STATEMENT OF PAMELA F. OLSON
TO THE US SENATE FINANCE COMMITTEE
ON COMPREHENSIVE TAX REFORM: PROSPECTS AND CHALLENGES

July 18, 2017

Chairman Hatch, Ranking Member Wyden, and distinguished members of the Committee, I appreciate the opportunity to appear this morning as the Committee considers the prospects and challenges for enacting comprehensive tax reform legislation. I had the honor of serving as Treasury's Assistant Secretary for Tax Policy from 2002 to 2004, and am currently US Deputy Tax Leader of PricewaterhouseCoopers LLP and leader of PwC's Washington National Tax Services practice. I am appearing on my own behalf and not on behalf of PwC or any client. The views I express are my own.

Introduction

Fixing our problems. As the Chairman's statement announcing this hearing noted, Congress will face tough decisions in designing a simpler and fairer tax system that will better serve American individuals, families, and job creators.

The fact that tax reform is hard is obvious from the fact that it has been 31 years since Congress last enacted comprehensive tax reform. The fact that tax reform is hard is so familiar it has its own hashtag - #trih.

Meaningful comprehensive tax reform, as opposed to temporary tax cuts, will require careful consideration of competing interests and taking into account the country's pressing fiscal concerns. As demonstrated by last week's reports from the Social Security and Medicare Trustees, measures to control rising spending levels must be carefully considered, but whatever spending decisions are made, to be sustainable, tax reform must produce sufficient revenues to cover the cost of what Congress agrees to spend. In addition, to be sustainable, a reformed tax system must attract and retain the business investment that is needed for the economy to grow. A system that leaves an unlevel playing field that continues to discourage capital investment and business formation in the country is an inherently unsustainable system.

The current political environment adds to the challenge of finding common ground on certain issues, but there is no body more capable of demonstrating how to work for the greater good on a bipartisan basis than this Committee. Rather than focusing on the challenges, I want to focus on the rewards of tax reform if we succeed, and the risks to the country if we fail.

The potential rewards of a well-designed system – stronger economic growth, increased attractiveness to capital investment, faster job creation, rising wages – will lead to a more broadly-shared prosperity and make the effort well worth undertaking.

Conversely, as described in my testimony to this Committee in 2015, the risks of inaction are great; moreover, they have increased during the intervening period. Over the last 30 years, the global economy has grown faster than the US economy and other countries have changed their

tax systems to increase their attractiveness as a location for investment. We must make tax policy choices that encourage US investment and level the playing field for American companies and workers in the global marketplace.

Prospects for comprehensive tax reform

There is widespread consensus that the United States needs to reform its tax system. Since the last comprehensive tax reform in 1986, the US business tax system has not kept pace with the rest of the world as other countries have lowered their corporate tax rates, adopted territorial tax systems, and increased their reliance on consumption taxes, like value-added taxes, that are adjustable at the border.

While my testimony is focused primarily on business taxation, there is also a recognition of the need to make the tax code simpler for individuals and families seeking to save for education and retirement and less burdensome for entrepreneurs seeking to start and grow their own businesses.

As the members of this Committee are well aware, revenue neutral tax reform produces vocal losers and largely silent winners. The base broadening that permits further rate reduction on a revenue neutral basis is unpopular with those whose base is broadened, but the greater the rate reduction, the more palatable the base broadening will be, and the greater the benefit will be for the US economy because taxes will have a reduced effect on decisions to work, save, and invest.

A competitive business tax system. The US corporate tax rate, including state and local taxes, is the highest among advanced economies. The combined US federal and state statutory corporate tax rate currently is more than 15 points higher than the average of other Organisation for Economic Cooperation and Development (OECD) countries. Moreover, the rest of the developed world continues to lower their rates, as shown in the chart below highlighting changes in the global tax environment since the last time the United States enacted comprehensive tax reform legislation.

We have acquired our top rank and increased the distance between the US and OECD average countries' corporate rates over a period of years because we have held our rate constant since 1993 (following a one point increase in the rate) while other countries have reduced their rates, a trend that may have slowed, but does not appear to have stopped nor certainly to have reversed direction. Nor does it seem likely to because, in contrast to the United States, other countries have increased their reliance on more stable sources of revenue that are more conducive to economic growth - in particular, consumption taxes like value-added taxes.

