THE LAFFER CENTER
at the Pacific Research Institute

Do We Want Special Interest Trade Protectionism in the Tax Code?

By Arthur Laffer and Peter Ferrara

EXECUTIVE SUMMARY

President Obama's FY 2016 budget plan includes a proposal to deny the standard business cost deduction to U.S.-based, foreign-owned companies for reinsurance premiums they pay to foreign reinsurance affiliates.[1] That same proposal is carried over, though never enacted, from President Obama's budgets for several recent years.

In Congress, Sen. Robert Menendez (D-NJ) and Rep. Richard Neal (D-MA) have previously introduced legislation in the Senate and House respectively to enact such a provision. A similar but slightly different version was also included in the tax reform legislation introduced by former House Ways and Means Committee Chairman Dave Camp in 2014, as well as in the tax reform proposals that were under development last year by former Senate Finance Committee Chairman Max Baucus.

Reinsurance is insurance for insurance companies. With insurers taking on so much liability from high potential cost events, they also need insurance to spread their own risks. The insurance company shares some of its premium revenue with the reinsurance company, in return for the reinsurance company sharing some of the risk and liability. This enables the insurance company purchasing the reinsurance to share and diversify the risks of insurance claims and liability, and further pool capital. Risk sharing, diversification, and capital pooling all reduce the costs associated with risk, and enable insurance companies to sell more coverage at lower prices.

Proponents of the budget proposal argue that reinsurance with affiliates of foreign insurance groups or holding companies simply amounts to profit shifting to foreign low tax or no tax jurisdictions, shielding profits from taxation under the high tax rate of the U.S. corporate income tax. But that claim is a completely false analogy—reinsurance, by definition, is a shifting of risks and premiums; that is, *ex ante*, it may be a shift of a profit or a loss, depending on whether the insured risk materializes. Moreover, the proposal fails to recognize the risk spreading and diversification benefits of the international reinsurance industry, lowering costs and assuring benefit payments to American consumers, especially vulnerable victims of natural disasters such as hurricanes and earthquakes.

International reinsurance is an ordinary, widespread, necessary, and legitimate practice in the global insurance industry, used liberally by both the U.S. and foreign companies alike. It helps to spread and diversify national and regional risks globally. By denying a deduction for a standard and legitimate business expense—for foreign but not U.S.-based companies—the proposal essentially creates a high tax rate on a very narrow tax base—which is very bad tax policy.

And by denying the deduction only to foreign companies, the proposal also involves trade protectionism implemented through the tax system, done at the behest of domestic insurers and reinsurers seeking protection from foreign competition. Protectionism smuggled into the tax code would violate the General Agreement on Trade in Services (GATS) of the World Trade Organization (WTO), and international tax treaties to which the U.S. is a signatory.

The economic effect of the proposal would be to raise the cost of capital and force insurers into less efficient and more vulnerable capital structures, with less risk spreading and global risk diversification. The result of that would be to raise the cost of insurance for consumers and business, particularly property and casualty insurance against such risks as hurricanes, earthquakes, and terrorism, as insurers seek to pass on the cost of the tax. The proximate result would be less essential insurance coverage against such risks. This consequence particularly harms small businesses, which cannot grow or even enter a market, without essential, affordable, insurance coverage; in addition, inadequate insurance coverage could impair a small business's ability to stay in business following a catastrophic event.

Accordingly, the ultimate result of enacting such a proposal would be an estimated loss of $1.35 billion in GDP, along with estimated private sector losses of $4.07 for every $1 in additional tax revenues collected.[2]

The proposal, consequently, amounts to bad tax reform. If Congress is to reform the corporate tax code, it should be on an equal basis for all industries, following sound, uniform principles for defining the corporate tax base, and making the tax code more neutral and internationally competitive, particularly with lower marginal tax rates.

INSURANCE AND A HEALTHY, GROWING, COMPETITIVE ECONOMY

The evolution of insurance into the institution as it is known today has taken place over hundreds of years. In an earlier day, when communities were more tight-knit, it was natural to look to one's family and neighbors for support when the unexpected occurred. As a result, burial societies were one of the earliest forms of insurance to develop.

In the modern age, however, insurance markets enable us to transfer the risk of a wider array of negative outcomes to an anonymous pool of like-minded, risk-sharing market participants. Being able to pay monthly premiums into a vast pool of funds that can be tapped into as unexpected needs arise is a significant benefit to individuals and societies.

These days, carriers pool financial resources in a complex financial latticework built on a foundation of statistical probabilities, and make them available at a moment's notice. By paying into a vast pool of funds in relatively small amounts month by month, the sudden costs of accidents, catastrophes, and other aspects of life that may require significant expenditures can be smoothed out over time and then spread across the vast pool in such a way that the cost of any single occurrence will not empty the pool. Insurance thus creates tremendous value to people who hold it.

Insurance, particularly property and casualty insurance, today protects investment in property, capital, and business operations. It protects these capital investments from natural disasters such as hurricanes and earthquakes, and from potentially crippling corporate and business liability lawsuits. Insurance also protects a homeowner's investment in the family home. The availability of this protection promotes capital investment and business enterprise by making the capital investment more secure from random, sudden losses.

Business and commercial enterprises often cannot function without insurance coverage against such risks. Lenders will not finance a company without adequate insurance coverage, and equity investors will shy away from underinsured companies as well, resulting in subpar stock values. Consequently, insurance is especially critical to start-ups, small businesses, and new market entrants, thereby increasing competition and growth.

These are the principle reasons that insurance has grown into such a major industry in the United States today. U.S. insurance companies directly employ about 2.3 million people domestically.[3] U.S. insurance companies earned about $1.3 trillion in premium revenue in 2013.[4] The U.S. insurance industry held $5 trillion in total assets that year as well.[5] Consequently, "the United States is the largest single-country insurance market in the world."[6]

Reinsurance supports the role of primary insurance, enabling more efficient risk sharing, diversification, capital efficiency, and fundraising than primary insurance alone. Reinsurance thereby expands the availability of primary insurance, and lowers its cost.

Primary insurance and reinsurance are both critical for supporting and inducing capital investment in an advanced economy. A well-functioning insurance market promotes capital investment and business start-ups because investors and entrepreneurs know they can buy protection for their capital and companies, protecting them from arbitrary, sudden losses. Such capital investment and business start-ups promote competition and provide the foundation for jobs, wage growth, and economic growth in a robust capitalist economy.

THE ROLE OF REINSURANCE

Property and casualty insurance protects homeowners and a broad spectrum of business enterprises, large and small, from a wide range of risks including potentially catastrophic hurricanes, earthquakes, terrorism, crop failure, workers compensation claims, and general liability. Managing and planning for such risks is particularly difficult in the case of natural disasters, or the asymmetrical warfare involved in terrorism, where the timing of such events is infrequent but the covered losses can be devastating. Commercial liability coverage protects businesses against liabilities from lawsuits, especially potentially costly class action suits, which also can result in infrequent and hard to predict, but devastating losses.

