



Submissions to the Ways and Means
Committee's Working Groups on Tax Reform:
International

April 15, 2013

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Memo to Ways and Means Working Group on International Taxation

A cut in the corporate tax rate and shift to territorial would keep the U.S. competitive on the international stage.

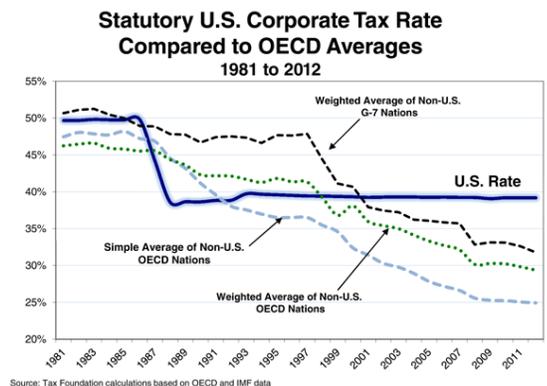
The U.S. corporate code needs an overhaul. Over the last 30 years the U.S. has fallen behind internationally, as countries from around the globe have cut rates and shifted to a territorial system of taxation. Since 2006, there have been 133 major corporate tax cuts, leaving the U.S. with the highest rate in the OECD. Furthermore, 28 of the 34 OECD countries now operate under a territorial system. In an increasingly globalized world, the inaction of the U.S. in the face of corporate tax reform around the globe has put U.S. companies on an uneven playing field. A rate cut and shift to territorial would lay the framework to make the United States competitive again.

High corporate tax rates damage economic growth and lowers workers' wages.

A review of all major studies on taxes and growth shows that corporate taxes harm economic growth more than any other type of tax. This is largely due to its impact on investment. Because investment is the key to higher productivity and wages, workers ultimately pay the price. Further, because capital is more mobile than labor, most studies find that the corporate tax is predominately borne by workers.

Not Only Does the U.S. have the Highest Corporate Tax Rate in the World, It Also Has a High Effective Rate

There is often lots of discussion about the United States' high statutory corporate tax rate being the highest in the world, but the studies show that its effective tax rate ranks similarly high against international competition. A comprehensive Tax Foundation study shows that the U.S. ranks near the top in nearly every analysis on effective corporate tax rates. In fact, the cross-study average U.S. effective tax rate was 27.9 percent, 7.6 percent higher than the global average.



While it would be inaccurate to consider the cross-study average U.S. ETR of 27.9 percent to be a definitive measure of the U.S. corporate tax burden, the measure does function as an approximation of the average tax cost to headquarter and/or invest in the U.S., specifically when compared to international competition. Investment that the high U.S. rate shifts abroad boosts productivity and spurs job creation in foreign economies rather than in the U.S. Cutting the corporate rate would bring the U.S. back in line with competitors and increase economic growth.

The U.S. has an out of date corporate tax system/Fear of Territorial Overblown

An extensive Tax Foundation study on the international results of territorial taxation shows that there is no evidence to support the fears of critics. The five countries surveyed experienced no sign of the most common fears of which critics warn – job loss, capital flight, and decreased revenues. In many of the cases, the opposite occurred, with unemployment rate decreases and revenue increases. The evidence makes clear that the benefits of a territorial system come with no apparent costs. Instead, a shift to territorial would place U.S. companies on a level playing field and promote the free flow of capital, encouraging economic growth at home and abroad.

Cutting the Corporate Rate Does Not Cut Tax Revenue

Cutting the corporate tax rate is one of the few tax cuts that actually pays for itself. The Tax Foundation model shows that cutting the tax rate to 25% would increase total federal tax revenues by \$20 billion. Furthermore, a cut to 14%

would maximize revenues, increasing the federal revenue by \$27 billion. More importantly, a substantial cut in the corporate rate would increase economic growth, improve real wages, and help all U.S. industries compete globally.

Tax Changes of the Past, Which Helped Growth and Which Did Not

Stephen J. Entin

Tax Foundation, Senior Fellow

The following charts give an overview of the impact of the tax changes since Kennedy. Some were highly successful at promoting growth. Others failed. The difference is in how they treated capital formation, and what they did through both rate and base changes to promote investment and encourage hiring. Links to papers on each administration's tax policies, and the economic modelling of their effects on GDP, are given below. They are from my time at the Institute for Research on the Economics of Taxation (IRET).

Also submitted in the Tax Foundation packet is my written submission to the **House Ways and Means Committee Hearing on Tax Reform and the U.S. Manufacturing Sector, July 19, 2012**. It describes the benefits of the Kennedy tax cuts, the effectiveness of the 1981 Reagan tax cut, the anti-growth impact of the Tax Reform Act of 1986, and the weak impact of the 2001 Bush tax cut, and the restoration of growth due to the 2003 Bush tax cut. That testimony makes the following points:

The Kennedy tax cuts were a successful effort to restore growth to the U.S. economy after three recessions in the eight years of the Eisenhower administration. Over 55 percent of the gains from the Kennedy tax cuts came from his business cuts, and only 45 percent from the more famous individual rate reductions. In 1962, Kennedy adopted the shorter guideline lives for depreciation and introduced the investment tax credit. In 1964, Johnson pushed Kennedy's personal rate cuts through Congress in a bill that also cut the corporate tax rate from 52 percent to 48 percent.

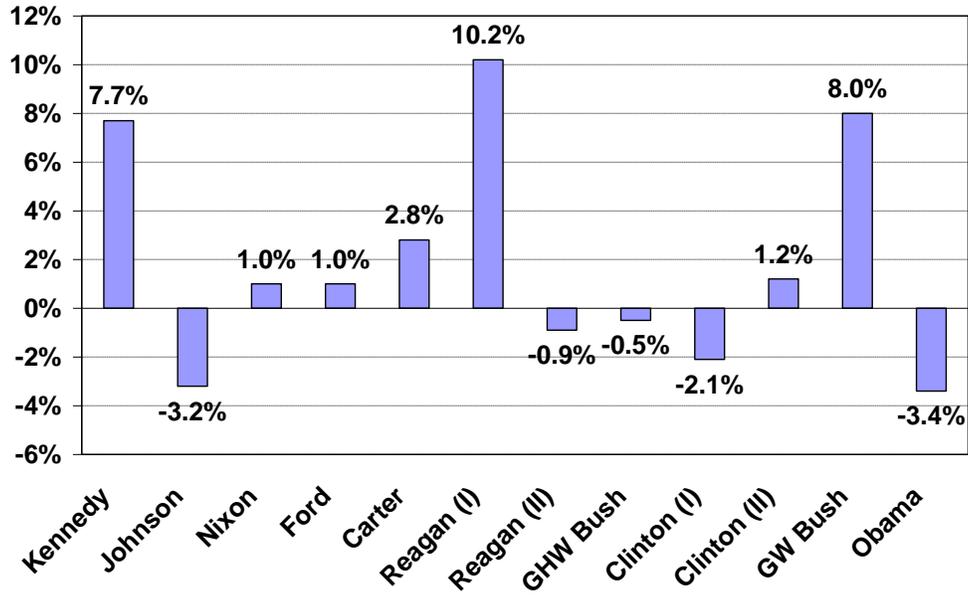
Kennedy's three business cuts did about equal amounts to promote investment. Kennedy shortened asset lives and cut the corporate rate. He did not attempt to pay for one by moving in the opposite direction with the other. He made modest spending cuts, but did not aim for revenue neutrality. The economy expanded rapidly.

