Research

The Cost of Inaction on Tax Reform

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Executive Summary

Congress is expected to take up tax reform in earnest this fall, and the stakes could not be higher. If Congress is successful in making fundamental, pro-growth changes to the tax code, it will significantly improve the trajectory of the U.S. economy—along with wages, jobs, investment, and the federal budget. If Congress fails to achieve such reform, the federal tax system could remain an anchor on the economy, weighing down the United States' potential for growth, and limiting its citizens' shot at the American Dream.

- Tax reform offers the potential for substantially boosting the economy – with mid-range estimates of a 4-percent increase in growth.
- Tax reform could reduce the time it takes a worker to double their standard of living from 70 to 50 years – closer to the 35-year period that marked the post-war period.
- Tax reform could increase average incomes by $3,000.
- Tax reform could stem the outflow of $900 billion in U.S. capital, and over 40,000 high quality headquarters jobs.
- Tax reform could reduce the budget deficit by over $1 trillion over the next decade.

Introduction

The central goal of tax reform should be to improve the United States' prospects for economic growth. According to the Congressional Budget Office's (CBO) latest projections, absent policy change, the economy will grow at a tepid 1.8 percent in real terms over the next 10 years[1]. This is far below the nation's 3.4-percent annual average growth enjoyed through most of the post-World War II era, and far below what is needed for the nation to meet both its challenges and potential.

Successful tax reform will not be achieved by simply tweaking the current code. Rather, it must fix the major policy design flaws that weigh down the economy. What happens if Congress and the administration fail to enact pro-growth tax reform? This analysis tabulates the costs of failure across 5 metrics – GDP, standards of living, income growth, high-quality jobs, and budgetary.

- **Lost Economic Growth**

In a seminal paper, David Altig, Alan Auerbach, Laurence Kotlikoff, Kent A. Smetters, and Jan Walliser, simulated multiple tax reforms and found GDP could increase by as much as 9.4 percent based on a highly efficient consumption-style tax.[2] The study examined other less ambitious, and gradually less efficient, tax reforms, also including a "clean," revenue-neutral income tax that would eliminate all deductions, loopholes, etc.; and shift to a single low rate. According to the study, this reform would raise GDP by 4.4 percent over a medium-to-long term horizon. While this estimate may not reflect what Congress ultimately enacts, it is a useful benchmark for assessing the growth potential from tax reform.

- **Reduced Standards of Living and the American Dream**

The sluggish pace of projected economic growth equates to an average 1 percent per capita income growth. At that rate, it would take 70 years for an individual to double their standard of living – an achievement that used to take just 35 years or about one working career.[3] Without substantially improving the rate of economic growth, the American Dream will be pushed beyond the reach of working Americans.

A 4 percent GDP improvement would translate into roughly .4 percent higher annual growth. While not sufficient to return the United States to historical rates, it would get us moving in the right direction. At this rate of growth, per-capita GDP growth would also be higher, averaging about 1.4 percent over the next ten years. This would allow for doubling of the standard of living in about 50 years—a meaningful improvement over the current outlook.

- **Lost Income**

Stronger economic growth, particularly when the United States is at full employment, means higher wages and incomes. While modest, 4 percent higher GDP would go a long way towards improving a family's bottom line. Assuming this rate growth, tax reform could improve per capita incomes by nearly $3,000 in real terms by the next decade.

- **High-Quality Jobs Shipped Overseas**

A anestimate on the macro-economic effects of fundamental tax reform, authored by John Diamond and George Zodrow, examined how a tax reform proposal would affect capital flows compared to current law.[4] In the long-run, the authors estimated that a reform that lowered corporate rates and moved to an internationally competitive divided-exemption system would increase U.S. holdings of firm-specific capital by 23.5 percent, while domestic ordinary capital would increase by 5 percent, on net. It is important to note that these are relative measurements – they were relative to current law. Current law is inducing capital flight, as high-profile tax "inversions" have made clear. Accordingly, the 23.5 percent and 5 percent increases in firm-specific and ordinary stock, respectively, may be interpreted in part as the effect of precluding future capital flight – on the order of $900 billion for tax reasons.[5] The largest American firms have nearly 280,000 headquarters employees, many of which would be at risk for having their positions relocated abroad. If roughly 15 percent of U.S. based market capital is at rest, it suggests a proportional overseas relocation of 41,000 U.S. headquarters jobs.

- **Squandered Budget Savings**

Stronger economic growth would substantially improve the budget outlook. Deficit savings could be used to pay down the nation's nearly $20-trillion debt, contribute to further rate reduction, or some combination of the two. According to the CBO, a 0.1 percentage point annual increase in productivity growth (a fair proxy for GDP growth from tax reform) would improve the 10-year deficit by $273 billion.[6] Accordingly, a 4-fold improvement would provide over $1 trillion in 10-year deficit savings.

Conclusion

Congress and the administration have an opportunity to meaningfully reshape the tax code for the first time in over 30 years. In so doing, policymakers can reverse the negative effects the broken U.S. tax code has on the economy and the wellbeing of American families and businesses. Squandering this opportunity would mean forgoing stronger growth, improved standards of living, higher wages, high-paying jobs, and budget savings, further confining the United States to a sluggish economic future.

[1] https://www.cbo.gov/about/products/budget-economic-data#4

[2] Altig, David, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters and Jan Walliser, "Simulating Fundamental Tax Reform in the United States." American Economic Review, Vol. 91, No. 3 (2001), pp. 574-595

[3] https://www.uschamberfoundation.org/sites/default/files/The%20Growth%20Imperative.pdf

[4] http://businessroundtable.org/sites/default/files/reports/Diamond-Zodrow%20Analysis%20for%20Business%20Roundtable_Final%20for%20Release.pdf

[5] https://www.americanactionforum.org/research/economic-risks-proposed-anti-inversion-policy-update/

[6] https://www.cbo.gov/sites/default/files/115th-congress-2017-2018/reports/52370-outlook_1.pdf