The United States has the world's largest property and casualty insurance markets, and the largest share of global market demand and coverage for property and casualty insurance. On average, the United States suffered approximately 50 percent of worldwide insurance losses due to natural catastrophes from 2004-2013.[7] In 2014, the United States suffered $15.3 billion in insurance losses due to natural catastrophes, which was 49.4 percent of worldwide insurance losses of $31 billion due to natural catastrophes in that same year.[8] From 1970-2014, 7 of the top 10 most costly insurance losses occurred in the United States.[9] This reflects the vulnerability to hurricanes along the Atlantic and Gulf coasts, and to earthquakes along the Pacific coast, and the continued development and increase in population along those coasts.

The risks arising from natural disasters have become increasingly challenging over the past quarter century. In 1989, Hurricane Hugo cost insurers $7.9 billion.[10] Several natural disasters have cost more than Hugo since. Hurricane Andrew in 1992 caused $15.5 billion in insured losses ($25.5 billion in 2011 dollars).[11] State Farm's losses of $4.6 billion in that hurricane equaled the entire capital of State Farm property and casualty at the time.[12] Insured losses from the Northridge Earthquake in 1994 totaled $17 billion, which

was greater than the total cumulative dollars ever collected for earthquake coverage in California.[13] In 2005 alone, Hurricanes Katrina, Rita, and Wilma that hit Florida and the Gulf coast caused $96.3 billion in insured losses.[14,15]

The U.S. losses from natural disasters will continue to grow because of further residential and commercial development along the coastlines and other areas subject to earthquakes, hurricanes, and floods. The U.S. Census Bureau projects that the population in states most subject to hurricanes[16] will increase by 51.3 percent between 2000 and 2030, which will account for 43.0 percent of the increase in the entire U.S. population during that time.[17] As the Federal Insurance Office of the U.S. Treasury Department stated last year, "several studies have shown…that many natural disasters which occurred in the past…would be far more costly were they to occur today, and that in general loss severity from natural catastrophes will continue to grow."[18]

The United States is by far the largest commercial liability insurance market in the world, accounting for 39.5 percent of the worldwide market in 2012.[19] The United States spent 1.6 percent of its entire GDP on commercial liability insurance premiums, more than any other country in 2012.[20] In part, this reflects the vulnerabilities of the U.S. legal system, with its plaintiff-friendly legal standards, class action lawsuits, and state judges favoring local interests such as local citizens, and local, small businesses, over deep-pocketed, national, multinational, commercial, or corporate enterprises. Potentially costly environmental lawsuits can also come from state or local regulatory agencies, state Attorneys General, or national environmental organizations.

Examples of costly commercial liability risks can be seen in U.S. asbestos litigation and Superfund hazardous waste cleanup liability.[21] Significant commercial insurance liabilities continue in the United States as well for coverage on errors and omissions liability, directors' and officers' liability, multiple peril, product liability, and other legal vulnerabilities.

Business and commercial enterprises often cannot function without insurance coverage against natural disasters in a highly developed country like the United States. Lenders will not finance a company without adequate insurance coverage. Equity investors will shy away from underinsured companies as well, resulting in subpar stock values. Moreover, regulators will not allow some enterprises, particularly sporting events and other mass entertainment venues, to even open their doors to the public without insurance coverage to protect them.

With insurers taking on so much liability from high potential cost events, they also need insurance to spread their own risks. Reinsurance is insurance for insurance companies. The insurance company shares some of its premium revenue with the reinsurance company, in return for the reinsurance company sharing some of the risk and liability. This enables the insurance company purchasing the reinsurance to share and diversify the risks of insurance claims and liability, and further pool capital. Risk sharing, diversification, and capital pooling all reduce the costs associated with risk, and enable insurance companies to sell more coverage and at lower prices.

As the Global Federation of Insurance Associations (GFIA) explains, "providing reinsurance protection to, and purchasing reinsurance protection from, other insurers is an integral part of the insurance business."[22] They add, "reinsurance is a genuine commercial activity, as supported by the presence of a significant number of large, third party insurers. Reinsurance consists of the

genuine transfer of risk, along with the transfer of the profits and losses that eventually emerge in relation to the transfer of those risks."[23]

Indeed, in 2014 global reinsurance capital totaled over half a trillion dollars, at $570 billion (see Figure 1).[24] The United States is the largest single country reinsurance market in the world, with about half of all worldwide reinsurance business originating in North America (see Figure 2).[25] However, the U.S. share of the global reinsurance market has been declining since 1997. In 1997, 61.6 percent of reinsurers were U.S. businesses. By 2013, that number had fallen to approximately 38.2 percent of the global market share (see Figure 2).

FIGURE 1

Global Reinsurer Capital

(fiscal year, billions of dollars; 2006–2014, 2014 is as of 1H)[26]

