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How Tax Reform Can Address America's Diminishing Investment and Economic Growth

By
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Introduction

America's economic problems are often attributed by those in the popular press and in political office to a "lack of demand," resulting in numerous policies aimed at boosting consumption. These policies appear to have worked, in that consumption has grown steadily in recent years such that it is now at an all-time high as a share of GDP. However, economic growth remains sluggish, keeping millions unemployed four years into the recovery.

Meanwhile, investment—the true engine of economic growth—is at a nearly record low, well below the levels seen in our largest trading partners. Cross-country comparisons show the U.S. has an extremely low level of investment and low economic growth relative to both developed and major developing countries.

A primary reason is U.S. tax policy, which is heavily slanted against investment. Tax reform can address these problems by cutting the corporate tax rate, currently the highest in the developed world, reducing individual income tax rates on non-corporate business, reducing investor-level taxes, improving business expensing, and moving to a territorial tax system.

Worldwide Imbalance: America Consumes, the World Invests

One of the key tradeoffs faced by any economic actor is whether to consume today or save and invest for tomorrow. For example, if one consumes his entire salary, say on fancy meals and vacations, it is gone forever and cannot be consumed again. As a result, he has not saved for retirement or a house or any unexpected costs, and he is not any wealthier at the end of the year. If instead he saves and invests a portion of his salary, he is wealthier at the end of the year. In general, the more he saves and invests the wealthier he becomes.

