Statement of

Kimberly A. Clausing
Thormund A. Miller and Walter Mintz Professor of Economics
Reed College

Before the
House Ways and Means Committee

23 May 2017

Chairman Brady, Ranking Member Neal, Members of the Committee: Thank you for inviting me to share my views on tax reform and competitiveness. Tax reform is an important priority, and it should reflect the revenue needs of our country. We need to meet those revenue needs without increasing the deficit, and we should do so in a way that is simple, fair, and efficient.

In my testimony today, I will talk about three broad issues related to good tax reform. First, I will discuss the concept of competitiveness, the contribution of our tax system to the nation's competitiveness, and other important features of national competitiveness. Second, I will address the business tax component of the Ryan/Brady tax plan, focusing in particular on the border-adjustment feature. Third, I will suggest alternatives to the Ryan/Brady plan that preserve the advantages of the plan without risking the substantial disadvantages of the plan. These alternatives will make our tax system better suited to a globally integrated economy. To be suited to the global economy, our tax system must serve the interests of American middle-class workers, workers too often been left behind in tax reform proposals.

Competitiveness and Tax Policy

By any broad measure, our nation's businesses are incredibly successful. Corporate profits are a higher share of GDP than they have been at any time in history, whether one considers corporate profits in before-tax or after-tax terms. Profits in the last 15 years have been about 50% higher than they were in the closing decades of the prior century. (See Figure 1.) Also, our companies are dominant on the lists of the world's most important companies, as measured by the Forbes Global 2000 list. (See Figure 2.) While our economy is about one-fifth the size of the world economy (16% in purchasing power parity terms (PPP)[1] and 22% in U.S. dollar terms), we have larger fractions of the world's top 2000 firms: 29% by count, 31% by sales, 35% by profits (consolidated), 24% by assets, and 42% by market capitalization.

[1] PPP numbers adjust for price differences across countries. This makes the United States a larger share of the world economy since price levels are lower in most developing countries. For example, India's economy is much larger in terms of PPP than in terms of USD, since a dollar of income can buy more goods and services in India than it can in the United States.

Figure 1: After Tax Corporate Profits, 1965-2015
(as a share of GDP)

