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C O N T E N T S

C O N T E N T S (Continued)

P R O C E E D I N G S

MR. SAMUELS: We'll leave the back door open because we'll get some stragglers, but I think I want to get started to keep us on schedule. We have a very full agenda.

Good morning. Thank you all for coming. I am John Samuels, the head of taxes at GE; but today I am here in my capacity as Chairman of the International Tax Policy Forum. We are very pleased to be here today cosponsoring this conference with Brookings.

I think we have a terrific program today, and I would like to thank Brookings for helping to make this conference possible. I am sure you are all familiar with Brookings and the important role it plays in fostering research and dialogue on important public policy issues like the ones we'll discuss today.

You are probably not, however, as familiar with the International Tax Policy Forum, an independent group of more than 30 major U.S. multinationals.

So before getting into our program, I would like to spend a minute telling you about what the ITPF is, and perhaps the best way to begin doing that is, as I said before, to tell you what the ITPF is not.

The International Tax Policy Forum is not a lobbying group with an agenda for particular legislative changes. We have not and do not lobby for specific or even general changes in law or policy. Indeed, I doubt—in fact I am confident that—we couldn't reach a consensus among our members on a particular set of legislative proposals the membership is so diverse.

Instead, the ITPF represents a unique intersection between business and the academic community. It was organized 14 years ago when several of us realized that the accelerating integration of the world's economies was going to make international tax policy a central and important focus of the public policy debate here in the United States. And we believed that it was critically important that any public debate on a subject as important at the country as international tax policy be as rich, robust, and informed as possible. We also understood that it would be impossible to have an informed debate on a subject as complex as international tax policy unless that debate was grounded in a solid body of contemporary economic research and analysis.

And we were very concerned back in 1992 when we looked around and realized there hasn't been any meaningful economic research or analysis done in the international area since Peggy Musgrave's work in the early 1960s. And everyone recognized that the world of the 1990s was very different than the world of the early 1960s.

So to address this dearth of what was then contemporary economic research in the international area, we established the ITPF in 1992 with the expressed purpose of encouraging and sponsoring independent academic research in the field of international tax. Our hope was to produce over time a body of economic research that would provide the kind of sound tax policy underpinnings that would be necessary for any consideration of fundamental changes to our international tax system.

Now, fast-forwarding to today, some 14 years later, under the guidance of Glen Hubbard, who is the chairman of ITPF's Board of Academic Advisors, and Jim Hines, who is the ITPF's Director of Tax Policy Research, we are supporting a wide variety of research projects undertaken by leading academic economics in areas of international tax of interest to them.

Our research program is overseen by our distinguished and independent Board of Directors who, in addition to Glen Hubbard of Columbia and Jim Hines of Michigan, includes Alan Auerbach of Berkeley, Mihir Desai of Harvard, and Michael Graetz of Yale.

I think we are indeed very fortunate to have this enormously talented group of leading academic thinkers in the field of international tax policy to help guide our research program.

I want to be clear on a very important point. It is the stated policy and practice of the International Tax Policy Forum not to attempt to control or influence the subject matter or the conclusions of the research we sponsor. Indeed, I hope I don't have to tell you that no good academic would allow that to happen.

Instead, our goal has been to develop over time a body of objective analysis on how tax policy affects international capital flows, cross-border investments, to help policymakers make more informed decisions about the design of the U.S international tax system.

To date, we have sponsored or cosponsored seven conferences on important issues of international tax policy, ranging from the optimal design of a territorial system to the effects of foreign direct investment on the domestic economy. These conferences have spawned more than 30 academic effects of international tax policy, papers that we hope have advanced the state of our knowledge and have contributed to a more rational and informed public policy debate.

Today we are going to be talking about another important and topical issue of international tax policy—how to think about tax reform in an open economy, a topic that is certainly timely in light of the recent release of the report of the President's Advisory Panel on Tax Reform.

We are fortunate to have a blue ribbon cast of participants with us today. In addition to the presenters themselves, our discussants include leading government and academic economists with distinguished tax policy backgrounds.

It will be surprising if all of the participants in today's conference find themselves in complete agreement on the subjects that we will discuss. I am sure, however, that several of today's presentations will gender some live and, I hope, enlightening discussion.

