Tax Reform and the Republican Manufacturing and Growth Agendas

by Thomas Duesterberg and Ike Brannon

Thomas J. Duesterberg

Ike Brannon

Thomas Duesterberg is a senior fellow at the Hudson Institute. Ike Brannon is the president of Capital Policy Analytics and a visiting senior fellow at the Cato Institute.

In this article, Duesterberg and Brannon argue that the Ryan-Brady tax reform proposal, with its emphasis on strengthening growth in domestic capital-intensive industries, is the most feasible plan being considered that would address the electoral program for industrial jobs and growth articulated by Republicans in 2016.

The surprisingly strong electoral showing of Republicans in 2016 owed a great deal to general dissatisfaction with the slow economic growth since the Great Recession, especially in the manufacturing sector. President Trump swept the industrial heartland by appealing to out-of-work or underemployed industrial workers and the many affiliated service sector workers who depend on a strong industrial economy.

Nearly six months into the new administration, many of the policies offered by Trump to address the decline in manufacturing and stimulate a recovery — building a border wall, rewriting trade agreements, rebuilding infrastructure, imposing buy-U.S. programs, and reforming healthcare — appear to be stymied, at least in the short term. The bump in "animal spirits" attributable to Trump's effective early use of the bully pulpit and the anticipation of the administration's deregulatory actions will prove temporary in the absence of major new programs, most of which require legislative cooperation or international agreements.

In this environment, tax reform is the repository of hope for accomplishing the major goals of the Republican economic agenda. Engendering an industrial recovery ought to be a bipartisan agenda, but the rancor of 2017 does not offer promise for Democratic acquiescence to any facet of the Trump agenda. Republicans at both ends of Pennsylvania Avenue are beginning to realize that tax reform is now the key element in their governing agenda, or at least the economic agenda. A reform effort largely along the lines of the plan[1] proposed by House Speaker Paul D. Ryan, R-Wis., and House Ways and Means Committee Chair Kevin Brady, R-Texas, provides the best hope for success, and it could be passed without any Democratic votes.

The relative decline of the U.S. industrial sector since the 1970s has been well-chronicled, and the social and cultural impact on the workers and communities that depend on that sector is now beginning to come into focus: a startling rise in alcohol abuse, drug abuse, and suicides that has led to the recent decline in life expectancy for

[1] Tax Reform Task Force, "A Better Way: Our Vision for a Confident America" (June 24, 2016).

American males.[2] Major increases in the disability rolls are related to the loss of jobs and to these social pathologies, as well. The proliferation of information and communications technology has accelerated the process started by the rise of global competition by enabling the rapid movement of ideas, including production processes and design expertise, to low-wage developing nations.[3]

The Obama years saw a privileging of environmental, redistributive, and regulatory concerns over production and job-creating policies, but it is also clear the country's problematic tax code accelerated the process of decline and now represents an obstacle to reinvigorating industrial growth. This comes at a time when analysts are finding a significant narrowing of production cost differences between manufacturers in the United States and developing-country competitors.[4]

It is worth noting that manufacturing is important to economic strength in ways often hidden by overused indicators, such as direct employment and share of GDP, in this sector. About two-thirds of research and development expenditures are performed by manufacturing companies, including familiar machinery producers such as Ford, Boeing, Cummins, and Caterpillar, and technology players such as Apple, Intel, and Pfizer. Wages and benefits for workers in this sector are on average higher than for the overall economy. The multiplier effect of manufacturing is much higher than it is for services, meaning that every dollar produced by manufacturing generates another $1.40 in related sectors. Productivity growth, along with constraints on price increases, has historically been much higher in manufacturing than in services or government. One estimate of manufacturing's footprint in the U.S. economy suggests that up to one-third of all economic activity, or GDP, is directly tied to manufacturing through upstream (mining and materials) and downstream (transportation, financing, and logistics) activities.[5]

Simply put — and articulated by both Republicans and Democrats — the well-documented differences in both statutory and effective corporate tax rates, especially for lower-margin, capital-intensive sectors such as manufacturing and mining, have hastened the offshoring of production and corporate inversions, and that has helped erode the domestic tax base. Almost all foreign competitors have territorial tax regimes so that they pay income tax only in the consuming (or destination) locations, while U.S. companies are liable for the U.S. and the destination-country taxes. Additionally, significant elements of the tax base in competitor nations are embedded in their VATs, which are rebated at the border, while U.S. exports to those nations must bear the local VATs as well as income taxes. While considerable debate surrounds analysis of the trade effect of border-adjustable taxes, it seems clear that at a minimum those tax regimes affect location decisions for companies that are subject to global competition.[6] Moreover, the existing tax code does little to encourage domestic capital formation, even though it is a key ingredient in boosting investment and thus strengthening productivity, wages, and employment.

The Ryan-Brady plan addresses these concerns by lowering the top-line corporate tax rate, as well as the top-line rate for passthrough entities by introducing a territorial system for taxing foreign-source income, and applying a border-adjustable tax. Also, the first-year expensing of capital investments called for in the Ryan-Brady plan would provide a significant boost to growth in the industrial sector as well as an incentive to produce domestically. The Tax Foundation model estimates that the combined effect of these changes would boost long-term growth by 6 percent, increase wages by 7.7

[2] *See* Angus Deaton and Anne Case, "Mortality and Morbidity in the 21st Century," *Brookings Papers on Economic Activity*, Conference Draft (Mar. 23-24, 2017); and Nicholas Eberstadt, "Our Miserable 21st Century," *Commentary* (Feb. 15, 2017).

