



Testimony before the Senate Committee on the Budget

Policy Prescriptions for the Economy

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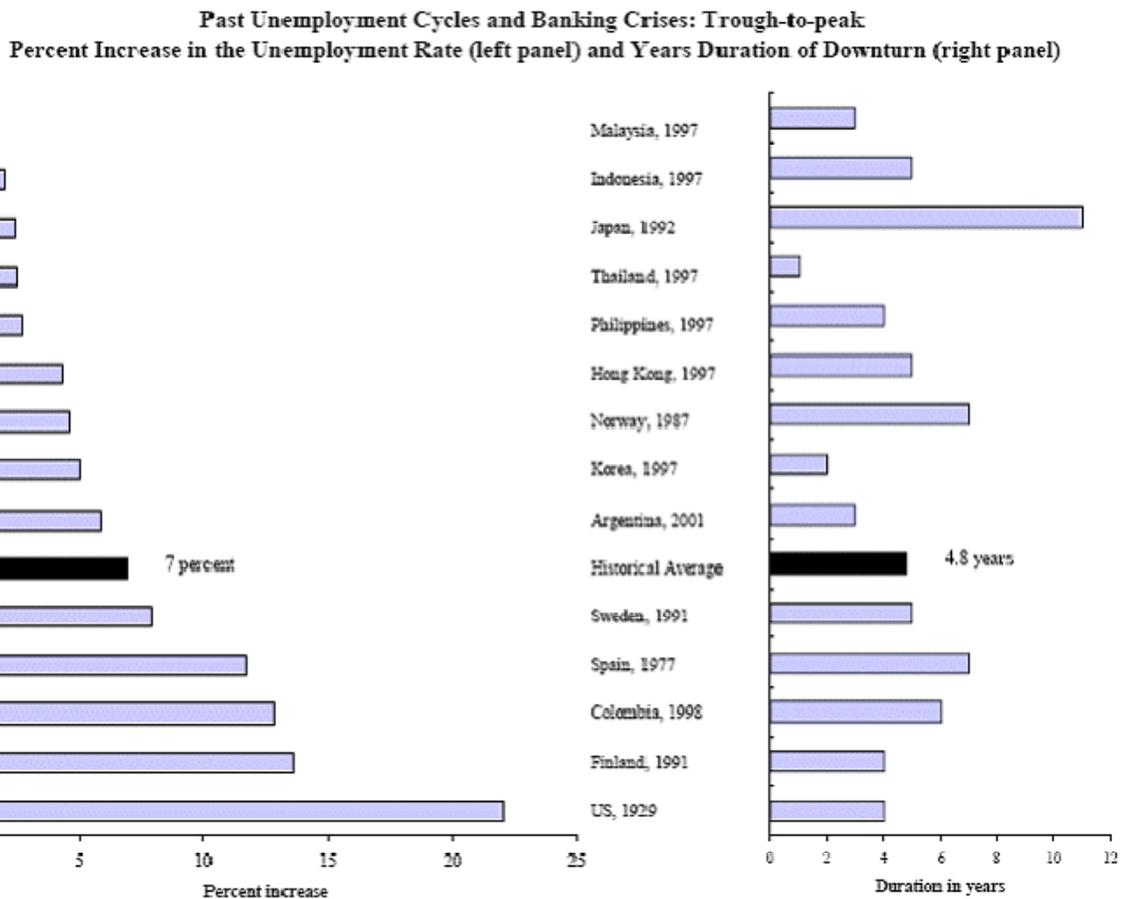
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Chairman Conrad, Ranking Member Sessions, and Members of the Committee, thank you for inviting me to appear today to discuss the state of the economy and the optimal policy prescriptions for the future.

Why has economic growth been slow?

Unfortunately, according to the latest indicators, the U.S. economy continues to disappoint and performs more poorly than original forecasts that were made by the more optimistic economists, who also tended to be supporters of the idea that our economy needs a big Keynesian stimulus. The weakness sadly does not come as a surprise to those of us who were convinced at the outset of this crisis that we would experience a nonstandard recession and recovery. We have known for some time that financial crises inevitably create lengthy periods of slow economic growth that are more pronounced than the slowdowns caused by typical recessions.

Figure 1:

