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Mr. Chairman and Members of this distinguished committee, it is an honor to participate in these hearings on business tax reform. I teach at the University of Michigan, where I am the Richard A. Musgrave Collegiate Professor of Economics in the department of economics and the L. Hart Wright Collegiate Professor of Law in the law school, and where I serve as Research Director of the Office of Tax Policy Research in the Stephen M. Ross School of Business. I taught for years at Princeton and Harvard prior to joining the Michigan faculty, and have been a visiting professor at Columbia University, the London School of Economics, the University of California – Berkeley, and Harvard Law School. I am a Research Associate of the National Bureau of Economic Research, Research Director of the International Tax Policy Forum, and former Co-Editor of the American Economic Association's *Journal of Economic Perspectives*.

Business activity constitutes the core of the U.S. economy, and Americans benefit greatly from the opportunities provided by a thriving U.S. business sector. Heavy tax burdens threaten the vitality of U.S. businesses by discouraging business investments and reducing funds available for business expansions. A tax system that imposes undue burdens on U.S. businesses reduces the productivity of the U.S. economy, and in so doing reduces the wages and employment opportunities of Americans. Given the economic challenges facing the country now and in the future, it is important that U.S. businesses operate in a tax environment that does not excessively discourage investment and that is conducive to normal business operations.

This committee is well aware of the challenging features of the current U.S. system of taxing business income. From the standpoint of C corporations, the U.S. corporate income tax rate of 35 percent is one of the highest in the world, and well above the OECD average;

furthermore, the United States is the only major capital exporting country that taxes the active foreign business income of its resident corporations. From the standpoint of the millions of U.S. businesses such as partnerships, subchapter S corporations, and LLCs that are taxed on a pass-through basis, the progressive U.S. individual income tax system imposes tax rates that can exceed the 35 percent corporate rate. And from the standpoint of family farms and other family-owned businesses, U.S. estate and gift taxes can make intergenerational transfers of business assets problematic.

There are features of the existing U.S. tax system that mitigate the burdens associated with high tax rates. These features include the deductibility of interest expense; accelerated depreciation of plant and equipment investment and R&D; tax credits for low income housing investment and incremental research expenditures; the deduction for domestic production activities; deferral of U.S. taxation of unrepatriated foreign income; and many others. As a result of these and other aspects of the U.S. tax system, and the variety of taxpayer situations, business tax rates measured as ratios of tax payments to some measures of pretax business income may differ significantly from statutory rates, and in particular are often lower than statutory rates.

It is true that these base-narrowing aspects of the U.S. tax system produce for many taxpayers average burdens that are somewhat below those suggested by statutory tax rates; but there are also many taxpayers who benefit little from them – and it is important not to be misled by some simple average tax rate calculations to conclude that the U.S. tax system imposes light burdens on U.S. firms. Tax obligations are the product of statutory provisions and taxpayer behavior, so heavy taxation that redirects business activity or discourages it altogether may generate only modest tax revenue even as it imposes significant burdens. For example, the Tax Reform Act of 1986 greatly expanded the number of "baskets" used in the foreign tax credit calculation, thereby increasing U.S. taxation of income earned by international joint ventures, and in the process (and until repealed ten years later) significantly reducing the extent to which U.S. firms undertook joint ventures in foreign countries. This imposed a burden on U.S. firms in the form of lost foreign business opportunities, but much of the burden did not appear in the ratio of tax payments to income.

As the result of high U.S. tax rates together with other tax provisions that only partly mitigate the burden of high rates, U.S. businesses are currently taxed to an extent that business activity, and the employment opportunities that accompany it, is significantly reduced. Cross-country statistical evidence consistently shows that countries with heavier business tax burdens have lower rates of business formation, expansion, and capital investment. Indirect evidence of the impact of U.S. tax burdens appears in the induced use of substantial debt finance to produce interest deductions that help to mitigate tax burdens, and in the examples of U.S. corporations that undertake complicated and costly inversion transactions in order to become taxable by Canada, Britain, the Netherlands, or Ireland, rather than the United States.

