth-friendly, followed by consumption taxes and then by personal income taxes. Corporate income taxes appear to have the most negative effect on GDP per capita."[42] Alan Auerbach and I found support for this assertion in a review of the literature that we conducted in 2005, which suggested that a transition to an ideal system might increase economic output between 5 and 10 percent.[43]

While the literature unanimously supports the idea that a consumption tax would boost output, it is important to consider the reform's possible effects on distributional equity. Different models of consumption taxes have differing effects on the distribution of the tax burden, but advocates of consumption taxation have made significant adjustments and improvements to consumption tax models in response to this concern. A value-added tax (VAT), for example, is one pure form of a consumption tax —a firm pays tax on the difference between its total revenue and the cash it has paid to other businesses, and is not allowed to deduct wages paid before calculating its tax. But under the VAT, everyone pays the same tax rate regardless of income.[44] Hall and Rabushka (1995) showed how a VAT could be modified to maintain the economic benefit while maintaining the tax code's current redistributive role. Their "flat tax" is a two-part VAT that allows firms to deduct wages before calculating their tax, but workers must pay tax on the wages that they receive at the same rate faced by the corporation, with income up to a set amount excluded.[45]

David Bradford took this logic one step further in the development of his X-tax. He, too, passed the responsibility for paying taxes on wages on to the workers, and then taxed their wages using a graduated rate system. In principle, this approach allows for any possible level of redistribution, which weakens the logical basis for opposition to a consumption tax on social-justice concerns.[46]

---

[41] Pecorino, Paul. "The Growth Rate Effects of Tax Reform." *Oxford Economic Papers* 46, no. 3 (1994): 492-501.
[42] Jens Arnold, "Do tax structures affect aggregate economic growth? Empirical evidence from a panel of OECD countries", *OECD Economics Department Working Paper* 643, 2008.
[43] Auerbach, Alan J. and Kevin A. Hassett, ed. *Toward Fundamental Tax Reform.* Washington DC: The AEI Press, 2005.
[44] It is possible to add progressivity to a VAT by narrowing the base; however, this creates inefficiency.
[45] Robert E. Hall and Alvin Rabushka, *The Flat Tax: Updated Revised Edition*, Second Edition, Revised ed. (Hoover Institution Press, 1995)
[46] Bradford, David F, "The X Tax in the World Economy." *CEPS Working Paper No. 93* (August 2003). http://www.princeton.edu/~ceps/workingpapers/93bradford.pdf

A 2001 paper by Altig, Auerbach, Kotlikoff, Smetters and Walliser explored the degree to which this redistributional twist compromised the economic effects of a consumption tax, using a model to estimate the effects of different types of tax reform on individuals in twelve different income classes.[47] They simulate several different approaches to tax reform, including a proportional income tax, a proportional consumption tax, a standard flat tax, a flat tax with transition relief and the X-tax. Some tax reforms, notably the flat tax, increased overall long-run welfare at the expense of the poor, which is a concern for many critics of consumption taxes. However, their model found that under the X-tax, aggregate long-run consumption increased by 7.5 percent, and long-run welfare improved for individuals in every income class.

For a good review of the X-tax, my AEI colleague Alan Viard and Robert Carroll of Ernst & Young have set out to introduce the Bradford X-tax to the broader public in their book entitled, "Progressive Consumption Taxation: The X-Tax Revisited,"[48] which I would recommend to anyone interested. Their book sets forth solutions to commonly perceived problems concerning the taxation of pensions and fringe benefits, business firms, financial intermediaries, international transactions, owner-occupied housing, state and local governments, and nonprofit institutions, and the transition. By adopting these proposed approaches, the United States can move to a progressive tax system that no longer penalizes saving and investment.

Conclusions

Tax reform is the great untapped policy opportunity available to policymakers today. Best would be a sweeping fundamental reform, but a well-designed corporate reform could increase expected growth without threatening America's coffers. The largest obstacle to growth in the U.S. today is the high corporate income tax, which discourages investment in capital and industry at home and weakens the competitiveness of the U.S. in comparison with other OECD countries. In order to encourage companies to locate in the U.S. and to increase investment at home, the corporate tax rate should be reduced. In addition, other aspects of capital taxation discourage saving and investment and weaken the economy in the long run.