In this spirit, I encourage our large and very well-informed audience to join in the discussion today. Remember—where there is heat, there is often light.

And we are fortunate to have as our luncheon speaker Edward Lazear, a Senior Fellow at the Hoover Institution and a Professor at the Stanford Business School, who was also member of the President's Advisory Panel on Tax Reform. He is certainly someone who is in a position to talk to us about important issues of tax policy.

Finally, I would like to express my appreciation and thanks to Bill Gale of Brookings who is under the weather and can't be here today, and to Peter Merrill and Jim Hines who, as research directors of the International Tax Policy Forum, have made this conference possible.

I'm going to turn the program over for a moment to Eric Toder, who is pinch-hitting for Bill Gale, and then we'll get to our main event, or our lead-off hitter, I should say.

MR. TODER: Thank you, John.

I am Eric Toder, and I am happy to welcome you here on behalf of the Urban-Brookings Tax Policy Center. This conference is part of our ongoing series that the Tax Policy Center has been participating in and sponsoring to try to raise the level of debate on tax issues and inform the public, and we are really pleased to have an outstanding panel here today.

I was asked to note that any comments that you make here will be recorded, so keep that in mind.

I'll just talk very briefly about the issues that we are discussing today. International tax reform poses really special challenges to tax reforms. We all in the tax reform business think a good tax system should minimize distortions particularly in how we treat different kinds of investments and let the market work. But in a world with sovereign countries having independent tax policies, it is really impossible to eliminate distortions on all margins, and the typical thing is that you can't equalize tax rates paid by U.S. companies on all investments regardless of location and at the same time equalize tax rates on all corporations in the same location.

While the rules for international tax are extraordinarily complex, there are choices between broad conflicting principles, and the Tax Reform Panel has addressed two of them. The first is whether to tax normal returns to corporate investment at all, or replace the corporate tax with a consumption tax, a cash flow-type tax. The second is if one does keep an income tax, should you tax income on a world-wide basis with credits, or should have a territorial system. And the third is if you have a consumption tax, there are many design issues within that, too, and one of the issues that will be discussed today is whether it should or should not be border-adjustable and what that matters, or what the consequences are.

So today's speakers will be talking about the implications of these choices for the location of investment and in consequence for trade flows, for the value of assets held by U.S. individuals and value of equities by U.S. corporations if there is a transition, and also, I suppose, foreign asset-holders.

And I anticipate we will be learning a lot about these issues today.

So I don't want to take any more of anybody's time, so I would like to pass the baton to Rosanne Altshuler who, if she weren't on the Tax Reform Panel, would probably be one of the critics on this session, because she probably knows as much about this topic as anybody else in this room.

So I'll turn it over to you.

MS. ALTSHULER: Thank you, Eric, and thank you for inviting me. I can tell you from my experience on the panel that it is much easier to be a critic than to actually be on the panel—much, much earlier.

I look forward to the panels that have been organized for today's conference, and what I want to do is to spend my time discussing the international provisions in the Panel Report.

Today my talk is going to be all about international, so I am going to let Eddie Lazear talk to you more generally about the report. So I am actually going to skip ahead to the next slide.

[Slide presentation.]

So let me start by saying that the panel focused on four big-picture reform approaches—reform of the current income tax system—and that was part of the Executive Order; one of our recommendations had to use the current income tax system as a base; second, a progressive consumption tax—and what the panel looked at was modeled on David Bradford's "X tax"; a partial-replacement VAT—what this lingo means is either add a VAT to the current system to buy down rates, or replace the corporate income tax with a VAT; and a national retail sales tax.

We ultimately made two recommendations—the panel ultimately made two recommendations. The report was unanimous. What this means is that the panelists unanimously believe that these two plans are better than the current system.

A simplified income tax plan, which I'll spend most of my time talking about today—just because the international provisions require more time to explain in that plan, not because it is a better plan or because I think it is a better plan—it is just going to take up more of my time. And a growth and investment tax plan—and this is our lingo—so the simplified income tax plan is the SIT, and the growth in investment tax plan is the GIT.

So the GIT is a progressive consumption tax, so it's like an X tax, modified to have a tax on financial income at the individual level.

