

Perspectives on the Need for Tax Reform

United States House of Representatives

Subcommittee on Tax Policy,

Committee on Ways and Means

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American Action Forum

May 25, 2016

*The views expressed here are my own and not those of the American Action Forum. I thank Gordon Gray for his assistance.

Chairman Boustany, Ranking Member Neal, and members of the Committee, thank you for the opportunity to offer my perspective on the need for tax reform. There are many criteria that could be used to guide tax reform; economic efficiency, distributional fairness, administrative ease, compliance cost, simplicity, transparency, and many others. My view, however, is that tax reform should be focused on addressing the major issues of our time, which I would identify as:

- Diminished long-term potential for economic growth;
- International competitiveness and the headquarters location decisions; and
- Lost faith in the U.S. tax system.

Let me discuss these in turn.

Pro-Growth Tax Reform

The Congressional Budget Office (CBO) projects U.S. economic growth to average only 2.1 percent over the next decade, consistent with the experience of the tepid recovery seen since the trough of the Great Recession in 2009. Over the long term, CBO pegs the potential for trend economic growth at 2.0 percent.

This rate of growth is below that needed to improve the standard of living at the pace typically enjoyed in post-war America. From the end of World War II until 2007, the U.S. economy grew at an average rate of 3.2 percent, sufficiently fast to absorb population growth and still double the standard of living (Gross Domestic Product, or GDP, per capita) roughly every 35 years. Put differently, in one person's working career you could anticipate a doubling of the standard of living, thereby providing the capacity for families to pursue their version of the American Dream – buy a house, send a child to college, take a vacation, or whatever their version of the Dream might be.

A 2 percent growth rate translates into doubling GDP per capita roughly every 75 years. The American Dream is disappearing over the horizon. The nation should not settle for 2 percent growth and forgo rising wages for American families, but rather embark on a pro-growth policy agenda that addresses the necessary structural changes to public policy.¹ Tax reform figures prominently in this agenda.

One of the largest distortions income taxes create is decreasing the effective return to work and saving. As people work less and investment in skills, capital, innovations, technology and business models decreases, the economy grows more slowly than it otherwise would. Income taxes have other secondary effects as well, such as incentivizing movement of compensation into tax-free benefits. Much of the academic literature on the effect of

income taxes tends to take a broad approach that focuses on how income taxes affect overall economic growth and output.

The last time the United States undertook fundamental tax reform was the Tax Reform Act of 1986 (TRA86). If history is any guide, a 1986 style reform offers positive impacts on economic growth. This is borne out by retrospective analysis of the TRA86, which found that the 1986 tax reform produced about one percentage point higher growth over a long period. Further studies have shown that the negative relationship with higher marginal rates and taxable income, hours worked, and overall economic growth.²

An important step in the analysis of tax reform and growth was made by the highly respected economists David Altig, Alan Auerbach, Laurence Kotlikoff, Kent A. Smetters, and Jan Walliser; who analyzed multiple tax reforms. They found that GDP could increase by as much as 9 percent higher from tax reform.³ The highest growth rate was associated with a consumed-income tax system that avoided double-taxing the return to saving and investment. A consumed-income approach has been contemplated in past reform efforts, and should be on the table for the Congress. The study also simulated a “clean,” revenue-neutral income tax that would eliminate all deductions, loopholes, *etc.*; and lower the rate to a single low rate. According to their study, this reform raises GDP by 4.9 percent over the long-term – a growth effect that translates (roughly, and admittedly by rounding up) into about 0.5 percent higher trend growth, resulting in faster employment and income growth.

Such an improvement in trend growth would also improve the budget outlook. Deficit savings could be used to pay down the debt, contribute to further rate reduction or some combination of the two. According to the CBO, a 0.1 percentage point annual increase in GDP growth would improve the 10-year deficit by \$327 billion.⁴ Accordingly, a 5-fold improvement would provide \$1.5 trillion in deficit savings.

International Competitiveness and Headquarter Decisions

The U.S. corporate tax code has remained largely unchanged for decades, with the last major rate reduction passed by Congress in 1986.⁵ However, during the interim competitor nations have made significance changes to their business tax systems, by reducing tax rates and moving away from the taxation of worldwide income. Relative to other major economies, the United States has gone from being roughly on par with major trading partners to its current position of imposing the highest statutory rate of corporation income. While less stark than the U.S.’s high statutory rate, the United States also imposes large *effective* rates. According to a study by PricewaterhouseCoopers, “companies headquartered in the United States faced an average effective tax rate of 27.7 percent compared to a rate of 19.5 percent for their foreign-headquartered counterparts. By

country, U.S.-headquartered companies faced a higher worldwide effective tax rate than their counterparts headquartered in 53 of the 58 foreign countries.”⁶

The United States fails another competitiveness test in the design of its international tax system. The U.S. corporation income tax applies to the worldwide earnings of U.S. headquartered firms. U.S. companies pay U.S. income taxes on income earned both domestically and abroad, although the U.S. allows a foreign tax credit up to the U.S. tax liability for taxes paid to foreign governments. Active income earned in foreign countries is generally only subject to U.S. income tax once it is repatriated, giving an incentive for companies to reinvest earnings anywhere but in the U.S. This system distorts the international behavior of U.S. firms and essentially traps foreign earnings that might otherwise be repatriated back to the U.S.

