Testimony

# Opportunities for Pro-Growth Policy in the 114th Congress

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**The views expressed here are my own and not those of the American Action Forum, the Partnership for the Future of Medicare or the Center for Health & Economy. I thank Angela Boothe, Laura Collins, and Gordon Gray for their assistance.*

Chairman Ryan, Ranking Member Levin, and members of the committee, thank you for the opportunity to speak with you today regarding opportunities in the 114th Congress to promote more rapid economic growth. I believe that there are three policy areas in particular where much progress can be made to promote a stronger economy:

- Aggressively pursue new trade agreements and pass trade promotion authority legislation to facilitate trade negotiations;
- Reform America's income tax code, enhancing the nation's competitiveness abroad and improving incentives to work and save at home; and
- Improve the condition of the U.S. health care system by trimming away the most cumbersome pieces of the Affordable Care Act.

## TRADE AGREEMENTS

Trade is an important driver of economic growth in the U.S. and globally. Trade creates jobs, increases Gross Domestic Product (GDP), and opens markets to American producers and consumers. The U.S. is the world's largest participant in global trade—with almost $2.3 trillion in exports of goods and services and imports of $2.7 trillion—and has established trade agreements with 20 countries.[1] The U.S. and our trading partners generate 25 percent of global goods trade.[2] The U.S. is the largest exporter of services in the world.[3] Trade supports nearly 11 million jobs in the U.S.[4] and U.S. exports comprise a full 13 percent of U.S. GDP.

These numbers are significant, and pursuing a robust trade agenda in 2015 will lead to increased economic growth. Two agreements the U.S. is negotiating have the potential to become final in 2015. Both the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) are major trade deals with huge economic potential. Combined, these agreements have the potential to create more than 1 million new jobs in the U.S. and increase GDP by over $200 billion.[5]

Finalizing these trade agreements depends in large part on Congress passing trade promotion authority (TPA) legislation. TPA allows for effective negotiations between the U.S. and potential trade partners. Through the TPA, the U.S. and its trade partners negotiate with confidence that the agreements reached will be the final version implemented once Congress approves.

Since 1974, every U.S. president has had the ability to negotiate free trade agreements under some form of TPA. TPA expired in 2007 and has not yet been reauthorized. This has contributed to slower negotiations for TPP and

TTIP during the Obama Administration. Passing TPA will help propel these negotiations forward so we can begin to reap the many economic benefits of these free trade agreements.

# TAX REFORM

There are few policy areas in greater need of fundamental reform than the U.S. tax code. Fundamental modernization and simplification of the tax system has been an elusive dream for Congresses and administrations over the past 30 years. Indeed, over the 100 year history of the U.S. income tax system, only a handful of meaningful simplification efforts have been successful. This committee is to be commended for its recent contributions to this effort, which have included proposals for comprehensive overhaul of both the corporate and individual tax systems. The research literature indicates that these components are essential to any pro-growth overhaul; a transformation that is long overdue.

## *Corporation Income Tax*

The U.S. corporate tax code has remained largely unchanged for decades, with the last major rate reduction passed by Congress in 1986.[6] However, significant global economic and geopolitical changes have occurred in the intervening years, during which time the rest of the world has made significant changes to their corporate tax systems, both in terms of rates and in the taxation of overseas income. Relative to other major economies, the U.S. has gone from being roughly on par with major trading partners to its current position of imposing the highest statutory rate on corporation income. While less stark than its high statutory rate, the U.S. also imposes large *effective* rates. According to a study by PricewaterhouseCoopers, "companies headquartered in the United States faced an average effective tax rate of 27.7 percent compared to a rate of 19.5 percent for their foreign-headquartered counterparts. By country, U.S.-headquartered companies faced a higher worldwide effective tax rate than their counterparts headquartered in 53 of the 58 foreign countries."[7]

The U.S. fails another competitiveness test in the design of its international tax system. The U.S. corporation income tax applies to the worldwide earnings of U.S. headquartered firms. U.S. companies pay U.S. income taxes on income earned both domestically and abroad, although the U.S. allows a foreign tax credit up to the U.S. tax liability for taxes paid to foreign governments. Active income earned in foreign countries is generally only subject to U.S. income tax once it is repatriated, giving an incentive for companies to reinvest earnings anywhere but the U.S., owing to its high corporate tax rate. This system distorts the international behavior of U.S. firms and essentially traps foreign earnings that might otherwise be repatriated back to the U.S.