In addition, the tax code today discourages labor force participation in multiple ways, especially for older workers and secondary earners, who are usually women. A goal of tax reform should be to reduce these work disincentives, by lowering marginal tax rates and changing how secondary and older workers are treated by income and payroll tax schemes.

These measures together can help increase the capital stock and hours worked, thus driving expected economic growth away from the disappointing "new normal."

---

[47] Altig, David, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters, and Jan Walliser. "Simulating Fundamental Tax Reform in the United States." *The American Economic Review* 91, no. 3 (2001): 574-595.
[48] Robert Carroll and Alan D. Viard. *Progressive Consumption Taxation: The X-Tax Revisited.* AEI Press. June 2012.

Statement of Jane G. Gravelle
Senior Specialist in Economic Policy
Congressional Research Service
Before
The Joint Economic Committee
United States Senate
July 31, 2013
on
Lessons From Reagan: How Tax Reform Can Boost Economic Growth

Mr. Chairman and Members of the Committee, I am Jane Gravelle, a Senior Specialist in Economic Policy at the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss tax reform.

The Tax Reform Act of 1986 (TRA) has often been invoked as an example of a successful tax reform. As Congress considers tax reform currently, comparing and contrasting the current environment with that surrounding the 1986 Act can be helpful in understanding what expectations Congress might have for the development and consequences of tax reform.

The TRA was preceded by a major tax cut for individuals and significant liberalizations of depreciation for businesses in 1981. These were followed by two revisions (in 1982 and 1984) that took back some of this revenue. TRA, by contrast was, much like many of the proposals today, proposed to be revenue and distributionally neutral. There is some disagreement about whether a tax reform should be revenue

neutral or whether it should gain revenue, given the debt challenges the country faces. Debt and deficits were a problem in 1986 as well, but addressing those issues via the tax system was delayed until 1990 and 1993.

The objectives of TRA, as stated in the 1984 Treasury Report,[1] were for fairness, simplicity, and economic growth. However, much of the discussion in the report spoke to neutrality (or what economists would term efficiency) rather than economic growth. In outlining the goals of tax reform, it opened with economic neutrality, and proceeded to discuss a number of objectives before specifically listing economic growth in 11th place. The discussion of economic growth itself was explicitly linked to neutrality.

The first section of this testimony, focusing on a revenue and distributionally neutral reform, addresses the differences between economic growth and efficiency, and the expectations for growth that accompany income tax reform of this nature. The following sections consider other aspects of TRA and the economic conditions that lead to comparisons and contrasts with the current reform proposals, including the overall economic environment, the feasibility of significant base-broadening, open economy considerations for the corporate tax (both in economic effects and compliance), the risks of adopting a plan that loses revenue and contributes to the deficit in the long run, and the prospects for simplification.

Economic Growth and Efficiency

While the terms "economic growth" and "efficiency" are often used interchangeably, each is a distinct concept. Economic growth refers to responses that increase income and output. Efficiency refers to reallocating resources to maximize

[1] *Tax Reform for Fairness, Simplicity, and Economic Growth*, the Treasury Department Report to the President, November 1984.

welfare. Many, indeed most, of these efficiency effects are not detectable as a change in output, and particularly in output net of depreciation which is a better comparison.[2] For example reducing distortions in the corporate tax may largely change the share of corporate versus non-corporate production, or lead to changes in debt shares that re-allocate risk.[3] In sum, efficiency gains, while desirable to pursue, are often barely noticeable as output effects.

Economic growth, by contrast, generally arises from increases in labor supply, savings, and investment. There is evidence that suggests, however, that TRA did not have much of an effect on growth, and economists argued that it should not have been expected to.[4] This limited effect was expected in part because supply responses (such as labor supply) are small and in part because a revenue neutral tax reform that included many base broadening provisions might have minimal aggregate effects on effective marginal tax rates.[5]

---

[2] An example of a change that increases gross output, but does not change net output other than by a negligible amount, is shifting investment from residential structures which have low depreciation rates to business equipment which has a high rate. Most of the gross output effect from this shift results from an increase in depreciation. Thus, additional output will be used first to replace depreciating assets, with a likely negligible increase that could add to current and future income.