Let me now turn to what I am here to talk about today, which is international tax. As I'm sure all of you are aware, we spent a lot of time in the beginning of this project going around the country holding public hearings. We had excellent witnesses all around and some very good witnesses, some of whom are in the room today, on international tax. And what I have done is taken some quotes from the witness, and this is basically what they told us about the state of the current internal tax system.

"A cumbersome creation of stupefying complexity." And this was from a tax lawyer. "Is there anybody who really understands these rules? I think the answer is no."

"It is difficult to overstate the crisis in the administration of the international tax system in the United States. Our current system is deeply, deeply flawed."

So our study of the current treatment of cross-border income concluded that it encourages wasteful tax planning, results in uneven outcomes for firms depending on their planning sophistication and circumstances, distorts economic decisions—in fact, likely distorts economic decisions to a greater extent and is more complex than a system that simply exempted active foreign business from U.S. tax.

And, despite its complexity, it raises relatively little revenue from the foreign income of U.S. multinational corporations. In fact, estimates suggest that—and these estimates, of course, are based on different assumptions about how you would exempt foreign income from taxation—but there are estimates out there that suggest that exempting foreign source income could actually raise tax revenue.

The panel found this disturbing. After our study and talking to many, many witnesses, we saw that there was no consensus from experts on reform options, and the staff found this very disturbing.

What was the panel approach for international? Well, we tried to have some goals. We tried to keep some big-picture goals in our minds. The panel wanted a system in which the tax cost of investing aboard did not depend on affirmed special circumstances.

Some panel members were particularly disturbed by the wide differences in firm-level effect of tax rates.

The panel wanted a system that would encourage growth. They wanted to lower the corporate tax rate. That was an important goal. There were many constraints on the panel, making it very difficult to lower the corporate tax rate, and one of the constraints that I didn't talk about was a constraint that the panel put on themselves, which was to repeal the Alternative Minimum Tax at a cost of $1.3 trillion over the 10-year budget window.

They wanted to lower the corporate tax rate—hey understood or believed that this was important—reduce incentives for wasteful tax planning, make businesses more competitive in their foreign operations, simplify the rules, and there was a desire to require some disclosure of where profits are earned.

These are tough goals to try to satisfy, but you want to think big when you are working on a panel like this.

The focus on the panel was on outbound policy. What I mean by this is the panel didn't address inbound policy directly. Instead, they wanted to encourage inbound investment by making the U.S. a more attractive location for operations.

Again, after the study of international tax, there seemed to be four distinct options. One option would be to do nothing, and that was immediately rejected—why, I don't know.

[Laughter.]

It would have made our job a lot easier, and it would have made a lot of people—and I am sure some of them in the room—a lot happier.

Incremental reform—for example, we could have accelerated some provisions of AJCA [ph.], not necessarily a bad idea; the interest expense allocation rules that use worldwide fungibility; the reduction in the number of foreign tax credit baskets; the recharacterization of overall domestic losses. This would be a very incremental approach since many of those provisions are going to take effect in 2007 anyway. And this incremental approach was also rejected.

The panel wanted to look at big-picture options. That's what they thought they were asked to do. Another option that was looked at and studied was to tax financial income, book income. Using book income may provide a more level playing field among corporations and reduce the widely varying effective tax rates that are fund under current law.

This was an option that we looked at for quite a long time, and we saw that there were so many important considerations, one being that it is not going to be attractive as a policy option unless the corporate rate is substantially lower than current law, and it did not look like we were going to be able to get that rate down to one that we were comfortable with, and we had experts that we talked to at public hearings give us estimates of what they thought the rate would have to be to go worldwide, for instance, without deferral, and we couldn't get down to that type of rate of below 30 percent, for instance.

There were also substantive policy choices, and I will not have time to go through them, but there are consolidation issues, and there are issues that involve corporate tax rules governing things like tax-free mergers and separations and the tax distributions of appreciated property to shareholders that would be impacted.

So I think this is a policy option that deserves further analysis, but it is one that was not included in the report.

Ultimately, as we all know, in the simplified income tax, a dividend exemption proposal was recommended. I go back and forth—I like to call it "dividend exemption" but nobody likes to call it that; "territorial" is just a better word and just resonates more; so territorial.

