Testimony of Dr. Rosanne Altshuler
Professor, Department of Economics, Rutgers University

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Hearing on Tax Reform: A Necessary Component for Restoring Fiscal Responsibility

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Chairman Conrad, Ranking Member Sessions, and Members of the Committee, it is an honor to appear today to discuss the need for and the benefits of fundamental tax reform.

I am a professor in the economics department of Rutgers University. During various leaves from this position, I have served as Special Advisor to the Joint Committee on Taxation, chief economist for the President's Advisory Panel on Federal Tax Reform in 2005, and director of the Urban-Brookings Tax Policy Center. I have worked on building the case for tax reform, evaluated the economic consequences of different tax reforms, and studied the implementation issues and transition costs associated with various reforms.

Building the case for tax reform is easy. The current system is riddled with tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers. These provisions create complexity, generate large compliance costs, breed perceptions of unfairness, create opportunities for manipulation of rules to avoid tax, and encourage the inefficient use of our economic resources. The many changes we have made to the tax code --- more than 4,400 over the past ten years --- have made the income tax system even more difficult for taxpayers to understand, less stable, and increasingly unpredictable. The state of our current system reflects that we have forgotten that the fundamental purpose of our tax system is to raise revenues to fund government.

Congressional Budget Office (CBO) analysis shows that the government begins this year with a projected budget deficit of 9.8 percent of GDP and its future growth is driven by rising health care costs, an aging population, and the interest payments on an ever-increasing public debt. Reducing the deficit to an economically sustainable level will require both a scaling back of expenditure programs and an increase in tax revenues. The question I address in my testimony today is how best to reform the tax system so that it can raise revenue in a manner that is simple, efficient, and fair.

I will make three broad points in my testimony today.

1. **The fiscal challenges ahead require that we reform our income tax system or turn to new revenue sources.** Raising significantly more revenue from the current tax system is politically infeasible and would be damaging to economic growth.

2. **We must broaden the base of our income tax.** While there are many fundamental reforms that could be considered, a reform that broadens the base would not only raise revenue but would simplify the system, increase transparency, make the system less distortive by both allowing for a lower rate and reducing tax-induced biases towards certain activities, and improve the fairness of the system. Although politically difficult, this type of reform is implementable and follows a wave of similar base-broadening, rate-reducing tax reforms that have been enacted in developed countries over the past twenty years.

3. **The current U.S. approach to international corporate taxation needs to be updated to reflect the increased competition our U.S. multinationals face from foreign-based corporations.** Broadening the base and lowering the rate are essential and straightforward first steps to international tax reform. We also need to consider updating our system to reflect the international tax rules used by our major trading partners.

The remainder of my testimony elaborates on these points.

Must we reform the current system to meet the fiscal challenges ahead?

Before considering fundamental reforms of the tax system, a natural question is whether the current U.S. tax system can simply be "dialed up" through increases in statutory marginal tax rates to raise the revenues required to bring the deficit under control. A 2010 study I coauthored with Katherine Lim and Roberton Williams of the Urban-Brookings Tax Policy Center suggests that raising significantly more revenue from the current system is politically and economically infeasible.[1] We considered a series of illustrative incremental changes to the current income tax system aimed at reducing the deficit to an average of 3 percent of GDP over the years 2015 to 2019 (the last five years of the 2010 budget window).[2]

Using figures from the March 2010 CBO budget update, we found that no tax increases would be necessary to reach our 3 percent average deficit target if the 2001 and 2003 tax cuts were to sunset as scheduled in 2010 and Congress stops "patching" the alternative minimum tax (AMT). While tax policy under this scenario raises substantial revenue, it would subject almost one-third of taxpayers to the AMT by 2019[3] and remove some significant benefits for lower and middle income taxpayers.[4]

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[1] See Rosanne Altshuler, Katherine Lim, and Roberton Williams, "Desperately Seeking Revenues," *National Tax Journal*, June 2010. The estimates discussed in this testimony were recalculated from the original article using the March 2010 CBO budget update.