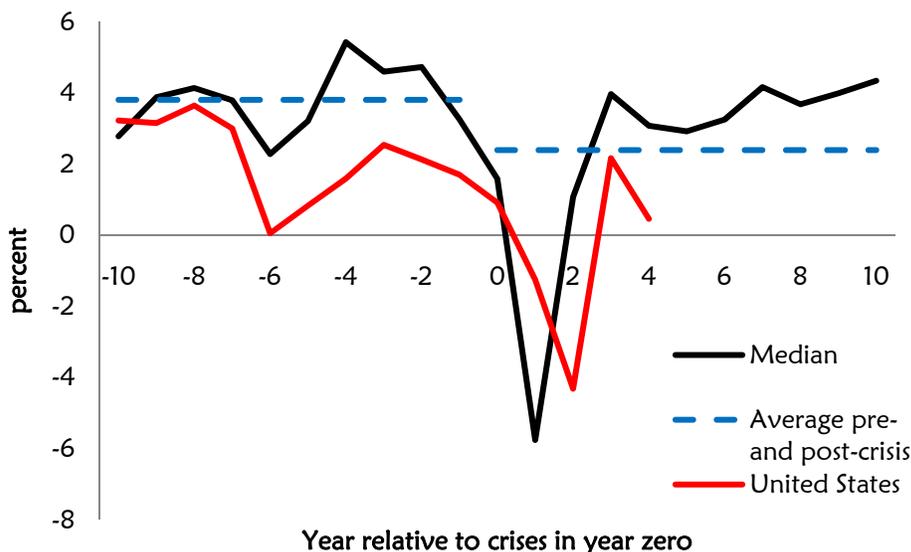


Economists Carmen Reinhart and Kenneth Rogoff have studied the history of financial crises and found that they are inevitably followed by lengthy periods of slow economic growth. In Figure 1, which is taken from their study, it can be seen that the typical duration of the employment downturn after a financial

crisis is 4.8 years.¹ Another study by Ms. Reinhart and her husband Vincent Reinhart found that economic growth rates tend to be lower for as much as a decade after the crisis.² I should add that their work, which is by far the most famous, is not the only that shows this connection, nor am I engaging in ex post theorizing. Back in early 2009 when I was testifying before the House Budget Committee, I made the same point drawing on work by economists at the IMF.³

Figure 2:

Growth of real GDP per capita
 (Median experience around the 15 most severe financial crises of the second half of the 20th century)



Source: Author's Calculations from data provided by Vincent Reinhart.

Those of us who argued that the financial crisis history was the correct analogy for the current crisis were criticized throughout the debate by Keynesians as being too pessimistic. Yet, as Figure 2 shows, the U.S. economy has actually performed worse than even we, the pessimists, expected. There is no question that this disappointing growth is the result of policy error. Given that such a lengthy period of slow growth is the challenge, it was a mistake to address it with short term Keynesian stimulus.

While there is debate about the size of the multiplier effects of a Keynesian stimulus, let us assume, for the sake of argument, that they are substantial. Even then, every stimulus effort has not two but three stages. When the stimulus is imposed, there is some positive short-run increase in GDP. When the

¹ Carmen M. Reinhart and Kenneth S. Rogoff, "The Aftermath of Financial Crisis." National Bureau of Economic Research Working Paper 14656 (2009). <www.nber.org/papers/w14656>

² Vincent Reinhart and Carmen M. Reinhart. "After the Fall." Paper presented at the Federal Reserve Bank of Kansas City Symposium, *Macroeconomic Challenges: The Decade Ahead*, Jackson Hole, WY, August 26-28, 2010.

³ Kevin A. Hassett. "The Economic Outlook and Budget Challenges: A Testimony in front of the House Committee on the Budget." January 27, 2009. <<http://www.aei.org/docLib/20090217-HassettTestimony.pdf>>
 Claessens, Stijn, M. Ayhan Kose and Marco E. Terrones. "What Happens During Recessions, Crunches and Busts." *IMF Working Paper*, WP/08/274, December, 2008, http://www.aei.org/docLib/20081212_IMF.pdf.

stimulus is removed, there is an approximately equal and opposite reduction in GDP. But after that, the stimulus must be paid for with higher taxes or ongoing borrowing--causing a further reduction in GDP. The key observation is that the total impact of the Keynesian policy is negative in the long run.

A policy involving Keynesian stimulus might be defensible if the economy were in a typical recession, which can be expected to last on average about 11 months, and be followed by a recovery with sharply higher growth. Between World War II and 1990, the average rate of growth in gross domestic product (GDP) in the five quarters after a recession was 6.8%. In such a case, adding a percent or two of growth during the recession might well be worth having three percent growth instead of five percent growth in the recovery. But in the lengthy, slow-growth aftermath of a financial crisis, the hangovers arrive before growth has lifted off. Indeed, Keynesian stimulus in this circumstance will inevitably run the risk of tossing the economy back into recession even if one adopts the view that an increase in government spending will have a large positive effect on the economy. This is because the hangover will arrive when the economy is still weak.

Fears about the future

Recently, strong fears of a double dip recession have emerged in response to the slow economic growth of the past three years and the bleak outlook for the future. One particular focus of concern has been the level of indebtedness. Government debt commonly soars in the wake of a financial crisis, and skyrocketing debt-to-GDP ratios of many countries have triggered apprehension about future growth. This thinking is derived from a different set of work by economists Carmen M. Reinhart and Kenneth S. Rogoff.⁴ In a widely-cited study, they document a strong relationship between high debt levels and slow growth, using data on forty-four countries spanning about two hundred years. Their main finding is that for developed countries, a gross debt-to-GDP level above 90 percent causes average growth to fall significantly.

