

Written Submission of Stephen J. Entin
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House Ways and Means Committee Hearing on
Tax Reform and the U.S. Manufacturing Sector
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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.