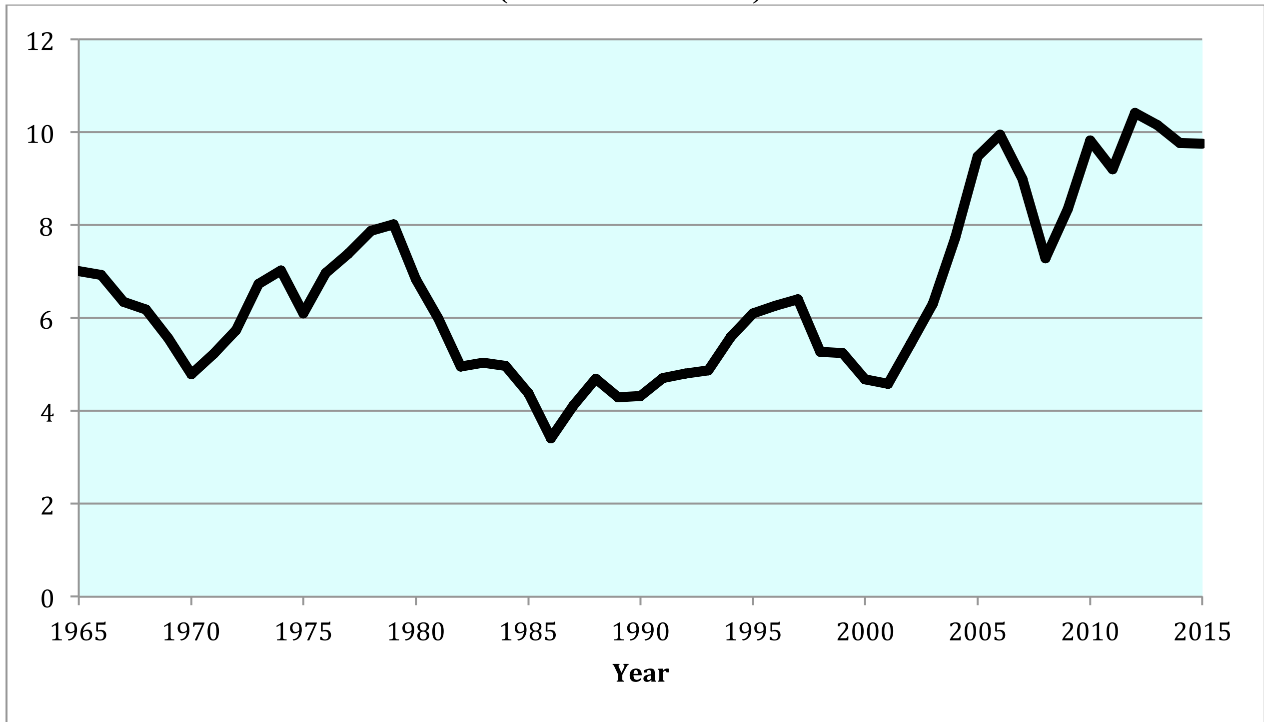
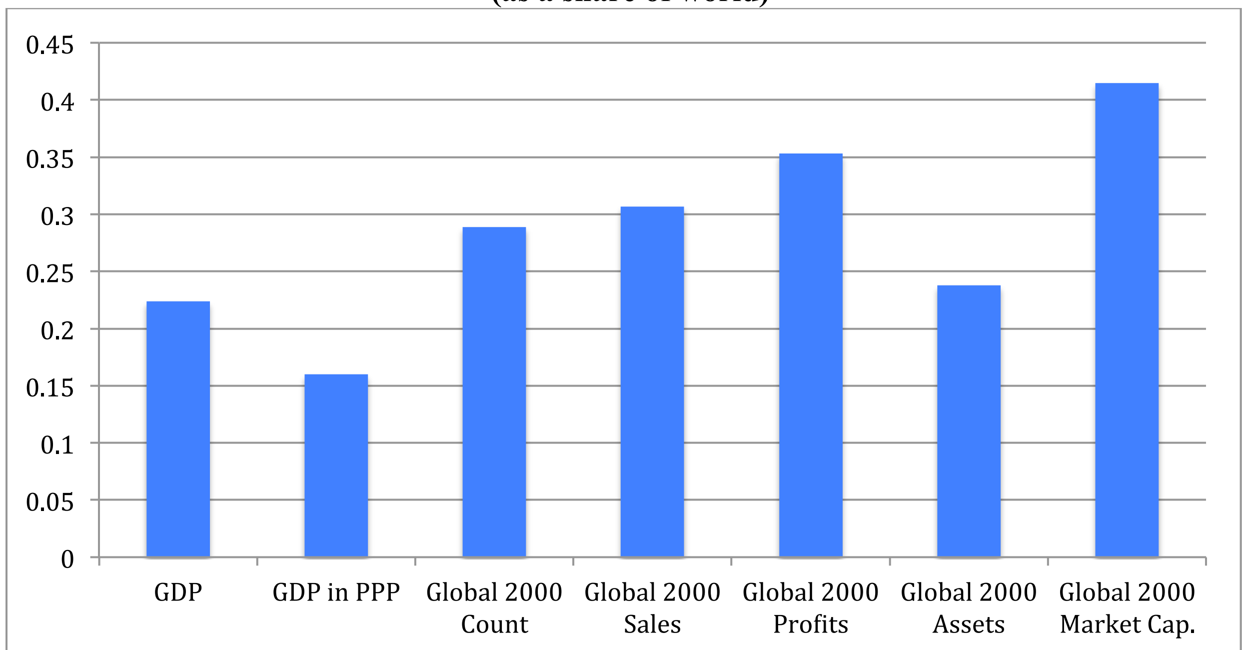
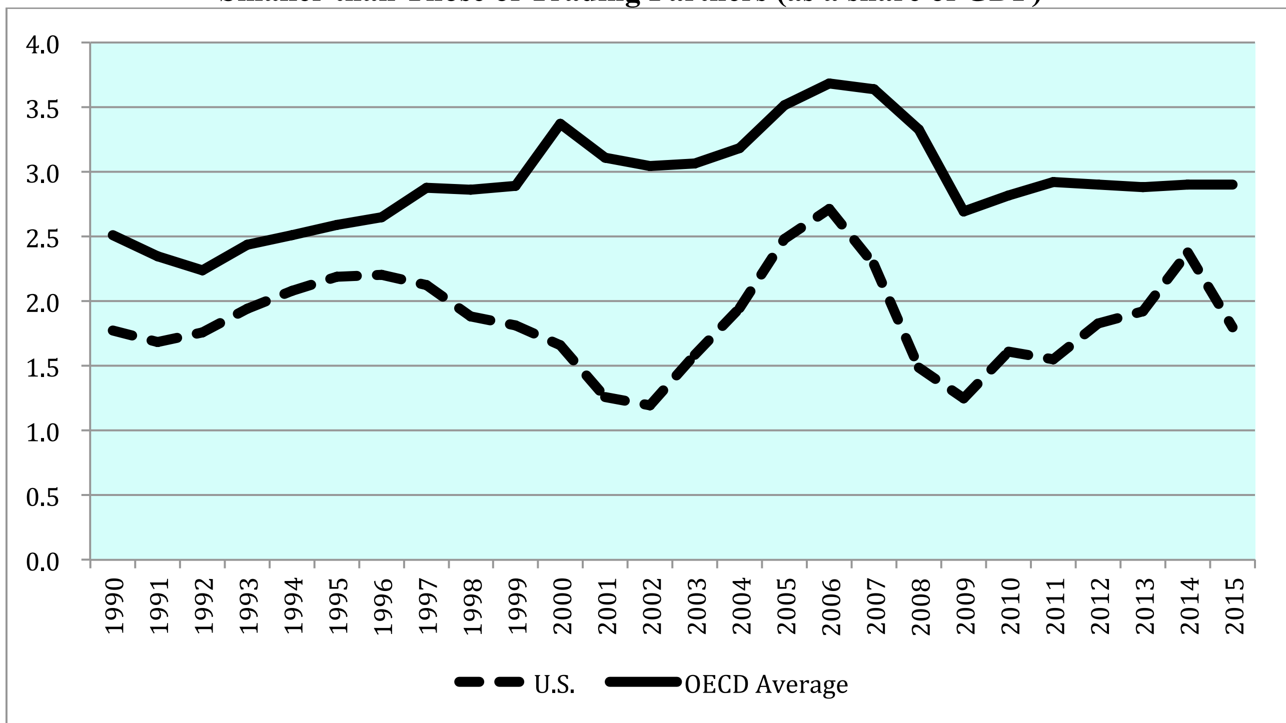