[3] Economic distortions are referred to by economists as Harberger triangles (the area on a supply and demand curve representing the distortion) and Nobel Laureate James Tobin, referring the shortfall in output from a recession (termed Okun gaps) once quipped "It takes a heap of Harberger triangles to fill an Okun gap." A rough estimate of the efficiency gain from eliminating all corporate distortions is about 10% to 15% of corporate revenue, which is, in turn, about 2% of output. This cost amounts to between 2/10 and 3/10 of a percent of output, and most of it would be reflected in more optimal debt equity ratio, payout ratios, and changes in the mix of output. Only a small share would increase output through more optimal capital-labor ratios. See CRS Report RL3229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle and Thomas L. Hungerford.

[4] See Alan J. Auerbach and Joel Slemrod, "The Economic Effects of the Tax Reform Act of 1986," *Journal of Economic Literature* , Vol. 35, June 1997, pp. 589-632 for a discussion.

[5] Ibid. Auerbach and Slemrod provide an extensive review of studies, along with a discussion of the reasons growth effects should not be expected. While most research they reviewed did not suggest growth effect, one found a significant labor supply response for high income married women. See Nada Eissa. "Taxation and the Labor Supply of Married Women: The Tax Reform Act of 1986 as a Natural Experiment," National Bureau of Economic Research, Working Paper No. 5023, February, 1995. Note also a study by Barry Bosworth and Gary Burtless which considers not only TRA but the 1981 tax cut, concluding that while labor supply increased it could not be attributed to these tax changes because the increases were greater

An example that illustrates that efficiency gains might not be associated with economic growth can be found in the corporate tax reform of TRA. The reform reduced the corporate income tax rate largely by repealing the investment credit. This tradeoff, while it led to significant increases in the neutrality of tax burdens across assets, tended to increase the overall cost of capital because the investment credit applied only to new investment, while the corporate rate reduction provided a windfall for old capital. The same trade-off would likely occur currently with the single largest corporate base-broadening provision commonly discussed, accelerated depreciation.[6] Other corporate base broadening provisions discussed, such as the production activities deduction, or disallowing interest deductions would not change overall effective tax rates, but would raise rates on some activities or sources of investment and lower others.[7]

Individual base broadening can also offset the individual rate reductions if they have marginal effects. That is, if the tax rate falls but more of income is taxed, incentives to supply labor or save may be absent or may work in the opposite direction. This issue was discussed in a recent CRS report on itemized deductions, where it was estimated that

---

among lower income individuals. They also found no evidence of a savings effect. See "Effects of Tax Reform on Labor Supply, Investment, and Saving ," *Journal of Economic Perspectives*, Vol. 6, Winter 1992, pp. 3-25. See also the collection of articles in Joel Slemrod, ed., *Do Taxes Matter?: The Impact of the Tax Reform Act of 1986,* MIT Press, Cambridge, MA, 1990.

[6] See Alan D. Viard, "The Quickest Way To Wreck Tax Reform," *Real Clear Markets*, March 23, 2013, at http://www.aei.org/article/economics/fiscal-policy/taxes/the-quickest-way-to-wreck-corporate-tax-reform, and Jane G. Gravelle, "Reducing Depreciation Allowances to Finance a Corporate Tax Rate." *National Tax Journal*, Vol.. 64, December, 2011, pp. 1039-1053.

[7] That corporate reforms might increase efficiency but not affect output is discussed in Nicholas Bull, Tim Dowd, and Pamela Moomau , Corporate Tax Reform: A Macroeconomic Perspective, *National Tax Journal*, December 2011, vol. 64, pp. 923–942 at http://ntj.tax.org/wwtax/ntjrec.nsf/175d710dffc186a385256a31007cb40f/3d9c4a8a018f29c5852579680051854a/$FILE/A01_Dowd.pdf.

revenue neutral rate reductions traded off for the elimination of itemized deductions would leave overall top effective marginal tax rates on income essentially unchanged.[8]

Overall Economic Environment

Some aspects of the economy today are similar to those at the time of TRA. In both cases, revisions were considered in an environment where concerns about the deficit were important issues. However, two factors differ substantially from 1986: a much lower rate of inflation, and a more integrated worldwide economy. Because of lower inflation rates, some issues addressed in the Treasury study preceding TRA, such as those related to indexing capital income for inflation or addressing the generous treatment of debt finance where nominal interest is deducted may be of lesser importance now.[9]

While open economy considerations were given relatively little attention in 1986, they now are central to proposals to lower the corporate tax rate. These open economy issues not only have been part of the impetus for corporate rate reductions and have raised questions about the economic effects of changes in taxation of foreign source income, but also point to one of the central issues of compliance: international profit shifting of income, in part from transferring intangible assets to low- or no-tax jurisdictions.