Figure 1. The U.S. Second Among Developed Countries in Consumption

Source: World Bank

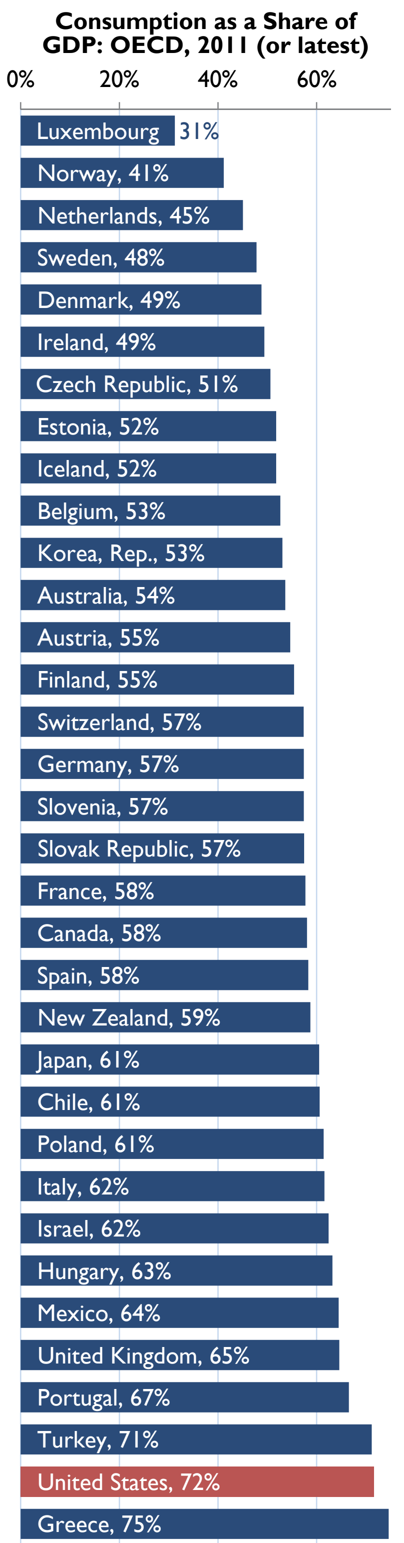


Figure 2. The U.S. Second to Last Among Developed Countries in Investment

Source: World Bank

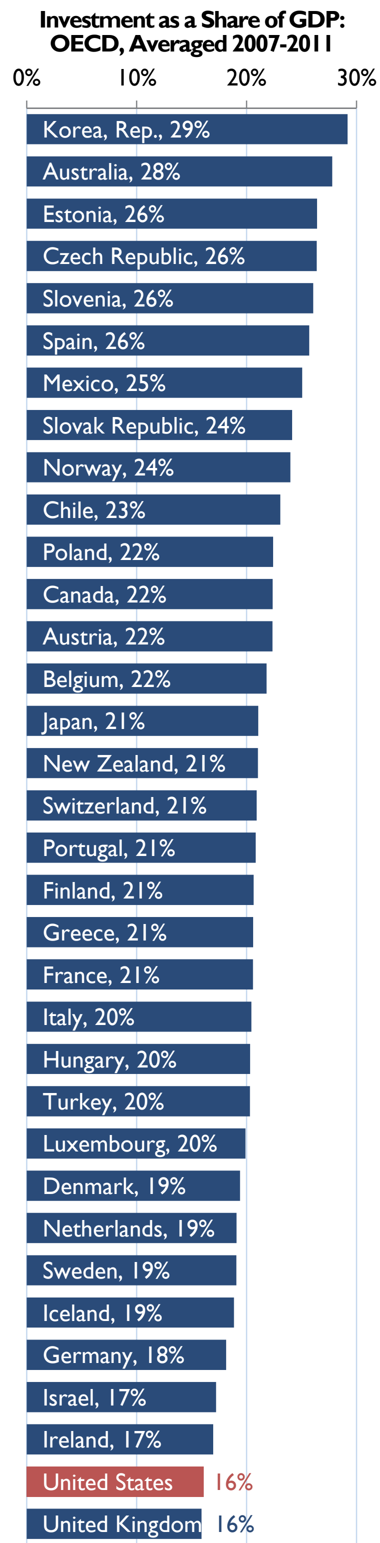
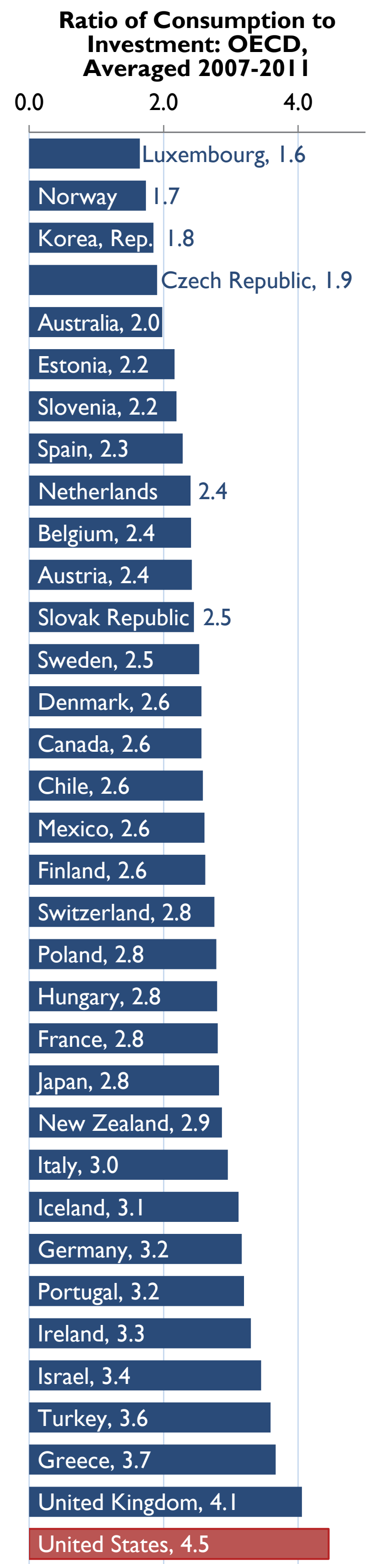