It is important to note that the panel proposal, for those of you who have looked at it closely, is not the JCT option presented earlier this year. It has some of the features of the JCT option, but it also deviates in some of the expense allocation rules that I'll get into later.

On the territorial tax regime, briefly, dividend exemption. Income earned abroad by foreign affiliates, and this is subsidiaries and branches, just like in the JCT report, would fall into two categories. You would have active dividends, which would fall under foreign business income, which would be exempt from U.S. taxation, and then you would have mobile income which would be tacked to the U.S. parent on a current basis.

The foreign tax credit system would as a result serve a much more limited function. You would still have foreign tax credits; they would be available to offset foreign tax paid on mobile income, including withholding taxes. The foreign tax credit would still be available. This may not have been spelled out exactly in the Appendix to the report which is a very important part of the report. Foreign tax credits would be available for withholding taxes on royalties, and the foreign tax credit basket rules would be replaced with—you would only need one basket, a single overall tax credit limitation.

You would need to have expense allocation rules, and here is where things get kind of complicated. These, the panel believes, are reasonable expense allocation rules; they make economic sense, and again, some of them deviate from expense allocation rules that have been discussed in the past and prior proposals.

The general rule is that business expenses that are attributable to exempt income, to exempt foreign earnings, wouldn't be allowed as a deduction from U.S. taxes. Interest expense would be allocated between U.S. and foreign income on a basis that takes into account all debt, both U.S. and foreign. This would be using the new AJCA [ph.] rules. Parent GNA [ph.] expenses not directly charged out would be allocated to foreign income pro rata based on worldwide income.

And, skipping to the next slide, as far as R and D is concerned, there would be no parent R and D expenses allocated against exempt foreign source income because that royalty income that is generated by those expenses would be fully taxed at the U.S. rate.

So that is a very brief explanation of the expense and allocation rules. I can answer questions on them either now or later.

It took me a long time to convince some of my colleagues on the panel that details really do matter, and in particular, the details here are extremely important and that people are going to want to know every single detail.

Now, these exemption and allocation rules, as we recognize in the report and write specifically in the report, will put pressure on the transfer pricing regime. We recognize that, and we are going to have to continue to devote resources to transfer pricing.

International tax is extremely difficult. Maybe you solve one problem, but you have another problem on the other side, and the question is to try to figure out what problems to go after. Subpart F rules, of course, would be required. And I put this on the slide—I didn't say this in the beginning of the talk—but under the simplified income tax, the SIT, the corporate rate would be lowered to 31.5 percent, so you have a lower rate.

There are some other international provisions, or what I like to think of as international provisions under the simplified income tax proposal. There is integration. The panel was very eager to have a system that provided some integration, and this is how this integration would work.

The shareholders would exclude 100 percent of corporate dividends paid out of income subject to U.S. tax. So if the income has been taxed at the corporate level in the United States, then it is not taxed at the shareholder level. That's the rule.

Corporations would notify shareholders, which means, let's say, that you are a U.S. multinational, and none of your income has been taxed at the U.S. rate, because let's say that for some reason all you have done is generated exempt foreign source income. You just have active dividends 100 percent. The shareholders would have to pay tax on your dividend distributions.

Another way of saying this is that corporations would notify shareholders regarding the proportion of dividends that can be excluded based on the amount of income subject to tax in the United States relative to worldwide earnings in the prior year. They also would be required to disclose domestic and worldwide revenues and income reported for financial accounting purposes. The idea of this is to make the system more transparent.

What about capital gains? You would exclude 75 percent of capital gains received by individuals' sales of corporate stock in U.S. corporations if they were held for more than one year.

Okay. There are other alternatives that were considered, that maybe should be considered, to this integration scheme. For instance, you could set a single dividend exemption percentage applicable to all U.S. companies and make it revenue-neutral and have it be the same rate on dividends and capital gains so that you wouldn't have any incentive favoring share repurchases over dividends.

You could use an excludable dividend account concept, like in the President's 2003 dividend exemption proposal. That was rejected as being too complex by the panel. The panel made a tradeoff of simplicity over more precise calculations.