Reinhart and Rogoff's work has received some criticism, for example that no evidence of causality is presented⁵ or that their findings are unlikely to be relevant to the U.S. economy of today.⁶ Also, their study only considers correlations between debt and growth and does not take into account other factors, as an IMF Working Paper by Manmohan S. Kumar and Jaejoon Woo points out.⁷ Fortunately, these authors explore the issue further and extend the empirical work by Reinhart and Rogoff in useful directions. Their analysis controls for other growth determinants and takes into account estimation issues, such as reverse causality and endogeneity. The result suggests an inverse relationship between the initial debt level and subsequent growth – on average, a 10 percentage point increase in the initial debt-to-GDP ratio is associated with a slowdown in annual real per capita GDP growth of around 0.2

⁴ Carmen M. Reinhart and Kenneth S. Rogoff, "Growth in a Time of Debt." National Bureau of Economic Research Working Paper 15639. January 2010. <<http://www.nber.org/papers/w15639>>

⁵ John Irons and Josh Bivens, "Government Debt and Economic Growth: Overreaching Claims of Debt 'Threshold' Suffer from Theoretical and Empirical Flaws" Economic Policy Institute Briefing Paper #271. July 26, 2010. <<http://www.epi.org/page/-/pdf/BP271.pdf>>

⁶ Yeva Nersisyan and L. Randall Wray, "Does Excessive Sovereign Debt Really Hurt Growth? A Critique of This Time is Different, by Reinhart and Rogoff." The Levy Economics Institute Working Paper 603 (2010)

⁷ Manmohan S. Kumar and Jaejoon Woo, "Public Debt and Growth." IMF Working Paper WP/10/174. July 2010. <<http://www.imf.org/external/pubs/ft/wp/2010/wp10174.pdf>>

percentage points per year. Moreover, they also present evidence of nonlinearity with high levels of debt (above the 90 percent threshold established by Reinhart and Rogoff) having a significantly larger negative effect on growth.

Reinhart and Rogoff's conclusions are further supported by the recent work of Caner, Grennes and Koehler-Geib (2010).⁸ They are mostly concerned with the existence of an identifiable threshold or a "tipping point." Moreover, they focus on the long-term effects and their data set includes 99 developed and developing countries. Their results establish a threshold of 77 percent public debt-to-GDP ratio. If public debt is above this threshold, each percentage point of debt costs 0.017 percentage points of annual real growth.

The results of these three studies suggest that the U.S. economy is indeed heading for unstable waters. The U.S. gross public debt to GDP has risen from 102 percent in 2010 to 109 percent in 2011 (based on the CBO data) and is predicted to reach 118 percent by 2021.⁹ If the research by Reinhart and Rogoff is accurate, then the expected level of public debt in the United States would reduce expected growth in the U.S. by about half a percentage point per year over the next decade. The current CBO outlook does not incorporate this effect, but should. Adjusting downward for this calculation would increase the 10-year deficit projection by about 1.1 trillion dollars.

What can be done about the present situation?

The good news is that there is substantial reason to believe that there is a way out of this destructive Keynesian cycle of escalating debt. Over the past several decades many developed countries have undertaken fiscal adjustments in attempts to reduce high debt levels. These countries' restructurings had varying degrees of success and failure, both in reducing debt and in stimulating growth. Their experiences provide a lesson for the United States today.

The economics literature has focused on answering two main questions in this area: what aspects of fiscal consolidations produce lasting reductions in debt, and what aspects encourage macroeconomic expansion?

The answer to the first question is clear. Based on a review of the economics literature and analysis of 21 OECD countries, two of my colleagues and I recently found that cutting expenditures is more likely to produce a lasting reduction in debt than increasing revenues.¹⁰ It is also typical that the more aggressively a country cuts expenditures, the more likely it is to successfully reduce debt in the long term. Averaging across a range of methodologies, the typical unsuccessful fiscal consolidation consisted of 53 percent tax increases and 47 percent spending cuts, as seen in Figure 3 below. The typical

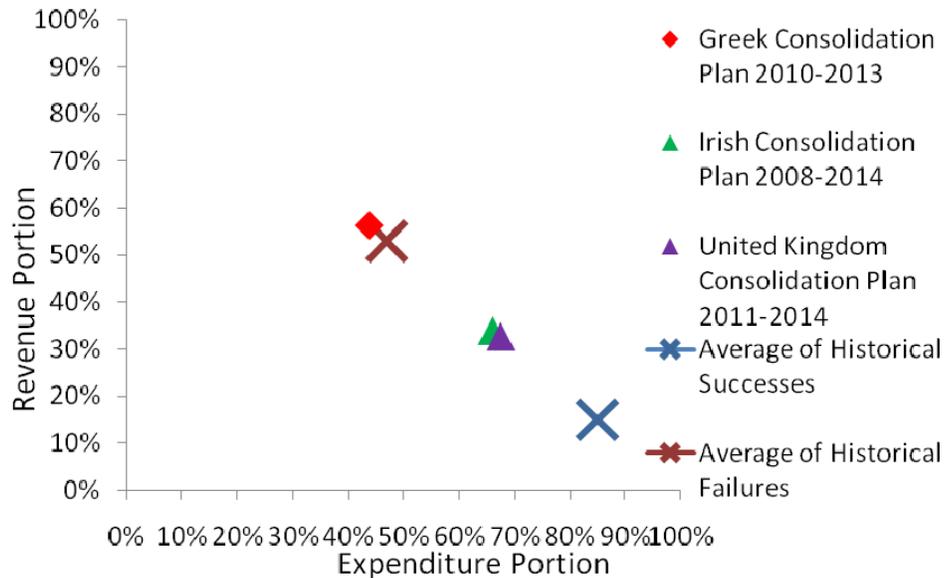
⁸ Mehmet Caner, Thomas Grennes and Fritzi Koehler-Geib, "Finding the Tipping Point – When Sovereign Debt Turns Bad." May 19, 2010. Available at SSRN: <http://ssrn.com/abstract=1612407>

