Tax Policy, Economic Efficiency, Job Creation and Growth

Testimony before the Committee on Finance, United States Senate

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Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to appear today to provide my views on the ways in which the U.S. tax system may be reformed to improve economic efficiency and promote job creation and economic growth. These objectives are always important in the design of tax policy, but they take on particular importance in the current environment, when unemployment remains high and severe budget pressure calls for a serious reconsideration of all spending programs, whether implemented directly or through the tax system.

My comments will focus primarily on two major tax policy areas, tax expenditures and the reform of the corporate income tax, but let me begin by discussing the role of tax reform in the current economic situation.

Tax Reform and Economic Recovery

Over the past three years, the main focus of U.S. fiscal policy has been to promote economic recovery from the 2007-9 recession through various measures that reduced federal taxes and increased federal spending. Opinions vary as to whether the mix and size of this policy response were appropriate, although I believe strong action was necessary, given the severity and length of the recession. But there can be no dispute that we face a daunting challenge of controlling the growth of our national debt and bringing spending and tax revenues into closer alignment now that a recovery is underway. On our current trajectory, the national debt will approach its postwar high relative to GDP by the end of this decade and far surpass this ratio shortly thereafter. This trajectory is unsustainable and must change soon. With our fiscal challenge in mind, it is appropriate to ask what the role of tax policy should be. As a matter of simple logic, tax policy can contribute to solving our fiscal problem only by increasing tax revenues. But

there are many ways in which tax revenues might be increased, and these have very different effects on economic efficiency – how well we utilize the resources at our disposal – on growth, on employment and, ultimately, on individual well-being. Whatever its *direct* effect on revenues, a tax policy that promotes growth produces a fiscal dividend in the form of the increased tax revenues generated by higher incomes. By contrast, tax policies that hinder growth make the job of deficit reduction harder by reducing the incomes on which taxes are paid. Thus, even a tax reform that is revenue-neutral without accounting for its growth effects can contribute to deficit reduction by increasing the tax base. This is certainly not the only reason, or even the main reason, for seeking growth-enhancing tax policies, for higher growth benefits society as a whole much more than it helps the government budget, but salutary budget effects do matter, particularly when deficit reduction seems so difficult to accomplish.

While a pro-growth tax reform may help us attack our fiscal problem, though, it can only be part of the solution. For example, if we were able through policy changes to increase real GDP growth by 0.5 percentage points per year over the next decade – a large increase, given historical variations – tax revenues would probably be around 1 percent of GDP higher at the end of the decade. That's a lot of money – around $150 billion relative to our current level of GDP. But it is still only a fraction of what we need in the long run, according to recent calculations I have done with William Gale.[1] So, we will still need a combination of substantial spending cuts and tax increases to close the fiscal gap and, to the extent that we rely on tax increases, tax reform again is relevant. Although tax increases are bound to hinder economic activity, the negative effects can be limited if the tax increases are effected within a broad-based tax system with low marginal tax rates. Put another way, a bad tax system becomes much worse as we seek to raise more revenue with it.

In summary, the need to deal with our fiscal imbalance makes tax reform more important. Further, tax reform need not conflict with our immediate objective of promoting economic recovery. For example, tax policies that encourage business investment not only spur capital accumulation and ultimately economic growth, but also increase the current demand for capital

[1] Auerbach and Gale (2011) estimate that, even under the most optimistic assumptions regarding current fiscal policy, a combination of tax increases and spending reductions (excluding interest) of 4-5 percent of GDP will be needed to prevent an explosion of the national debt to unsustainable levels. Under more realistic assumptions the needed adjustments are perhaps twice as large.

goods and the workers who produce them. Policies that promote economic efficiency can make workers more profitable for businesses to employ. The current state of the economy is certainly relevant as we consider the sequencing of tax reforms. For example, policies that might discourage consumer demand might appropriately be deferred. But there is no need to defer the considerable effort that tax reform requires and indeed good reason to act soon.