Figure 2: U.S. Share of Forbes Global 2000 Firms
(as a share of world)



Further, while our corporate tax system certainly has problems, high tax burdens for multinational corporations are not one of them. Due to the aggressive use of corporate loopholes, many U.S. multinationals have effective tax rates in the single digits, far lower than the U.S. statutory rate.[2] And, our purportedly "worldwide" system of taxation generates no revenue from taxing foreign income, while our trading partners that use purportedly "territorial" systems of taxation frequently tax more foreign income than we do, due to their tougher base erosion protections.[3] Further, U.S. corporate tax revenues are lower than the corporate tax revenues of our peer trading partners by about 1 percent of GDP. Part of the revenue shortfall is explained by profit shifting to tax havens, and there are also other reasons for weak U.S. corporate tax revenues.[4] These considerations do *not* mean that U.S. business taxation can not be substantially improved; I will discuss methods for improving business taxation below.

Figure 3: U.S. Corporate Tax Revenues,
Smaller than Those of Trading Partners (as a share of GDP)



[2]The U.S. statutory rate is indeed high relative to peer nations, but this is not the relevant measure of corporate tax burdens since most companies pay effective tax rates that are much lower than the statutory rate.

[3] The Joint Committee on Taxation provides detail on other countries' CFC laws. Some countries (e.g., France, Germany, Italy, and Japan) have very broad CFC laws that go beyond currently taxing passive foreign income; active foreign income is also currently taxed, when such income is insufficiently taxed in the source country. The French benchmark for insufficient taxation is less than half the French rate; the Japanese benchmark is less than 20%. Beyond CFC laws, many territorial countries have other provisions aimed at countering corporate tax base erosion that affect the taxation of foreign income, including thin capitalization (earnings stripping) rules, which are widely used. For details, see JCT, "Present Law and Issues in U.S. Taxation of Cross-Border Income" JCX-42-11.

[4] The U.S. tax base is notoriously narrow and there is also a preference in the U.S. tax code for non-corporate business structures. There are also important distortions within the corporate tax code. For example, debt-financed investments are tax-favored relative to equity-financed investments. This increased leverage creates financial vulnerability for the U.S. economy.

Broader Notions of Competiveness

In discussions about the "competitiveness" of U.S. multinational firms, corporate interests often emphasize tax burdens as a determinative influence. Yet, for many companies, the U.S. statutory rate and our purportedly "worldwide" system have more bark than bite, and multinational firms are often able to achieve very low *effective* tax rates. In terms of the ability to generate after-tax profits and market dominance, U.S. multinational firms are already quite competitive.

But broader notions of competitiveness emphasize the fundamentals that determine the health and well-being of our broader economy. Are workers well-educated and do they have the skills required to earn high-wages in the global economy? Are customers economically secure and sufficiently prosperous that they are not overleveraged? Are standards of living for the middle class rising at a pace that is consistent with societal expectations and a healthy middle class? Is our infrastructure sound? Are our political and economic institutions stable? Are we avoiding fragility in our financial system and other weak spots that could lead to recessions or crises?

While we often take such things for granted, they are essential to the success of U.S. businesses and the workers within them.[5] In short, the attractiveness of a particular country as a location for production depends on much else aside from the corporate tax environment: labor productivity and education, consumer market potential, infrastructure, government services, legal institutions, and other factors matter. And, of course, some of these other factors require government revenue, to finance investments in education, infrastructure, and essential services. The investments in our economy that make the middle class prosperous will also make our businesses successful.

Business Taxation Under the Ryan/Brady Plan

There are desirable features of the destination-based cash flow tax that is at the center of the Ryan/Brady Plan. First, by basing business tax liabilities on the destination of the customer, it becomes far more difficult for multinational firms to shift profits offshore. This is important, since offshore profit shifting has become a huge problem. My research suggests that this problem has increased dramatically over the past 20 years, and profit shifting to tax havens now costs the U.S. government in excess of $100 billion each year. These practices also hurt our trading partners.[6]

Figure 4 shows the dramatic increase in the revenue lost to profit shifting in recent years, and Figure 5 shows that most profit shifting is artificially directed toward tax havens. Indeed, the income booked in low-tax countries is implausibly high by any reasonable metric. As reported by Gravelle (2015), U.S. affiliate firm profits were 645% of Bermuda's GDP and 547% of the Cayman Islands GDP in 2004. As absurd as these numbers are, they increased by 2010, to 1614% for Bermuda and 2,065% for the Caymans. Further, estimates indicate that U.S.

---

[5] Of course, there are many other variables that affect particular companies competitiveness, including, but not limited to, the exchange rate, the firm's financial constraints, and the unique advantages of particular companies.
[6] See Clausing, Kimberly A. "The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond." 2016. *National Tax Journal*. December. 69(4). 905-934. Similar facts regarding the scale of the problem are reported by many sources, including Keightly (2013), Dowd, Landefeld, and Moore (2017), and Guvenen, Mataloni, Rassier, and Ruhl (2017).

multinational firms have accumulated over $2.5 trillion in permanently reinvested earnings in tax havens, over $1 trillion of which is held in cash.