⁹ "The Budget and Economic Outlook: An Update." Congressional Budget Office. August 2011. <<http://cbo.gov/ftpdocs/123xx/doc12316/08-24-BudgetEconUpdate.pdf>>

¹⁰ Andrew G. Biggs, Kevin A. Hassett, and Matthew Jensen, "A Guide for Deficit Reduction in the United States Based on Historical Consolidations That Worked," AEI Economic Policy Working Paper 2010-04 (2010) <http://www.aei.org/paper/100179>.

successful fiscal consolidation consisted of 85 percent spending cuts.¹¹ In particular, cuts to social transfers, largely entitlement spending and the government wage bill are more likely to reduce debt and deficits than cuts to other expenditures.

Figure 3:



Source: Andrew G. Biggs, Kevin A. Hassett, and Matthew Jensen. "A Guide for Deficit Reduction in the United States Based on Historical Consolidations That Worked." AEI Economic Policy Working Paper 2010-04. <http://www.aei.org/paper/100179>

There is more debate over the second question: what aspects of fiscal consolidation encourage macroeconomic expansion? The essence of the debate hinges on the balance between two economic effects of fiscal consolidation, the expectational effect and the Keynesian effect. The *expectational* effect is the positive effect on consumption and investment that occurs when policy is put on a sustainable path. These likely surge after a consolidation because of expectations of lower future tax liabilities and because of the elimination of uncertainty.

In other words, an immediate consolidation will alleviate the hoarding that accompanies fears of a larger and predominantly tax-driven consolidation in the future. Expenditure based consolidations would

¹¹ Many papers from the peer-reviewed literature confirm these results. Alesina and Perotti (1996) report that successful consolidations were 64 percent expenditure cuts and 37 percent revenue increases. Unsuccessful consolidations were 34 percent expenditure cuts and 66 percent revenue increases. Alesina and Ardagna (1998) report that successful consolidations were 62 percent expenditure cuts and 38 percent revenue increases. Unsuccessful consolidations were -79 percent expenditure cuts and 178 percent revenue increases. Alesina and Ardagna (2009) report that successful consolidations were 135 percent expenditure cuts and -35 percent revenue increases. Unsuccessful consolidations were 34 percent expenditure cuts and 66 percent revenue increases. Von Hagen and Strauch (2001) report that successful consolidations were 52 percent expenditure cuts and 48 percent revenue increases. Unsuccessful consolidations were 12 percent expenditure cuts and 88 percent revenue increases. Zaghini (1999) reports that successful consolidations were 77 percent expenditure cuts and 23 percent revenue increases. Unsuccessful consolidations were 2 percent expenditure cuts and 98 percent revenue increases. McDermott and Wescott (1996) found that expenditure based consolidations have a 41 percent chance of success; whereas revenue based consolidations have a 16 percent chance of success.

provide stronger expectational effects, because there is a better chance they are successful at reducing debt, and because higher near term taxes are hardly designed to ignite optimism in investors and consumers. The Keynesian effect reduces aggregate demand and therefore GDP growth. The controversy is over whether the expectational effects of fiscal consolidation can completely outweigh the Keynesian effects in order to create short-term growth.

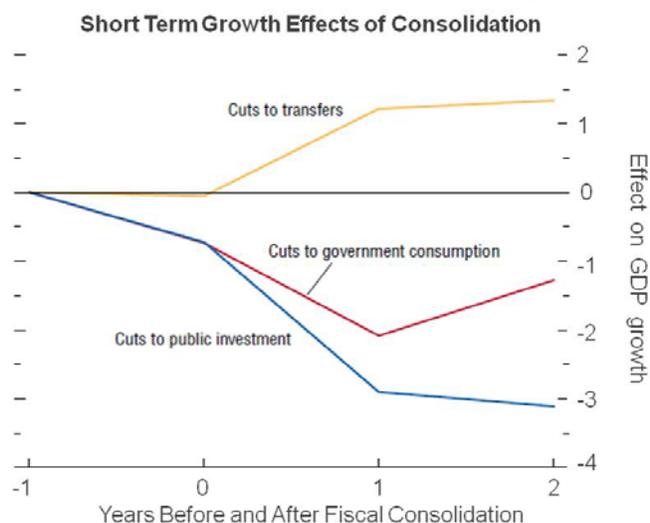
There is less controversy around the view that the long-term benefits of fiscal consolidation are substantial. Two schools of thought have emerged in the debate. Harvard economist Alberto Alesina and his various coauthors argue that consolidation, especially expenditure cuts, can lead to a burst of growth starting immediately.¹² A team of IMF economists, however, identified possible methodological flaws in Alesina’s studies and claim that the typical fiscal consolidation would be contractionary.¹³

It is beyond the scope of this testimony to resolve the dispute between the two corners of the literature. A fiscal consolidation optimist would believe that the Alesina work is correct, and then would expect that a large fiscal consolidation in the U.S. would lead to significant positive growth effects even in the near term.

