Testimony of
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Chairman Hatch, Senator Wyden, and other members of the committee, thank you for the opportunity today to address the issue of tax reform and its role in promoting stronger U.S. economic growth and higher wages for American workers.

My name is Dr. Laura Tyson and I am a professor at the Haas School of Business at the University of California Berkeley. I served as the Chair of the Council of Economic Advisers and as Chair of the National Economic Council under President Clinton. I was a member of President Obama's Economic Recovery Advisory Board and his Council on Jobs and Competitiveness. I am currently an economic adviser to the Alliance for Competitive Taxation, a coalition of American businesses that favor comprehensive corporate tax reform.

The views in this testimony are my own.

My remarks will focus on corporate tax reform. Over fifty years ago under President Kennedy and perhaps as recently as 30 years ago under President Reagan, the American economy was the most competitive in the world, and the U.S. could design its corporate tax code with little consideration of the global economic environment. American companies derived most of their income from their domestic operations and to the extent they were engaged globally, they were typically larger than their foreign-based counterparts.

But we no longer live in that world. Emerging market economies, falling trade barriers, and remarkable leaps in information and communications technology have expanded opportunities for U.S. companies abroad, but have also heightened global competition among companies to gain market share and lower production costs, and competition among countries to attract investment and jobs. Our corporate tax system was designed for an economy in which U.S. multinational companies earned most of their revenues at home, international competition was relatively unimportant, and most corporate profits were produced by tangible assets, such as machinery and buildings. This is not today's world.

Today, the United States faces growing competition from countries around the world for the activity of global companies. And American companies face significant and increasing competition from foreign-based global companies. Since 2000, the number of U.S.-headquartered companies in the Fortune Global 500 has declined by more than any other country – from 179 to 128. Foreign-based competitors to American companies are *all* headquartered in countries with lower tax rates. Further, multinational companies headquartered in other developed countries typically operate under territorial tax systems under which little or no home-country tax is imposed on their active foreign business earnings. Within the Fortune Global 500, 93 percent of the companies headquartered in other OECD countries are taxed under territorial systems. In addition to tax systems that are more conducive for locating business operations and global headquarters, many other OECD countries offer educated workforces, major universities, and world class infrastructure.

Our corporate tax system makes it harder for U.S. businesses – small and large – to compete with foreign companies, and reduces the competitiveness of the U.S. economy as a place to do business and create jobs. As a result of numerous credits, deductions and exclusions, the current system also results in high compliance costs for businesses – estimated at $110 billion in 2009 – and undermines the efficiency of business decisions in numerous ways. There is widespread bipartisan agreement that our corporate tax system is deeply flawed and in need of fundamental reform.

I believe there are ways to reform the corporate tax system that will strengthen the competitiveness of U.S. companies, make the United States a more attractive place to do business, reward work, and reverse the 40-year stagnation of middle class incomes. Such reforms can promote simplicity and efficiency in the tax code and be adopted without increasing the deficit. In the remainder of my remarks, I will suggest changes to current tax rules affecting both the domestic and the foreign-earned income of U.S. corporations to achieve these objectives.