[3] *See* Richard Baldwin, *The Great Convergence: Information Technology and the New Globalization*, Ch. 3 (2016).

[4] *See* Hal Sirkin et al., "The BCG Global Manufacturing Cost-Competitiveness Index," BCG Perspectives (Aug. 19, 2014).

[5] *See* Manufacturers Alliance for Productivity and Innovation, "The Facts About Modern Manufacturing" (Nov. 20, 2012); and Daniel J. Meckstroth, "The Manufacturing Value Chain Is Much Bigger Than You Think," MAPI Foundation (2016).

[6] Jason Furman et al., "Border Tax Adjustment and Corporate Tax Reforms," Peterson Institute for International Economics Conference (Feb. 1, 2017).

percent, and generate 1.7 million new jobs in the next decade.[7]

Additional benefits from this plan accrue specifically to workers. One of us has reviewed the substantial literature on the impact of corporate taxes on job creation and wages as well as on the incidence of corporate taxes on workers and other stakeholders.[8] The research comparing different tax rates on business income across states as well as across countries shows that workers are a primary beneficiary of lower corporate tax rates. Ultimately, three different entities pay corporation taxes: the owners of capital via lower returns (that is, reduced profits), consumers via higher prices for goods and services, and workers. The latter pay because corporate taxes dampen investment in plants and equipment, which serves to reduce productivity, and that ultimately determines wages.

Ike Brannon and Andrew Hanson's analysis of the empirical literature concludes that a tax rate reduction of the sort being discussed by Congress and the Trump administration would increase wages by 15 to 28 percent and lead to employment gains between 6 and 22 percent.

Another feature of the Ryan-Brady approach is the one-time reduction in the taxation of accumulated foreign earnings now held abroad by U.S. multinationals. A sizeable portion of these funds, if repatriated to the United States, could be used for domestic investment by the companies. There would, of course, be no incentive to keep earned profits abroad if the territorial system is adapted and top line rates are reduced to 20 percent. Some of the taxable income that would result from this could be dedicated to use in an infrastructure program, as well, which would give a boost to the industrial sector. U.S. makers of construction and transportation equipment are globally competitive in machinery used in major building projects.

Companies such as Apple, which currently borrows billions of dollars each year to pay dividends and buy back stock, would have more flexibility to deploy capital where it is most productive. This effect would be reinforced by the elimination of the deductibility of interest payments, another feature of the Ryan-Brady plan.

Among the tax reform plans that have been fully articulated, the Ryan-Brady version has the most realistic chance of becoming law in some form and has considerable potential for inducing large increments of growth in output and wages. It is close to being budget neutral, according to the Tax Foundation.[9] The border-adjustable tax is a key element in both offsetting revenue losses from lower tax rates as well as eliminating incentives to produce abroad. Opposition from key senators, retailers, and large-scale importers such as oil refiners may doom this feature of the bill, it is true. There may be other acceptable revenue-raising alternatives to the border-adjustable tax, but any other would likely meet heady opposition, as well.

In moving toward a politically feasible solution to the problems of growth and industrial decline, the macropolitical benefits of the Ryan-Brady plan ought to be kept at the forefront of the discussion. Tax reform alone cannot ensure the revival of the industrial sector or the careers of industrial workers; regulatory reform, infrastructure improvement, and investment in new, productivity-enhancing technology are essential ingredients of a comprehensive plan. But the reforms put forth in the Ryan-Brady tax plan are essential to revitalizing the manufacturing base. The investment-friendly provisions are especially important to the industrial sector and its workers, and the territorial system would reinforce incentives to produce domestically.

A final point: Presidential candidate Trump placed great hope in a new trade policy as another pillar of such a revival, but as C. Fred Bergsten laconically notes, solving the trade deficit issue "is a macroeconomic problem that requires macroeconomic solutions."[10] Eliminating incentives in the tax code that move production abroad would go a long way in addressing the

[7] Kyle Pomerleau, "Details and Analysis of the 2016 House Republican Tax Reform Plan," Tax Foundation (July 5, 2016).

[8] Ike Brannon and Andrew Hanson, "Corporate Taxes and Labor: An Investigation of Empirical Evidence," coming in *Tax Notes*, July 24, 2017.

[9] Pomerleau, *supra* note 7.

[10] C. Fred Bergsten, "Currency Manipulation in the NAFTA Renegotiation," Peterson Institute for International Economics (May 19, 2017).

trade imbalances systematically decried during the 2016 elections. The border-adjustable tax would speak to the political preference for "leveling the playing field" with our trading partners, nearly every one of which border adjusts its VAT. That approach is far preferable to a trade war that some of the more intemperate campaign rhetoric might invite. Different solutions to these problems may well emerge in upcoming negotiations, but the Ryan-Brady plan is the best and most realistic offer now on the table. ■