Testimony
of
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Chairman Camp and members of the Subcommittee, it is a pleasure to appear before you today to discuss reform alternatives for the corporate tax. I am an Associate Professor of Finance at Harvard Business School and a Faculty Research Fellow of the National Bureau of Economic Research.

In these comments, I want to emphasize possibilities for corporate tax reform that do not involve fundamental tax reform or significant marginal tax rate reductions. While both fundamental tax reform and lower marginal rates are laudable for various well-understood reasons, I want to highlight three reforms to the corporate tax that are somewhat more piecemeal but still can yield significant economic benefits to the country. I believe that reforming the corporate tax as outlined below would generate significant efficiency gains, would improve the competitive position of American firms in the worldwide markets in which they operate, and would create a more transparent and cost-effective reporting system for American firms and investors.

Three changes to the corporate tax are discussed at length below and I briefly summarize them here.

> First, capital gains earned by corporations are currently penalized in an anomalous way relative to intercompany dividends and relative to individual capital gains. Effectively, the current system of corporate capital gains taxation creates a third layer of taxation on capital. This system significantly influences business investment as estimates indicate that American corporations hold over $800 billion in unrealized corporate capital gains. This anomalous treatment also stands in contrast to the approach adopted by several other countries. Unlocking these gains through even partial tax relief would result in reallocations of capital toward more productive uses that would generate efficiency gains that are estimated to be as high as $20 billion a year.

> Second, the worldwide system of taxing foreign source income – or the income earned by multinational firms abroad - should be reconsidered. Foreign operations are increasingly important to American firms with more than thirty percent of profits coming from their global operations. The annual burden of the current system on American firms is conservatively estimated in our research at $50 billion a year. The current system conforms neither to traditional efficiency benchmarks nor to more recent

measures grounded in modern notions of multinational decision-making. In particular, recent research highlights that international tax rules distort which companies own what assets and that these distortions matter for productivity and efficiency. An emphasis on these distortions to ownership patterns provides a rationale for a move toward a territorial system of taxation that would bring the U.S. closer to the system employed by many other countries.

Finally, the reporting system used in corporate taxation should be restructured to bring reporting to tax authorities in line with reporting to capital markets. Currently, corporations must characterize their income in two significantly different ways to tax authorities and capital markets. Unsurprisingly, this has resulted in two completely different portraits of profitability. This dual system creates significant confusion as it is impossible to infer corporate tax payments from public financial statements or to truly understand corporate profitability. This system also creates latitude for opportunistic managers to take advantage of this discrepancy in a way that does not advance the interests of shareholders. At a minimum, reporting taxes paid in public financial statements is advisable. More ambitiously, if corporations simply paid taxes on reported GAAP income, significant compliance costs would be nearly eliminated, the top marginal corporate tax rate could be reduced significantly to 15% without a loss of revenue, and actions designed to exploit differences between these two reporting systems would be eliminated.

Significant opportunities for corporate tax reform exist by reconsidering the base of corporate taxation – in particular, the treatment of corporate capital gains and foreign source income – and by reconsidering the curious reporting practices for corporate profits. These changes, while piecemeal relative to fundamental tax reform, still have sizable consequences for economic efficiency that would be manifest in more productive allocations of capital, reduced compliance costs, and, ultimately, in greater incomes for American workers.

I. Fixing the anomalous treatment of corporate capital gains[1]

The appropriate taxation of capital income has preoccupied policy makers and scholars for the last half century. Within this debate, the taxation of capital gains has been a central topic. Surprisingly, this emphasis on capital gains has been limited to the role of capital gains at the individual level rather than at the corporate level. This asymmetry may have arisen due to a perception, unsupported by the evidence, that corporate capital gains were of a small magnitude relative to other sources of corporate income or relative to individual capital gains. In fact, reviewing the magnitude of corporate capital gains, the distortionary effects of corporate capital gains taxation, and the efficiency and revenue consequences of alternative treatments of corporate capital gains recommends a reconsideration of this aspect of the tax code.

Corporate capital gains make up an increasingly large portion of corporate income, now comprising approximately 20% of corporate income subject to tax, and one third of the dollar amount of taxable individual capital gains. The late 1990s and early 2000s saw a significant increase in the level of unrealized corporate capital gains. A modest estimate of unrealized corporate capital gains exceeds $800 billion.

[1] See Desai and Gentry (2003) and Desai (2006) for more details.

