Testimony

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On

Tax Policy and Economic Growth

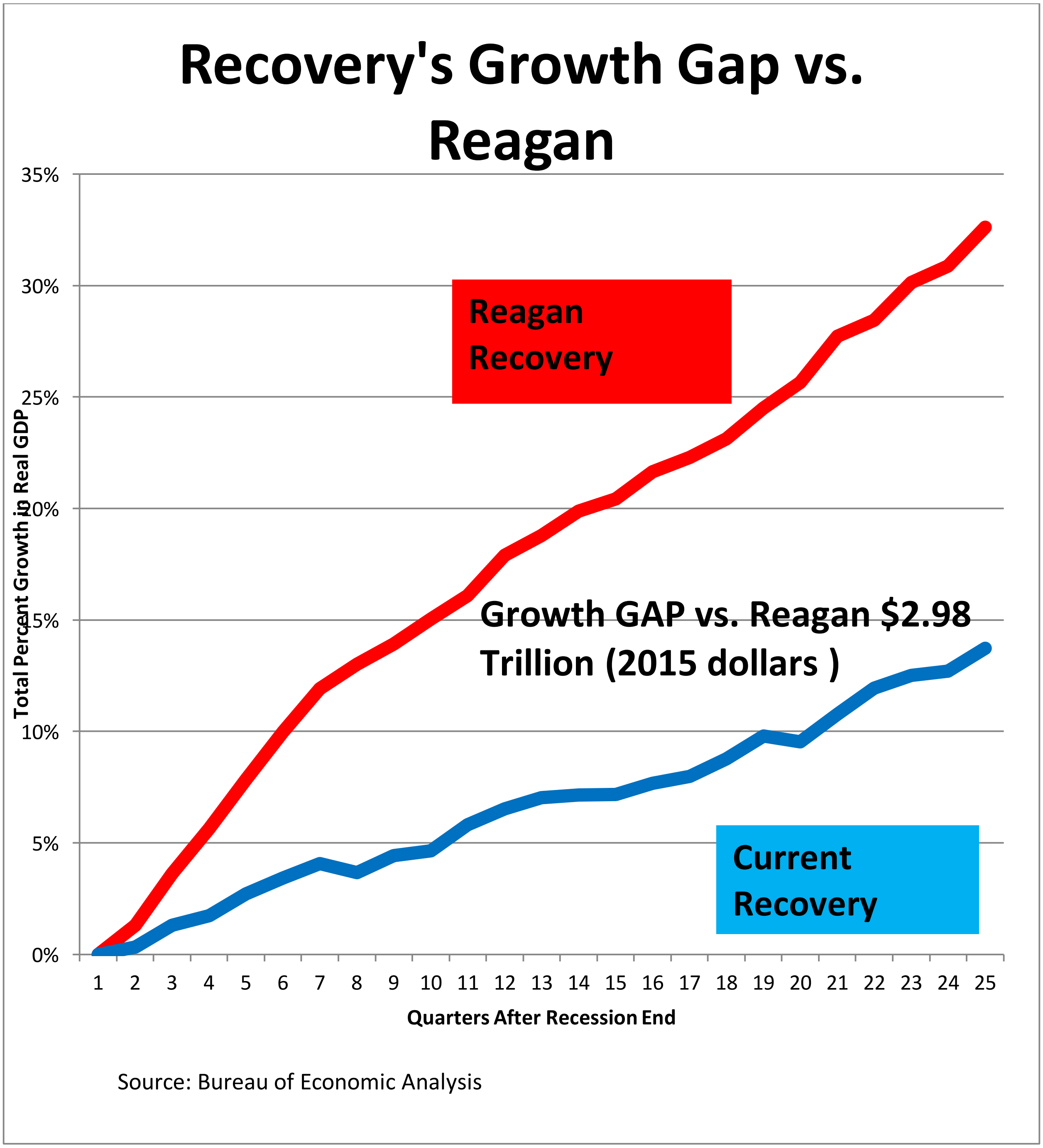
Mr. Chairman.

Thank you for the opportunity to testify before the House Ways and Means Committee on tax policy and economic growth. My name is Stephen Moore and I am an economist at the Heritage Foundation. Neither I nor the Heritage Foundation receive any federal funding.

The timing could not be more propitious for this hearing.