The 1981 Reagan tax cut was not revenue neutral. It focused on faster depreciation under ACRS, with a larger ITC, as well as individual rate cuts. It lowered the cost of capital and restored growth. The Tax Reform Act of 1986, much admired in the tax community in Washington, was not pro-growth. Its non-corporate business, corporate, and dividend rates cuts reduced the cost of capital. However, the offsets, including the higher tax rates on capital gains, repeal of the ITC, longer asset lives under MACRS, curtailment of retirement incentives, and harsh treatment of passive income, more than offset the capital cost cuts. The net effect was a higher cost of capital and slower growth. It is not a good model for real tax reform.

The 2001 Bush tax cut did little for investment, and did not break the economy out of its slow recovery. The 2003 tax cut did far more to lower the cost of capital. That is when investment recovered and job growth picked up.

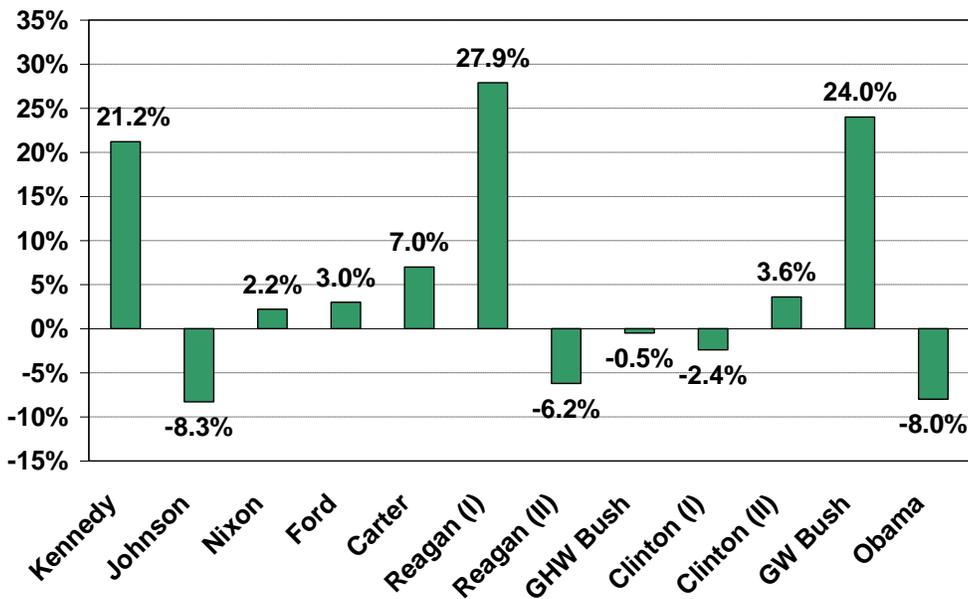
Two items on the reading list review the Bowles-Simpson plan (***Fiscal Commission Report Falls Short***) and the Wyden-Coats bill (***Economic Consequences of the Wyden-Coats Tax Plan***), which is based on Bowles-Simpson. Our economic model finds that both would damage the economy by lengthening asset lives, raising tax rates on capital gains, and tampering with the interest deduction. In neither case did the panels or sponsors obtain a cost of capital estimate from Treasury or the JCT to determine the net effect of the bills on the cost of capital. The tax rates reductions were not sufficient to offset the adverse effect of the revenue offsets on the incentive to invest.

Chart 1 Change in GDP Due To Tax Law Changes During Presidential Administrations



Source: Calculations by author

Chart 2 Change in Capital Stock Due To Tax Changes During Presidential Administrations



Source: Calculations by author

Neutral Cost Recovery

If depreciation lives must be lengthened, Congress can maintain their present value, and avoid harming investment, by augmenting the deferred allowances by some interest rate to reflect the time value of money and inflation. Perhaps 3% plus inflation would do nicely, which is about the after-tax return on capital over time. The Committee might want to pay out only the lower federal borrowing rates for each maturity, on the theory that there is more certainty to a tax saving than for capital investment; you might get away with that.

The notion that longer lives do not harm investment because current interest rates are low is not valid. They won't stay low if you make investment more attractive by lowering the corporate tax rate. If interest rates rise, then the rate at which businesses must discount the delayed capital consumption allowances must also rise, making them look even worse. So paying for a rate cut with longer asset lives will hurt. Note that if you do not make investment more attractive, raising its returns at the margin, interest rates may stay down, but so will investment, wages, job growth, and GDP.

If you tamper with the interest deduction, so that after-tax interest rates go up, then the discount applied to longer asset lives would make the delayed cost recovery allowances worth even less. So lengthening lives and disallowing some of the interest deduction while still taxing the lender would be the worst approach of all.

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Modeling the Effect of Depreciation, Corporate and Individual Tax Rates, and Miscellaneous Tax Provisions on GDP