Tax Expenditures

Tax expenditures are reductions in tax revenue associated with provisions that encourage certain activities in which taxpayers engage. Because they must be measured relative to some "normal" tax base, tax expenditures lack an unambiguous definition. For example, provision of tax-favored savings such as through 401(k) plans is a tax expenditure if we view income as an appropriate tax base, but not if we start with household consumption as our baseline, for savings would normally be excluded from a consumption tax base to begin with.

Much of the traditional discussion of tax expenditures has focused on whether direct spending programs might serve better to accomplish objectives toward which tax expenditures are directed. For this discussion, the ambiguity of tax expenditure definition has proved a hindrance and a source of controversy. But in the context of tax reform and deficit reduction, this problem is really beside the point. Whether we choose to refer to a particular tax provision as a tax expenditure or as a normal tax incentive is completely irrelevant to the consideration of whether the provision should continue to exist. The relevant question in our current environment, for any tax expenditure *or* any direct expenditure, is whether the expenditure is worth the scarce government resources being devoted to it. In either case, there will be an increase in the budget deficit with which we must deal through further spending cuts or tax increases; and, if the provision is poorly conceived, it will also distort economic activity. In light of the ongoing consideration in Congress of very large cuts in discretionary direct expenditures, it makes sense to expand the evaluation to tax expenditures as well.

In addition to their revenue cost, tax expenditures influence economic behavior. In some cases, this is the point of the provision. For example, the Research and Experimentation credit was intended to encourage private expenditures on qualified activities, following the view and supported by some evidence that the private sector undervalues the social benefits that such

activities generate. In other cases, such as the mortgage interest deduction, the exclusion for employer-provided health insurance, and the deduction for state and local taxes and exclusion of state and local bond interest, to cite some of the largest tax expenditures in terms of lost revenue,[2] the provisions originally arose as byproducts of how the tax system defined income at the time; even so, defenders of these tax expenditures subsequently have cited social purposes in support of their continuation. But even with a social objective, there remains an important question of how a tax expenditure should be designed to achieve this objective.

We may wish to subsidize the purchase of health insurance because otherwise some people will rely on unreimbursed private care or government care, both of which come at other individuals' expense. But this rationale applies more to the purchase of a basic insurance policy, not a very generous one; and it does not necessarily suggest that the subsidy should be greater for those in higher tax brackets, as occurs naturally in the case of an exclusion from income. One could easily argue that a tax expenditure to encourage the purchase of medical insurance should be capped at the cost of a basic policy, provided by a credit rather than an exclusion, and applicable only below a certain income threshold, where there is a real likelihood of relying on government or unreimbursed care. The cost of this modified tax expenditure would be a small fraction of the cost of the current exclusion, even taking account of the very high cap scheduled (but not yet implemented) under last year's health care legislation.

Likewise, some advocates, perhaps not as many as a few years ago, may view the promotion of home ownership as a good social objective and the mortgage interest deduction as a means of achieving this objective. But, again, this is not an argument for an uncapped subsidy, or for a deduction rather than a tax credit, or for a benefit made available to all taxpayers. Once again, the claimed objective can be achieved at much lower revenue cost. A similar argument can also be made with respect to the targeting of subsidies to state and local governments; the existing tax exclusion for interest on these governments' obligations and the deduction for their taxes are expensive and poorly targeted.

[2] According to the Joint Committee on Taxation (2010), in fiscal year 2011 the tax expenditure for the mortgage interest deduction is $93.8 billion; that for the exclusion of employer-provided health benefits is $117.3 billion; and those for deductions for state and local taxes and the exclusion of interest on public purpose state and local bonds sum to $96.8 billion.

In each of these instances, the tax law already includes some restrictions: the $1 million cap on mortgages, the recently enacted cap on excludable health benefits, and the disallowance of the deduction for state and local taxes under the Alternative Minimum Tax. But these limits are only small steps toward what reforms might achieve.

Let us also be clear that the cost of these and other tax expenditures is not simply that we are paying more than necessary to achieve our aims. We are also distorting private choices in a way that diminishes productivity and well-being. Americans have large houses and expensive medical care. But by investing more in housing, we may be investing less in productive plant, equipment, and ideas. By spending more on medical care, we may be spending less on other things we might value more.

