WRITTEN STATEMENT SUBMITTED FOR CONSIDERATION TO:
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

HEARING ON TAX REFORM AND THE U.S. MANUFACTURING SECTOR

HEARING DATE: JULY 19, 2012

SUBMITTED BY:

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ON HIS OWN BEHALF AS A FORMER
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Introduction

My name is Ernest S. Christian. I am pleased to submit on my own behalf this written statement about the dynamic role of lower tax rates and improved capital cost recovery allowances in economic growth -- with special emphasis today on manufacturing.

I am a former Treasury tax official and, in and out of government, have been a tax lawyer in Washington, DC since the early 1960s. At present, I am a co-chairman of the Center for Strategic Tax Reform (CSTR), a role that I share with several former members of this Committee. CSTR is a nonprofit §501(c)(6) organization that Dr. Murray Weidenbaum, former Chairman of the President's Council of Economic Advisors, and I formed over 20 years ago to promote pro-growth tax reform. The views expressed here are solely my own.

During the 1970s, I served as both the Deputy Assistant Secretary and Tax Legislative Counsel of the Treasury Department, where I designed and drafted the Asset Depreciation Range System (ADR) of depreciation enacted in 1971. That tax reform measure continued the essential acceleration of depreciation allowances that began in the Kennedy administration. During the Reagan administration, I assisted with further reforms, including lower tax rates and designing the present capital cost recovery system known as MACRS and its predecessor -- ACRS.

Overview

Changes in tax rates and capital cost recovery allowances both have profound effects -- for good or ill -- on manufacturing's key role in job creation. On the positive side, to maintain and expand manufacturing and manufacturing jobs, and for the overall health of the U.S. economy, the Congress should reduce the corporate tax rate and make permanent either 50 percent or 100 percent first-year expensing of business capital equipment. That should be followed with tax reforms that better enable businesses to export goods and compete directly in foreign markets.

On the negative side, the worst thing Congress could do is, with one hand, cut nominal or statutory tax rates, and with the other, reduce capital recovery allowances from their already inadequate levels. This would increase the effective tax rate for many manufacturers and others -- and would increase the “tax cost” of job-creating investment all across the U.S. economy. The tax code should not drive more manufacturers offshore.

Ever since the Kennedy administration in the 1960s, tax reformers who have focused on economic growth have sought not just to lower tax rates, but also to accelerate depreciation allowances so as to alleviate the long-standing tax bias against job-producing “capital-intensive” businesses. It would be a tragedy if, because of budget pressures outside the jurisdiction of this Committee, the Congress were to reverse the course of tax reform and start back down the road of making manufacturing in the U.S. even more tax-expensive and less productive.

I applaud this Committee’s focus on the need to remove tax impediments to economic growth. And I agree especially with Chairman Camp’s emphasis on the need both to lower the tax rate and to have a correct tax base to which that rate is applied. If the Congress were to go in the wrong direction on either of these elements of the tax code, we would end up with a system that further retards economic growth and the true cause of tax reform could be set back for decades.

My purpose is to assist in the Chairman’s effort to keep tax reform on the right path toward producing highly positive economic results. This can be accomplished by making first-year expensing permanent and phasing in a major reduction in the corporate tax rate in a way that maximizes the bang-for-the-buck from these two components of fundamental tax reform.

Phase-In of Pro-Growth Tax Reform That Works

Alex Brill, a former Policy Director and Chief Economist of this Committee, recently suggested that 50 percent first-year expensing be made permanent and that a corporate rate cut be phased in. (See “A Pro-Growth, Progressive, and Practical Proposal to Cut Business Tax Rates,” AEI Tax Policy Outlook No. 1, January 2012.)

Following up on that, I have worked with Gary Robbins, formerly a Treasury Department tax economist and now president of Fiscal Associates, to formulate a specific proposal and to quantify its revenue consequences (both static and dynamic) as well as its all-important growth effects.