Michael Schuyler

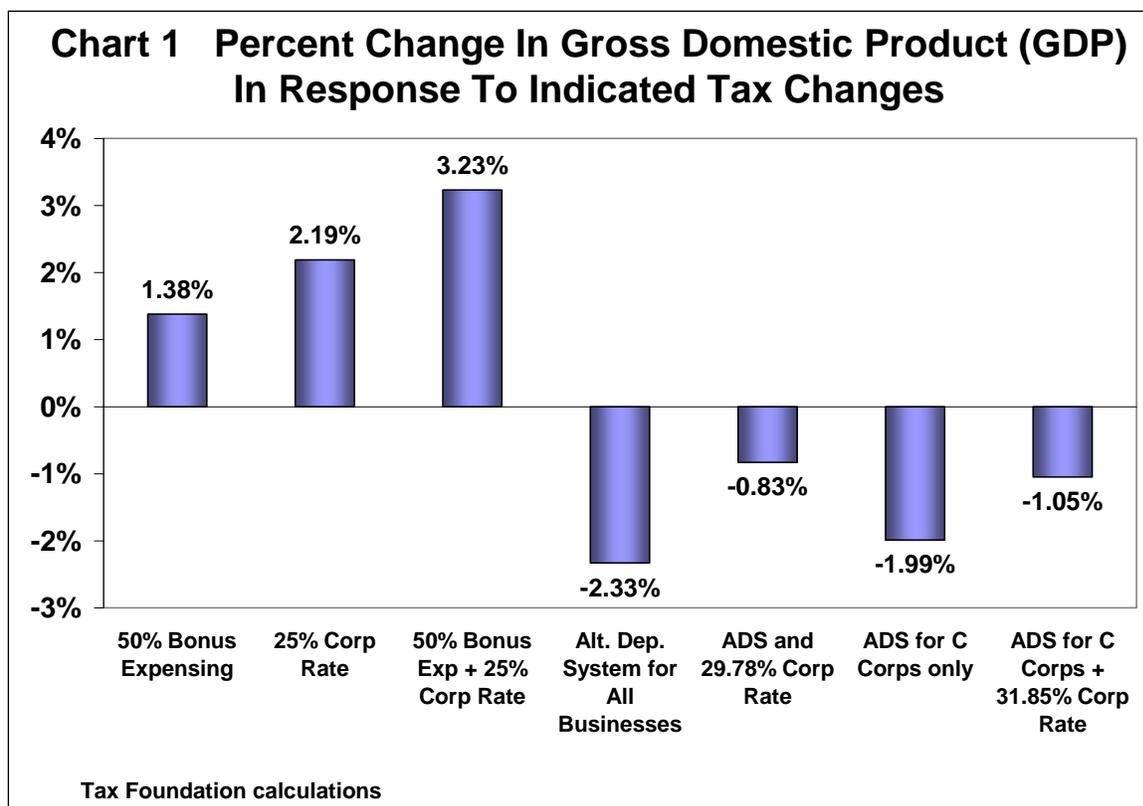
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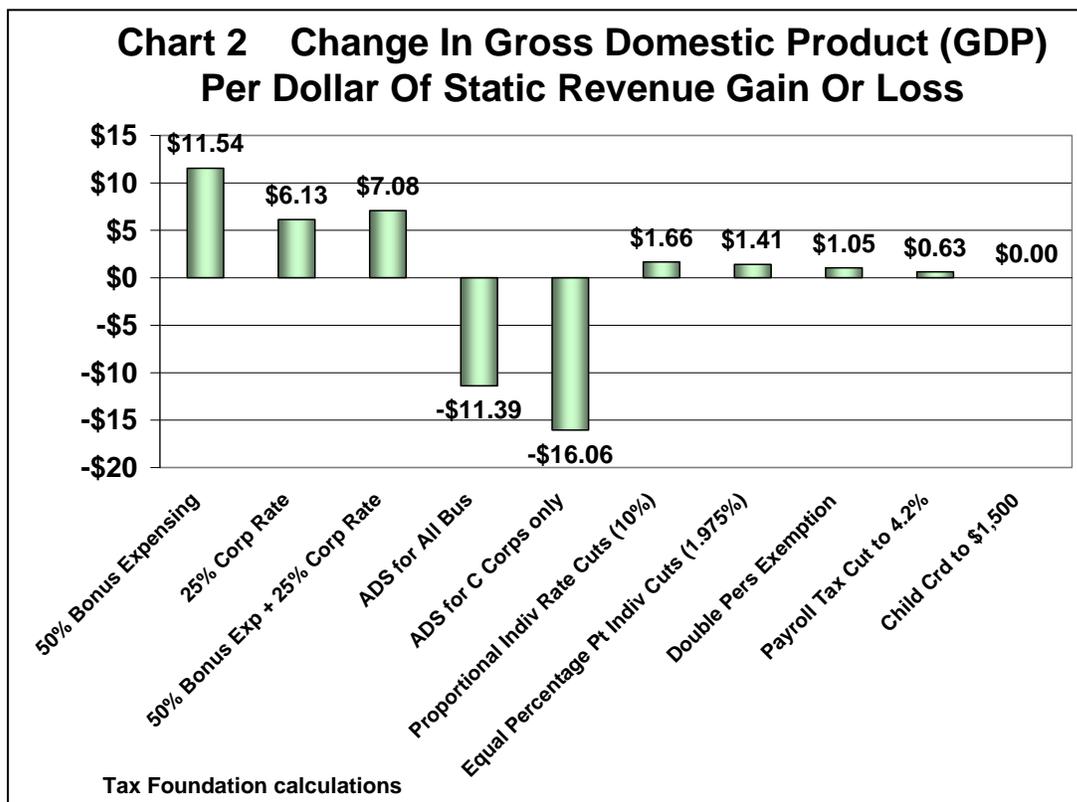
The Tax Foundation's dynamic tax simulation model was used to examine the growth and revenue effects of a number of possible tax changes. In general, tax changes that lessen the tax bias against saving and investing would be far more helpful to growth than those that are targeted to labor income or simply attempt to lower personal income taxes. Also, although a cut in the corporate tax rate would be extremely beneficial by itself, the dynamic growth and tax revenue effects would be negative if Congress offset it by lengthening capital cost recovery periods in a bid to keep the package revenue neutral according to a convention (static) revenue estimate that ignores economic growth.

The Tax Foundation model has two main parts. One is a production function relating capital and labor inputs to economic output. The model is calibrated to National Income and Product Accounts (NIPA) data and draws on empirical relationships seen among the variables in the approximately seventy years since the end of World War II. The other main component is an income tax calculator. The calculator determines how various tax changes would alter tax filers' tax liabilities and marginal tax rates. The model uses the IRS Public Use File for 2005 (a more typical year than those in the middle of the last recession), with the records aged to 2008 and the dollar amounts then inflated to 2012 dollars. The model also includes equations based on tax parameters and NIPA data for calculating corporate income, payroll, excise, property, and other taxes.

The parts of the dynamic simulation model are interactive, with changes tax rules affecting tax liabilities and marginal tax rates, those changes impacting economic growth, and economic growth, in turn, having a feedback on taxes. This is a comparative equilibrium model. It estimates the new levels of taxes and economic activity after people have adjusted their production, consumption, and saving behavior to the altered incentives cast up by the tax changes. While the adjustment will not be instantaneous, empirical evidence suggests most of it will have been completed within several years.

Charts 1 and 2 show the main results and they are described below.





Bonus expensing permits taxpayers to write off a specified percentage of their capital equipment expenditures when the investment costs are incurred. This directly lowers the cost of capital, which persuades businesses to invest more. Because the desired capital stock is extremely sensitive to its expected after-tax real return, the added investment and expansion of the capital stock is large. The model estimates that 50% bonus expensing enacted on a permanent basis would raise GDP approximately 1.4%. Every dollar of static revenue loss would pay for about \$11.50 of extra GDP. Further, the positive economic feedback would increase employment and real wages, while ultimately increasing the government's revenue.

Lowering the federal government's corporate tax rate to 25% would also have a large positive impact by lowering the cost of capital. The model estimates that the corporate rate cut would increase GDP by approximately 2.2% and add over \$6.10 to GDP for every dollar of static revenue loss. After accounting for growth effects, total federal revenues would increase.

If 50% bonus expensing were combined with a 25% corporate rate, GDP would grow by approximately 3.23%, and the GDP gain per dollar of static revenue loss would be about \$7.10. Total federal revenue would rise on a dynamic basis.

The alternative depreciation system (ADS) sharply reduces the present discounted values of capital cost recovery allowances compared to the current system by combining longer depreciation periods with straight line depreciation. It would revert to a depreciation regime even worse than the Bulletin F lives of the Eisenhower Administration, before the Kennedy Guideline lives were adopted. The Tax Foundation's model estimates that switching to ADS would severely raise the cost of capital, leading to a substantially lower capital stock and a fall in GDP of approximately 2.3%. For every dollar of supposed revenue increase in a conventional static estimate, GDP would drop approximately \$11.40. If ADS were applied only to the investments of C corporations, it is estimated that GDP would fall about 2%, and every dollar of supposed static revenue gain would cost approximately \$6 of diminished GDP.

Suppose Congress cut the corporate income tax rate but shifted to ADS in order to maintain static revenue neutrality. The model estimates that this combination would only allow the corporate rate to be cut to about 29.8%, instead of the 25% rate that is often discussed. This static-revenue-neutral package would decrease GDP by 0.83%. Further, while the package would score as revenue neutral in a conventional revenue estimate, the Tax Foundation's dynamic estimate is that it would reduce total federal revenues.

If ADS were only applied to corporate investment, the model estimates that the corporate income tax rate cut would be still smaller, to a rate of 31.85%, and the GDP loss would exceed 1%.

For a good review of capital consumption allowances and how they affect the economy, see the Tax Foundation paper *The Tax Treatment of Capital Assets and Its Effect on Growth: Expensing, Depreciation, and the Concept of Cost Recovery in the Tax System* by Stephen J. Entin, Tax Foundation Senior Fellow.

We have also run other changes to illustrate that different taxes have more or less effect at the margin on economic activity.