A pessimist would point to the alternative work of the IMF and argue that the growth effects of a typical fiscal consolidation are more uncertain. But it is important to note that even in this case, the IMF study points to positive growth effects if the fiscal consolidation is correctly designed. That is, both sides of the literature find that reducing expenditures will provide a better growth outcome than increasing revenues.

Although the IMF finds that a tax-based consolidation would reduce GDP by around 1.6 percentage points three years following implementation, they find that the negative effects of a spending-based consolidation would be small and statistically insignificant. That is, even in the most pessimistic corner of the fiscal consolidation literature, there is little to dissuade us from pursuing a consolidation today. Moreover, they find that spending-based consolidations that are focused primarily on transfer cuts could produce positive near-term growth effects.

The latter point is especially interesting since the authors study near-term cuts in entitlements. One might expect these to have



Note: Results based on a 5% of GDP Fiscal Consolidation where the expenditure cuts are primarily to transfers, government consumption, or public investment.
 Source: International Monetary Fund. "Chapter 3: Will it Hurt? Macroeconomic Effects of Fiscal Consolidation," in *World Economic Outlook*. (IMF, October 2010). <http://www.imf.org/external/pubs/ft/weo/2010/02/>.

¹² Alberto Alesina and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes Versus Spending," *NBER Working Paper* w15438 (2009). Alberto Alesina and Silvia Ardagna, "Tales of Fiscal Adjustment," *Economic Policy*, Vol. 13, No. 27 (1998): 489-545. Alberto Alesina and Roberto Perotti, "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects," *NBER Working Paper* 5730 (1996).

¹³ Daniel Leigh, Pete Devries, Charles Freedman, Jaime Guajardo, and Andrea Pescatori, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," in *World Economic Outlook: Recovery, Risk, and Rebalancing*. (Washington, DC: International Monetary Fund, 2010).

a relatively large short-run negative effect on consumption behavior. The fact that expectational effects dominate even when entitlements are cut immediately suggests that out-of-control entitlement spending has a profoundly negative impact on forward-looking sentiment and business and consumer confidence.

This result also suggests a policy opportunity. Given the massive imbalances that exist today, it is likely that consumers have very little faith that current programs will remain in place throughout the course of their lifetimes. Accordingly, cuts to entitlements that phase in gradually over time will likely have little impact on their perceived lifetime wealth, as the benefit cuts are effectively already factored into consumer expectation. If consumers don't expect promised benefits to be paid, government can reduce promised benefits without causing today's consumption to go down.

Which means, of course, that the expectational effects of a fiscal consolidation would dominate and produce significant near-term growth if there are few immediate cuts to benefits but significant longer-term cuts. If, in addition, the fiscal consolidation were paired with a tax reform that broadened the tax base and reduced marginal tax rates, then a significant growth spurt would be the natural expectation to draw from the economic literature.

One way that we could easily cut fiscal outlays to provide an immediate boost to the economy would be to change the indexing formula for Social Security from wages to prices. A recent analysis by the Social Security Administration found that over a 75 year time horizon, this would improve the long run budget condition by \$4.5 trillion in present value.¹⁴

Responding to President Obama's American Jobs Act

Having established what components a successful fiscal consolidation contains, and the principles that should guide policymakers at this crucial moment in history, I now turn to the proposal that the President has recently unveiled for boosting the performance of the economy. In the next section I will discuss a few additional proposals.

The headline observation to make about the President's proposal is that it mostly attempts to provide yet another short term stimulus, and thus, sadly, does not appear to be a reasoned response to the evidence that this recovery is consistent not with the typical postwar recession, but rather, with the typical post-financial-crisis recovery. Now is the time to address our big problems, not to ignore them and hope that a shot of economic adrenaline will save the day. Nevertheless, some of the proposals merit bipartisan support.

Let me turn to some of the major proposals, and discuss them in a bit more detail.

i) Payroll Tax Cut

There are two provisions of the President's proposal that relate to payroll tax cuts. One provision would cut the payroll tax in half to 3.1% for employers on the first \$5 million in wages, providing broad tax relief to all businesses but targeting it to the 98 percent of firms with wages below this level. The employee side of this would likely provide a small positive near term consumption stimulus that would

¹⁴ Social Security Administration. <http://ssa.gov/OACT/solvency/provisions_tr2008/charts/chart_run176.html>

be offset in an approximately equal and opposite manner when removed. This is, in other words, just a continuation of the policy approach that has led us into this Keynesian downward spiral. The employer side of this would likely stimulate some hiring, as it seems unlikely that wages would adjust much to a near term temporary measure given the high unemployment rate.