Our proposal is permanent 50% first-year expensing for all businesses and a phased-in reduction of the corporate tax rate to 25%. The results are illustrated in Table I below.

Table I – One Percentage Point Per-Year Corporate Rate Cut plus 50% Expensing for All Businesses

Calendar Year	Corporate Rate Cut	Static Cost of Rate Cut ($)	($) Static Cost of 50% Expensing plus MACRS	Combined Static Cost ($)	Combined GDP Growth	Combined Dynamic Cost ($)
2013	34%	-9.2	-70.5	-78.5	0.3%	-68.9
2014	33%	-24.4	-66.8	-88.9	0.7%	-67.8
2015	32%	-37.9	-62.7	-97.4	1.0%	-61.9
2016	31%	-49.9	-48.0	-94.6	1.4%	-44.1
2017	30%	-66.4	-36.7	-99.9	1.7%	-35.4
2018	29%	-79.0	-27.8	-103.9	1.9%	-25.9
2019	28%	-90.9	-20.9	-109.3	2.1%	-17.5
2020	27%	-101.5	-16.5	-115.8	2.3%	-11.0
2021	26%	-116.2	-14.3	-128.2	2.5%	-10.4
2022	25%	-131.1	-12.5	-141.5	2.6%	-9.8
				-1,057.8		-352.7
					% Reflow	66.7%

Note: All dollar amounts are in billions of dollars. The column "Static Cost of Rate Cut" shows the cost of changing the corporate rate to the rate indicated in the "Corporate Rate Cut" column from 35 percent without 50% Expensing. The "Static Cost of 50% Expensing plus MACRS" shows the effect of 50% Expensing without a change in the corporate rate. The "Combined Static Cost" column is not equal to the sum of the two prior columns because it accounts for interactions between the parts of the plan. Additional GDP results in additional federal receipts. That is the difference between the combined static and dynamic cost of the plan. The "% Reflow" is the ratio of the additional receipts to the "Combined Static Cost."

Note: For this purpose, MACRS includes other cost recovery provisions that under present law remain in effect in 2013 and thereafter. So-called "bonus depreciation", a temporary provision which expires, is replaced by the more correctly denominated 50% expensing rule which works in essentially the same way except that it is a permanent part of the law.

Table I tells us many important things. The static "cost" of rate reduction builds up over time, but the static cost of 50% expensing declines rapidly and is nearly gone after 10 years. The combined annual static cost of these two reform components is on average about $100 billion per year -- essentially equal to the annual cut in spending beginning in 2013 that is required by the Budget Control Act of 2011. Those who are concerned about the potential negative impact of spending cuts on our fragile economy might welcome the significant tax cuts in 2013 – 2015 as shown by Table I.

Indeed, the most powerful part of the story is in the last two columns of Table I which illustrate the highly efficient, large bang-for-the-buck growth effects of combining rate reduction and expensing. The dynamic cost is only $353 billion over 10 years and the boost to GDP is a whopping 1.8% or, in dollar terms, roughly $3,599 billion -- thereby providing a 10-to-1 return ($3,599 divided by $353). Moreover, even the 10-year $1,057.8 billion static cost (for those who prefer old-fashioned accounting) is only 29% of the $3,599 billion of induced GDP growth -- thereby providing almost a 3.5-to-1 return.

Given the current fragile condition of the economy, fine-spun arguments about the distinction between dynamic and static scoring are largely irrelevant. Absent a powerful pro-growth tax cut, and sensible long-term reductions in spending, it is highly likely that we face a 4% economic decline starting in the first quarter of 2013 according to the Congressional Budget Office (CBO). Keep in mind that compared to where we would have been if GDP had returned to its historic trend of 3.2% per year growth, we are already $2 trillion in the hole (i.e., GDP is that amount smaller than it should be this year).