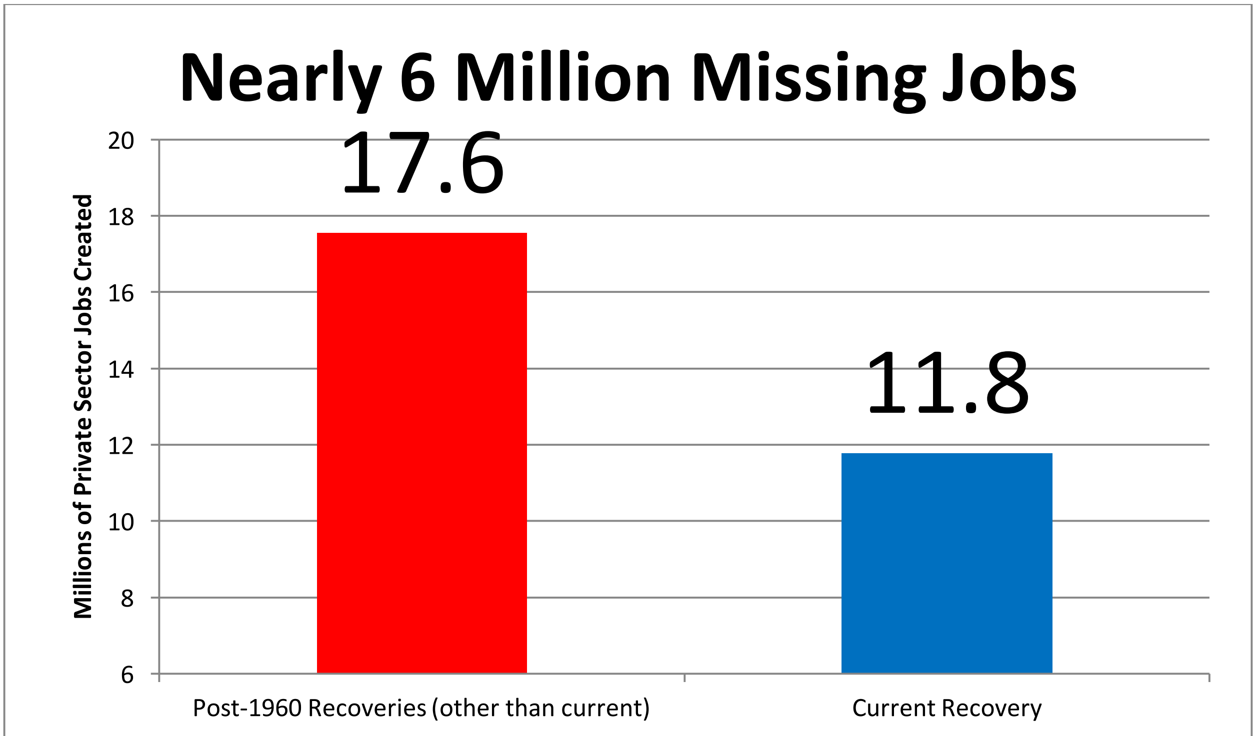
Last week the Commerce Department reported that the 4th Quarter gross domestic product grew by a minuscule 0.7 percent. This disappointing number is significant because now officially the growth gap between the Reagan recovery and the Obama recovery is just under $3 trillion. In other words, if the economy had grown as fast under Obama since the recovery began than it did under Reagan's recovery, we would have $3 trillion more output over the last 12 months. See chart 1.

CHART 1



We would also have 5 to 6 million more jobs. See chart 2. The jobs lost from anemic growth are roughly the size of the entire labor force of Ohio.

CHART 2



Source: Bureau of Labor Statistics, based on percentage change in private sector jobs 73

I would argue that the major reason that American workers are so angry and anxiety-ridden, and the reason that so many Americans are doubtful that the American dream is not going to be achievable for their children is that wages and salaries - or what Reagan used to call "real take home pay" - has been flat and even slightly negative now for a decade. Official Census Bureau figures show that since Obama took office seven years ago, the real median household income is DOWN by $1,300. For over half of Americans, this is no recovery at all and a recession that never ended.

