CHAIRMAN
PAUL RYAN HOUSE BUDGET COMMITTEE
BUDGET.HOUSE.GOV PHONE: 202.226.7270

THE FISCAL EFFECTS OF FASTER GROWTH

THE BUDGETARY IMPACT OF THE PATH TO PROSPERITY *UNDER ALTERNATIVE GROWTH SCENARIOS*

March 22, 2012

KEY POINTS:

- **Experts point to tax reform as an essential remedy for the short-term economic malaise as well as a steady foundation for longer-term growth and prosperity.**
- **A better-designed tax system, by incentivizing economic growth, could raise output.**
- **The rate of economic growth is one of the most important factors affecting the federal budget – and *The Path to Prosperity* contains a number of policy changes, such as fundamental tax reform and structural Medicare reforms, with the potential to significantly change the economy's growth path.**
- **Assuming higher growth within a realistic range, the budget could achieve balance in the mid-to-early 2020s, with the upper-bound growth assumption producing budget balance within the ten-year budget window – much sooner than CBO's estimated balance date of 2039.**

The Path to Prosperity budget resolution, which passed yesterday out of the House Budget Committee, relies upon Congressional Budget Office (CBO) scoring conventions, which essentially assume that the policies in the budget have no impact on the size of the overall economy (i.e., GDP remains fixed relative to the base case). A cautious, conservative approach to scoring is common and appropriate when legislating, but it is also common and appropriate to take a separate look what the impact on the economy of certain policies might be and how pro-growth policies might affect the federal budget. The following analysis makes the case that the policies advanced in *The Path to Prosperity* budget resolution could result in faster economic growth and better fiscal outcomes than a static score might suggest.

The Economic Case for Tax Reform

The U.S. tax code is not only complex and unfair, it also impedes, rather than promotes, economic growth and job creation. A high corporate tax rate, combined with an antiquated system of international taxation, handicaps U.S. businesses operating abroad and deters foreign capital investment into the domestic economy – a double hit to international competitiveness.

Not surprisingly, there has been a growing interest in wholesale tax reform that would attack the root problems of the broken tax code rather than trim around the edges. Bold plans have been offered by bipartisan groups like the Bowles-Simpson Fiscal Commission and individual lawmakers on both sides of the aisle. These plans often differ in substance, but there is a common motivation supporting the reform efforts: Experts point to tax reform as an essential remedy for the short-term economic malaise as well as a steady foundation for longer-term growth and prosperity.

Economic growth over the long term is mainly driven by two factors: the supply of labor and the degree of productivity, which is in turn determined by investment, advances in technology, and the size of the capital stock. A country's tax structure shapes both of these factors to the extent that it rewards, or deters, behavior linked to economic growth – namely work, saving and investment. When marginal tax rates are elevated, it lowers the after-tax return (i.e., the reward) from these activities, causing individuals and businesses to hire fewer workers and invest less than they otherwise would, leading to lower economic growth. Conversely, a better-designed tax system, by incentivizing the factors that determine economic growth, could raise output.

The U.S. tax code is currently littered with special credits, deductions and loopholes, which sum to well over $1 trillion per year. To put that figure in perspective, that is roughly the same amount that is collected in total individual income taxes each year. In other words, the special deductions and loopholes in the code end up narrowing the tax base to a significant degree. This is important because a narrow tax base requires much higher tax rates to raise a given amount of revenue. As mentioned before, high marginal tax rates dampen the incentives to work, save and invest, which reduces economic output. Lower economic output, in turn, mutes the intended revenue gain from higher marginal tax rates.

In its current form (narrow tax base, high tax rates), it is nearly impossible to raise more revenue from the tax code without causing a significant amount of economic damage. At a recent House Budget Committee hearing, Treasury Secretary Tim Geithner admitted that the tax provisions in the President's latest budget would add burdensome complexity to the code, because, "if you try to get more revenues out of the current tax system in a rational way, you're going to do things that are complicated, there's no doubt about it and that's why it'd be better to do it through tax reform."[1]

Currently – as exemplified by the proposals contained in the President's budget – the trend in Washington has been to raise the top few individual tax rates and to add new surtaxes on incomes above certain amounts. Yet this approach fails to recognize an important feature of the U.S. economy – namely, the non-corporate small-business sector (partnerships, S-corps, etc.) whose owners pay taxes under the individual income tax.