[2] There is a range of suggested targets for the budget surplus/deficit. The 3 percent of GDP target is sometimes put forth as consistent with stabilizing the debt to GDP ratio at current levels.

[3] See Katherine Lim and Jeffrey Rohaly, "The Individual Alternative Minimum Tax: Historical Data and Projections, Updated October 2009," Urban-Brookings Tax Policy Center Working Paper (October 2010), for estimates of the number of taxpayers subject to the AMT under different baselines.

[4] The Urban-Brookings Tax Policy Center website provides detailed information on the Bush tax cuts at http://www.taxpolicycenter.org/taxtopics/Expiration_Bush_Tax_Cuts.cfm.

If the 2001 and 2003 tax cuts were extended, the AMT were patched, the estate tax was maintained at 2009 parameters, and the budgetary effects of the 2010 healthcare reform act are taken into account, all income tax rates would have to increase proportionally by 30 percent to reach the 3 percent average deficit target. The proportional increase in statutory rates would have to be 50 percent if, in addition, several expiring provisions that were enacted in the American Recovery and Reinvestment Act of 2009[5] and other expiring provisions that have been in effect for a number of years were extended. This would increase the current 10 percent bottom statutory marginal rate to 15 percent and the top 35 percent rate to 51 percent. In effect, the continuation of the 2001 and 2003 tax cuts, the AMT patch, and all of the extenders --- as Congress just did for this year and next --- would force the administration and Congress to turn elsewhere for additional tax revenue.

Protecting low and middle income taxpayers from these marginal tax increases would result in top rates that would stifle economic activity. If families with income under $250,000 were protected from the rate increase required to meet the deficit target, the top two rates would need to rise from their current 33 and 35 percent rates to 66 and 70 percent if the 2001 and 2003 tax cuts were extended (and the AMT were patched, the estate tax was maintained at 2009 parameters, and the budgetary effects of the recent healthcare reform act were taken into account) and to 84 and 89 percent if the other expiring tax provisions described above were also extended.[6]

Our exercise clearly demonstrates that simply increasing statutory marginal income tax rates within our current system is not a realistic approach to reducing the deficit. Further, it shows that raising revenue solely from high-income individuals is not the answer to the revenue problem going forward.[7] Changes must be made to the tax base if we hope to raise any additional revenue from the income tax system.

Can the corporate tax system raise significant revenues?

Increased revenues from the corporate tax could be a target for deficit reduction. However, raising the statutory corporate tax rate will do little to buy down the deficit. In 2010, corporate revenues were less than ten percent of total revenues and one percent of GDP. Going forward, CBO forecasts corporate revenues as averaging about ten percent of total revenues and two percent of GDP for the period 2012-2021. Moreover, any increase in the corporate income tax rate will reduce domestic income and lower wages (through an outflow of capital) and adversely affect economic efficiency. And in the domestic context in particular, the corporate income tax is

[5] These provisions include the Making Work Pay tax credit, the American Opportunity tax credit, and the exclusion from taxable income of certain amounts of unemployment benefits.

[6] We did not take behavioral effects into account in our analysis. Tax rates would have to be even higher if changes in taxpayer behavior in response to the increased rates were factored into the analysis.

[7] A CBO revenue option finds that raising the tax rate on ordinary taxable income in excess of $1 million for joint filers ($500,000 for other filers) by 5 percentage points would raise about 223 billion over the ten year period 2010-2019 (see CBO, *Budget Options: Volume II*, August 2009). That amounts to less than one-third of the revenue required to hit the 3 percent deficit target if the Bush tax cuts are extended, the AMT is patched, the estate tax was maintained at 2009 parameters, and the budgetary effects of the recent healthcare reform act were taken into account and less than one-fifth of the revenue required if other expiring tax cuts are extended as well.

essentially optional for all nonpublic companies because they can use legal forms of business that provide limited liability but that are taxed at the individual level as pass-through entities. As a result, only about one-half of domestic net business income is subject to the corporate income tax.[8]

Most revenue from today's corporate income tax comes from multinational corporations that are competing in a global market. Raising revenue from corporate tax rate increases is problematic now that the United States is about to have the highest statutory corporate tax rate (counting state corporate taxes) among OECD countries. OECD data shows that in 2010, the average combined national and sub-national corporate tax rate in the OECD was 25.1 percent. The U.S. combined rate was 39.2 percent, second only to Japan. The Japanese government has proposed a 5 percentage point reduction in its corporate rate as part of tax system reforms for 2011. As of April 1, when Japan reduces its rate, we will have the dubious honor of imposing the highest combined corporate tax rate.