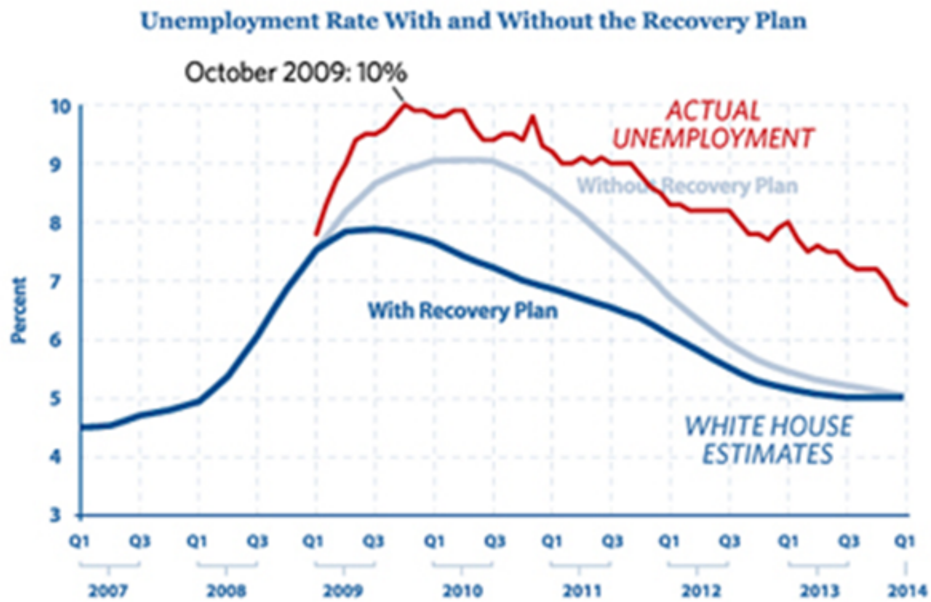
Now we are seeing that 2016 is off to a miserable start and it's hard to see much improvement in GDP in the first quarter. I've long argued that America is stuck in a 2 percent growth rut, but now the danger is we are falling below that anemic rate and there is even some chatter about a potential recession this year. At 2 percent growth the economy doesn't spin off enough jobs to increase wages, and tax revenues grow much too slowly to balance the budget.

So the economy needs growth steroids and where should they come from?

Let's start with what we must not do. The 2009 Keynesian economic stimulus plan that cost $830 billion may go down in history as one of the costliest public policy mistakes of all time. The evidence is now nearly irrefutable that the Obama spend and borrow policy with promised Keynesian "multiplier effects" gave us the slowest recovery from a recession in 50 years. Given how far the economy fell in 2008-09 when the real estate bubble popped, we should have had faster growth than normal during a rapid catch-up phase. That never happened and the vaunted "summer of recovery" that Vice President Joe Biden kept promising hasn't happened now for six summers.

The best evidence of the complete failure of the Obama stimulus comes from comparing the Obama administration itself. In early 2009 the White House economics team published a report showing what unemployment would be without the stimulus plan and with the stimulus spending. Not only was unemployment much higher than the White House predicted it would be with the gusher of spending, it also turned out to be higher than it would have been had we done nothing! See Chart 3.

CHART 3



Source: "The Job Impact of the American Recovery and Reinvestment Plan," 2009, president's Council of Economic Advisers; Bureau of Labor Statistics, Labor Department. Graphic: The Heritage Foundation, April 2015.

Let me repeat: this is not my analysis, but that of the Obama administration itself. The White House's own claims when it sold Congress on the stimulus program shows the unemployment rate would have fallen faster and the economy more briskly had we not borrowed $830 trillion. Now the Obama administration says that its own forecasts were wrong and that the economy turned out to be weaker than they thought.