A uniform, 10% cut in marginal individual income tax rates would be economically beneficial. However, the economic impact per dollar of tax change would be smaller than for reforms that concentrate on capital income. The model estimates that GDP would rise nearly 1% and that each dollar of static revenue loss would pay for about \$1.65 of higher GDP.

Suppose that each rate bracket received the same percentage point tax cut and that the size of the reduction were adjusted to have the same static revenue cost as a 10% proportional rate cut. This would allow the rate in each bracket to be lowered by 1.975 percentage points. It would not be as economically helpful as the across-the-board cut because it would reduce rates proportionately less for the most productive earners. The model estimates it would boost GDP by about 0.85% and grow GDP by approximately \$1.40 for every dollar of static revenue loss.

Doubling the personal exemption would provide relatively weak economic benefits. It would primarily affect the first dollars of income. It would lower marginal tax rates for some people but have no impact on marginal tax rates for many others. The model estimates it would lift GDP by approximately 0.7% and raise GDP by only about \$1.05 for each dollar of static revenue cost.

Raising the child credit from \$1,000 to \$1,500 would have only a negligible effect on marginal tax rates and produce virtually no growth dividend.

The federal government's second largest tax is the Social Security tax. For two years, 2011 and 2012, the employee share of the tax was reduced from 6.2% to 4.2% as a temporary stimulus measure. The rate reverted back to its normal level of 6.2% at the start of 2013. The model was used to investigate how much stimulus was truly provided by the rate reduction, by assuming the employee-share rate was permanently decreased from 6.2% to 4.2%. The brief answer is that a lower payroll tax rate supplies some positive stimulus, but disappointingly little. Despite the high revenue cost, the GDP gain would be only about 0.5%, or 63 cents of added GDP for every dollar of static revenue cost. The reason for the weak effect is that although the rate cut would lower marginal tax rates on labor income, the supply of labor is much less responsive to after-tax returns than is capital.

Procedures for Developing a Pro-Growth Tax Reform

Stephen J. Entin

Tax Foundation, Senior Fellow

Congress is proceeding backwards. It should start with developing the right tax base, then worry about spending, revenues and tax rates. Instead, it has put spending aside, set a revenue target (static neutrality), chosen a rate target, and is scrambling to find a tax base that will meet these constraints and still be pro-growth.

Congress should recognize that the broad-based income tax discriminates against income used for saving and investment compared to income used for consumption. The bias costs about 10 percent of potential GDP in perpetuity. Tax reform should remove these biases by constructing a saving-consumption neutral tax base that measures income correctly.¹

Once a neutral tax base is set, then, and only then, should Congress choose tax rates that would fund a given level of spending, or restrain spending to arrive at a desired level of tax rates. If tax rates are kept low enough on a neutral tax base, the reform would reduce the cost of capital and spur investment. If not, rearranging deductions and the relative treatments of industry A vs. industry B, or C-corporation X vs. S-corporation Y, or debt vs. equity, won't promote growth.

The current approach assumes no spending cuts are available to aid the process (not even cuts in "corporate welfare"), sets a revenue target (revenue neutrality) and a desired tax rate (top rates of 25%) without checking to see if enough true "loopholes" are available for meeting the targets, and is scrambling to find a tax base to fit those numbers. It put determining the right the tax base last instead of first. It is likely to result in continued or worsened double taxation of the C-corporation by curbing interest deductions, or moving farther from expensing toward long asset lives that diminish the value of the capital consumption allowances and raise the cost of capital.

Static revenue neutrality ignores the dynamic revenue feedback from reforms that, if done right, would partly or, in some cases, completely, restore revenues. Using economic analysis to determine the likely revenue effects of changes in the economy would ease the burden of reforming the system (fewer losers would need to be created), and it would help the Committee learn which tax changes are pro-growth, and which damage the economy.

Whatever approach is used, the Committee must ask Treasury or the Joint Committee on Taxation to check the resulting cost of capital or "service price." If the offsets and rate structure contained in the bill raise the pre-tax return that capital investment must earn to break even after taxes, it will reduce investment, productivity, wages, employment and GDP. In addition to throwing people out of work, the reduced GDP will eat into the projected static revenues.

Proposals to Reduce the Deduction for Interest Paid Are Bad Tax Policy and Bad Economics

¹ This will not be an income tax. It will be a consumed- income tax, cash flow tax, or Flat Tax, or (less visibly and less desirably) one of the broad consumption taxes such as a VAT or national retail sales tax. These fall on GDP less saving or investment, and do not double tax the C-corporation, nor fall on already-taxed assets in estates. They either allow a deduction for saving and tax the returns (as in a pension or IRA), or disallow a deduction for saving and do not tax the returns (as in a Roth IRA). All involve expensing, not depreciation. See: Reforming Taxation:

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Tax Foundation, Senior Fellow

Several proposals to reduce the deduction for interest paid have been floated, sometimes based on the claim that there are negative tax rates on debt-financed investment, and sometimes based on the notion that it is an acceptable means of equalizing the treatment of debt and equity. Both claims are wrong. The analysis behind these ideas is incomplete and defective.

The current tax treatment of interest is correct. Do not change it. Alternatively, raise revenue by not taxing interest at all, as in the Flat Tax or VAT.

Equity versus debt

The distortion between debt and equity finance is due to over-taxation of equity, not under taxation of debt. There is ample literature on how to end the distortion by integrating corporate and personal income taxes. See the 1991 Treasury study. Do not try to make the tax treatment of debt as bad as equity.

Disallowing some of the borrower's deduction for interest while still taxing the lender's receipt of interest would extend the double taxation of equity to debt. Even if the corporate tax rate were reduced in the process, two half wrongs do not make a right.

To the extent that we merely trade higher taxes on incremental debt finance for lower taxes on incremental equity finance, the cost of capital will not fall and the growth gains from the reduction of the tax on equity will be offset.

Two acceptable ways to treat interest, and a possible source of revenue for tax reform

There are only two reasonable ways to treat interest: 1) the borrower deducts interest paid and the recipient pays tax on interest received (current practice); or 2) there is no deduction on interest paid by the borrower and no taxation of interest received by the lender (Armey Flat Tax, VAT, sales tax). Mixing these systems, disallowing a deduction while taxing the lender, is just wrong, and involves a double tax of the earnings of the investment bought with the borrowed money.

However, switching from method 1 to method 2 could raise revenue by about \$100 billion a year. In effect, it would capture the tax on interest currently lost when interest is paid to tax exempt or low bracket lenders. It would be enough to pay for a 10 point reduction in the corporate income tax and retain MACRS with 50% bonus expensing. So to pay for tax reform with little or no economic harm, stop taxing interest.

The switch would disallow the deduction for interest by businesses and individual borrowers. The reversal of the treatment of interest (from having the borrower deduct it and the recipient pay tax on it, to neither having a deduction nor taxing the receipt) would raise more than \$50 billion from individual income taxes. It would pick up another, larger amount on business tax returns. Non-financial corporate and non-corporate business interest paid exceeded interest received by more than \$600 billion in 2011 (NIPA Table 7.11, Bureau of Economic Analysis). At an average tax rate of about 20%, that would yield \$120 billion a year in revenue. There is some overlap in the two figures. Also, some of this revenue would decline as interest ceased to be taxable, because interest rates would drop to levels on currently tax-exempt bonds as the tax premium comes out of the rates, but much would remain, well over \$100 billion a year.

Nonetheless, because of the decline in interest rates, borrowers and lenders, at the margin, would see little change in their after-tax interest costs. There would be little damage to the cost of capital or investment. However, tax exempt

interest recipients who currently get the higher taxable rates set by others in the credit markets would see their interest income fall (see below).