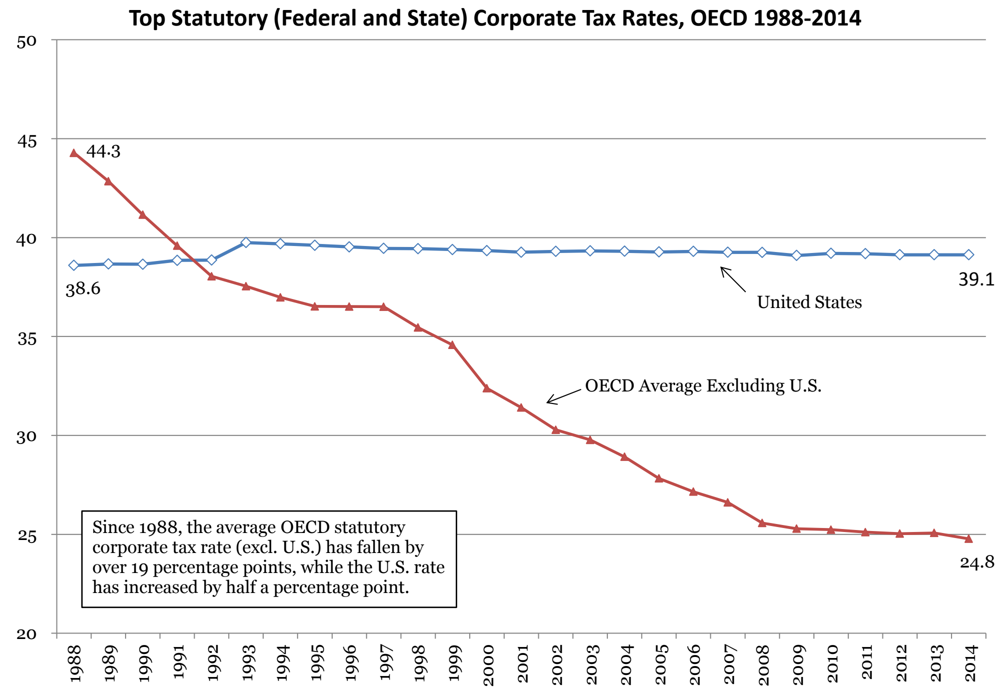
Domestic Tax Reform

It is important to begin testimony at a hearing about tax reform, economic growth and efficiency by noting that of all taxes, corporate income taxes are the most harmful to economic growth because they reduce the returns to savings and investment.

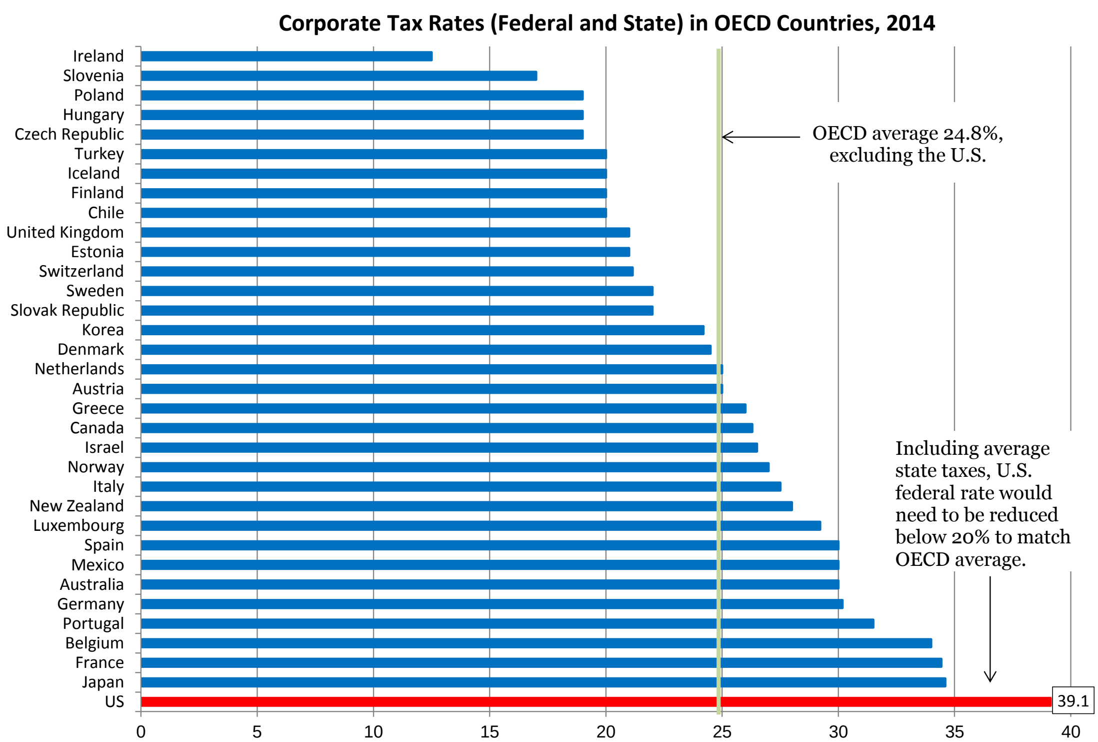
After the 1986 tax overhaul, the United States had one of the lowest corporate tax rates among developed countries. Since then, countries have been slashing their rates in order to encourage investment by their domestic companies, to attract investment by foreign companies, and to discourage their domestic companies from moving their operations and their income to lower-tax foreign locations.