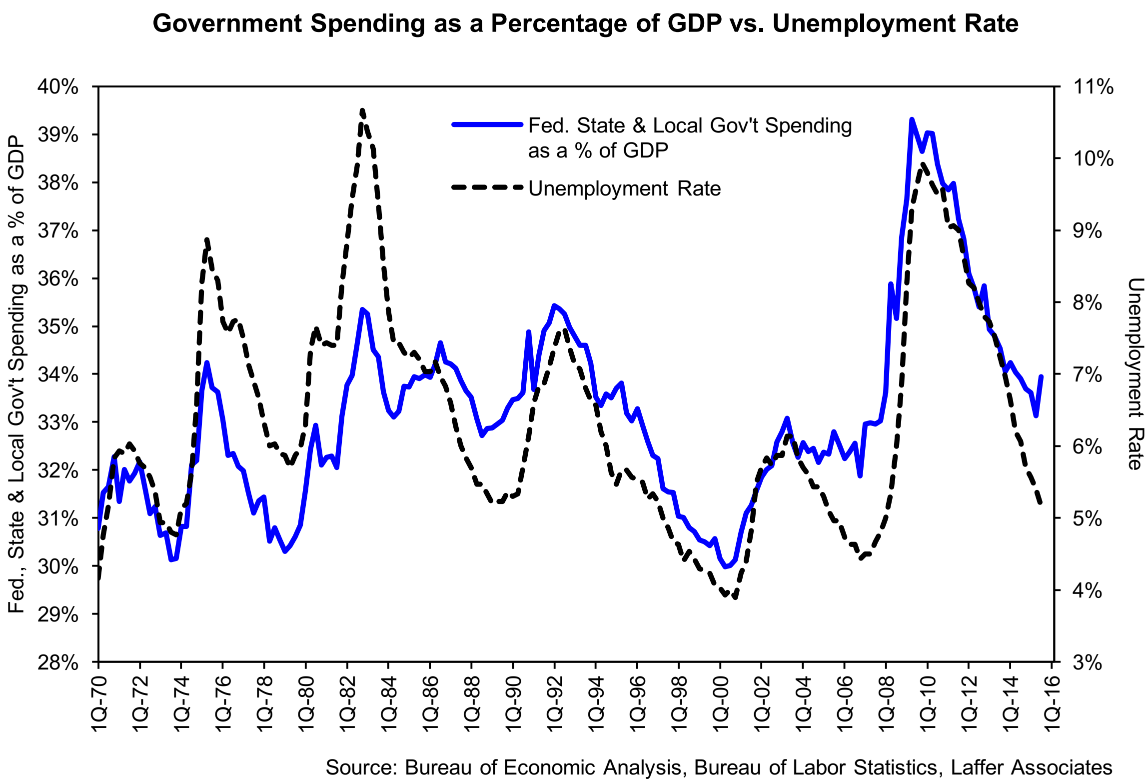
But in my judgment what made the economy weaker than they thought was that almost every policy decision from 2008-2010 on economic and fiscal policy was exactly the wrong thing to do.

The reasons for our worst in modern times recovery can't all be blamed on the failed stimulus bill. Obamacare, the tax hikes on the rich, minimum wage increases, EPA regulations on our energy industry, and Dodd-Frank have slowed growth and hiring too.

One of the lessons that we have hopefully learned or relearned over the past decade is that government spending on food stamps and unemployment benefits, green energy subsidies for companies like Solyndra, and transit grants for rail projects to nowhere, is no way to improve growth in the short term and certainly not in the medium or long term. The Congressional Budget Office tells us that the long term effects of the stimulus plan are negative. In other words, we are a little poorer this year and every year going forward because of the massive borrowing. All we have to show for ourselves after the borrowing binge is massive debt repayments that will be made over decades. This didn't exactly help "the children."

What is done is done and if anything good can come of this fiasco, it is to learn the lessons of what went wrong and to never, ever make these mistakes again. Government borrowing and spending does not stimulate the economy. It never has as Chart 4, prepared by Arthur Laffer and I, shows.

CHART 4



I am not reflexively against borrowing during a time of emergency - nor should Congress be. It matters a lot what you buy with the debt. In the 1980s we bought a ferocious economic recovery and an end to the Cold War. It would be hard to argue that this borrowing didn't dramatically benefit future generations. In the 1990s under Bill Clinton we balanced the budget through growth of the economy and spending restraint, and that too was beneficial. Government spending fell from about 22 percent of GDP to below 19 percent during Clinton's presidency even as the economy boomed.

So since traditional Keynesian spending stimulus doesn't help, what CAN this Congress do to re-ignite American prosperity? I would recommend a short term and long term strategy. In a forthcoming report that I prepared for the Committee to Unleash Prosperity and Freedom Works, I recommend 12 steps to economic recovery. Although this report is not yet public, I will mention one here because the findings are so astonishing. We estimate that the value of oil and gas under federal lands that can be recovered with existing technologies like horizontal drilling and Fracking is at today's prices roughly $50 trillion. This is arguably the greatest treasure chest in world history. Not only would we massively stimulate the economy by drilling on non-environmentally sensitive federal lands, while ensuring at least a half-decade of energy independence, but of special note to this committee, we estimate that over the next 20 years the government would raise $3 trillion in revenues for Uncle Sam - at zero cost to taxpayers!