Figure 4: Estimated Revenue Loss to U.S. Government from Profit Shifting (in billions of U.S. dollars)

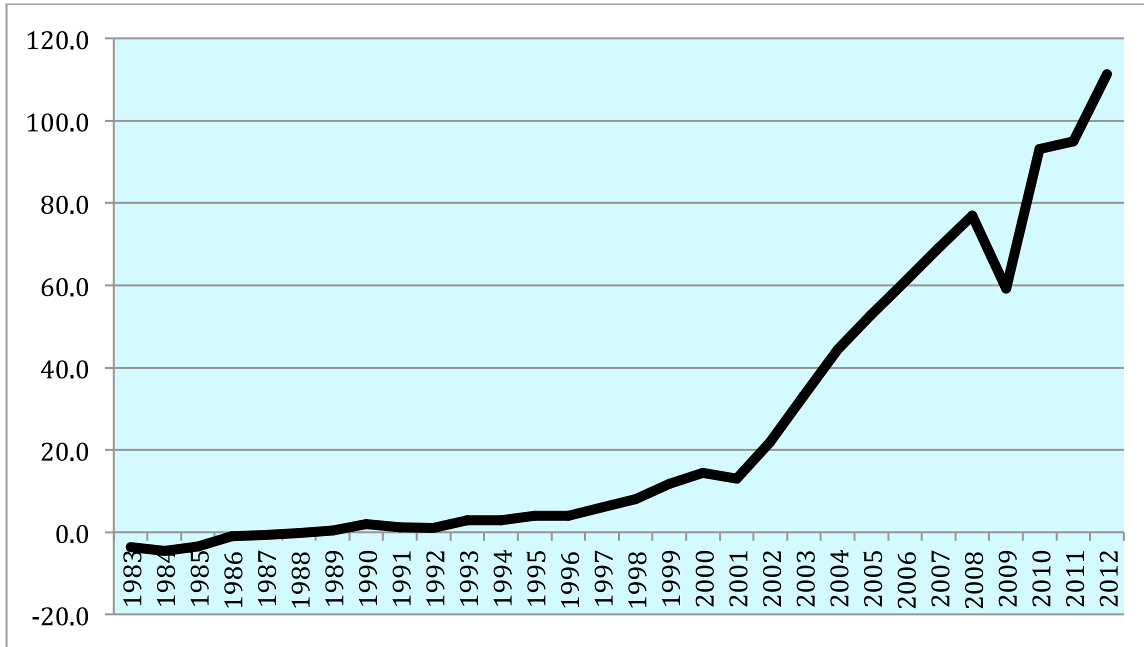
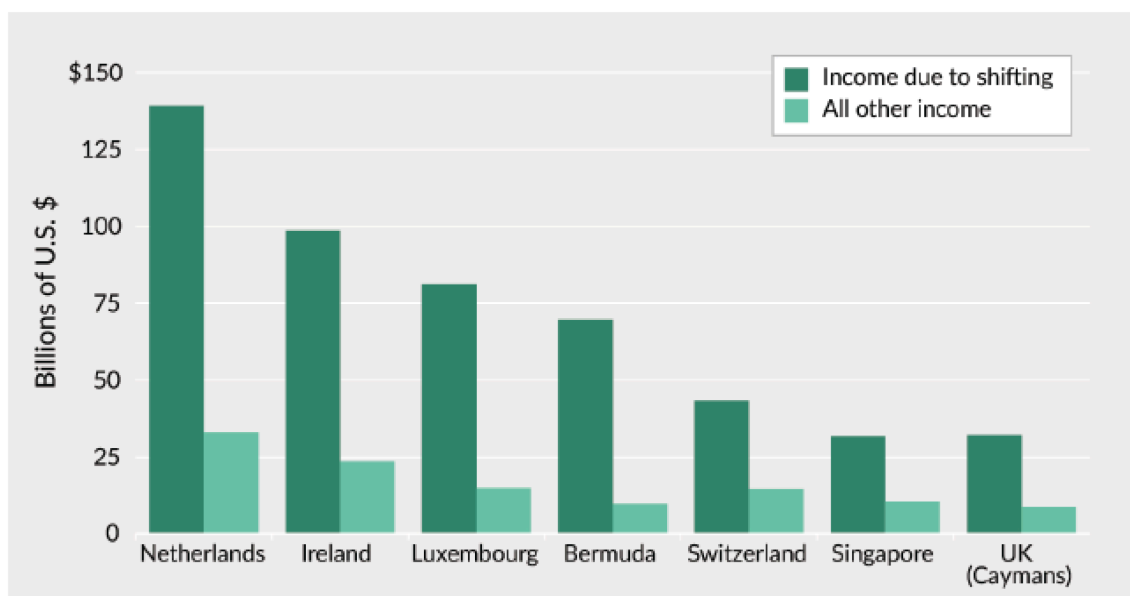


Figure 5: Main Destinations for Profit Shifting



A second advantage of the Ryan/Brady plan is that the combination of expensing and eliminating the interest deduction for debt-financed investments eliminates the current tax-incentive favoring debt-financed investments. At present, our tax system actually generates a negative tax rate for investments financed with debt, whereas tax rates are positive for equity-financed investments, about 30% of which face double-taxation by the United States since they are also taxed through the individual income tax.[7] Eliminating the tax incentive that favors debt will reduce leverage in the United States, and this will make our economy less fragile, particularly in times of downturn.

However, there are five serious flaws associated with the Ryan/Brady plan.

