Statement of Ike Brannon[1]
To the Senate Finance Committee
On "Tax Reform Options: Incentives for Capital Investment and Manufacturing"
March 6, 2012

Chairman Baucus, Senator Hatch, and members of the Committee: I thank you for the privilege of appearing before you today. I believe that today's topic is an incredibly timely and salient one, given that tax reform has become more prominent in the press—and more urgent with every passing day.

One thing that distresses me about the current *zeitgeist* is the implicit notion that what holds true for tax reform on the personal side also works on the corporate side. I subscribe to the notion—as I assume everyone else on this panel does—that the tax code has become too complicated, with too many deductions, exclusions, credits, and other favored tax treatment for a wide variety of activities, and that the economy would benefit greatly from an aggressive pruning.

However, the overarching goal of any tax reform should be to maximize economic growth, first and foremost. The provisions we eliminate, the transition rules we impose, and the investment incentives we keep in the tax code should all be done with this in mind. And the answer as to how we treat depreciation, research and investment incentives, and other investment incentives needs to be carefully considered before we proceed.

Corporate tax reform is way overdue

We need a tax policy that provides incentives for businesses and entrepreneurs to locate in America and spend at a faster rate on innovation, workers, repairs, and new plants and equipment. As it stands, the US corporate tax code is uncompetitive in an increasingly global economy, and overly complex.

The corporate income tax harms our international competitiveness in two important ways. First, the corporate tax is far too high. The United States has the second highest corporate tax rate in the OECD. Both the US statutory rate of 35 percent and the effective tax rate experienced by US companies are among the highest of our developed competitors.[2] Around the world the US corporate tax rate is exceeded only in a handful of countries, all of which are developing countries that have major extractive industries with significant foreign investment.

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[1] Director of Economic Studies and Director of Congressional Relations, American Action Forum. This testimony represents my own viewpoint and not necessarily that of the Forum.

[2] Some defend the high corporate tax rate by arguing that the effective corporate tax rate is much lower. This misses an important point. Every country's effective tax rate is also lower than its statutory rate. A recent study by two economists at the University of Calgary (http://www.cato.org/pubs/tbb/tbb_64.pdf) concludes that the marginal tax rate in the U.S on new investment is 34.6 percent, higher than any other country in the OECD. A study by PwC puts the US average book effective tax rate above the average of the largest 58 countries and above the average of the EU nations.

Second, the United States remains the only developed country to tax corporations based on their worldwide earnings. Our competitors follow a territorial approach in which, say, a German corporation pays taxes to Germany only on its earnings in Germany, to the U.S. only on its earnings here, and so forth. If we were to adopt the territorial approach, we would place our firms on a level playing field with their competitors.[3]

Proponents of the worldwide approach argue that because it doesn't let American firms enjoy lower taxes when they invest abroad, it gives them no incentive to send jobs overseas. Imagine two Ohio firms, they say: one invests $100 million in Ohio, the other $100 million in Brazil. The worldwide approach treats the profits on these two investments equally, giving the company that invests in Brazil no advantage over its competitor.

But this line of reasoning ignores three points. First, because firms all over the world will pay lower taxes than the two Ohio companies, the likeliest outcome of the scenario is that both firms will have trouble competing effectively with global rivals. Second, when American multinational firms invest and expand employment abroad, they tend also to invest and expand employment in the United States. In the end, healthy, competitive firms grow and expand, while uncompetitive firms do not, meaning that our goal should be to make sure that American companies don't end up overtaxed, uncompetitive, and eventually out of business.

And finally, because the U.S. is the lone holdout using a worldwide approach, it is at a disadvantage as the location for the headquarters of large, global firms. As the U.S. loses the headquarters, it will lose as well the employment, research and manufacturing that is typically located nearby. A chief tax officer for a fortune 500 company quipped that their company was headquartered in the US solely because of a "historical accident."[4] The number of *Fortune* Magazine Global 500 companies headquartered in the United States has fallen more than twenty percent since 2005.[5]

Forcing Pepsi to pay much higher taxes on its profits in Eastern Europe will not result in the U.S. increasing its exports of soda and potato chips: it will mean the diminution of Pepsi's overseas operations, with a concomitant reduction in employment here. And this is the big difference between proponents of a territorial tax system and those—like the Administration and Dr. Gravelle—who favor a move towards a worldwide tax system: Do U.S. corporations operate abroad in order to avoid expensive labor costs here or in order to service and compete in those markets abroad? An honest analysis would concede that some of both is at work, but I submit that in a global economy that is growing more integrated every day—and where tens of millions of households in developing countries are joining the ranks of the middle class every year—the main driver in the expansion of U.S. companies abroad is the profitable opportunities presented by these growing markets.

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[3] Of course, we have what is essentially a hybrid system in how we tax foreign-sourced profits as we allow companies to defer paying US taxes until that money is returned to the US, but this compromise brings with it another set of problems.

