



PREPARED REMARKS BY COUNCIL OF ECONOMIC ADVISERS CHAIRMAN KEVIN HASSETT
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Thank you, Mark, for that introduction and thanks to both the Tax Policy Center and the Tax Foundation for hosting me today. When this speech was scheduled, TPC had not yet released its report on the Big 6 tax plan and my instructions were to focus on taxes and economic growth. I feel compelled to respond to the report and will do so while continuing to pursue my original charge.

I've spent most of my life focusing on taxes and how taxes impact behavior, so I am pleased to be here today to talk about this topic. I think you would agree with me that taxes do impact the economy – otherwise, neither of your organizations should exist.

In other words, taxes matter. They impact the economy. It is scientifically indefensible to say – as the TPC report of last Friday does – that “the framework [would] have little macroeconomic feedback effect.” It is simply inconsistent, with mountains of evidence that I am about to discuss, to have *no* growth effects from tax changes this significant. It's inaccurate. It's fiction. As for the static analysis released last week, to which I will return later, it, too, is based on many fictions. The Tax Foundation behaved responsibly when they decided to wait for the final details to analyze the bill. I am sure many people in these halls have been struck and perhaps even dismayed by the pushback from around Washington regarding the TPC report. That's what happens when you behave irresponsibly. That's why the Tax Foundation decided, correctly, to wait for the complete plan.

One of the most influential books in economic theory is Arthur Okun's *Equality and Inefficiency: The Big Tradeoff*, which recently was republished by the Brookings Press on its 40th anniversary. I am sure many in this room read it, too. Art, a former CEA Chair and long-time Brookings scholar, argued that rational tax policy debate needs to account for the fact that redistribution is done with a leaky bucket. Art would probably be surprised to find that TPC now claims the bucket has no leaks.

Bet let's get back to tax reform and growth, as Art would want. Let me start with a little history. In the U.S., federal income taxes were born in 1913, over 130 years after the founding of our nation. The top marginal tax rate on individual income has fluctuated quite a bit from its original 7 percent. It peaked at 94 percent during World War II and ebbed to a post-war low of 28 percent towards the end of Reagan's presidency. Today, the top marginal rate is 39.6 percent, somewhere between its historical war-time high and birthweight low.

Throughout the century of the federal tax system in the United States, tax reform efforts have been a bipartisan tradition. President Kennedy's tax initiative, signed into law by President Johnson as the Revenue Act of 1964, lowered the top marginal rate on individual income from 91 percent to 70 percent. The legislation passed as a majority of Republicans in both houses of Congress joined a majority of Democrats in supporting the legislation. President Reagan's 1986 Tax Reform Act was signed into law when Democrats controlled the U.S. House of Representatives. Majorities of both parties, Democrat and Republican, voted in favor of a bill that President Reagan then signed into law. The top marginal

rate fell from 50 to 28, and both sides viewed the development with favor. Bipartisanship has been good for tax reform. And tax reform, as we shall see, has been good for America.

Economists who have studied the effects of taxes over time have developed a consensus: lower marginal tax rates and a broader base increase rates of economic growth and well-being. I have been in this room often over the past 20 years, and have witnessed head-nodding that broadening the base and lowering the rates, as President Trump's plan aims to do, is a recipe for better tax policy. I can't recall ever seeing anyone in this room argue that narrowing the base and raising rates was a recipe for growth. For years, TPC analyzed tax bills without providing dynamic scoring, but now provides a dynamic score, but with zero effect. I suppose that's some progress.

This consensus has spread around the world as well, and has been especially visible in the corporate tax space. In 1989, the year the Berlin Wall fell, the average statutory corporate tax rate imposed by central and sub central governments in the OECD was 43 percent. In 1989, the comparable rate in the U.S. was about 39 percent. In the time since the Wall fell, the OECD average corporate tax rate has trended downwards to its current 24 percent, about half of its 1989 level. The U.S. corporate tax rate, however, is still stuck in the same place it was when the Wall crumbled, almost 20 years ago. We've seen the results of that stasis, which has essentially incentivized American firms to offshore and kept foreign investment away.