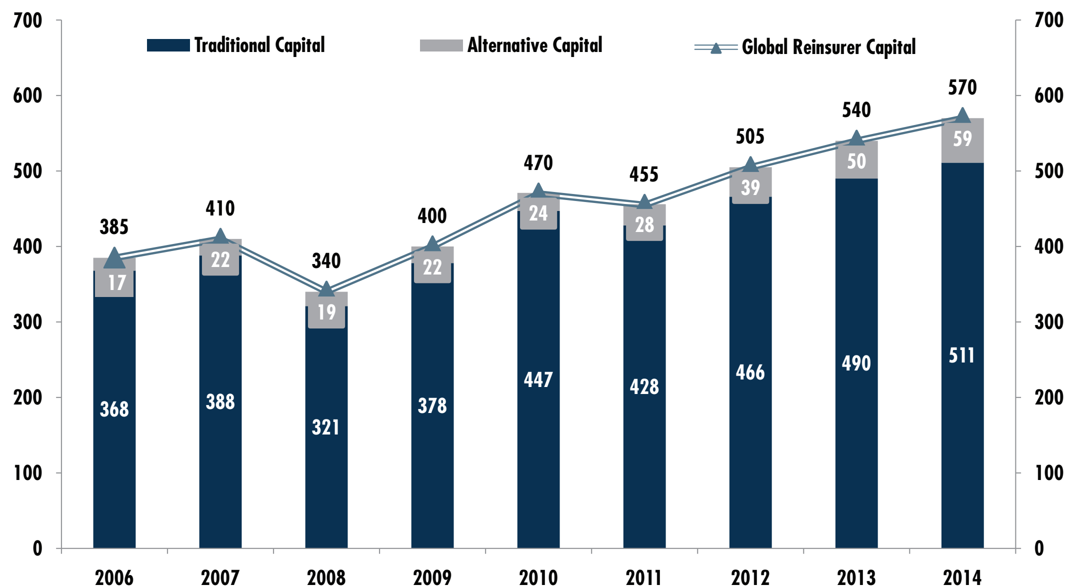
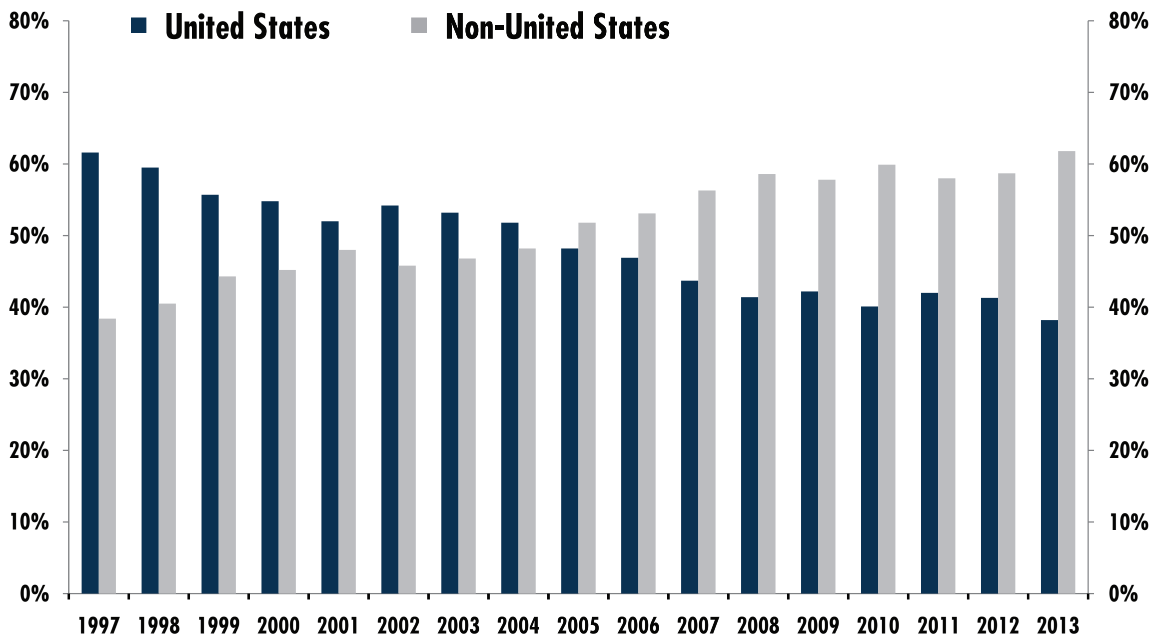


FIGURE 2
Market Share of U.S. and Non-U.S. Reinsurers
(percent, 1997-2013)[27]



Reinsurance and Capital Efficiency

Regulation, whether at the state level or through the market (i.e. credit rating agencies, consumer choice with its preference for financially stronger insurers[28], market competition), forces insurance companies to maintain adequate capital reserves. The more volatile the potential loss claims—whether from hurricanes, earthquakes, or terrorism—the more capital an insurance company must keep, even through years of minimal claims before a disaster strikes.

Capital, consequently, can serve as a limit to how much insurance a company can sell. When a company is bumping up against capital limits, regulators and the market will both keep an insurance company from selling any additional insurance coverage.

As Walter Kielholz, the former CEO of reinsurer Swiss Re explains:

> "A unique characteristic of the insurance industry is that its product is basically a promise. Unlike a physical product or even some other service, customers pay premiums for a promise that they will be compensated in the case of an adverse event. In order to demonstrate that they can keep this promise, customers and public officials require insurers to show that they have sufficient resources. Insurers need to supply their own capital to support their promise."[29]

Kielholz explains what this capital requirement involves: "Insurer capital comes from investors which means there is a cost associated with it. The cost of this capital is the expected rate of return insurers have to pay for the capital they use." Kielholz elaborates:

> "The cost of capital is a well-established economic concept….First, the cost of capital is a forward-looking concept: it is the return investors demand in order to be induced to invest the funds. Second, the cost of capital is determined in capital markets and includes the notion of opportunity costs. Investors face an ever-growing array of opportunities from which to choose and the cost of capital or expected return must compensate for other foregone opportunities. Finally, the cost of capital is dependent on risk: higher risk investments require higher returns to attract capital."[30]

Reinsurance serves as an alternative or supplement to simple capital accumulation by the original insurer. An insurance company nearing its capital limits can quickly return to selling more insurance policies in the market by entering into reinsurance contracts with other insurance companies. The insurance company effectively gains the capital of the reinsurer to back up its own liability risk. This is particularly important when a natural disaster, or other high cost event such as terrorism, suddenly and unexpectedly depletes much of an insurance company's capital.

The reinsurer effectively guarantees the primary insurer's promises to pay with its own capital. But that guarantee does not come for free—the reinsurer must be compensated for that effective use of its capital. The price of this service is still part of the primary insurer's cost of capital as described above.

The reinsurer also contributes something that ultimately reduces the overall cost of capital. The risk sharing and diversification that occurs through utilizing reinsurance actually increases capital efficiency, meaning more business risks can be underwritten with the same amount of capital. That is because diversification, which a reinsurer can efficiently accomplish by combining a particular insurer's current risks with an offsetting risk profile, reduces volatility of the entire risk distribution. Risks with lower volatility can be serviced with less capital, which means increased capital efficiency, and reduced capital costs. In other words, increasing capital efficiency is a way of effectively reducing capital costs.

Again, Kielholz explains that, "by holding a diversified book of business, insurers can operate with less capital and still maintain a low risk of insolvency. In this sense, risk diversification is a substitute for capital. A company with a diversified book of risks will have lower capital costs and will therefore have a competitive advantage over less diversified competition."[31]

In addition, by reducing the overall cost of capital to an insurer, the use of reinsurance indirectly benefits policyholders. This is because policyholders ultimately must cover the cost of capital of the insurer or else policies cannot be underwritten. Accordingly, "a reinsurance arrangement that minimizes the total capital is the best deal for the combined welfare of primary insurers, reinsurers and policyholders."[32]

Reinsurers may have other ways of effectively reducing the cost of capital. For instance, they may have established investor networks, which can raise capital with lower transactions costs. If they can manage the investment of their capital reserves more effectively—with some combination of lower transactions costs, better investment returns, increased economies of scale, or more effective leverage—that too would increase capital efficiency, and effectively reduce the cost of capital. Ceding risk to reinsurers who are known to be financially secure may provide additional comfort to potential customers and potential investors, and further ease a primary insurer's transaction costs.

