Testimony before the House Ways and Means Committee

Regarding the Importance of Comprehensive Tax Reform

Kevin A. Hassett

Director of Economic Policy Studies

American Enterprise Institute

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The views expressed in this testimony are those of the author alone and do not necessarily represent the views of the American Enterprise Institute.

Chairman Camp, Ranking Member Levin, and members of the committee, it is an honor to appear before you to discuss the need for comprehensive tax reform.

In the wake of the recent financial crisis, Americans are hopeful that the economy will return to normal, and policy makers are rightly seeking ways to hasten this restoration. Everyone is disappointed with the recovery so far, and the sad fact is that this disappointment was predictable. It is normal for recessions that are accompanied by a financial crisis to linger uncomfortably long.

According to a study last summer by Carmen and Vincent Reinhart (2010), absent significant policy changes, we shouldn't expect the economy to fully rebound for quite some time.[1]

Reinhart and Reinhart examined economic indicators in the ten years preceding and following the fifteen most severe financial crises in modern history. Their findings (summarized in Table 1), suggest that economic growth for the rest of this decade will be about one percentage point slower than we have grown accustomed to. This slow growth has a real human cost. Fully a decade after the typical financial crisis, the unemployment rate remained about double what it was before the crisis. That means that we should expect the policy status quo to give us an unemployment rate eight years from now that is still above 8 percent.

As we look in this new Congress for areas of agreement between the parties, let us begin by stipulating that the status quo is unacceptable to everyone. I would add that we should also stipulate that this low-growth baseline is a medium-term problem. It will take years for Americans to do the hard work of digging out from the mess we are in. Thus, a short-term stimulus is of little use, and more fundamental changes must be considered.

To skip to the conclusion of my testimony, amidst all this bad news, there is some good news as well. We can do much to speed up the economic recovery process, indeed the literature on fundamental tax reform suggests that a well-designed reform could deliver about a percent a year of extra growth over the next decade, offsetting the handicap that is the residual of the financial crisis.[2]

The Tax Reform Opportunity

As April 15th approaches each year, taxpayers are frustrated by the complexity of our current income tax system. With its various rates, credits, and phase-outs it's difficult for the average person to understand what their marginal tax rate really is. Illustrating this point, Figures 1 and 2 (from Hassett, Lindsey, and Mathur 2009) show the marginal tax rates for those filing married or single with two children.[3]

Now progressives generally favor tax rates that increase along with incomes. Others favor rates that are flat across incomes. Nobody I know thinks the marginal tax rate schedule should look like a city skyline, but that is what we have. This is logically indefensible and a national embarrassment. Through comprehensive tax reform, the system could be streamlined to improve taxpayers understanding (helping them make rational choices) and remove distortions that hamstring economic growth.

A sound reform should not only fix our rates, but also should reform the definition of the tax base as well.

Let's begin with an idea that everyone accepts: the government should try to minimize distortions to relative prices and try not to have a heavy tax on apples, with no tax on oranges.

Consider the following illustration from a volume on fundamental tax reform that I edited in 2005 along with my colleague Alan Auerbach of UC Berkeley:[4]

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[1] Vincent Reinhart and Carmen Reinhart, "After the Fall," (paper presented at the annual Federal Reserve Bank of Kansas City conference, Jackson Hole, Wyoming, August 17, 2010).
[2] 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.
[3] Kevin A. Hassett, Lawrence B. Lindsey, and Aparna Mathur, "Moving Toward a Unified Credit for Low-Income Workers," *Tax Notes.* August 10, 2009: 589-602.
[4] Alan J. Auerbach and Kevin A. Hassett, *Toward Fundamental Tax Reform*, (Washington, DC: AEI Press, 2005), 6.

> Think of consumption today as being represented by apples, and consumption ten years from now as oranges. If you give up an apple today, you get a number of oranges ten years from now that depends on the interest you get on the money you saved by not eating the apple. At 10 percent interest, a dollar saved today becomes $2.60 ten years from now. If we tax that interest at 50 percent, a dollar saved today only yields $1.63 ten years from now.