Taking into account the double taxation of corporate earnings that is part of the US tax system, the United States remains on the leader board, but its ranking falls from first to third among OECD countries. Although the double tax was reduced through a reduction in the tax rate on dividends in 2003, the tax rate was increased in 2010 and again in 2013. Reducing the double tax, particularly using the corporate dividends paid deduction mechanism the Committee staff

has considered, could provide effective tax rate relief to US corporations as part of a comprehensive tax reform package.

Bills introduced by members of this committee in prior Congresses, including bills introduced by Senator Wyden and Senator Cardin, would have significantly reduced the corporate tax rates in recognition of the need for a competitive business tax system. Senator Wyden's bills from 2010 and 2011 would have reduced the US federal corporate tax rate to 24 percent.

In the seven years since Senator Wyden first proposed a 24-percent federal corporate tax rate as part of comprehensive tax reform legislation, however, other countries have reduced their corporate tax rates further. Together with average state corporate income tax rates of about 6 percent, even a 24-percent federal rate would leave the United States about 5 percentage points higher than the average rate for all other OECD nations. I strongly encourage you to find a way to achieve an even greater level of corporate rate reduction.

This Committee's 2015 bipartisan business income tax working group, chaired by Senators Thune and Cardin, recognized the fact that the high US corporate tax rate places American companies at a disadvantage in the global economy. The working group on international reform, chaired by Senators Portman and Schumer, reached a similar conclusion about the need for a lower rate to attract income from innovation.

The business income tax working group also examined how to achieve lower business income tax rates while maintaining revenue neutrality through various base broadening measures. Base broadening measures that close loopholes or eliminate provisions that distort investment decisions are worthy of consideration. Those should be distinguished from measures that broaden the base for the sake of a broader base but that would have the likely effect of discouraging investment in the United States. The latter represent a false choice; they may appear to increase revenue but, because they discourage investment, the increase is illusory.

Opportunities for investment are increasingly global and the competition for investment is fierce. Every decision to invest elsewhere makes more logical the next decision to invest elsewhere as the locus of activity shifts to other locations. The US market remains globally attractive but that is despite our tax system, which impedes investment, not because of it. By failing to address the features of our tax system that discourage investment here, we will leave investments on the sideline. Moreover, if we broaden the base in ways that make US investment less rewarding, we will lose investments to other jurisdictions.

In summary, tax reform must produce a competitive tax rate for American companies to thrive in the ever-changing global marketplace. Our tax system should serve to facilitate, not impede, investment in the United States and to promote the efficient, effective, and successful operation of American businesses in today's global marketplace. A tax system that allows US companies to compete more effectively will translate into increased domestic investment, jobs, and wages.

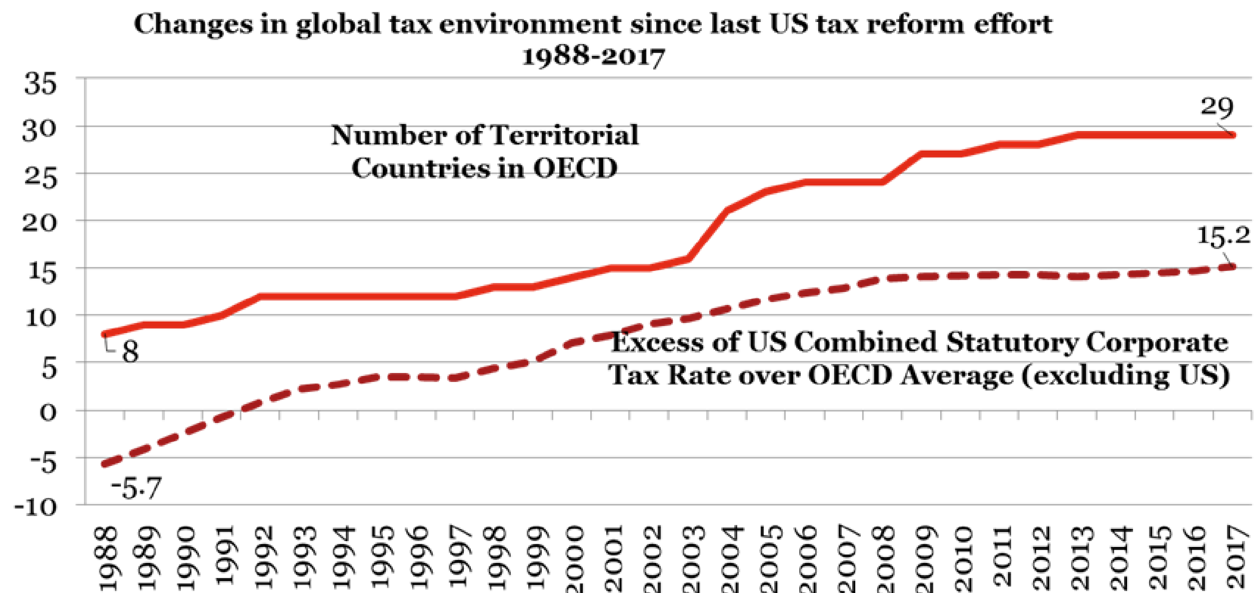
Modern international tax rules. In addition to cutting corporate tax rates, other countries have moved to modernize their international tax rules to reduce barriers to domestic investment. By contrast, the US international tax system remains mired in a system of worldwide taxation

