INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/226

UNITED STATES

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

July 2016

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with the United States, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July, 8, 2016 consideration of the staff report that concluded the Article IV consultation with the United States.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 8, 2016, following discussions that ended on June 20, 2016, with the officials of the United States on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 24, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Statement** updating information on recent developments.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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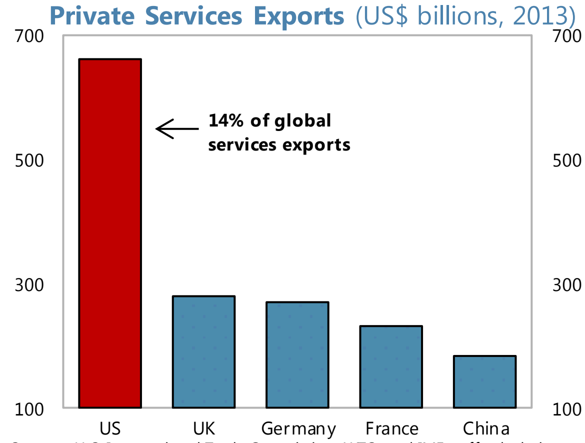
International Monetary Fund
Washington, D.C.

- ***Trade integration***. The free exchange of goods and services has been a hallmark of American economic success. New trade agreements, such as the Trans Pacific Partnership (TPP), cement and extend this principle by going beyond the removal of tariff barriers—which are already low—and include rules on investment, competition policy, intellectual property rights, and regulations. By preserving a level playing field in future growth areas, such as services, the TPP has the potential to set a new standard and pathway for international economic cooperation. It would also aid the U.S. economy by capitalizing on its strength in the fast growing area of tradable services. Resisting all forms of protectionism will also be essential. There will likely be transition costs to both jobs and incomes from greater trade integration as well as potential effects on income polarization. The consequences for trade-affected U.S. workers should be taken into account and policy efforts should be taken to mitigate the downsides through training, temporary income support, and job search assistance, including deployment of the existing trade adjustment assistance program.

Private Services Exports (US$ billions, 2013)



Sources: U.S. International Trade Commission; WTO; and IMF staff calculations

25. Authorities' views. The administration has proposed a "surge" in new infrastructure and clean energy investment funded through an excise on crude oil and a one-time 14 percent tax on unrepatriated corporate profits (as a transition to broader business tax reform). There has been broad recognition of the importance of education and job training to support future growth and productivity. The administration has already expanded grants and tax credits to increase access to college and had proposed making community college free for two years. There is a hope that the recent step to make the research and experimentation tax credit permanent could help with productivity. Federal funding for job training has been increased in recent years, and, in the past two years, 75,000 additional individuals have been enrolled into federally-supported apprenticeship programs. Continued efforts along these lines could help lessen the skills mismatch that is currently visible in the U.S. labor market. There is a strong commitment to working with Congress to pass the TPP and move ahead with other plurilateral trade agreements. The U.S. is committed to resisting financial and trade protectionism. Given that trend declines in productivity are widespread globally, officials noted the value of further examining the productivity slowdown from an international perspective.

26. Steps should also be taken to avoid self-inflicted wounds from future disagreements on the path for fiscal policy. Whatever gains could be achieved in supporting growth through the supply-side measures described above could be easily dissipated by a repetition of past political brinkmanship over appropriations and the debt ceiling. Near-term uncertainties have certainly been diminished by the passage of the Bipartisan Budget Act of 2015, the Protecting Americans from Tax

Hikes Act, and the Fixing America's Surface Transportation Act. However, it will be important to identify more lasting institutional solutions.

- One possibility would be to replace the debt ceiling with a bipartisan agreement on a clear, simple medium-term fiscal objective (with an integrated view of all budget functions and numerical goals for both debt and deficit).

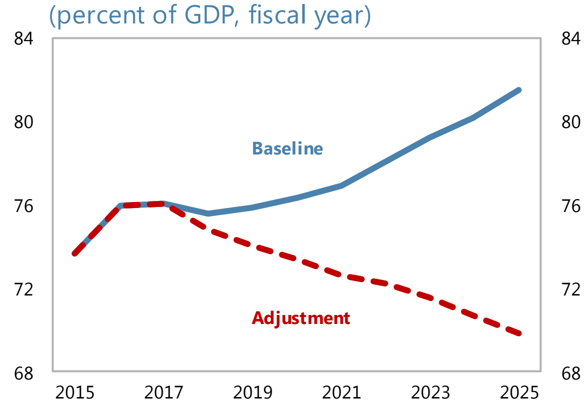
- Alternatively, a legislative process could be introduced that adjusts the debt ceiling automatically, consistent with whatever agreement is struck on the broader budget parameters.