The Feasibility of Significant Base Broadening

TRA is widely seen as a model for base-broadening, rate-reducing tax reform. TRA broadened the base and lowered the rate on the corporate side, where the highly distorting investment tax credit was eliminated to finance a significant rate cut. The scope

---

[8] CRS Report R43079, *Restrictions On Itemized Tax Deductions: Policy Options and Analysis*, by Jane G. Gravelle and Sean Lowry.

[9] Note that TRA ultimately did not index capital income for inflation, although accelerated depreciation was designed to offset the effects of inflation.

of reform of the individual income tax was much more limited compared to the size of the individual income tax. Fringe benefits were largely untouched. Restrictions on itemized deductions were limited to disallowing consumer interest deductions (but not the much larger mortgage interest deduction), capping the mortgage interest deduction at a fairly high level, increasing the floor on medical expenses, and disallowing state and local sales taxes. Itemized deductions for state and local income and property taxes and for charitable contributions were not affected. Taxation of capital income at the individual level was altered by taxing capital gains at ordinary rates, limiting IRA contributions, and restring tax shelters.

Precisely because the corporate tax reform was so significant, there is relatively little low hanging fruit for corporate base broadening. The largest provision (setting aside deferral which affects foreign source income) is accelerated depreciation for equipment. Although it is technically a tax expenditure, the only reason tax depreciation exceeds the value of estimated economic depreciation is because inflation has fallen since 1986 when these rules were established. The elimination of the investment credit and a small change in depreciation in TRA were enough to finance most of the 12 percentage point reduction in the corporate rate. By contrast, CRS estimates that eliminating accelerated depreciation for the corporate sector currently would permit a permanent reduction of two to three percentage points in the long run. CRS estimates that eliminating every tax expenditure except deferral of foreign source income would permit roughly a five percentage point reduction in a revenue neutral change.[10]

---

[10] CRS Report RL3229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle and Thomas L. Hungerford. Note that the estimates based on tax expenditures can vary because of fluctuations in investment and corporate taxes. As noted subsequently, the JCT has estimated a seven percentage point reduction, but that estimate is during the budget horizon when the gains from slowing depreciation are

What about individual reform? The size of individual income tax expenditures relative to individual income tax revenues is much larger than in the case of corporate tax expenditures and revenues. Eliminating all of them would permit a much larger rate reduction than in the case of the corporate tax (43% as compared to 14%).[11]

Unlike the case in 1986 when one of the objectives was to replace many rate brackets with a two tiered structure,[12] rate compression is not as significant with the fewer rates today. Although some proposals would decrease the number of rates, the current tax reform objective appears largely to lower rates across the board and broaden the base. A recent CRS report examined all of the major tax expenditures, considering the large share associated with capital income preferences where changes are unlikely, those that are difficult to change for practical reasons, and those that are broadly used and popular. It concluded that base broadening in the individual income tax is unlikely to finance more than a one or two percentage point reduction (not the large reductions in TRA).[13]

Open Economy Considerations for the Corporate Tax

Much of the impetus for a corporate tax rate reduction has been due to open economy issues, since the U.S. statutory rate is higher than those of other countries

---

larger, a point that was noted in their memorandum. See memorandum, "Revenue Estimates," from Thomas Barthold of the Joint Committee on Taxation, October 27, 2011

[11] A five percentage point rate reduction in the corporate tax would amount to a 14% reduction. Because individual income tax expenditures are much larger large relative to tax revenues, the rate could potentially be reduced by 43% on average. See CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford.

[12] About 40% of taxpayers had no change or increases in statutory marginal tax rates according to Jerry A. Hausman and James M. Poterba, Household Behavior and the Tax Reform Act of 1986," *Journal of Economic Perspectives*, Summer 187, vol. 1, pp. 101-119.

[13] CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford.