When considered within the broader nature of capital taxation, the current system of taxing corporate capital gains appears anomalous. In particular, dividends and capital gains earned by corporations are treated asymmetrically, and the absence of relief for corporate capital gains results in a third level of taxation on capital income. Individual capital gains are taxed at preferential rates, in recognition of the importance of encouraging corporate investment and mitigating the impact of situations in which investors are "locked into" investments they would prefer to sell were it not for the associated capital gains taxes. Despite both considerations applying with equal or greater force to corporate investments, corporate capital gains are currently taxed at ordinary income rates. Many other countries exempt from tax corporate capital gains or tax them at preferential rates, further contributing to the anomalous nature of current U.S. tax policies.

The corporate capital gains tax has a variety of distortionary effects in addition to those usually considered with respect to the individual capital gains tax. For example, foreign and domestic investors are taxed differently, thereby affecting the pattern of asset ownership. Additionally, corporations respond to the corporate capital gains tax with a variety of tax planning activities that have distortionary effects.

A variety of alternatives exist to the current practice of taxing corporate capital gains at the same rate as ordinary income. The efficacy of any alternative depends on the responsiveness of corporate capital gains realizations to tax rates. Measured elasticities of corporate capital gains realizations to tax rates are higher than individual elasticities, giving rise to greater potential efficiency gains associated with reduced tax rates. The reduced "lock-in effect" associated with a reduction in the corporate capital gains tax rate to 15% would produce annual efficiency gains of $16.7 billion a year. Repealing the corporate capital gains tax entirely would eliminate the "lock-in effect" and thereby produce an efficiency gain of $20.4 billion a year. In addition, these reduced corporate capital gains tax rates would generally reduce the tax burden on corporations, improving efficiency by encouraging greater corporate investment.

While seemingly abstract, these large efficiency gains can be understood as a measure of economic surplus or income that is currently foregone because of the presence of this taxation. These improvements in economic efficiency correspond to increases in national income and corresponding increases in wages. Tax relief of various stripes has the potential to generate sizable efficiency gains relative to lost tax revenue. Several features of corporate capital gains taxes suggest that corporate capital gains tax relief has the potential to produce significant efficiency gains. The greater responsiveness of corporations to taxation, interactions with other financing frictions, and the preexisting distortions in the taxation of capital income suggest that alternative, less onerous treatments of corporate capital gains have the potential to yield greater efficiency gains, relative to revenue consequences, than other sources of tax relief.

II. Reconsidering the worldwide system of taxation[2]

Markets and economies evolve continuously, making yesterday's tax solutions possibly much less efficient or desirable today. Time also brings changes in our understanding of the impact, and wisdom, of different tax choices, again carrying the message that what might have

[2] This section draws on Desai and Hines (2004) and the details of the efficiency calculations can be found there. Other arguments for reconsidering the tax treatment of foreign source income can also be found at Desai (2004) and the slides entitled "Taxation and Global Competitiveness" prepared for the President's Advisory Panel on Federal Taxation available at www.taxreformpanel.gov/meetings/docs/desai.ppt.

seemed to work for yesterday may not be sensible today. A rapidly integrating world and a wave of recent scholarship on multinational firms combine to suggest that the mismatch between yesterday's tax policy and today's reality is particularly pronounced with respect to international taxation.

The rising economic importance of international transactions has put increasing pressure on corporate tax systems to accommodate foreign considerations. This accommodation has not been an easy or simple process. In many countries, particularly high-income countries such as the United States, corporate tax provisions are designed on the basis of domestic considerations. Subsequently, modifications intended to address problems and opportunities that arise due to global capital and goods markets are incorporated, often as afterthoughts. While such a method of policy development has the potential to arrive at sensible outcomes, doing so requires greater degrees of luck and patience than most would care to attribute to existing political systems.

Several recent developments have contributed to a growing sense of unease over the structure of U.S. corporate taxation, particularly its international provisions, and have prompted calls for reform. The European Union successfully challenged export subsidies embedded in the U.S. corporate income tax, leading the World Trade Organization to authorize tariffs on American exports. Reported cases of corporate malfeasance and the aggressive use of tax shelters have drawn attention to the tax avoidance activities of many corporations, with particular attention on the role of tax havens. The difficulty of spurring investment through traditional channels has frustrated policymakers intent on reversing the large loss in manufacturing jobs in the early 2000s. These events have each contributed to an increasing dissatisfaction with the structure of corporate taxation, and at the same time reflect the insufficiency of evaluating corporate taxes on the basis of strictly domestic considerations. The international tax provisions at the center of the trade dispute are emblematic of immensely complex international rules appended to a corporate tax system designed primarily with domestic activity in mind.

