

Written Testimony of John L Buckley
Subcommittee on Select Revenue Measures
Committee on Ways and Means
July 30, 2014

INTRODUCTION

Chairman Tiberi, Ranking Member Neal, I want to thank you and the other Members of the Subcommittee for the opportunity to appear before you today.

While examining the projected macroeconomics effects of Chairman Camp's tax reform proposal is important, I am hopeful that this hearing will not be the last hearing to examine Chairman Camp's tax reform proposal. Its impact on critical sectors like manufacturing, housing and charities may not be captured in the macroeconomic models being discussed today, but they are important nonetheless.

In my testimony, I intend to offer a broad overview of the models that have been developed to analyze the macroeconomic impact of changes to our tax laws. But more importantly, I intend to ask the question of whether the economic principles underlying those models remain relevant in a world where companies, responding to market forces, are moving production offshore where there is a virtually unlimited supply of labor. In such a world, I believe that enhancing the competitiveness of US businesses and workers through public and private investments in physical and human capital is the key to long- term growth.

In simple terms, the question is whether the largest economic challenge faced by this country is the lack of jobs or too few people looking for work. I believe we all can agree it is the lack of job opportunities. Yet, the macroeconomic models discussed today assume that expanding the number of people looking for work (labor supply) will result in

increased economic growth. Most handle the problem of unemployment by simply assuming it does not exist.

As a result, the models encourage the enactment of tax policies that could reduce the competitiveness of domestic businesses in the world economy. For example, the staff of the Joint Committee on Taxation (JCT staff) analyzed Chairman Camp's tax reform plan utilizing the macroeconomic model that they developed. Using that model, they projected that the Camp proposal could reduce domestic business capital from what would be expected under current law, hardly positive for the goal of enhancing the competitiveness of the domestic economy.

MULTIPLE MODELS AND ASSUMPTIONS

All of the macroeconomic models being discussed today are based on extraordinarily complex mathematical formulae. The projections produced by any one model are completely dependent on the structure of the model and the assumptions used. It is important to understand that there is no consensus in the economic community on a single model and there are many differing opinions on basic assumptions to be used.

As a result, the JCT staff used two models and an array of different assumptions in their macroeconomic analysis of the Camp proposal.

The Congressional Budget Office (CBO) has followed a similar approach in the past. "CBO does not believe that any single model can adequately explore the macroeconomic implications of fiscal policy: the best that analysis can do is to combine the separate insights that they can glean from different models."¹

The concluding paragraph of the recent Business Roundtable study of the Camp proposal contains caveats similar to the concerns that led the JCT staff to provide an array of models and assumptions in their report to Chairman Camp. It states that the results of any one study of the impact of tax reform are "at best suggestive".

¹ CBO, "Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates" (Dec. 1, 2005), page 1. CBO Issue Brief.

Thus, it is clear that a serious examination of the macroeconomic effects of tax reform should not rely on the results of a single model with one set of assumptions.

RESULTS OF ANALYSIS USING JCT MODEL

The JCT staff has developed its own model (JCT model) for purposes of analyzing the macroeconomic impact of tax legislation. The JCT model, like all of the other models discussed today, is a supply-side model, based on the assumption that the amount of domestic economic activity is determined by the supply of labor and capital. In the long run, aggregate demand is assumed to equal supply; that is, no unemployment or unused capital. As a result of those assumptions, increases in the number of people willing to work (labor supply) or business capital are projected to result in greater economic growth.

Using their model, the JCT staff analyzed the impact of the Camp proposal following basic rules used in revenue estimating. They analyzed the actual Camp proposal and did not assume any legislative changes not contained in the proposal or any modifications to the actual Camp proposal. They utilized the most recent economic projections of the CBO, which means that their model contemplates an economy with substantial short-term levels of unemployment.

Those features of the JCT model may not be a surprise to many Members of this Subcommittee since they are a logical extension of the way in which the JCT staff does revenue estimates. But, as will be explained below, those features depart from the structure of most macroeconomic models developed by other governmental bodies, academics, and think tanks. However, they are consistent with the structure of models used by private corporations in business planning. Not surprisingly, they need to plan in the context of actual economic conditions, not a hypothetical economy based on “counterfactual” modeling assumptions.

The JCT presents the results of its model under 6 different sets of assumptions concerning responsiveness of labor supply to rate reductions and monetary policy of the Federal Reserve. The model shows modest increases in gross domestic products after 10 years under each set of assumptions relative to what would be expected under current law. The projected increases range from 0.1% to 0.6%.

On the surface, the JCT model shows positive, but modest, effects from the Camp proposal. But, when you examine the details, a less positive picture emerges.