The tax system has two effects on the business sector. The first is that it collects revenues from income generated by businesses, and thereby reduces the extent of business formation and expansion. The second is that the tax system influences the character of business operations. Some of the behavioral influence of the tax system is deliberate; for example, the research and experimentation credit is designed to encourage and reward research spending, and the low-income housing credit is designed to encourage and reward provision of low-income housing. As a result of these tax provisions, the U.S. economy has more research and more low-income housing than it would otherwise. But many of the behavioral effects of the tax system, such as encouraging the greater use of debt finance, affecting business organizational forms, and discouraging dividend payments and plant and equipment investment, are the undesired byproducts of a system that taxes investment returns.

An obvious solution to the problems caused by heavy tax burdens is to reduce statutory tax rates on business income. The difficulty of course is that the government needs revenue with which to operate, so to the extent that lower tax rates reduce tax collections the resulting revenue shortfall would need to be financed with higher taxes on something else, spending cuts, or greater government borrowing, none of which may be a particularly attractive alternative.

It is tempting in this situation to conclude that the most promising direction of reform is to broaden the business tax base and lower business tax rates in a revenue-neutral manner. Such a conclusion must be approached very cautiously. It is certainly true that sensible revenue-neutral tax reforms have the potential to improve the efficiency and fairness of the tax system by

replacing undesirable tax provisions with better alternatives, but it is challenging to generate significant reductions in average business tax burdens with revenue-neutral business-only tax reforms, for the simple reason that a tax reform that is revenue-neutral within the business sector leaves average business tax burdens largely unchanged.

A revenue-neutral business tax reform that lowers statutory tax rates while expanding the tax base nonetheless has the potential to change incentives for different business activities, but to be clear, what such a change would do is to encourage some business activities while actively discouraging others. For example, a reform that limited the deductibility of interest expense and used the accompanying revenue to finance a reduction in statutory tax rates would encourage investment by some firms and discourage investment by others, the difference reflecting the ability and willingness of different taxpayers to finance their investments with debt. Proposals to reduce the deductibility of interest expense are typically motivated by a desire to level the playing field between debt and equity, and by a desire to finance a tax rate reduction. It is true that reducing the deductibility of interest expense reduces the attractiveness of debt finance, and it is also true that a statutory tax rate reduction by itself would encourage investment, but in this example it is not true that for the business sector as a whole this revenue-neutral reform necessarily increases investment incentives, because the loss of interest deductions also affects incentives to invest.

This example is just one illustration of a much broader principle, which is that it is impossible to find a tax reform that reduces every marginal tax rate while keeping average rates unchanged. Marginal tax rates influence behavior, and the problem caused by taxation is that it produces positive marginal rates: a system that taxes income discourages the production of income. There is no avoiding this problem if the system is to raise revenue, since raising revenue requires a positive average tax rate, and the average tax rate in the economy, or in the business sector, is just the combination of the marginal rates. The implication for tax reform is that any revenue-neutral income tax reform increases some marginal tax rates and reduces others, discouraging income production by some taxpayers and encouraging income production by others.

While this principle of taxation is obvious once stated, it is useful to stress its application to specific policies. If a tax reform were to repeal Section 199, the domestic production activities deduction, and use the revenue thereby generated to finance a reduction in statutory tax rates, then the reform would encourage investment by firms that currently benefit little from the domestic production activities deduction and discourage investment by firms that currently benefit more than average from the deduction. If instead a tax reform were to impose further limits on the ability of corporate taxpayers to use loss carryforwards, using the revenue from this change to reduce statutory corporate tax rates, then the net effect of the change on aggregate corporate investment is unclear, since firms differ in the extent to which they anticipate possibly needing to use loss carryforwards in the future, and the degrees to which they value the form of tax insurance that loss carryforwards provide. This last example illustrates that even if a tax reform repeals favorable tax provisions not directly related to investment, and uses the revenue to finance statutory rate reductions, the effect of removing the favorable tax provisions is to increase tax burdens, and reduce investment, by firms that are significantly affected.