(although average and marginal tax rates are similar to those of other countries).[14] As noted above, corporate base broadening to lower the corporate statutory rate using domestic provisions is unlikely to lower the cost of capital (and encourage investment), and might raise it and discourage investment (as in the case of reducing depreciation to finance a rate cut).

The deferral of tax on foreign source income is an alternative base broadener. Under current law, income earned by foreign subsidiaries is not taxed unless it is paid to the U.S. parent as a dividend, and the deferral of tax on these earnings is considered a tax expenditure. Estimates in the past have indicated that this provision would finance less than a percentage point reduction in the corporate rate.[15] However, the Joint Committee on Taxation has recently substantially increased the revenue estimates of this provision which is now estimated to permit a reduction of almost four percentage points, making it the largest single tax expenditure.[16] Based on CRS review of economic theory and analysis, eliminating deferral to finance corporate rate reduction would encourage an inflow of capital into the United States, both because the incentive to invest abroad is reduced and the tax rates on inbound investment is lower.[17]

---

[14] See CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications* by Jane G. Gravelle.

[15] CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle and Thomas L. Hungerford.

[16] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13, February 1, 2013, at https://www.jct.gov/publications.html?func=select&id=5. For corporate receipts see Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2013 to 2023, February 5, 2013, at http://www.cbo.gov/publication/43907.

[17] See CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle. A review of empirical studies showing responsiveness to differential tax rates can be found in Rudd de Mooij and Sjef Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research," *International Tax and Public Finance*, Vol. 10, November 2003, pp. 673-693. Applying a simulation model using the central tendency from these estimates suggests the effects on output would likely be positive, but small. See CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications* by Jane G. Gravelle, where an effect of slightly larger magnitude (a ten percentage point reduction in the corporate rate) was examined.

The elimination of deferral would also address the issue of profit shifting since there would no longer be a benefit to multinationals to shift profits to low or no-tax jurisdictions. Corporate rate reductions of the magnitude that might be feasible would probably not have much effect on profit shifting, since profit shifting involves paper transactions, and multinationals have developed methods of shifting profits not only to low tax jurisdictions such as Ireland, but out of Ireland to locations such as Bermuda.[18]

Although these are traditional solutions, there is a strong interest in moving in the other direction, to a territorial tax. A pure territorial tax could make profit shifting even more attractive, and these proposals have contained anti-abuse provisions to address this issue, although it is not clear how effective they would be.[19]

Revenue Neutrality in the Budget Horizon and in the Long Run

One of the statements made about TRA is that it increased corporate taxes in order to cut individual taxes. A closer examination of the Act suggests that most of the tax increases for the corporate sector (and some for the individual sector) were timing effects and disappeared in the long run. For example, the capitalization rules which disallowed the immediate deduction of certain costs gained significant revenue in the short run, but not in the long run when disallowance of deductions for new costs was largely offset by the delayed deductions of earlier costs. Research suggests that TRA, although enacted in a time when revenues, or at least deficit reduction, were needed, lost revenues over the long run.[20]

---

[18] See CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle for a discussion of methods.
[19] See CRS Report R42624 *Moving to a Territorial Income Tax: Options and Challenges*, by Jane G. Gravelle for a discussion of the reasons for this proposed change and design issues for anti-abuse rules.
[20] Jane G. Gravelle, Equity Effects of the Tax Reform Act of 1986, *Journal of Economic Perspectives*, Volume 6, Winter 1992, pp. 27-44

There are similar risks in this tax reform environment. For example, the Joint Committee on Taxation's estimates for eliminating corporate tax expenditures other than deferral suggest that adjusting depreciation would permit about a 4 percentage point rate reduction in budget horizon.[21] A study by economists at the Department of Treasury estimated the long run revenue raised by depreciation (relative to GDP) would be 30% smaller than revenue raised in the budget window.[22] Another provision, capitalization of research and development costs, permits approximately another percentage point reduction and essentially disappears at the end of the ten year period. Thus, considering these two provisions. the long run revenue-neutral rate reduction would be around five percentage points compared to the seven percentage points in the budget window. Proposals have also been made to finance a territorial tax with a one-time revenue gain from a repatriation holiday, which would mean a long run revenue loss.[23]

Simplifying the Tax System

Simplification is often at the top of the list of tax reform goals but notoriously hard to achieve especially when trade-offs are made in other ways. One study concluded that TRA achieved little in simplification, with some provisions simplifying matters but others complicating them.[24] One way of reducing complexity in the individual tax is to reduce the number of itemizers, which would require cutting back on itemized deductions or increasing the standard deduction. Placing caps or limits on itemized deductions,

---

[21] Based on data in a memorandum on revenue estimates from Thomas Barthold of the Joint Committee on Taxation, October 27, 2011. Note that the memorandum cautioned about the difference between long run effects and effects in the budget window..

