CHAPTER 3: THE GLOBAL MACROECONOMIC SITUATION

Chapter 3 of the *Report* assesses trends in the global economy, focusing on slowing growth around the world and the ramifications this will have for U.S. growth. Further, the *Report* underscores the benefits of U.S. trade with the world. Trade agreements such as the Trans-Pacific Partnership (TPP) provide comprehensive benefits including increased exports, higher gross domestic product (GDP), and more jobs across America.

The extensive economic problems around the world illustrate why the President's claim that America enjoys the "strongest, most durable economy in the world" is not a remarkable achievement. Also, regarding trade, several specific elements of the TPP agreement the Administration negotiated are cause for concern.

Finally, absent from the *Report* is any serious discussion of increasing international competitiveness and boosting growth by reforming America's tax system. Currently, the United States has the highest corporate tax rate in the OECD and is one of the few OECD countries with a worldwide tax system. Such an uncompetitive system has led many companies to move headquarters and capital overseas. Instead of seriously addressing the fundamental reforms required, the Administration instead proposes higher taxes and spending that would drive more companies offshore and hinder economic growth.

Chapter 3 of the *Report* focuses on economic growth throughout the world and trade policies that would boost both American and international growth. While the *Report* begins with a message from the President, echoing his State of the Union address, that America has "the strongest, most durable economy in the world,"[1] the litany of problems around the world gives context to why this is not surprising. In fact, claims about America's current economic strength relative to the rest of the world are much like taking pride in—as House Speaker Paul Ryan termed it—"the nicest car in the junkyard."[2]

Eurozone

Overall, 2015 was a tumultuous year for the Eurozone. The Eurozone's growth rate of 1.6 percent annually in the third quarter and its low year-over-year inflation rate of 0.4 percent belie the fluctuations which occurred in the Eurozone in 2015. While consumers benefitted from the decline in oil prices last year and the European Union (EU) is largely unaffected by the supply-side effects, the Eurozone continued to be adversely affected by economic slowdowns in China and other emerging markets, which accounted for nearly 25 percent of the area's exports.[3] It also remains to be seen how southern European countries will handle their high debt-to-GDP ratios and how countries like Greece will fare after the bailout negotiations of last year.

In the beginning of 2015, the Greek parliament could not elect a President and had to have a special election, which put Alexis Tsipras and the Syriza party in charge.[4] Tsipras and Syriza quickly called for an end to austerity and began demanding renegotiations of the previous rescue agreement. Starting in February 2015, the Greek government negotiated a four-month extension to Greece's bailout in exchange for lifting some anti-austerity measures.

In the middle of 2015, the European Central Bank (ECB) ended emergency funding to Greece. Facing a crisis, the Greeks closed banks and instituted capital controls, leading Greek voters to overwhelmingly reject the European Union's bailout terms in a July referendum. By June, Greece was facing a potential exit from the Eurozone and an impending bankruptcy.[5] In the end, Greece and its creditors agreed to a third bailout dependent upon the very tax increases and spending cuts that Syriza pledged to end when the party took power.[6]

Like many major central banks, including the Federal Reserve, the European Central Bank had trouble hitting its inflation target of 2 percent in 2015. Plagued by weak growth, the ECB pursued a strategy of large-scale asset purchases, commonly called "quantitative easing." In March 2015, the ECB began purchasing securities including central government bonds and bonds issued by recognized agencies, international organizations and multilateral development banks located in the euro area.[7] The monthly purchases of these assets—totaling 60 billion euros—were initially set to continue until March 2017, though the ECB left further action on the table. In December 2015 the Bank announced that the program would continue until "the Governing Council sees a sustained adjustment in the path of inflation that is consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term."[8]

Further stimulative attempts by the ECB occurred this year to boost the lackluster recovery the Eurozone has experienced in the wake of the 2008 financial crisis.[9] Current projections for Eurozone growth are currently 1.8 percent for the year,[10] and if the projection is met, it would be one of the stronger years since the end of the 2008 financial crisis.

Japan

As aforementioned in Chapter 2, the Japanese economy has been stagnating for years, slowed by an aging and shrinking population, outdated and rigid regulations, and increasing debt. In 2012, the Japanese legislature elected Shinzo Abe to be Japan's prime minister. Prime Minister Abe quickly laid out a new economic plan, nicknamed "Abenomics," to revive Japan's stagnating economy. Abenomics had three principles or "arrows": accommodative monetary policy, expansionary fiscal policy, and structural reforms.

The monetary arrow set a 2 percent inflation target for the Bank of Japan (BoJ) to achieve through monetary policy. Financial markets were stunned in late 2014 when the BoJ announced it was pursuing stepped-up quantitative easing to shake the deflationary mindset.[11] Even with quantitative easing, the BoJ still had not achieved its 2 percent inflation target as of January 2016, leading the BoJ governors to vote 5-4 to begin using negative interest rates.[12]

The fiscal policy arrow first involved a massive stimulus package focused on infrastructure and private investment in 2013 with supplementary fiscal measures in 2014 and 2015.[13] Although the *Report* highlights the recent labor negotiations and "flexible" stimulus aspects of this arrow, absent is any mention of Prime Minster Abe's efforts to lower the corporate tax rate. Prime Minster Abe has been clear he wants to lower Japan's corporate tax rate of 35.6 percent, the second highest in the G-7 countries behind the United States, to spur investment and encourage more foreign investment.[14] However, Japan's fiscal measures have to be limited because its public debt is approaching 245 percent of GDP, the highest among countries in the OECD.[15]

The final arrow of Abenomics promised structural reforms to Japanese markets. As aforementioned, Japan has both a shrinking population and labor force. Prime Minister Abe wants to spur population growth and encourage more women to join the workforce. Besides labor market reforms, Abenomics hopes to liberalize the agricultural market by curtailing government subsidies and opening up Japan to the international market through trade agreements such as the Trans-Pacific Partnership.[16]

Growth effects from Abenomics have yet to materialize, and slow growth continues. Japan's GDP contracted from the second quarter of 2014 through the second quarter of 2015.[17] After returning to growth temporarily, Japan again contracted by 1.4 percent in the fourth quarter of 2015.[18] The opportunities from structural reform have yet to give Japan the boost it was looking for, and larger government spending has increased the public debt-to-GDP ratio to nearly 250 percent. The *Report* obliquely refers to Japanese debt trends and demographics, but it fails to make parallels to the similar challenges facing America, which are also discussed in Chapter 2 of this *Response*.

China and Other Emerging Markets

The four largest emerging market economies are Brazil, Russia, India, and China (BRIC). All four were part of the ten largest countries by GDP in 2014.[19] As the *Report* notes, India and China accounted for half of the underperformance of the G-20 economies compared to 2010 projections.

China's economy grew 7.3 percent in 2014 and only 6.9 percent last year after years of double-digit growth—its lowest rate of growth since 1990 according to official data. Much of the deceleration has been concentrated in the country's industrial and construction sectors. China's industrial sector has been slowing over the past few years, weighed down by weak demand from many of its trading partners and appreciation in the Chinese yuan.[20] Slowing demand and yuan appreciation led to a surprising devaluation by the People's Bank of China in August that stunned financial markets.[21]

Over the past few years, China's housing market experienced a severe contraction. In January 2014, China's year-over-year housing starts were growing at almost a 10 percent rate. Growth in housing starts began to slow in September 2014 and continued for 12 months. Fortunately, housing starts began to rebound at the end of 2015.[22]

Meanwhile, other BRIC countries are experiencing slow growth or outright recession. Brazil is in the midst of its deepest recession since 1901. Analysts estimate the Brazilian economy contracted by 3.7 percent last year and project it will contract by roughly 3 percent in 2016.[23] Inflation in the Brazilian economy rose to 10.7 percent in 2015, its highest rate in 13 years.[24]

Russia is experiencing similar problems, albeit for different reasons. According to official preliminary estimates, its economy contracted 3.9 percent in 2015.[25] While gridlock and corruption may play a part, low oil prices and international sanctions appear to continue weighing on the Russian economy. The International Monetary Fund (IMF) and the World Bank project further contraction in 2016.[26] Although the Central Bank of Russia has been able to lower inflation, it remains elevated at 12.9 percent.[27]

India is the outlier among the BRIC economies. India experienced year-over-year growth of 7.3 percent[28] with an inflation rate of 5.6 percent in December.[29] Unlike many of the other emerging markets, low oil prices have been a boon for India since it imports so much crude oil. Although headline growth is solid, the numbers mask an economy in need of reforms. Prime Minister Modi has been trying to push through land and labor reforms to boost employment and investment, but the pace has been slower than anticipated.[30]

Oil

A common threat to oil-producing emerging markets is the precipitous decline in the price of crude oil. Although cheaper oil helps consumers, it harms the bottom line of oil producers, which includes many emerging market economies. While the *Report* briefly mentioned declining oil prices, it did not discuss root causes. The fall in the price of oil can be traced to three main causes: the U.S. fracking revolution, weak global demand, and a glut of crude oil exacerbated by high levels of production by the countries that make up the Organization of Petroleum Exporting Countries (OPEC)—primarily Saudi Arabia.

As detailed in Chapter 6, the fracking revolution in the United States has fundamentally changed the global oil market. For the first time in decades, there is a substantial source of incremental supply outside of OPEC that expanded quickly at costs far below the $100 per barrel price that had prevailed. Even as the oil price fell, technological innovation continued to reduce shale oil extraction costs, which made the U.S. production rate surprisingly resilient.[31]

Technology is not the only development that will make U.S. oil production more resilient; recent policy changes are helping as well. The *Report* makes no mention of last year's removal of America's 40-year-old oil export ban.[32] Independent analysis has shown this will further increase U.S. production and investment through 2030 while lowering prices for American consumers.[33] Further analysis by the U.S. Energy Information Administration confirmed that gasoline prices either will not change or will decline as production increases.[34]

Another factor in the falling price of oil is the economic deceleration in China and other countries that has considerably weakened global demand. This decrease has hit the U.S. energy sector especially hard since these struggling countries have not been able to absorb the incremental supply as expected. To the extent stock traders interpret an oil price decline as reflecting weakening demand and infer that economic growth is slowing, stock prices tend to go down. However, different forces are acting on demand and supply simultaneously, and it can be difficult to discern the reasons for, and implications of, oil price movements.

Finally, the international boycott of Iranian oil has come to an end, and it is unclear how much additional supply will enter the world market as a result. Saudi Arabia has been increasing its rate of production in the face of falling oil prices to prevent U.S. firms and the Iranian government from gaining market share.[35]

International Trade

In general, America benefits from entering into trade agreements. Because the United States already has open markets and low tariffs, trade agreements generally have the effect of further opening foreign markets for American goods and services while requiring relatively little sacrifice on the part of the United States. Businesses benefit when new foreign markets and customers become available. They also benefit from lower input prices. Workers benefit from trade through greater demand for their products and the higher wages that accompany export-related jobs. Additionally, trade benefits consumers through lower prices due to reductions in tariffs and restrictions.

Last year, Congress enacted legislation to reauthorize Trade Promotion Authority (TPA) for the first time since 2002. TPA provides the President with the necessary authority to negotiate trade agreements with other nations. It also reaffirms the special function performed by Congress in determining U.S. trade policy. Under the U.S. Constitution, the President can negotiate trade agreements, but only Congress can approve or reject an agreement and enact the terms of the agreement into U.S. law. TPA set forth the priorities of Congress relative to trade policy, and it provides the President with instructions on how to conduct trade agreements that will engender congressional support. TPA also establishes a detailed process for congressional review and consideration of trade agreements. These provisions guarantee that our system of checks and balances remains intact with regard to international trade policy.

Enactment of TPA has been particularly important for the President's negotiations relative to the Trans-Pacific Partnership (TPP) agreement. As mentioned in the *Report*, the TPP is a proposed Asia-Pacific free trade agreement involving 12 countries, including the United States, Canada, Japan, Australia, New Zealand, Mexico, Vietnam, Singapore, Malaysia, Brunei, Chile, and Peru. The TPP offers tremendous potential for new markets and increased exports for U.S. businesses. According to the International Trade Administration, goods exported to TPP countries support 3.1 million U.S. jobs. Services exports to these countries support an additional 1.1 million U.S. jobs. Upwards of 177,000 U.S. businesses export goods to TPP countries, and 97 percent of those are small- and medium-sized businesses.[36]

A strong TPP agreement holds great promise in terms of increasing America's economic and strategic influence in the region. Indeed, the Administration has positioned the TPP as the key economic component to a "rebalancing" in the Asia-Pacific Region relative to China. Lawmakers on both sides of the aisle see the TPP as a crucial measure to ensure that America establishes the rules of the road in the new global economy, rather than ceding that role to China. The TPP offers the United States the opportunity to both generate new, high-paying jobs here at home and establish an economic framework that will benefit American interests over the long term.

Nonetheless, Congress will only approve an agreement that achieves the standards prescribed in TPA. Unfortunately, at this stage it seems the President has fallen short in the negotiations with regard to a number of significant elements. For example, the President has failed to achieve adequate intellectual property protections for innovative American pharmaceuticals.[37] Such protections are foundational for U.S. trade and must be robust to give American businesses the confidence to sell their products abroad. The current deal also fails to protect proprietary data stored by financial services companies. It also inexplicably denies market access for certain U.S. goods. Hopefully, the Administration will choose to address these concerns prior to any congressional action on the TPP agreement.

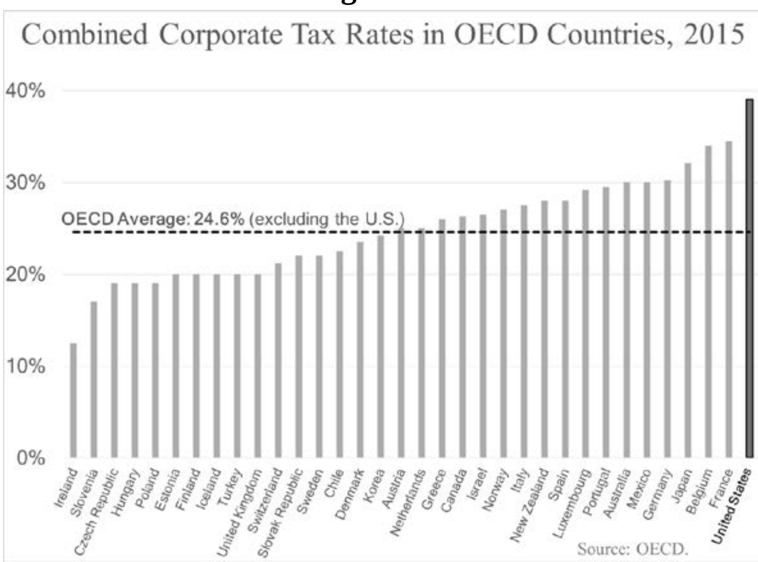
In a positive development, Congress recently enacted the largest legislative reform in customs and enforcement policy in nearly 20 years. The *Trade Facilitation and Trade Enforcement Act* authorizes the U.S. Customs and Border Protection and modernizes operations for more efficient flow of trade across the border.[38] It also establishes robust tools that will strengthen enforcement of U.S trade laws and better ensure a level playing field.

International Tax Competitiveness

Last year's *Economic Report of the President* contained an entire chapter dedicated to business tax reform and its potential to boost economic growth.[39] In addition, the budget submitted by the Administration last year contained a reserve fund for "business tax reform that is revenue neutral in the long run."[40] The reserve fund for business tax reform is missing from the President's FY2017 budget. In fact, the Administration's budget plan now represents a net tax increase on both businesses and individuals that totals $2.8 trillion. This is hardly a constructive first offer to spur bipartisan action on tax reform. Similarly, this year's *Report* seems to indicate a lack of enthusiasm for reforming the tax code, since it only contains passing references to business tax reform. In fact, the largest discussion in the *Report* is a single paragraph in Chapter 2.[41]

Any discussion of the global macroeconomic situation must address the severe uncompetitive nature of the U.S. tax system compared to those of our trading partners. Among the 34 advanced economies in the OECD, the U.S. corporate rate is the highest at 39 percent, including the 35 percent Federal rate and state taxes (Figure 3-1).[42] The President's FY2017 budget contains a brief reference indicating that it still endorses the Administration's past framework for business tax reform, which proposed a Federal corporate rate of 28 percent.[43] While this would be an improvement, it falls short of the 25 percent rate supported by many in Congress. A corporate income tax rate of 25 percent (not including state taxes) would be closer to the average of other developed countries, while a 28 percent rate would still place the U.S. rate among the highest.

Figure 3-1

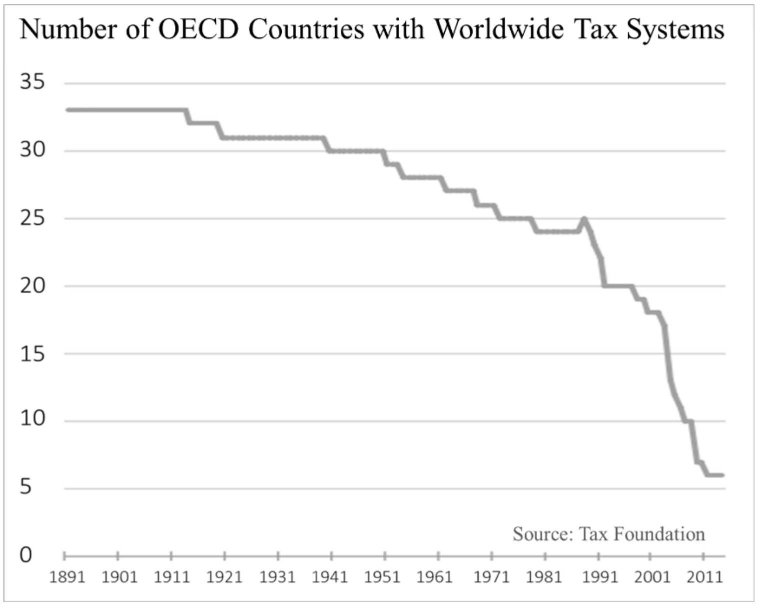


Additionally, America is facing new competitive pressures because many of our trading partners have adopted "patent boxes" or "innovation boxes," which are also discussed in Chapter 5 of this *Response*. These arrangements tax the income from intellectual property at rates far below the statutory rate of the host country, and could entice companies to locate valuable intellectual property and related jobs overseas.

International Tax Systems

In addition to facing the highest corporate rate in the developed world, U.S. businesses are burdened with an uncompetitive worldwide tax system rather than a territorial system. Territorial systems allow active income earned overseas to be brought back to the home country with little or no tax. In contrast, the worldwide system of the United States is an outlier, subjecting all income of companies to U.S. tax, regardless of where in the world it is earned. Because the tax is triggered when the profits are brought back to the United States, companies have a strong incentive to leave earnings overseas. This creates a "lock-out" effect, which results in reduced levels of investment by these companies in the United States. Figure 3-2 below illustrates the trend of our international competitors choosing to adopt territorial tax systems, while the United States has been left behind.

Figure 3-2



In testimony last year before the Senate Finance Committee that echoed past testimony before the JEC, Laura D'Andrea Tyson, former CEA Chair during the Clinton administration, argued that the United States should move to a territorial system. This would allow U.S. multinationals to compete more effectively in foreign markets, which comprise roughly 80 percent of the world's purchasing power.[44] However, the Administration instead clings to international tax reform that it describes as "hybrid," in which an immediate 19 percent minimum tax would be imposed on all new foreign earnings of U.S. companies going forward.[45] In her testimony, Tyson argued forcefully against the competitive disadvantage of such an approach, which she explained would amount to an effective rate of at least 22.4 percent and incentivize American companies to move their headquarters overseas.[46]

Corporate Inversions

In a recent speech before the New York Bar Association Tax Section, CEA Chairman Furman highlighted the disturbing trend of U.S. companies merging with foreign companies and moving their headquarters to the lower-taxed jurisdiction, known as "corporate inversions."[47] However, the Administration's proposed legislative solution to corporate inversions is deeply flawed.

Under current law, an "inverted" company continues to be taxed as a U.S. corporation if 80 percent or more of the shareholder ownership does not change after the inversion, unless there are "substantial business activities" in the foreign jurisdiction.[48] The Administration's anti-inversion proposal would lower the 80 percent threshold of shareholder ownership to 50 percent, effectively meaning that foreign ownership would have to dominate following the merger or acquisition in order for the new entity to change tax headquarters.

Requiring the American share of the business to be smaller than the foreign share would create several unintended consequences. For example, this could encourage larger U.S. companies to splinter into smaller spin-offs that would then be acquired by more dominant foreign competitors. It would also make American companies attractive takeover targets for large foreign multinationals, a phenomenon that is already occurring.[49] The President's framework would give a greater advantage to foreign competitors than already exists. While foreign competitors could be nimble with their investments and already enjoy more favorable tax systems, U.S. companies would be stuck in an even more uncompetitive tax system.