Negative tax rates on debt financed investment are a myth

Testimony by Professor Robert Pozen and work done at Treasury have purported to find negative tax rates on debt finance investment. Such conclusions can only be reached by disregarding some of the tax currently collected on the returns on the investment, or by using rough averages instead of looking at the marginal lender and marginal investor. Both are mistakes.

There is no negative tax rate on debt financed investment, at least not at the margin.

If a business passes through part of the return on a debt-financed investment to be taxed on the lender's tax form, it is still taxed. One must look at the combined tax at the borrowing firm and the lender to see the whole tax, but it is there.

In the ordinary case of a business buying an asset with its own money, it gets a deduction for the cost of the asset and pays tax on the earnings. One deduction, one tax, both on the business's tax return. In the case of a pass-through entity such as a partnership or subchapter-S company, the deduction and the return are both passed through to the partners on a pro-rate basis. There is a tax deduction on the partner's return and a tax on the partner's tax returns. Again, one deduction, one tax, both on the partner's tax return.

With debt financed investment, a portion of the return is passed through to the lender (the interest). Meanwhile, the capital consumption allowance is taken by the business that borrowed the money and bought a machine or building. This may give an appearance of a negative tax rate at the investing business, but creates a higher, offsetting tax rate on the tax return of the lender. That tax must be added to the tax of the investment-owner to measure the total tax on the return on the investment. Leaving it off understates the taxes paid.

To the extent that a C-corporation finances its investment with debt, and a portion of the return is passed through to the lender, the C-corporation is in part acting like a pass-through. Pass-through treatment is a valid approach to corporate taxation, and this partial treatment is also valid. As long as the return on the asset is taxed somewhere, and the deduction for the asset's cost is allowed somewhere, there is no violation of sound tax principles.

What about the tax exempt or low bracket entities that receive interest?

There is a more subtle claim about negative tax rates, that the tax rate of the C-corporation may be higher than that of the lender, so the deduction of interest by the C-corporation saves more in taxes than the lender pays back.

This is especially true if the lender is a tax-exempt entity, such as a state or local government exempt from federal tax, or a charity or university that has an endowment. These entities are seldom the marginal lenders funding incremental private sector investment; they cannot work harder, save more, and consume less to buy added bonds; they are constrained to pay out their revenue (charities) or dependent on donors for money and unable to will them to give more (universities) or not likely to raise taxes to lend more to business (the governments).

The tax exempt status of these entities was set by Congress, supposedly because they perform a useful social function worthy of subsidy. It makes no sense to make up the revenue loss for subsidizing a general good by specifically and narrowly taxing capital investment more heavily, depressing investment, productivity, wages, and GDP. Find some other more general tax offset to pay for these tax waivers, or end their tax exempt status.

What of lower bracket individuals? A C-corporation may deduct interest at a 35% corporate rate (though less on average), and the lender may be in the 10% or 15% or 25% tax bracket. There is relatively little lending by such

taxpayers compared to people in the 33%, 35%, or 39.6% brackets, or who also face the 3.8% health care surtax on interest income. The Treasury probably does not lose much on individuals. Lower bracket individuals are also much less likely to be the marginal lenders who provide saving for additional investment, and that is what policymakers need to focus on.

Conclusion

At the margin, there is no negative tax rate due to the pass-through of interest to the lenders, and no excuse for reducing the deduction for interest while taxing the recipients. Either allow the deduction and tax the recipients, or tax interest out of the tax system at both ends.

for the record of the
House Ways and Means Committee Hearing on
Tax Reform and the U.S. Manufacturing Sector
July 19, 2012

Mr. Chairman and Members of the Committee:

I am currently President and Executive Director of the Institute for Research on the Economics of Taxation. I served as Deputy Assistant Secretary for Economic Policy in the Treasury Department for eight years during the Reagan Administration.

The Committee is considering the state of U.S. manufacturing, and changes to the tax treatment of manufacturing under a possible tax reform effort. Taxes have a major effect on the profitability and competitiveness of U.S.-based manufacturing and U.S.-headquartered firms.

There are two broad issue areas to consider – tax rates and tax base. By tax rates, I mean the schedule of marginal tax rates applied to taxable income. The tax base is what is considered income subject to tax. Income as defined for tax purposes is often significantly different from the true income of the taxpaying business, making the effective tax rate quite different from the apparent statutory rate. As the Committee considers tax reform, it should give some very serious study to the combined effect of changes in tax rates and the tax base on the ability and incentive to invest and employ capital in the United States. Rate and base considerations are equally important, and they may affect different businesses and industries very differently. A “one-size-fits-all” reform could be very disruptive and damaging.

Tax rates. For Schedule C corporations, tax rates include the statutory tax rate of up to 35% at the corporate level, and the tax rates applied to corporate shareholders on dividends and capital gains. For non-corporate business owners and participants in pass-through entities, the key rates are the top rates on the taxpayers’ personal income.

Tax base. The current definition of taxable income (the tax base) needs at least two major reforms. The one I shall discuss here is the capital cost recovery system, which dictates how rapidly a business can deduct the cost of plant, equipment, structures, and inventory as business expenses. The other key decision is whether the tax is to be imposed on activity within the United States (territorial taxation) or on the world-wide earnings of U.S.-based businesses (global taxation). I will not address the global versus territorial issues except to say that adopting territorial taxation would aid U.S. competitiveness, increase U.S. as well as foreign hiring by U.S. multinationals, and greatly simplify the tax system.

Key points to guide reform.

- The income tax is heavily biased against saving and investment, hurting investment and lowering productivity and wages. All would gain by fixing the biases.
- Increasing the double taxation of corporate income by raising tax rates on capital gains and dividends would dramatically reduce capital formation and wages, and would not raise the expected revenue.

- Keeping the current treatment of capital gains and dividends while cutting the corporate tax rate would raise GDP, employment, and wages. It would increase, not decrease, federal revenue over time.
- The definition of the tax base (taxable income) is at least as important as the tax rate. Overstating business income by undercounting investment expenses (requiring depreciation instead of expensing) leads to less investment and lower wages. Expensing (immediately deducting the cost of the asset for tax purposes) is the right approach, and gains revenue over time.
- We should not repeat the Tax Reform Act of 1986, which tried to perfect the "broad-based income tax"; rather, we should adopt a different tax base that is more neutral in its treatment of saving and investment relative to consumption.
- Do not trade expensing for a corporate tax rate reduction. Do both. That is the only way to measure income correctly across businesses and impose a uniform, neutral tax. The combination would obviate the need for the manufacturers' credit. Both provisions are affordable on a dynamic basis, taking added growth into account. Use dynamic scoring.

Current tax system is biased against saving and investment.

Federal and state tax systems hit income that is saved harder than income used for consumption. The federal system has at least four layers of possible tax on income that is saved.

1) Income is taxed when first earned (the initial layer of tax). If one uses the after-tax income to buy food, clothing, or a television, one can generally eat, stay warm, and enjoy the entertainment with no additional federal tax (except for a few federal excise taxes).

2) But if one buys a bond or stock or invests in a small business with that after-tax income there is another layer of personal income tax on the stream of interest, dividends, profits or capital gains received on the saving (which is a tax on the "enjoyment" that one "buys" when one saves). The added layer of tax on these purchased income streams is *the basic income tax bias against saving*.