There is also a corporate residency provision in the simplified income tax, and this is something that just takes the AJCA provisions and takes them another step. It is exactly the JCT option. So again, I can answer questions about that later on. I just want to move forward.

Concluding remarks on the simplified income tax proposal—and I guess these are my remarks, not the remarks of the panel—I think the territorial proposal deserves further study. The goal was not to draft legislation. I don't think that anybody could possibly expect that a panel of nine people working to reform the entire individual and corporate income tax system could come up with legislation that is ready to go to Congress or ready to go to the President. We did not do that; that was not our goal.

We wanted to present the Treasury Secretary with a starting point. There are still details of this regime that need to be worked out. We need good people studying these regimes. We need the Treasury to look at this more carefully.

Another remark is that the plan does represent a refinement of prior proposals. We did put a lot of thought into this, but again, we didn't write legislation. Legislation can certainly be written using what we gave as guidelines.

I think what the plan does is it allowed policymakers to focus on important questions regarding the taxation of cross-border income in today's global economy. So basically, what we are saying is look, we are going to exempt active income from U.S. taxation.

What that means is that firms are no longer going to be able to shelter royalties with excess credits, so they are going to be taxed on their royalties at the U.S. rate.

So, what this gives us an opportunity to do is to step back and say should royalties be taxed at a lower rate. Maybe that's what we want. Maybe what we should have is a territorial system with a lower rate on royalties. I think that putting forward a proposal like this allows us to focus in on that type of question.

Maybe we want to subsidize foreign direct investment abroad, and maybe the way we want to do it is having no interest allocation rules, no expense allocation rules, have a tracing system like the European countries do, and have negative effective tax rates. Maybe that's what we want. This allows us, using this as a starting point, to talk about some of those questions.

We have that under the current system, but it is only available to firms that are in certain situations. This way, everybody is going to be taxed on their royalties, and we decide as policy makers whether or not we want to continue.

This is one of the most difficult areas in tax reform. That is my concluding remark on the simplified income tax.

Now, in my remaining time, I want to talk a little bit about the growth in investment tax plan, and then, hopefully, I'll have time to answer some questions.

The panel started with a progressive consumption tax, and I think a shorthand for this is an "X" tax. Businesses would be taxed on business cash flow at 30 percent, and the middle of the slide gives you what business cash flow is. It is sales minus purchases from other businesses, minus wages and compensation, and that gives you business cash flow, which would be taxed at 30 percent under the GIT. And wages and compensation, the way this works, is that wages and compensation are taxed at the individual level with progressive tax rates. There is expensing of new investment, but no interest deductibility.

So you have an effective marginal tax rate on new investment of zero. It should be very powerful for investment for growth.

Now, international. International, as with the income tax, with a consumption tax, you have some very difficult questions that you have to deal with.

There is a question about what you want your tax base to be. Do you want your tax base to be domestic consumption or domestic production?

The panel recommended using a destination basis. Using a destination base means that the tax base is going to be domestic consumption wherever it is produced. That is in contrast to using an origin basis—which I should have put on the slide, but there was too much on the slide already. An origin basis would have a tax base that is equal to domestic production. The panel chose a destination basis.

How does this work? Sales to customers abroad which are not consumed in the U.S. would be exempt from tax, while purchases from abroad which are consumed in the U.S. would be included. So that means the exports are exempt and imports are taxable.

What this means, though, is that you need border adjustments to make your system destination-based. And just as an aside royalties received from abroad would be exempt, because they are payments for the export of technology. They are payments for the export of an intangible.

So the choice was made to go with the destination basis tax, which means that we would need border adjustments, which I'll get to in a second.

There are some real advantages. The panel believes that there are some real advantages to using a destination basis. One is the transfer pricing implication. You get rid of transfer pricing. It is out of the picture. Since the base is domestic consumption, there is no incentive to over- or under-charge for sales with related parties. And this is, I think, a big advantage.

The other advantage here has to do with the administration. When you impose a destination basis, what you are doing is closing the system. Closed systems only allow businesses to claim deductions that are offset by current inclusions elsewhere. If there is a deduction, then there is going to be an inclusion somewhere else. That's important, because that means that you are going to prevent U.S. businesses from structuring transactions with foreigners to avoid U.S. tax.