In short, the reform of tax expenditures offers two important benefits. First, like direct expenditure reductions, cuts in tax expenditures help us toward our goal of deficit reduction. Second, modifying the incentives that tax expenditures provide can make them work better at achieving their desired ends and eliminate the economic distortions they now cause. I can think of no coherent rationale for ignoring tax expenditure reform when large cuts in direct spending are taking place.

Corporate Taxation

At the federal level, our corporate income tax runs a distant third to the personal income and payroll taxes as a source of revenue. But when thinking about growth and employment, we focus on the corporate tax because of its potential impact on the investment, production, and employment decisions that U.S. businesses make.

The basic form of the U.S. corporate income tax has changed little over time. But the environment in which U.S. corporations operate has changed markedly. With the growth in importance of international capital flows and multinational corporations, countries have been under pressure to modify their corporate taxes to remain attractive to business, and the result has been a change in the international corporate tax environment. Among the lowest tax rates in leading economies just after the Tax Reform Act of 1986, the U.S. corporate tax rate is now much higher than those in most of these other economies. We also stand basically alone in our continuing attempt to impose tax on the active worldwide income of our resident corporations;

countries that previously followed this approach, notably the United Kingdom and Japan, have recently adopted the territorial tax system already found elsewhere. It is therefore easy for some to recommend that we follow suit and join the race to the bottom, lowering our tax rate and adopting a territorial system. One obvious obstacle to doing so is the revenue cost.

It may seem apparent that cutbacks in corporate tax expenditures can be used to offset any revenue loss from rate reduction and the adoption of a territorial system, but among the important tax expenditures one finds listed for the corporate sector are such items as the R&E credit and accelerated depreciation – provisions that reduce the cost of capital and encourage domestic investment. Cutting back on these tax expenditures to offset the revenue cost of reducing the corporate tax rate could actually increase the cost of capital, since investment incentives are more directly tied to new investment. It is true that a lower corporate tax rate would also reduce the incentive for companies to use internal transfer pricing to shift profits abroad. But adoption of a territorial system could have the opposite effect. While a territorial system might make the United States a more attractive place for the location of multinationals – this is a key argument in favor of its adoption – it also provides an added incentive for these companies to shift profits abroad and permanently avoid any U.S. tax on these profits. Taken together, lowering the corporate tax rate and adopting a territorial system would have an uncertain impact on profit shifting, and paying for these changes by cutting back on corporate tax expenditures will not necessarily lead to a net increase in domestic investment. Given a choice between the current system and one with the combination of changes just described, it is hard to pick a winner. But we have more choices.

If we focus just on domestic activities, the corporate tax imposes important distortions that impede economic activity. The favorable treatment of debt finance provided by the deductibility of interest encourages corporate borrowing. While the favorable tax rates on shareholder dividends and capital gains partially offset this, a net tax benefit to borrowing remains. This can lead companies to distort their investments toward those more easily financed by borrowing and to borrow too much, given the added risk that borrowing entails. In light of recent events, it is very hard to believe that we are still wedded to a tax system that encourages borrowing.

Limiting the deductibility of borrowing would not only encourage equity finance and a more productive investment mix, but would also discourage investment overall by raising the

corporate cost of capital. To implement this reform without discouraging investment, then, one would want to couple it with an offsetting policy to encourage investment, such as through more generous accelerated depreciation allowances. In the extreme, one would eliminate the interest deduction entirely and allow immediate write-off of investment. The resulting tax system, known as a cash-flow tax, has been long recognized[3] to eliminate all net tax on new investments, and would therefore remove not only the corporate tax distortions associated with borrowing but also the tax wedge that currently discourages new equity-financed investment. That is, the corporate tax on equity-financed investment and the corporate *subsidy* of debt-financed investment would both be eliminated.

Moving all of the way to a corporate cash-flow tax would eliminate important domestic distortions; moving even part of the way would help. But the full or partial version of this reform does not deal with the international profit shifting incentives discussed above. The United States might become a more attractive place to invest, but other countries with low corporate tax rates would still be more attractive places to report profits and perhaps also to earn them, particularly in the case of investments with high rates of return.