While the U.S. has maintained an international tax system that disadvantages U.S. firms competing abroad, many U.S. trading partners have shifted toward a territorial system; that system exempts entirely, or to a large degree, foreign source income. Of the 34 economies in the OECD for example, 26 have adopted such systems, including recent adoption by Japan and the United Kingdom.[8]

## *Who Does Tax Reform Help?*

Corporations are not the only entities that bear the burden of the corporate tax structure; everyone is burdened by the corporate tax rate. Corporations are not walled off from the broader economy, and neither are the taxes imposed on corporate income. Taxes on corporations fall on stockholders, employees, and consumers alike. The incidence of the corporate tax continues to be debated, but it is clear that the burden on labor must be acknowledged. Indeed, one recent study found that labor bears as much as 70 percent of the corporation income tax rate.[9] Other studies have found similar implications, with a study by economists at the American

Enterprise Institute concluding that for every 1 percent increase in corporate tax rates, wages decrease by 1 percent.[10]

## *Improving the Corporate Tax Code*

The negative incentives created by the high corporate tax rate show that the high level of corporate tax liability effectively taxes the success of U.S. companies. In order to remove the drag on the economy, the corporate tax rate must be decreased and the code reformed.

Many studies exist examining the positive impacts of reducing the corporate tax rate. Of note, one study found that cutting the corporate tax rate by 10 percentage points can increase the annual growth rate by between 1.1 percent and 1.8 percentage points.[11] The Tax Foundation has found similar results, estimating that the potential growth effects from corporate rate reduction, from 35 to 25 percent would raise GDP by 2.2 percent, increase the private-business capital stock by 6.2 percent, boost wages and hours of work by 1.9 percent and 0.3 percent, respectively, and increase total federal revenues by 0.8 percent.[12]

Reform of the international tax system is also an essential element of any pro-growth corporate tax reform. One recent estimate on the macro-economic effects of fundamental tax reform, authored by John Diamond and George Zodrow, examined how reform similar to that proposed by former Chairman Camp would affect capital flows compared to current law.[13] In the long-run, the authors estimated that this type of reform that lowers corporate rates and moves to an internationally competitive divided-exemption system would *increase* U.S. holdings of firm-specific capital by 23.5 percent, while the net change in domestic ordinary capital would be a 5 percent increase. It is important to note that these are relative measurements – they are relative to current law. If the recent spate of announcements of inversions is any indication, current law is inducing capital flight. Moreover, to the extent that the rest of the world has reduced its corporate rates and moved to a territorial system, a Camp-style reform may merely move the U.S. to the middle of the pack in terms of its tax climate. 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 tax inversions.

Placing a value of this potential equity flight is uncertain, but based on these estimates, roughly 15 percent, or $988 billion in U.S. based capital is at risk of moving overseas. Reforming the international corporate code would preclude this capital flight and prevent associated job losses.[14]

## *Individual Income Tax*

While the corporate tax is in sore need of repair, a corporate tax overhaul that does not also address the individual code would leave out the most significant interaction between federal taxation and the economy. In 2011, 145 million tax returns were filed, addressing over $8.3 trillion in income.[15] These returns also include millions of businesses that do not file as C-Corporations. As of 2009, there were 31.7 million non-farm businesses filing tax returns: 1.7 million C-corporations, 22.7 million sole-proprietors, 4.1 million S-corporations, and 3.2 million partnerships (including LLCs). The past several decades have seen the relative growth of non-farm sole proprietors, S-corporations and partnerships, and the associated diminution of the C-corporation.[16] Any business tax reform must therefore also contemplate the individual code. The revenue raised from the individual code totals over 5 times the amount raised from U.S. corporations, underscoring the need to approach tax reform in a wholesale fashion.

### *The Current Burden of the Individual Code*

As many Americans have experienced, the tax filing process is extremely time intensive and requires the help of outside expertise. The Taxpayer Advocate Service (TAS), the watchdog office within the Internal Revenue Service (IRS), stated that complexity is the single most serious problem with the tax code. TAS found that taxpayers spend about 6.1 billion hours each year complying with the filing requirements imposed by the IRS—the working equivalent of over 3 million full-time employees. The TAS estimates that the compliance costs of these requirements amounted to $168 billion in 2010.

This complexity is also straining the administrative capacity of the IRS. As the amount of work required to complete tax filing increases, the ability of the agency to respond to inquiries declines. According to the TAS, the IRS received 115 million calls in fiscal years 2011 and 2012, and in 2012 the IRS answered 68 percent of calls received, as compared to 87 percent in 2004.[17]

The burden on individuals filing their taxes also translates to a large scale negative economic impact. Fichtner and Feldman assessed the costs that the U.S. tax code extracts from the economy as taxpayers through complexity and inefficiency. The study finds that, in addition to time and money expended in compliance, foregone economic growth, and lobbying expenditures amount to hidden costs are estimated to range from $215 billion to $987 billion.[18]

### *The Benefits of Comprehensive Tax Reform*

One of the largest distortions income taxes create is decreasing the effective return to work and saving. As people work less and investment decreases, the economy grows more slowly than it otherwise would. Income taxes have other secondary effects as well, such as incentivizing movement of compensation into tax-free benefits. Much of the academic literature on the effect of income taxes tends to take a broad approach that focuses on how income taxes affect overall economic growth and output.

