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on
Lessons From Reagan: How Tax Reform Can Boost Economic Growth

Mr. Chairman and Members of the Committee, I am Jane Gravelle, a Senior Specialist in Economic Policy at the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss tax reform.

The Tax Reform Act of 1986 (TRA) has often been invoked as an example of a successful tax reform. As Congress considers tax reform currently, comparing and contrasting the current environment with that surrounding the 1986 Act can be helpful in understanding what expectations Congress might have for the development and consequences of tax reform.

The TRA was preceded by a major tax cut for individuals and significant liberalizations of depreciation for businesses in 1981. These were followed by two revisions (in 1982 and 1984) that took back some of this revenue. TRA, by contrast was, much like many of the proposals today, proposed to be revenue and distributionally neutral. There is some disagreement about whether a tax reform should be revenue neutral or whether it should gain revenue, given the debt challenges the country faces. Debt and deficits were a problem in 1986 as well, but addressing those issues via the tax system was delayed until 1990 and 1993.

The objectives of TRA, as stated in the 1984 Treasury Report,[1] were for fairness, simplicity, and economic growth. However, much of the discussion in the report spoke to neutrality (or what economists would term efficiency) rather than economic growth. In outlining the goals of tax reform, it opened with economic neutrality, and proceeded to discuss a number of objectives before specifically listing economic growth in 11th place. The discussion of economic growth itself was explicitly linked to neutrality.

The first section of this testimony, focusing on a revenue and distributionally neutral reform, addresses the differences between economic growth and efficiency, and the expectations for growth that accompany income tax reform of this nature. The following sections consider other aspects of TRA and the economic conditions that lead to comparisons and contrasts with the current reform proposals, including the overall economic environment, the feasibility of significant base-broadening, open economy considerations for the corporate tax (both in economic effects and compliance), the risks of adopting a plan that loses revenue and contributes to the deficit in the long run, and the prospects for simplification.

Economic Growth and Efficiency

While the terms "economic growth" and "efficiency" are often used interchangeably, each is a distinct concept. Economic growth refers to responses that increase income and output. Efficiency refers to reallocating resources to maximize

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[1] *Tax Reform for Fairness, Simplicity, and Economic Growth*, the Treasury Department Report to the President, November 1984.

welfare. Many, indeed most, of these efficiency effects are not detectable as a change in output, and particularly in output net of depreciation which is a better comparison.[2] For example reducing distortions in the corporate tax may largely change the share of corporate versus non-corporate production, or lead to changes in debt shares that re-allocate risk.[3] In sum, efficiency gains, while desirable to pursue, are often barely noticeable as output effects.

Economic growth, by contrast, generally arises from increases in labor supply, savings, and investment. There is evidence that suggests, however, that TRA did not have much of an effect on growth, and economists argued that it should not have been expected to.[4] This limited effect was expected in part because supply responses (such as labor supply) are small and in part because a revenue neutral tax reform that included many base broadening provisions might have minimal aggregate effects on effective marginal tax rates.[5]

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[2] An example of a change that increases gross output, but does not change net output other than by a negligible amount, is shifting investment from residential structures which have low depreciation rates to business equipment which has a high rate. Most of the gross output effect from this shift results from an increase in depreciation. Thus, additional output will be used first to replace depreciating assets, with a likely negligible increase that could add to current and future income.

[3] Economic distortions are referred to by economists as Harberger triangles (the area on a supply and demand curve representing the distortion) and Nobel Laureate James Tobin, referring the shortfall in output from a recession (termed Okun gaps) once quipped "It takes a heap of Harberger triangles to fill an Okun gap." A rough estimate of the efficiency gain from eliminating all corporate distortions is about 10% to 15% of corporate revenue, which is, in turn, about 2% of output. This cost amounts to between 2/10 and 3/10 of a percent of output, and most of it would be reflected in more optimal debt equity ratio, payout ratios, and changes in the mix of output. Only a small share would increase output through more optimal capital-labor ratios. See CRS Report RL3229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle and Thomas L. Hungerford.

[4] See Alan J. Auerbach and Joel Slemrod, "The Economic Effects of the Tax Reform Act of 1986," *Journal of Economic Literature* , Vol. 35, June 1997, pp. 589-632 for a discussion.