Since 1986, capital has become increasingly mobile, and differences in national (statutory) corporate tax rates have a growing influence on where multinational companies locate their operations and report their income.

In the most recent and audacious move to attract the activity of global companies, the British government has reduced its corporate tax rate from 30% in 2007 to 20% beginning next month – half of the combined U.S. federal and average state corporate tax rate. Further, since 2013, the British government has applied a special tax rate on income from patents, which phases down to 10 percent in 2017. Currently 12 EU countries have or are implementing such special tax regimes for income from intellectual property – commonly called patent boxes – with tax rates generally in the range of 5 to 15 percent on such income. These patent boxes are recognized as legitimate means to promote innovation and economic development provided the income taxed under such regimes is substantively connected to in-country activities.



Source: OECD Tax Database



Source: OECD Tax Database.

The United States now has by far the highest statutory corporate tax rate among developed countries. Other researchers, using a variety of methods have found that even after accounting for various deductions, credits, and other tax-reducing provisions, U.S. companies face higher effective corporate tax rates than most of their competitors.[1]

The relatively high U.S. statutory rate decreases the incentive to invest in the United States by both U.S. and foreign firms. Setting the rate at a more competitive level would encourage more domestic investment by U.S. and foreign investors.

Capital has become increasingly mobile, and differences in national statutory corporate tax rates have a growing influence on where multinational companies locate their operations and report their income. The high U.S. statutory rate magnifies the attractiveness of investing in lower-tax locations and increases the incentive to shift income out of the United States.

It is not possible for the United States to stay competitive as a place to do business with a statutory corporate tax rate that is more than 14 percentage points (58 percent) above the OECD average.

Higher investment in the United States by both domestic and foreign companies would boost economic growth, while the resulting increase in capital – new businesses, factories, equipment, and research – would improve labor productivity and increase employment. That should, in turn, boost real wages over time, as increases in labor productivity have historically been closely related to growth in labor incomes, although this relationship has weakened over time.

Productivity gains in the United States are substantially attributable to the U.S. activities of multinational companies. A Federal Reserve study of labor productivity in the U.S. private sector between 1977 and 2000 found that the U.S. multinational sector accounted for three-fourths of the increase in labor productivity over this period.

American multinational companies are the chief instrument by which our economy competes globally, yet these companies are the most affected by the lack of a competitive tax code. Removing the tax barriers to the ability of these globally engaged companies to be competitive in world markets can pay substantial dividends to the U.S. economy.

In 2012, U.S. multinational companies directly employed 23.1 million American workers, with average compensation of $76,500, 34 percent greater than compensation of workers in non-multinational companies. Through their supply chains, U.S. multinational companies support an estimated 21 million additional U.S. jobs. Spending by the employees of U.S. multinational companies and suppliers is estimated to support a further 28 million jobs. Overall, more than 71 million U.S. jobs are directly or indirectly supported by U.S. companies with global operations.

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[1] See, Jack Mintz and Duanjie Chen, "U.S. Corporate Taxation: Prime for Reform," Tax Foundation, February 2015, showing the United States has the second highest marginal effective corporate tax rate of 95 countries in the world, and Phillip Dittmer, "U.S. Corporations Suffer High Effective Tax Rates by International Standards," Tax Foundation, September 2011, which provides a survey of nine different effective corporate tax rate studies that each show the United States is in the highest quartile among countries.

The competitiveness of globally-engaged U.S. companies matters to the health of the U.S. economy. U.S. multinational companies tend to be large, capital-intensive, skill-intensive, research-intensive and high productivity – all features that contribute to high wage jobs and rising living standards. In 2012, they accounted for about 20% of private sector U.S. jobs, 23% of U.S. private sector GDP, 30% of U.S. private capital investment, and about 76% of all U.S. private sector R&D.

Despite the rapid growth of their foreign markets, U.S. multinational companies still locate significant shares of their real economic activities at home – 70% of their value added, 66% of their employment, 73% of their capital investment, and 84% of their R&D. Much of the domestic economic activity of U.S. multinational companies is related to their headquarter functions and has significant local spillover benefits to the broader economy.