The last time the United States undertook a fundamental tax reform was with the Tax Reform Act of 1986 (TRA). If history is any guide, a 1986 style reform offers positive economic growth. This is borne out by retrospective analysis of the TRA which found that the 1986 tax reform produced about one percentage point higher growth over a long period. Further studies have shown that the negative relationship with higher marginal rates and taxable income, hours worked, and overall economic growth.[19]

An important step in this literature area was made by highly respected economists David Altig, Alan Auerbach, Laurence Kotlikoff, Kent A. Smetters, and Jan Walliser, who simulated multiple tax reforms. They found that GDP could increase by as much as 11 percent higher from tax reform.[20] The highest growth rate was associated with a consumption-based tax system that avoided double-taxing the return to saving and investment, which while contemplated in past reform efforts, is not currently under consideration by the Congress. The study also simulated a “clean,” revenue-neutral income tax that would eliminate all deductions, loopholes, *etc.*; and lower the rate to a single low rate. According to their study, this reform raised GDP by 5.1 percent over ten years—a growth effect that roughly translate into about .5 percent higher trend growth, resulting in faster employment and income growth.

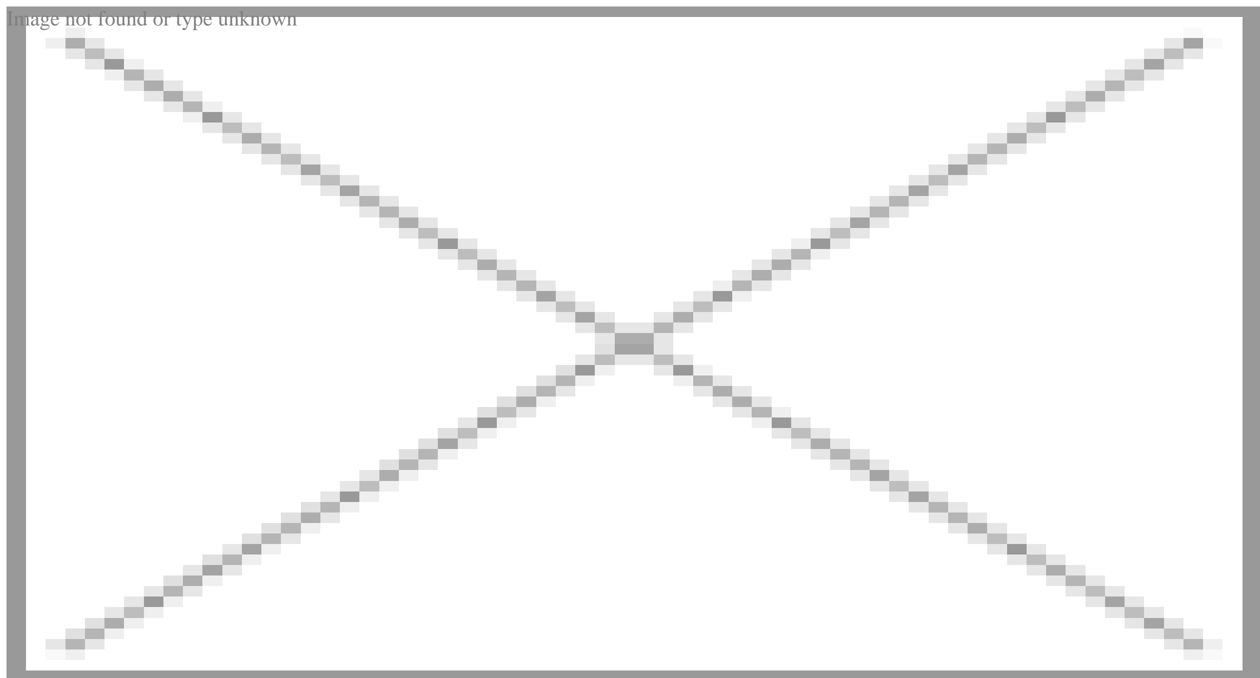
## HEALTH CARE REFORM

Health care programs continue to be the largest driver of projected federal shortfalls. The Congressional Budget

Office (CBO) estimates that federal spending on health care will reach $1 trillion in 2015.[21] Any serious effort to promote economic growth will have to address the U.S. health care system. As part of bringing sanity to federal health care programs, many of the changes made by the Affordable Care Act (ACA) must be reversed to mitigate the law's negative economic impacts. The regulatory burden, requirements forced upon employers and individuals, and poorly constructed revenue streams should be changed to reverse their downward pressure on the economy.