Any increase in the corporate tax rate can be expected to induce additional U.S. tax avoidance through transfer pricing and other methods of income shifting. Clausing (2009) finds that every one percentage point differential between the U.S. and a particular foreign corporate tax rate is associated with a 0.5 percentage point increase in reported profits abroad.[9] Clausing notes that an effect of this magnitude implies that, in 2004, the corporate tax rate differential induced U.S. and foreign-owned multinational corporations to shift over $180 billion in profits—and over $60 billion in tax revenues—out of the United States.

This leakage in revenue due to income shifting, along with the small role played by the corporate tax in the U.S. revenue structure, suggests that corporate rate increases can, at best, move the deficit only marginally toward a sustainable path. A more credible perspective would use a broadening of the corporate tax base to "pay down" the current law's high marginal corporate income tax rates.[10] That in turn means that corporate tax reform is unlikely to be a significant net revenue raiser. Ameliorating the United States' fiscal challenges will require either more comprehensive personal income tax reforms or tapping new sources of revenues.

The economic benefit of base broadening tax reform

The income tax imposes efficiency costs on the economy. These costs arise when taxes discourage work, savings, and investment; distort the economic decisions of individuals and businesses; and divert resources from productive uses in our economy. When taxpayers change their behavior to minimize their tax liability, they often make inefficient choices that they would

[8] U.S. Department of Treasury, Treasury Conference on Business Taxation and Global Competitiveness Background Paper, July 2007.
[9] See Kimberly Clausing, "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal*, December 2009.
[10] A closer look at the potential sources of corporate base broadening, however, suggests that it may not be possible to enact a revenue neutral corporate tax reform that produces a meaningful corporate rate cut. See Eric Toder's January 31 blog entry on TaxVox (http://taxvox.taxpolicycenter.org/2011/01/31/corporate-tax-reform-wheres-the-beef/) for a clear explanation why it will be difficult to significantly lower the corporate rate through corporate tax expenditure reform alone.

not make in the absence of tax considerations. These tax-motivated behaviors divert resources from their most productive use and reduce the productive capacity of our economy. These distortions waste economic resources, reduce productivity, and, ultimately lower living standards for all.

Economists call the efficiency cost of the tax system the "excess burden" indicating that the true cost of the tax system exceeds the revenue collected. Economic theory shows that the excess burden, or cost, of a tax is approximately proportional to the square of the tax rate. Roughly speaking, this means that if you double the tax you quadruple the excess burden.

It is impossible to design an income tax system that does not impose some efficiency cost on the economy. The goal should be designing a system that raises the required revenue in a way that minimizes tax distortions to behavior and has desirable distributional consequences. It is easy to understand that raising a set amount of revenue with a narrow tax base requires higher tax rates than a broader base. What is often ignored is the drag on the economy created by the higher rates.

The tax plan in the December 2010 report of the National Commission on Fiscal Responsibility and Reform demonstrated that by cutting back tax preferences and broadening the base, the current system could generate revenues of about 21 percent of GDP with top individual and corporate statutory rates of 28 percent.[11] The lower rates made possible by the reform combined with the stripping away of tax provisions that distort economic activity would leave us with a system that is less costly to our economy. At the same time the new system would be perceived as being fairer than the current system and would also have the benefits of being considerably less complex and easier to administer.[12]

Should the corporate tax be reformed?