Further, foreign direct investment by U.S. multinational companies is not zero-sum – it increases rather than reduces employment, investment, and R&D in the United States. Research has found that each 10 percent increase in foreign employment is estimated to result in a 6.5% increase in U.S. employment. Similar complementary relationships are found between the foreign affiliate operations and the domestic exports, R&D, capital investment, and employee compensation of U.S. multinational companies.

The pro-growth rationale for reducing the U.S. corporate tax rate is compelling. There is some evidence that the growth effects from corporate rate reduction also provide a significant offset to the cost of rate reduction found in conventional estimates that assume no change in the size of the economy. This includes past research by the Joint Committee on Taxation that finds the feedback effect from corporate rate reduction can offset between 12 percent and 28 percent of the conventional revenue cost within 5 to 10 years of enactment.[2] I believe with a full accounting for cross-border investment and income shifting, the offsets from corporate rate reduction are likely to be even greater. But by itself such a cut would reduce corporate tax revenues.

So how should we finance a rate reduction large enough to have a significant effect on the competitiveness of U.S. companies and on the competitiveness of the U.S. as a location for investment without increasing the deficit? Like most economists, I believe that we can and should pay for such a rate reduction mainly by broadening the corporate tax base through the elimination of tax breaks and preferences. Combining rate reduction with base broadening is the approach adopted in the 1986 tax reform and it is the approach advocated by numerous independent bipartisan commissions and think tanks.

Base broadening would not only raise revenues to pay for a rate reduction, it would also reduce the complexity of the tax code and increase its efficiency. The current system of deductions and credits not only reduces corporate tax revenues, it also results in large and economically unjustifiable differences in effective tax rates across economic activities and these differences distort investment decisions, often with harmful effects on productivity and growth.

[2] Joint Committee on Taxation, *Macroeconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief*, (JCX-4-05), March 1, 2005.

Given the importance of the statutory corporate tax rate in influencing the location of highly profitable and mobile capital, a significant reduction in this rate that is paid for by broadening the corporate tax base can achieve meaningful efficiency gains and boost economic growth. And over time as growth increases, a revenue-neutral corporate tax reform will increase corporate tax revenues and reduce the deficit.

International Tax Reform

There is also widespread agreement that, in addition to reducing the corporate tax rate and broadening the corporate tax base, the United States should reform the way it taxes the foreign earnings of U.S. companies.

With 95% of the world's consumers located outside of the United States, American companies need to have a presence in foreign markets to compete there. Products need to be tailored to local consumer preferences, shipping costs may make it impractical to export certain products abroad, and the provision of services requires employees in the local market. If a U.S. company isn't established in a given foreign market, a non-U.S. competitor will likely win the business there.

Every other G-7 country and 28 of the other 33 OECD member countries have international tax systems that allow their globally-engaged companies to repatriate their active foreign earnings at home without paying a significant additional domestic tax. This approach, referred to as a participation exemption or territorial tax regime, is grounded in the principle of "capital ownership neutrality" – that is, the amount of corporate tax imposed on a company's active foreign earnings should be independent of the residence of that company's parent.

The current U.S. system, in contrast, is based on a worldwide approach: the foreign earnings of U.S. companies are subject to U.S. corporate tax with the amount owed offset by a credit for taxes paid in foreign jurisdictions. With the adoption of territorial tax systems by the United Kingdom and Japan in 2009, and by thirteen other OECD member countries since 2000, the U.S. international tax system now lies far outside of international norms.

The combination of a relatively high corporate tax rate and a worldwide approach to taxing active foreign earnings disadvantages globally-engaged U.S. companies when they compete in third country markets with multinational companies headquartered in territorial systems or their local competitors. U.S. multinational companies cannot bring profits home from their foreign affiliates without paying the high U.S. corporate tax rate, while most foreign-based competitors pay only the local tax rate on such profits.

This combination also reduces the competitiveness of U.S. multinational companies in cross-border acquisitions. In such acquisitions, a U.S. acquirer of a foreign company owes a U.S. tax on the resulting foreign income stream that would not be owed by a foreign acquirer headquartered in a territorial system.

If the United States were to adopt the type of territorial systems used by the countries with which we compete, then U.S. multinational companies would face the same effective tax rates in foreign markets as the foreign firms with which they compete in these markets.