What principles should guide tax reform, understanding that any reform that is revenue-neutral within the business sector will necessarily encourage some business activities and discourage others? Economic theory notes that an efficient tax system imposes the lightest tax burdens on two types of activity: those that generate positive spillover benefits for the economy, and those that are the most responsive to taxation. Research spending is a common example of the former. Studies consistently find that the social rate of return to research endeavors significantly exceeds the private return, implying that innovators capture only a portion of the benefits they provide the economy. As a result, the level of research activity undertaken by private researchers in the absence of external support is less than the level that maximizes economic performance, and in order to improve the efficiency of the economy it is necessary to provide additional inducements for research. This is, indeed, the standard justification for the tax system's favorable treatment of research expenditures.

It is important to recognize that there are two ways in which the research and experimentation credit and favorable research cost recovery provisions encourage research undertaken in the United States. The first is by encouraging individual taxpayers to adjust their production processes in the direction of greater research intensity: for example, an electronics

firm might spend more on research and less on advertising in response to a more favorable tax treatment of research. There is a good body of accumulated evidence that firms respond to the research credit in this way. The second channel is possibly even more consequential, and it is that the favorable tax treatment of research expenditures reduces the tax burden on firms that are research-intensive, and as a result these firms expand their operations more than do otherwise similarly-situated firms that are less research-intensive. This second channel does not require that any individual taxpayer modify its production process in reaction to research tax benefits, but the economy effectively does so by expanding the operations of some firms more than others.

The second implication of economic theory is that business activities that are highly sensitive to taxation should be taxed at lower rates than business activities that are less sensitive to taxation. This reflects what is known as the Ramsey Rule, a proposition originally derived in the context of commodity taxes but that applies quite generally to settings in which taxes distort the economy. Business taxation is certainly one of those settings, because the imposition of business taxes necessarily reduces the level of business activity. The challenge for smart business tax design is to find a program that does the least possible damage to the economy while collecting the revenue that the government needs. In this context it makes little sense to attempt to impose heavy tax burdens on highly responsive business activities, since such taxes greatly depress investment and employment in the relevant business sectors, and if the heavy taxes were instead directed at less responsive activities, the results would not be great, but at least they would not impose as many economic costs.

International shipping offers an example of a highly responsive business sector. Shipping firms can be headquartered anywhere, and the ships of course go everywhere, so any attempt to impose heavy home-country taxes on international shipping income is doomed simply to encourage shipping assets and shipping companies to sail out of the U.S. tax jurisdiction. And that is exactly what has happened to the U.S. international shipping fleet over the last 40 years.

To some degree the same process is responsible for the waves of corporate inversions and foreign takeovers of U.S. companies, and for the far greater number of other international business transactions that receive less attention but are nonetheless similar to inversions and takeovers. The worldwide tax system operated by the United States puts U.S. companies at a

competitive disadvantage relative to firms from other countries, and as a result, foreign firms expand in third country markets at the expense of U.S. firms. This process goes on every day, and while not as visibly dramatic as a corporate inversion or a foreign takeover of a U.S. company, it has much of the same impact, in that a business asset that otherwise would have been owned and controlled by a U.S. company is instead under the control of a foreign company. The evidence is that foreign direct investment is extremely responsive to taxation, and also that when U.S. companies expand their foreign operations they correspondingly expand their domestic operations, so the disadvantage created by the U.S. tax system has the effect of significantly shrinking the size of the U.S. business sector relative to what it would be otherwise. This in turn reduces the demand for U.S. labor, and thereby depresses wages and employment opportunities in the United States.

The evidence that international business activities are highly responsive to taxation, together with the reality that every other major capital exporting country operates a territorial tax system, implies that the U.S. attempt to subject active foreign business income to significant U.S. taxation is inconsistent with optimal tax principles. The same principles also carry implications for the taxation of domestic business operations. There is evidence that investment in domestic manufacturing industries is particularly responsive to taxation, which in turn implies that an efficient domestic tax system imposes a lower tax on returns to manufacturing investment than on returns to investment in other industries. This domestic production activities deduction is largely directed at domestic manufacturing, and to the extent that the activities that it covers in fact are highly responsive to taxation, this deduction is a sensible feature of an optimal tax system.