According to the U.S. Treasury Department, over 80 percent of U.S. businesses are unincorporated and are taxed at individual tax rates – the second highest share among industrialized economies.[2] According to the Joint Committee on Taxation (JCT), roughly 50 percent of U.S. non-corporate business income is taxed at the top two individual tax rates.[3] Given the non-corporate small-business sector's importance to the economy (they create two-thirds of net new jobs and account for about half of non-farm private-sector GDP, according to the Small Business Administration), raising the top individual tax rates can do an inordinate amount of damage to growth and job creation in the United States.[4]

Given these facts, economists across the political spectrum have for years recommended cleaning out the special credits and deductions in the tax code in order to broaden the tax base, lower tax rates, and flatten the tax structure, with the aim of creating a pro-growth code that is simple, fair and competitive. Cleaning out the various preferences in the tax code would ensure that individuals and businesses make decisions based on economic fundamentals rather than tax considerations, leading to a better allocation of resources throughout the economy. With a broader tax base, marginal tax rates could be lowered across the board, lessening distortions and better promoting activities that support economic growth and job creation.

---

[1] Timothy Geithner, Testimony before the U.S. House, Committee on the Budget, "The President's Fiscal Year 2013 Budget: Revenue and Economic Policy Proposals," February 16, 2012.
[2] U.S. Treasury Department, "Treasury Conference on Business Taxation and Global Competitiveness," Background Paper, July 23, 2007 http://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf
[3] Senate Finance Committee, "Facts Are Stubborn Things: The Impact of the President's Small Business Tax Hikes," February 24, 2012. http://finance.senate.gov/newsroom/ranking/release/?id=203b0b68-d7d1-4853-9e38-930adc71cd18
[4] U.S. Small Business Administration, Frequently Asked Questions. http://www.sba.gov/sites/default/files/sbfaq.pdf

Like the individual income tax, the corporate tax contains a host of special carve-outs and deductions that serve to narrow the tax base by about 25 percent. This in turn necessitates the high rate that is undermining U.S. competitiveness.

Elevated corporate tax rates hinder American competitiveness by making the U.S. a less desirable destination for investment and jobs. Business location and investment decisions are becoming increasingly sensitive to country tax rates with growing global integration. Foreign investment is important to an economy because it is a key source of innovation and jobs. In response, many countries have been lowering business taxes.[5] But the United States risks falling behind as it maintains its high tax rate while other countries lower theirs. By deterring potential investment, the U.S. corporate tax restrains economic growth and job creation.

The U.S. tax rate differential with other countries also fosters a variety of complicated multinational corporate behaviors intended to avoid the tax – profit-shifting, corporate inversions, and transfer pricing – which have the effect of moving the tax base offshore, costing jobs and decreasing corporate revenue.

The structure of U.S. international taxation is also out of sync with the international standard used by the majority of other countries, putting U.S. businesses operating abroad at a competitive disadvantage. Most countries operate under a so-called "territorial" system of international taxation, whereby their businesses operating abroad are only subject to the tax of the country where they do business. The United States has an antiquated "worldwide" system of international taxation, whereby U.S. businesses operating abroad pay both the foreign-country tax and U.S. corporate taxes when profits are repatriated. They are essentially taxed twice. This puts them at an obvious competitive disadvantage. (Foreign tax credits are meant to ameliorate this disadvantage to a certain extent, but they end up further complicating the business tax code and adding to compliance costs.)