Affiliate Reinsurance

U.S.-based property and casualty insurance companies rely heavily on reinsurance with affiliates within the same commonly owned (as through a parent company) insurance group of companies. Nearly half of U.S. insurance companies pay at least 60 percent of their premiums to affiliate reinsurers.[33] More than a third pay at least 90 percent of their premiums to such affiliate reinsurers.[34]

One reason for this widespread practice is that reinsurance among affiliates provides all the benefits of reinsurance–risk sharing, diversification, and capital efficiency. So the group of affiliates as a whole needs less capital, and can sell more insurance at lower prices, than it could if each affiliate stood alone without reinsurance.

As GFIA explains:

> "Commercially driven affiliate reinsurance is fundamental to risk management and, as such, is therefore necessary for reinsurance groups to undertake….Fundamentally, affiliate insurance is essential to match risk with capital. This affords the added benefits of diversification which provides enormous benefits to insurance consumers. Affiliate reinsurance promotes competition in markets, which provides additional insurance capacity and puts downward pressure on prices paid by the ultimate consumers."[35]

Worldwide Risk Sharing and Capital Pooling

Purchasing foreign reinsurance enables these reinsurance functions to be done on a global basis, which allows for maximum risk sharing, diversification, and capital pooling. The Brattle Group, in its study of the proposed deduction disallowance for foreign affiliate reinsurance (a different version nonetheless related to the current legislative proposal) states:

> "The reinsurance market is global, because the insurance industry needs to be able to diversify risk across the widest possible geographic area. U.S. insurers in particular must be able to diversify across the globe because the United States represents such a large concentration of insured risk. Access to foreign reinsurance allows U.S. insurers to provide greater amounts of coverage to U.S. consumers at more affordable prices."[36]

Foreign reinsurance is particularly important to the American insurance industry. American insurance companies need to reinsure globally so their disproportionately large risks and potential liabilities can be shared and diversified across the widest possible pool of capital and risk. As GFIA explains, "No major reinsurer exists on a purely regional or national basis; all major reinsurers are global businesses with a broad diversification of risk. Diversification of risk is essential to the effective operation and risk management of both insurance and reinsurance groups."[37]

Global reinsurance markets also provide a broad, global network for capital regeneration after a natural disaster or other spike in claims. Reinsurance firms worldwide are particularly able to draw on investor networks to access capital reserves, enabling them to support new insurance underwriting and assure a continued supply of insurance coverage, keeping premiums from spiking long term.

As the Brattle Group notes:

> "For instance, after Hurricanes Andrew and Katrina, foreign insurance companies quickly mobilized to replenish their capital base, which they used to fund additional risk-bearing entities and to support new business written by their U.S. subsidiaries and other entities. This capital-generation function of reinsurance helps to lessen the effects of the cycles and crises to which the insurance industry is susceptible. Following catastrophic losses in 2004 and 2005, reinsurers raised about $30 billion in new capital, including through new equity capital for start-up companies, seasoned equity issues and catastrophe bonds. Despite the large unexpected losses, reinsurance prices began to soften as early as the end of 2006 and the beginning of 2007."[38]

This example again demonstrates how reinsurance operates at maximum effectiveness in a global marketplace. Or as the Tax Foundation stated in their report on the proposed restriction on the deductibility of foreign reinsurance premiums, "In effect, the worldwide insurance market is a peaceful, nimble, and powerful system for international disaster relief."[39]

Global Reinsurance and Capital Efficiency

Only a global reinsurance market can diversify risk most efficiently. GFIA explains:

> "Affiliate reinsurance is extensively used within *both* domestic and foreign insurance groups within country markets for *bona fide* non-tax business purposes. Affiliate reinsurance reduces the total amount of capital needed to support the company's combined businesses. Lower capital requirements are a result of the benefits of diversification through pooling of risks of potential losses at a global level. Insurers in particular must be able to diversify across the globe because certain countries are 'over exposed' to catastrophe risk in the case of P&C risk (Japan, New Zealand, China, Chile, Mexico, and the United States) and because of pandemics in the case of mortality risk."[40]

For example, a U.S. insurance company from Florida with concentrated risks for hurricane insurance covering Florida homeowners and businesses can purchase reinsurance for a substantial portion of that risk from a foreign reinsurer that also has taken on reinsured risk from Japanese insurers concentrated in insurance for covering earthquakes. Because Florida hurricanes have no correlation with Japanese earthquakes, the diversified risk held by the foreign reinsurer has less volatility overall than the undiversified risk held by either the Florida and Japanese insurance companies separately. That lower volatility means that the diversified risks held by the foreign reinsurer can be covered at lower cost and with less capital than would be needed overall by the Florida and Japanese insurers with their concentrated risks held separately.

Or a U.S. insurance company from California with concentrated risks for earthquake insurance covering California homeowners and businesses can purchase reinsurance for a substantial portion of that risk from a Bermuda reinsurer that has also taken on reinsured risk from insurers with a concentration of insurance for covering floods in Thailand or earthquakes in New Zealand. Because California earthquakes have no correlation with floods in Thailand or earthquakes in New Zealand, the diversified risk held by the Bermuda reinsurer can be served with less capital than would be needed overall by the California and Asian insurance companies with their concentrated risks separately.

These examples demonstrate how a global scope provides optimal diversification, thereby maximizing capital efficiency and reducing the effective cost of capital. In sum, global diversification enables scarce capital to be used to maximum efficiency and effectiveness.

Finally, a global reinsurance market enhances the efficiency and effectiveness of capital by channeling risk to those reinsurance firms in the market with highly specialized expertise in covering a particular insurance risk. For example, Bermuda's reinsurers specialize in highly volatile risks involving large, infrequent claims growing out of their historic familiarity with hurricane risk, which they have extended to experience with similar earthquake and excess liability risks. Smaller and less experienced insurers can best diversify similar risks with these most experienced, world class reinsurers.

The benefits of a global market for reinsurance explain why a vast majority of reinsurance premiums paid by U.S.-based insurance companies were paid to foreign reinsurers or to U.S. firms with foreign owners in 2013.[41] According to the U.S. Treasury Department's *Annual Report on the Insurance Industry* for the year 2014:

> "When the countries of the reinsurers' ultimate parent companies are taken into consideration, the importance of the global reinsurance market to U.S. ceding companies is even more evident. Reinsurers owned by groups headquartered or domiciled outside the United States accounted for approximately 92 percent[42] of reinsurance premiums ceded by U.S.-based insurers in 2013."[43]

Notwithstanding that the Treasury Department acknowledges the importance of foreign reinsurance, the Administration and some within Congress have proposed to deny deductions for reinsurance paid to foreign affiliate reinsurers. That is bad policy for the reasons outlined above.