It is in this context that the pro-growth tax cut in Table I is almost "free" in the sense that if we don't do it, the economy and revenue will continue to muddle along at a subpar or worse rate. CBO's current-law forecast shows the result of accepting this low level of recovery and growth as the "new normal." By the end of the budget window, in 2022, GDP will be 16.5% below its 50-year trend level or $3.6 trillion too low, or a $12,000 loss for every man, woman and child, each and every year into the future.

The tax cut illustrated in Table I is especially powerful and needed not just because it reduces the corporate rate. Indeed, most of its strong boost to economic growth comes (a) from moving closer to the free-market neutrality of full expensing and farther away from the distortive, efficiency-reducing effects of the "winners and losers" class lives that underlie the MACRS system; and (b) because the 50% expensing rule applies to capital investments made by unincorporated businesses as well as in the case of corporations.

Although not discussed in detail here, we have analyzed and would also recommend a proposal that reduces tax rates for unincorporated businesses as well as corporations. When combined with first-year expensing for all businesses, that approach would produce an even more powerful boost to economic growth.

Important Perspectives on Tax Reform

Nominal vs. Real Tax Rates

Alan Viard, a Resident Scholar at the American Enterprise Institute, recently reiterated the perils of tax changes that reduce the nominal statutory rate, but ignore the effective rate of tax. (See "The Benefits and Limitations of Income Tax Reform," AEI Tax Policy Outlook No. 2, September 2011.) When the nominal rate is cut, but deductions are denied, and the tax base is therefore changed, the effective rate of tax may go up or down or remain the same.

Suffice it to say that if the corporate tax rate were to be cut and depreciation deductions for new purchases of capital equipment were reduced, the effective rate of tax (Note) for job-

(Note) Here we are talking about the real (cash) effective rate, not the somewhat different "effective rate" often used as a financial accounting term.

creating companies that are purchasing a lot of new capital equipment would go up, but would go down for those that are not, and would remain about the same for those in the middle.

Chris Edwards at the Cato Institute has correctly pointed out that when Canada cut its corporate tax rate from 29 percent to 15 percent over the last decade, the reforms did not broaden the tax base in anti-growth ways such as by reducing depreciation allowances. In addition, recent research by Douglas Holtz-Eakin and Ike Brannon at the American Action Forum reveals that of 96 corporate rate cuts of one percentage point or more among OECD countries since the year 2000, only 25 were paid for with some other tax increase.

The "Economic Efficiency" Notion

The notion that lowering the business rate while cutting back depreciation to the vastly disparate "class lives" would introduce efficiency gains for the economy is wrong. It assumes that the existing class lives are accurate, closely matching the ever-changing, almost impossible to quantify decay rates for innumerable kinds of business assets across various industries. They aren't -- and here I speak from experience, having been at the Treasury Department in the period 1971-1975, where I was responsible for updating and rearranging the class lives, often using data that was even then out of date.

Despite the best efforts of many people in the 1970s, including those in the Treasury Department's then, but now disbanded, Office of Industrial Economics, the task proved to be impossible -- and still is. Therefore, the class lives in the old ADR system -- and as now carried forward into MACRS -- are at best only rough approximations and make arbitrary distinctions that have become more distortive with the passage of time. Consequently, if present capital cost recovery allowances were, for example, to be cut back to the class life system, disparities in depreciation rates would tend to be magnified and, instead of economic inefficiencies being reduced, they would be increased.

Neither MACRS nor Expensing Is a Loophole

There are loopholes in the Internal Revenue Code -- hundreds of them, in fact, but allowing a business to deduct when incurred (or soon thereafter through MACRS) the costs of the tools that it puts in the hands of its workers is not one of those loopholes. Allowing expensing is not a subsidy like allowing a business to deduct the cost of healthcare benefits that are not included in employees' income. The costs of a machine tool, a forklift, a rolling mill in a steel plant, the components of a refinery and so forth are in all cases just as much an expense of doing business as the wages of the employees who operate the equipment.