There is now a broad consensus in this country, on both sides of the aisle, that it is time to, shall we say, "Tear down this rate." Even President Barack Obama proposed lowering the Federal corporate rate to 28 percent. My guess is that President Obama did not make that proposal because he thought it would have no effect. This bipartisan consensus within the United States echoes what policymakers around the world have learned. In France, a country not exactly known for its long-standing devotion to supply-side economics, President Emmanuel Macron has proposed cutting the corporate tax rate to 25 percent. And France's current corporate rate of 33 percent is *already* lower than ours. France joins such countries as Denmark, Sweden, and Greece – a country that recently elected an avowedly socialist government named the Coalition of the Radical Left or SYRIZA in Greek -- in having lower corporate tax rates than our own. Let me repeat that: even the Coalition of the Radical Left in Greece, a country under deep austerity measures, understands the bucket leaks.

Against this backdrop, let's look at President Trump's Unified Framework for Tax Reform. First, the framework entails reforms to both the individual income tax system and the corporate tax system.

On the individual side, President Trump's framework lowers the numbers of brackets to four rates: one of 0, one a 12 percent, another at 25, one at 35, and leaves the door open for an additional fifth higher marginal tax rate to ensure that the wealthy do not pay a lower share of taxes than they pay today. And don't forget more people are eligible for the zero rate under this plan.

President Trump's plan retains incentives for home mortgage interest and charitable contributions, but otherwise eliminates itemized deductions in favor of a doubling of the standard deduction. In pursuit of simplification, the Unified Framework repeals personal exemptions, and it enhances the Child Tax Credit by increasing its size and raising the income level at which it phases out, a reform that also eliminates the marriage penalty. Those who care for other dependents, like the elderly, will receive a new \$500 non-refundable credit. The Alternative Minimum Tax and the Death Tax will both be eliminated. The idea is to simplify the system, end wasteful tax breaks, and eliminate loopholes. It is a simpler, fairer system that increases the base and lowers rates.

The Unified Framework also brings reform on the business side. It lowers the statutory corporate tax rate from 35 percent to 20 percent, below the average rate of the OECD. Firms will be able to immediately write-off the full cost of new investment in depreciable assets (other than structures) for at least five years. The R&D and low-income housing credits will remain. But most deductions for C-corporations will be eliminated at the discretion of the tax-writing committees. And the deductibility of net interest expenses will remain only in part for C-corps. The Unified Framework brings tax relief to the small and family-owned businesses conducted as sole proprietorships, partnerships, and S-corporations: their top marginal rate will be capped at 25 percent. Again, it increases the base and lowers rates – something we all agree is good policy.

This plan is pro-growth. On the individual side it is pro-work. When you get more of an economic input like work, you get more economic output – and you get more economic growth. And on the corporate side, companies will no longer be incentivized to offshore, and what they save in taxes should help raise corporate investment and wages.

So let's put this in perspective given the bipartisan history I just discussed.

On the individual side, we are broadening the base and lowering rates, which is the approach that has received so much praise in these halls over the years. Given the overall revenue targets, Chairmen Brady and Hatch are working with the professional staff and the Members of their Committees to place the brackets and other details at a fiscally responsible level. There are enough degrees of freedom that outside bodies, like the TPC, can easily use this time to opine about where the brackets should be, and whether an additional top rate is needed. It is hard to imagine a better set-up for bipartisanship. But it would be better to opine making sure that growth effects are included, because as I mentioned at the beginning of my speech, if you don't believe tax rates push the economy one way or another, you may as well close up shop.

On the corporate side, we are just responding to the global consensus that corporate tax rates are harmful generally and particularly for the U.S., given how uncompetitive our rates are. You might have noticed, over the years, that I have some pretty strong opinions about corporate taxation, and how much it ultimately ends up hurting American workers and their families.

Perhaps the reason I hold these beliefs is that I started graduate school back in 1984, and was taking Alan Auerbach's public finance class when the 1986 Tax Act was enacted. At the time, I began working on how the 1986 reforms would affect business capital spending. The literature surprisingly found little effects of tax policy on the economy, often suggesting that tax and interest rate variables did not drive capital spending. But Alan and I noticed something funny in the data. Politicians tended to pass Investment Tax Credits in recessions, then let them expire when the recession was over. Thus it appeared that the economy partly drove tax policy, even if to tax policy also affects the economy. However, because recessions induced tax-cuts, any analysis of how tax cuts affected the economy would need to separate this out to not wrongly conclude that tax cuts caused recessions. When Alan and I discovered a way to overcome this problem, we found very large effects of tax policy on investment behavior. Since then, there has been a veritable scientific revolution of papers that use different methods to identify tax effects, and like our first study, they have found again, and again and again, that tax policy is a major driver of economic growth, if one does the science correctly.