Both our individual and business tax systems are inefficient and hopelessly complex. A high statutory rate and numerous deductions and exclusions distort corporate behavior in many ways. By reducing the after-tax return to investments, the high statutory rate discourages saving and reduces aggregate investment. The patchwork of rules that govern the taxation of business activity create incentives that favor debt over equity, encourage investment in tax-favored equipment and certain other assets over other kinds of investment, and drive capital out of the corporate sector into non-corporate forms of businesses. The current tax treatment of income from cross-border investment also creates inefficiencies that I discuss in the next section of my testimony.

There are many possible reforms of the corporate system ranging from scrapping it and replacing it with a VAT to incremental reforms of the current system. For example, one of the

[11] See, National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, 2010.
[12] Prior to the report of the National Commission, Senators Ron Wyden and Judd Gregg put forward the "Bipartisan Tax Fairness and Simplification Act of 2010." Their plan base-broadening plan would have similar attributes. The Bipartisan Policy Center's Debt Reduction Task Force has also crafted a base broadening, rate-lowering plan. See Bipartisan Policy Center Debt Reduction Task Force, *Restoring America's Future,* 2010.

recommendations of the 2005 President's Advisory Panel on Federal Tax Reform proposed moving the corporate income tax system to a cash-flow tax.[13] Professor Alan Auerbach of the University of California at Berkeley has proposed replacing the corporate income tax with a destination-based cash-flow tax.[14] These tax reforms have many merits. Most significantly they enhance economic growth by encouraging saving and investment and have the potential to significantly simplify the tax system. It is important to note, however, that these fundamental reforms have not been adopted in other countries and may be difficult to implement. While these reforms deserve careful study and consideration, today's competitive world economy demands that we begin updating our system for taxing business income now.

Transforming our current system from one with a high rate and a narrow base to one with a broader tax base and a lower tax rate could reduce a number of distortions associated with the current corporate tax system. In addition, a lower rate will enhance the U.S. economy by encouraging investment in the United States by both U.S. and foreign businesses.

It will not be easy to cut corporate tax preferences and we will have to choose carefully. While some tax preferences benefit only a limited number of businesses, others cut taxes for a broader set and, in addition, lower the cost of domestic investments. It is not possible for us to stay competitive and grow our economy, however, with a statutory corporate tax rate that is 14 percentage points above the OECD average. And if we delay reform of our system, this gap will surely increase. As noted above, Japan is lowering its statutory corporate rate. Both the UK and Canada also plan to reduce their rates in the coming years. The UK corporate statutory rate will land at 24 percent in 2014 almost 10 percentage point higher than the 15 percent statutory rate Canada will have in place by 2012.

One often hears that the fact that the statutory rate is high is not important since our narrow base reduces the effective tax rate below the statutory rate. This argument ignores the important role statutory rates play in business decisions. The statutory rate influences tax planning and higher rates mean that more tax planning is necessary to lower the tax cost of running a business. Tax planning is especially important for U.S. multinationals that compete with foreign corporations subject to significantly lower taxes on their worldwide earnings. While aggressive tax planning has become a necessity it represents a pure waste of our economy's resources.

Statutory rates also influence where corporations do business. High corporate rates increase incentives for shifting income out of the United States and magnify the attractiveness of investing in low-tax locations. The statutory rate also influences financing decisions. The tax advantage to debt is an increasing function of the statutory rate. Finally, statutory tax rates play a role in determining the effective marginal tax rate of an investment. A high U.S. statutory rate can decrease the incentive to increase investments in the U.S. by both U.S. and foreign firms.

Retaining a corporate statutory rate that is significantly out of line with our competitors is not a viable path for increasing U.S. investment, jobs, and economic growth.

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[13] See, President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, 2005.
[14] See Alan J. Auerbach, *A Modern Corporate Tax*, 2010, available at http://www.americanprogress.org/issues/2010/12/pdf/auerbachpaper.pdf.

Should we reform our system for taxing cross-border income?