Figure 3. U.S. Consumption Relative to Investment is Highest in Developed World

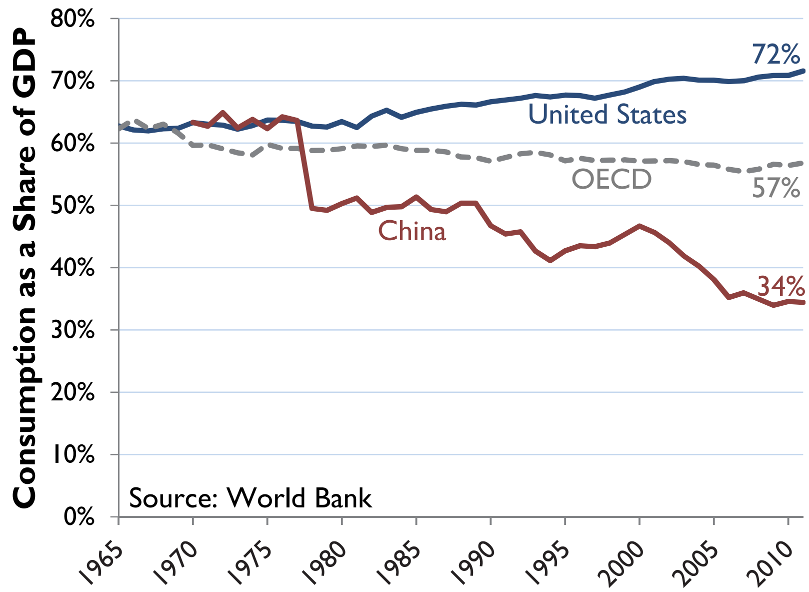
Source: World Bank



So it is with nations to a large degree. There are two major components of private-sector GDP: consumption and investment.[1] Americans as a whole consume much more than they invest. In fact, Americans consume about 72 percent of GDP—higher than any developed country except Greece (see Figure 1 comparing the U.S. to other developed countries in the OECD).[2] Meanwhile, Americans invest about 15 percent of GDP—lower than any developed country except the UK (see Figure 2).[3] Among developed countries, the U.S. has the highest ratio of consumption to investment, followed by the UK and Greece (see Figure 3).

Further, consumption in the U.S. has been increasing as a share of GDP since the 1960s, while it has been decreasing in other developed countries and in China (see Figure 4). The average OECD country consumes 57 percent of GDP compared to 72 percent in the U.S., while China consumes 34 percent of GDP. In the 1960s, these countries consumed roughly the same, about 63 percent of GDP. The financial crisis and Great Recession did not interrupt the United States' consumption, which has increased as a share of GDP every year since 2006.

Figure 4. U.S. Consumption Rising from an All-Time High, Shrinking in Other Countries



In contrast, investment in the U.S. has been decreasing as a share of GDP since the 1960s, and the decline has accelerated since the financial crisis of 2008 (see Figure 5). Investment was about 20 percent of GDP in the 1960s, fluctuated considerably thereafter with the business cycle, but declined for the most part after the 1980s, never exceeding 21 percent of GDP after 1984. With the financial crisis, investment dropped to 14

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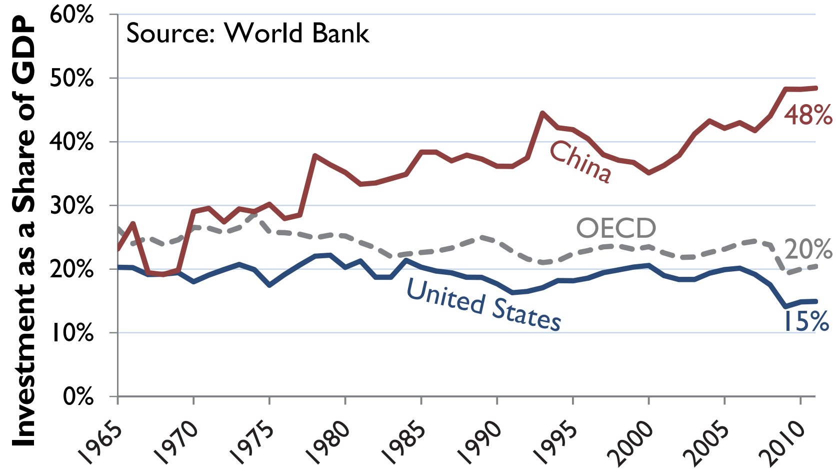
[1] The other components of GDP are government spending and net exports.

