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What Tax Reform Means for US Growth

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Republicans are closer than ever to delivering on their tax reform promise. Their plan would reduce the corporate and individual tax rates, increase deductions, and simplify the existing tax code. While Republicans and some economists argue that reform would significantly boost economic growth and raise wages, critics have doubts about the growth effects of the legislation, given the large budget deficit.

“The economy, up until this year, has been very much disappointing, and if you look at real wage growth, it’s been as bad as you’ve ever seen in the recovery,” said Kevin Hassett, chair of the White House Council of Economic Advisers, at the Cato Institute on Nov. 30.

Republicans believe tax reform is a once-in-a-generation opportunity to overhaul a complex, costly, and unfair U.S. tax system that caters to special interests. They blame the existing tax code for chasing American companies and jobs overseas. Hence, they argue the new bill will encourage more investment and job creation.

There is a disconnect between corporate income growth and wage growth in the United States, said Hassett.

“Historically, if profits go up, then wages go up, and if profits go down, then wages go down. The correlation is really almost perfect,” he said. But this pattern was broken in the 1990s. Over the last eight years, corporate profits have increased by 11 percent per year, while real wage growth has been almost nonexistent, he said.

Typically, when companies make a profit, they expand their businesses by buying more equipment, a situation called capital deepening, in which the capital per worker increases in the economy, he explained.

This capital deepening has added about a percent per year to real wage growth since World War II, he said. During the second half of the Obama administration, however, the contribution of capital deepening to increasing wages went negative for the first time in U.S. history.
Hassett said that American workers haven't seen an increase in wages because most of the profits are overseas.

For many years, U.S. corporations have left cash in their foreign subsidiaries to avoid high taxes. The total amount of accumulated income across all industries is nearly $2.5 trillion, according to estimates.

The existing U.S. tax code has also created a strong incentive for American corporations to reincorporate abroad in low-tax countries, like Ireland, a strategy known as tax inversion.
"Profits are not located in the U.S., so they are not creating capital in the U.S., they're not creating jobs in the U.S., they're not driving wages in the U.S., and this tax reform will address that in a very significant way," Hassett said.

Impact on Business Investment

The tax plan would reduce the corporate income tax rate from 35 percent to 20 percent, which is the centerpiece of this tax reform.

In addition, the plan aims to level the playing field for American companies. It moves from a worldwide taxation system—which taxes income earned anywhere in the world—to a territorial system only taxing income earned inside the home country.

The existing worldwide tax system double-taxes the foreign income of U.S. companies as soon as these earnings are repatriated. In other words, the U.S. companies have to pay U.S. tax on top of what they already pay in foreign countries, and that is why they prefer to keep the money offshore rather than reinvest it back in the United States.

By contrast, in a territorial tax system, the companies would be taxed on their U.S. income only and would be exempt from paying taxes on most or all foreign income. This system would make it easier for U.S. companies to compete internationally.

As a transition to the territorial system, there will be a one-time tax payable on profits accumulated overseas by U.S. multinationals. The Senate bill proposes a tax rate of 14.5 percent on cash and 7.5 percent on non-cash assets repatriated from overseas. These rates are slightly higher than the House's proposal.

The tax plan is not only offering a repatriation holiday, but also changing the overall environment by cutting corporate tax rates and making the United States an attractive place to invest, said Hassett.

According to FactSet, a data-gathering firm, cash repatriation will boost mergers and acquisitions (M&A) in the United States.

Potential investment could come in all shapes and sizes and boost economic growth, wrote Bryan Adams, director of Factset, in a report.

“When companies have more money to spend, they will spend it, and M&A will be a primary beneficiary of that spending,” Adams stated.

Bringing back the money trapped overseas, along with tax rate cuts, will increase the median wage by $4,000 a year in the three- to five-year range, according to Council of Economic Advisers estimates. And more optimistic forecasts suggest that “the effects are quite a bit larger than that,” Hassett said.

But some economists are cautious about how rapidly these changes will show up in gross domestic product (GDP) and wage growth.

Donald Marron, director of economic policy initiatives at the Washington-based think tank Urban Institute, said it would take a while for the capital to be depreciated, used out, and eventually reinvested in the United States.