Someone please show me any other plausible plan that raises $3 trillion over the next decade without wrecking the economy.

My colleagues Arthur Laffer, Larry Kudlow and I have recently recommended an immediate stimulus plan for the economy. We call this an insurance policy against recession. We propose a permanent reduction in the corporate/business tax rate from 35 percent to 15 percent.

This should be accompanied by expensing for business capital purchases and perhaps a 5% voluntary repatriation tax on the $2 trillion owned by U.S. multinational firms that is parked abroad to avoid the high corporate tax.

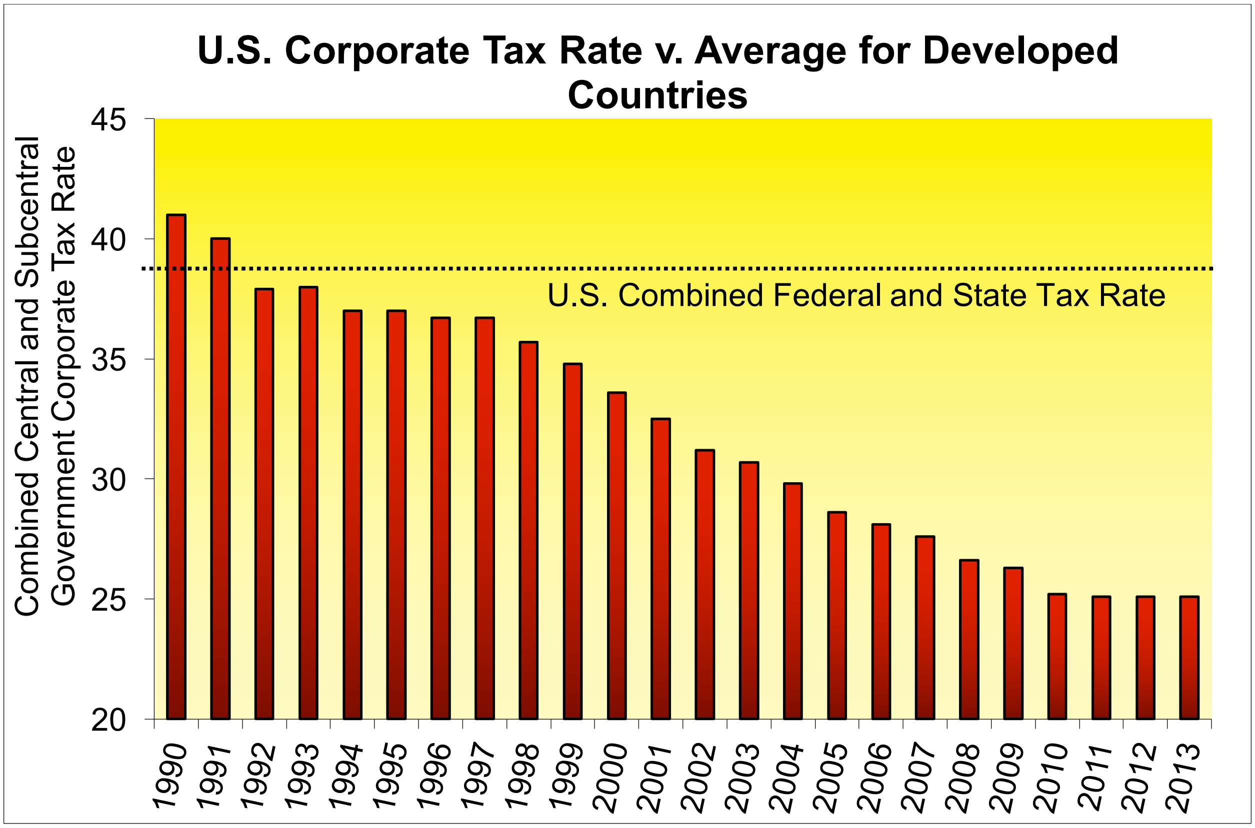
This won't cost the Treasury much in lost revenues, and who knows? It may raise money over five years through the money and businesses repatriated back to America. Apple and GE might bring back tens of billions of dollars for assembly plants and research centers on these shores.