The President is also proposing a full holiday on the 6.2% payroll tax firms pay for any growth in their payroll up to \$50 million above the prior year, whether driven by new hires, increased wages or both. This is the kind of job creation measure that CBO has called the most effective of all tax cuts in supporting employment. This type of hiring subsidy would likely have a positive effect on hiring, and policies of this form have often been supported by conservatives in the past as an alternative to minimum wage legislation.

ii) Extension of expensing

Another proposal included in the President's American Jobs Act is the extension of temporary 100 percent bonus depreciation for certain business assets. Permanent expensing would likely be a part of any major tax reform that draws on lessons from the academic literature, and temporary expensing likely has a significantly larger near term effect on capital formation than permanent expensing.¹⁵ Investment would certainly jump up for one year if this temporary measure were adopted, but it would jump back down the following year, and such a pattern is not the appropriate response to the policy challenge we face as a nation.

iii) Limit on Certain Itemized Deductions

The President's proposal outlines a 28 percent limitation on certain deductions and exclusions for individuals who earn more than \$200,000 a year and families that earn more than \$250,000. Most tax reform proposals argue for base broadening paired with tax rate reductions, and I view this proposal as a clever way to achieve base broadening. The problem with it is that it is not paired with permanent rate reductions, so it is a permanent tax hike that would make tax reform down the road much less likely, as revenue neutrality would be much harder to achieve. It is the height of folly to accept permanent harm in exchange for a near term "fix."

iv) Tax on Carried Interest

The provision in the American Jobs Act that calls for "special rules for partners providing investment management services to partnerships" is a particularly egregious case of punishing winners for their success and productivity. While the tax treatment of carried interest paid to fund managers may seem unusual, it actually follows from partnership tax principles that apply to industries throughout the economy. Internal Revenue Code (IRC) section 702(b) sets forth the general rule that partners are taxed on partnership income in the same manner "as if such item were realized directly from the source from which realized by the partnership." If a furniture store partnership, for example, realizes long-term capital gains or dividends, the partners who receive that income are taxed at the capital gains rate.

¹⁵ Hassett, Kevin A., and R. Glenn Hubbard "Tax Policy and Business Investment," *Handbook of Public Economics* Vol. III, Auerbach and Feldstein eds, Elsevier Science B.V., 2002.

Some critics are troubled by the fact that the carried-interest arrangement allocates part of the fund's capital gains and dividends to the managers when such income "belongs" to the investors who put up the money. It is not clear, of course, why the gains and dividends do not belong to the managers, whose labor helped produce this income. In any case, IRC section 704(a), a rule that also applies throughout the economy, permits the partnership agreement to allocate different items of partnership income and expense in any desired manner. If the furniture store partnership has two partners, one of whom works and the other of whom puts up the money, the partnership agreement may allocate any capital gains and dividends received by the store to the working partner, who would then be taxed at the 15 percent rate on that income. The provision in the Jobs Act is clearly intended to target managers who receive carried interest from hedge funds, private equity funds, and real estate firms, although it could also affect some other partners. Targeting the successful for special tax treatment is the worst way to incentivize success and productivity.

v) Work-Sharing

President Obama included a work-sharing proposal in his American Jobs Act, adopting a concept that is commonly used in Europe. Work-sharing is especially popular in Germany, where it is known as "Kurzarbeit" or "short work." That policy enables firms that face a temporary decrease in demand to avoid shedding employees by cutting hours instead. If hours and wages are reduced by 10 percent or more, the government pays workers 60 percent of their lost salary. This encourages firms to use across-the-board reductions of hours instead of layoffs. As a result, this policy has kept the unemployment rate in Germany from rising even though the country has seen a sharper decline in GDP than the United States.

The economic argument in favor of such a policy is powerful. When a recession strikes, firms are faced with a dilemma: sales and profits are down, and many workers are idle. But finding skilled workers is costly and time-consuming, involving large fixed costs. If a firm fires workers, it may incur large hiring and training costs when the recession ends and sales turn back up. Thus, a firm would prefer, all else equal, to hoard labor during a recession. Firms might well prefer to respond to a 20 percent cut in sales by reducing everyone's work by 20 percent. That way, employees remain part of the firm, and ramping up production is less costly down the road.

A number of factors discourage American firms from making that choice. The biggest is government policy. If a firm lays off workers, the government mails the unemployed a check. If the firm reduces work-hours, there is no government assistance, and employees are left to face the entire decrease in wages on their own.

A U.S. program based on Germany's would be attractive to firms, workers and taxpayers. It would subsidize firms as they hoard labor, enabling them to keep the best parts of their team even when sales dip. As the economy expands, firms will then be able to expand rapidly too, without sinking tons of time and resources into costly search.

Currently, 17 states utilize work-sharing in some form to make up part of employees' reduced wages. But few companies are participating because the government's contribution is not large enough to make work-sharing attractive. If the U.S. is to share in the labor-market success of its German friends, it needs a significant expansion of subsidies for work-sharing. Compared with the \$787 billion economic stimulus, the costs would be low.