[2] This is the World Bank's household final consumption expenditure measure, which consists of "the market value of all goods and services, including durable products (such as cars, washing machines, and home computers), purchased by households. It excludes purchases of dwellings but includes imputed rent for owner-occupied dwellings. It also includes payments and fees to governments to obtain permits and licenses. Here, household consumption expenditure includes the expenditures of nonprofit institutions serving households, even when reported separately by the country. This item also includes any statistical discrepancy in the use of resources relative to the supply of resources." *See* World Bank, *Household final consumption expenditure, etc. (% of GDP)*, http://data.worldbank.org/indicator/NE.CON.PETC.ZS.

[3] This is the World Bank's gross capital formation measure (averaged over five years because of volatility), which consists of "outlays on additions to the fixed assets of the economy plus net changes in the level of inventories. Fixed assets include land improvements (fences, ditches, drains, and so on); plant, machinery, and equipment purchases; and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings. Inventories are stocks of goods held by firms to meet temporary or unexpected fluctuations in production or sales, and "work in progress." According to the 1993 SNA, "net acquisitions of valuables are also considered capital formation." *See* World Bank, *Gross capital formation (% of GDP)*, http://data.worldbank.org/indicator/NE.GDI.TOTL.ZS.

percent of GDP in 2009 and has only recovered to 15 percent of GDP as of 2011. Other OECD countries followed a similar trend though at higher levels of investment. The average OECD country now invests about 20 percent of GDP. China, on the other hand, has seen a huge increase in investment, starting from about 20 percent of GDP in the 1960s to 48 percent of GDP today.

Figure 5. U.S. Investment near Record Low, Chinese Investment Soars



The shifting of investment and production to China and other developing countries means fewer jobs and less economic growth in the U.S. Figure 6 shows the relationship between investment and real economic growth over the long run (2001-2010) among developed (OECD) and large, emerging (BRIC) economies. The United States' low investment and low economic growth stands in sharp contrast to the high investment and high economic growth of China and India, and even the moderate investment and economic growth of countries like South Korea, Slovakia, and Estonia. Among these countries and over this time period, average investment has a 73 percent correlation with average real economic growth, indicating a very strong positive relationship. This means that in the long run, economic growth is largely determined by investment. Furthermore, it indicates that if the U.S. increased investment by about 50 percent, GDP growth would likely double.

In contrast, among the same countries and over the same time period, consumption has a negative 22 percent correlation with average real economic growth, which means boosting consumption tends to detract from growth over the long run, although the relationship is a weak one relative to investment (see

Figure 6. Investment Drives Long-run Economic Growth
Investment Versus Real GDP Growth in OECD and BRIC Countries