While the U.S. has maintained an international tax system that disadvantages U.S. firms competing abroad, many U.S. trading partners have shifted toward territorial systems that exempt entirely, or to a large degree, foreign source income. Of the 34 economies in the Organization for Economic Cooperation and Development (OECD), for example, 28 have adopted such systems, including recent adoption by Japan, the United Kingdom and New Zealand.⁷ According to a 2015 study by the Tax Foundation, the US ranks last in corporate income tax competitiveness compared to OECD countries.⁸

One manifestation of the competitive disadvantage of the U.S. corporation income tax is decisions on the location of headquarters. The issue of so-called “inversions” remains at the forefront of tax policy and politics. Originally, tax inversions involved a single company flipping the roles of U.S. headquarters and foreign subsidiary — i.e. “inverting.” Tax changes in the early 2000s largely ended this practice. Next, whenever a U.S. firm sought to acquire or merge with a foreign firm, the tax advantages of being subjected to a lower rate and a territorial base made it inevitable that the combined firm would be headquartered outside the U.S.. In these cases, inversions took place in the context of these otherwise strategic and valued business opportunities. Most recently, foreign firms have recognized that freeing U.S. companies of their tax disadvantage allows foreign acquirers to use the same capital, technologies and workers more effectively. Inversions are now occurring because foreign firms are acquiring U.S. firms.

A recent macroeconomic analysis of former Chairman Camp’s tax reform proposal is instructive on the incentives inherent in the current tax code for capital flight. John Diamond and George Zodrow examined how reform similar to that proposed by former Chairman Camp would affect capital flows compared to current law.⁹ In the long-run, the authors estimated that a reform that lowered corporate rates and moved to an internationally competitive divided-exemption system would *increase* U.S. holdings of firm-specific capital by 23.5 percent, while the net change in domestic ordinary capital would be

a 5 percent increase. It is important to note that these are relative measurements – they are relative to current law. If the recent spate of announcements of inversions is any indication, current law is inducing capital flight. Accordingly, the 23.5 percent and 5 percent *increases* in firm-specific and ordinary stock, respectively, may be interpreted in part as the effect of precluding future tax inversions.

Placing a value of this potential equity flight is uncertain, but based on these estimates, roughly 15 percent, or \$876 billion in U.S. based capital is at risk of moving overseas. Reforming the international corporate code would preclude this capital flight and prevent associated job losses.¹⁰

Finally, it is an important reminder, particularly in the current political climate, that the burden of the corporate tax is borne by everyone. Corporations are not walled off from the broader economy, and neither are the taxes imposed on corporate income. Taxes on corporations fall on stockholders, employees, and consumers alike. The incidence of the corporate tax continues to be debated, but it is clear that the burden on labor must be acknowledged. Indeed, one recent study found that labor bears as much as 70 percent of the corporation income tax rate.¹¹ Other studies have found similar implications, with a study by economists at the American Enterprise Institute concluding that for every one percent increase in corporate tax rates, wages decrease by one percent.¹² These wage effects should be considered in thinking about the impact of tax reform.

Restoring Faith in the Tax Code

The U.S. code is complex, confusing, costly to operate and comply with, and leaves taxpayers distrustful that everyone is paying the share Congress intended. In 2013, over 147 million individual tax returns were filed, covering over \$9.1 trillion in income.¹³ These returns also include millions of businesses that do not file as C-Corporations. As of 2012, there were 31.1 million non-farm businesses filing tax returns: 23.6 million sole-proprietors, 4.2 million S-corporations, and 3.4 million partnerships (including LLCs). The IRS also recognized 1.6 million C-corporations.¹⁴ The tax system is often the most direct interface between individuals and businesses and the federal government.

Unfortunately, that experience is often deeply unsatisfactory. The IRS has 1,050 forms with which taxpayers must contend and requires an average of 11.1 hours per paperwork submission. The overall burden on taxpayers is 8.9 billion hours in paperwork burden imposed by the tax collection system on taxpayers.¹⁵

As many Americans have experienced, the tax filing process is extremely time intensive and often requires the help of outside expertise. Tax compliance is so onerous for individual

taxpayers, 94 percent of individual taxpayers used a preparer or tax software to prepare their returns. The Taxpayer Advocate Service (TAS), the watchdog office within the IRS, has stated in the past that complexity is the single most serious problem with the tax code. This complexity is also straining the administrative capacity of the IRS. As the amount of work required to complete tax filing increases, the ability of the agency to respond to inquiries declines. According to the TAS, the IRS received over 100 million calls in 2015 and answered only 62 percent of calls received, as compared to 87 percent in 2004. The IRS failed to respond in a timely manner to 50 percent of taxpayer letters received in 2012, compared to 12 percent in 2004.¹⁶