I don't have time to go into the scientific methodology in great detail, but have done so in more detail in a number of recent review articles. But for thinking about the broad-brush growth impact of the President's proposals, a number of recent papers published in top journals provide a guide to the possible scale of the growth effects. Romer and Romer (2010), utilize narrative history to separate out tax changes with motivations unlikely to be driven by the business cycle; they estimate that a 1 percentage point reduction in the total tax share of GDP increases GDP by 1 percent on impact, and by between 2.5 and 3 percent over three years. Cloyne (2013) and Hayo and Uhl (2014) apply the same approach using data from the United Kingdom and Germany, and obtain almost identical estimates. Other authors, such as Mertens and Ravn (2013), have extended this work with more sophisticated methods and find that a 1 percentage point reduction in the average personal income tax rate raises real GDP per capita by 1.4 percent in the first quarter, and by up to 1.8 percent after one year. They further find that a 1 percentage point cut in the average corporate income tax rate raises real GDP per capita by 0.4 percent in the first quarter, and by 0.6 percent after a full year. Using a similar approach, Mertens and Olea (2017) find that in the first two years following a tax decrease of 1 percent, GDP is expected to be higher by about 1 percentage point.

Applying these estimates to the proposed reduction in the statutory corporate income tax rate from 35 to 20 percent and the simultaneous introduction of full expensing requires calculating the effect these changes would have on federal tax liabilities, which will depend on the bill's final details. But just to illustrate the scale of these effects, a rough preliminary estimate of the combined revenue effect of the corporate tax proposal, combined with these macro elasticity estimates, implies that tax cuts of this scale would lift GDP per capita by approximately 4 percent over the first year. Although there are a number of reasons to expect that the actual impact of the reform would be much smaller than that, including the fact that we are currently near full employment, the potential for a significant growth effect is still very reasonable and empirically valid.

Approaching the question from a different angle, we can recall that a primary mechanism by which a cut in the corporate tax rate affects business investment is through lowering the user cost of capital. The current consensus in the academic literature implies that a tax change that lowers the user cost of capital by 1 percent would raise aggregate investment by between 0.5 to 1 percent. Calculating the effect on the average user cost of capital of reducing the statutory corporate tax rate to 20 percent, and introducing full expensing, depends upon the values of the relevant parameters and the final details of the bill. But a reasonable range implies an expected short-term, but sustained, boost to capital spending and then GDP growth of much more than 1 percent.

So I'll repeat it again: existing evidence clearly indicates taxes matter for the economy.

These estimates may seem implausibly large to some not familiar with the scientific literature. This is particularly the case when compared to results typically predicted by so-called general equilibrium models that make sure that the movements in one market do not violate the basic laws of economics in another. But even these modelers are catching up. IMF economists Sandra Lizarazo, Adrian Peralta-Alva, and Damien Puy have developed a new DSGE model that generates growth effects from changes in individual income tax rates that are in the range of Mertens and Ravn (2013) and Barro and Redlick (2011), providing reassuring replication by a modeling alternative. Interestingly, they find that their model is able to reproduce the observed macroeconomic effects when any budget shortfall is eventually made up for by cuts in government spending, but not if tax cuts today are reversed with tax hikes in the future. This suggests that modelers who care about the validity of their models with respect to the latest time series evidence should focus on those simulations. Simulations that assume that taxes will

be raised in the future to offset cuts today, which significantly mutes their effects, are inconsistent with the macroeconomic literature.

There is another important factor to consider when thinking about how these changes will affect the economy. A recent NBER working paper (Güvenen, Mataloni, Raiser and Ruhl 2017) argues that profit-shifting by large multinational firms causes part of their economic activity to be attributed to their foreign affiliates, leading to an understatement of U.S. GDP. Moreover, this profit-shifting activity has increased significantly since the mid-1990s, resulting in an understatement of measured U.S. aggregate productivity growth.

The authors correct for this mismeasurement by “reweighting” the amount of consolidated firm profit that should be attributed to the U.S. under a method of formulary apportionment. Under this method, the total worldwide earnings of a multinational firm are attributed to locations based upon apportionment factors that aim to capture the true location of economic activity. The authors use equally weighted labor compensation and sales to unaffiliated parties as proxies for economic activity. Applying the formulary adjustment to all U.S. multinational firms and aggregating to the national level, the authors calculate that in 2012, about \$280 billion would be reattributed to the U.S. Given that the trade deficit was equal to about \$540 billion, this reattribution would have reduced the trade deficit by over half in 2012.