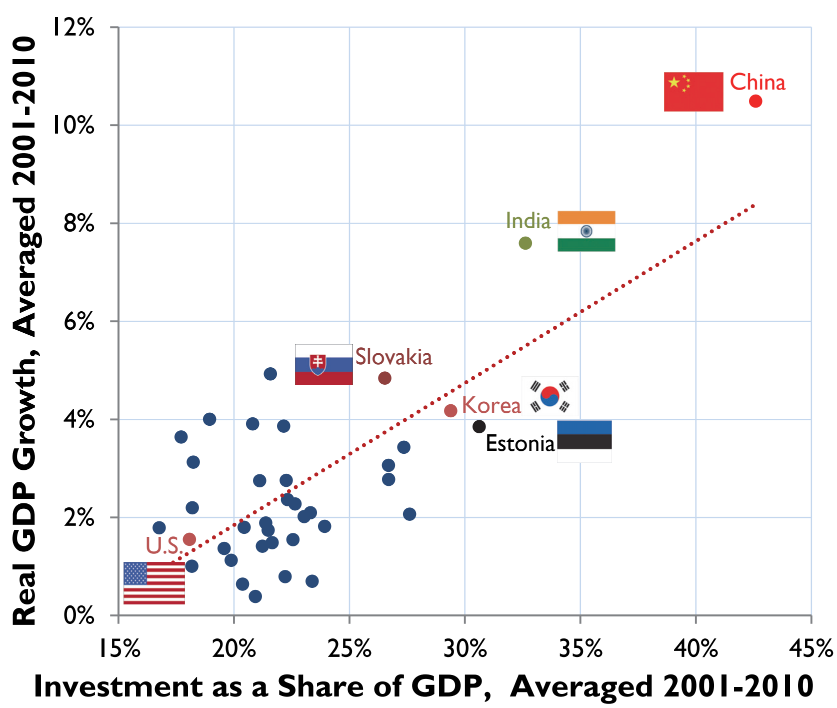
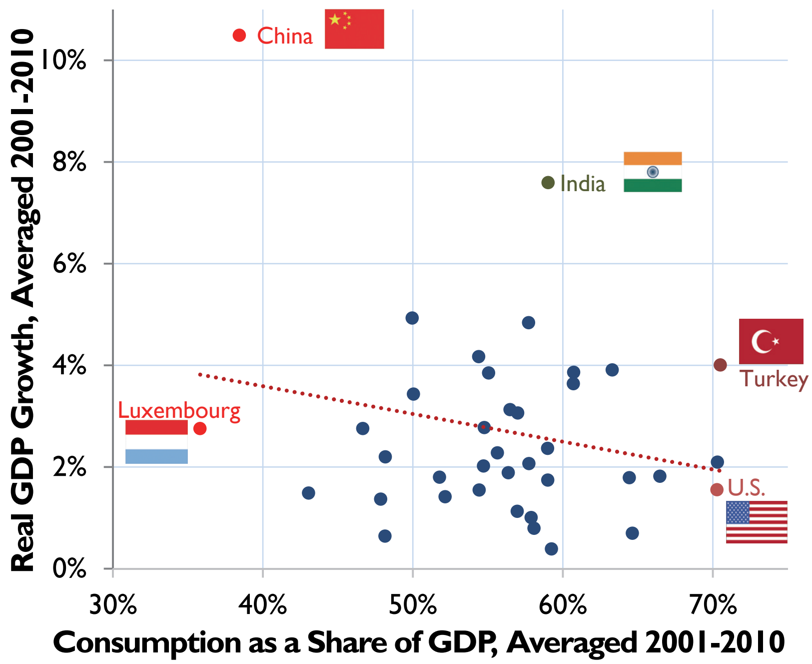


Figure 7). Despite these long-run effects, many Keynesian economists argue for temporarily boosting consumption during recessions. In essence, it trades future consumption for current consumption, and there is an inherent loss of wealth in the process.

Figure 7. Consumption Detracts from Long-run Economic Growth
Consumption Versus Real GDP Growth in OECD and BRIC Countries



The Heavy U.S. Tax Burden on Investment and Options for Reform

Since investment is the key to long-run economic growth, and investment is chronically low in the United States, policy should not aim to permanently depress investment and the stock of capital. Unfortunately, U.S. tax policy does just that, particularly at the federal level. The following are five ways to reduce the excessive taxes on investment.

#1: Cut the Federal Corporate Tax Rate

The combined U.S. statutory corporate tax rate is the highest in the developed world, at 39.1 percent (35 percent federal rate plus an average of state and local rates). As Figure 8 shows, the U.S. corporate tax rate was competitive in the 1990s but tax competition has left us behind in the intervening years. The average corporate tax rate among OECD countries is now 25 percent. The best course of action is to reduce the federal corporate tax rate from the current 35 percent to 20 percent or lower so as to be competitive after state and local taxes are included.