Similar considerations may apply to patent boxes of the type recently introduced by European countries. These patent boxes offer favorable tax rates on certain forms of intellectual property income. A common justification for adopting patent boxes is that the favorable tax treatment of patent box income gives appropriate incentives in settings in which ownership of intellectual property has spillover economic benefits that cannot be addressed in some other way. A second and likewise important consideration is that the activities of firms that are apt to hold certain types of qualifying intellectual property may be particularly responsive to taxation, either because these firms and their assets are internationally mobile, or because the nature of

competition and demand in their industries makes their operations likely to diminish significantly if confronted with competitors located in more favorable tax environments.

The general point is that economic theory does not imply that it is efficient to have a level playing field in which all business activities and income are taxed to the same degree. Efficient tax burdens vary with spillovers associated with economic activity and with degrees of responsiveness to taxation. If businesses in different industries and lines of activity are equally responsive to taxation and produce the same economic spillovers, then they should be taxed equally; otherwise they should not.

The propositions of optimal tax theory apply to a world of complete information in which behavioral elasticities and economic spillovers are readily identified and measured, and tax laws can be crafted with precision to distinguish taxpayers in different situations. The real world differs from this stark description. As a result, it may be difficult or impractical to introduce some of the distinctions between taxpayers that are implied by theory, and efforts to do so could be hampered by misinformation or create unanticipated opportunities for inefficient tax avoidance. It is natural in such a setting to conclude that an appropriate default position is that the tax playing field should be level unless there is a very strong reason to think otherwise.

This position is perfectly reasonable, but it is inconsistent with our understanding of the effects of taxation on economic efficiency, and risks consigning the economy to a lower level of performance than is necessary given the tax burdens required to finance government expenditures. A more appropriate default, one that promotes economic efficiency, is that tax burdens should reflect the responsiveness of different activities to taxation, with more responsive activities subject to lower tax burdens. To the extent that it is difficult or costly to maintain and enforce tax distinctions among business activities with differing response elasticities, of course these practical considerations influence the desirability of attempting to draw such distinctions. But given the imperative of offering the best possible economic opportunities to American workers, entrepreneurs, customers, and others, and the significant burdens that taxes already impose on the U.S. business sector, it is important to tailor the U.S. tax system in a way that causes the least possible economic disruption.

Several existing aspects of the U.S. tax system appear to be designed in this spirit, including provisions such as the domestic production activities deduction and the research and experimentation credit. It follows that an across the board reduction in business tax expenditures used to finance lower business tax rates is unlikely to improve the efficiency of the U.S. system. More targeted reforms, including the adoption of a territorial tax regime, are far more promising.

Another promising direction of reform lies in efforts more effectively to integrate corporate and personal taxes. As many have noted, equity-financed corporate investment in the United States is taxed very heavily, and in particular is taxed more heavily than debt-financed investment. To the extent that equity and debt finance are imperfect substitutes from the standpoint of borrowers the optimal taxation of the two is not identical, and there are reasons why debt financed investments may be somewhat more tax responsive than equity financed investments; but the magnitude of the difference in current tax treatment of debt and equity surely exceeds that implied by optimal tax theory. As a result, reforms that move in the direction of integrating corporate and individual taxes on corporate income have considerable appeal from an efficiency standpoint. They also have appeal from the standpoint of taxpayer equity, imposing less of a double burden on corporate income and better distinguishing shareholder/taxpayers with greater ability to pay from those with less ability to pay.

It is important to address these and other significant issues in the design of U.S. business taxes, in part because the tax burdens on U.S. businesses are so substantial and their consequences so dramatic for the U.S. economy. American workers bear the brunt of these taxes in the form of diminished employment opportunities. Business tax reductions would stimulate business formation, expansion, and investment; improve productivity; and thereby create greater opportunities for American workers. At any rate of tax and level of business tax burden, however, it is valuable and necessary to design the tax system to cause the fewest economic disruptions, and theory indicates that simply broadening the base and lowering rates is unlikely to move the system in that direction. The existing U.S. tax system has many features that reflect the nuances of economic realities, and our goal should be to modernize and improve this system with attention to the details of taxpayer behavior and a sense of the appropriate level of business taxation in a modern economy.