

Growth-Oriented Tax Reform and International Competitiveness

Testimony by

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Mr. Chairman, Ranking Member Neal, and other members of the committee, thank you very much for this opportunity to discuss one of the most important issues confronting our country – how to make its economy grow faster and how to increase our international competitiveness. For reasons I will discuss, faster growth will not only raise living standards, it is also likely to reverse the tendency over the last quarter century or so for the distribution of income to become less equal. Increasing growth is also crucial to facing our long-run fiscal challenges. I believe that the type of reform Chairman Brady and his colleagues are advancing is designed to target these objectives.

Forty years ago when I was in graduate school, the basic outline of the proposal now under consideration was thought to be the best type of structure America could have. It would end three major distortions that have created inefficiencies and bad incentives for our economy. First, it would end the tax bias on a cash flow basis against investing in long-lived plants and equipment. Second, it would end the tax bias in favor of debt over equity finance, one that enhances the riskiness of our financial structure. Third, it would reduce the incentives to invest overseas and import rather than produce domestically and export. In a sentence, the blueprint for tax reform before us, if enacted, would make America the best place in the world in which to invest and start a business.

This decades-long view in the public finance profession is neither ideological nor partisan. Allow me to quote from a paper authored by one of my colleagues in graduate school, Larry Summers. In 1981, he wrote, "...[T]he welfare cost of capital income taxation may have been seriously underestimated. For reasonable parameter values, the annual welfare gain from a shift to consumption taxation is conservatively estimated at 10 percent of GNP...[I]t is unlikely that the

basic conclusion of this analysis would be altered. Capital income taxes are likely to appear very undesirable in any sort of realistic life cycle formulation.”¹ While the proposal before us is not a shift to a consumption tax per se, it makes great strides in eliminating most of the biases in the current tax code that led to Summers’ conclusion.

Tax reform can have big consequences. One survey of 69 public finance economists published by the National Bureau of Economic Research found a median estimate that the 1986 tax reform increased long-run growth of the U.S. economy by about 1 percent per year.² The reform that is now under consideration is even larger and will produce an even greater acceleration of growth.

My own work indicates that passage of something like the House blueprint would lead to an acceleration in real GDP growth to about 3 ½ percent for a period of four to five years before moderating to a longer-run rate of growth of about 2 ¾ percent. In my estimation, failure to pass such a reform would likely produce a slowing of economic growth to the 1 ½ to 2 percent range. Note that this does not produce a result much different from Summers’ 10 percent of GNP estimate in the intermediate term.

Moreover, a look at the current economic recovery indicates that a lack of capital formation and entrepreneurship has been the chief cause of it being the worst recovery on record. From 1965 through 2010, real growth averaged 3.1 percent a year; note that this timeframe includes the negative effects of the Great Recession. From 2011 through 2016, a period of continuous recovery,

¹ Summers, L.H. (1981) “Capital Taxation and Accumulation in a Life Cycle Growth Model”, *The American Economic Review*, Vol. 71, No. 4, 533-44, September.

² Fuchs, V. R. et. al. (1997), “Why Do Economists Disagree About Policy? The Roles of Beliefs About Parameters and Values”, *National Bureau of Economic Research*, NBER Working Paper No. 6151, August. <http://www.nber.org/papers/w6151.pdf>

real growth averaged just 2 percent annually. This is odd because recoveries from steep recessions usually involve faster, not slower growth. Employment was not the problem. Growth there in the last six years mirrored that of the previous 45 years – roughly 1 ½ percent a year.

What collapsed was capital formation, which fell by almost 50 percent, from 3.2 percent to 1.7 percent, and productivity growth, which declined by nearly two-thirds, from 1.1 percent to 0.4 percent. The productivity collapse was reflected by poor showings in two of the best indicators of increasing productivity – the movement of workers to take new jobs, which has been the worst in decades, and the rate of growth of new businesses, which has been the worst on record. In fact, in recent years for the first time since such data were collected, more firms went out of business than were formed.

The tax reform blueprint targets both capital formation and entrepreneurship. It not only reverses declines in incentives created recently, it actually makes the incentives better than the long-term average. Hence, one would expect both productivity and capital formation to rise to exceed their long-term trends, at least in the intermediate term. This, in turn, will produce higher than average GDP growth.

All or nearly all of that extra growth will show up in increased labor compensation. The reason is two-fold: First, we are now at roughly full employment, the point at which bargaining power for workers strengthens, so labor's share of the economic pie will grow. Second, by expanding the capital stock and entrepreneurial activity at the same time, we are increasing the value of each worker. In the most simple formulation, when workers have more machines to work with, they are worth more. And when the growth of new businesses is healthy, workers' ability to find jobs best tailored to their skill set rises, along with their ability to produce. My estimates suggest that passage of tax reform like that presently under consideration will lead to the first

sustained decline in income inequality in America since the 1960s. By the way, it was in the mid-sixties that we passed a similar bill, the Kennedy tax cuts, at a time of comparably low unemployment.