## Regulation

The regulatory burden created by this massive law places a severe drag on the economy, and should be rolled back. According to a recent American Action Forum (AAF) study, the regulations in the ACA alone have imposed more than $27.2 billion in private sector costs, $8 billion in costs to state governments, and have created over 159 million paperwork hours for local governments.[22] Over the almost five years since its enactment, the ACA has resulted in annual cost of $6.8 billion, as compared to an annual $2.6 billion in increased benefits. The following chart breaks down the paperwork hours according to the type of regulation:




## Impact on Businesses

The ACA's extensive requirements are diverting time and productivity from the private sector, slowing economic growth. In line with the regulatory burdens addressed above, AAF estimates that on average, individuals who work for a company with 50-99 employees lose $935 annually due to ACA regulations, and employees of smaller businesses with 20-49 employees, lose $827.50 annually. Further, the ACA's regulations are reducing small business wages by $22.6 billion each year and these regulations (as well as rising health insurance premiums) have already reduced the number of jobs by 350,000 across the country.[23]

## Employer Mandate and the 30-hour Work Week

The employer mandate has resulted in serious problems for employers; forcing many to provide coverage or pay hefty penalties and the mandate has stalled an already damaged economy.[24] Under the ACA's mandate, businesses that employ a worker for more than 30 hours a week must provide health insurance for that employee. In order to avoid the cost of the employer mandate penalty, employee hours would have to be reduced below the 30 hours per week threshold. According to AAF estimates, an employee earning the national average of $24.31 an hour would see a reduction in wages of $13,370 annually if their hours were cut below the 30-hour ACA standard. As illustrated in this example, defining full time employment as a 30-hour work week does not benefit the individual or the employer.[25]

Along with the potential for decreases in the number of full-time employees (and therefore wages), the ACA not only punishes employers for not providing coverage, but also for offering health insurance plans that are not up to ACA standard benefit requirements. The House has already moved to increase the workweek provision to 40 hours per week, and a complete repeal of the employer mandate should be pursued, as it would lift some of the pressures on the economy.

### *Poorly Designed Taxes*

Finally, getting rid of two poorly designed taxes within the ACA could improve economic growth in the health insurance sector, and the innovative medical device industry. Both the health insurer tax (HIT) and the medical device tax should be repealed. The concept is a simple one, fewer burdens on industry allows for greater economic productivity.

The HIT, also known as the Health Insurance Annual Fee, was designed as a way to gain revenue from the newly generated profits for health insurance companies created by the employer and individual mandates. The HIT is assessed to insurers based on their share of total premiums paid; the total dollar amount to be collected across all insurers is set in statute and not actually based on profits. ACA provisions required the tax to collect $8 billion in 2014, and will collect $11.3 billion in 2015. According to previous AAF research, this additional tax will be passed along to consumers, resulting in a premium increase of $60-$160 per person in 2014.[26] Repealing this tax on health insurance would prevent premium increases for millions of consumers and decrease health insurer payments to the federal government. More importantly this tax is poorly designed, and an excellent example of how not to structure taxes.

The medical device tax included in the ACA establishes a 2.3 percent sales tax on all medical devices.[27] The tax creates higher costs for innovative health care companies, many of whom have high initial capital investments. The tax is poorly designed because it is levied on each individual sale and not a company's net profit. This means companies that are still in the red with their investments must pay the tax on sales of their device, despite not having turned a profit.

The medical device tax has already cost the industry over $900 million.[28] There is broad bipartisan support for repealing this tax, and President Obama has indicated he would sign legislation doing so. In order to create large benefits for this industry and to decrease costs for medical device consumers, Congress should repeal the medical device tax early this year.

## CONCLUSION

As Congress looks to encourage economic growth in 2015, action should be taken in all three of these policy areas. Freeing industries to trade globally, creating a competitive environment of corporations and for

consumers, as well as repairing some of the damage done to the health care sector will work in tandem, bolstering the U.S. economy. Hindrances created through delayed trade agreements, high demands on the health care system, and disincentives that exist in such a complicated tax code slow down economic activity across the country. The 114th Congress should approach the big picture of economic growth by taking steps to lessen the burden of the tax code, finalizing trade negotiations, and making changes to the health care system as it exists under the ACA.

[1] "Trade Agreements Benefit U.S. Exports," U.S. Department of Commerce, International Trade Administration, Washington, DC available at http://www.trade.gov/mas/ian/build/groups/public/@tg_ian/documents/webcontent/tg_ian_