Successful corporate tax reform requires the corporate income tax to be placed firmly in an international setting, which is not currently the case in the United States. To be sure, the U.S. corporate income tax includes many provisions concerning the taxation of foreign income, but these provisions largely reflect attempts to apply the logic of domestic taxation to foreign circumstances. As a consequence, the current U.S. corporate income tax includes foreign provisions that distort taxpayer behavior and impose significant burdens on international business activity, particularly given the greater mobility of international business activity. A simple framework for considering the burden of this tax system indicates that the current system imposes a burden of approximately $50 billion a year.

Assessing the burden of the current system is useful but does not provide guidance on how international considerations might be better incorporated into a reform of corporate taxation. Incorporating realistic assumptions about the nature of multinational firm activity yields some novel analyses of what constitutes efficient systems. These analyses imply that efficiency requires that foreign investment income face no residual tax upon repatriation. From the standpoint of countries (such as the United States) that employ a worldwide regime and impose residual repatriation taxes, a reduction in the tax burden on foreign income would not only improve national welfare but also improve world welfare. Consequently, a movement to reform corporate taxation in the direction of exempting foreign income has a compelling logic. Of course, the history of taxation in the United States and elsewhere offers many examples of persistent differences between what countries do and what they should do. Nonetheless, thinking clearly about the burden of the current system and the appropriate efficiency benchmarks provides the foundation for closing the gap between old rules and new realities.

In order to evaluate the wisdom of current U.S. taxation of foreign income it is necessary to consider appropriate welfare standards. While there is a timeless quality to the economic principles that form the basis of efficient tax policy design, the application of these principles to the taxation of foreign income has varied over time, and in particular, has undergone a significant recent change. Until recently, three benchmarks were commonly used to evaluate the efficiency of international tax systems: capital export neutrality (CEN), national neutrality (NN) and capital import neutrality (CIN).

CEN is the doctrine that the return to capital should be taxed at the same total rate regardless of investment location, with the idea that adherence to CEN promotes world welfare. A system of worldwide taxation with unlimited foreign tax credits satisfies CEN, since then foreign and domestic investments are all effectively subject to the same (home country) tax rate, and firms that maximize after-tax returns under such a system thereby also maximize pretax returns. NN is the doctrine that foreign investment income should be subject to home country taxation with only a deduction for foreign taxes paid. The idea behind NN is that home countries promote their own welfare by subjecting foreign income to double taxation, thereby discouraging all but the most productive foreign investments, and retaining investment capital for use at home. Thirdly, CIN emphasizes that the return to capital should be taxed at the same total rate regardless of the residence of the investor. Pure source-based taxation is consistent with CIN, as long as individual income tax rates are harmonized to ensure that the combined tax burden on saving and investment does not differ among investors residing in different countries.

These traditional welfare benchmarks suffer from a number of shortcomings. CIN offers little guidance for the design of a single country's system of taxing foreign income, since its application requires simultaneous consideration and coordination of corporate and personal taxes in all countries in the world. While CEN and NN do not suffer from this shortcoming, they have other worrisome features. Tax policies adopted by other countries matter not at all in determining whether a country's tax system conforms to CEN, which seems an unlikely feature of a benchmark that is intended to characterize policies that promote global efficiency. Tax policies that implement NN would subject foreign investment income to punishing home country taxation, thereby discouraging multinational business operations and, as a realistic matter, more likely reduce rather than advance home country welfare. As an empirical matter, such policies have not been adopted by any major capital-exporting nation. Moreover, a very common policy approach – exempting foreign income from taxation – is incongruent with any of these welfare benchmarks.