The current U.S. Rate of 35 percent (federal) is the highest of all the nations we compete with. The rest of the world is at a rate closer to 25 percent with some nations like Ireland as low as 12.5 percent. Let's go from the highest rate in the world to one of the lowest and jobs and capital flows will reverse course and rush back the United States.

We have seen companies like Burger King, Medtronics. Pfizer, and dozens more leave the U.S. in search of lower tax rates. In January Johnson Controls announced a merger and we could wind up with yet another American company leaving to reside in foreign nations.

Liberals like to pretend that the U.S. tax rates aren't chasing out businesses and jobs, but then why are all the nations we compete with slashing their rates? See chart 5. The international average has come down from almost 40% in 1990 to 25% today. For two and a half decades the U.S. rates haven't budged, while the rest of the world keeps chopping. We're like a 6th grader who stops growing and then goes out and tries to play competitive basketball with 20 year olds over six feet tall.

CHART 5



Even President Obama's own tax reform commission, headed by former Fed chairman Paul Volcker found "deep flaws" in the corporate tax. It concluded that:

"The high statutory corporate tax rate reduces the return to investments and therefore discourages saving and investment...The tax acts to reduce the productivity of American businesses and American workers, increase the likelihood and cost of financial distress, and drain resources away from more valuable uses."

As for the stimulus value of our proposed business tax cut, the Tax Foundation finds that immediate expensing and cutting the business tax rate are the best short-term strategy for generating more growth. Here is how the Foundation put it: “A cut in the corporate tax rate would have large effects on GDP, but minimal effects on federal revenue in the long run.” Nothing else has this kind of big bang for the buck payoff. By the way, for those Keynesians out there stuck on the demand side, tax rebates and credits produce almost no positive feedback.

Over the longer term, the ideal tax reform is some form of a flat tax. Make the base broad and get rates down as low as possible. The Tax Foundation finds that a tax reform that would cut tax rates to about 15 percent, as Senators Rand Paul and Ted Cruz have recommended, would increase economic growth by almost 10 percent over a decade. The growth derives from lower tax rates and the economic efficiency that derives from this policy change and by reducing taxes on capital investment and savings.

We have found in our polling at Heritage that what Americans want most from a revamped tax system is "fairness." Loopholes, special interest favors and carve outs from the tax base are inexcusable and bad economics. By the way, in the tax bill that passed late last year, Congress extended the solar energy credits so that solar power companies can make money even though their produce loses money. This credit was immediately capitalized into the value of companies like Solar City so in a sense, the Congress wrote a check to the shareholders of this company. Is there a more egregious example of corporate welfare in modern times?

Tax reform requires a cut in the capital gains tax. Some economists have suggested that capital gains tax rates have little impact on growth and only lead to a tax cut for the rich. However, in a forthcoming study by myself and my Heritage colleague Joel Griffith, which may be the most definitive economic history of the capital gains tax, we come to a different conclusion. We find that throughout most of the last 50 years, lowering the capital gains tax is associated with more federal revenues and higher rates are associated with less revenues. This is because the capital gains tax is a voluntary tax. Investors can avoid paying the tax by holding on to stock or other assets, which is called the "lock in effect." Investment in venture capital, and technology firms, and overall business investment, are all positively associated with lower rates of capital gains tax. The Clinton capital gains tax cut from 28 to 20 percent had very sudden and dramatic effects on business investment and revenues grew much fast than expected by the Congressional Budget Office when the tax cut occurred.

It is worth mentioning that business investment has been lagging in recent years as the capital gains tax has been raised by 60 percent, from 15 percent to 23.8 percent. In the latest 4th quarter GDP report, business investment was negative.

In sum, Congress should get ahead of a potentially painful slowdown in the economy in 2016 by passing a REAL stimulus plan - and that is a corporate tax cut. This will bring money home to the U.S. with little if any revenue loss. Congress should never believe in the false gold of Keynesian demand side stimulus plans and "shovel ready jobs." On net, they never materialized.

Finally, Mr. Brady, I am very excited about your chairmanship of this committee. I know you have for years expressed a commitment to fundamental tax reform and I believe you can get this done in the next couple of years. The last time tax reform happened was 30 years ago and Ronald Reagan helped clean out the stables of the tax code and chop the top tax rate to 28 percent. It passed 97 - 3 in the United States Senate. That miracle can happen again with your leadership and vision and we at Heritage wish to help you every step of the way.