The burden on individuals filing their taxes also translates to a large scale negative economic impact. Fichtner and Feldman assessed the costs that the U.S. tax code extracts taxpayers through complexity and inefficiency. The study finds that, in addition to time and money expended in compliance, foregone economic growth, and lobbying expenditures amount to hidden costs are estimated to range from \$215 billion to \$987 billion.¹⁷

Thus individuals are confronted with a burdensome and costly tax code that, despite its progressivity is perceived as being skewed to benefit the wealthy or well connected. News reports of firms not paying corporate taxes or politicians bemoaning those not paying their “fair share” further this perception. Though these reports are often highly misleading, their conclusions are widely accepted among the American public.¹⁸ Sound tax reform can reconcile these perceptions of being unfair with economic efficiency. Many of the tax expenditures in the tax code fail the economic cost-benefit test and also broadly benefit higher income individuals and businesses.¹⁹ Efficient tax reform can broaden the tax base, lower overall rates, and reduce or eliminate tax provisions that feed the perceived unfairness in the tax system.

Conclusion

The U.S. tax system hasn’t been overhauled in 30 years. Since the 1986 tax reform effort, individual and corporate tax rates have crept up, while the number of tax expenditures has expanded. The tax system is ripe for an overhaul, an effort that could simultaneously enhance the nation’s growth outlook, staunch the flow of corporate inversions, and improve public perceptions of fairness. Thank you for the opportunity to address the need for tax reform as a pressing and overdue policy imperative. I look forward to your questions.

Notes

¹ <http://waysandmeans.house.gov/wp-content/uploads/2016/02/20160202FC-Holtz-Eakin-Testimony-CLEAN.pdf>

² See: Feldstein, Martin, "The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act." *Journal of Political Economy*, June 1995, (103:3), pp 551-72; Carroll, Robert, Douglas Holtz-Eakin, Mark Rider and Harvey S. Rosen, "Income taxes and entrepreneurs' use of labor." *Journal of Labor Economics* 18(2) (2000):324-351; Prescott, Edward C., "Why do Americans Work So Much More Than Europeans."

Federal Reserve Bank of Minneapolis July 2004; Skinner, Jonathan , and Eric Engen. "Taxation and Economic Growth." *National Tax Journal* 49.4 (1996): 617-42; Romer, Christina D., and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks." National Bureau of Economic Research NBER Working Paper No. 13264 July 2007 Web.<http://www.nber.org/papers/w13264>

³ Altig, David, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters and Jan Walliser, "Simulating Fundamental Tax Reform in the United States." *American Economic Review*, Vol. 91, No. 3 (2001), pp. 574-595

⁴ <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51129-2016Outlook.pdf>

⁵ <http://americanactionforum.org/research/economic-and-budgetary-consequences-of-pro-growth-tax-modernization>

⁶ PricewaterhouseCoopers (2011). *Global Effective Tax Rates*. Washington, DC

⁷ http://businessroundtable.org/uploads/studies-reports/downloads/Taxation_of_American_Companies.pdf

⁸ http://taxfoundation.org/sites/taxfoundation.org/files/docs/TF_ITCI_2015.pdf

⁹ http://businessroundtable.org/sites/default/files/reports/Diamond-Zodrow%20Analysis%20for%20Business%20Roundtable_Final%20for%20Release.pdf

¹⁰ <http://www.americanactionforum.org/research/economic-risks-proposed-anti-inversion-policy-update/>

¹¹ William C. Randolph, "International Burdens of the Corporate Income Tax," Congressional Budget Office *Working Paper* No. 2006-09, at <http://www.cbo.gov/ftpdocs/75xx/doc7503/2006-09.pdf> (April 3, 2009).

¹² Kevin A. Hassett and Aparna Mathur, "Taxes and Wages," American Enterprise Institute *Working Paper* No. 128, June 2006.

¹³ <https://www.irs.gov/pub/irs-soi/soi-a-inpd-id1505.pdf>

¹⁴ <https://www.jct.gov/publications.html?func=startdown&id=4903>

¹⁵ <http://www.americanactionforum.org/insight/tax-day-2016-regulatory-side/>

¹⁶ <http://www.americanactionforum.org/insight/tax-day-2016-regulatory-side/>

¹⁷ Fichtner, Jason J. and Jacob M. Feldman, "The Hidden Costs Of Tax Compliance." Mercatus Center 2015 Web. <http://mercatus.org/sites/default/files/Fichtner-Hidden-Cost-ch1-web.pdf>

¹⁸ See for example, http://www.americanactionforum.org/wp-content/uploads/sites/default/files/Future_of_Taxes_and_Small_Biz_final%5b1%5d.pdf and <http://www.americanactionforum.org/insight/oxfam-report-factual-inaccuracies-musings/>

¹⁹ http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf