CHAPTER 8: THE MISSING CHAPTER ON TAX REFORM

- Chapter 3 of the *Report* emphasizes tax policy as a means of redistributing income among taxpayers, but it ignores the pressing need to overhaul the extraordinarily burdensome tax code.

The *Response* seeks to fill the void by addressing:

- How comprehensive tax reform will spur economic growth, boosting American jobs and investment;
- How our high corporate rate and outdated international rules have made American firms less competitive;
- Why tax reform that fails to address individual tax rates will penalize small businesses;
- Why heavy taxation on savings and investment, estate taxes, and slow cost recovery dampens growth; and
- How simplifying the tax code could relieve businesses, families, and individuals of an unnecessary burden.

THE CONNECTION BETWEEN TAX REFORM AND ECONOMIC GROWTH

Tax policy affects individuals, businesses, and the broader economy in ways that either help or hinder American prosperity. An economy operating at full potential needs its working age population in the workforce (labor supply), businesses willing and able to hire and equip workers with the best equipment and know-how (capital investment), and technological innovation that empowers workers to produce more per hour (productivity). Given the declines in labor force participation and sluggish productivity growth during the Obama Administration described in Chapter 2 combined with tax increases on capital that will be

discussed in this chapter, the current forecast of slow economic growth should not be surprising.

As explained by the Joint Committee on Taxation (JCT), tax policy affects economic growth in several ways. For example, lowering the tax rate paid by individuals allows them to keep more of the money they earn, thus increasing the incentive to work. Similarly, lowering the tax rates paid by businesses allows them to invest more in their workers by purchasing equipment that will make employees more productive.[i] That higher productivity leads to higher wages for workers.[ii]

Tax policy can also distort individual behavior and the broader economy by rewarding certain types of activities or industries over others. In an efficient economy, taxpayers would make decisions based on what is best for their business or family, rather than what produces the best tax outcome.

In addition, tax policy can have a direct impact on the location of investments. If the domestic tax climate makes it less profitable to invest in the United States, then businesses have a greater incentive to invest in and possibly even relocate to other countries with more favorable tax systems. A tax code that makes America the best place in the world to work, invest, and start a business is a key ingredient in strong economic growth.

A Lost Opportunity for Pro-Growth Reform

Four years ago in the 113th 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 possibility of fundamental reform was diminished by President Obama's insistence on massive tax increases on the individual side of the tax code, where the rates and rules affect not only every individual taxpayer, but also the vast majority of businesses. Discussions then pivoted to reforming the business side of the tax code in isolation because the Administration had indicated openness to revenue neutrality in

that context.[iii] Unlike the 2017 *Report's* single paragraph[iv] on the subject, the 2015 *Report* contained an entire chapter dedicated to business tax reform and its potential for spurring economic growth.[v] However, the Administration's refusal to address the high individual tax rates paid by small businesses limited prospects for business tax reform.

Later in the 114th Congress, the conversation narrowed again to international tax reform, a subset of business tax reform addressing the overseas tax climate for American companies. Unfortunately, President Obama's Fiscal Year 2017 budget plan with large net tax increases on the business side of the code doomed the possibility of business tax reform or even more limited international tax reform during his tenure.[vi] Recognition that taxes should be reformed in a holistic way that addresses the needs of individuals and all types of businesses, both domestically and abroad, is the key to boosting economic growth and making the tax code work for Americans.

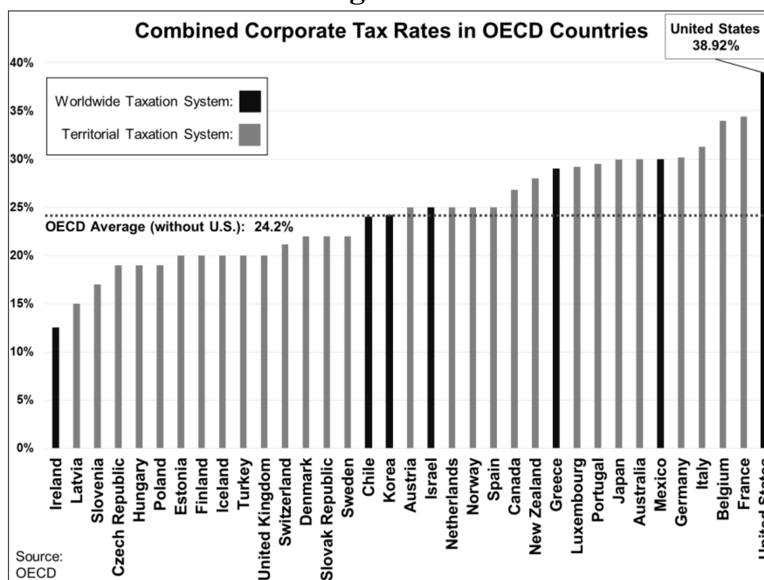
The Highest Corporate Tax Rate in the Developed World

Members of Congress from both parties as well as the Obama Administration have acknowledged that the U.S. corporate tax rate is too high and internationally uncompetitive. The decades-old corporate rate reduction in the *Tax Reform Act of 1986* lowered the U.S. rate so that it would be one of that era's lowest internationally.[vii] Since then, America has lost ground by standing still while our global competitors moved aggressively to lower their corporate rates and attract investment to their shores. Today, the U.S. corporate rate is the highest in the developed world.

Among the 34 advanced economies in the OECD, the U.S. corporate rate tops all others at nearly 39 percent, including both the 35 percent Federal rate and average state taxes (see Figure 8-1).[viii] President Obama's framework for business tax reform proposed a Federal corporate rate reduction from 35 percent to 28 percent.[ix] While this would have been an improvement, it would

have left the U.S. rate still among the highest and far above the 24.2 percent average rate enjoyed by our OECD competitors. In contrast, America's competitive position would be dramatically improved by the 20 percent corporate rate in the tax reform framework contained in Speaker Ryan's *Better Way* plan.[x] Further, President Trump proposed a top business rate of 15 percent for all sizes and types of companies.[xi]

Figure 8-1



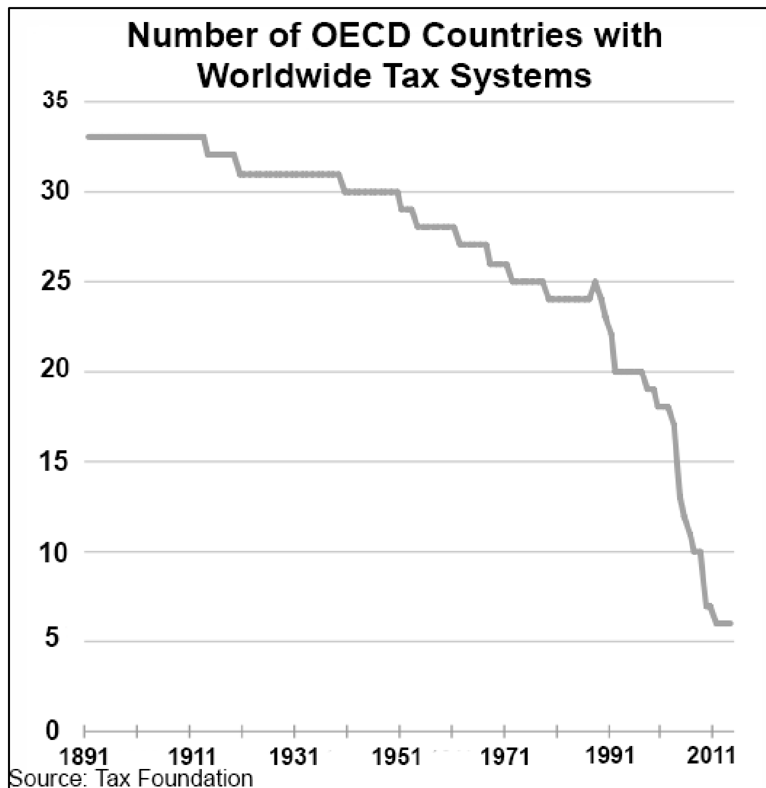
Clearly, the need for bold rate reduction and reform has become even more urgent with the proliferation of patent boxes, or innovation boxes, among our trading partners. These arrangements tax the income from intellectual property at rates far below the statutory rate of the host country, and can entice companies to locate valuable intellectual property and related jobs overseas.[xii]

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, America's worldwide system subjects all income to U.S. taxation, regardless of where it was earned. As illustrated in Figure 8-1 by the relatively few dark bars in the graph, America is an outlier in taxing worldwide earnings and has the OECD's highest tax rate. The tax is triggered when profits are brought back to the United States, giving companies 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. The other six OECD countries with worldwide systems have the advantage of significantly lower corporate rates. Figure 8-2 shows the growing trend to territorial tax systems.

Figure 8-2



Rather than proposing a competitive territorial system, the Obama Administration proposed international tax reform that it described as "hybrid," in which an immediate 19 percent minimum tax would be imposed on all new foreign earnings of U.S. companies.[xiii] Former CEA Chair during the Clinton Administration, Laura D'Andrea Tyson, criticized both the Obama Administration's failure to adopt a territorial approach and the 19 percent minimum tax, which she pointed out would amount to an effective rate of 22.4 percent because of its disallowances of other taxes paid.[xiv] In contrast, the *Better Way* tax reform plan calls for a purely territorial system with no international minimum tax so that American companies are free to use foreign earnings to expand investment and jobs in the United States without penalty.[xv]

The exceedingly high U.S. corporate rate and uncompetitive international taxation creates a strong incentive for American companies to move their corporate headquarters overseas to more favorable tax climates. The Obama Administration attempted to address this practice—also called a corporate inversion—through a series of punitive legislative proposals and regulations."[xvi]

Alternatively, the experience in Great Britain provides a lesson on how pro-growth tax reform can more effectively stem the tide of inversions and entice inverted companies to return. 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 an internationally competitive tax system. As a result, companies have returned to Great Britain and new companies are incorporating there.[xvii] The best solution for stopping the loss of U.S.-headquartered companies is to treat the root of problem—an uncompetitive tax system—rather than enact punitive measures to treat the symptoms.

Passthrough Businesses and the Individual Tax Rate

While the Obama Administration proposed a lower tax rate for C corporations that pay the corporate tax, no similar rate reduction

was offered to the 95 percent of businesses that pay taxes at the individual level rather than corporate level, known as passthrough businesses.[xviii] The vast majority of small businesses are organized as passthroughs, and as such a lower corporate rate would be little help to them.

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, with the combination of ACA taxes and President Obama's insistence on raising the top individual rate and reviving other penalties, the top rate paid by small businesses is now 44.6 percent.[xix] Significantly, the claim in Chapter 3 of the *Report* that the hike in the top individual tax rate and capital gains rate was simply a return to Clinton-era rates is false, since it ignores the impact of the ACA's 3.8 percent tax on investment income.[xx]

The President's reform framework would have put small businesses in an even worse position. If certain business tax preferences were eliminated—a common feature of President Obama's and most reform frameworks—and the proceeds used only to lower the corporate rate, then many small and mid-sized passthrough businesses would have faced an even higher effective tax rate. The 2015 *Report* argued that higher passthrough rates are justified because C corporations face a double tax at both the corporate and shareholder level on dividends and capital gains, while passthroughs generally pay only a single layer of tax. However, CBO has found that passthrough businesses pay an effective tax rate of 27 percent, only 4 percentage points lower than the C corporation effective rate of 31 percent.[xxi]

Under President Obama's framework, C corporations would have experienced a top rate reduction from 35 percent to 28 percent, while small businesses would have been taxed at a top rate of 44.6 percent and lost many of the tax preferences that lower their effective rate. This could have led to the worst of both worlds for businesses, as President Obama's preferred corporate rate would

not have been low enough to make large corporations competitive, while the tax burden on smaller companies would have increased.

Policies aimed at penalizing the wealthy through higher individual tax rates often hit business income, which in turn lowers opportunities for workers, as explained above. In fact, the Obama Administration's own Treasury Department found that almost 80 percent of taxpayers in the highest one percent of income earners are business owners.[xxii]

Double Taxation of Savings and Investment

Another Obama Administration tax increase aimed at the wealthy raised the top capital gains rate from 15 percent to 23.8 percent when ACA taxes are included.[xxiii] President Obama also proposed another hike in the top capital gains rate to 28 percent.[xxiv] As this section makes clear, America already has the second-highest integrated capital gains rate in the developed world. Further, there are sound economic and policy justifications for keeping capital gains taxes low.

Under the current tax code, the published tax rates for long-term capital gains and qualified dividends are lower than the tax rates on ordinary income. In reality, however, capital gains and dividends face a hidden double tax that often exceeds ordinary income rates. The dividends companies pay to shareholders are first taxed at the corporate level. Shareholders also pay the corporate tax when they sell stock and consequently receive a reduced capital gain. In addition, whenever a taxpayer buys stock, land, or another capital asset, the income used to purchase the asset was likely taxed at the individual level already.

A 2015 Ernst & Young study explains the economic damage caused by the double tax:

> *The double tax affects a number of economic decisions. It lowers the after-tax return of equity-financed corporate investment, which discourages*

> *capital investment and results in less capital formation. With less capital available for each worker to work with, labor productivity is lowered, which reduces the wages of workers and, ultimately, Americans' standard of living. In addition to discouraging capital formation generally, the double tax also distorts a number of other economic decisions.*[xxv]

Inflation also operates as a hidden tax on capital gains. Ordinary income, such as wages or salaries, is generally taxed in the year it is earned. Capital gains are not taxed until the gain is realized (generally when the asset is sold). This delay can lead to pernicious effects. Economist Kyle Pomerleau illustrated this point using a hypothetical saver: this saver may purchase stock for $89.18 in 2000 and sell it in 2013 for $100 dollars. Nominally, this saver earned $10.82 in capital gains profit. At a 23.8 percent capital gains rate, the saver would pay $2.57 in taxes. However, because of inflation, the $100 in 2013 is worth less than the original $89.18. In real terms, the saver paid $2.57 in taxes on a capital loss of $4.88, essentially an infinite effective tax rate.[xxvi]

The level of the capital gains rate can have a very strong influence on taxpayer behavior and the economy as a whole. Taxpayers can avoid paying a high capital tax by holding onto their assets, which inhibits capital from moving to its highest valued uses, dampening economic growth. When capital gains taxes are low, taxpayers do not face as strong a disincentive to sell assets. For example, after the capital gains tax rose to 28 percent in 1987, sales of capital assets sank and remained depressed until Congress lowered the capital gains rate to 20 percent in 1997.[xxvii] Following this cut, capital gains tax revenues ballooned and helped balance the budget.[xxviii]

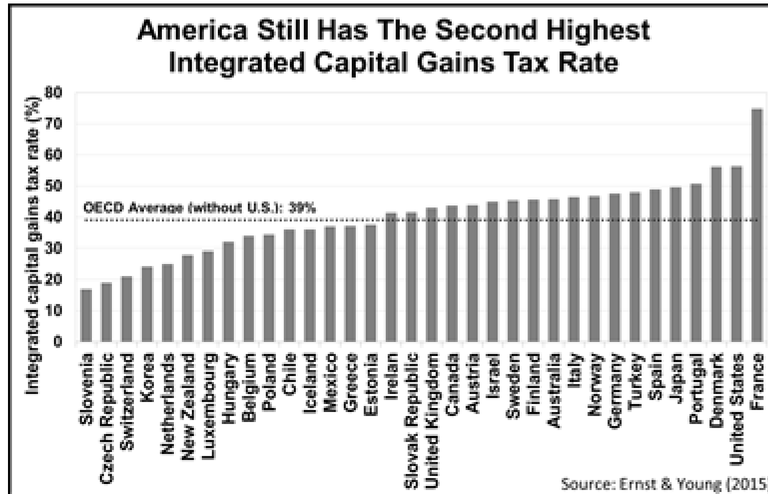
This raises the question of what capital gains rate would generate the most tax revenue. The JCT estimates that we are already near the revenue-maximizing rate, and that is perhaps why the Obama

Administration's proposed additional hike went no further than 28 percent. Other economists, such as Ohio State University economist Paul D. Evans, have come to a very different conclusion. Using statistical analysis through the years 1976 to 2004, Professor Evans estimated how taxpayers would respond to increasing capital gains taxation and found the revenue-maximizing rate would be much closer to 10 percent.[xxix] This implies that tax reform could raise more revenue and free up more capital for the economy.

The Tax Foundation modeled President Obama's proposed 28 percent capital gains rate and found that it would reduce GDP by 0.8 percent in the long run and result in lost revenues of over $11 billion. Even worse, it would reduce the capital stock (tools, machines, factories, buildings etc.) by over 2 percent and lower wages by over 0.65 percent.[xxx] In an ever competitive world, American workers cannot afford to be less productive.

Regarding international competition, the 2013 increase in the capital gains tax rate was opposite the historical trend among our OECD trading partners. Using an integrated capital gains rate that accounts for the corporate and individual double tax on capital gains, the United States ranks second in severity (Figure 8-3). Even adding Brazil, Russia, India, and China, our rate remains the second highest.

Figure 8-3



In 2000, the average OECD integrated capital gains rate was 45.2 percent. By 2014, the other OECD countries had an average integrated capital gains rate of 39.7 percent, over five percentage points lower than in 2000. Japan, the world's third-largest economy, reduced its top integrated rate by 6 percentage points. Canada reduced its top rate almost 20 percentage points from over 63 percent to just under 44 percent.[xxxi] Over that same time, the United States' integrated capital gains rate declined from 54.5 percent following the 2003 capital gains rate cut, and then rose to a level of 56.3 percent. This is not only a net increase of almost 2 percentage points domestically; it also places the U.S. rate more than 16 percentage points above the OECD average.[xxxii]

Rather than a separate rate structure for capital gains, the *Better Way* tax reform plan would tackle double taxation by allowing taxpayers to deduct half of their income from savings (capital gains, dividends, interest, etc.) from taxation. The other half would be subject to the ordinary income tax rates. With the addition of the plan's top individual rate of 33 percent, this would effectively lower the top capital gains rate from the current 23.8 percent to 16.5 percent. Additionally, the *Better Way* plan also reduces the corporate tax rate from 35 percent to a flat 20

percent.[xxxiii] This reform would reduce the top integrated rate from a punishing 56.3 percent to roughly 41 percent, an over 15 percentage point decrease that would place the United States only slightly above the OECD average.[xxxiv] The Tax Foundation's analysis of the corporate rate and capital gains rate reductions in the *Better Way* found that these two changes would boost GDP growth by 2.0 percentage points in the long run.[xxxv]

Cost Recovery and Investment

Under the current tax code, a business generally cannot deduct the full cost of equipment in the year it is purchased. Instead, a company can deduct the cost from taxes only over a number of years under applicable depreciation schedules. In essence, the tax code requires businesses to defer recognition of a substantial portion of equipment cost for purposes of reporting their income, so that the income reported and taxed in a given year exceeds the actual cash profit earned. This tax treatment discourages businesses—particularly those that depend on cash flow—from purchasing new equipment. It also requires business owners to track when an asset was purchased, which depreciation schedule applies to particular assets, and how much has already been deducted from the purchase price.

Expensing allows businesses to recognize the full cost of an asset in the tax year it is purchased when reporting its income. With expensing, businesses pay less tax early on after they purchase an asset and can recover its cost faster. Later on, their tax payments will be larger as there is no depreciation to deduct from the earnings. Faster cost recovery means breaking even sooner on an investment, which encourages more investment.

In 2015, Congress took the welcome step of making recent levels of allowable expensing for small businesses permanent,[xxxvi] a move based on legislation introduced by the current JEC Chairman, Rep. Pat Tiberi.[xxxvii] This greatly improves certainty, encourages investment, and relieves paperwork burdens on small

businesses. However, the tax code still limits the amount a business may expense, the type of assets that can be expensed, and the total amount of asset purchases a company can make and still qualify for small business expensing.[xxxviii]

In order to boost economic growth, Congress has also passed temporary extensions of bonus depreciation, under which companies of all sizes can deduct a large portion of the purchase price in the first tax year. However, bonus depreciation is currently scheduled to phase down from an extra 50 percent deduction in the year of purchase to 30 percent in 2019, after which it will expire.[xxxix]

In the last Congress, the current Committee Chairman introduced legislation that would have made 50 percent bonus depreciation permanent.[xl] The Tax Foundation estimates that this policy would improve economic growth by 1 percent in the long run.[xli]

The *Better Way* tax reform plan takes this pro-growth policy a step further by allowing full expensing for all business assets purchased domestically.[xlii] The Tax Foundation estimates that this element of the plan alone would boost GDP by 5.4 percent over a decade and add over a million new jobs.[xliii]

The JCT has also acknowledged the growth potential of policies that allow businesses to recover the costs of their investments more quickly. In 2012 testimony before the Senate Finance Committee, JCT noted that while the extent of growth resulting from expensing differs in the economic literature, "changes in taxes do have a noticeable impact on investment."[xliv] Faster cost recovery is one of the most powerful policies used to boost growth and productivity.

While a change from depreciation to expensing appears to have a large impact on revenue in the short term, over the long run much of the revenue will be recouped as the depreciation deductions that would have been taken in later years disappear. Additionally, the positive growth effects from faster cost recovery can mitigate the

revenue loss in the first decade. For example, the Tax Foundation estimates that without accounting for growth effects, moving to expensing would reduce Federal revenues by $2.2 trillion dollars. When the macroeconomic effects are included, the loss drops to $883 billion.[xlv] The loss will drop even further in the second decade as write-offs from the old depreciation system fully disappear. Thus, while the loss to the Treasury from moving to expensing would be largely temporary, the benefits to the economy and workers from greater levels of investment would be lasting.

Should Death Be a Taxable Event?

The current tax system treats a taxpayer's death as a taxable event. While an exemption is provided for assets worth $5 million ($10 million for spouses) or less, indexed for inflation, the tax code imposes an estate tax of up to 40 percent on the remaining assets of the deceased.[xlvi] The exemption amounts may seem large at first glance, but the estate tax has a disproportionate impact on family-owned businesses and farms, many of which may appear rich in land, equipment, or inventory, but in reality are cash-poor. As a result, the estate tax often breaks up businesses or family farms by forcing the sale of land or other assets to pay the tax.

In 2011, economist Stephen J. Entin authored a report on the economic effects of the estate tax that concluded the tax was so devastating that it reduced, rather than raised, Federal revenue on a dynamic basis:

> *In reality, the estate tax is so destructive on investment and employment that it reduces Federal revenue over time by eroding the tax base. Our report takes this into consideration by applying a model of the estate tax's effect on capital formation, GDP, wages, and other income to calculate the budget effect of reducing the tax,*

allowing for the increase in GDP and other revenue. [xlvii]

Another analysis examined the damaging economic effects of compliance costs associated with the estate tax—which involve complex valuations by both the taxpayer and tax collector of a variety of assets—and concluded that compliance and avoidance costs outweigh any revenue raised by estate taxes.[xlviii] Economic efficiency is also lost when family businesses spend resources in order to manage estate taxes so the company can survive to the next generation that could be put to more productive uses.

Moreover, the estate tax may even be counterproductive with respect to the Obama Administration's goal of reducing income inequality outlined in Chapter 3 of the *Report.* The previous analysis also determined that estate taxes have either a negligible or counterproductive effect on inequality by preventing the transfer of assets to heirs.[xlix] The *Better Way* tax reform plan would repeal the estate tax, which would not only reduce the emotional and financial toll on families grieving the death of a loved one, but also remove an impediment to economic growth. The Tax Foundation's model predicts that this change will boost economic growth by 0.9 percent over a decade.[l]

The Cost of Unnecessary Complexity

As of 2014, a compilation of all the statutes, regulations, and case law necessary to comply with the tax code totaled 74,608 pages.[li] The U.S. Taxpayer Advocate Service (TAS) has also stated, "The most serious problem facing taxpayers—and the [Internal Revenue Service (IRS)]—is the complexity of the Internal Revenue Code."[lii] In a 2012 report, TAS found that the tax code had been changed 4,680 times since 2001, a rate of more than one change per day.[liii] More changes and complexities have been added since then.