To attack this important remaining problem, one needs some additional provisions to deal with cross-border transactions. One approach, proposed in 2005 by the President's Advisory Panel on Tax Reform in its "Growth and Investment Tax" plan, would be to ignore foreign source earnings (in the same way a territorial system would) and to impose border adjustments on cross-border transactions, of the form typically followed in other countries for existing value added taxes.[4] A simpler alternative I recently proposed (Auerbach 2010) would be to disregard both foreign earnings *and* cross-border transactions entirely in the domestic corporation's tax calculation. Either way, the resulting *destination-based* corporate cash-flow tax would retain the desirable properties already described with respect to domestic operations and also remove corporate incentives to shift profits abroad by eliminating the U.S. tax consequences of doing so.

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[3] See Brown (1948).

[4] This approach is also advocated and discussed in a recent review of the UK tax system by Auerbach, Devereux and Simpson (2010).

As an extra bonus, provisions currently in place to prevent this activity, such as interest allocation rules, would be superfluous and could be repealed.[5]

Finally, some thought is needed about the borderline between C corporations and other business entities. Gradually over recent decades, the U.S. business sector has evolved into one that, to a considerable extent, is not subject to the corporate income tax. In 1980, C corporations accounted for 80 percent of U.S. business income, with the remainder being accounted for by partnerships, sole proprietorships, limited liability companies and S corporations. By 2007, the C-corporation income share had fallen to 53 percent, with the fastest relative growth experienced by S corporations, whose income share rose from 1 percent in 1980 to 14 percent in 2007.[6] Tax rules have played a role in this growth, for example around the Tax Reform Act of 1986, when relative changes in corporate and individual tax rates made corporate tax avoidance more valuable (Auerbach and Slemrod, 1997). Reforming the corporate tax alone will not eliminate the tax incentive for businesses to avoid the C-corporation form. Further adjustments would be required, either to the tax treatment of corporate distributions at the investor level or to the ability of entities like C corporations to avoid being taxed like them.[7]

Conclusions

I have concentrated here on two major issues in tax reform, tax expenditures and corporate taxation, because I view each as having a high potential payoff. For the individual income tax, there are items on the tax reform agenda beyond tax expenditures. There is also the question of whether some new vehicle, such as a value added tax or an environmental tax, should be introduced in place of some existing taxes or in addition to them. But, even without the comprehensive tax reform that seems so difficult to approach, there are major improvements in our tax system and the competitive environment it produces that can be achieved through

[5] It is quite possible that adoption of such a new system of corporate taxation, particularly with respect to cross-border transactions, would require modification of existing tax treaties which were not designed to deal with such a system. But there is no logical reason why adjustments akin to those permitted under VAT rules should not also exist under a destination-based cash-flow tax, which is closely rated in its underlying structure.

[6] See President's Economic Recovery Advisory Board (2010), Table 8.

[7] The 2005 Growth and Investment Tax Plan, discussed above, would have imposed the same business-level tax on all business entities except sole proprietorships. But, as discussed in Auerbach (2010), limiting the extension of coverage to large entities outside the C-corporation sector would accomplish much the same objective and leave most businesses unaffected.

sensible reform of tax expenditures and the corporate income tax. Substantial cuts in tax expenditures could be accomplished without harming their apparent objectives, while actually reducing economic distortions that hinder growth and employment and reduce economic well-being. Corporate tax reform could remove the economic distortions of corporate borrowing and investment decisions while at the same time alleviating the pressure to compete in a global race to the bottom.

While not focusing in my comments on the important issue of distributional equity, both sets of reforms I have laid out should be progressive in nature. At least in the examples cited above, modifying tax expenditures to eliminate unneeded subsidies and undesirable effects should leave a greater share of the remaining benefit at the lower end of the income distribution. And, by reducing the tax incentives for companies to locate their profits and capital in other countries, the prospect will be enhanced for higher labor productivity and wages in the United States.

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