[5] Ibid. Auerbach and Slemrod provide an extensive review of studies, along with a discussion of the reasons growth effects should not be expected. While most research they reviewed did not suggest growth effect, one found a significant labor supply response for high income married women. See Nada Eissa. "Taxation and the Labor Supply of Married Women: The Tax Reform Act of 1986 as a Natural Experiment," National Bureau of Economic Research, Working Paper No. 5023, February, 1995. Note also a study by Barry Bosworth and Gary Burtless which considers not only TRA but the 1981 tax cut, concluding that while labor supply increased it could not be attributed to these tax changes because the increases were greater

An example that illustrates that efficiency gains might not be associated with economic growth can be found in the corporate tax reform of TRA. The reform reduced the corporate income tax rate largely by repealing the investment credit. This tradeoff, while it led to significant increases in the neutrality of tax burdens across assets, tended to increase the overall cost of capital because the investment credit applied only to new investment, while the corporate rate reduction provided a windfall for old capital. The same trade-off would likely occur currently with the single largest corporate base-broadening provision commonly discussed, accelerated depreciation.[6] Other corporate base broadening provisions discussed, such as the production activities deduction, or disallowing interest deductions would not change overall effective tax rates, but would raise rates on some activities or sources of investment and lower others.[7]

Individual base broadening can also offset the individual rate reductions if they have marginal effects. That is, if the tax rate falls but more of income is taxed, incentives to supply labor or save may be absent or may work in the opposite direction. This issue was discussed in a recent CRS report on itemized deductions, where it was estimated that

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among lower income individuals. They also found no evidence of a savings effect. See "Effects of Tax Reform on Labor Supply, Investment, and Saving ," *Journal of Economic Perspectives*, Vol. 6, Winter 1992, pp. 3-25. See also the collection of articles in Joel Slemrod, ed., *Do Taxes Matter?: The Impact of the Tax Reform Act of 1986,* MIT Press, Cambridge, MA, 1990.

[6] See Alan D. Viard, "The Quickest Way To Wreck Tax Reform," *Real Clear Markets*, March 23, 2013, at http://www.aei.org/article/economics/fiscal-policy/taxes/the-quickest-way-to-wreck-corporate-tax-reform, and Jane G. Gravelle, "Reducing Depreciation Allowances to Finance a Corporate Tax Rate." *National Tax Journal*, Vol.. 64, December, 2011, pp. 1039-1053.

[7] That corporate reforms might increase efficiency but not affect output is discussed in Nicholas Bull, Tim Dowd, and Pamela Moomau , Corporate Tax Reform: A Macroeconomic Perspective, *National Tax Journal*, December 2011, vol. 64, pp. 923–942 at http://ntj.tax.org/wwtax/ntjrec.nsf/175d710dffc186a385256a31007cb40f/3d9c4a8a018f29c5852579680051854a/$FILE/A01_Dowd.pdf.

revenue neutral rate reductions traded off for the elimination of itemized deductions would leave overall top effective marginal tax rates on income essentially unchanged.[8]

Overall Economic Environment

Some aspects of the economy today are similar to those at the time of TRA. In both cases, revisions were considered in an environment where concerns about the deficit were important issues. However, two factors differ substantially from 1986: a much lower rate of inflation, and a more integrated worldwide economy. Because of lower inflation rates, some issues addressed in the Treasury study preceding TRA, such as those related to indexing capital income for inflation or addressing the generous treatment of debt finance where nominal interest is deducted may be of lesser importance now.[9]

While open economy considerations were given relatively little attention in 1986, they now are central to proposals to lower the corporate tax rate. These open economy issues not only have been part of the impetus for corporate rate reductions and have raised questions about the economic effects of changes in taxation of foreign source income, but also point to one of the central issues of compliance: international profit shifting of income, in part from transferring intangible assets to low- or no-tax jurisdictions.

The Feasibility of Significant Base Broadening

TRA is widely seen as a model for base-broadening, rate-reducing tax reform. TRA broadened the base and lowered the rate on the corporate side, where the highly distorting investment tax credit was eliminated to finance a significant rate cut. The scope

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[8] CRS Report R43079, *Restrictions On Itemized Tax Deductions: Policy Options and Analysis*, by Jane G. Gravelle and Sean Lowry.

[9] Note that TRA ultimately did not index capital income for inflation, although accelerated depreciation was designed to offset the effects of inflation.

of reform of the individual income tax was much more limited compared to the size of the individual income tax. Fringe benefits were largely untouched. Restrictions on itemized deductions were limited to disallowing consumer interest deductions (but not the much larger mortgage interest deduction), capping the mortgage interest deduction at a fairly high level, increasing the floor on medical expenses, and disallowing state and local sales taxes. Itemized deductions for state and local income and property taxes and for charitable contributions were not affected. Taxation of capital income at the individual level was altered by taxing capital gains at ordinary rates, limiting IRA contributions, and restring tax shelters.