Current U.S. law attempts to blunt these competitive disadvantages for U.S. multinational companies through deferral – allowing U.S. parent companies to defer the payment of U.S. corporate tax on the foreign earnings of their foreign subsidiaries until they are repatriated.

Under the current U.S. corporate tax system, U.S.-based multinational companies have a strong incentive to keep their foreign earnings abroad. Not surprisingly, as their foreign earnings have grown – international operations now account for more than half of the income of US multinational companies – and as foreign corporate tax rates have plummeted, the stock of foreign earnings held abroad by U.S. multinational companies has increased. These accumulated foreign earnings are currently estimated at about $2.1 trillion, some of which has been reinvested to expand their foreign operations and some of which is held in cash and other liquid investments.

For the reasons cited earlier, the competeveness of globally engaged American companies matters to the health of the U.S. economy in many ways. Deferral is essential to maintaining the competitiveness of these companies as long as the United States relies on a worldwide approach to corporate taxation and has a relatively high statutory corporate tax rate.

But deferral is not without significant costs for both U.S. multinational companies and for the U.S. economy. Deferred earnings are “locked out” – the government receives no tax revenues from them and they are not directly available for use in the United States by the U.S. parent companies. Moreover, U.S. companies incur costs from locked out earnings due to the suboptimal use of these earnings and from higher levels of domestic debt. Treasury economist Harry Grubert and Rutgers economics professor Rosanne Altshuler estimate that the hidden cost of retaining profits overseas is about 7 percent of incremental deferred foreign income and these costs grow as the stock of that income grows.[3] These costs are a drag on the competitiveness of globally-engaged U.S. companies. The current system undermines the ability of U.S. companies to compete with foreign companies in the acquisitions of U.S. companies. It also makes investments by U.S. shareholders in U.S. companies with foreign operations less attractive relative to investments in foreign companies that can repatriate profits without a corporate tax penalty.

A participation exemption or territorial system similar to those in other developed countries would allow U.S. multinationals to put their foreign earnings to work in the United States and to compete more effectively in foreign markets, which today represent about 80 percent of the world’s purchasing power and which will become even more important in the future.

As part of comprehensive corporate tax reform, the United States should adopt a territorial approach to taxing the foreign earnings of U.S. multinational companies. Such a system would provide a level playing field that supports U.S. companies’ global competitiveness. It would also eliminate the rising costs associated with locked out earnings and boost their repatriation, with significant benefits for U.S. output and employment.

[3] Harry Grubert and Rosanne Altshuler, “Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax,” National Tax Journal, September 2013.

Based on recent research that incorporates conservative assumptions, my colleagues and I estimate that under a territorial system, U.S. companies would repatriate an additional $100 billion a year from future foreign earnings, adding about 150,000 U.S. jobs a year on a sustained basis.[4] We also estimate that under a transition plan for taxing the existing stock of deferred foreign earnings, similar to one proposed by former Ways and Means Chairman Dave Camp, U.S. multinational companies would repatriate about $1 trillion of these earnings, adding more than $200 billion to U.S. GDP and about 1.5 million U.S. jobs in the first few years following enactment.

A territorial tax system does have one potential disadvantage: it could strengthen the existing incentives of U.S. multinational companies to shift their profits to lower-tax jurisdictions. The exceptionally high U.S. corporate rate, significant cuts in foreign corporate tax rates, the rise of competitors based in territorial systems, the deferral option, and the rising importance of patents and other intangible assets already make these incentives powerful, and income-shifting by US multinational companies is already substantial.

Other developed countries with territorial systems have adopted a variety of exceptions and anti-abuse rules to discourage income shifting by their multinational companies and to safeguard their domestic tax base with successful results. These include rules aimed at taxing foreign passive income on a current basis and “thin cap” rules that limit excessive interest expense. Some countries have not extended their territorial systems to foreign affiliates in “black listed” tax haven countries. In those black listed countries, the foreign tax credit system with deferral applies. If base erosion were a particular problem of territorial systems, one might have expected some of the 28 countries in the OECD using territorial tax systems to switch to a worldwide tax system like the United States. However, only two OECD countries have ever switched to a worldwide tax system (Finland and New Zealand) and both subsequently switched back to territorial systems.