CEN, NN, and CIN rely on the intuition that FDI represents the transfer of net savings between countries. This characterization of FDI was discarded long ago by the scholarly community that studies multinational firms. Instead, modern scholars view FDI as arising from differential capabilities, and consequently differential productivity, among firms, and the extension of intangible assets across borders. This intuition squares well with empirical FDI patterns, which include the fact that most of the world's FDI represents investment from one high-income country into another, and the fact that a very high fraction of such investment takes the form of acquiring existing businesses. Consequently, most FDI represents transfers of control and ownership, and need not involve transfers of net savings. This emphasis on transfers of ownership, and the productivity differences that drive ownership patterns, implies that CEN, NN, and CIN do not characterize optimal tax systems, whereas other welfare benchmarks do. The modern view of FDI as arising from productivity differences among firms, with ownership changes taking the form of FDI, raises the possibility that greater outbound FDI need not be associated with reduced domestic investment. Indeed, it is conceivable that greater outbound FDI is associated with greater domestic investment, either by home country firms undertaking the FDI or by unrelated foreign investors. Under this view, in short, multinational firms are not engaged in the reallocation of the capital stock as much as they are engaged in the reallocation of ownership and control of existing capital stocks.

This emphasis on ownership suggests that tax policies should be evaluated on the basis of their effects on the allocation of ownership of productive assets. Global efficiency is characterized by ownership arrangements that maximize total world output, whereas national welfare (taking the tax policies of other countries as given) is characterized by tax policies that maximize home country incomes. This perspective yields the welfare benchmarks of capital ownership neutrality (CON) and national ownership neutrality (NON), in which CON is a direct analogue to CEN, and NON a direct analogue to NN. CON requires that tax rules not distort ownership patterns, which is equivalent to ownership of an asset residing with the potential buyer who has the highest reservation price in the absence of tax differences. As a practical matter, CON is satisfied by conformity among tax systems, including situations in which all countries exempt foreign income from taxation, and situations in which all countries tax foreign incomes while providing complete foreign tax credits. The national welfare considerations that form the basis of NON suggest, much as is evident in practice, that countries should want to exempt foreign income from taxation. This policy prescription stems from the observation that outbound foreign investment need not be accompanied by reduced domestic investment in a world of shifting ownership patterns. As a result, countries have incentives to select tax rules that maximize the productivity of foreign and domestic investment, since doing so improves tax collections as well as private incomes. When both capital stocks and ownership claims are affected by tax rules, then NON need not correspond exactly to maximizing national welfare, and home countries might benefit from imposing modest taxes on foreign investment.

The CON/NON framework places productivity differences among multinational owners, and the transfers of control induced by tax rules, front and center in analyzing the efficiency of taxation. The relevance of such a framework depends on the degree to which such differences matter relative to the actual transfers of net saving emphasized in the CEN/NN/CIN framework. That scholars who study multinationals have dismissed the view of FDI as transfers of net savings as neither satisfying theoretically nor confirmed empirically suggests that employing welfare frameworks that rely exclusively on such notions is incomplete at best. That incorporation of modern interpretations of FDI produces tax policies that countries actually use further suggests the importance of these alternative frameworks.

The CON/NON paradigms carry direct implications for U.S. taxation of foreign income. The NON logic implies that the United States would improve its own welfare by exempting foreign income from taxation, rather than, as it does now, subjecting foreign income to taxation imposing significant burdens on American firms. In addition, should it be relevant to American policy, CON implies that a reduction of U.S. taxation of foreign income would improve world welfare by moving U.S. taxation more in the direction of other countries that currently subject foreign income to little or no taxation.

Improving the taxation of foreign investment income requires abandoning the notion of international tax provisions as appendages to a domestic corporate tax. At first glance it is perfectly logical to posit that, given that the U.S. tax system requires American companies to remit 35 percent of their taxable incomes to the U.S. government, the same type of taxation should apply to foreign income. Unfortunately, the realities of a competitive world capital market suggest otherwise. U.S. taxation of foreign income impairs the productivity of American firms in the global marketplace, and interestingly, impairs the productivity of investments located in the United States, since it distorts ownership patterns by foreign investors as well as Americans.

It would appear that the current taxation of foreign income, a product of many complex appendages to the domestic corporate tax, imposes significant burdens on U.S. firms. The simple framework developed above suggests that the annual burden on American firms is conservatively estimated at $50 billion a year. The current U.S. tax regime conforms neither to traditional efficiency benchmarks nor to more recent measures grounded in modern notions of multinational decision-making. Ownership based concepts of efficiency imply that national and world welfare would be advanced by reducing U.S. taxation of foreign income, thereby permitting taxpayers and the country to benefit from greater market-based allocation of resources to the most productive owners.