1. In the short and medium run, the plan is likely to generate large economic shocks that would harm American workers and trade-dependent businesses.
2. It risks the world trading system, harms our trading partners and allies, and generates substantial risks to U.S. exporting firms due to possible retaliation and incomplete loss offsets.
3. At the proposed tax rates, the Ryan/Brady plan will lose tax revenue, increasing the budget deficit.
4. At the proposed tax rates, the Brady/Ryan plan makes our tax system less progressive, after several decades when the middle class has not benefited from economic growth.
5. This is an untested tax reform that is not ready for primetime. There are many important details that still need to be worked out. Absent several years to work on these issues, the system will function poorly, will lose revenue due to inadvertent tax planning opportunities, and will generate new distortions, such as tax-inefficient mergers between exporters and importers.

Because of these flaws, I recommend that Congress reject the Ryan/Brady plan. However, I offer several suggestions for alternative reforms that would retain the advantages of the Ryan/Brady plan without generating these substantial disadvantages.

Serious Flaws of the Ryan/Brady Plan

1. <u>Large Negative Shocks to Import-Intensive Industries are Likely</u>

The Ryan/Brady plan includes a border adjustment that would exempt income from exporting while taxing imported goods at 20 percent. Many economists argue that, if the equilibrium trade balance is unchanged, this must generate either an immediate 25% appreciation of the dollar or a slower, subsequent reduction in the prices of imported goods. While this argument has solid theoretical background, in practice there are many factors that may interfere with quick exchange rate and price adjustment.

- Some countries fix their exchange rates so these exchange rates won't adjust quickly.
- Many traded goods are priced in dollars, so changes in these trade contracts will take time, or we will have to wait for price adjustment, which can be quite slow.

---

[7] See Burman, Clausing, and Austin. "Is U.S. Corporate Income Double-Taxed?" May 2017. Forthcoming, *National Tax Journal*. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2965188

- Exchange rates are notoriously difficult to forecast in reality. As many experts have noted, theoretical models of exchange rates do not do a good job predicting future exchange rate movements. Exchange rates can be misaligned for lengthy periods, and there is no guarantee that we will end up at the "theoretically correct" exchange rate.[8]
- There is some evidence that indicates that countries with VATs trade less (both imports *and* exports), although that evidence is incomplete.
- There are very few examples of countries similar to the United States adopting VATs under floating exchange rates (when market forces determine short run movements in exchange rates). In those cases, the exchange rate often did *not* appreciate as expected. And, of course a VAT is not exactly the same as the Ryan/Brady business tax.
- *Even if the dollar does appreciate by 25%*, that will create large redistributions of wealth away from Americans and toward foreigners, and it will also risk generating an emerging market crisis due to the presence of $9 trillion of dollar denominated debt in emerging markets.

For many of these reasons, the business community is understandably skeptical of smooth exchange rate adjustment, and the political support of various business groups indicates that exporters, including those that have been aggressive at profit shifting in the past, are far more likely to be in favor of the Ryan/Brady plan than importers. If the economists that emphasize the theoretical prediction that exchange rates will simply adjust were correct, these business people would be misunderstanding their own economic interests. While I suppose that is possible, I'm more inclined to suspect that businesspeople understand their own economic interests.

Thus, if we take as given that exchange rate adjustment may not be smooth or complete, this suggests that American workers could be hurt by large shocks to industries that use imports intensively, including of course the retail sector, which now employs 1 in 10 American workers.

2. <u>Serious Risks to the World Trading System and to Exporting Companies</u>

Most international trade lawyers are quite certain that the Ryan/Brady plan is incompatible with our trade obligations under the WTO (World Trade Organization). Our trade rules are quite clear that border adjustments are not allowed for direct taxes such as corporate income taxes. Since the Brady/Ryan plan allows a deduction for wages, and includes many other features that are common to corporate income taxes, it will be ruled a direct tax and our trading partners will be authorized to retaliate with tariffs.

The WTO incompatibility is no mere technicality, since the Ryan/Brady plan harms our trading partners in several ways. First, it generates an incentive to produce in the United States for exports to third markets. Second, it exacerbates the profit shifting problems of our trading partners, since the United States will appear like a giant tax haven from their perspective. For foreign firms, profit shifting to the United States will not generate extra tax liabilities in the United States, but it will reduce their profits in their home countries. From their perspective, the United States will function like a huge Bermuda! (Bermuda has zero corporate tax.)

---

[8] See Kenneth Rogoff, *Perspectives on Exchange Rate Volatility in* INTERNATIONAL CAPITAL FLOWS 441-53 (Martin Feldstein ed.,1999). And more recently, Rogoff's op-ed in the Boston Globe. "Trump's Damaging Border Tax." 20 March 2017.

Since our trading partners are likely to be upset by the economic consequences of this plan, as well as the nationalistic way it was marketed, they are likely to bring dispute settlement suits to the WTO, and they are likely to win. At this point, there is no good outcome for the United States. It is possible our trading partners will retaliate with historically large tariffs; tariffs would be authorized in amounts sufficient to reduce U.S. exports by hundreds of billions of dollars.[9] Or, we will reluctantly amend our laws to make them WTO compatible by either dropping the border adjustment (which will reduce U.S. government revenues and generate large profit shifting problems) or dropping the wage deduction (which converts a progressive tax on business income into a regressive consumption tax, a simple VAT). Regardless of outcome, trade disputes of this magnitude are likely to generate substantial uncertainty, an unstable investment environment, and a threat to a trading system that has served U.S. interests well – a system we spent 50 years negotiating in the aftermath of World War II.