Precisely because the corporate tax reform was so significant, there is relatively little low hanging fruit for corporate base broadening. The largest provision (setting aside deferral which affects foreign source income) is accelerated depreciation for equipment. Although it is technically a tax expenditure, the only reason tax depreciation exceeds the value of estimated economic depreciation is because inflation has fallen since 1986 when these rules were established. The elimination of the investment credit and a small change in depreciation in TRA were enough to finance most of the 12 percentage point reduction in the corporate rate. By contrast, CRS estimates that eliminating accelerated depreciation for the corporate sector currently would permit a permanent reduction of two to three percentage points in the long run. CRS estimates that eliminating every tax expenditure except deferral of foreign source income would permit roughly a five percentage point reduction in a revenue neutral change.[10]

[10] CRS Report RL3229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle and Thomas L. Hungerford. Note that the estimates based on tax expenditures can vary because of fluctuations in investment and corporate taxes. As noted subsequently, the JCT has estimated a seven percentage point reduction, but that estimate is during the budget horizon when the gains from slowing depreciation are

What about individual reform? The size of individual income tax expenditures relative to individual income tax revenues is much larger than in the case of corporate tax expenditures and revenues. Eliminating all of them would permit a much larger rate reduction than in the case of the corporate tax (43% as compared to 14%).[11]

Unlike the case in 1986 when one of the objectives was to replace many rate brackets with a two tiered structure,[12] rate compression is not as significant with the fewer rates today. Although some proposals would decrease the number of rates, the current tax reform objective appears largely to lower rates across the board and broaden the base. A recent CRS report examined all of the major tax expenditures, considering the large share associated with capital income preferences where changes are unlikely, those that are difficult to change for practical reasons, and those that are broadly used and popular. It concluded that base broadening in the individual income tax is unlikely to finance more than a one or two percentage point reduction (not the large reductions in TRA).[13]

Open Economy Considerations for the Corporate Tax

Much of the impetus for a corporate tax rate reduction has been due to open economy issues, since the U.S. statutory rate is higher than those of other countries

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larger, a point that was noted in their memorandum. See memorandum, "Revenue Estimates," from Thomas Barthold of the Joint Committee on Taxation, October 27, 2011

[11] A five percentage point rate reduction in the corporate tax would amount to a 14% reduction. Because individual income tax expenditures are much larger large relative to tax revenues, the rate could potentially be reduced by 43% on average. See CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford.

[12] About 40% of taxpayers had no change or increases in statutory marginal tax rates according to Jerry A. Hausman and James M. Poterba, Household Behavior and the Tax Reform Act of 1986," *Journal of Economic Perspectives*, Summer 187, vol. 1, pp. 101-119.

[13] CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening*, by Jane G. Gravelle and Thomas L. Hungerford.

(although average and marginal tax rates are similar to those of other countries).[14] As noted above, corporate base broadening to lower the corporate statutory rate using domestic provisions is unlikely to lower the cost of capital (and encourage investment), and might raise it and discourage investment (as in the case of reducing depreciation to finance a rate cut).

The deferral of tax on foreign source income is an alternative base broadener. Under current law, income earned by foreign subsidiaries is not taxed unless it is paid to the U.S. parent as a dividend, and the deferral of tax on these earnings is considered a tax expenditure. Estimates in the past have indicated that this provision would finance less than a percentage point reduction in the corporate rate.[15] However, the Joint Committee on Taxation has recently substantially increased the revenue estimates of this provision which is now estimated to permit a reduction of almost four percentage points, making it the largest single tax expenditure.[16] Based on CRS review of economic theory and analysis, eliminating deferral to finance corporate rate reduction would encourage an inflow of capital into the United States, both because the incentive to invest abroad is reduced and the tax rates on inbound investment is lower.[17]

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[14] See CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications* by Jane G. Gravelle.

[15] CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle and Thomas L. Hungerford.

[16] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2012-2017*, JCS-1-13, February 1, 2013, at https://www.jct.gov/publications.html?func=select&id=5. For corporate receipts see Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2013 to 2023, February 5, 2013, at http://www.cbo.gov/publication/43907.