Figure 8. Falling Behind by Standing Still

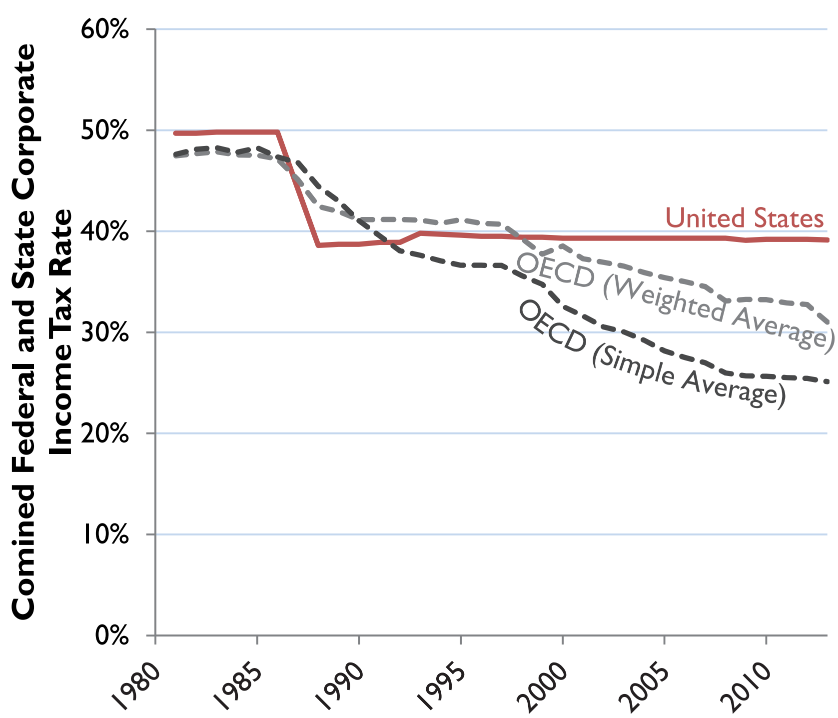
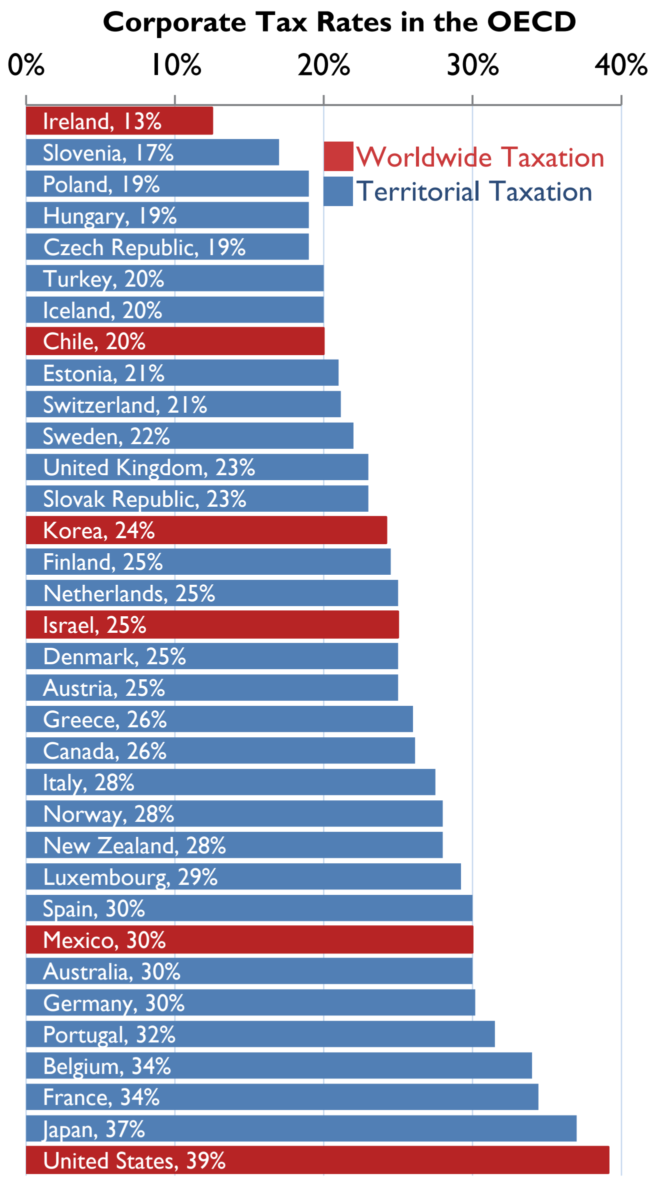