Exporting firms thus face large risks under the Ryan/Brady plan. Trading partners are likely to retaliate, and the world trading system may be permanently harmed. In addition, if the exchange rate does appreciate, that will reduce the gain from the export subsidy, yet losses are not fully refundable under the Ryan/Brady plan. This issue is also discussed further below.

3. At Proposed Tax Rates, the Ryan/Brady Plan Loses Revenue

According to the nonpartisan Tax Policy Center, the business tax features of the proposal are a large share of their estimated ten-year $3 trillion revenue loss. While the border adjustment raises revenue, that revenue is ultimately borrowed from future taxpayers, since it is the trade deficit that generates revenue from this provision. When trade deficits subsequently turn to surpluses in the future, the border adjustment would lose revenue.

The revenue loss is not inherently a result of the tax base under the Ryan/Brady plan, but rather the tax rates that were chosen, which are too low to generate revenue neutrality. Beyond that, the corporate rate chosen is intellectually incoherent. One of the advantages of this type of destination-basis cash flow tax is it curbs profit shifting by removing the incentive for shifting profits and activities abroad. The plan also exempts the normal return on capital from taxation, due to expensing.

Yet, if we are only taxing "above normal" profits – likely due to luck or market power – and the tax base is now immobile since it depends only on the location of immobile customers, why lower the tax rate below the top personal rate? The usual arguments for a lower rate do not apply.

Further, the discrepancy between the top personal rate and the business rate will create new avoidance opportunities as wealthy individuals seek to earn their income in tax-preferred ways, reducing their labor compensation in favor of business income. Companies would be inclined to tilt executive compensation toward stock-options and away from salary income, and high-income earners would be inclined to earn income through their businesses in pass-through form. Thus, tax revenue leakage in the personal income tax system is also likely.

---

[9] See, e.g., https://piie.com/system/files/documents/bown20170201ppt.pdf

Increases in the budget deficit are likely to increase the trade deficit, since countries must borrow from abroad (and run a trade deficit) whenever their spending exceeds their income, and budget deficits increase the U.S. demand for loanable funds. This deterioration of the trade deficit, if not properly understood, could lead to more rounds of protectionist trade policies, further harming the world trading system.

4. Such a Regressive Tax Plan is Not Warranted in the Current Economic Environment

According to the nonpartisan Tax Policy Center, the Ryan/Brady plan benefits the top 1% with a tax cut that is 1,000 times the size of the tax cut for the bottom four quintiles of the income distribution. The top 1% receive a tax cut that averages $213,000. The tax cut of the bottom 80% averages $210. The average federal tax rate falls by about 0.4 percentage points for the bottom 80% of the population, but it falls by 3.4 percentage points for the top quintile, and by 9 percentage points for the top 1%.[10]

This tax plan follows several decades of dramatically increasing income inequality, sharply declining shares of GDP that go to labor, sharply increasing shares of GDP that go to corporate profits, and middle class wage stagnation. Because of these trends, in terms of progressivity, tax policy should be moving in the opposite direction of the Ryan/Brady plan.

5. Many Large Technical Problems

As one example, it is likely that many profitable firms would show losses under the Ryan/Brady plan. Exporters will not have taxable revenue, but they will have many deductible expenses. The Ryan/Brady plan suggests unlimited carry-forwards, but this doesn't solve the problem for businesses with losses that may not be offset. There would then be a large tax incentive for exporting companies to merge with non-exporters in order for the losses to be more useful. Should our tax laws encourage ADM and Target to merge? That seems perverse.

There are other technical problems that remain to be worked out. For example, it is very difficult to deal with financial institutions and financial flows.[11] There are likely to be very large impacts on state government corporate tax systems, since they will no longer be able to "piggy back" on the federal corporate income tax base, and these problems have also not been carefully considered. Also, there are large transition effects associated with moving to a destination-basis cash flow system that would need to be carefully considered.

---

[10] See http://www.taxpolicycenter.org/publications/analysis-house-gop-tax-plan-0.

[11] The pure form of this tax leaves out financial flows entirely. An augmented form of the tax can capture financial transactions in the base, but this would introduce complexity as all companies would need to keep track of financial transactions, as well as whether the transactions occurred with foreign companies. There is also substantial ambiguity between what transactions are real and what are financial, and such ambiguity raises both technical considerations as well as opportunities for tax avoidance. For a more detailed treatment of these complex issues, see David Weisbach, *A Guide to the GOP Tax Plan – The Way to a Better Way* (Univ. of Chicago Coase-Sandor Inst. for Law & Econ., Working Paper No. 788, 2017). Also see Alan Auerbach, Michael Devereux, Michael Keen, and John Vella. *Destination Based Cash-Flow Taxation*. Oxford University Centre for Business Taxation. WP 17/01. January 2017.

Alternatives to the Ryan/Brady Plan

While the advantages of the Ryan/Brady plan are salutatory, the risks are simply too great. It does not make sense to risk the world trading system and the fate of many important industries. Large revenue losses that reward the top 1% with a tax cut 1,000 times the tax cut for the bottom 80% are not warranted. And, simply put, the plan is not ready for primetime; too many details need to be worked out; no country has tried a similar plan in the past.

