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Statement by

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Chairman Tiberi and members of the Subcommittee, thank you for inviting me to testify. Reforming the taxation of corporate income ranks among the most important steps Congress can take to promote investment, create jobs, and boost growth. I wish you well on this endeavor. My remarks today are distilled from a recent Policy Brief published by the Peterson Institute for International Economics, titled "Corporate Tax Reform for a New Century" (PB11-2, April 2011). Let me summarize six points from the Policy Brief.

High Tax Rates

Among advanced OECD nations, the United States has the second worst corporate tax system from the standpoint of encouraging investment in P&E or R&D, or promoting production for home or export markets. The US statutory corporate rate (federal and state combined) is second highest, after Japan. The US average effective corporate tax rate (again combined) is also second highest, after Japan. According to one study, the US marginal effective corporate tax is highest in the OECD. When compared to China or up-and-coming emerging regions, such as Eastern Europe and Turkey, the United States is even worse -- tax purgatory. Box 1 briefly describes statutory, average effective, and marginal effective corporate tax rates.

Box 1. Tax Rates Defined

Statutory tax rate. The rate specified in the tax code (federal and/or state) applied to the highest bracket of corporate income. Since states have different rates of corporate income tax, typically an average is calculated for the several states (currently about 4 percent).

Average effective tax rate. This is defined as the amount of tax paid by all corporations (or a subset of corporations) divided by a measure of corporate profits. The World Bank, for example, uses as its denominator "commercial profits", a concept similar but not identical to figures found in corporate financial statements. Consequently, the average effective rate reflects tax credits, special deductions, loss carryforwards, capital gains treatment and the like, all of which serve to reduce the statutory rate.

Marginal effective tax rate. This is the most difficult calculation. The purpose is to estimate that tax rate that will be paid on income from a new investment over the life of that investment, regardless of the tax that might be paid on income from existing investment. Like the average effective tax rate, the marginal effective tax rate is expressed as a percentage of corporate profits. The calculation attempts to reflect circumstances faced by individual firms, such as their loss carryforwards, bonus depreciation, anticipated tax credits, etc.

The damage inflicted by the US system deters both foreign investment in the United States and investment at home by US companies. Credible evidence indicates that cutting the corporate tax rate by 1 percentage point will, over time, increase the output produced by foreign firms operating in the United States by at least 2 percent. Foreign firms employ over 5 million Americans. Cutting the US corporate tax rate by 10 percentage points could potentially increase their employment by 1 million more Americans.

Modest Revenue Collection

I am often asked, "If US corporate tax rates are so high, why are corporate tax payments so modest?" In a good year – for example, 2007 – US corporate tax payments (federal and state combined) were 3.0 percent of US GDP, compared with the OECD average of 3.9 percent. The main reason is that the US corporate tax base is far smaller than the OECD average: 13 percent of GDP compared to 22 percent. The difference is partly explained by the dazzling array of US pass-through firms which skip the corporate tax system. Large firms which have a choice – everything else being equal – would often rather invest and produce elsewhere and ship their goods and services to the US market. Our corporate tax system does a good job at encouraging the best and brightest firms to invest abroad. It does an even better job at discouraging tomorrow's global 1000 corporations from locating their headquarters in the United States.

Rate Cuts and Revenue Collection

For OECD countries, between 1981 and 2007, there was virtually no connection between the combined federal and subfederal corporate tax rate and corporate tax revenue expressed as a percent of GDP. If anything, the relationship was slightly negative. During this period OECD tax rates were progressively slashed from the mid-40% range to the mid-20% range. The policy implication for the United States is short and powerful: the US statutory rate could be safely cut from 35 percent to 25 percent with no appreciable impact on corporate tax revenue.

Moreover, serious econometric analysis (PB11-2) shows that, if there is a loss of corporate revenue from cutting the corporate tax rate, that will be offset by higher personal income and payroll taxes, as investment surges, people go back to work, and wages rise. After reviewing various studies, I conclude that cutting the statutory tax rate by 10 percentage points would

increase the US capital stock by at least 5 percent, and put at least 600,000 people back at work in US firms – in addition to new American employees in foreign firms. Existing employees would enjoy wage gains of almost 2 percent because the additional capital stock would boost productivity.

Inward Foreign Direct Investment

Inward foreign direct investment brings jobs and technology to the United States. In their path-breaking study, *Foreign Direct Investment in the United States* (3rd edition, 1995), Graham and Krugman showed that foreign firms on average spent more money on R&D and paid better wages than their domestic counterparts. Nothing I have read since contradicts a generally favorable impression. In fact, the recent CEA publication, *U.S. Inbound Foreign Direct Investment* (June 2011) reinforces this impression. While the United States has attracted a huge stock of inward foreign direct investment ($3.4 trillion) by firms that employ 5.7 million Americans, more would be better. Other countries are catching up, but the United States is still the largest destination for inward foreign investment.

How do taxes fit in the equation? Obviously the United States holds many attractions for foreign firms, but a competitive tax system is not among them. It is not surprising that foreign firms attempt to repatriate as much income as possible to their parent firms abroad in the form of interest and royalties, which count as deductions from corporate taxable income and are taxed at low or zero rates under US double-tax treaties. Of course the IRS seeks to deter excessive interest payments resulting from unduly high debt leverage (characterized as "earnings stripping") and excessive royalty payments for intellectual property rights. But in my view, this is not the time to "crack down" with new legislation designed to give the IRS even stronger tools. By and large, inward foreign investment is great for the US economy, and we should want more of it. To lessen tax abuse, the first step the Congress should take is to sharply lower the US corporate tax rate so that foreign firms doing business here have less incentive to remit income to their parent firms abroad in the form of interest and royalty payments.

Worldwide Tax Conceits

The United States is the charter member of a shrinking club that espouses worldwide taxation of corporate income. Among countries tracked by the OECD, only 6 others practice worldwide taxation, and most of them impose substantially lower corporate tax rates than the United States. All the rest, some 26 countries, have adopted territorial tax systems. Nevertheless, US tax authorities – the Treasury and the JCT -- firmly adhere to the outmoded notion that worldwide taxation is somehow the norm. This notion in turn fosters two damaging conceits.

The first conceit is calculating tax expenditures -- the difference between an imagined "ideal" tax system and the actual US tax system – on the supposition that worldwide taxation is the "ideal" system. In reality, worldwide taxation is not the ideal. In fact, it is not even the norm. Yet this conceit leads the Treasury Department to publish a forecast of $213 billion as the tax expenditure over the years 2012 to 2016 associated with deferred US taxation of foreign income.

The notion that worldwide taxation is the ideal, and should become the norm, leads to a second and even worse conceit. The conceit is thinking that the central answers to transfer price abuse, earnings stripping, and parking income abroad will be found in curtailing deferral, curbing the foreign tax credit, and enacting higher penalties. Such misguided answers are offered in hopes of protecting the high US corporate tax rate from its own destructive consequences -- in a world where other countries are sensibly slashing their own corporate tax rates. The outmoded tax strategy brings to mind medieval attempts at protecting the castle by digging a wider moat. Water moats didn't protect castles in the Middle Ages and tax moats won't protect the American economy in the 21st century.

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More detail will be found in the referenced Policy Brief. Thank you for the opportunity to testify.