[4] "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century." Office of Tax policy, U.S. Department of the Treasury, 20 December 2007.

[5] *Fortune Magazine Global 500 Annual Index*, 2011.

While the high corporate tax rate and worldwide taxation of earnings hurts US competitiveness, the tax code's myriad tax breaks, deductions, and credits mean that our tax rate needs to be kept higher to collect the necessary amount of revenue. And its complexity comes at a price: The U.S. corporate tax system costs businesses an estimated $40 billion per year in compliance costs, according to a Treasury Department Study.[6]

In its current form, the corporate tax code has no defenders. An ideal tax code would, as the philosopher Jean-Baptiste Colbert described so elegantly three centuries ago, pluck the goose so as to get the largest amount of feathers for the smallest possible amount of hissing. Our corporate tax system raises revenue at a significant cost to economic growth.

There had been a noticeable convergence on several key issues of corporate tax reform

Before the Administration's release of *The President's Framework for Business Tax Relief* I had been optimistic (perhaps unrealistically so) that there was some space to complete corporate tax reform in 2012. I was heartened by the fact that both tax-writing committees had dedicated so much time and energy to studying the intricacies of the corporate tax code, and the Ways and Means *Discussion Draft* on corporate tax reform presented what I saw as a good starting point for debate: it took a step towards the White House position in its proposal to tax all income held overseas as a part of any transition to a territorial regime as well as its insistence at the adoption of other base-erosion rules. It also pointedly (and encouragingly) left several other potentially contentious provisions purposefully alone, which I saw as another good sign.

The depth and variety of hearings in the Senate Finance Committee—as well as the comments proffered by the various members during the course of these hearings—led me to believe that this committee is serious about achieving corporate tax reform immediately as well.

However, the President's Framework does not bode well for an immediate solution. In it, the administration has essentially reversed course on the taxation of foreign-sourced income, proposed higher taxes on "pass-throughs" and other small business entities that do nothing for economic growth—or equity, for that matter—and pays only lip service to the idea of reform while subsequently proposing new tax breaks for favored industries. It is this last item to which I will devote the rest of this testimony.

[6] Cited in: "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century." Office of Tax policy, U.S. Department of the Treasury, 20 December 2007.

Do Investment Incentives Belong in the Tax Code?

While both parties agree that corporate tax reform should involve a form of rate reduction and base broadening, several questions remain for resolving the details:

a. Exactly how low do we take the tax rate (do we have to insist on revenue-neutral reform?),
b. Which tax provisions do we jettison to pay for the lower rate, and, most importantly,
c. Which provisions should we keep?

In particular, the question *du jour* is whether we should keep incentives for investment, such as the research and experimentation (R&E) credit and bonus depreciation, and retain a higher rate overall, or else eliminate these deductions and take the rate down further. As a trained economist I am going to use my professional prerogative to prevaricate. The answer is that it depends on the political constraints that would govern any transition to a new tax regime.

It is important to realize that both the R&E tax credit and bonus depreciation are costly. Removing these provisions alone would allow the tax rate to fall by 3-5 percentage points, I estimate, based on the analysis done by the Treasury Department for their 2007 report on corporate tax reform, with which I assisted.

Removing these provisions would also significantly simplify the code. For example, while the R&E tax credit may encourage investment, what exactly constitutes "research and experimentation" is ambiguous, and interpretations can be overly inclusive. Removing the R&E credit may also level the playing field across sectors since some industries can take advantage of the credit more easily than others.

The tax code should be designed to maximize economic growth. Therefore, while simplification is desired, provisions that incentivize growth should not be removed for the sake of simplification alone. Corporations doing business in the US will retain their tax lawyers and attempt to parse the law so as to minimize their obligations to the government as much as possible. Nothing we do can change this, so we should not sacrifice other interests in a quest to make life easier for corporate tax departments.

And one can argue—and many do—that the benefits to eliminating all tax expenditures to finance the lowest corporate tax rate does, in the long run, buy us the maximum "bang for the buck" when it comes to economic growth. The difference between this and keeping in place provisions to encourage research and investment is that the former increases the returns to past and future investment while the latter does so solely for new investment. While increasing the returns to investment that has already occurred may not be productive (since it does not generate *new* investment) it does penalize companies playing by the tax rules in place at a particular time. A company that has a much lower tax bill associated with new investments in 2014 than in 2013 will delay investments until 2014 unless we figure out a fair and sensible way to transition to such a system. In the past such tax changes have often been accompanied by various phase-ins that lessen the differences in tax costs between two periods, which then reduces the tax benefits. If such a "transition period" would be a constraint that our duly elected Congress would feel obligated to include in any tax reform, then it may very well make more sense from a growth perspective to go with the lowest rates possible and eschew investment incentives.