In sum, foreign affiliate reinsurance is not a profit shifting, tax avoidance strategy. Rather, it serves a critical and highly beneficial economic function in U.S. and global insurance markets, greatly expanding the availability of essential insurance coverage, at much lower cost. Foreign affiliate reinsurance is a highly effective, highly beneficial, risk shifting and risk protection strategy that promotes a healthy and growing economy. As GFIA explains:

> "Affiliate reinsurance involves the real economic transfer of risk, and may result in a transfer of losses, rather than profits, between two separately incorporated entities, pursuant to legally binding contracts. Today, tax codes specifically recognize reinsurance transactions between affiliated companies, requiring that such transactions are priced at arm's length, have economic substance, and do not involve tax avoidance."[44]

Regulatory oversight of reinsurance transactions by both state regulators and the IRS focuses on making sure that such transactions involve actual risk shifting (i.e., a shifting of a potential profit or loss), and actuarially fair pricing of such real risk shifting, which ensures that the transaction is not just a tax dodge, but an economically meaningful and valid market transaction. GFIA explains, "Under current tax laws around the world, affiliate reinsurance is already required to be on arm's length terms and priced in accordance with the current OECD arm's length pricing guidelines."[45]

THE TAXATION OF REINSURANCE

For all of the reasons explained above, the premiums insurance companies pay to reinsurers, including foreign affiliate reinsurers, are *bona fide* expenses made in the ordinary course of their insurance business. Therefore, since the income is calculated on revenue minus expenses, all reinsurance premiums paid to the reinsurance company to accept the transfer of insurance risk under contract should be deductible under standard income tax law and practice. The GFIA explains that:

> "Affiliate reinsurance is an 'ordinary course of business' transaction. Affiliate reinsurance involves the *bona fide* shifting of insurance risks in the same manner and for the same purpose as in the case of a transaction with an unaffiliated insurer. It must meet regulatory, actuarial and accounting standards to be classified as reinsurance. It must be priced at arm's length in accordance with applicable transfer pricing regimes."[46]

But the proposal under consideration would discard this fundamental framework of the tax code just in the case of foreign affiliate reinsurers and *arbitrarily deny a deduction for premiums paid by U.S.-based, foreign-owned insurance companies to such reinsurers*, even though reinsurance plays an essential role in the business of insurance. Reinsurance premiums are a standard, *bona fide* cost of doing business for an insurance company. They do not involve "profit shifting" to take advantage of low tax foreign jurisdictions, but are "risk-shifting" to share and diversify risks in the deep, global reinsurance markets, lowering costs while helping to ensure payment of benefits, as discussed above.

This arbitrary change in fundamental tax policy would effectively raise the cost of capital in global reinsurance markets. Without the ability for U.S. insurers to deduct reinsurance premiums paid to foreign affiliate reinsurers, deductibility of premiums, the cost of reinsurance will be higher for primary insurers, requiring primary insurers to commit more capital for the same amount of reinsurance. A tax on capital will reduce capital investment, thereby reducing jobs, productivity, wages, and overall GDP.

There is no apparent rationale for such an arbitrary change in fundamental tax policy, except for the trade protectionism manifest in favoring domestic reinsurance companies by disadvantaging affiliates of foreign reinsurance companies, in violation of international trade obligations as discussed further below.

STEALTH TRADE PROTECTIONISM THROUGH THE TAX CODE

The proposal to disallow deductions for reinsurance premiums paid to foreign affiliates is stealth trade protectionism advanced by domestic U.S. insurers and reinsurers seeking protection from foreign competition. Such trade protectionism under the guise of federal tax policy would violate the General Agreement on Trade in Services (GATS) of the World Trade Organization (WTO). Indeed, the United States is not just a signatory to that agreement. The agreement is the result of U.S. international trade policy going back decades and it reflects the global leadership of the U.S. government in promoting international adoption of the agreement and the policies it embodies.

Under the proposal, reinsurance premiums paid to foreign reinsurers by their U.S.-based affiliates are not deductible from the U.S. affiliate's taxes. Reinsurance premiums paid to U.S. reinsurers by their U.S. affiliates, however, are fully deductible by the U.S. affiliate.

Article XVII: National Treatment of the GATS Treaty provides:

> "[E]ach Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than it accords its own like services and service suppliers."[47]

This article, a straightforward nondiscrimination requirement, originally championed by the United States itself, is well understood by trade officials around the world. The European Commission has already registered its objection to such proposals. In a letter to former Treasury Secretary Tim Geithner, the acting head of the European Union Delegation to the United States of America stated:

> "I am writing to express the concern of the European Commission about a proposal included in the Administration's budget proposal in relation to affiliated reinsurance. This proposal, if adopted, would deny U.S. tax deductions on reinsurance cessions to affiliated reinsurance companies located outside the U.S.
>
> "We believe the proposal is at odds with the principle of a level playing field for all U.S. insurers and reinsurers, by introducing a tax regime that would penalize foreign-owned U.S. insurance companies that reinsure their risks with affiliated foreign companies. This penal tax regime would only apply to foreign owned insurers; thus it would not result in protecting the U.S. tax base, but in creating a disadvantageous tax environment for foreign insurance tax providers. This could result in higher premiums for U.S. policy holders or even in the withdrawal of non-US operators from the U.S. reinsurance business, leading to job losses….
>
> "Indeed, the main aim of the proposal appears to protect the U.S. insurance and reinsurance industry through a discriminatory treatment of foreign insurers and reinsurers. This would contravene the commitment of G20 leaders to fight protectionism.
>
> "I take the liberty of recalling that the U.S. has specific commitments in insurance services under the WTO General Agreement on Trade in Services (GATS). The U.S. GATS commitments on the cross-border supply of reinsurance services include a reservation regarding the imposition of a Federal Excise Tax of 1%; there are however no limitations regarding the supply of insurance services within the U.S., so that a foreign-owned insurer established in the U.S. is entitled to the same treatment as a U.S.-owned insurer. As there is no specific national treatment limitation on the deductibility of reinsurance premiums paid to offshore affiliated reinsurance, any differentiated treatment of the tax deductibility of reinsurers paid to offshore as opposed to onshore affiliates, by foreign owned rather than U.S.-owned insurers, would contravene the U.S. GATS commitment that reinsurers and insurers of any other WTO member must be treated no less favourably than U.S. suppliers of such services."[48]

A WTO dispute settlement panel will likely agree with that objection if the United States under the Obama Administration were to adopt a proposal such as described above.