Recent discussions of base protection measures in the United States have considered the imposition of a minimum tax under which the foreign income of a U.S. multinational company would be taxed currently in the United States unless the foreign rate of tax it pays in the foreign jurisdiction exceeds some specified minimum rate. This is not a form of base protection measure that has been adopted by other OECD countries.

The Obama Administration’s proposed 19 percent minimum tax on future foreign earnings is of this form. It would end deferral and require that the foreign earnings of a U.S. company be taxed at an effective rate of at least 22.4 percent in every foreign jurisdiction in which the company operates or else it would have to pay an additional tax to the United States at the time this income is earned. (The difference between the stated rate of 19 percent and the actual result of 22.4 percent is due to the fact that the minimum tax would continue to apply until 85 percent of the foreign effective tax rate exceeded 19 percent.) Tax owed to the United States would be computed on a tax base that excludes a risk-free return on equity invested in active assets. Some have suggested that the risk-free return might be defined as the return on U.S. Treasuries, a

[4] Eric Drabkin, Kenneth Serwin, and Laura D’Andrea Tyson, “Implications of a Switch to a Territorial Tax System in the United States: A Critical Comparison to the Current System,” Berkeley Research Group, November 2013.

return significantly lower than the return earned on equity investments by U.S. corporations both at home and abroad.

It is notable how the minimum tax approach, which imposes a penalty on lower taxed foreign earnings, varies from the incentives being offered in other countries like the United Kingdom, with the rule of law, educated workforces, major research centers and universities, and world class infrastructure. These countries are using tax policy as a "carrot" to attract the income and the operations of U.S. companies with significant intangible assets and the positive externalities associated with them – including spillover effects boosting innovation, productivity, and wages. The minimum tax is a "stick" approach to capturing the global income of such companies. But this approach cannot succeed in the long run when there are foreign-headquartered companies capable of operating in the friendly, carrot jurisdictions. Ultimately, the minimum tax approach will drive the real economic activity of U.S. companies, including the positive externalities associated with them and their tax base, to these foreign locations and foreign owners.

Adoption of a minimum tax of this magnitude and structured in this manner would harm the global competitiveness of American companies that earn a large share of their income in global markets. A significant share of corporate income earned by U.S. multinationals in Europe would likely be subject to the minimum tax. Sixteen of the 28 EU countries had statutory tax rates below 22.4 percent in 2014, and effective tax rates are likely to be still lower. Further, while the competitors of American companies could fully avail themselves of the benefits of the current and planned patent boxes in 12 EU countries with tax rates in the 5 to 15 percent range, American companies would pay a non-competitive rate as high as 22.4 percent on such income.

In such situations, U.S. companies would be at a competitive disadvantage in acquiring foreign companies with desirable intellectual property. Instead, as a result of their significant global tax disadvantage, existing U.S. companies with such property would become attractive targets for foreign acquirers and would have even stronger incentives to move their headquarters, their R&D and their future intellectual property to lower-tax foreign locations with territorial systems. And start-up companies based on innovations and intellectual property developed in the US would have an incentive to incorporate in such locations.

In a world with highly mobile capital, especially highly profitable intangible capital, the United States should move to a hybrid territorial system with base protection measures consistent with the practices of its major trading partners.

It would be ill-advised for the United States to adopt unilateral approaches, such as the minimum tax approach proposed by the Obama Administration, that disadvantage U.S. multinational companies, precisely when developed countries are adopting patent boxes and other preferential tax measures to attract the income and activity of these companies.

A territorial system along with multilateral cooperation to combat base erosion can best protect our tax base and that of our trading partners, while reducing the risk of double taxation and the creation of barriers to foreign investment. The ongoing OECD Base Erosion and Profit Shifting project provides a venue for adoption of base protection measures on a multilateral basis and should be considered as the appropriate forum for developing such measures. Recent developments show that the OECD project is encouraging greater multilateral cooperation in international tax policy.

Conclusion

The United States last reformed its business tax code in 1986, when it had one of the lowest corporate tax rates in the world and the competitive dynamics of the global economy were very different. It is time for another comprehensive corporate tax reform that, without increasing the budget deficit, reduces the tax rate, broadens the tax base, makes the corporate tax system simpler and more efficient, and adopts a hybrid international system with effective safeguards to protect the U.S. tax base.