However, I am not sure that the fact that some—but by no means all—companies argue for such a "flat" tax reform means that this is the preferable one from a societal perspective. Corporations that have indicated they are all in favor of lower rates—and are willing to see the government jettison all deductions to get there-- advocate this way in no small part because it will help their accounting profits, i.e. those contained in financial statements, which in turn affect stock prices and bonuses. Accounting profits and profits reported for tax purposes (which approximate what economists refer to as "economic" profits) are not always aligned, and therefore corporate calls to eliminate all deductions may not generate the maximum economic growth possible. They may in fact also be advocating for such a tax reform to minimize their **tax bill**—which is different than their profits reported for shareholders and the financial markets—but regardless of what metric they are trying to maximize, that may not be relevant for policy.

The fiduciary responsibility of a company's management is to advocate for whatever tax policy would benefit their bottom line the most. The idea that companies are wedded to some philosophical tax approach, and that we should recognize this preference and acquiesce to it *regardless of what it means for economic growth*, is misplaced.

Also, the tradeoff that corporations think they have in front of them may not, in fact, be politically doable. For instance, a recent Duke/CFO Survey asked firms if they would sacrifice all existing tax exemptions in return for a reduction in the *overall* corporate rate to 25%,[9] and a significant share answered in the affirmative. However, it is unclear as to whether the corporate CIO's and Chief Tax officers fully understood the question posed. For example, Edward Rapp, Chief Financial Officer of Caterpillar, has advocated for a *combined* 25% federal and state tax rate, which would necessitate a corporate rate on the order of 20 percent, a proposition that is not on the table.[10] A 25 percent federal rate would still mean a combined rate of nearly 30 percent, making the United States the nation with the 8th highest rate. I do not believe our current budget and political constraints would permit a 20 percent federal corporate tax rate if it would mean that the corporate tax would produce less revenue, which I believe would be the case in the relevant budget window.

Imposing a "flat" corporate tax rate bereft of deductions means that all industries would each pay about the same tax rate on their profits. However, it is not clear that we want our finance sector to face the same rate as our IT, biotech and manufacturing sectors. Everyone in this room can doubtless look at the tables of effective tax rates by industry and rail against the senselessness of one particular industry being below that of another industry, but to insist that we arrive at a tax code that does not provide any particular incentives to invest (and necessarily favor certain sectors) is not necessarily the path to higher growth.

One way reduce the corporate tax rate, simplify the tax code, and continue to encourage capital investment and associated economic growth would be to jettison the R&E credit and any bonus

[9] Duke CFO Magazine Global Business Outlook Survey- Third Quarter, 2011
[10] Zajac, Andrew: "Slashing U.S. Tax Rates a Must: Caterpillar CFO." CFOWorld, 22 September, 2011.

depreciation—and all other corporate tax expenditures—but allow for the full and immediate expensing of capital goods.

I do not believe that full expensing of capital goods represents a tax expenditure: The tax code has to make some choice as to the pace at which firms can depreciate capital investments. I submit that the most rational and *simple* way to do this is to simply do away with the complicated, arbitrary, and often nonsensical depreciation schedules that frequently have little basis in reality, and instead to allow firms to expense capital investment at once. Furthermore, full expensing of capital goods will itself encourage research and development, reducing the need for a separate R&E tax credit.

Over the past 30 years the corporate tax has only raised about 10 percent of total receipts. If reform sacrifices some revenue, it will likely be mostly offset by efficiency gains, and outweighed by increases in economic growth.

Nobel Laureate Robert Lucas remarked in an interview that reducing or eliminating the corporate income tax was "the largest genuinely free lunch I had seen," and estimated that the U.S. capital stock would be up to 50 percent larger with a more enlightened approach to taxing capital, and bring with it higher productivity, wages, and employment.[12]

Conclusion

Economic growth should have primacy in any debate over corporate tax reform. Most of the deductions, exemptions, and expenditures in the tax code do relatively little to incentivize growth given their cost, and our economy—and government coffers—would be better off if they were eliminated and the savings were used to "buy" a lower corporate tax rate.

The one possible caveat to that is that if it is politically feasible, the full and immediate expensing of capital equipment would remove a major source of arbitrariness from the tax code, which would increase investment and also be consistent with the desire to make the corporate tax code more neutral.

Americans—from homeowners to small businesspeople to the millions of unemployed—are in desperate need of faster and prolonged economic growth. Congress should therefore move away from ephemeral and ineffective short term stimulus proposals and evaluate tax proposals based on whether they're likely to trigger and support that growth. Tax policy can play a key role in spurring an economic recovery—but not without sustained reform of the corporate tax system.

I look forward to answering your questions.

[12] See Lucas, Robert: "Supply Side Economics: An Analytical Review." *Oxford Economic Papers*, April 1990, p. 293-316. And Levy, David: "Interview with Robert Lucas." *The Region*, June 1993.