Memo to the Staff of the Senate Committee on Banking, Housing and Urban Affairs

From Center for Economic and Policy Research (CEPR)
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Proposals for Increasing Economic Growth and Workers' Security

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Proposals

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1. Mandated Severance Pay

Donald Trump managed to capture news stories and headlines with his efforts to save 700 jobs at a Carrier air conditioning factory in Indiana, which had been slated to be outsourced to Mexico. While it doesn't make sense to have the president chasing after individual companies over their employment decisions, we should have a policy to protect long-term workers like the ones at this factory.

If we had a modest severance pay requirement (e.g. two weeks per year of service, up to 40 weeks), we would be providing a substantial degree of protection to these workers. In the event a company decided to lay off a worker after they had been employed for twenty or twenty-five years, they would at least have a substantial sum of money which they may be able to use to start a business, pay for going back to school, or help tide them over until they were prepared to retire.

More importantly, a severance pay requirement would change the incentives for employers. If they knew that they would face a substantial payout for large-scale layoffs, they would have more incentive to keep long-term workers on the job. This means investing in new technologies so that their operations stay competitive and continually retraining their workers so that their skills keep up with the technology.

If they really have no use for their workers, for example if the market for their product collapsed, then this sort of modest severance pay requirement would not prevent them from making layoffs and shutting down their operation, which is what we would want. However, the layoff of long-term employees has large externalities on both the workers and the larger community.

Since older workers have a difficult time getting re-employed, many will suffer through a difficult period of unemployment. There is much research showing this can have a devastating impact on both the worker and their family. In addition, unemployed workers will impose a cost on the community in the form of unemployment insurance and other benefits. A severance pay requirement gets companies to internalize these costs.

While excessive severance pay requirements can deter hiring, there is little evidence that requirements along the lines suggested here would impede growth. Severance pay requirements are in place in most other wealthy countries, including successful economies with low unemployment, like Germany and Denmark. It should be on the agenda in the United States.

2. **Limit Interest Deductions that Reduce Business Tax Liabilities**

Under current tax law, debt financing is tax-preferred relative to equity financing because, while interest payments are deductible from business income, dividends are not. This has encouraged the excessive use of debt, which puts businesses at risk in an economic downturn. Highly leveraged companies were much more likely to enter bankruptcy in the 2008 financial crisis. Private equity firms, in particular, routinely take advantage of these rules by vastly increasing the debt levels of their portfolio companies. Simply by substituting deductible interest payments for non-deductible dividend payments, businesses increase after-tax earnings; for private equity firms, this increases the value of portfolio companies. This private gain, however, has social costs. Most obviously, the substitution of debt for equity leads to reduced tax revenue. In addition, the substitution can result in the overleveraging of portfolio companies, putting them and their employees at greater risk of bankruptcy or insolvency.

There are a number of ways in which the interest deductibility of debt can be capped so that the choice of debt or equity financing is made based on the needs of a business to finance its growth, rather than on consideration of tax avoidance. Interest deductions could be capped at a specified amount (like student loan interest deductions, which are capped at $2,500 per year) or the amount of debt on which interest deductions are allowed could be capped (like the home mortgage interest deduction which is available with respect to the first $1,000,000 of mortgage debt). Alternatively, only a specified percent—such as 65 percent—of interest paid during the year could be allowed as deductions.

3. Replacing the Corporate Income Tax with a Requirement to Provide non-Voting Shares

It is becoming increasingly difficult to enforce the corporate income tax as companies become more adept at tax avoidance schemes and hiding their profits in other countries. These tax avoidance efforts not only deprive the government of revenue, they have created a huge tax avoidance industry. In fact, much of the profit of the private equity industry stems from its ability to reduce the tax liabilities of the companies it takes over.[1] For this reason the tax avoidance industry has become a major generator of inequality, since many of the richest people in the country have made their fortune in the private equity industry.

A requirement that companies turn over non-voting shares, equal to 25 percent of their outstanding common stock, would largely eliminate the opportunities to avoid the corporate income tax by gaming the system. This would both ensure the government gets the targeted revenue and also eliminate the enormous waste involved in tax avoidance, putting the tax avoidance industry out of business.

The non-voting shares would be treated the same way as the voting shares, with the exception that they give the government no say in the running of the company. If the company pays a dividend of $2.00 for each share of common stock, then it will also pay a dividend of $2.00 for each share of non-voting stock held by the government. If the company buys back 10 percent of its common shares for $100 each, then it would also buy back 10 percent of the government's shares for $100 each. If there is a takeover or leveraged buyout of the company for $150 a share, then the buyer must also pay $150 for each of the government's shares.

This system also has the advantage that if a company is making money from overseas operations, then the government will be able to share in these profits. Game playing about what was earned by the Irish or Cayman Island subsidiary won't help them avoid paying the government its share.

1 The operations of the private equity industry are detailed in Appelbaum, Eileen and Rosemary Batt. 2013. *Private Equity at Work: When Wall Street Manages Main Street*. New York: Russell Sage.

While issuing shares in lieu of taxes should be mandatory, it could even be initiated on a voluntary basis. This would both allow some companies to avoid the bookkeeping requirements associated with paying corporate taxes and also reduce the burden on the Internal Revenue Service. It can then focus its resources on monitoring the companies that don't accept the deal. More importantly, if a large segment of corporate America was comfortable operating with the government holding non-voting shares, it would make it easier at some future point to require the issuance of non-voting shares.