This distortion grows bigger and bigger with the time horizon. Under the same assumptions, one dollar saved today produces $17.45 thirty years from now, but only $4.32 if the interest is taxed. Since it is not efficient for the tax system to create big changes in relative prices, and compounding is, as Einstein said, "the most powerful force in the universe," reform efforts should promote efficiency by minimizing taxes to capital income.

While a consensus has emerged in the literature that consumption-based taxes are more efficient than income-based taxes, there is less agreement on how much this inefficiency costs the American economy and how much of this cost could be eliminated by changing the tax structure.

Finally, I should add that these distortions could well be a big deal, and a well-designed reform could easily produce significant growth effects. 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.[5] My review of the literature with Alan Auerbach suggested that this consensus is a fair reading of the broader tax reform literature.[6]

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.

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 the ball and chain.

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."[7]

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.

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.

Statutory Tax Rates

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 (see Table 2).[8] Hence within the OECD countries, the U.S. has the highest statutory rate of taxation at the national level.

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[5] 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.
[6] Alan J. Auerbach and Kevin A. Hassett, *Toward Fundamental Tax Reform*, (Washington, DC: AEI Press, 2005), 150.
[7] *OECD Tax Policy Studies: Tax Policy Reform and Economic Growth* (OECD Publishing, 2010), 10.
[8] "OECD Tax Database," http://www.oecd.org/ctp/taxdatabase.

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. In 2011, the United States will be left with the highest national and combined corporate tax rates in the world when Japan introduces a planned 5 percentage point reduction to its top rate.

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 (see Figure 3). 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 U.S., on the other hand, has not reduced its top statutory rate since 1993.

If we look at the frequency distribution of countries (using a kernel estimator) at different tax rates in 1981, 1996 and 2010, we can see a striking change in the U.S. position relative to other OECD countries (see Figure 4).[9]

In 1981, the bulk of OECD countries had an average combined tax rate of slightly above 47 percent.[10] 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.

Effective Tax Rates

The statutory tax rate is an imperfect measure of tax competitiveness, because it does not take into account the breadth of the tax base. This causes countries with high rates and a narrow base, such as the United States, to appear more uncompetitive. "Effective" tax rates resolve this issue by taking into account tax offsets, the present value of depreciations, and other deductions that narrow the base.

Effective tax rates can be measured using an approach outlined in a 1999 paper by economists Michael Devereux and Rachel Griffith.[11] Extending a literature that dates back to the early 1960s, they propose that effective rates be explored using two main measures. The first is the "effective marginal tax rate" (EMTR), which applies to marginal investment projects where the last unit invested provides just enough pre-tax return to cause the project to break even after-taxes. In other words, the marginal investment equates the net present value of the income stream to the net present value of the investment costs.

The EMTR would always be applicable under the assumption that "all potential investment projects that earn at least the cost of capital will be undertaken."[12] However, in the real-world there are many cases when an investor must make a choice between two projects that each earns more than the minimal return required to make the project worthwhile. The effective average tax rate (EATR) summarizes the distribution of tax rates for an investment project over the range of possible profitability levels. When deciding between mutually exclusive projects where the net present value of the income streams are *greater* than the pre-tax net present value of the investment costs, the EATR will inform the decision. That is, the EATR is likely the right rate to consider when exploring whether taxes are inducing firms to locate plants abroad. Conditional on that decision, the EMTR will inform the scaling of the project. If the concern is the observation that many profitable plants have been moved abroad, then the right effective rate to inspect is the EATR.

[9] Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).
[10] "OECD Tax Database," http://www.oecd.org/ctp/taxdatabase.
[11] Michael Devereux and Rachel Griffith, "The Taxation of Discrete Investment Choices," Institute for Fiscal Studies, Working Paper Series No. W98/16 (1999).
[12] *Doing Business 2011: Making a Difference for Entrepreneurs*, (International Bank for Reconstruction and Development/The World Bank, 2010).