In addition to the 50 percent of shareholder ownership threshold, the Administration would also tax inverted companies as U.S. corporations if the "management and control" of the company is primarily in the United States. This test would chase high-quality management jobs outside the United States, as domestic and foreign companies would respond by moving jobs. This concern was echoed by Senator Charles Schumer when he spoke about legislation similar to the Administration's proposal.[50]

Further, while the Administration's plan is aimed at trapping American-headquartered companies in the U.S. tax system, the proposal is likely to discourage new companies from choosing American headquarters. Every day, entrepreneurs launch new companies and decide where to place the headquarters. Selecting a location that attempts to trap its businesses in an uncompetitive tax system indefinitely would be illogical.

Like the United States, Great Britain underwent a period of "headquarter flight," but responded as the United States should: by lowering its corporate tax rate and moving to a competitive international tax system. As a result, companies have returned to Great Britain and new companies are incorporating there.[51] The best solution for stemming inversions is to treat the root of problem—an uncompetitive tax system—rather than enact punitive measures to treat the symptoms.

Using New Taxes for Spending Programs Rather Than Competitiveness

The President's proposed framework would impose a 14 percent tax on existing earnings of American companies invested overseas, known as "deemed repatriation." However, rather than using this revenue to transition to a more competitive international tax system, the Administration would use these revenues solely to pay for infrastructure spending, as explained more fully in Chapter 6 of this *Response*. The President's proposed tax is substantially higher than rates outlined in other reform plans, such as the one introduced by then-House Ways and Means Chairman Dave Camp in the last Congress, and does not contribute to American companies' competitiveness in the world marketplace.

Passthrough Businesses

While the Administration has proposed lower tax rates for C corporations, no similar rate reduction is offered to the 95 percent[52] of businesses that pay taxes at the individual level rather than corporate level, known as passthrough businesses. The vast majority of small businesses are organized as passthroughs, and as such, a lower corporate rate would be of little help. When President Obama took office, the top Federal tax rate paid by small businesses was identical to the top rate paid by large corporations, 35 percent. However, because of ACA taxes and the President's insistence on raising the top individual rate and imposing other penalties, the top rate paid by small businesses is now 44.6 percent.[53]

The President's framework would put small businesses in an even worse position. If certain business tax preferences are eliminated, and the proceeds used only to lower the corporate rate, then many small businesses will face even higher effective tax rates. CEA Chairman Furman's recent speech, as referenced earlier, argued that higher passthrough rates are justified because C corporations face a double tax, at both the corporate and shareholder level, while passthroughs generally pay only a single layer of tax. Such a statement seems to suggest that the effective tax rates of passthroughs must already be far lower than the rates paid by double-taxed corporate taxpayers. However, CBO has determined that even with just a single level of tax, passthrough businesses only enjoy a four percent lower effective tax rate of 27 percent, compared to the C corporation effective rate of 31 percent.[54]

Under the President's framework, C corporations would experience a top rate reduction from 35 percent to 28 percent, while small businesses would be taxed at a top rate of 44.6 percent and lose many of the tax preferences that lower their effective rate.

Chapter 5 of the *Report* discusses technology and innovation, and one section laments the decline of "business dynamism" and start-ups.[55] Ironically, while the *Report* acknowledges that barriers to market entry play a role in discouraging start-ups, the Administration does not seem to recognize that rising tax burdens on small businesses may be a source of declining entrepreneurship, representing another significant market barrier.

Lost Opportunities for Pro-Growth Reform

In the last Congress, policymakers seemed focused on comprehensive tax reform to boost economic growth and fix our broken tax system for businesses, families, and individuals alike. Unfortunately, the President's insistence on massive tax increases on the individual side of the tax code diminished possibilities for fundamental reform. Then discussions turned to business tax reform, since the Administration had indicated openness to revenue neutrality in that context. However, the Administration's refusal to address the tax rates paid by small businesses further limited the possibility of reform.

More recently, the conversation narrowed to international tax reform, a subset of business tax reform. However, the President's recent budget submission with large net tax increases on the business side of the code seems to destroy the possibility of either broad business tax reform or even limited international tax reform occurring during the current Administration. Declining prospects for reforming the tax code in a holistic way will only continue to further disadvantage American businesses competing abroad and at home while making foreign headquarters more attractive. The Administration's apparent waning enthusiasm for reform also represents a tragic lost opportunity to boost economic growth and create more jobs at a time when the country is in dire need of both.

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