Shifting to a territorial corporate tax system would boost the competitiveness of U.S. businesses operating abroad while greatly reducing complex tax-evasion issues such as profit-shifting and transfer pricing.[6]

Currently, U.S. companies have an estimated $1.4 trillion parked offshore and are reluctant to repatriate those funds back home due to the significant taxes that could be incurred under the current U.S. tax system.[7] A worldwide tax system essentially locks this money out of the U.S. economy, where – if it were repatriated – it could be used to fund investment, business expansion and job creation in the United States. Policymakers on both sides of the aisle have proposed a temporary repatriation tax holiday in order to give businesses an incentive to send these funds home and put them to work in the U.S. economy. A switch to a territorial tax system would give U.S. businesses a permanent incentive to do exactly that.

Estimates of Potential Economic Benefits from Tax Reform

Nearly all economists believe that fundamental tax reform can lead to higher economic output and stronger job creation over time. Many believe that the overall economic boost could be significant. These views have been confirmed by academic empirical work and "event studies" that seek to isolate the economic effects from real-world instances of tax reform both in the United States and abroad. The following summarizes a sample of the overall literature showing the potential economic effects of tax reform:

- Economists David Altig, Alan Auerbach, Laurence Kotlikoff, Kent Smetters and Jan Wallsier conducted a study simulating five different tax reform proposals ranging from a consumption tax to a proportional

[5] U.S. Treasury Department, "Treasury Conference on Business Taxation and Global Competitiveness," Background Paper, July 23, 2007. http://www.treasury.gov/press-center/press-releases/Documents/07230%20r.pdf
[6] See, for instance: Ways and Means Committee discussion draft of Participation Exemption (Territorial) System, October 26, 2011. http://waysandmeans.house.gov/UploadedFiles/Summary_of_Ways_and_Means_Draft_Option.pdf
[7] J.P. Morgan Estimate via U.S. Chamber of Commerce, "The Need for Pro-Growth Corporate Tax Reform" http://www.uschamber.com/reports/need-pro-growth-corporate-tax-reform

income tax. This oft-cited paper, *Simulating Fundamental Tax Reform in the U.S.*, published in the *American Economic Review* in 2001, found that these reform proposals increased GDP by between 5 and 9 percent over the long run, using a large-scale dynamic life-cycle economic simulation model. The authors note that "fundamental reform of the U.S. tax system offers significant long-run economic gains."[8]

- In a broad survey of 69 public finance economists conducted by Victor Fuchs, Alan Krueger, and James Poterba in 1998, respondents, at the median, believed that the 1986 tax reform act (TRA86) – the last major instance of fundamental tax reform in the United States – led to (or would have led to had none of the provisions been changed) a 1.0 percent increase in GDP over a decade. More than 25 percent of surveyed economists thought GDP growth caused by TRA86 reforms was greater than or equal to 3 percent.[9]

- Economists Robert Gordan and Young Lee used both cross-sectional and time-series information to estimate how a country's year-over-year GDP changes were explained by changes in the corporate tax rate between 1970 and 1997. In the main result of the study, the authors found "a significant effect of corporate tax rates on economic growth, even after controlling for other determinants/covariates of economic growth." Specifically, the results suggest that if policymakers cut the corporate tax rate by 10 percentage points, economic growth could increase by 1.1 to 1.8 percent annually.[10]

- Earlier in his career, economist Lawrence Summers studied the economic effects of replacing capital taxation with consumption taxation. Capital taxation was assumed to represent the combined effect (i.e., the double taxation) of corporate taxes, individual income taxes, and property taxes. Summers concludes that the annual welfare gain from a shift to consumption taxation is conservatively estimated at 10 percent of gross national product (GNP) over the long term.[11]