“Even if you are an optimist about the potential for a reform, for corporate tax reductions to encourage investment, you may want to be humble about how rapidly that’s going to happen,” Marron said during a panel at the Cato Institute on Nov. 30.

Full Expensing Provision

Both bills agree on reducing the corporate income tax rate to 20 percent. However, while the House bill calls for an immediate tax cut, the Senate defers the change until 2019.

Some are concerned that the delay would disappoint businesses, which would put off investment. “I don’t think it will have a big impact,” said Ryan Bourne, chair of public understanding of economics at the Cato Institute.

Because of the full expensing provision of the tax bill, “it might even boost investment more in the near term than cutting the rate straightaway,” he explained.

The tax reform bill allows businesses to expense the full value of capital expenditures, known as full expensing. This provision encourages firms to invest more under the higher tax rate in order to take the entire deduction in the first year.

The companies will effectively expense against the current 35 percent corporate tax rate, reducing the taxes they owe, and then they will pay 20 percent tax when the profits are realized from those investments, Bourne said.

The Senate and House bills allow companies to immediately and fully expense new equipment for five years. In addition, in the Senate bill, this provision phases out by 20 percentage points per year after that.

For the first time, businesses of all sizes will be able to benefit from this provision. Capital-intensive sectors are expected to get a short-term boost from this tax break. The resulting investment boom will spur economic growth, according to experts.

“Businesses are already ramping up investment in part because of that provision,” said William McBride, manager at PricewaterhouseCoopers, a consulting firm.

“We’re already seeing some positive effects and I think that will continue through next year,” he told NTD, a sister media to The Epoch Times.

The U.S. economy grew faster than expected in the third quarter, buoyed by strong business spending on equipment and an accumulation of inventories. GDP expanded at a 3.3 percent annual rate, the highest in three years.

Deficits

Critics argue the Republican tax reform plan will do little to improve economic growth and will expand the budget deficit over the next decade. They are concerned about the effects of the deficit on economic growth.

“There is this quietly raging debate about to what extent we should worry the deficits would crowd out private investment and undermine growth in the future,” said Marron.

According to the Congressional Budget Office (CBO), a federal agency within the legislative branch, the Senate’s tax plan would increase the deficit by $1.4 trillion over the next 10 years. And the Joint Committee on Taxation (JCT), a committee of the Congress, showed in its recent analysis that the Senate plan would add nearly $1 trillion to the federal budget deficit, including the positive effect of an increase in GDP by about 0.8 percent on average over the next decade. Higher GDP leads to more income for the government and thus lower deficits.

According to Marron, the models of economists at JCT and CBO have deficits crowding out a significant amount of growth.

“There is a race between whatever pro-growth effects of all the provisions added together against the drag that comes from the deficits,” Marron said.

“The deficits obviously accumulate over time. So, oftentimes, you may see short-run growth and some encouragement for additional investment. But the crowding out effect is undermining that over time,” he argued.

No one has a crystal ball, but Republicans and some economists criticize the JCT and CBO models for underestimating economic growth.

“I see people who have such confidence in their own models that they feel comfortable disregarding the evidence,” Hassett said.

“We should have a high degree of confidence that we have this fundamentally indefensible corporate tax system that is harming American workers and harming our economy.
“And if we fix it, that is going to help the economy.”

What’s Next?

Although Republicans are close to the finish line, some important work is still ahead of them. For tax reform to become law, both chambers have to pass the same legislation and send it to the president to sign.

The House and Senate bills are not identical but are very much on the same page. In order to create a unified tax reform bill, the House and Senate have formed a conference committee to iron out the differences.

House Ways and Means Committee Chairman Kevin Brady (R-Texas) is leading the conference committee.

“In the weeks ahead, we will send a bill to the president for the first time in 31 years that cuts taxes for families and job creators and ushers in a new era of economic growth,” Brady said in a statement.

According to Goldman Sachs economist Jan Hatzius, a conference agreement between the House and Senate could be voted upon by mid-December.

“While it is possible that consideration of tax reform could spill over into January, at this point enactment in December looks far more likely,” Hatzius stated in a report.