established more than a century ago. The worldwide system may have served us well in the past. It no longer does. Its adverse effect is exacerbated by the disparity between the US corporate tax rate and those of other countries.

The United States is the only OECD country to combine a high statutory rate with a worldwide tax system. No other developed country in the world subscribes to such a toxic brew – not one. Under US tax rules, federal corporate income tax on active foreign earnings generally is deferred until those earnings are repatriated to the United States. All but five of the other 34 OECD countries allow companies to repatriate foreign earnings to their home countries with little or no additional tax, as shown on the chart below.

Regardless of one's view on the taxation of foreign income, it is difficult to see the current system as anything other than the worst of all possible worlds. It produces little tax revenue; yet, because of the disparity between US and foreign tax rates, creates a "lock-out effect" discouraging US companies' reinvestment of foreign earnings in the United States. A now retired tax director described it as "the 35-percent investment tax credit to leave my money offshore." The Joint Committee on Taxation (JCT) staff estimates that the amount of unrepatriated foreign earnings of US companies increased to $2.6 trillion by the end of 2015, up from $1.7 trillion in 2010.

The Senate Finance Committee international tax reform working group chaired by Senators Portman and Schumer called for ending this lock-out effect by adopting a dividend exemption system with "robust and appropriate base erosion rules." The international tax reform working group examined the need to make the United States a more hospitable environment for headquartering companies so as to remove incentives for "inversions" and also cited the global effort to address base erosion and profit shifting (BEPS) led by the OECD.



While the need to protect our tax base is self-evident, all antibase erosion measures are not created equal, a point acknowledged in the international tax reform working group report. The effects of antibase erosion rules must be carefully considered. The unintended consequences could be significant. The best antibase erosion measure is a well-designed system, starting with a low rate that attracts investment and reduces the incentive to avoid the tax system. A well-designed system would also prevent base erosion by clearly defining the base subject to tax.

What has been called a foreign minimum tax is the antibase erosion measure that has generated the most proposals. The concept has significant flaws. While it can be drafted to clearly define the base subject to tax, it does so as a secondary right to tax. As a secondary measure, it may discourage some tax planning, but it would do nothing to discourage other countries from trying to tax a greater share of US companies' global profits. Indeed, it may even encourage them to do so. Other countries have been active in redefining their tax bases legislatively and administratively to the detriment of the US Treasury since before the OECD commenced work on the BEPS project. A minimum tax does not address or even respond to those actions. Thus, it does nothing to give the United States a means of proactively responding to the threats to our tax base.

Because a minimum tax would only apply to US-based companies, it would put US companies at a competitive disadvantage relative to their global competitors. The United States can raise the tax paid by US-based businesses on their foreign operations, though perhaps only temporarily, but it cannot raise the tax paid by foreign companies on their foreign operations. The effect of a minimum tax would likely be a continued disadvantage to US ownership of businesses and assets and to US headquartering. It would thus have the effect of discouraging US investment. Stronger subpart F or controlled foreign corporation rules may well have the same effect. Because they apply only to the subsidiaries and activities of US-based businesses, they put those businesses at a disadvantage in the global marketplace.

While reducing their corporate rates and adopting territorial systems, other countries have focused their attention on increasing revenues from activities within their borders. While this has involved some broadening of domestic income tax bases, the primary increase has come from increased reliance on consumption taxes, such as value-added or goods and services taxes. Because the tax base for a consumption tax is goods and services consumed within a country's borders, it provides a relatively fixed definition of the tax base and may have an antibase erosion effect on the country's income tax base as well. The House Republican proposal for tax reform released in June of last year uses a similarly defined tax base. Unlike other countries, however, the House proposal is the effective repeal of the corporate income tax and replacement of it with a domestic consumption tax. In so doing, it necessarily excludes from the tax base all income attributable to goods and services consumed outside the United States.