- Harvard economist Martin Feldstein studied the economic evidence from the 1986 Tax Reform Act (TRA86) and found that this reform model, which broadened the tax base and lowered the top marginal rate from 50 percent to 28 percent, produced extra revenue in subsequent years. Feldstein studied individual returns of over 4,000 taxpayers and found that the taxable income of various income groups rose significantly between 1985 and 1988 (i.e., pre-TRA86 and two years thereafter). In other words, as marginal tax rates fell and the after-tax reward to work effort and risk-taking increased, earnings rose and taxable income increased. Lower marginal rates increase incentives for economic activity, but also decrease the incentive to shelter income from taxation. For taxpayers at the top marginal rate, Feldstein estimates that each 1 percent rise in the net-of-tax share (i.e., the increase in after-tax reward) led to about a 1 percent rise in taxable income. Using these findings, Feldstein estimates that combining base broadening with a 10 percent cut in all tax rates would lead to higher revenue equal to about 4 percent of existing individual income tax receipts.[12]

- In their 2005 compendium, *Towards Fundamental Tax Reform,* economists Kevin Hassett and Alan Auerbach conclude: "Based on results from a fairly large number of different models, the literature suggests that a wholesale switch to an ideal system might eventually increase economic output by between 5 and 10 percent, or perhaps a slightly higher range."[13]

---

[8] Altig, David, Alan J. Auerbach, Laurence J. Kotlikoff, Kent A. Smetters, Jan Walliser, "Simulating Fundamental Tax Reform in the U.S.," *U.C. Berkeley*, September 29, 1999. http://elsa.berkeley.edu/~auerbach/ftp/taxreform/flatfinal.pdf

[9] Victor R. Fuchs, Alan B. Krueger, James M. Poterba, "Economists' Views about Parameters, Values, and Policies: Survey Results in Labor and Public Economics," *Journal of Economic Literature,* September, 1998.
http://www.jstor.org/discover/10.2307/2564804?uid=3739584&uid=2129&uid=2&uid=70&uid=4&uid=3739256&sid=55912592933

[10] Lee, Young, Roger H. Gordan, "Tax Structure and Economic Growth," *U.C. San Diego*, July 15, 2004.
http://www.econ.ucsd.edu/~rogordon/papers.html

[11] Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *The American Economic Review, September, 1981.*
http://www.nber.org/papers/w0302.pdf

[12] Martin Feldstein, "The Tax Reform Evidence From 1986," *The Wall Street Journal,* October 24, 2011.
http://online.wsj.com/article/SB10001424052970204002304576629481571778262.html

[13] Auerbach J., Alan, Kevin A. Hassett, *Toward Fundamental Tax Reform,*(Washington D.C.:The AEI Press,2005)

An Alternative Growth Scenario for *The Path to Prosperity*

The rate of economic growth is one of the most important factors affecting the federal budget. Increased growth leads to higher revenue levels and lower spending demands on the part of the government (e.g., unemployment benefits, income support programs, etc.), resulting in lower deficits. The Office of Management and Budget (OMB), for instance, estimates that if real GDP growth is higher by 1 percentage point in a given year, resulting in a higher trajectory for output and taxable incomes, the deficit will be $722 billion lower over a ten-year period.[14] If that higher rate of growth were *sustained* throughout the ten-year period (say, due to a "productivity shock" like the changes in computer and information technology in the 1990s), the overall effect on the deficit would be orders of magnitude higher.

Similarly, far-reaching policy changes can significantly change the economy's growth path. The fiscal year 2013 Republican budget, *The Path to Prosperity*, contains a number of such policy changes, including a framework for fundamental tax reform.

The reform plan, which was first advanced by the House Ways and Means Committee, would broaden the tax base, lower marginal rates and flatten the tax structure from six rates to just two: 10 percent and 25 percent. The plan would also lower the U.S. corporate rate from 35 percent down to 25 percent and would transition to a territorial system of international taxation, which would put U.S. businesses competing abroad on a level playing field with their foreign competitors and incentivize the repatriation of funds, currently held offshore for tax reasons, to be put to use in the U.S. economy.

Another important policy change in *The Path to Prosperity* is structural reform of Medicare, featuring a competitive-bidding premium-support system that harnesses the power of competition to lower the cost trajectory of this program. This reform proposal, along with other policies aimed at reducing government spending over time, puts the budget on a sustainable trajectory and a pathway to balance. This path is likely to result in a so-called "fiscal dividend" – the economic benefits that result from putting the budget on a sustainable course. For instance, interest rates would likely be lower than they would otherwise be and confidence would likely rise as households and businesses would discount the possibility of future tax hikes aimed at shoring up a large budget deficit.