[22] James B. Mackie III and John Kitchen, "Slowing Depreciation in Corporate Tax Reform," *Tax Notes*, April 29, 2013, pp.511-521. It would be even smaller if nominal growth rates were lower.

[23] See CRS Report R42624 *Moving to a Territorial Income Tax: Options and Challenges*, by Jane G. Gravelle

[24] Joel Slemrod, Did the Tax Reform Act of 1986 Simplify Matters? *Journal of Economic Perspective*,- Volume 6 , Winter 1992. pp. 45-57

however, would probably not reduce the number of itemizers but would add to complexity of those who do itemize. Reducing the number of different savings plans might also simplify matters. Attempts to scale back fringe benefits are, however, likely to add complexity.[25] For the corporate income tax, eliminating the production activities deduction might simplify compliance but instituting anti-base erosion rules with a territorial tax may complicate compliance with international tax rules.

[25] See discussion of simplification in CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening,* by Jane G. Gravelle and Thomas L. Hungerford.

PREPARED STATEMENT OF HON. AMY KLOBUCHAR, VICE CHAIR, JOINT ECONOMIC COMMITTEE

I would like to thank Chairman Brady for holding this hearing on tax reform and economic growth and thank our distinguished panel of witnesses for being here today.

As we all know, getting tax reform legislation passed will require bipartisan cooperation. That was certainly one of the lessons of the 1986 tax reform, when a Republican President worked with a Democratic-controlled House, in a divided Congress, to enact sweeping tax reform. Together they were able to lower tax rates and reduce tax loopholes.

While some tax rates were lower during the Reagan administration, tax revenues as a share of gross domestic product (or GDP) averaged about 18 percent. The few times that the budget has been balanced or generated a surplus, revenues made up about 19 percent of GDP. Yet, over the last several years, overall revenues have averaged about 15 percent of GDP, which is the lowest in generations.

Our tax code certainly needs serious reform. I think we're off to a good start with Senator Hatch working with Senator Baucus to move forward on tax reform together and start the discussion, soliciting everyone's input. Senator Baucus and House Ways and Means Chairman Dave Camp had their first stop on their tax reform listening tour in Minnesota—they visited some great Minnesota companies like 3M, who has said that they're willing to put all their tax breaks on the table for a lower corporate rate.

We all agree that the tax code is broken. It is overly complex, out-of-date, and inefficient. As a part of balanced deficit reduction, tax reform provides us the opportunity to protect the middle class, promote economic growth and build upon the deficit reduction already achieved.

Deficit reduction must be done in a balanced way that includes a mix of spending cuts and revenue. Congress has already achieved $2.4 trillion in savings with approximately $1.8 trillion coming from spending reductions and interest savings and $600 billion from revenue.

If sequestration continues, additional spending cuts will occur, which would mean the ratio of spending cuts to revenue would be four-to-one. Such a ratio of cuts to revenue would be in sharp contrast to the recommendations of the bipartisan fiscal commissions that examined this question, including the 2010 Simpson-Bowles Fiscal Commission that recommended $4 trillion in deficit reduction in a more balanced manner.

We have an opportunity to achieve a better balance of spending cuts to revenue with tax reform. I believe it is critical that the tax reform process start with and adhere to the framework included in the Senate's FY14 Budget Resolution that would achieve $1.85 trillion in additional deficit reduction divided evenly between responsible spending cuts and new revenue. Comprehensive tax reform is about more than fiscal discipline and balanced deficit reduction. If done right, it has the potential to lay the groundwork for expanded economic growth across the country.

My home state of Minnesota is the hub of several major industries like medical device, finance, insurance, agriculture, food processing, and retail. With our entrepreneurs, innovators and a talented workforce, Minnesota has weathered the recession and moved towards growth earlier than other states. But there is more that can be done to encourage economic growth and investment.