TAS also estimated that Americans spend over 6.1 billion hours each year preparing their taxes.[liv] The IRS projects that 90 percent of taxpayers seek assistance with tax preparation, either through hiring a paid preparer (56 percent) or buying software (34 percent).[lv] Even 27 percent of IRS employees turn to outside help with tax preparation.[lvi]

The JCT has identified four specific negative effects of complexity in the tax code:

- Decreased levels of voluntary compliance;
- Increased costs of compliance for taxpayers;
- Reduced perceptions of fairness in the Federal tax system; and
- Increased difficulties in the administration of tax laws. [lvii]

While estimates of the annual cost of compliance differ, a 2011 study by Arthur Laffer, Wayne Winegarden, and John Childs found that Americans paid over $430 billion in a single year to comply with the tax code. Of this amount, $216 billion was borne by individuals, businesses incurred roughly $162 billion, and the remaining $53 billion represented preparers' fees, IRS administration, and auditing.[lviii]

Another calculation conducted by economists at the Mercatus Center found a range of compliance costs between $67 and $378 billion annually. The researchers then projected lost economic growth from time spent planning and filing taxes at $148 to $609 billion per year. Combining both the compliance and growth estimates, the study projected that the U.S. tax system costs $215 to $987 billion each year.[lix]

The compliance burden that the U.S. tax system imposes on the domestic economy also is large compared with other OECD countries. National Taxpayer Union Foundation analyst Michael Tasselmyer measured the average time required each year for an

American business to comply with taxes compared to peers in the OECD. On average, a business spends just under 180 hours, or 22 and a half working days, to comply each year. France is the closest competitor on complexity with an average of 133 hours, representing more than a full work week less than in the United States.[lx]

Many of these estimates were done prior to implementation of the ACA, which imposed new taxes on both individuals and businesses. Even a provision designed to benefit taxpayers has added complexity and compliance burdens. The ACA distributes its premium tax credit for purchasing health insurance on the exchanges through the IRS. As GAO has noted, the IRS has had severe difficulty implementing the premium tax credit, further burdening taxpayers with opaque requirements.[lxi]

In one of the studies previously mentioned, Laffer and his coauthors also estimated the economic benefits of reducing compliance costs. For every $100 billion reduction in compliance costs, the study projects the economy would benefit by $30 to $34 billion per year.[lxii]

Another analysis indicated that low- and middle-income taxpayers would benefit most from simplification. The study found that 54 percent of the time and money saved by simplifying individual taxes would benefit taxpayers with $50,000 or less in adjusted gross income.[lxiii]

The *Better Way* tax reform blueprint would make great strides in simplification for both individuals and businesses. Individuals would be able to file taxes on a form no larger than a postcard. In addition, other elements of the plan such as flatter tax rates, elimination of special tax provisions, full expensing, and repeal of the estate tax would vastly reduce the compliance costs of businesses.[lxiv]

CONCLUSION

Recommendations

In order to boost economic growth, job creation, and the wages of workers, the JEC Majority recommends enacting tax reform that:

- Simplifies and modernizes our broken tax code;
- Lowers and consolidates tax rates for both individuals and businesses;
- Moves to a more competitive territorial tax system;
- Eliminates special tax preferences that reward certain industries over others;
- Reduces the double taxation of capital and eliminates estate taxes.

In a time of stagnant economic growth and declining workforce participation, our nation desperately needs pro-growth policies like those outlined above that reward work, savings, and investment while relieving unnecessary burdens on families and businesses. The Committee urges the new Congress and Administration to implement the policies outlined in this *Response* that will restore prosperity and boost America's true growth potential.

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