In a supplementary analysis of *The Path to Prosperity*, CBO examined the potential long-term economic effects of this fiscal path relative to the trajectory implied by current law and the trajectory implied by an extension of current tax and spending policies. Under the latter two paths, debt as a share of the economy continues to rise to unsustainable levels. That increased level of government borrowing would crowd out private investment over time and harm the economy, according to CBO's analysis.

By contrast, *The Path to Prosperity* lowers the debt burden and puts the budget on a sustainable path, which leads to more private investment and a stronger economy. As CBO notes, "the debt that would occur under the paths specified by the Chairman and his staff would lead to higher national income over the long run than would occur with the higher amounts of debt under the other two scenarios."[15]

In its range of estimates, CBO found that the economy under *The Path to Prosperity* could be 1 percent larger in 2030, 3 percent larger in 2040 and 6 percent larger in 2050 relative to its long-term base case. By contrast, under the path implied by the extension of current tax and spending policies, the economy would *shrink* by as much as 10 percent in 2030 and 28 percent in 2040. In other words, the difference in outcomes between these two trajectories could sum to as much as 11 percent of total economic output in 2030 and over 30 percent of output in 2040.

---

[14] "Economic and Budget Analysis," *Office of Management and Budget,* February 2012. http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/econ_analyses.pdf

[15] "The Long-Term Budgetary Impact of Paths for Federal Revenues and Spending Specified by Chairman Ryan," Congressional Budget Office, March 20, 2012. http://www.cbo.gov/sites/default/files/cbofiles/attachments/03-20-Ryan_Specified_Paths_2.pdf

In a somewhat similar exercise, House Budget Committee (HBC) staff attempted to illustrate the potential fiscal effects resulting from an alternative growth scenario (AGS). This scenario was meant to capture a range of possible economic outcomes that could be associated with the implementation of the policies in the budget. For instance, as Alan Auerbach and Kevin Hassett note in their book on fundamental tax reform, the evidence from the broad academic literature on this subject suggest that such a bold reform plan could "eventually increase economic output by between 5 and 10 percent, or perhaps a slightly higher range."[16] Similarly, Columbia University economist Glenn Hubbard suggests that fundamental tax reform could lead to a growth boost of between 0.5 and 1.0 percentage point per year over a decade.[17]