But that will not be the only response. As the Peterson Institute for International Economics observed in 2012:

> "The U.S. owned insurance companies that are championing the Neal and Menendez bills should consider the possibility that 'look alike' legislation abroad could harm their own operations. This is not an idle fear. In 2008, after 70 years of a state-owned monopoly, Brazil opened its reinsurance market to private firms, including foreign firms. However, in December 2010 and March 2011, to protect its domestic insurance industry, Brazil issued Resolutions 225 and 232 that required 40 percent of reinsurance to be placed with Brazilian-owned companies and capped reinsurance payments to foreign affiliates at 20 percent of the initial premium. U.S.-owned insurance companies operating in Brazil rightly objected to this protectionist outbreak. But U.S. protests over such measures, and U.S. efforts to open foreign reinsurance markets, will be seriously undermined if the United States enacts its own version of stealth protection. Since U.S. insurance firms are among the most competitive in the world, it seems likely that the United States would lose from emulation abroad..."[49]

In another publication, the Peterson Institute adds that:

> "Equally important, it is a bad idea to deny U.S. non-financial companies the benefit of competition between U.S.-owned and foreign-owned firms in an industry that collects hundreds of billions of dollars of premiums annually…[50] Following ratification in 1913 of the 16th Amendment to the U.S. Constitution, which permitted the imposition of income taxes, the United States began to negotiate bilateral treaties with other countries to avoid double taxation of income. Today, the United States has more than 50 double-tax treaties in force. Nondiscrimination is a fundamental clause in these treaties."[51]

For example, Article 24 of a 1998 treaty with Switzerland provides:

> "Nationals [including legal persons] of a Contracting State shall not be subject in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected."[52]

Consequently, not only is the proposed stealth tax increase on premiums paid to foreign affiliate reinsurers bad economic policy, and bad tax policy as discussed in particular below, it violates international trade obligations and U.S. international tax treaties.

ECONOMIC IMPACT OF THE TAX PROPOSAL

If a proposal to eliminate the deduction for reinsurance premiums paid to foreign affiliate reinsurers were enacted, U.S. primary insurers would reduce their purchases of the now more costly foreign affiliate reinsurance in the global marketplace. To that extent, the benefits of that global reinsurance would be lost as well. That would include the maximum diversification available only in the global marketplace, the improved access to global capital markets that foreign affiliate reinsurance provides, and the substantial contributions foreign affiliates make in meeting domestic reinsurance needs.

U.S. primary insurers would respond to such a tax change by trying to increase their capital and buy non-affiliate reinsurance, so they could maintain their supply of insurance products. Holding additional capital or acquiring non-affiliate insurance are not perfect substitutes for foreign affiliate reinsurance. Holding capital is a more expensive alternative because it does not offer the offsetting cost savings of diversification

like reinsurance does. And non-affiliate reinsurance is more expensive because it bears the costs of adverse selection and moral hazard.

The Brattle Group estimated a deduction disallowance would result in a net loss of about one-fifth of all reinsurance purchased by U.S. primary insurers and about two-fifths of foreign reinsurance, based on analysis of detailed market practice data published by the National Association of Insurance Commissioners (NAIC).[53,54] For catastrophe insurance, that loss of foreign reinsurance would be closer to one half, as riskier lines of insurance that most need foreign reinsurance that would be cut back the most.

Based on NAIC data, the Brattle Group estimated that the supply of primary insurance would decline by at least $11.2 billion and as much as $12.7 billion as a result of these changes.[55] The total supply of insurance would decline by 4 to 5 percent.[56] As a matter of economics, a decline in supply translates into an increase in price. The Brattle Group estimates that as a result, buyers would have to pay at least an additional $11.0 billion and as much as an additional $13.0 billion in premiums for less insurance coverage than they held at the time of that report.[57]

The effects would be more pronounced in the riskiest lines of insurance. For earthquake insurance, the decline in insurance coverage would be at least 13.8 percent and as much as 16 percent.[58] The resulting premium price increases would be at least 7.4 percent, and as much as 8.7 percent.[59] For products liability, the decline in coverage would be 13.2 percent to 13.6 percent.[60] The increase in premium price would be 7.1 percent to 7.3 percent.[61]

The effects would also be particularly pronounced in the states most vulnerable to natural disasters. The Brattle Group estimates that Californians would see a price increase of 7.4 percent for earthquake insurance, costing them $72 million more per year.[62] Insurance costs across 18 lines of business would cost Californians $2.9 billion more per year.[63] The price of commercial multiple peril insurance in Florida would increase by 12.6 percent, costing businesses in that state $264 million more per year.[64] Prices for homeowner multiple peril insurance would increase by 4.2 percent, costing homeowners in Florida an additional $266 million per year.[65] The price of commercial multiple peril insurance in Texas would increase by 5.2 percent, costing businesses in that state $112 million more per year, and in Louisiana by 5.5 percent, costing businesses there an additional $28 million per year.[66]

Officials from these affected states have already written to their Congressional representatives opposing the tax change because of their concern over these negative effects on their states. Kevin McCarty, Insurance Commissioner for the State of Florida, writes:

> "Foreign-based reinsurers provide a majority of our state's reinsurance capacity, particularly for hurricane risk. Florida insurers use both affiliated and non-affiliated reinsurance. A meaningful number of Florida residential insurers use affiliate reinsurance with Australian, Bermudian and European affiliates, and an important segment of the companies that provide direct commercial insurance coverage in Florida reinsure these policies through European parent companies.
>
> "The European parent companies have stated that they will reduce their writings in Florida if this proposal becomes law because the tax will impede their ability to pool risk globally, thus increasing their capital costs and limiting their ability to maximize capacity to Florida consumers. If reinsurance transactions are subject to punitive taxation, the result will be higher capital costs and thus higher consumer insurance costs.

"As an insurance regulator, I know that reinsurance is fundamentally an essential risk management tool. Tax policy that interferes with utilization of sound risk management tools is counterproductive and runs afoul of the obligation I have to protect Florida consumers….Florida, more than any other state, relies on the international insurance markets to manage its property catastrophe risk. The ability to diversify catastrophic risk across the globe allows international insurers and reinsurers to provide more capacity at a lower price than otherwise would be possible. If enacted, the proposed reinsurance tax would increase taxes on the U.S. taxpaying subsidiaries of all foreign reinsurers that provide vital insurance and reinsurance coverage to America's commercial insurers, with a disproportionate share of that tax revenue coming out of the pockets of Floridians."[67]

Similarly, Wayne Goodwin, North Carolina Commissioner of Insurance writes:

"Though sister states like Florida, Mississippi, Louisiana and Texas would be impacted even more than the Tar Heel state, I expect that the proposed tax on global reinsurers would disproportionally affect states like ours because of our own vulnerability to hurricanes and named storms. You know all too well the devastation North Carolina has sustained from hurricanes and related storms and disasters over the last 60 years. Because of the increased risk or hazard of damage here and throughout the Southeastern United States, we depend quite heavily on foreign and domestic reinsurers from around the world to provide backup insurance coverage. Insurance companies covering homes and businesses here pool their risks jointly with other disasters around the world, thus spreading the costs much more broadly and keeping premiums lower in the long run for insureds. To meet the demand for coverage needed for catastrophes – and because more credit agencies require more of it to maintain solid ratings – domestic private insurance markets and domestic reinsurance markets need *global* reinsurers to help address insurance capacity concerns."[68]