The magnitudes we are talking about are staggering. Real GDP will be nearly \$2 trillion higher five years after the bill takes effect than it otherwise would have been. As labor's share of national income rises, workers will be getting an increasing piece of a rapidly growing pie. This will mean that annual real wage increases will rise to the 4 percent range. In recent years, they have been essentially flat. Even if one assumes, as some do – wrongly in my view – that all of the tax benefits will go to a relative few, the real wage increases for working individuals will dwarf the static magnitudes of tax cuts by a margin of five or six to one.

Let me now turn to one of the most misunderstood parts of the tax reform blueprint – the change in corporate taxation to a territorial system based on where goods are sold rather than where they are produced. We are one of the few major economies that currently follows the reverse system – global taxation with tax based on where goods are produced, rather than where they ultimately end up. This is the difference between a territorial destination-based system and a global production-based system.

At the simplest level, when you tax something, you discourage it. So, taxing goods by where they are produced discourages production. The result gets even worse when other countries tax based on goods' destination. Under the current system, when we produce something and ship it to Germany, we tax its production here, and the Germans tax its sale in Germany. Alternatively, when something is produced in Germany and shipped here, Germany rebates a portion of the tax on its production, and we impose no tax on its sale in America. Our exports are taxed in both countries, while their exports are taxed in neither.

In addition, taxing companies on a global system rather than a territorial one affects where the company is headquartered and where it chooses to have its intellectual property taxed. With global taxation, the value added by these two components of the company all end up being taxed in the country where the company is headquartered. With territorial taxation, only the portion consumed in that country is subject to taxation. Coupled with the fact that America has one of the highest corporate tax rates in the world, this double-whammy causes firms to consistently headquarter and shift production outside of the U.S. We lose both jobs and tax revenue as a result.

Border adjustment in a territorial system ends this by taxing goods on where they are destined, not where they are produced. Indeed, it is hard to picture territoriality without an attendant border adjustment. But, there are a few misunderstandings about the process.

First, border adjustment is not complicated; it is far simpler than our current system. With border adjustment, companies do not track each individual product as it crosses borders in the production chain; they simply subtract the total value of goods exported from the total value of goods imported. So, a product that crosses a border many times simply gets netted out.

Second, border adjustment will lead to a currency adjustment that will largely offset the tax. Claims that U.S. consumers will pay the cost of this border tax are simply not borne out by the facts. Some claim that this is theoretical; well, so technically are supply and demand, yet the world still works that way. In fact, currencies move *because* of changes in supply and demand. When we are incentivized to buy fewer imports, the supply of dollars to purchase euro, yen, or renminbi decreases. When taxes on our exports are reduced, the demand for dollars to purchase those goods overseas increases. Higher demand, lower supply means a higher price. Thus, under the proposed system, the dollar would be worth more.

Currency adjustment makes the border tax trade-neutral, so to the extent currencies adjust, the legislation is trade-neutral. This is not protectionism, but a stronger dollar increases the purchasing power of Americans in the global market. And there is an added benefit to levelling the playing field in this way. When the dollar appreciates, neither the domestic consumer nor the company importing the goods pays the tax. The tax is instead paid by the exporting country, because the dollar cost of the good must drop in order to retain its market share, even though the cost of the good in the exporting country's currency remains the same. So in essence, the bulk of the revenue collected from border adjustment would be paid by Chinese, European, and Mexican exporters, not American consumers. How much? One forecasting company, Macroeconomic Advisers, estimates that border adjustment will be 65 percent offset by a currency change, and this is one of the lower estimates around. Under this assumption, they foresee a one-time increase in the price level for consumers of 1 percent. On the other hand, foreigners would be paying nearly \$800 billion of the \$1.2 trillion estimated to be collected from the tax.³ Frankly, it boggles my mind that some people do not consider this a good trade-off from the point of view of the American national interest.

Will there be transition costs in making these changes? Yes, though there are ways to mitigate them. Further, the long-run benefits to the U.S. economy are many times any short-term costs involved in transition. We can discuss these issues and ways to reduce their impact in detail if you wish. The proposal now before us represents a consensus view within the public finance profession on how taxation should be approached if our objective is to maximize U.S. economic

³ Nunns, J.R. et. al. (2016), "An Analysis of the House GOP Tax Plan", *Tax Policy Center*, September 16. <http://www.taxpolicycenter.org/publications/analysis-house-gop-tax-plan/full>

growth and the welfare of our citizens. It is also likely to produce an increase in real wages and a reduction in income inequality. I sincerely hope that Congress does not miss this opportunity.