Expensing the cost of capital investments produces the correct measure of income when the goal is to avoid double taxing investment. Double taxation occurs under a depreciation regime because deductions are allowed only over a period of years -- and, as a result, the present value of the deductions is always less than the actual expense incurred. Thus, because only a partial deduction is allowed, the equipment is partially double taxed, with the severity of the penalty being proportionately greater the longer the so-called "class life" arbitrarily assigned to the item of capital equipment. As the Treasury Department recognized in its 1984 tax reform proposal ("Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President, November 1984"), if deductions for capital cost recovery are deferred and devalued, the face amount of deductions should be increased to start with in order to avoid double taxation. It is far simpler to allow first-year expensing.

When Economy Slows Congress Improves Capital Cost Recovery

Typically, when the economy slows, one of the first things almost every administration and Congress has done is to improve capital cost recovery by enacting an investment credit, a more accelerated cost recovery system, and/or allowing for partial or full expensing of the costs of the tools and equipment necessary for economic growth and job creation. It would be counterproductive and wrong for Congress in the current extraordinarily difficult economic circumstances to move in the opposite direction.

Tax Reform Requires Lower Rates and a Movement Toward Expensing

Since the 1960s, tax reform has been about lowering the tax rate and correcting the tax base to assure that there are no incorrect omissions from the tax base and that nothing is included in the tax base twice and double taxed. For a long time, the most obvious example of double taxation was the corporate income tax itself. Because the same dollar of earnings is taxed both to the corporation and its shareholders, tax reformers sought to integrate the two taxes. The effort partially succeeded in many foreign countries, but not here. In recent years, the two-layers-of-tax problem has been alleviated somewhat by the soon expiring lower tax on dividends and by increased use of "pass-through" entities. But the more damaging double taxation from the failure of the tax code to allow for first-year expensing continues. The problem should be fixed, not made worse.

It may be appropriate to "capitalize and depreciate" capital equipment costs for the purpose of financial accounting, but when done for the entirely different purpose of imposing a tax, the result is to discriminate against capital equipment, which is the most critical component of economic growth and job creation.

Since the 1970s (the renowned *Blueprints for Tax Reform*, for example) all the way up through Congressman Paul Ryan's current-day Roadmap, tax reform proposals have provided for the combination of lower rates and a movement toward expensing.

Here are a few examples: The National Commission on Economic Growth and Tax Reform in 1996 ("The Kemp Commission"); The President's Advisory Panel on Federal Tax Reform in 2005 (the "Breaux-Mack Commission"); and The USA Tax -- the ground-breaking, bipartisan proposal by then Senators Sam Nunn and Pete Domenici (USA Tax Act of 1995, as introduced in S. 722 on April 25, 1995) and subsequently fully explained in "USA Tax System -- Description and Explanation of the Unlimited Savings Allowance Income Tax System," *Tax Notes Special Supplement*, Mar. 10, 1995, pp. 1481-1575.

Summation and Conclusion

The intellectual and moral integrity of tax reform lies in its dedication to economic growth -- the real kind that arises from allowing the free market to function properly within a tax code that has low rates and an evenhanded, non-distortive tax code that is as close as possible to full first-year expensing.

It is improbable that the Congress will be able to achieve growth-oriented tax reform in a “revenue neutral” manner by closing loopholes. There simply aren’t enough of them to go around -- and certainly neither expensing nor MACRS is a loophole.

The bottom line choice is either to cut spending enough to pay for all or part of the tax cut that is inherent in true tax reform -- or to bite the bullet and enact a net tax cut. Either one will boost economic growth substantially and make all Americans better off.

America is in an emergency situation that requires extraordinary measures. The question of whether and when the tax cut will “pay for itself”, in terms of enhanced revenue to the federal government, is not the point. More jobs, economic growth and making more Americans better off is what the exercise of government is all about. The tax cut I am suggesting is one that jumpstarts economic activity in the short term and moves us when fully phased in to a far more efficient and growth-oriented tax code over the long term -- and that’s an ideal tax reform.