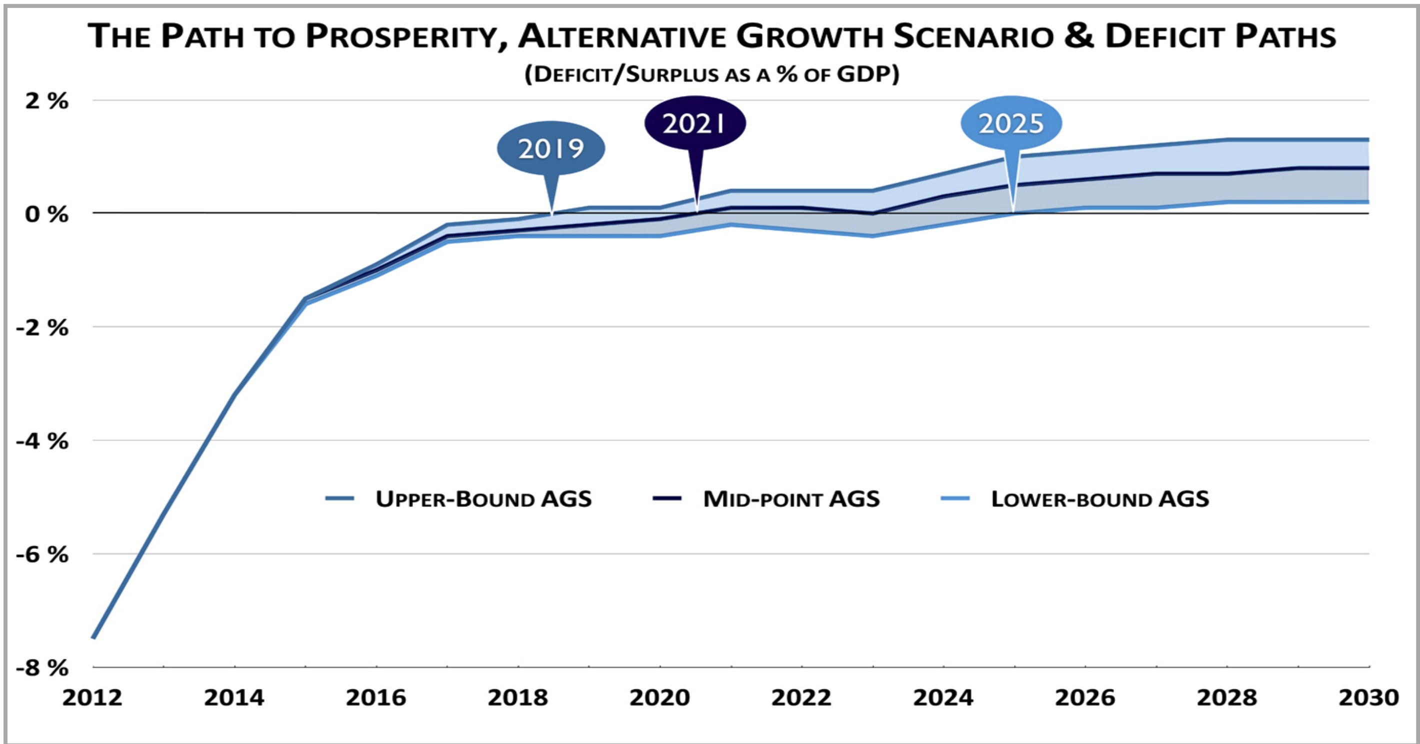
HBC staff first constructed a "base-case" long-term GDP path using a standard assumption that nominal GDP grows by a fixed amount (about 4.3 percent per year) after the ten-year window. Tax reform was assumed to be enacted in 2013 with the economic benefits beginning to materialize in 2015. The alternative scenario was then obtained by applying the growth rule of thumb above to the base case, increasing GDP growth over the subsequent decade by 0.5 to 1.0 percentage point per year and then allowing GDP to ratchet back down to its trend rate in subsequent years.

Under this scenario, GDP growth is significantly higher than the base case over the medium and longer-term. As mentioned earlier, fundamental tax reform would likely boost the supply of labor and the degree of productivity in the economy (through, for instance, more investment and a higher capital stock). By 2030, the level of economic output is between 6 and 13 percent higher than the base case – within the general range mentioned by Auerbach and Hassett.