Instead of moving forward with this plan, Congress should focus on a revenue neutral business tax reform that reduces the corporate tax rate and eliminates the major corporate tax expenditures including deferral, taxing accumulated offshore earnings in full. Eliminating deferral would eliminate the incentive to earn income in low-tax countries, by treating foreign and domestic income alike for tax purposes. Pairing that reform with a lower corporate tax rate need not raise tax burdens on average, although it would create winners and losers among corporate taxpayers. A more fundamental reform would require worldwide corporate tax consolidation; this would better align the tax system with the reality of globally-integrated corporations.

Taxing foreign income currently also eliminates the incentive to build up large stocks of unrepatriated foreign income, now estimated at $2.6 trillion. This income is often invested in U.S. capital markets, and it increases the credit-worthiness of U.S. multinational corporations, who can easily finance worthy investments. But corporations are inhibited from repatriation by the prospect of more favorable tax treatment if they delay, so this makes it difficult for them to return profits to shareholders. Indeed these concerns about repatriation give the multinational business community a large interest in corporate tax reform. Settling the future tax treatment of foreign income should be a key goal of these efforts.[12]

In terms of more incremental reforms, even a per-country minimum tax would be a big step toward reducing profit shifting toward tax havens and protecting the corporate tax base. A minimum tax would currently tax income earned in the lowest tax countries, and my prior work shows that 98% of the profit shifting out of the United States is destined for countries with foreign tax rates below 15%.[13] Other helpful incremental steps include stronger "earnings-stripping" rules and anti-corporate inversion measures such as an exit tax.

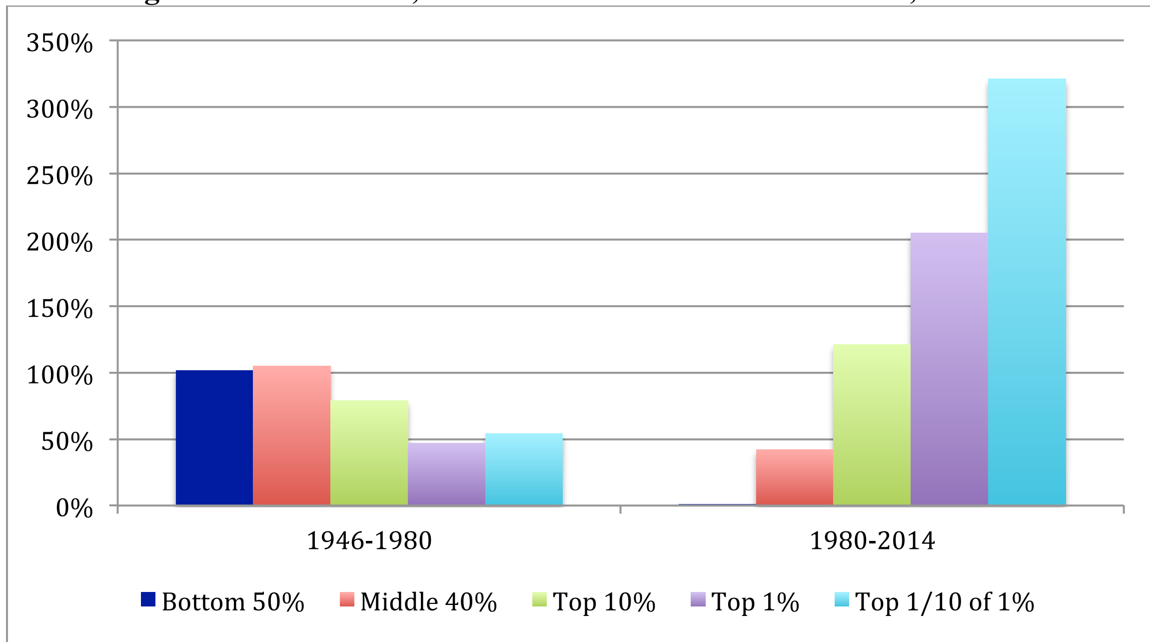
In general, making our tax system compatible with the global economy is an important goal. This involves several important changes. First, we need a simplified corporate tax system that actually collects the tax that is due. As it is, too many people waste their careers pursuing tax-related gimmicks and shenanigans. Profit shifting costs the U.S. government over $100 billion each year. Simple reforms like a per-country minimum tax – or better yet, ending deferral – would solve that problem and make our corporate tax system compatible with the global operations of multinational firms.

---

[12] Toward this end, the US Congress did a great disservice when they enacted a one-time holiday on dividend repatriation as part of the American Jobs Creation Act of 2004. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418. Ever since, companies have been more likely to delay repatriation in the hope of future holidays (or permanently more favorable treatment).
[13] *See* Kimberly Clausing, *The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond*, 69 NAT'L TAX J. 905, 905-934 (2016).

Second, but even more important, we also need a tax system that reflects the real struggles of the middle class. Too much of the economic growth of prior decades has ended up in the hand of those at the top of the income distribution, and middle class wages have stagnated.

Figure 6: Before 1980, Growth Lifted all Boats. Since then, not so much.