Need for tax certainty. It is important to consider how global tax policy changes have heightened the level of uncertainty for US companies competing globally since the 2015 Senate Finance Committee international tax reform working group completed its report. Global tax controversies continue to increase, creating ever higher levels of uncertainty for US businesses competing around the world.

It is worth noting that a core part of the OECD's mandate is to reduce tax controversies and minimize the risk of double taxation. The OECD historically has consisted of a small group of relatively like-minded countries focused on helping member countries agree on uniform, consistent international tax rules, in order to minimize double taxation that could inhibit cross-border trade and investment. With more than 90 countries now participating in OECD's BEPS tax work, there are fundamental questions about the OECD's ability to achieve the consensus that will allow it to continue operating in coming years as a standard-setting body for international tax rules.

The BEPS project highlighted difficulties in achieving consensus with a large number of participating countries whose interests may not be aligned. Where such a consensus proved elusive, the final BEPS reports resorted to a "menu of options" approach, the antithesis of certainty. Without clarity from the United States, this puts US companies at greater risk of double taxation at worst, and increased global tax controversies at best.

Although the US Treasury was a very active participant in the BEPS discussion, the work began and proceeded without the direction from Congress that should have preceded the effort given what was at stake for the US treasury. It is critical that Congress move forward with reform of our tax rules and provide the clarity needed for the continuing discussions of international tax rules.

The most dramatic example of the clash between outdated US international tax rules and the actions of foreign authorities has been the European Commission's (EC) ongoing "State aid" investigations. The EC State aid investigations have been a matter of ongoing bipartisan concern by members of Congress. The US business community appreciated the efforts in early 2016 of Chairman Hatch, Ranking Member Wyden, and Senators Portman and Schumer in writing to then-Treasury Secretary Jack Lew to express objections to the EC's actions in this arena.

Secretary Lew communicated US concerns about the EC State aid investigations to European authorities. A 2016 Treasury white paper highlighted the potential for lost US tax revenue, increased barriers to cross-border investment, and the undermining of the multilateral progress made toward reducing tax avoidance.

The EC's subsequent actions suggest that US objections have had no discernable effect on the EC's approach to its State aid investigations and rulings that seek retroactive recoveries of EU taxes the EC asserts should have been paid. In the absence of US action on tax reform, such controversies appear likely to continue as foreign tax authorities seek to claim a portion of the foreign earnings of US companies that remain unrepatriated or "locked-out" of the United States.

Changing views on taxation. A key challenge facing US tax reform efforts is how best to raise needed revenue in a manner that is both efficient and conducive to the economic growth that will produce jobs and rising wages. Over the course of recent decades, foreign governments in both the developed and the developing world have adopted policies that reflect a changing view of business income taxes.

This changing view reflects a recognition that the share of GDP attributable to intangible assets, such as patents, knowhow, and copyrights, has increased substantially. Unlike property, plant, and equipment, intangible assets are highly mobile and more likely to be exploitable on a global basis, increasing their value. This shift has been accompanied by the reorganization of economic activity around global value chains and strategic networks that flow across national borders.

The rise in the value of intangibles and the interconnected nature of the global economy has led to a recognition that it is more difficult to measure and tax income earned within a country. To fund their governments, other countries have addressed this issue by relying more heavily on consumption-based taxes, such as value-added or goods and services taxes, that are applied to a tax base that is more easily measured and less mobile. Consumption taxes have the added benefit of being more conducive to economic growth.

At the same time, many foreign governments have recognized the global mobility of capital and intangible assets and have come to view changes to business income tax rates as a competitive tool that can be used to attract investment. By reducing statutory business income tax rates, adding incentives for research and development, innovation, and knowledge creation, and adopting territorial systems that limit the income tax to activities within their own borders, governments have sought to attract capital that will yield jobs, particularly high-skilled jobs for scientists, engineers, and managers.