In a forthcoming AEI paper, my colleage Aparna Mathur and I computed the EATR and the EMTR for all countries in the sample and for each time period using the methodology outlined by Devereux and Griffith (1999) assuming fixed parameter values for the economic depreciation rates, the inflation rate, and the annual discount rate.[13]

Effective Average Tax Rates

Our analysis finds that the United States' performance in the global economy does not look much better when scored with effective average tax rates than when scored with the top statutory tax rates. The kernel densities (Figure 5) show that the U.S. has moved far to the right of the mode of the OECD distribution. Or, more accurately, the OECD moved to the left. In 1996, the United States' EATR was slightly below the OECD average, 29.2 versus 29.7. In later years, the OECD average improved by over 9 percentage points, while the United States' EATR remained relatively unchanged. In 2010, the U.S. effective average rate was 29 percent, while the average for all the other OECD economies was 20.5 percent.

Effective Marginal Tax Rates

The United States compares marginally more favorably to other OECD countries when it comes to the effective marginal tax rate. However, even the EMTR is significantly higher than the OECD average. According to the distribution charts (Figure 6), in 1981 the United States was left of the mode, however in the intervening years the rates in other countries have declined leaving the United States with one of the highest effective marginal tax rates. In 2010, the U.S. effective marginal tax rate was 23.6 percent, relative to the non-U.S. OECD average of 17.2 percent (see Table 3).

Tax Revenues

Any discussion of tax rates is incomplete without an analysis of trends in corporate tax revenues. With one of the highest corporate tax rates in the world, one might expect the share of revenues from corporate capital to be higher in the U.S. than in other OECD economies. This is not the case, however. As Figure 7 clearly shows, except for a brief period in the 1990s, U.S. corporate tax revenues have been consistently lower than those of the OECD economies.[14]

In 1981, the U.S. raised about 2.3 percent of GDP from revenues, but between 2000 and 2004, it raised between 1.7 to 1.9 percent of GDP from revenues. The 2005 number was slightly higher than 1981, leading to the upward spike in the chart. The chart also shows that for the U.S., revenues dipped substantially below the OECD average in 1983, 1987, and peaked in 1995.

For the average OECD country, corporate income tax revenues relative to GDP increased between 1981 and 2008 from about 2.4 percent to 3.9 percent, before declining precipitously in the aftermath of the Great Recession. For the U.S., revenues have shown a slight uptick in the most recent year, narrowing some of the revenue gap with the OECD economies. The glaring result from comparing the U.S. relative tax position to the relative revenue position is that despite (or perhaps because of) the relatively higher corporate tax rates in the U.S., the U.S. earns less federal revenue from corporate income as a percentage of GDP than the average OECD economy.

This pattern is consistent with the literature that explores the responses of tax revenue to changes in the corporate tax rate. Alex Brill and I found significant evidence that a reduction of the corporate tax rate in the U.S. would increase corporate tax revenue.[15]

Conclusion

Given the significant headwinds that the economy faces, the indefensible state of the current tax code, the horrifyingly high U.S. corporate tax rate both statutory and effective, and the consensus that the economic impact of a fundamental tax reform would be positive, opposition to tax reform this year would be difficult to comprehend.

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[13] Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).
[14] "OECD Tax Database," http://www.oecd.org/ctp/taxdatabase
[15] Kevin A. Hassett and Alex Brill, "Revenue-Maximizing Corporate Income Taxes: The Laffer Curve in OECD Countries," AEI Working Paper #137 (2007).