The Camp proposal is projected to increase economic growth in a manner reminiscent of economic stimulus legislation. It would provide a net \$590 billion reduction in individual income taxes over 10 years (not including additional individual income tax revenues from the impact of the business reforms). Since the proposal is essentially revenue neutral, it would result in a net \$590 billion tax increase on corporate income and business income of individuals. Since individuals have greater proclivity to spend, that shift of tax liability is assumed to increase demand for goods and services. In the context of current economic conditions with substantial unemployment and unused business capital, the increased demand is projected to result in greater economic growth. This stimulus effect may be the primary driver of the economic growth projected by the JCT model.

The individual rate reductions would provide an incentive for people to work, leading to an increase in the supply of labor. Since the JCT model assumes that in the long run there is full-employment, the increased labor supply also results in greater economic growth. However, the projected growth is delayed because of the current levels of substantial unemployment.

The positive effects of the Camp proposal flow from those two effects of the net \$590 billion reduction in individual income taxes. They come at a price. Because of the net increase in business taxes, the JCT concludes that the Camp proposal overall “is expected to increase the cost of capital for domestic firms, thus reducing the incentive for investment in domestic capital stock.” The increased cost of capital will not be uniform for all businesses. Businesses, like many manufacturers, that

are capital intensive or have large research costs would see the largest increase in the cost of capital.

Not surprisingly, the increase in the cost of capital is projected to result in a reduction in business investment relative to what is currently projected. Also, that increased cost of capital is projected to result in a small reduction in savings by individuals.

Under the JCT model, over the next 10 years, the net effect of those positive and negative impacts is a modest increase in economic growth. In the short term, the negative effects of the reduction in business capital are muted because there is unused business capital in our current economy. Also, the Camp draft defers the repeal of accelerated depreciation until 2016, delaying the negative impact of that change. But, a statement in the JCT macroeconomic analysis suggests that the Camp proposal could be negative in the long term for business investment. “Over time, the cumulative effects of the repeal of [accelerated depreciation] and amortization of intellectual property begin to outweigh the positive incentives from reduced rates in standard [JCT model] simulations.”

The JCT analysis does not answer the question of whether the long term stimulus and labor supply impacts of the individual tax reductions will offset the long term, negative impact on business investment.

OTHER MACROECONOMIC MODELS

Regardless of one’s views concerning the merits of the JCT model, it is difficult to disagree with the conclusion that the Camp proposal would increase the cost of capital for domestic firms, resulting in lower domestic business capital. The net \$590 billion tax increase on business income is a fact that should eliminate the possibility of debate. Moreover, the corporate rate reductions in the Camp proposal largely benefit existing corporate investments, whereas, the “business reforms” in the Camp proposal largely reduce incentives for future investments.

Other models have projected substantially larger growth effects from the Camp proposal, notwithstanding its effect of increasing the domestic

cost of capital. One example is the model that was developed by Professor Diamond and his colleague, Professor Zodrow, and used in their study of the Camp proposal commissioned by the Business Roundtable (Business Roundtable model). That model had a different outcome from the JCT model largely because it was modeling a different economy and different proposal.

Consistent with the structure of most macroeconomic models, the Business Roundtable model did not attempt to analyze the impact of the Camp proposal on our actual economy. Instead, it starts with a hypothetical economy constructed through counterfactual assumptions.

Macroeconomic models based on supply-side principles have always had conceptual difficulties in modeling an economy with unemployment or unused business capital. In such an economy, increases of labor or capital do not result in economic growth; they merely increase the supply of unused labor or capital. The Business Roundtable model solves that conceptual difficulty by simply assuming that in all periods there is no unemployment and the supply and demand for capital are in equilibrium. As a result, the model projects immediate increases in economic growth from a larger supply of labor even though there is substantial unemployment in our economy.

Many of us do not always conduct our affairs in a manner designed to maximize our long-term financial condition. Our ability to do so is limited by our inability to accurately predict the future. As a result, many individuals may not fully respond to the incentive effects of the rate cuts. The JCT model assumes that individuals are “myopic”; they act on the basis of current conditions without the ability to accurately predict the future. The Business Roundtable model assumes that we have an economy in which individuals always act in their best interest and, in doing so, they have the benefit of “perfect foresight”; that is the ability to accurately predict future economic conditions and governmental actions. The assumption of perfect insight is one reason why the Business Roundtable model has more favorable projections than the JCT model.

After creating a hypothetical economy through “counterfactual” assumptions, the Business Roundtable model creates a hypothetical legislative proposal quite different from the Camp proposal.

