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Lightly Edited Transcript

Thank you for inviting me to speak to your conference. It is an unfortunate fact about the current tax system that you can have two full days devoted to the topic, "Why Taxes Matter: The Impact of Tax Policy on Strategic Business Decisions" and barely begin to scratch the surface of these issues. Since I only have thirty minutes, I am going to confine myself to a much simpler topic which is: what would it take for taxes not to matter for strategic business decisions and for those decisions to be made for business reasons, not for tax reasons.

The one word answer to that question is 'neutrality', that is the concept that the tax system should be neutral between different business decisions, not tilting the playing field in any particular direction. In general, neutrality is what allows business decisions to be made for business reasons. And this, with a few very important exceptions that I will return to at the end of this talk, is what maximizes overall efficiency and increases the level of output. This is the organizing principle that underlies the President's approach to business tax reform, and this is the concept that should motivate reform more broadly.

One advantage of starting with the concept of neutrality is that it, at least temporarily, takes you out of the charged debates over the level of revenue and the distribution of revenue because for any given level and distribution of revenue that we could agree on, there are wide differences between the degree of neutrality in the system, depending, for example, on the magnitude of inefficient tax expenditures and the tax rate. We can generally agree that the more neutral the tax system is, the better it would be.

In the case of the business tax reform, today there is actually general agreement that the medium and long term revenue reform should be revenue neutral over that horizon, but improve the efficiency of the economy by broadening the base, lowering the rates, and moving towards a more economically neutral system. There is, however, some disagreement on the short term revenue level, which I will return to at the end of these remarks.

Let me start first with four significant ways that the tax code departs from the principle of neutrality and some of the implications that these departures have for tax reform.

The first departure is distorting the form of investment by industry and asset. This is the fact that the tax code is filled with special benefits for particular industries, and it has a complex set of rules around depreciation that do not match the economic, real-world depreciation of the

assets. Based on the combination of these, a CBO study in 2005 found that the marginal tax rate on manufacturing buildings was 32 percent while the marginal tax rate on investment in petroleum and natural gas structures was 9 percent. It is this type of difference that causes business decisions to be made on what maximizes the after-tax rate of return, leading to too much capital in industries that are tax-preferred and too little capital in industries that are tax-disadvantaged. The misallocation of capital increases economic inefficiency and slows economic growth.

The general response to this problem is a broader base and lower rates. And, in particular, what the President would do in his approach is that every tax benefit that is for a particular industry, for instance, the tax benefits associated with oil and gas, he would eliminate them and put that money back into lower rates. In addition, it would look more broadly at structural aspects of the tax code and use those to lower rates as well.

<u>The second, perhaps even more significant departure from neutrality, is distorting the financing of investment</u>. And, in particular, the way in which profits are taxed at the entity level and then taxed again at preferred rates at the individual level while debt is deductible at the entity level and fully taxable at the individual level. These together with other rules result in the fact that the according to the Department of the Treasury the marginal tax rate on equity financed investment is 37 percent, which is among the highest in the OECD. But the marginal tax rate on debt financed investment and equipment is -60 percent, the lowest in the OECD. And the gap between these two rates is the largest of any country in the OECD. If you look at the tax rates on an integrated basis, so you count the fact that you are paying taxes on dividends and capital gains at the preferential rate and potentially with deferral while you are paying taxes and interest at the full rate, you still have a very large gap with the integrated tax rate on equity financed investment being 37 percent and on debt financed investment being -4 percent. These debt-equity tax differences lead to overleveraging which in turn increases financial fragility.

A broader base and a lower rate helps narrow the gap between debt and equity tax rates as well. But additional steps, like reducing the deductibility of interest for corporations, should also be considered as part of a reform plan.

<u>The third significant departure from neutrality is distorting the form of investment</u>. And in this case, it is the fact that for C corporations, you're facing partial taxation at two different levels, at the entity level and then on preferred basis at the individual level; whereas for pass-throughs, you face taxes at only one level. The combined taxes at both levels, again according to Treasury analysis, for corporate business income works out to 32 percent and for non-corporate business income works out to 26 percent.

This has not always been the case, and the evolution of this disparity has actually led to a massive shift in business income. In 1980, 78 percent of business net income was in C corps, by 2008 it had fallen to 27 percent. The flipside of this was that S corps went from 1 percent of

income in 1980 to 22 percent in 2008, and partnerships have gone from 3 percent of net income in 1980 to 32 percent in 2008. This has important implications in terms of what we should and should not do in tax reform.

Let me start with what we should not do. Specifically, we do not need to and necessarily want to have the top statutory rate for individuals and the top statutory rate for businesses being the same. What we care about is on an integrated basis are those two rates the same? And as long as you are retaining taxation of capital gains and dividends at the individual level, then it is probably not going to be the case that identical business and individual/pass-through rates will lead to a neutral system. In fact, some difference between these two rates, combined with the capital gain and dividend taxes, can result in a neutral system that does not distort decisions about business form.