III. Revisiting the Dual Reporting System[3]

IRS Commissioner Mark Everson and SEC Chairman Christopher Cox have advanced a remarkably simple, but controversial, proposal. Discussions are underway to have companies publicly disclose how much they pay in taxes. Remarkably, the amount corporations pay in taxes is impossible to decipher from annual reports. Their proposal, which will likely meet fierce opposition from accountants, lawyers and managers, is a laudable first step in restoring some sanity to the way corporate profits are reported to tax authorities and the capital markets.

Given that thirty-five cents of every pretax dollar is supposed to go the government, one would think that this figure would be easily deduced or that it would be clearly reported. Leading accounting scholars have reviewed the intricacies of tax footnotes of leading companies and cannot answer a simple question: how much did this company pay in taxes? This raises a much larger question: How did we end up in a world where something as important as the amount of taxes paid was obscured from investors?

When the corporate tax was introduced, making reporting profits more credible was a central goal. Indeed, the profits reported to tax authorities and capital markets were essentially the same. As the corporate tax evolved, well-considered exceptions – such as the way investment was expensed – were introduced to permit fiscal policy goals. An investment stimulus might involve accelerating those expenses to make investment more attractive while accounting standards wouldn't permit such a treatment.

In the last decade, the two reporting systems have developed into parallel universes. Large, unexplained gaps – more than $100 billion – have developed between the profits reported to capital markets and tax authorities that can no longer be explained by accepted differences between the two reporting systems.

[3] For a more detailed discussion of the dual book system and the gaps between profits reported to capital markets and tax authorities, see Desai (2003, 2005). For a discussion of the ways in which earnings manipulation and tax avoidance are related, Desai and Dharmapala (2005, 2006a, 2006b). For international evidence on these links, see Desai, Dyck and Zingales (2005).

In fact, we shouldn't be surprised by these developments. Imagine if you were allowed to represent your income to the IRS on your 1040 in one way and on your credit application to your mortgage lender in another way. You might, in a moment of weakness, account for your income in a particularly favorable light to your prospective lender and go to fewer pains to do so with the IRS. Indeed, you might take great liberties to portray your economic situation in two divergent ways that would serve your best interests. You might find yourself coming up with all kinds of curious rationalizations for why something is income (to the lender) or an expense (to the tax authorities).

In fact, you don't have this opportunity and for good reason. Your lender can rest assured that the 1040 they review in deciding whether you are credit-worthy would not overly inflate your earnings given your desire to minimize taxes. Similarly, tax authorities can rely on the use of the 1040 for other purposes to limit the degree of income understatement given your need for capital. In that sense, the uniformity with which you are forced to characterize your economic situation provides a natural limit on opportunistic behavior.

While individuals are not faced with this perplexing choice of how to characterize your income depending on the audience, corporations do find themselves in this curious situation. Dual books for accounting and tax purposes are standard in corporate America and, judging from recent analysis, are the province of much creative decision-making. Indeed, something as simple as interest expense on debt can be engineered to appear as an expense to tax authorities and a dividend to the capital markets.

This confusing state of affairs has naturally drawn the attention of tax authorities, given the loss of tax revenues, but why is the SEC interested? Indeed, investors might be thought to benefit from lower taxes paid to the government. This simple logic doesn't account for the fact that managers don't always do the right thing for shareholders. If managers are opportunistic, then the extra latitude afforded by the dual reporting system can be costly to investors.

Indeed, research shows just that – actions associated with corporate tax avoidance are not valued by the market unless the firms are well-governed. And, the actors in various corporate scandals – including Enron and Tyco – were expert in exploiting the dual tax system to manufacture accounting earnings. No corporate tax shelter was ever undertaken that reduced book income and, often, the primary benefit of a corporate tax shelter is the reported income it produces.[4]

The proposal to publicly report taxes paid is an eminently sensible idea. More ambitious alternatives should also be considered. Corporate tax returns could be made public so shareholders could benefit from the additional information. More ambitiously still, we could junk the dual book system and simply allow corporations to pay taxes, at a lower rate, on the profits they report to capital markets. Such a change would save corporations and the governments the considerable resources now dedicated to compliance and allow for a lower marginal rate. Rough estimates, elaborated on in Desai (2005), suggest that a 15% tax on reported profits would generate the same revenues as the corporate tax does now. Such a change would embody a central lesson of economics – the virtues of tax with a lower rate on a more sensible base.

[4] For a specific discussion of Enron, Tyco and Xerox, see Desai (2005) and for a discussion of Dynegy, see Desai and Dharmapala (2006a, 2006b).

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