Tables

Table 1: Median Behavior Surrounding the 15 Most Severe Financial Crises

	Growth of Real GDP per capita (%)	Unemployment rate (%)	Change in equity prices (%)	Real house prices
6-10 years before	3.3	4.1	8.1	73.3
2-5 years before	4.4	3.5	14.5	92.1
1 year before	3.2	3.4	-15.1	100.0
Crisis Year	1.6	5.1	-27.6	95.1
1 year after	-5.8	6.8	-4.5	83.7
2-5 years after	3.0	9.0	10.9	76.4
6-10 years after	3.8	6.2	12.1	82.8

Notes:

- House prices are indexed to t-1=100
- Countries in the sample: Spain 1977, Norway 1987, Finland 1991, Sweden 1991, Japan 1992, Indonesia 1997, Korea 1997, Malaysia 1997, Philippines 1997, Thailand 1997, Chile 1981, Colombia 1998, Mexico 1994, Argentina 2001, and Turkey 2001
- Unemployment average excludes the following countries: Thailand 1997, Chile 1981, Mexico 1994, Argentina 2001, and Turkey 2001

Source: Vincent Reinhart and Carmen Reinhart. "After the Fall," (paper presented at the annual Federal Reserve Bank of Kansas City conference, Jackson Hole, Wyoming, August 17, 2010).

Table 2:

2010 Top Statutory Corporate Income Tax Rates		
Country	**Central Govt.**	**Combined**
Australia	30.0	30.00
Austria	25.0	25.00
Belgium	33.0	33.99
Canada	18.0	29.52
Chile	17.0	17.00
Czech Republic	19.0	19.00
Denmark	25.0	25.00
Finland	26.0	26.00
France	34.43	34.43
Germany	15.83	30.18
Greece	24.0	24.00
Hungary	19.0	19.00
Iceland	15.0	15.00
Ireland	12.5	12.50
Italy	27.5	27.50
Japan	30.0	39.54
Korea	22.0	24.20
Luxembourg	21.84	28.59
Mexico	30.0	30.00
Netherlands	25.5	25.50
New Zealand	30.0	30.00
Norway	28.0	28.00
Poland	19.0	19.00
Portugal	25.0	26.50
Slovak Republic	19.0	19.00
Spain	30.0	30.00
Sweden	26.3	26.30
Switzerland	8.5	21.17
Turkey	20.0	20.00
United Kingdom	28.0	28.00
United States	35.0	39.21

Sources:

- Authors' table. Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).
- "OECD Tax Database," http://www.oecd.org/ctp/taxdatabase.

Table 3: 2010 Tax Rates

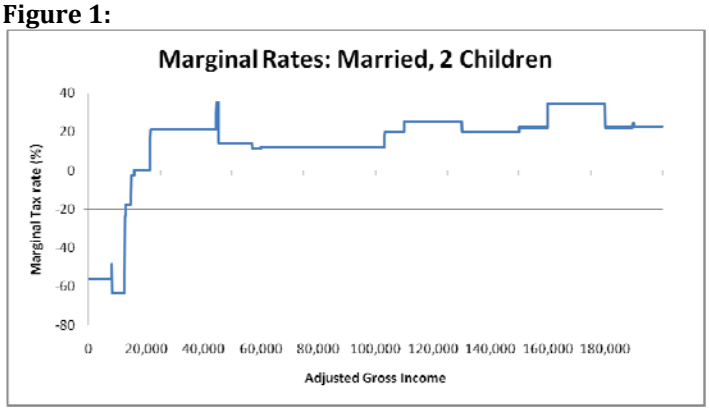
Country	EATR	EMTR	Statutory Combined	World Bank Estimate
Australia	22.2%	17.0%	30.0%	25.9%
Austria	20.8%	18.2%	25.0%	15.7%
Belgium	22.3%	13.9%	34.0%	4.8%
Canada	25.5%	23.4%	29.5%	9.8%
Chile	13.9%	11.5%	17.0%	
Czech Republic	18.4%	18.1%	19.0%	7.4%
Denmark	19.9%	16.5%	25.0%	21.9%
Finland	20.7%	17.3%	26.0%	15.9%
France	27.5%	23.8%	34.4%	8.2%
Germany			30.2%	22.9%
Greece	17.9%	13.4%	24.0%	13.9%
Hungary	15.7%	13.4%	19.0%	16.7%
Ireland	10.9%	9.7%	12.5%	11.9%
Iceland			15.0%	6.9%
Italy	24.3%	22.6%	27.5%	22.8%
Japan	33.0%	30.5%	39.5%	27.9%
Korea	18.1%	13.6%	24.2%	15.3%
Luxembourg	20.1%	13.9%	28.6%	4.1%
Mexico	28.4%	27.7%	30.0%	
Netherlands	19.4%	15.1%	25.5%	20.9%
New Zealand			30.0%	30.4%
Norway	24.2%	22.1%	28.0%	24.4%
Poland	16.2%	14.1%	19.0%	17.7%
Portugal	18.3%	12.2%	26.5%	14.9%
Slovak Republic	19.2%	19.3%	19.0%	7.0%
Spain	27.5%	26.3%	30.0%	20.9%
Sweden	18.5%	12.6%	26.3%	16.4%
Switzerland	15.4%	10.9%	21.2%	8.9%
Turkey	13.1%	7.3%	20.0%	8.9%
United Kingdom	22.3%	18.8%	28.0%	23.2%
United States	29.0%	23.6%	39.2%	27.6%
Average excluding U.S.	20.5%	17.2%	25.5%	15.9%