4. Protect Workers' Pay and Pensions in Bankruptcy Proceedings

A. Update the WARN Act

In 1988, recognizing the disproportionate burden on workers and communities that a sudden major layoff or closing of a facility can cause, Congress passed the WARN Act. This Act requires an employer with one hundred employees or more (or an employer shutting down a facility with 50 employees or more) to provide workers with 60 days' advance notice of the mass layoff or shutdown. The employer is required to provide 60 days' compensation following the WARN Act notice, whether the facility remains open and employees continue to work, or the employer chooses to close the facility immediately.

Today thousands of operating businesses, employing millions of U.S. workers, are owned by holding companies, private equity firms, and other remote entities that exercise *de facto* control over decisions regarding mass layoffs and facility closings. However, these firms have become adept at calling the shots at the companies they own while making sure they have implemented policies and procedures that let them avoid being considered a "single employer" for the purpose of the WARN Act.

It is gratifying that in March 2017 the U.S. Supreme Court overturned a ruling by the U. S. District Court for Delaware that let private equity firm Sun Capital Partners, Inc. off the hook under the WARN Act when one of the companies it owned declared bankruptcy. To fully resolve the issue of responsibility for WARN Act payments to workers, however, requires a revision of the five-factor test that courts use when considering whether a remote entity is a "single employer" for purposes of the WARN Act.

Congress should direct the Department of Labor, which developed the five-factor test, to provide a broader interpretation of the third factor, *de facto* control, commensurate with changes in the structure of today's more complex organizations. Having representatives on the board of a company should count strongly in favor of a finding that a firm exercises *de facto* control, particularly if combined with financing or consulting agreements, or if accompanied by an action that was decisive or the "proximate cause" of the layoffs, such as a decision to withhold funding. Broadening the interpretation of *de facto* control along these lines would protect banks and other creditors from WARN Act liability without letting firms that should be considered single employers for the purpose of the WARN Act escape responsibility for their actions.

B. Hold Remote Entities Accountable for Pension Liabilities in Bankruptcy of Operating Businesses

The bankruptcies of numerous businesses owned by holding companies, private equity firms, or other remote entities raise the concern that some of these entities are using the bankruptcy courts to rid themselves of the pension obligations they assumed when they acquired these businesses.

A particular provision of the Employment Retirement Income Security Act (ERISA) protects the interests of workers in multiemployer pension plans by requiring that employers that withdraw from a plan pay their fair share of the plan's unfunded liabilities. The bankruptcy of a business is a common reason for such a withdrawal. To be responsible for these liabilities, the entity must be: (1) under "common control" with the company; and (2) a "trade or business." To be in a parent-subsidiary group under "common control," the parent must have at least an 80 percent interest in the subsidiary.

Remote entities have developed practices to game these requirements, such as when Sun Capital Partners, Inc. split its ownership of an operating business by having one of its funds own 70 percent and another own 30 percent. As a result of tactics like this, there has been an overall increase in companies that declared bankruptcy and shifted workers' pension payments to the Pension Benefit Guaranty Corporation (PBGC). This has contributed to a record-high deficit at that agency and raised the prospect that the PBGC might need to be bailed out by taxpayers.

Congress should update ERISA to remove any doubt about the obligations of remote entities for employee pensions. Amending ERISA to take account of developments in the ownership, governance, and management of operating businesses would restore the protections for workers' pensions that the ERISA legislation was designed to address.

5. Use 15 Percent of the Budget of the National Institutes of Health (NIH) to Make Drugs Available at Generic Prices

The system of financing prescription drug development through patent monopolies is becoming ever more dysfunctional. Newly developed drugs often have list prices that run in the tens of thousands annually, and sometimes in the hundreds of thousands. This is for drugs that would sell for a few hundred dollars in a free market without patent protection. In aggregate, we will spend more than $440 billion on prescription drugs in 2017 (2.2 percent of GDP) on drugs that would likely sell for less than $80 billion in a free market. This gap of $360 billion a year is almost $3000 for every family in the country.

In addition to making drugs unaffordable for many people in the United States and elsewhere, patent monopolies also provide enormous incentives for waste and corruption. The massive gap between the patent protected price and free market price (equivalent to tariffs of several thousand percent) leads companies to promote their drugs in situations where they are not appropriate and may not be an effective treatment. It also causes them to misrepresent the safety and effectiveness of their drugs. An entire industry (pharmacy benefit managers) has come into existence as a result of the huge gap between the list price of drugs and the actual cost of production.

This proposal would use some of the funding for NIH to bring new drugs to the market that could be immediately sold at generic prices. The funding could be used to conduct clinical trials or other research, where all the results are fully public. This means that research results would be posted on the internet in a timely manner and all patents would be placed in the public domain on a copyleft basis.[2] It could also be used to buy up the rights to existing drug patents, with the patents then being placed in the public domain so the drug could be sold as a generic. (A recent analysis[3] showed that the government could save an enormous amount of money by doing this with Gilead Sciences, the company that holds the rights to the Hepatitis C drug Sovaldi.)

By using a portion of the NIH budget for this purpose (15 percent would be roughly $5 billion a year) the government would be able to demonstrate the effectiveness of directly funded research as an alternative to providing incentives through patent monopolies. In addition to directly lowering the cost of health care by making effective new drugs available at generic prices, this could create a process whereby more money would go into directly funded research so that this route could eventually replace the system of patent supported research.

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2 "Copyleft" is a concept taken from the Free Software Movement. Anyone is free to use a patent as long as the products are themselves available on a copyleft basis. If they want to gain a patent for private use, they must negotiate a payment.

3 Bach, Peter B. and Mark Trusheim. 2017. "The U.S. Government Should Buy Gilead For $156 Billion To Save Money On Hepatitis C." *Forbes*, January 17. https://www.forbes.com/sites/sciencebiz/2017/01/17/the-u-s-government-should-buy-gilead-for-156-billion-to-save-money-on-hepatitis-c/.