3) If the saving is in corporate stock, there is also the corporate tax to be paid before any distribution to the shareholder, or any reinvestment of retained after-tax earnings to increase the value of the business. (Whether the after-tax corporate income is paid as a dividend, or reinvested to raise the value of the business, which creates a capital gain, corporate income is taxed twice — *the double taxation of corporate income*.)

4) If a modest amount is left at death (beyond an exempt amount barely big enough to keep a couple in an assisted living facility for a decade), it is taxed again by *the estate and gift tax*.

An additional problem is that business income is often overstated, raising the effective tax rate. In particular, employing depreciation to define capital cost recovery allowances understates costs, overstates income, and effectively raises the tax rate on investment returns. Depreciation makes businesses wait to claim part of the cost of their investment. The delay reduces the value of the write-offs due to the time value of money and inflation.

Real tax reform would end the biases.

Real tax reform would end these biases and over-statements or double counting of capital income by taking a few key steps. They would fundamentally shift the tax base from "broad-based income" to "consumed income", "personal expenditures", or "cash flow".

- Step 1: Give all saving the same treatment received by pensions; either defer tax on saving and its returns until the money is withdrawn for consumption, or tax the saving up front and do not tax the earnings.
- Step 2: Adopt expensing instead of depreciation; alternatively, adjust the depreciation allowances for the time value of money (index unused portions by an appropriate discount rate) to preserve their present value.
- Step 3: Tax income in the corporate sector either at the level of the firm or at the level of the shareholder, but not both; that is, integrate the corporate and personal income taxes.
- Step 4: Eliminate the estate tax.
- Step 5: Move to a territorial tax system.

Corporate reform: expensing, rate reduction, and the cost of capital.

It is impossible to create a good pro-growth reform by tinkering with the corporate tax system in isolation and clinging to "static revenue neutrality." Growth requires a net reduction in the tax on additions to the capital stock. Except for some blatant tax subsidies to uneconomical activities, as with alternative energy credits, there are no large anomalies in the corporate tax system that are not reductions in the marginal tax on capital. Many so-called tax expenditures are the proper tax treatment under a non-distorting, saving-consumption neutral tax. This includes expensing or accelerated depreciation, and other offsets to production costs. Ending these provisions would mismeasure income and offset the benefits of lower tax rates.

A good tax reform would adopt a system that measures income correctly, and then decide what rate to impose to meet the desired revenue target. It should not pre-select a set of tax rates and then distort the tax base and the definition of income to accommodate the revenue target. Tax reform should not become a process for devising a politically acceptable tax hike. It should be a move toward a more economically efficient tax system that allows the government to collect revenue with less collateral damage to economic activity, income, and employment.

A good tax reform should spur growth. The Committee must be given information on what the proposed tax changes would do the economy. That requires a calculation of the impact of the tax changes on the required return, or "service price" of capital. The service price is the pre-tax return on capital needed for it to be profitable and worth creating. If the service price is increased by the tax reform, the capital stock will be depressed, along with jobs, wages, and other tax revenue. If the service price is reduced by the tax reform, the capital stock will expand, along with jobs, wages, and revenue from other taxes. These effects will feed back into the federal revenue stream. The Committee is not receiving this information under current procedures, either from the Joint Tax Committee, the CBO, or the Treasury.

Don't trade expensing for a corporate rate cut. Do both.

Some reform plans, and some business representatives, would trade expensing for corporate rate cuts. This is a bad and unnecessary trade. Reduction or elimination of expensing, or lengthening of asset lives by other means, would raise the service price. Reduction of the corporate tax rate (and, for non-corporate businesses or pass-through entities, reduction of the top individual income tax rates) would reduce the service price. Also, increases in the tax rates on capital gains and dividends would raise the service price, directly offsetting the economic benefits of reduction in the corporate tax rate. Do not sell out the shareholders to please the executives.

The Bowles-Simpson plan, and the Wyden-Coats bill would end bonus expensing and sharply increase asset lives in exchange for a lower corporate tax rate. At the rates being offered, the trade would raise the cost of capital, depress investment, and reduce employment. The expected net revenue gain in Bowles Simpson would never happen. Restricting the deductibility of interest by corporate borrowers has also been suggested. For example, the Wyden-Coats

bill would disallow the deduction of the inflation component of the interest rate and interest payments, while continuing to tax the inflation-related portion of interest to the lender. These ideas would harm the economy.

Expensing and neutrality. Expensing of equipment is akin to the neutral tax treatment of saving in pensions and IRAs. Tax neutrality between saving and consumption requires that we tax either the income that is saved or the returns on the saving, but not both. Income put into a regular IRA or pension is tax deferred (expensed) and the subsequent returns (principal and earnings) are taxed on withdrawal. (In a Roth IRA, the saving is taxed before it is put into the account, and the earnings are not taxed.) Fully expensing investment and taxing the returns (any earnings and residual scrap value) is neutral. Depreciation, which allows a deduction of only a portion of the full present value of the investment, results in a partial double tax on the returns on the income invested. Depreciation makes it less attractive to use income for investment than for consumption, distorting economic behavior and reducing capital formation and income.

Ordinary investments barely earn the time value of money. The present value of their returns just equals their up-front cost. Immediate expensing reduces the current tax by the identical present value amount as the tax levied on the future normal returns. Expensing offsets only the tax on normal returns. Higher returns, called “economic profits”, are taxed even with expensing.

In effect, expensing recognizes time value as a cost. It treats consumption today and saving for consumption at a later date evenly. It is “saving-consumption neutral”. Expensing is part of all the real tax reforms (Flat Tax, NRST, X-tax, personal expenditure tax or cash flow tax, etc.) that are saving-consumption neutral. By contrast, restricting capital consumption allowances to arbitrary depreciation schedules does not acknowledge the time value of money, mismeasures (overstates over time) the actual income of the affected business, and discriminates against saving in favor of consumption. A reform that reduces capital consumption allowances and overstates business income before lowering the tax rate would be like a store that doubles prices on Thursday to have a half-off, or worse, a third-off sale on Friday.

Expensing applies to non-corporate businesses and S-corps, not just C-corps. Ending expensing would hurt these other forms of businesses. They would bear a significant portion of the cost of cutting the C-corporation tax rate if it were “paid for” by ending expensing. Ending expensing would hurt those industries which are heavily capital intensive and whose capital must be replaced frequently to remain competitive. These sectors include some parts of the manufacturing sector and rapidly evolving sectors such as high tech. Expensing has less effect on the service industries. Utilizing depreciation instead of expensing overstates the income of the former while not affecting the latter. The degree to which depreciation understates costs and overstates income varies by asset class and industry. It is larger the longer the life of the asset. It increases as the rate of inflation rises. Many assets are assigned different asset lives if they are used in different industries. There are tens of thousands of different asset/write-off combinations. Industries have different mixes of assets and replace them at different rates. The result is a large degree of mismeasurement of income among businesses and widely varying effective tax rates. To measure income correctly across businesses, one must use expensing; then whatever tax rate is selected applies across industries without distorting the mix of investment and output.

Expensing as a targeted cost-effective route to growth. The following table shows the service price-induced economic changes from expensing and corporate rate cuts. We have estimated the corporate tax rate reductions that would provide roughly equivalent increases in GDP as would be expected from 50% and 100% expensing of equipment. Both methods of improving GDP are inexpensive in static terms compared to the massive stimulus spending of recent years. In dynamic terms, they are both costless in the longer term. Both expensing and corporate rate reductions are powerful spurs to investment, and both would eventually return their costs to the Treasury as higher revenues from other taxes due to added growth of GDP. We can afford both. Doing both at once would result in lower static costs than shown

here. At a lower corporate tax rate, faster write-offs appear to lose less revenue. With faster write-offs, there is less taxable income, and a rate cut appears less expensive. In dynamic terms, both raise revenue over time.