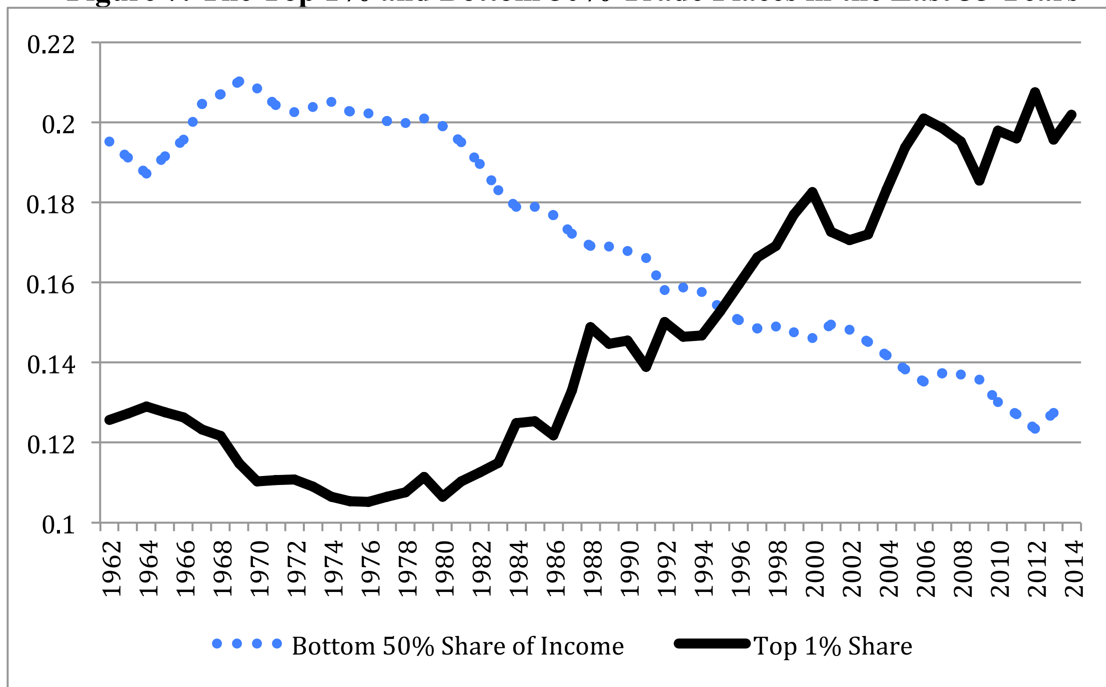
Note: Figures compiled based on data from Piketty, Saez, and Zucman (2016).[14]

This was not always the case. Figure 6 shows that pre-tax income growth over the period 1946 to 1980 exceeded 100% for the bottom 90% of the population, and growth in incomes were actually lower for the top shares of the population. However, between 1980 and 2014, the growth of the bottom 50% is literally invisible in the chart, at 1%. Growth in incomes for the middle 40% is 42 percent, and it accelerates from there, with growth of the top 1% exceeding 200% and growth in incomes for the top tenth of the top 1% exceeding 300%. As a result, there has been an increasing concentration of national income at the top of the income distribution. The top 1% now have a fifth of national income, 50% more income than the bottom half of the income distribution. (See Figure 7.)

These figures help explain why typical American households are not content with the pace of economic progress. The standard expectation that every generation would be better off than the one prior has been disappointed. Nearly 90% of children born in the 1940s out-earned their parents, but that share has fallen steadily. For children born in 1970, only 60% out-earn their parents; for those born in the 1980s, only half do.[15]

[14] See Thomas Piketty, Emmanuel Saez, and Gabriel Zucman. "Distributional National Accounts: Methods and Estimates for the United States." December 2016.
[15] See Raj Chetty et al. "The Fading American Dream: Trends in Absolute Income Mobility Since 1940." *NBER Working Paper No. 22910*. December 2016.

Figure 7: The Top 1% and Bottom 50% Trade Places in the Last 35 Years



Note: Data from World Top Incomes Database. Accessed 14 March 2017.

Our tax system needs to reflect these changing realities by making sure that tax cuts are directed to those that are *not* in the top 1%, focusing instead on the bottom 80% of the population that has been frustrated by our prior record of economic progress. The tax system can better serve American workers by expanding the earned income tax credit, by providing wage insurance for workers who have lost their job due to technological disruption or due to competitive pressures, and by making sure that tax cuts are larger for the middle class than for the rich. We also need to work to solidify the economic fundamentals of our economy. This requires responsible tax legislation that gives us the revenue we need for vital investments in education, infrastructure, healthcare, and other urgent priorities.

Thank you again for inviting me to testify today. I look forward to your questions.

Note: This testimony draws on other work by the author, and in some cases sections of text are excerpted. Interested readers are referred to the following articles by the author for more detail on the arguments above.

- "Problems with Destination-Based Corporate Taxes and the Ryan Blueprint." (with Reuven Avi-Yonah). 2017. *Columbia Journal of Tax Law.* 8. 229-255. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2884903
- "Competitiveness, Tax Base Erosion, and the Essential Dilemma of Corporate Tax Reform." 2016. (6) *BYU Law Review*. 1649-1680. http://digitalcommons.law.byu.edu/cgi/viewcontent.cgi?article=3075&context=lawreview
- "The Effect of Profit Shifting on the Corporate Tax Base in the United States and Beyond." 2016. *National Tax Journal*. December. 69(4). 905-934. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685442
- "Labor and Capital in the Global Economy." *Democracy: A Journal of Ideas.* 43. 2017. http://democracyjournal.org/magazine/43/labor-and-capital-in-the-global-economy/
- "Strengthening the Indispensible U.S. Corporate Tax." Washington Center for Equitable Growth. August 2016. http://equitablegrowth.org/report/strengthening-the-indispensable-u-s-corporate-tax/