Our current system for taxing the income earned abroad by U.S. firms is very complex, induces inefficient behavioral responses, and leaves both companies and policy analysts dissatisfied. Under our current system, all income of U.S. corporations is subject to U.S. corporate tax whether it is earned at home or abroad. A number of proposals have been put forward to reform our system by adopting a territorial tax system which would exempt foreign source income from the U.S. corporate income tax.[15] For example, one proposal of the 2005 President's Advisory Panel on Federal Tax Reform recommended combining a territorial tax system with a simplified income tax. More recently, the National Commission on Fiscal Responsibility and Reform put forward a base-broadening individual and corporate tax reform with a territorial system. The remainder of my testimony discusses issues associated with territorial taxation.

The U.S. is one of only a handful of advanced economies that taxes the dividends of their home country corporations when they are repatriated home. All other G-7 countries and all but six other OECD countries (Chile, Ireland, Israel, Mexico, Poland, South Korea) have adopted territorial or "dividend exemption" tax systems that exempt some (or all) of active foreign earnings from home country taxation.

Understanding the economic consequences of moving to a territorial system requires some background on how the current U.S. system operates. Two features of the U.S. international tax system are illustrative of the issues associated with our current rules. The first concerns the timing of the U.S. taxation of foreign earnings of foreign subsidiaries. The active business earnings of foreign subsidiaries of U.S. parent corporations generally are not taxed at home until they are distributed as dividends. As a result, the tax on dividend payments can be thought of as being elective, much like the tax on capital gains. Because of the "time value of money" advantage of postponing tax payments, this "deferral" of U.S. tax allows foreign business income to be taxed at a lower effective rate than it would be if it were earned in the United States thereby influencing when and in what form foreign subsidiary profits are repatriated to the United States.[16]

Another distorting feature of the U.S. system that affects incentives involves the mechanism to prevent the double taxation of corporate income. The U.S. provides a credit for foreign taxes paid to foreign governments. The credit is limited to the U.S. tax that would be owed if the income were earned in the United States. Two steps are important in the foreign tax credit limitation calculation. First, the foreign income is separated into baskets to restrict cross-crediting, i.e., credits flowing over from highly taxed income to shield income that has been lightly taxed. There are effectively two foreign tax credit baskets: one for active income and one

[15] For an extensive analysis of proposals to reform the taxation of international income see Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," in *Fundamental Tax Reform: Issues, Choices and Implications,* John W. Diamond & George R. Zodrow editors, 2008. This part of the testimony borrows some material from this paper.

[16] U.S. tax is not deferred on passive investment income or other easily moveable income. Provisions contained in "subpart F" of the tax code prevent businesses from moving this income to low-tax countries and retaining it there indefinitely. These rules can influence how foreign operations are financed and structured.

for passive income. Within any basket, excess credits generated by one type of income (e.g., dividends in the active income basket) can flow over to other income in the basket (e.g., royalties in the active income basket) and shield that income from any residual U.S. tax.

In the second step of the foreign tax credit limitation calculation, parent overhead expenses such as interest are allocated to each basket to calculate the net foreign income on which the credit can be claimed. This only affects companies if they cannot credit all the foreign taxes they have paid. If a company has excess foreign tax credits, allocation of expenses to foreign income increases U.S. tax by reducing allowable credits. If the company does not have excess credits, or is currently not repatriating income, the allocations have no effect on current U.S. tax liability. As pointed out in a series of papers by Harry Grubert of the U.S. Treasury Department and co-authors, allocations of overhead expenses can play an important role in the design of a territorial tax system.[17]

The credit and deferral features of our current tax system create a situation in which the tax consequences of investment abroad depend on the circumstances of the taxpayer. For instance, certain corporations may be able to set up their operations in a way that either avoids the repatriation of foreign profits through deferral or avoids taxation on repatriated foreign profits through the credit. Either approach may effectively "self-help" the corporation to territorial tax treatment.

By establishing repatriation of a dividend as a taxable event, the U.S. worldwide system distorts various business decisions. To redeploy earnings in the U.S., U.S. tax generally must first be paid, unless tax planning has ensured that sufficient tax credits are available. Further, the tax planning opportunities engendered by the complicated rules surrounding deferral may allow some corporations to help themselves to results that are even more favorable than territorial taxation. In these cases, the United States government effectively subsidizes marginal investment abroad. As a result, our system is worldwide for some corporations, territorial for some other corporations, and better than territorial for a third set of corporations.