However, a work-sharing program should also be accompanied by a reduction in the duration of unemployment insurance benefits. Indeed, we would move toward a 21st century UI system if we built in automatic switches that significantly increase work sharing subsidies during recessions rather than extending UI benefit duration. The logic supporting this is sound. First, work sharing works, and it will be relied upon more if it is predictable. Second, workers have a harder time reconnecting to the workforce the longer they are unemployed, and unemployment spells clearly respond to lengthy duration of UI benefits. This view is supported by academic work by Alan Krueger, the President's new nominee to be chairman of the Council of Economic Advisers. In a study with Bruce D. Meyer for the National Bureau of Economic Research Working Paper series in 2002, Mr. Krueger examined the labor supply effects of social insurance programs. The author's empirical work found that unemployment insurance (UI) and workers' compensation (WC) insurance tend to increase the length of time employees spend out of work.¹⁶

There are those who say it is too late, but it is not. Even at this late stage, the potential benefits seem quite impressive. Every month there is a huge amount of churning with firms adding and subtracting millions of jobs. For July 2011 the Labor Department reported that 3.6 million private jobs were "destroyed," while about 3.7 million were created. The July data are typical. The net monthly job gain or loss conceals a huge amount of churning that produces this figure. This is an important policy opportunity, because there is already a massive amount of job creation out there. If we can slow job destruction even a little bit, then we will have set the stage for big increases in net job creation.

The Layoff Prevention Act of 2011 (S. 1333), which is intended to support the development and expansion of state work-sharing programs would likely have a significant positive effect on net job creation.

vi) Various Oil Provisions

The administration also seeks to acquire additional revenue through a number of measures designed to increase taxes on oil companies. These are analogous to the attempt to increase taxes on carried interest in that the changes target special treatment for an industry that is out of political favor. The oil measures appear to be motivated by an ongoing witch hunt against oil companies rather than any economic rationale. For example, the tax increase for "dual capacity" tax payers seeks to undo decades of legal precedent and disallow oil companies from receiving a credit against U.S. for a share of the taxes they pay to other countries. One recent study found that this seemingly punitive action would actually reduce U.S. tax revenue.¹⁷

Tax reform, a key component

As we consider ways to stimulate our stagnant economy, tax reform should be the primary target. It provides us some of the best—and most broadly agreed upon—opportunities to improve the health of

¹⁶ Alan B. Krueger and Bruce D. Meyer. "Labor Supply Effects of Social Insurance." National Bureau of Economic Research Working Paper 9014. June 2002. <<http://www.nber.org/papers/w9014>>

¹⁷ Joseph R. Mason. "Budget Impasse Hinges on Confusion among Deficit Reduction, Tax Increase, and Tax Reform: An Economic Analysis of Dual Capacity and Section 199 Proposals for the U.S. Oil and Gas Industry." American Energy Alliance. July 12, 2011. <<http://www.americanenergyalliance.org/wp-content/uploads/2011/07/2011-07-12-Mason-Oil-Tax-Deficit-Study-1.pdf>>

the economy in the long run while also encouraging growth in the short run. That is, we get a growth effect without a hangover.

The complexity of our current tax code introduces a number of problems and inefficiencies. Through comprehensive tax reform, the system could be streamlined to improve taxpayers understanding (helping them make rational choices) and remove distortions that hamstringing economic growth.

As we begin discussing tax reform, let's lay out the goals that any tax reform should aim to achieve. First, tax reform should improve incentives to invest; second, reform should reduce the corporate tax rate to increase international competitiveness. Third, the reform should smooth out variable treatment of different industries and assets while seeking to distort economic activity as little as possible. Fourth, the tax reform should improve incentives to work.

A reform that accomplished these objectives would accomplish exactly what we need to at this point in history. Just to sketch the terrain, a survey of 69 public finance economists conducted by Victor Fuchs, Alan Krueger, and James Poterba (1998) found that, at the median, respondents believed that the 1986 tax reform produced about one percentage point higher growth over a long period.¹⁸ My review of the literature with Alan Auerbach suggested that this consensus is a fair reading of the broader tax reform literature.¹⁹

There are many possible reforms that would broaden and/or modify the base and then lower marginal rates. The key point is that they can conceivably have effects big enough to offset the growth shortfall that results from the financial crisis. Choosing to do another Keynesian stimulus instead of a tax reform at this juncture in history would be a horrendous choice.

The Case of the Corporate Tax

In the previous section, I argued that the case for reform could easily be made by highlighting the inefficiency of our current system. In this section, I provide another motivation for major surgery to the tax code: our corporate tax is now a worldwide outlier, and has become the economic equivalent of a ball and chain. If policymakers do not have the stomach for a big tax reform, they should at least reduce the corporate tax rate.

A study published in 2010 by the Organization for Economic Cooperation and Development (OECD) reviewed tax policy reform across OECD nations and listed recommendations based on that experience. The study concluded that, "The analysis suggests a tax and economic growth ranking order according to which corporate taxes are the most harmful type of tax for economic growth, followed by personal income taxes and then consumption taxes, with recurrent taxes on immovable property being the least harmful."²⁰

Given this, and the general observation that fundamental reform would be most beneficial if we moved toward consumption taxation, I will digress and discuss in a little more detail the case for corporate tax reform specifically.

¹⁸ Victor R. Fuchs, Alan B. Krueger, and James M. Poterba, "Economists' Views about Parameters, Values, and Policy: Survey Results in Labor and Public Finance," *Journal of Economic Literature* 36 (3): 1387-1425.

¹⁹ Alan J. Auerbach and Kevin A. Hassett, *Toward Fundamental Tax Reform*, (Washington, DC: AEI Press, 2005), 150.