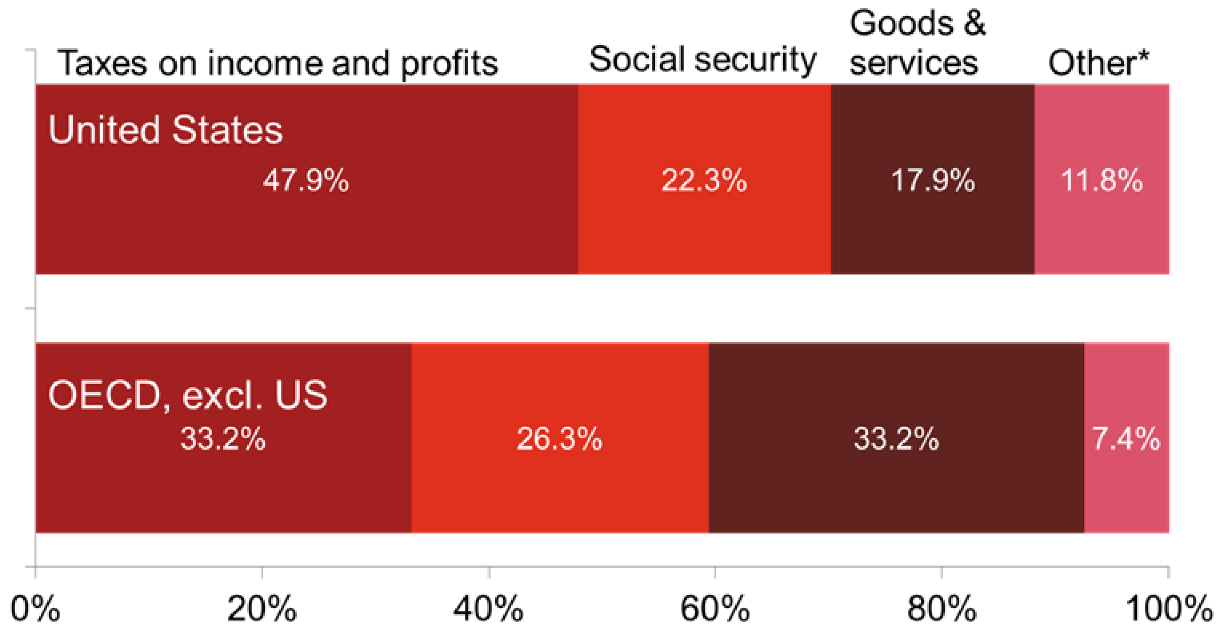
These trends reflect a practical recognition of the challenge of taxing highly mobile intangibles and capital and also the fact that economists across the political spectrum have concluded that consumption-based taxes are a more efficient way of raising revenue in an open economy than the corporate income tax.

The approach taken by other countries is reflected in a bill introduced by Senator Cardin during the last Congress. It included a progressive consumption tax that would reduce the US corporate tax rate to 17 percent and exempt most individual taxpayers from income taxation by lowering rates and providing a family allowance of $100,000 for joint filers and $50,000 for single filers. The 10-percent credit-invoice, border adjustable value-added tax included in Senator Cardin’s bill contained an exemption from collecting the tax for small businesses with under $100,000 in annual receipts.

The extent to which the United States is out of sync with the competitive and pro-growth tax policies of other nations can be seen in the chart below, which shows the federal government’s primary reliance on income taxes in contrast to most of the world’s major economies, which rely to a more significant degree on consumption taxes. Other OECD countries on average rely equally on income and profits taxes and goods and services taxes while the United States relies 2.7 times more heavily on income and profits taxes than goods and services taxes.

While the addition of an alternative tax base may be beyond the reach of the current tax reform effort, there are practical limits to generating sufficient revenues through our existing income and payroll tax bases to meet the obligations for Social Security, Medicare, and other federal programs without incurring unsustainably high levels of federal debt or imposing levels of spending reductions that appear politically unlikely. An alternative tax base, coupled with lower

rates on existing tax bases, would better align our tax system with the tax systems of every other developed country.



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In conclusion, I believe that Congress must move swiftly to reform the tax code. To be sure, there are challenges to doing so, but the opportunities for a stronger economy, job and wage growth, and more broadly-shared prosperity will reward the effort. Tax reform is also essential to respond to the risk inherent today in other countries' continued updating of their tax systems to be more internationally competitive.

In a rapidly-changing world, I do not think our country can afford to look at tax reform as a once-in-a-generation exercise. I would challenge the Congress to look at tax reform as an exercise regularly undertaken. Much as the 2015 PATH Act served as a stepping stone to the current tax reform effort by making the research credit and other significant provisions permanent, Congress should not view the meaningful tax reform achieved by this Congress as the final word for another generation. It should be the responsibility of each succeeding Congress to examine the tax system and to build on the reforms enacted by this Congress. The United States first must regain, but then must maintain, a tax code that promotes economic growth and improves the economic well-being of all Americans.