[17] See CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle. A review of empirical studies showing responsiveness to differential tax rates can be found in Rudd de Mooij and Sjef Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research," *International Tax and Public Finance*, Vol. 10, November 2003, pp. 673-693. Applying a simulation model using the central tendency from these estimates suggests the effects on output would likely be positive, but small. See CRS Report R41743*, International Corporate Tax Rate Comparisons and Policy Implications* by Jane G. Gravelle, where an effect of slightly larger magnitude (a ten percentage point reduction in the corporate rate) was examined.

The elimination of deferral would also address the issue of profit shifting since there would no longer be a benefit to multinationals to shift profits to low or no-tax jurisdictions. Corporate rate reductions of the magnitude that might be feasible would probably not have much effect on profit shifting, since profit shifting involves paper transactions, and multinationals have developed methods of shifting profits not only to low tax jurisdictions such as Ireland, but out of Ireland to locations such as Bermuda.[18]

Although these are traditional solutions, there is a strong interest in moving in the other direction, to a territorial tax. A pure territorial tax could make profit shifting even more attractive, and these proposals have contained anti-abuse provisions to address this issue, although it is not clear how effective they would be.[19]

Revenue Neutrality in the Budget Horizon and in the Long Run

One of the statements made about TRA is that it increased corporate taxes in order to cut individual taxes. A closer examination of the Act suggests that most of the tax increases for the corporate sector (and some for the individual sector) were timing effects and disappeared in the long run. For example, the capitalization rules which disallowed the immediate deduction of certain costs gained significant revenue in the short run, but not in the long run when disallowance of deductions for new costs was largely offset by the delayed deductions of earlier costs. Research suggests that TRA, although enacted in a time when revenues, or at least deficit reduction, were needed, lost revenues over the long run.[20]

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[18] See CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle for a discussion of methods.
[19] See CRS Report R42624 *Moving to a Territorial Income Tax: Options and Challenges*, by Jane G. Gravelle for a discussion of the reasons for this proposed change and design issues for anti-abuse rules.
[20] Jane G. Gravelle, Equity Effects of the Tax Reform Act of 1986, *Journal of Economic Perspectives*, Volume 6, Winter 1992, pp. 27-44

There are similar risks in this tax reform environment. For example, the Joint Committee on Taxation's estimates for eliminating corporate tax expenditures other than deferral suggest that adjusting depreciation would permit about a 4 percentage point rate reduction in budget horizon.[21] A study by economists at the Department of Treasury estimated the long run revenue raised by depreciation (relative to GDP) would be 30% smaller than revenue raised in the budget window.[22] Another provision, capitalization of research and development costs, permits approximately another percentage point reduction and essentially disappears at the end of the ten year period. Thus, considering these two provisions. the long run revenue-neutral rate reduction would be around five percentage points compared to the seven percentage points in the budget window. Proposals have also been made to finance a territorial tax with a one-time revenue gain from a repatriation holiday, which would mean a long run revenue loss.[23]

Simplifying the Tax System

Simplification is often at the top of the list of tax reform goals but notoriously hard to achieve especially when trade-offs are made in other ways. One study concluded that TRA achieved little in simplification, with some provisions simplifying matters but others complicating them.[24] One way of reducing complexity in the individual tax is to reduce the number of itemizers, which would require cutting back on itemized deductions or increasing the standard deduction. Placing caps or limits on itemized deductions,

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[21] Based on data in a memorandum on revenue estimates from Thomas Barthold of the Joint Committee on Taxation, October 27, 2011. Note that the memorandum cautioned about the difference between long run effects and effects in the budget window..

[22] James B. Mackie III and John Kitchen, "Slowing Depreciation in Corporate Tax Reform," *Tax Notes*, April 29, 2013, pp.511-521. It would be even smaller if nominal growth rates were lower.

[23] See CRS Report R42624 *Moving to a Territorial Income Tax: Options and Challenges*, by Jane G. Gravelle

[24] Joel Slemrod, Did the Tax Reform Act of 1986 Simplify Matters? *Journal of Economic Perspective,*- Volume 6 , Winter 1992. pp. 45-57

however, would probably not reduce the number of itemizers but would add to complexity of those who do itemize. Reducing the number of different savings plans might also simplify matters. Attempts to scale back fringe benefits are, however, likely to add complexity.[25] For the corporate income tax, eliminating the production activities deduction might simplify compliance but instituting anti-base erosion rules with a territorial tax may complicate compliance with international tax rules.

[25] See discussion of simplification in CRS Report R42435, *The Challenge of Individual Income Tax Reform: An Economic Analysis of Tax Base Broadening,* by Jane G. Gravelle and Thomas L. Hungerford.