In fact, establishing greater parity between large corporations and their large non-corporate counterparts should be considered as a way to help improve equity, reduce distortions in how businesses organize themselves, and finance lower tax rates. A variety of ways to do this have been proposed, including ones discussed in the 2005 report of President Bush's Advisory Panel on Tax Reform and the reform options developed by President Obama's Economic Recovery Advisory Board in 2010. It is, of course, essential that any changes in this area should not affect small businesses. And, in fact, tax reform can and should simplify and cut taxes for small businesses.

The fourth departure from neutrality in the current tax system is the location of investments and profits. This one is perhaps the least straight forward of all of the ways in which we would strive for neutrality because there are different and competing concepts for neutrality. One goes by the name of capital export neutrality and says: you have a given amount of capital, you are deciding where to locate it, and you don't want to locate it somewhere just because the tax rate there is lower. This is an important factor. But there is also another margin which we need to be mindful of which has been termed capital ownership neutrality. And that says that something is going to take place in a given location. It is definitely going to be there no matter what, and the question is: who owns it. And in this particular case you ideally want to have a system that is neutral in terms of the opportunities that an American corporation has to own the asset versus a foreign corporation, which leads to all the advantages associated with that global competitiveness.

Unfortunately, these two concepts of neutrality are in conflict and create a tradeoff. There is a third factor that matters too, and that is not where you locate your investment but where you locate your profits, the issue of base erosion and profit-shifting. And unlike the location and ownership of investment, this factor is less subject to any type of tradeoff or difficult tension. In fact, base erosion requires, for a given amount of revenue, higher tax rates on businesses investing in the United States, distorting all of those decisions and tax advantages, for an activity that has no economic benefit.

Such profit-shifting is extensive. If you look at the pre-tax profitability of controlled foreign corporations, it is negatively correlated with local country statutory tax rates, even after you take into account a variety of real, economic factors. To leave economic studies and just put forward a stark fact, I feel safe in saying that the fact that U.S. foreign company profits represent 646 percent of Bermuda's GDP and 547 percent of Cayman Island's GDP probably didn't reflect business decisions made for purely business reasons. The tax rates on foreign income are really stunning when you look at them. For example, Rosanne Atshuler and Harry Grubert's effective tax rate simulations found that the effective tax rate on investments in a low-tax country, which is defined as a 5 percent rate, was -24 percent, and the effective tax rate on investments in a high-tax country, that is defined as a country with a tax rate of 25 percent, was 13 percent. And that is basically because of a variety of factors, including a mismatch between being able to take your deductions upfront and not pay your taxes until later if ever.

I think all of this though has some good news for us, which is, even if you cannot achieve perfect neutrality on every dimension simultaneously when it comes to international taxation, we can do significantly better than the current system. That is because we have a current system that I sometime like to call a 'stupid territorial system', which is, we have a low or negative tax rate on overseas income but we do it in a way that requires corporations to go through a variety of hoops that are very inefficient, for example, encouraging indefinite deferral of overseas investment, not allocating that financing in the most efficient way. Shifting to a smarter system that is a hybrid system, that balances the two competing neutrality principles, that deals with the issue of base erosion, that does all of this in a smarter way than the current system, has the potential to be win-win: reducing distortions in the allocation of capital, increasing investment in the United States, increasing global competitiveness, and raising revenue that can pay for lower rates. The President's proposal in this regard would be an international minimum tax, that is very much motivated by balancing these types of concerns.

Let me now turn briefly to an important caveat to the principle of neutrality, which is while business decisions are generally optimal, in some cases there is a demonstrated, what an economist would call, an externality that can be remedied through the tax code.

In general, we want to look at tax benefits and say, if they benefit just one industry, we don't want them, and we would rather have a lower rate. But if they have a broader, economy-wide benefit, then there is an argument for them. And just to give three examples:

<u>The R&D tax credit</u> is motivated by the fact that the social returns to R&D are roughly twice the private returns that an individual company can capture. That means that individual companies will not have the motivation to invest as much as our society would benefit from R&D, and that gives us motivation for subsidizing R&D. Obviously, the way that we want to

subsidize it is in a manner that is predictable and as simple as possible, which is why the R&D credit should be reformed and increased.

The production tax credit which the President's framework proposes to make permanent and refundable, and this is to encourage investments in renewable energy like wind and solar. That again, if you take into account climate change, have benefits in excess of what's captured by any individual company.

The manufacturing deduction, or Section 199, is an area where there are considerable spillovers to other parts of the economy, to investment and innovation, and as a result, is justified of being reformed and continued and cutting the tax rate on manufacturing to 25 percent.

Finally, let me very briefly discuss that context for business tax reform.

I think there is general agreement on medium and long term revenue neutrality. I think there is an important difference on what to do with the one-time revenue associated with the transition to a reformed system. The President in the State of the Union proposed to take this revenue and put it in a one-time investment in infrastructure, so that you are creating jobs and enhancing growth both through tax reform and through business investment. I think this is also more fiscally responsible because you are not paying for permanent tax rate changes with a temporary revenue source.

So, in conclusion, there are a lot of difficult and controversial issues in tax reform, but I believe that if we started with the basic economics and started by asking the question, not what's the rate, not all these other questions, but the basic question of what it would take for taxes to not matter between our decisions and to make the tax system more neutral. I think that is the right and most productive way to have a conversation about how to move forward on reforming the business tax code, increasing the competitiveness of our country, and increasing economic growth.