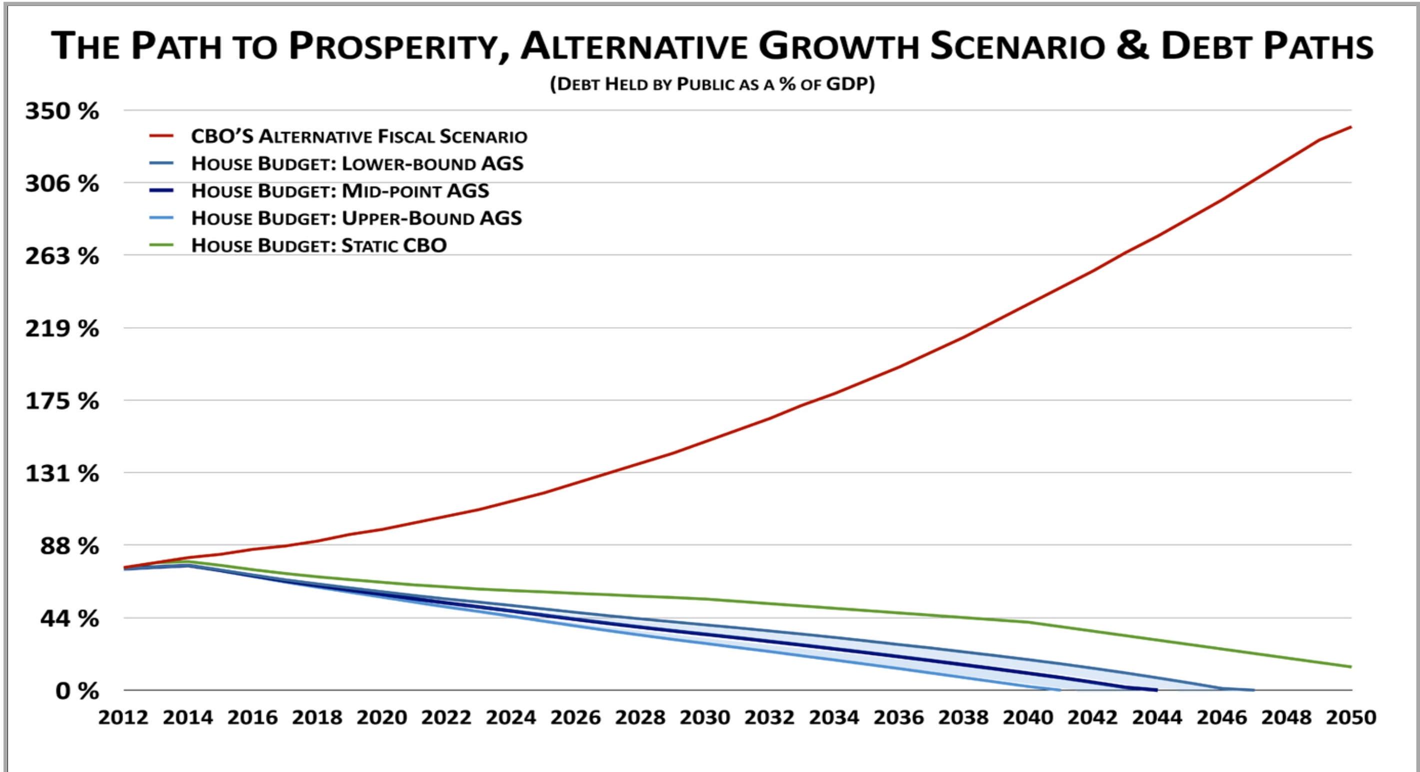
A larger and faster-growing economy leads to significantly higher revenue than the base case. This higher amount of revenue, when compared to the spending levels outlined in *The Path to Prosperity*, leads to a much-improved fiscal path. Assuming higher growth within the range cited above – percentage-point increases of 0.5 (lower-bound AGS), 0.75 (mid-point AGS), and 1.0 (upper-bound AGS) – the budget could achieve balance in the mid-to-early 2020s, with the upper-bound growth assumption producing budget balance within the ten-year budget window – much sooner than CBO's estimated balance date of 2039.

---

[16] Auerbach J., Alan, Kevin A. Hassett, *Toward Fundamental Tax Reform,* (Washington D.C.:The AEI Press,2005)
[17] R. Glenn Hubbard, "Tax Reform is the Swiftest Path to Growth," *The Wall Street Journal,* August 12, 2011.
http://online.wsj.com/article/SB10001424053111904140604576496512439008854.html



The improved path for deficits also leads to a better trajectory for debt as a share of the economy. For instance, under the alternative growth path, the debt is fully paid off in the mid-to-late 2040s.



The analysis above is not meant to be a formal "score" in any conventional sense. Rather, it is an exercise that draws upon academic studies and straightforward assumptions to illustrate a plausible range of possible economic outcomes from implementing pro-growth policies and how those outcomes might influence the path of the federal budget.

This document was prepared by the Republican staff of the Committee on the Budget, U.S. House of Representatives. It has not been approved by the full committee and may not reflect the views of individual committee members.