Ralph T. Hudgins, Georgia Commissioner of Insurance, writes:

"I am concerned that adding new taxes will increase the cost and reduce the availability of reinsurance in Georgia. Ultimately, Georgia homeowners will pay the price. The President's proposal. …had too many unintended consequences, such as passing higher insurance rates down to policyholders….Global reinsurers play an important role in our insurance marketplace. Their financial strength and active participation in U.S. markets help protect Georgians from the risks associated with large-scale disasters. Georgia needs this global insurance and reinsurance capacity and the proposed discriminatory reinsurance tax would damage our state's economic recovery and increase insurance costs for our citizens."[69]

James J. Donelson, Louisiana Commissioner of Insurance, writes:

"The proposed tax rule changes would have the effect of taxing the non-U.S. reinsurers that are needed to expand market capacity and reduce the concentration of insurance risks that result in higher insurance costs for U.S. policyholders. The proposed rules on reinsurance taxation are limited to non-U.S., international insurance groups that establish U.S. affiliates that cede premium to related offshore insurers. Non-U.S. companies are an important segment of the reinsurance market and a substantial source of reinsurance capital that permits the U.S. to spread insurance risk to capital markets around the world.

> "Most of the reinsurance that protects homes against hurricanes, tornadoes, and earthquakes in the U.S. comes from non-U.S. reinsurance companies. Bermuda based companies alone provide 40% of the U.S. reinsurance of risks for hurricanes, and, following Katrina, Rita and Wilma in 2005, those reinsurers contributed $17 billion in claims payments to U.S. consumers. In Louisiana those companies paid an estimated $9 billion for residential and commercial property claims from hurricanes Katrina and Rita."[70]

Finally, Scott Kipper, Nevada Commissioner of Insurance, writes:

> "Terrorism risk insurance is critical to maintaining the economic health of our economic engine – the Las Vegas Strip….If enacted, [the proposed tax change] will impede the market's ability to provide terrorism risk insurance in Nevada….Access and availability of commercial property and liability insurance is an issue of great concern in Nevada, home to one of the country's largest tourist destinations with billions in investment in hotels, casinos, and restaurants. Our state relies on this economic engine for jobs and revenue. As an insurance regulator, I know it is essential that insurance groups be able to pool risk in order to diversify their portfolios.
>
> "The use of reinsurance increases an insurer's capacity to meet customers' needs and thus makes insurance markets more competitive. Anything that interferes with the freedom to pool risk will make insurance markets less competitive and thus contribute to insurance prices that are higher than they otherwise would be. In Nevada, this would be felt by the commercial buyers of insurance they need to stay in business—terrorism risk insurance, liability insurance, and commercial property insurance."[71]

The concerns outlined above by these state insurance commissioners are all valid. In addition to hurting insurers, however, the effects of the restricted supply of insurance coverage would also affect the economy more broadly. Oil, chemical, and manufacturing businesses rely on property and casualty coverage to be able to be protected from crippling liability and the catastrophic effects of natural disasters. The hotel and mass entertainment industries rely on insurance protection against terrorism. Small businesses can obtain financing to operate only with insurance protection against both corporate liability and natural disasters. Financing will be available for commercial and residential real estate development only if their construction can be protected from hurricanes and earthquakes. Insurance and reinsurance are fundamental components of the basic financial infrastructure of our modern 21st century economy.

To be successful, an insurance company must embrace the following:

1. The insurer must understand all exposures that might cause an insurance policy to incur losses;

2. It must conservatively assess the probability of any exposure leading to a loss and the probable cost in the event it occurs;

3. It must set a premium that, on average, will result in an after-tax profit after both prospective costs in the event of losses and operating expenses are met; and,

4. It must be prepared to forgo the opportunity to write a policy if the appropriate premium cannot be obtained.

Removing the deduction for premiums paid to foreign reinsurers will not affect an insurance company's ability to effectively follow disciplines 1 or 2 above. However, by increasing after-tax operating costs to the insurer, the proposed change in tax policy will affect a reinsurer's ability to align with disciplines 3 and 4. Either the reinsurer (which operates according to the same economic principles as any other insurer) will need to increase premium prices in order to cover an increase in its costs (3), be willing to write fewer policies (4), or some combination of the two.

With deductions disallowed for reinsurance purchased by U.S.-based insurance companies from foreign affiliates, the economic effects of the proposed deduction disallowance would be severe. Much more of the reinsurance currently purchased by U.S.-based insurance companies would be lost, and the cost of what remains would be higher, increasing costs for primary insurance in the United States. Those higher costs, and the loss of the benefits of global reinsurance, would leave the entire U.S. insurance industry at a serious competitive disadvantage.

Moreover, U.S.-based insurance companies would likely suffer foreign trade retaliation in response to the U.S. government's trade protectionism in the tax code. Given the size and importance of the insurance industry in the United States, both of the effects could have potentially crippling effects on the economic recovery.

The Dynamic Perspective

The Tax Foundation's study of the economic impact of the proposed tax changes focused on the impact of the tax changes on the fundamental user cost of capital. A disallowance of the deduction for reinsurance would raise the cost of capital, as domestic savers and investors would ultimately bear the burden of the increased tax on reinsurance. The Tax Foundation's Taxes and Growth model estimates that the proposed tax increase would raise the cost of capital by 0.3 percent.[72] Capital investment would ultimately decline as a result because over the long term more savings would be devoted to taxes rather than investment.

The Joint Committee on Taxation (JCT) estimates that limiting the deductibility of reinsurance premiums would lead to a static revenue increase of $710 million in the first year of collections, 2016.[73] But as the Tax Foundation observes, "This estimate does not include any sort of dynamic adjustment for the lower capital stock and lower labor productivity that result from the higher service price [cost] of capital."[74] Taking into account that limitation, the estimated resulting negative impact on GDP under the Tax Foundation's model would be twice the JCT's estimated revenue gain, at minus $1.35 billion.[75]

The dynamic effect on the capital stock would be to reduce private business capital by $7.8 billion, and household capital by $2.2 billion, for a total capital reduction of nearly $10 billion.[76] When taking that dynamic capital reduction into account, the Tax Foundation's model estimates the reinsurance deduction limitation would raise only $440 million in additional revenue.[77] So the resulting decline in GDP would be three times the revenue raised. But the Tax Foundation's model does not even account for the foreign trade retaliation against U.S.-based insurance companies in international markets, meaning the resulting decline in GDP could be far larger than estimated.