There appears to be a consensus among economists that a well-designed macroeconomic model should not project positive economic benefits from proposals that continue our fiscal policies that are unsustainable over the long term. The need to finance the growing deficits would “crowd out” private capital, eliminating the potential benefits of the proposal. As a result, most models will project positive outcomes only if the Federal budget is placed on a sustainable path. To “solve” this problem, the models assume the legislative proposal being analyzed will be accompanied by enactment of tax increases, entitlement reductions, or a combination thereof.

In that respect, the Business Roundtable model is consistent with the structure of most models. It assumes that the Camp proposal will be accompanied by dramatic reductions in entitlement programs that would result in Federal debt as a percent of our economy not growing from current levels. Recent estimates from the CBO suggest that accomplishing that goal would require entitlement cuts totaling \$2 trillion over the next ten years with even greater reductions thereafter. The reductions are assumed to have no negative effect on the economy because of the model’s assumption that we will always have a full-employment economy.

The Business Roundtable model does differ from most other models in one respect. It modifies the Camp proposal by assuming further reductions in the corporate rate to approximately 20%. This modification to the Camp proposal has the benefit for modeling purposes of substantially reducing the adverse impact on domestic business investment that would occur under the actual Camp proposal. But, it does result in a hypothetical proposal that violates the Chairman’s commitment to a revenue-neutral reform using existing revenue estimating methods.

Then, the model analyzes the effect of the hypothetical proposal on the hypothetical economy using one set of highly uncertain assumptions. One the key assumptions in the Business Roundtable model is the

assumption that corporations will substantially reduce tax-motivated income shifting in response to the reduction in corporate rates and that reduction will begin immediately. The report to the Business Roundtable acknowledges that assumption is an “important determinant” of the model’s results and it also acknowledges that the extent to which corporations will actually reduce income shifting is unclear.

Finally, consistent with the structure of other models, the Business Roundtable model makes one final intellectual leap. It assumes that the projections based on analyzing the impact of a hypothetical proposal on a hypothetical economy using highly uncertain assumptions is predictive of the impact of the actual Camp proposal on our actual economy.

It is no surprise that macroeconomic models like the Business Roundtable model have been consistently wrong in their past projections of the macroeconomic effects of tax legislation. One striking example of wildly inaccurate projections occurred in the context of the 1993 deficit reduction legislation. Then Rep. John Kasich said in the Floor debate that virtually all economic projections said that the bill would kill jobs. His observation was accurate, but the projections were wrong. One of the strongest periods of economic growth in recent history occurred after the enactment of the 1993 tax increases.

TIME TO EXAMINE UNDERLYING PRINCIPLES

I would encourage this Subcommittee not to become part of the debate among economists concerning whose model is the best. Instead, an examination of the supply side principles underlying all of these models is in order.

During the last 30 years, most major tax legislation has been shaped by supply side principles and the notion that market outcomes not affected by tax incentives offer the best path for economic growth. The Camp proposal is consistent with those concepts, responding to the call for an “even playing field” not affected by tax incentives.

A recent article by Sandile Hlatshwayo and Nobel Laureate economist Michael Spence suggests that those economic theories have little relevance now when “ the global economy has an abundance of human resources and they are becoming more accessible as time goes on.”² Those resources are becoming more accessible because multinationals have become adept at creating and managing global supply chains and they are getting better all the time.

The Spence article looks at employment growth in the US between 1990 and 2008 in the tradable sector of the economy (the sector subject to cross-border competition) and the non-tradable sector. Not surprisingly, virtually all of the domestic employment growth during that period (97.7%) occurred in the non-tradable sector, with employment in government, healthcare and retail accounting for most of that growth. The article concludes that there is “ a long-term structural challenge with respect to the quantity and quality of employment opportunities in the United States” since continued large employment growth in those non-tradable sectors is unlikely.

In the opinion of the authors, the domestic employment challenge is not the result of market failures. Multinational enterprises moving jobs overseas are doing exactly what the market is telling them to do. A tax reform plan based on the primacy of market outcomes will not reverse the declines in domestic manufacturing employment. Indeed, a tax reform plan like the Camp plan could worsen domestic employment challenges by repealing broad-based incentives for domestic investment under the guise of economic neutrality while liberalizing tax rules for the overseas operations of US multinationals. Those provisions would create a playing field that tilts in favor of investments overseas.

Perhaps, one goal of tax reform should be an “even playing field”. Narrowly targeted tax benefits need to be carefully scrutinized. However, even though it may violate concepts of economic neutrality, I believe that the even playing field should tilt in favor of domestic investment. It is especially important to not have an even playing field

² Michael Spence and Sandile Hlatshwayo, “ The Evolving Structure of the American Economy and the Employment Challenge”, Council on Foreign Relations, March, 2011.

that tilts in favor of foreign investment, as would be the result under the Camp proposal.

I would like to thank the Subcommittee, once again, for inviting me to testify today and would be happy to answer any questions you may have.