Extrapolating the 2012 findings to subsequent years shows that transfer pricing continues to account for at least half of the trade deficit over 2013–2016. Here is where it gets interesting. There is also a literature that looks at the relationship between tax rates and transfer pricing. That literature implies that a corporate tax cut to 20 percent would dramatically reduce the trade deficit and increase GDP accordingly. Note that this effect happens totally within the current account (for those into NIPA accounting), and thus should be thought of as a change that would be part of a static score. The growth effects mentioned in previous paragraphs would be additive to this.

Companies should bring their operations back with the certainty that tax rates are going to stay at a set level, so they can invest those funds in America and American workers.

Going to the way-back machine, let’s look at the bipartisan President’s Advisory Panel for Tax Reform convened by President George W. Bush. It looked at a plan very similar to President Trump’s Unified Framework for Tax Reform, called the “Growth and Investment Plan.” On the business side, this plan lowered corporate rates and allowed for the full expensing of new investments, and lowered the top marginal rate on small business income below the top marginal rate on individual income. On the individual side, the plan created three brackets at low rates and repealed the alternative minimum tax. Sound familiar? The Treasury Department estimated that the plan would increase output by about 5 percent in the long-run. Such an effect would be consistent with the latest empirical evidence.

And looking beyond models and into the real world, the UK gives us a good recent example of a country that undertook corporate tax reform that lowered the rates and broadened the base between 2006 and 2016. The revenues collected through the British corporate tax over the time period – as corporate rates have fallen – have surged past British government forecasts.

I hope that all of this has convinced you that the reputable scientific analysis based on the economic effects of taxes clearly suggests that this tax reform will fundamentally positively alter economic activity of our country. I am sure that there are some of you who believe the effects will be small, but even you

have to admit that all of this evidence adds up to a chance of something much, much better than what we have recently experienced.

Based on the scientific evidence, to me at least, it therefore seems prudent to adopt these reforms. Over the course of the Obama administration, U.S. corporate profits rose by a healthy 11 percent per year. But workers' pay didn't keep pace, and median wage growth was a paltry 0.6 percent per year. This disconnect between profits and wages is a radical departure from previous economic norms. Workers used to get a 1.1 percent raise for a 1 percent increase in corporate profits. Now the pass-through to workers is closer to 0.4 percent. Why did it change so much? Because the profits are offshore, benefiting other nations' workers. In 2016, U.S. firms kept 71 percent of foreign-earned profits abroad. What would happen if they didn't do that? A simple back-of-the-envelope calculation suggests U.S. workers in 2016 would have received a raise of nearly 1 percent. What if these firms didn't do that for the next 8 years? The median U.S. household would get a \$4,000 real income raise.

Or, look at it another way, we know from several studies that high corporate tax rates serve to depress the wages of workers over the long-run, through a combination of disincentives to bring profits home to invest, and a reduced impetus for domestic investment in general. Those effects are felt across the income distribution, resulting in lower wages for higher- and lower-skilled workers alike. For the median household in the U.S., a top corporate marginal rate cut from 35 to 20 percent would boost wage growth almost four-fold -- from the current 0.6 percent per year to as much as 2 percent, providing up to \$7000 of additional income. It's time for a bipartisan consensus to use tax policy to fix wage growth.

I am all for having a robust debate, as you can see from the fact that I am standing here. So therefore I would be remiss if I didn't say a few more things about the report TPC put out last week.

I think we can all agree that the TPC report did not, to say the least, contribute to the mood of bipartisan cooperation that has been so common in past successful attempts to reform the tax code. First, there are many parts of the plan that are still to be determined, yet the TPC report chose to make assumptions and publish an analysis that is unlikely to have much to do with the final bill. To the extent that such imagined numbers are used to attack the process would hardly be considered a constructive contribution.

Second, the report ignored things about the bill that are publicly known. For example, the reconciliation instructions in the Senate that are under debate have made room for \$1.5 trillion in statically scored revenue cost. Yet the report makes assumptions that would deliver a score of \$2.4 trillion. I frankly just don't understand what the purpose of a document is that shows a score for one number when there is agreement that the bill has to score to something else. And as my speech today shows, the TPC report also ignored *any* growth effects from tax reform and suggested there would be none.

This is a historic opportunity for tax reform, and we cannot afford to squander it. It's also an opportunity to continue the historic tradition of working together in enabling tax-reform. My hope is that we all can cooperate in a more nonpartisan fashion, just like TPC and Tax Foundation have done in coming together to co-host this event.

Thank you, and I look forward to your questions.