Figure 9. America's Uncompetitive Corporate Tax System



#2: Improve Capital Allowances

U.S. businesses are generally not allowed to immediately deduct the cost of investments in buildings, machines, and other equipment but instead must write these investments off over years or even decades.[4] Stretching out these deductions reduces the incentive to invest. Furthermore, the U.S. is below average among developed countries in the generosity of these capital allowances.[5] As a result, the U.S. effective corporate tax rate, which factors in these deductions, is the highest, or nearly the highest, in the developed world, according to most studies.[6] Since these effective rate estimates are backward looking, they have not taken into account many of the recent statutory tax rate reductions abroad, particularly Japan's lowered tax rate, which leaves the U.S. with the highest statutory tax rate and probably the highest effective tax rate in the developed world. The solution is to lower the U.S. effective corporate tax rate both by lowering the statutory corporate tax rate and by making capital allowances more generous.

#3: Move to a Territorial Tax System

While most countries largely exempt from domestic taxation the foreign income of corporations, the U.S. taxes this income at the

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[4] Stephen Entin, *The Tax Treatment of Capital Assets and Its Effect on Growth: Expensing, Depreciation, and the Concept of Cost Recovery in the Tax System*, TAX FOUNDATION BACKGROUND PAPER NO. 67 (Apr. 24, 3013), http://taxfoundation.org/article-ns/tax-treatment-capital-assets-and-its-effect-growth-expensing-depreciation-and-concept-cost-recovery.

[5] Oxford University Centre for Business Taxation, Katarzyna Bilicka & Michael Devereux, *CBT Corporate Tax Ranking 2012* (June 2012).

[6] *Id. See also* Duanjie Chen & Jack Mintz, *Corporate Tax Competitiveness Rankings for 2012*, CATO INSTITUTE TAX AND BUDGET BULLETIN NO. 65 (Sept. 2012), http://www.cato.org/sites/cato.org/files/pubs/pdf/tbb_65.pdf; Phillip Dittmer, *U.S. Corporations Suffer High Effective Tax Rates by International Standards*, TAX FOUNDATION SPECIAL REPORT NO. 195 (Sept. 13, 2011), http://taxfoundation.org/article/us-corporations-suffer-high-effective-tax-rates-international-standards; William McBride, *GAO Compares Apples to Oranges to Find Low Corporate Effective Tax Rate*, TAX FOUNDATION TAX POLICY BLOG, July 2, 2013, http://taxfoundation.org/blog/gao-compares-apples-oranges-find-low-corporate-effective-tax-rate.

highest rate in the developed world.[7] As shown in Figure 9, the U.S. is one of only six developed countries that continues to tax on a worldwide basis as opposed to territorial. This puts U.S. businesses operating abroad at a distinct disadvantage, since companies based in other countries only pay tax where the profits are earned, while U.S. companies must also pay an additional tax if they bring their profits home. The solution is to do what most of the developed world has already done: switch to a territorial tax system.

#4: Reduce Shareholder Taxes

Shareholder taxes on capital gains and dividends are a double tax on corporate profits, and the U.S. has some of the highest shareholder taxes in the developed world. This year's biggest tax increases were on capital gains and dividends, which are now taxed at a top federal rate of 23.8 percent, while state and local shareholder taxes push the combined top tax rate to 27.9 percent. California has the highest combined tax rate on capital gains in the U.S. at 33 percent, which is the second highest in the developed world.[8] Dividend taxes rank similarly high. Many countries do not tax capital gains, including China and India, and many other countries do not tax dividends, such as Slovakia and Estonia, while many others credit shareholders for taxes paid at the corporate level.[9] To make America more competitive, and increase the incentives to save and invest, it is imperative that shareholder taxes, as well as taxes on interest, come down from current levels.

