BUDGET BULLETIN

SENATE COMMITTEE ON THE BUDGET

CHAIRMAN MIKE ENZI | @BUDGETBULLETIN

115th Congress, 1st Session: No. 2 May 18, 2017

America's Economic Growth Triggers

Status Report on Regulation, Taxation, Litigation

by Republican Staff: Becky Cole, Susan Eckerly, and Thomas Fuller

Overview: Economic Uncertainty vs. Growth

The federal government is currently focused on boosting American economic growth with new policies that encourage private investment, entrepreneurship, and innovation. In the first quarter of 2017, the U.S. economy expanded by an annual rate of only 0.7 percent. Such sluggish output fueled by harmful economic policies hinders job creation, reduces revenue growth, and increases long-term debt. Reversing this trend is a top priority for the new administration of President Donald Trump and congressional leaders.

According to the Congressional Budget Office (CBO), a mere 0.1 percent increase in productivity growth could reduce the deficit by $273 billion over a 10-year period. CBO annually produces long-term budget projections based on an extended baseline for the next 30 years. Congress's nonpartisan budget office currently projects future gross domestic product (GDP) growth will lag behind historical averages, assuming that current law generally remains unchanged. Real GDP will increase by only 1.9 percent per year – about a percentage point below the annual average growth rate over the past 50 years.

Problems with growth are creating economic uncertainty, and research has proven that uncertainty negatively impacts economic activity and growth. As the Federal Reserve Bank of St. Louis explains, economic uncertainty is often measured in a company's decision whether or not to expand by hiring more workers or adding to its capital stock.

In this way, government policymaking can affect business profitability. While a Stanford University professor, former Federal Reserve Chairman Ben Bernanke asserted in 1983 that macro-level economic factors play an important role at the micro-level. This means that uncertainty, whether over a change in policy, the price of a commodity, or unpredictable litigation, impacts how a business invests.

To this point, the St. Louis Fed also has shown that an increase in economic uncertainty is associated with slower GDP growth. Unfortunately, until the government provides businesses with more certainty, cash will remain on the sidelines rather than fund more private sector hiring and investments in new products or services.

This *Budget Bulletin* provides a status report on three policies producing economic uncertainty that could be converted to triggers of robust growth: regulation, taxation, and litigation.

Regulation

Overall, federal regulations burden the economy in two ways: the cumulative burden of existing regulations and the continuing flow of new ones annually. The Mercatus Center at George Mason University estimates that the growth of regulation since 1980 slowed the growth of the economy by an average of 0.8 percent annually and cost the economy roughly $4 trillion in GDP in 2012 alone.

The American Action Forum has looked at government regulatory impact statements and estimates the federal government added close to $940 billion in cumulative regulatory burdens to the economy in the decade following the Great Recession of 2007-2009. Put another way, the Trump administration reports that the former administration of President Barack Obama added about 600 major regulations with an estimated combined cost of $740 billion.

These Obama administration regulations have wreaked havoc across all economic sectors, especially burdening the fossil-fuel energy sector due to new rules related to climate change and renewable-fuel standards. In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 regulatory structure has hit the financial sector, banking system, and home-building industry particularly hard. Along with these sector-specific clusters of regulations, broad employment and health mandates have raised labor costs across sectors.

Creating difficulties with determining current regulatory compliance costs, the government measures the impact of new rules before they are implemented, and only for regulations deemed economically significant. Ex post facto review is rare.

Government and private sector studies show that regulations have disproportionately hurt small businesses. According to the National Federation of Independent Business, the regulatory burden ranks as the second-highest concern of the nation’s small business owners. Notably, small businesses create two-thirds of net new American jobs.

Congress and the Trump administration have started with a two-pronged approach to providing regulatory relief, reducing the stock and flow of regulation in order to help revive the economy.

Currently, 14 Congressional Review Act (CRA) resolutions of disapproval enacted this year are reducing the recently added regulatory compliance burden, estimated as saving the economy nearly $4 billion.