Reforming the tax code will provide certainty for businesses, reduce costs of compliance and eliminate a barrier to expansion. In order to achieve these outcomes, I believe that our work on tax reform should be guided by the following commonsense principles and goals:

First, it is imperative that comprehensive tax reform encourage job creation, savings, investment, and economic growth in the United States. The tax code should not hinder the ability of U.S. corporations to compete at home or abroad. Yet, at the current level of 35 percent, our corporate tax rate is among the highest in the world. We should lower the corporate tax rate to a level that would ensure certainty and promote competitiveness, and closing certain loopholes would help us pay for the reduction in the overall corporate tax rate.

Comprehensive tax reform must also recognize the importance of small businesses as drivers of economic growth and job creation. Many small businesses operate as partnerships or sole proprietorships, and some small businesses are established through unique structures like employee ownership or they utilize incentives specifically designed to boost small business. No matter the structure under which a small business operates, comprehensive tax reform should be done in a way that makes the tax code more simple, fair and competitive for these businesses.

The tax code should also recognize and support growing industries like the medical device manufacturing industry. I, along with Representative Paulsen and Senator Coats, have done a lot of work to fully repeal the medical device tax. This sector of our economy is responsible for millions of high-quality jobs and is a significant economic driver for our nation—enjoying an annual trade surplus of roughly $5.4 billion.

Second, predictability and certainty should be key goals of comprehensive tax reform. The current tax code's unpredictability hinders economic growth by not allowing individuals, small businesses, and corporations to adequately plan for the future.

For example, the research and development (R&D) tax credit has expired and been extended numerous times since 1986. This uncertainty means that entrepreneurs, inventors, scientists and employers are forced to put on hold their important work while Congress works to renew the provision. By making the R&D credit permanent, these scientists and researchers would have the certainty they need to continue focusing on their work without an interruption caused by an expiring provision of the tax code.

Third, we agree that fairness must remain a hallmark of the American tax system. Fairness in the tax code helps middle class families achieve their goals from homeownership to paying for college for their children to ensuring they have retirement security.

By taking a more balanced approach to tax expenditures, we can continue to encourage specific policy goals while bringing down the deficit. For example, the home mortgage interest deduction could be capped at $500,000. That means a family with a $750,000 mortgage would be able to deduct the interest from the first $500,000 of that mortgage from their income. A cap at this level has the potential to save $40 billion over 10 years.

Fairness in the tax code also ensures that an executive assistant is not paying a higher effective tax rate than the CEO in the corner office. Enacting the "Buffett Rule" would bring in more than $46 billion over 10 years in new revenue that could be used to pay down the deficit.

Fourth, comprehensive tax reform should create a more efficient tax system that raises revenue for both deficit reduction and essential government programs.

One way to raise revenue in the tax code is to close loopholes and remove inefficient or unnecessary expenditures such as tax breaks for large oil companies. We have already eliminated biofuel subsidies. The oil industry is one of the most profitable the world has ever seen, with the five largest oil companies in the U.S. earning nearly $1 trillion in profits over the last decade. Yet, these companies still receive billions of dollars in tax breaks every year. If tax subsidies for oil companies are repealed, we would save $40 billion over the next 10 years.

Our work to reduce the deficit combined with comprehensive tax reform that adheres to the principles of expanded economic growth, predictability, efficiency and fairness will provide a stable economic framework so that businesses and entrepreneurs can invest and families can succeed well into the future.

CONCLUSION

We all agree that our tax code is broken. It is now nearly four million words long, which is about seven times longer than Tolstoy's War and Peace.

The National Taxpayer Advocate reported this year that U.S. taxpayers spend 6.1 billion hours figuring out their federal taxes. Almost 60 percent of Americans pay someone else to prepare their returns, and 30 percent of Americans have to purchase software to do their returns.

Just in the period since 2001, Congress has made more than 4,600 changes to the tax code. That is, on average, more than one change every single day.

This hearing is looking back at tax reform and economic growth in the past, and it's worth noting that the Clinton Administration achieved record budget surpluses, tax relief for middle-class families, economic growth of almost four percent per year, the creation of over 22 million jobs, and the lowest unemployment rate the country had seen in 30 years.

That's an economic record that would also be worth examining.

Again, thanks to Chairman Brady and our witnesses.

○