²⁰ *OECD Tax Policy Studies: Tax Policy Reform and Economic Growth* (OECD Publishing, 2010), 10.

While there is broad consensus that the high statutory corporate tax rate in the U.S. makes investments in the U.S. uncompetitive relative to other OECD economies, some question the extent to which *effective* taxes paid by corporations are equally high. As there will be much discussion of these factors in coming months, I turn to providing some hard data. To skip to the conclusion, even if one looks at effective rates, the U.S. is in a bad spot.

The top national statutory corporate tax rates in 2010 among the 31 members of the OECD ranged from 8.5 percent in Switzerland and 12.5 percent in Ireland to 35 percent for the U.S.²¹ Hence within the OECD countries, the U.S. has the highest statutory rate of taxation at the national level.

The picture changes only marginally when we add the sub-national corporate tax rates to the top national rate. In the case of the United States, the average top statutory rate imposed by states in 2010 added just over 4 percent (after accounting for the fact that state taxes are deducted from federal taxable income)—for a combined top statutory rate of 39.2 percent. Among all OECD countries in 2010, the United States' top statutory combined corporate tax rate was the second highest, after Japan's at 39.5 percent.

Top combined statutory rates amongst OECD countries have fallen from an average of about 48 percent in the early 1980s to 25.5 percent in 2010. The main wave of reforms occurred in the mid to late 1980s but has continued in the 1990s and through the 2000s. In fact, the OECD average fell almost 9 percent in the first decade of the 21st century. The United States, on the other hand, has not reduced its top statutory rate since 1993.

In 1981, the bulk of OECD countries had an average combined tax rate of slightly above 47 percent.²² The U.S. rate was about 3 percentage points higher than that, at 50 percent. In 1996, the U.S. tax rate was close to the average for the bulk of OECD countries, at approximately 39 percent. However, in 2010, with no change in the top rate since the 1990s, the U.S. is now amongst only 4 other OECD countries that have tax rates above 30 percent. Thus, the competitive gap between U.S. and OECD corporate tax rates has opened up since the 1990s primarily because of widespread and substantial rate reductions abroad, rather than any significant corporate tax increase in the United States.

Many have argued that despite our high statutory corporate tax rate, loopholes cause the United States to collect relatively little revenue. In other words, even if the rate is 39.2 percent, firms pay far less than that. In truth, the U.S. ranks little better when looking at the effective rates than when looking at statutory rates.

Let's look at the effective average tax rate (EATR)—the difference between the pre-tax return and the post-tax return expressed as a fraction of pre-tax economic profits. The EATR computes, simply, a firm's tax liability as a fraction of pre-tax economic profits in country x. This rate differs from the statutory rate because it reflects the lower rate that the firm actually pays once we have included other features of the tax code such as depreciation allowances or interest rate deductions.

There are a few different ways to calculate the EATR, but in each case, the U.S. effective rates are uncompetitive. The World Bank, considering the effective rates, ranks the U.S. tax climate worse than all

²¹ "OECD Tax Database," <http://www.oecd.org/ctp/taxdatabase>.

²² "OECD Tax Database," <http://www.oecd.org/ctp/taxdatabase>.

but two industrialized countries for incorporation.²³ A 2010 paper by tax experts Kevin S. Markle and Douglas A. Shackelford also concludes that from 1988 to 2007, U.S. firms faced the second highest effective rates in the developed world.²⁴ And finally, my own research with my AEI colleague Aparna Mathur ranks the U.S. tax climate at second worst for locating investments in plants and machinery.²⁵

The last argument I will offer for lowering the corporate tax rate is one of incidence. Recent research from a variety of studies shows that the brunt of the corporate tax rate is borne by workers as much or more than capital owners. This counterintuitive result comes because capital tends to flow from higher tax jurisdictions to lower ones. As this happens, workers are left with less capital and become less productive. The result is that they ultimately bear the incidence of the tax in the form of lower wages.

Recent empirical estimates of the share of the corporate income tax that falls to labor could potentially range from 75 to 100 percent.²⁶ Given that huge burden on workers, lowering the corporate tax rate in the current economic condition could yield double benefits.

Summing Up

At this critical juncture in U.S. history, it is essential that we all work together to 1) accomplish a fiscal consolidation and 2) to accomplish a fundamental tax reform. A fiscal consolidation that pushed the U.S. debt level away from the danger zone could easily increase expected growth by about half a percentage point a year. A tax reform could provide an additional growth stimulus of at least the same scale. Combined, these policies would more than offset the growth handicap associated with the financial crisis.

²³ World Bank Doing Business Report. <http://www.doingbusiness.org/rankings>

²⁴ Kevin S. Markle and Douglas A. Shackelford, "Cross-Country Comparisons of Corporate Income Taxes." <http://resources.news.com.au/files/2010/05/24/1225870/574129-aus-tax-review-paper.pdf>

²⁵ Kevin A. Hassett and Aparna Mathur. "Report Card on Effective Corporate Tax Rates," *AEI Tax Policy Outlook*, February 2011.

²⁶ See for example Hassett and Mathur (2010), Felix (2007), Desai et al (2007) and Arulampalam et al.(2008)