#5: Lower Tax Rates on Pass-through Business Forms

In the U.S., most business income is taxed under the individual income tax code, not the corporate code. These businesses are partnerships, S corporations and sole proprietorships whose profits are passed through to owners' tax returns. Further, most of this pass-through business income is taxed at the top marginal tax rate, which is nearly 50 percent including federal and average state and local rates, and above 50 percent in some high tax states.[10] No other developed country has such a large share of businesses and business income

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[7] William McBride, *New Zealand's Experience with Territorial Taxation*, TAX FOUNDATION FISCAL FACT NO. 375 (June 19, 2013), http://taxfoundation.org/article/new-zealands-experience-territorial-taxation; PWC, *Evolution of Territorial Tax Systems in the OECD*, prepared for the Technology CEO Council (Apr. 2, 2013), http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf; Phillip Dittmer, *A Global Perspective on Territorial Taxation,* TAX FOUNDATION SPECIAL REPORT NO. 202 (Aug. 10, 2012), http://taxfoundation.org/article/global-perspective-territorial-taxation.

[8] Kyle Pomerleau, *The High Burden of State and Federal Capital Gains Taxes,* TAX FOUNDATION FISCAL FACT NO. 362 (Feb. 20, 2013), http://taxfoundation.org/article/high-burden-state-and-federal-capital-gains-taxes.

[9] OECD, *OECD Tax Database*, *Corporate and capital income taxes*, http://www.oecd.org/tax/tax-policy/oecdtaxdatabase.htm#C_CorporateCaptial.

[10] U.S. Department of the Treasury, Office of Tax Analysis, Matthew Knittel et al., OTA Technical Paper 4: *Methodology to Identify Small Businesses and Their Owners* (Aug. 2011), http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf; Scott Hodge & Alex Raut, *Individual Tax Rates Also Impact Business Activity Due to High Number of Pass-Throughs*, TAX FOUNDATION FISCAL FACT NO. 314 (June 5, 2012), http://taxfoundation.org/article/individual-tax-rates-also-impact-business-activity-due-high-number-pass-throughs; Gerald Prante & Austin John, *Top Marginal Effective Tax Rates by State and by*

subject to such high individual tax rates.[11] This reduces the incentive for these businesses to invest in the U.S. The solution is to reduce the top marginal tax rate on individual income to 25 percent or lower so as to match the average corporate entity tax rate in other developed countries.

Conclusion

While the rest of the world has been competing for capital, the U.S. remains trapped in a policy debate over how best to boost consumption. Perhaps policy officials are unaware that the U.S. has one of the highest rates of consumption in the world and one of the lowest rates of investment and economic growth. If the U.S. is to achieve even the average economic growth rate among developed countries, it will require boosting investment significantly above current levels.

Tax reform can address these problems. First, corporate investment can be increased by reducing the statutory corporate tax rate, currently the highest in the developed world. Second, improved capital allowances would boost both corporate and non-corporate investment. Third, most business income is taxed under the individual code, so reducing the top marginal tax rate on individual income would also boost business investment. Fourth, reducing relatively high shareholder taxes would reduce the double taxation of corporate investment. Finally, moving to a territorial tax system like that of our major trading partners would allow U.S. multinational corporations to invest more at home and abroad.

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Source of Income, 2012 Tax Law vs. 2013 Scheduled Tax Law (as enacted in ATRA) (Feb. 3, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2176526.

[11] OECD, Center for Tax Policy and Administration, *Survey on the Taxation of Small and Medium-Sized Enterprises: Draft Report on Responses to the Questionnaire*, tables 1-3, http://www.oecd.org/tax/tax-policy/39597756.pdf.