COMPARISON OF PARTIAL EXPENSING WITH THE MANUFACTURER'S CREDIT

VERSUS A LOWER CORPORATE TAX RATE

Gains to GDP and Changes in Federal Budget Resulting from:	GDP (%)	Private GDP (%)	Capital Stock (%)	Federal Revenues		% Reflow (%)	Federal Outlays (billions)	Change in Budget Surplus (billions)
				Static (billions)	Dynamic (billions)			
Adding 100% Expensing for Equipment	2.71%	2.81%	7.64%	-\$34.20	\$48.70	243%	\$14.60	\$34.10
Lowering Corporate Tax Rate to 22%	2.75%	2.85%	7.74%	-\$64.50	\$21.60	133%	\$14.80	\$6.80
Adding 50% Expensing for Equipment	1.36%	1.41%	3.80%	-\$17.40	\$24.60	241%	\$7.40	\$17.20
Lowering Corporate Tax Rate to 29%	1.30%	1.35%	3.62%	-\$28.40	\$12.20	143%	\$7.00	\$5.20

Numbers are comparative statics results after all economic adjustments (5-10 years). Base is 2008 GDP with MACRS, no PEPs and Pease.

The figures for expensing show the advantage added by expensing assuming the manufacturer's credit remains in place.

In the model runs, the reductions in the corporate tax rate are trimmed by a half percentage point to reflect a repeal of the manufacturer's credit, which is about its economy-wide value over manufacturing and non-manufacturing. Most proposals to reduce the corporate tax rate assume an end to the manufacturer's credit as a partial pay-for (a pay-for that would actually lose revenue).

Private sector labor income lies in line with private sector GDP, in the form of higher wages and higher hours worked. The federal wage bill rises in line with private sector hourly wages, which raises federal outlays as GDP increases.

Expensing boosts GDP, the capital stock, and labor income by more than a reduction in the corporate tax rate, per dollar of apparent static revenue loss. For the same gains in GDP, expensing costs less, generates more revenue reflow, and raises the budget surplus more than the tax cuts.

Both the rate cuts and the expensing increase the budget surplus (reduce the deficit), so there is no need to trade one for the other. Just use dynamic estimation and, if necessary, phase in the rate cuts over time.

Expensing is more cost-effective, in terms of both static and dynamic government revenue effects, because it focuses on new investment. Both expensing and a reduction in the corporate tax rate reduce the cost of capital and lead to more capital formation. However, some of the corporate rate reduction applies to current income from past investment. Expensing is concentrated on reducing the cost of investment going forward. Expensing does more to increase the capital stock, sooner, than a corporate rate cut of equal “static” revenue cost to the government. Because expensing is a more powerful reduction in the cost of capital than corporate tax rate reduction, per dollar of static revenue loss, a revenue neutral trade of current expensing for a rate cut would raise the cost of capital and would lower capital formation, GDP, employment, and wages.

A switch to expensing has mainly a temporary effect on the federal budget while some old investment is being depreciated along with the outlays for new investment now being expensed. After old investment has been written off, write-offs decline to about the same amount as under a depreciation system with pieces of several years’ past investments being deducted in any given year. Even in static terms, the annual cost of expensing largely disappears over a few years. Most is gone within a decade as old 3, 5, 7, and 10 year assets complete their tax lives. Only small amounts of residual write-offs for 15 and 20 year structures linger beyond the budget window. There is a modest residual static tax reduction of about 5% or 10% of corporate tax revenue going forward because the quantity of investment is rising over time. However, in dynamic terms, expensing raises revenues in the out years due to additional growth.

One way to lower the initial cost of cutting the corporate tax rate while extending expensing would be to implement 50% expensing on a permanent basis, and phase in a ten point cut in the corporate tax rate one point per year for ten years. That would slow the GDP gains, but we would get the full benefit eventually. However, the slower rise in GDP would be lost income for the public during the transition, about ten times the amount of tax revenue saved by the government. It is not worth the budget savings.

Corporate rate cuts needed too. Many typical firms in modest-profit industries that employ a typical mix of equipment and structures would benefit greatly from expensing. Some businesses, however, would prefer a corporate tax rate reduction, for several reasons. Some businesses have few assets to depreciate. Think of engineering, software, or architectural firms. All their work involves human capital, and salaries are naturally expensed. Others do not care because they have abnormal profits that dwarf the normal return (patents, market power). Those “economic profits” are taxed even under expensing. Those firms may prefer a lower corporate tax rate on these higher profits. A lower corporate tax rate would boost the competitiveness of such firms in the world economy and increase their hiring and output in the United States.

Accounting quirks cloud the issue. Other firms may favor rate cuts over expensing for less savory reasons. Old firms growing slowly may be jealous of new firms growing fast, with more new investment to write off. Some executives may be more concerned with the appearance of the bottom lines in their financial statements than with the real tax burden on their companies. Accounting conventions do not show accelerated depreciation as a tax reduction and a profit increase, even though it is both. The convention does show a tax rate cut as a profit increase. This quirk in the accounting may cause some business managers to recommend trading a bigger real tax saving from expensing for a smaller tax saving from a rate cut because it makes their annual reports look better. Congress may be talked into making a trade that reduces investment even though it seems to boost reported profits.

- The Financial Accounting Standards Board’s Accounting Standards Codification of Generally Accepted Accounting Principles assumes a slow pattern of “economic depreciation” as the norm. Any taxes saved by more accelerated recovery allowances are reported as creating a future “deferred tax liability” of equal size, offsetting the current tax saving. The delay in the tax payment is not discounted to reflect the value of paying later, so the value to the firm is never shown.

- This is bad accounting, and contrary to what business school students are taught in deciding whether to invest or not. MBA candidates are correctly taught to ignore depreciation, and to evaluate an investment by looking at discounted cash flow.
- Similarly, stock analysts are trained in business school to back out expensing and value stocks on a cash flow basis. This is reflected in their reports, so the shareholders and the stock market are not fooled.

Lessons from past tax reforms.

Several major tax reforms in the past have altered the treatment of capital cost recovery as well as the corporate tax rate, capital gains, and dividends. After reductions in the tax on capital, the economy has done well. After increases, it has faltered. New proposals should bear these lessons in mind.

Capital taxes under Kennedy. The Kennedy tax reductions of 1962 reduced asset lives by moving from the Bulletin F lives to the Guidelines, and by introducing an investment tax credit. Combined, the effect was similar to expensing. In 1963, Kennedy and Congress also enacted a phased cut in the corporate tax rate from 52 percent to 48 percent, and reduced individual tax rates. The cuts in the business taxes provided about 55 percent of the economic kick from the Kennedy tax packages. The 1962 elements provided roughly two-thirds of the business tax cut contribution, about twice the effect of the corporate rate cuts of the 1963 Act. The Kennedy cuts spurred several years of above normal economic growth, until the Johnson Vietnam surtax reversed the effect.²

ADR. In 1971, the Treasury encouraged investment by modernizing the recovery allowances with the introduction of the asset depreciation range (ADR) and expanding the ITC. These changes had a slightly larger impact on the service price than the subsequent two point reduction in the corporate tax rate in the 1976 Act from 48% to 46%.³