Sources:

- Authors' calculations. Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).
- *Doing Business 2011: Making a Difference for Entrepreneurs*, (International Bank for Reconstruction and Development/The World Bank, 2010)

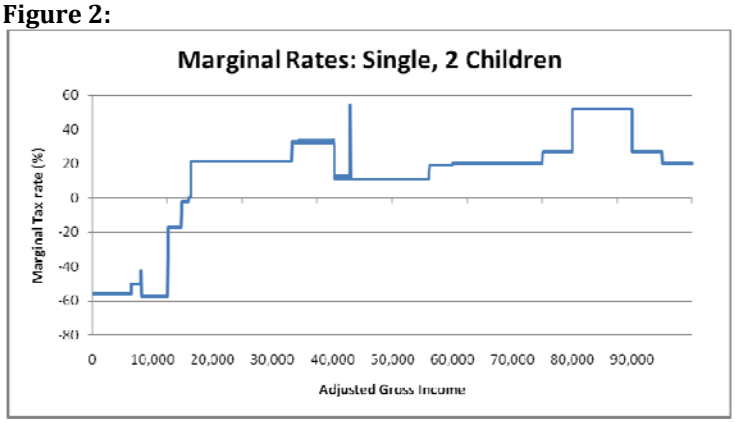
Figures

Figure 1:



Source: Kevin A. Hassett, Lawrence B. Lindsey, and Aparna Mathur. "Moving Toward a Unified Credit for Low-Income Workers," *Tax Notes.* August 10, 2009: 589-602.

Figure 2:



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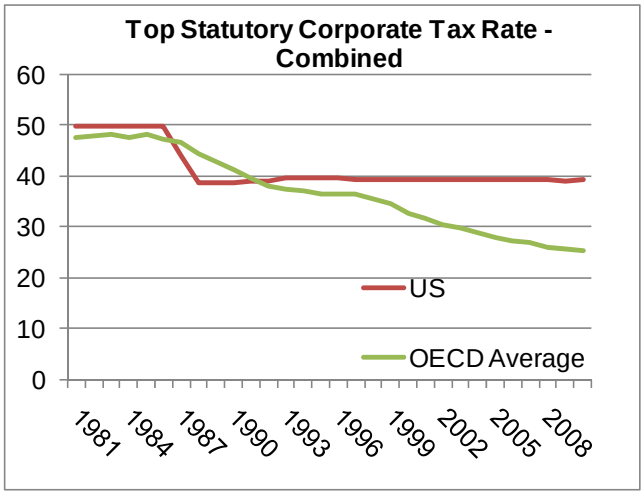
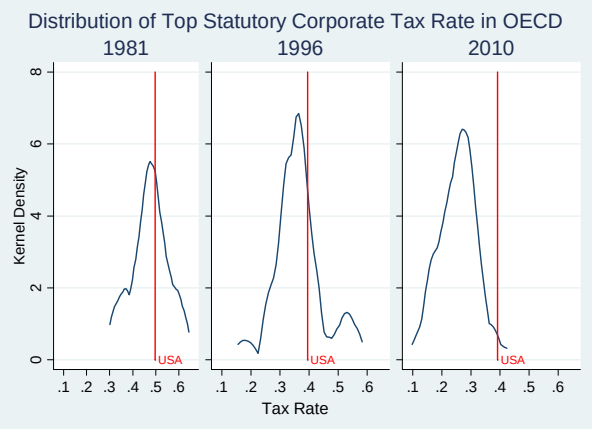