- Carefully-designed mechanisms could be built in to support fiscal discipline by triggering automatic revenue or spending adjustments if congressionally approved targets are breached.

- Consideration could also be given to more permanently shifting to a budget cycle where annual spending levels are agreed for a two-year period (helping to divorce budget decisions from the electoral calendar).

27. Demographic trends and rising interest rates will lead to larger fiscal imbalances over the medium-term. Specifically, over the next decade healthcare and social security outlays are expected to increase by 1¾ percent of GDP and interest spending will rise by 2 percent of GDP. As a consequence, the federal debt is forecast to begin rising in 2019 and exceed 80 percent of GDP by 2025. Regrettably, the U.S. continues to lack a detailed medium-term fiscal consolidation plan to prevent this renewed rise in the public debt. Such a plan would need to target a medium-term federal government primary surplus of about 1 percent of GDP (a general government primary surplus of about ¾ percent of GDP) which would put the public debt ratio firmly on a downward path. Since many of the policies needed to boost growth and tackle poverty will have fiscal implications—the largest of which is linked to public infrastructure spending—their costs should fit within this overall deficit envelope.

Federal Debt Held by the Public
(percent of GDP, fiscal year)



Source: IMF staff estimates

28. Achieving this medium-term path will require actions on multiple fronts:

- ***Tax reform***. The Joint Committee on Taxation estimates that a comprehensive reform of the U.S. tax system that removes exemptions, simplifies the system, and reduces statutory rates (both for individual and corporate income taxes)—would raise the level of real GDP by up to 1.6 percent over the next ten years. Reform of the corporate income tax is badly needed and could help revitalize business dynamism and investment (Box 6). For the personal income tax, the structure could be made more progressive so as to help mitigate income polarization and assist the working poor. This could involve capping itemized deductions, including for mortgage interest, to lessen the tax benefit for the most well off. Finally, as has been advocated in past consultations, additional revenues should be generated through the introduction of a federal level VAT and a broad-based carbon tax (see 2015 Article IV), including an increase in the federal gas tax (which has been 18 cents per gallon since 1993).

- ***Pension reform***. The expected depletion of the social security trust fund calls for early steps toward fundamental reform of the pension system. These would include raising the income ceiling for social security contributions, indexing benefits and contribution provisions to chained CPI, raising the retirement age, and instituting a greater progressivity in the benefit structure.

- ***Healthcare cost containment***. Healthcare inflation has come down but it appears largely linked to slow wage growth in the health sector (which has already started to bounce back). More is needed to sustainably lower the path of future healthcare costs. This could be achieved through better coordination of services to patients with chronic conditions, greater cost sharing with beneficiaries, innovations in efficiency technologies (e.g. electronic health care records, remote consultations with doctors, international outsourcing of some diagnostic functions), and changing incentives away from remuneration per procedure and toward payments for achieving specified health outcomes. Higher Medicare premiums would also help address financial imbalances in the publicly-funded health system.

29. Authorities' views. On the tax side, the administration has argued for closing personal income tax loopholes for "carried interest" and to limit the value of itemized deductions and other tax expenditures for higher income households. They also would favor increasing the top tax rate on capital gains and dividends to 28 percent. The President has proposed a comprehensive, revenue-neutral business tax reform that would reduce the corporate tax rate to 28 percent, eliminate dozens of inefficient tax expenditures, impose a 19 percent minimum tax on foreign earnings that would be paid currently without possibility of deferral (with no additional tax upon repatriation), and limits on the use of excessive interest deductions by foreign companies to strip earnings. The administration recognizes there are imbalances in the entitlement system and has, over time, put forward various measures that could be part of a "grand bargain"—to strengthen the solvency of the system. In this regard, it was important not to understate the important progress, in part linked to the Affordable Care Act, that has been made in lowering the pace of cost increase in health care (which will lessen the medium-term fiscal imbalances due to aging). Tackling the financing gap in the social security system while ensuring beneficiaries receive robust benefits was seen as an increasing priority.