ECONOMIC REFORM: THE PRINCIPLES OF GOOD TAX POLICY

When it was created, the sole purpose of the tax code was to raise the necessary funds to run government. But in today's world, the tax code has many more facets, including income redistribution, rewarding favored industries, and punishing unfavored behavior.

And even with the greatly expanded tax mandate, designing a sensible, efficient tax code would be relatively straightforward if only people would stop changing what they do when the tax code changes. It's like dodgeball: if only the other guy wouldn't duck when you threw the ball at him it would be easy to win. But, the other guy does duck and he almost always ducks just when you're throwing the ball at him.

This is because taxes are a negative incentive, like scolding. You know exactly what some people will try not to do: they will try not to report taxable income. There are myriad ways to avoid paying taxes. They'll use avoidance and the underground economy; they will discover and utilize tax loopholes; they might even go out of business and become unemployed; or they might just move to a different jurisdiction.

The first rule of government when considering any potential tax reform must be *primum non nocere*—first do no harm. Unsound tax policy has the ability to harm the economy. A slower growing economy diminishes the vitality of the private sector from which government revenues are paid, and ultimately leads to weaker revenue growth for the government.

A balanced foundation for taxation was summarized well in the 19th century by economist Henry George.[78] According to George, the ideal tax by which public revenues conforms to the following conditions:

1. That it bear as lightly as possible upon production—so as to least check the increase of the general fund from which taxes must be paid and the community maintained.

2. That it be easily and cheaply collected, and fall as directly as possible upon the ultimate payers—so as to take from the people as little as possible in addition to what it yields the government.

3. That it be certain—so as to give the least opportunity for tyranny or corruption on the part of officials, and the least temptation to law-breaking and evasion on the part of the taxpayers.

4. That it bear equally—so as to give no citizen an advantage or put any at a disadvantage, as compared with others.

A proposal to deny deductions as previously described violates the principles outlined above.

A recent study from the Tax Foundation study applies these principles in analyzing the issue at hand—the proposed taxation of premiums paid to foreign affiliate reinsurers. The Tax Foundation rightly stated:

> "Any proposal to remove a deduction for a legitimate business expense does damage to the basic principle that income must be measured net of expenses. Reinsurance is, as described above, one of these ordinary and necessary expenses for doing business. Ignoring it adds confusion to the 'expenses' side of the corporate income tax base."[79]

The Tax Foundation explains further that:

> "One important and hard-won victory in tax policy is that 'special' deductions or preferences for individual industries are a bad idea; they erode the tax base and force higher rates on other taxpayers to create the same amount of revenue. This is both distortionary and unfair. The principle has won a virtually unanimous consensus in the field of tax policy. An appeal to neutral tax policy is a powerful argument."[80]

The Tax Foundation goes on to explain why the proposed disallowance for reinsurance premiums paid to foreign affiliate reinsurers violates this principle that a tax should be broad based, with minimal exclusions, saying:

> "But that neutral policy depends on getting the tax base right, and the income tax base is revenues minus expenses. The proposal to eliminate deductions for reinsurance premiums is a patchwork exception for individual industry."[81]

Finally, the Tax Foundation concludes:

> "Congress should not go through the tax code industry-by-industry, legislatively redesigning the definition of corporate income on an ad-hoc basis in an attempt to find more corporate revenue from overseas firms. Instead, it should look to larger reforms that make the U.S. more attractive as a domicile for corporations."[82]

The United States can no longer lead the world in economic growth and prosperity with corporate tax rates that are among the highest in the world. Sound corporate tax reform would involve closing wasteful special interest loopholes, broadening the tax base, and lowering the tax rate. These would be the first steps to the creation of good jobs with growing wages, and would provide a significant boost to the stagnant domestic economy. The proposed elimination of the deduction for premiums paid to foreign affiliate reinsurers is decidedly not a step in the right direction.

CONCLUSION

The fundamental framework of the income tax in America is that taxable income equals revenue minus expenditures incurred to produce that income. The tax is on net income, not gross income. But the Obama Administration and some members of Congress propose to depart from that fundamental framework by disallowing a deduction by insurance companies for premiums paid to foreign affiliate reinsurers.

Reinsurance is now routinely purchased by domestic U.S. insurance companies in the global reinsurance market to share and diversify risks, lower their costs, and increase the efficiency of their capital base, thereby enabling them to support more insurance coverage for consumers and business clients. All of that translates into lower costs of insurance for consumers and business, particularly small business. The global reinsurance market has been a major, perhaps even the primary, source of funds to cover catastrophic harms in the United States due to hurricanes (e.g., Katrina), earthquakes, and terrorism (e.g., 9/11).

Disallowing the deduction for foreign affiliate reinsurance would mean much less reinsurance for American insurance companies. The American insurers would turn to alternatives as a result, such as increased capital or non-affiliate reinsurance. But in the end, those more costly alternatives would mean a reduced supply of primary insurance, which in turn would mean higher costs for such insurance for consumers and business, especially small business.

That reduced supply and higher cost of such insurance would mean less volume of insurance sold and bought. That reduced insurance coverage would affect the economy more generally. It would harm operation and production in manufacturing, the hotel, restaurant and retail businesses, small business, and commercial and residential real estate development. Overall, that means reduced GDP, jobs, wages, and income.

The Tax Foundation analyzes the effect of the tax proposal through the resulting effect on the cost of capital. Disallowance of the deduction and the resulting negative impact on the functioning of the insurance industry would mean a higher cost of capital. That would result in reduced capital investment, which means reduced GDP, fewer jobs, and lower wages and incomes. Those economic effects would reduce any gain in revenue from the tax increase effectuated by disallowing the deduction.

Good tax reform promotes a tax code with the lowest possible tax rate on the broadest possible tax base. Fundamental to that result is to maintain intact the uniform definition of that tax base, which rests on the fundamental framework that taxable income equals revenue minus expenses incurred to generate that income. But the arbitrary disallowance of a regular insurance business expense for foreign affiliate reinsurance premiums violates these basic principles of good tax policy and reform.

Good tax policy and reform would involve lowering the corporate tax rate to internationally competitive levels, closing loopholes and broadening the tax base. These would be the first steps to the creation of good jobs with growing wages. This is the direction that tax policy and reform should take.

Instead, the Obama/Menendez/Neal proposal to eliminate the deduction for foreign reinsurance premiums follows the exact opposite path, applying a high tax rate to a very narrow tax base—a targeted and specific industry. The known result—surely accompanied by a number of unanticipated consequences as well—will be that domestic insurers use less foreign affiliate reinsurance, which will result in less tax revenue than expected and more expensive, less effective insurance.

Why would we ever want to engage in a policy action that we know will hurt a well-functioning, essential industry, as well as the broad economy, all for zero benefit?

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