Sources:

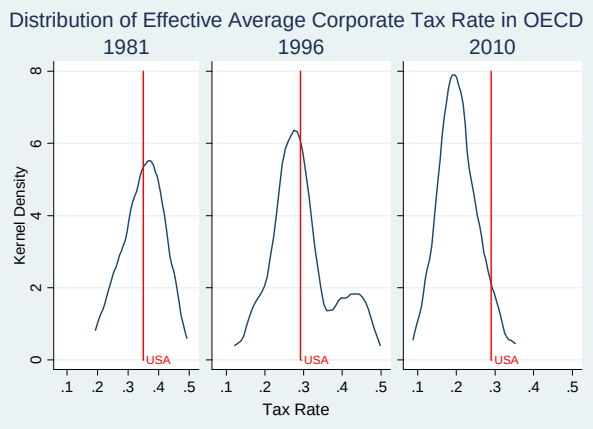
- Authors' chart. Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).
- "OECD Tax Database," http://www.oecd.org/ctp/taxdatabase

Figure 4:



Source: Authors' calculations. Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).

Figure 5:



Source: Authors' calculations. Kevin A. Hassett and Aparna Mathur, *Tax Policy Outlook* (forthcoming January 2011).

Figure 6:

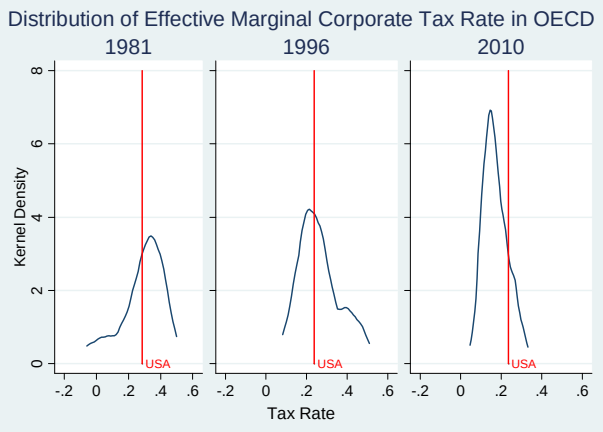


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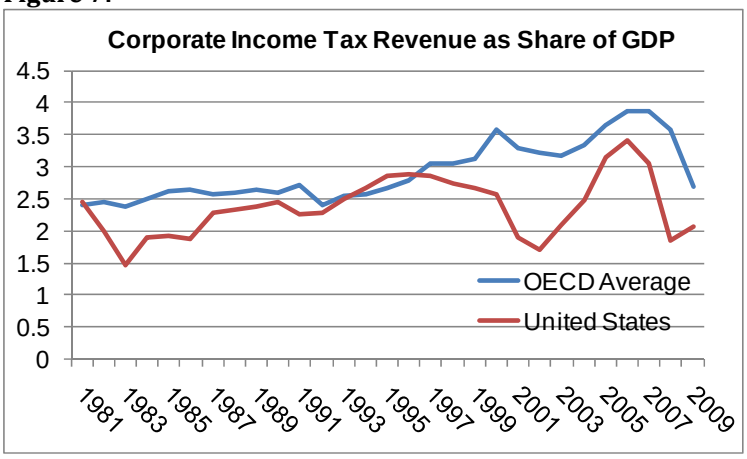
Figure 7:



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