Whether or not this outcome is intended, the current system arguably distorts more economic decisions and is more complex than a system that simply exempted active foreign business income from U.S. tax, while raising little revenue from U.S. multinational corporations. At the same time, arranging affairs to avoid taxation of foreign earnings is costly for U.S. multinational corporations, and these costs differ across companies. The result is a system that distorts business decisions, treats different multinationals differently, and encourages wasteful tax planning.

A territorial tax system would eliminate the burden of repatriation taxes on dividends. This would eliminate the incentive for firms to hold income in foreign operations abroad instead of sending it back home. Firms would no longer have to devote resources to planning how to send

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[17] See Harry Grubert and John Mutti, *Taxing International Business Income: Dividend Exemption versus the Current System,* Washington, D.C.: American Enterprise Institute, 2001; Harry Grubert, "Enacting Dividend Exemption and Tax Revenue," *National Tax Journal,* December, 2001; Rosanne Altshuler and Harry Grubert, 2001, "Where Will They Go if We Go Territorial? Dividend Exemption and the Foreign Location Decisions of U.S. Multinational Corporations," *National Tax Journal,* December, 2001; and Harry Grubert and Rosanne Altshuler, Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income, in *Fundamental Tax Reform: Issues, Choices and Implications,* John W. Diamond & George R. Zodrow editors, 2008.

funds home in a tax efficient manner. And our tax system would more closely resemble those of our major competitors. If we were to adopt the type of territorial systems used by our competitors, our firms would face the same effective tax rates abroad as firms headquartered in competitor countries.

The treatment of dividend remittances, however, is only one element of any option to move our system towards territorial taxation. Royalties would be fully taxed under a territorial tax system since there would no longer be excess foreign tax credits on dividend payments to shield taxes due on these payments. Income shifting becomes more attractive under territorial taxation but only to the extent of the burden of the repatriation tax faced by individual firms. As explained above, some firms are able to "self-help" to what is effectively a territorial tax system. For these firms, the income shifting incentives are not much different under territorial than under current law.

Designing a territorial tax system involves deciding how and whether to allocate overhead expenses incurred domestically to support foreign investments to exempt foreign income, defining what types of foreign income should qualify for exemption, deciding on whether royalties should be given special treatment, re-examining the rules we use to protect the tax base from income shifting through inappropriate transfer pricing, and devising transition rules among many other policy decisions. The behavioral distortions and revenue consequences of any move to territorial depend critically on these decisions. Treasury estimates from the report of the tax subcommittee of the President's Economic Recovery Advisory Board (PERAB) indicate that a territorial tax system with no expense allocation rules could lose $130 billion over ten years.[18] The PERAB report notes that JCT, Treasury, and CBO have studied the revenue consequences of territorial tax systems with expense allocation rules and estimated that these systems could generate from $40 billion to $70 billion in tax revenues over ten years.

Abandoning our worldwide approach to cross-border taxation would be a major policy move and deserves careful analysis. We need to ask and explore why the Japan and the UK have moved to territorial tax systems. And, among many other questions, we need to understand how the incremental incentive to engage in income shifting and invest in tangible and intangible assets abroad changes if we were to both lower the corporate rate AND adopt a territorial tax system. The time to do this analysis is now so we can make an informed decision on how to update our international tax system. Without more analysis we cannot move forward on choosing a new system for taxing international income.

Conclusion

The fiscal challenges ahead are daunting. Instead of spending the next two years engaging in an endless debate of whether to extend the 2001 and 2003 tax cuts, I urge you to focus on building support for and designing a base-broadening reform of the current system that can reduce our future unsustainable debt burdens and enhance the growth of the U.S. economy and the well-being of Americans.

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[18] The President's Economic Recovery Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation,* August 2010.

Thank you. I would be happy to answer any questions you may have.