Estimated Fiscal Impact of Various Policy Options
(cumulative primary deficit change, 2017–2025[1])

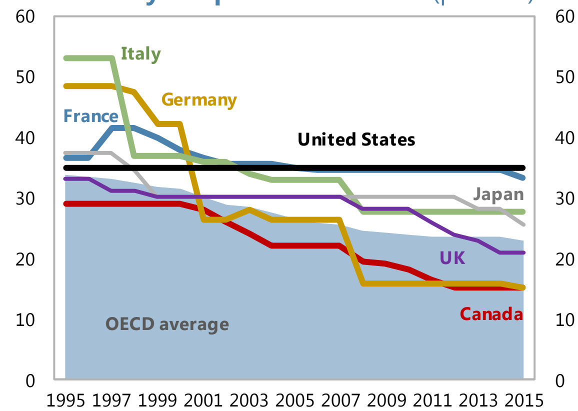
Infrastructure (drawing on American Society of Civil Engineers)	+5 to 8
Extend EITC to childless and younger workers (JCT)	+0.4
Increased funding for education and job training (CBO)	+0.5
Healthcare	
1% increase in payroll tax for Medicare Hospital Insurance (CBO)	-3.4
Increase premiums for Parts B and D of Medicare (CBO)	-1.4
Change cost sharing rules for Medicare / restrict Medigap insurance (CBO)	-0.5
Manufacturers rebate for Medicare Part D drugs for low-income patients (CBO)	-0.5
Social Security	
Increase maximum taxable earnings for payroll tax to $180,000 in 2017; index maximum to chained CPI thereafter (CBO)	-3.0
Indexing benefits to chained CPI (CBO)	-0.8
Phased increase of full retirement age to 70 (CBO)	-0.2
Extend the computation period for benefits by three years (CBO)	-0.2
Tax reform	
1% increase in personal income tax rates for upper-income groups (JCT)	-0.4
Eliminate fossil fuel preferences (JCT)	-0.2
Replace CPI with chained CPI for personal income tax brackets (CBO)	-0.6
Carbon tax (2015 Article IV report)	-4 to -5
For each 1% broad based VAT (CBO)	-2.4
For each 10 cents increase in federal gas tax and index for inflation (CBO)	-0.5
Immigration reform (CBO)	-1.5

Sources: CBO; JCT; ASCE; and IMF staff estimates
1/ Expressed as a percent of average 2017–2025 GDP.

Box 6. Reform of the U.S. Corporate Income Tax[1]

The shortcomings. There is bipartisan acceptance that the U.S. system for taxing corporate income is broken. The current tax structure is too complex, has a marginal rate that is too high and with a narrow base, is rife with legislated exemptions, favors debt financing, and incentivizes a range of cross-border avoidance and tax planning mechanisms to lower U.S. tax liabilities. Despite the well-documented distortions and shortcomings, and their negative implications for both productivity and the global competitiveness of U.S. businesses, reforming the system has proven politically impossible.

Statutory Corporate Tax Rates (percent)



Source: OECD

The priorities for incremental reform:

- Reduce the corporate income tax rate to 25 percent.
- Broaden the CIT base by eliminating the bulk of corporate tax expenditures including the Section 199 deduction (for domestic production activities) and repeal the corporate alternative minimum tax.
- Align depreciation allowances with rates of economic depreciation. Eliminate tax incentives for petroleum exploitation, including publicly traded partnerships.
- Adopt the recommendations of Base Erosion and Profit Shifting Action 4 by limiting interest deductions to 10–20 percent of EBITDA for both domestic and foreign-owned firms to reduce income-stripping as well as debt bias.
- Adopt a territorial system by excluding dividends of foreign subsidiaries from U.S. taxation. On a going-forward basis, impose a 15 percent country-by-country minimum rent tax on the foreign earnings of U.S. corporations. Maintain the current system of crediting for foreign taxes paid.
- Tax the existing stock of un-repatriated foreign-sourced earnings at a rate of 25 percent, with payments spread over the next 8 years.

More fundamental reform. Over a longer horizon, the U.S. should transform its corporate tax system into a rent tax. This would involve allowing U.S. corporations a general capital allowance against earnings for both debt and equity-financed investment and then taxing the remaining rents at a lower marginal rate. Normal returns to capital should be taxed at the investor level including by removing the current tax exempt status for pension funds and endowments. Partial crediting should remain for foreign taxes paid.

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[1] See K. Clausing, E. Kleinbard and T. Matheson, "U.S. Corporate Income Tax Reform and Its Spillovers", IMF Working Paper (2016)