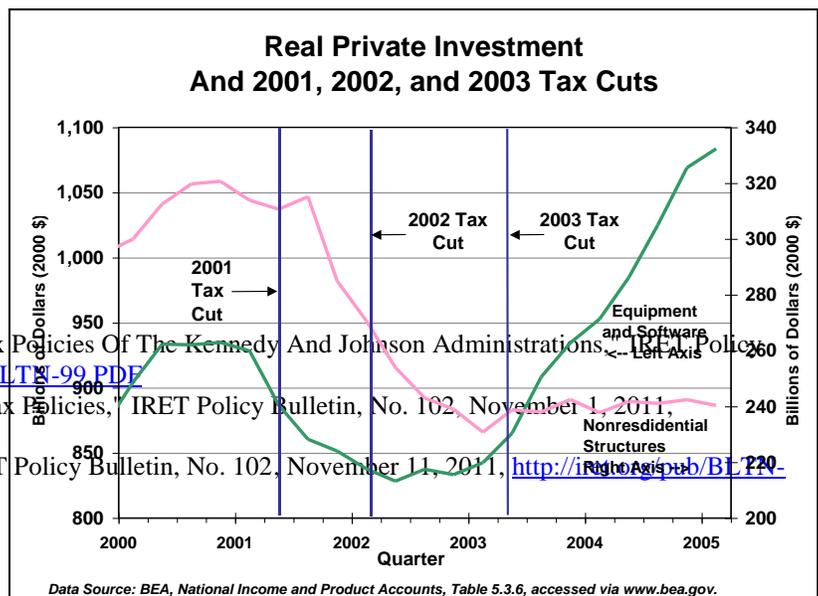
The Reagan tax bills. The Economic Recovery Tax Act of 1981 (ERTA) provided a more rapid write-off of equipment and structures by moving from ADR to the Accelerated Cost Recovery System (ACRS). That, and reductions in marginal individual income tax rates, including capital gains, were responsible for the remarkable rebound from the 1981-82 recession, a rebound that puts the current miserable economic recovery to shame. Subsequent legislation in 1982 (TEFRA), 1984 (DEFRA), and the Tax Reform Act of 1986 (TRA86) reduced acceleration of depreciation or lengthened asset lives. In each case, the service price rose and investment was discouraged. TRA86 moved from ACRS to MACRS (Modified ACRS). TRA86 also raised the tax rate on capital gains, repealed the investment tax credit, and took other steps that raised the service price. Even though TRA86 cut the corporate tax rate from 46% to 34% and lowered the top tax rate on dividends, the other elements of the bill resulted in a slight rise in the service price, and the economy was weaker after its passage. The 1981 Act was good for growth, while the 1986 TRA was not. TRA86 and the percentage point increase in the payroll tax in the 1988-1990 period paved the way for the 1990 recession.⁴

The Bush tax cuts. The 2001 tax reduction (the first Bush tax cut) did almost nothing for

² Stephen J. Entin, "Economic Consequences Of The Tax Policies Of The Kennedy And Johnson Administrations," IRET Policy Bulletin, No. 99, September 6, 2011, <http://iret.org/pub/BLTN-99.PDF>

³ Stephen J. Entin, "The Nixon, Ford, And Carter Era Tax Policies," IRET Policy Bulletin, No. 102, November 1, 2011, <http://iret.org/pub/BLTN-101.PDF>

⁴ Stephen J. Entin, "The Reagan Era Tax Policies", IRET Policy Bulletin, No. 102, November 11, 2011, <http://iret.org/pub/BLTN-102.PDF>



investment, even though the slump in investment was the cause of the 2001 recession. Its individual marginal tax rate reductions were scheduled to be phased in over six years, and nothing specific was done to lower the service price of capital. Investment continued to fall throughout 2001. In 2002, Congress passed a 30 percent "bonus expensing" provision, which immediately halted the decline in equipment investment. In 2003, Congress bit the bullet. It moved to 50% expensing, lowered the tax rates on capital gains and dividends to 15%, moved forward the remaining individual marginal rate cuts, and lowered the estate tax. From that moment, equipment spending took off like a rocket, and investment in structures began to recover. (See chart.)⁵

Wyden-Coats. The Wyden-Coats bill (formerly Wyden-Gregg) and the Bowles-Simpson Commission emulate TRA86. They would cut tax rates on businesses in exchange for higher tax rates on capital gains and dividends, and provide much slower tax depreciation of plant, equipment, and structures. The Wyden-Coats bill would revert to the Guidelines with straight line depreciation, which would be worse treatment than under the pre-Kennedy Bulletin F lives in the Eisenhower Administration. Capital gains and dividends would be taxed at rates up to 22.75%. In spite of retaining the top business tax rates of 35% for individuals, and cutting the top corporate tax rate to 24% for corporations, Wyden-Coats would raise the service price of capital and depress the growth of GDP. I estimate that Wyden-Coats would reduce GDP over time by 4.3%, with 3.2% due to the change in depreciation alone. The adverse shift in the tax treatment of dividends and capital gains would more than cancel out the benefits of the proposed cut in the corporate tax rate. Although the bill is scored to be about revenue neutral, it would lose substantial revenue due to the drop in GDP.⁶

Tax treatment of interest.

Another tax change sometimes mentioned as a partial "pay-for" for a corporate tax rate reduction is the restriction of the interest deduction. (For example, the Wyden Coats bill curbs interest deductions for corporations by disallowing a deduction of the inflation portion of the interest rate, while continuing to tax lenders on the inflation portion.) Restricting the deduction of interest by borrowers, while continuing to tax lenders, is horrible tax policy. It exaggerates the tax base. It is not a fit response to the higher taxation of equity compared to debt finance. That problem arises from the double taxation of corporations and shareholders on the same income. That should be ended by one of the many methods of integrating the corporate and individual tax, or making all corporations pass-through entities. The double taxation should not be extended to debt finance to even out the differential. (Nor should pass-through entities be attacked in the process of tax reform. They are being taxed in a more nearly correct, more saving-consumption neutral manner than C-corporations.)

Financing a purchase is not additional GDP over and above the production of the machine or building or consumption item or service (except for the small amount of intermediation services provided by the bank or broker) that is part of national output and income. Taxes on financing flows should be a wash to the Treasury, as when you deduct the interest you owe me and I pay tax on it. Not allowing the deduction is wrong. Either interest should be deductible by the borrower and taxable to the lender, or non-deductible and non-taxable.

But aren't some savers/lenders tax exempt? Yes, but that is because Congress created a tax break for charities, presumably because it furthers important public policy goals. It is senseless to create an incentive at one end of a transaction only to take it back at the other end. In particular, it is wrong to punish all borrowers if some lenders are tax exempt. Note that tax exempt entities are not the marginal sources of lending, because they are limited as suppliers of funds by the amount of their grants and contributions, and by the distributions they are required by law to make. At the

⁵ Stephen J. Entin, "The Economic Consequences Of George W. Bush's Tax Policies," IRET Policy Bulletin, No. 104, December 5, 2011, <http://iret.org/pub/BLTN-104.PDF>

⁶ Stephen J. Entin and Michael Schuyler, "Economic Consequences Of The Wyden-Coats Tax Plan," IRET Policy Bulletin, No. 100, October 28, 2011, <http://iret.org/pub/BLTN-100.PDF>

margin (where it matters), when people want to expand the capital stock, the lenders who provide the saving are taxable.

Conclusion. Expensing and corporate rate reductions are both powerful spurs to investment. Expensing is less costly in a static revenue sense, and its cost diminishes with time. In a dynamic sense, both would eventually return their costs to the Treasury by increasing revenues from other taxes due to added growth of GDP. Both should be part of a pro-growth tax reform.

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