Over the long term, the best hope for reducing regulations is President Trump's Executive Order 13371, "Reducing Regulation and Controlling Regulatory Costs." This executive order requires agencies to cut two regulations before adding a new one and beginning in fiscal year 2018 places a cap on agency regulatory activity. Release of the president's semi-annual regulatory agenda is expected by the end of May, which will detail the progress that the Office of Management and Budget (OMB), in particular OMB's Office of Information and Regulatory Affairs, is making with implementing the two-for-one regulatory cap system.

Taxation

Taxation affects the economy by changing the relative trade-off between high-taxed and low-taxed alternatives. Concerning labor, taxes reduce wages, making workforce participation less desirable. Concerning capital, taxes reduce profits, making investment less desirable. Together, less labor and capital result in a smaller economy and a lower standard of living.

The decision to work an additional hour or invest in an additional unit of capital depends on how taxes impact these decisions "at the margin," meaning marginal tax rates influence behavior more than effective tax rates. While capital can be more responsive to taxes than labor, capital effects tend to occur more slowly, as businesses take time to transition investment decisions into a new tax structure.

As Congress considers tax reform, the level of economic growth resulting from legislative changes will influence which policies are implemented. Adopted in the 114th Congress, the fiscal year 2016 budget resolution (S. Con. Res. 11) directed CBO and the Joint Committee on Taxation (JCT) to provide macroeconomic feedback when reviewing major legislation.

JCT has multiple dynamic models, which it combines with different assumptions about Federal Reserve policy and labor-supply elasticity that produce a range of results. For example, in 2014 JCT found then-House Ways and Means Committee Chairman Dave Camp's comprehensive tax proposal would increase economic growth by 0.1 percent to 1.6 percent during the 10-year budget window, for a total increase in revenues relative to the static estimate of $50 billion to $700 billion. Without the macroeconomic feedback, JCT projected the bill would increase revenues by only $3 billion.

Tax reform that reduces short-term revenue may reduce slack in the economy by aligning actual GDP with potential GDP, but it is also important to ensure that reforms are long-lasting on the supply side of the economy in order to raise future GDP. Furthermore, a reduction in revenue –

unless offset by spending cuts – would increase the debt and federal borrowing, likely resulting in an increase in interest rates and crowding out of private investment. These factors could reduce economic growth in the long term.

Litigation

The American legal system is one of the most litigious in the world. Litigation imposes various types of costs that the disputing parties have to pay. For example, the parties likely will be responsible for paying their own attorney, may have to pay a fee to the court, and frequently will need to provide the funds required to take depositions or to hire expert witnesses. Litigation costs even can dictate whether and how the parties will choose to proceed with their case.

There also are less predictable costs associated with litigation that can change substantially from case to case and make planning virtually impossible. These costs include exorbitant sums awarded to plaintiffs or large settlements paid to forego the risks or uncertainty of a long, drawn-out trial.

The U.S. Chamber of Commerce Institute for Legal Reform (ILR) has worked to quantify the impact of litigation costs on U.S. employers. “Litigation costs affect the ability of companies to compete and prosper,” according to ILR’s June 2013 report. Indeed, the ILR report found that liability costs in the United States, as a share of GDP, are the highest of surveyed countries – 2.6 times larger than the average in Eurozone countries. Working with Lawyers for Civil Justice and the Civil Justice Reform Group, ILR also revealed that multinational companies pay four to nine times more in litigation costs in the United States than in other countries, with an average U.S. litigation cost in 2008 of nearly $115 million.

The uncertainty that litigation produces particularly weighs on small businesses, which tend to operate on tight margins and struggle to afford litigation insurance or law firm retainers. One bad ruling against a small business could mean bankruptcy.

Litigation costs act as a tax on small and large businesses through legal expenses and insurance premiums for policies that guard against the considerable risks involved with litigation. The unpredictability and inefficiency of the legal system add additional risk and uncertainty to the economy. As with excessive taxes and regulation, excessive litigation stifles business investment and economic growth.

Taking its lead from the states, Congress is beginning work on litigation-reform proposals. Together with regulatory and tax reform, litigation reform would help reduce economic uncertainty and increase business investment, triggering more economic growth and job creation.