So there are some real administrative advantages to using a destination basis tax. Destination basis is what was chosen by the panel.

So, moving forward, is this an unusual choice? No. It would be unusual if we went origin-based. VATs in place around the world all use a destination basis.

Are there problems? Yes. Are they big? Well, yes. It is a GATT-WTO problem. Under GATT, direct taxes are not border-adjustable, but indirect taxes are. The problem is that no country has a tax like the GIT. Nobody has a progressive consumption tax. So it is not clear at all, and what this tax looks is a corporate income tax with a tax on wages.

So it is quite possible that you would have a problem with GATT, and in fact, the U.S. Trade Representative would likely be required to negotiate with trading partners.

The panel's conclusion was that the historical distinction between indirect and direct taxes has no economic significance for border adjustability. GATT imposes really a crazy rule. A VAT can be estimation-based, but if the VAT is amended to be a two-tier consumption tax for the sole purpose of making it progressive, the system cannot be destination based. It has to be origin-based. And hence, arguably, it has to be nonadministrable because you have these huge administration problems when you go origin-based.

So there is a GATT problem; we would most likely have to renegotiate with our trading partners. But on the other hand, the GIT—I almost said the "X" tax—the GIT should be border-adjustable. It is a cash flow tax. It is economically equivalent to a VAT with a wage subsidy. It should be border-adjustable.

With time, let's see—do border adjustments matter? Not when switching between a destination and an origin-based tax. Theoretically, border tax adjustments should not confer a trade advantage, and actually, Mihir and Jim, this was part of ITF research that has some interesting results on whether or not border tax adjustments matter, actually looking at the data, which I think that very little research has done that.

The switch from an income tax to a consumption tax would have economic implications, and they would be favorable to investment in the United States.

If you are switching to a consumption tax—this is a tax in which there is no tax on capital in the margin—you obviously are going to be encouraging investment, and there would possibly be a trade advantage here.

There are some issues involved with implementing a border-adjustable cash flow tax. There is the problem with the refunds at the border. First of all, at what rate are we going to refund exports; once you decide on the rate, there are evasion problems, an d I hope that all of these issues will come up later—I'm sure—I'm sure every issue that I have raised, we will talk about until 1:30 today. Evasion is a problem with VATs. This is something that our talking to international organizations helped us understand. The higher the rate, obviously, the bigger the problem. There have been export scams in Europe, and we have to be concerned about that. There are transition implications. There are possible transition problems. In fact, the panel would phase in border tax adjustments. And then, there are some treaty problems, and one is that it's possible that we would have to renegotiate all of them.

[Laughter.]

But I think that there is a way to get everybody to the table. What you do is you keep your withholding rate, so that your treaty partners would have something to gain by coming to the table.

So there are problems, but I think the destination base is definitely the way to go, and the GIT is a very attractive task, and we did think carefully about all of these issues.

There is also the issue that once you turn that progressive consumption tax into the GIT, is there an impact on the legality of border adjustments. There really shouldn't be, but it might be harder to argue that you have a consumption tax, even though it still is a cash flow tax. And then there is the problem of incorporating yourself to evade—or, using businesses to evade the tax on capital. You are going to need some sort of an anti-deferral regime. Of course, that's not an international issue; I don't know why I put that up.

Finally, to conclude, as you know, there were two options that were put forward—the GIT and the SIT. But we also have a very nice chapter, I think, on the value-added tax. And as far as international is concerned—and again, this is speaking as Rosanne Altshuler, Associate Professor at Rutgers University—as far as international is concerned, this solves a lot of your problems. If you have a VAT, just add a VAT to the system, you buy down rates. Treasury did just incredible work for us, and they said that we could have a revenue-neutral system that had a top individual rate of 15 percent, a corporate rate of 15 percent, making the U.S. a tax haven, and a 17.6 percent tax-exclusive VAT rate that would be revenue-neutral.

If you lower the rate, you reduce a lot of problems. You would still have the refund problem of the VAT—there is still that potential for abuse—but it is not at 30 percent anymore; it's at 17.6 percent.

I'm not even sure there are any transition problems—well, transition to the extent that now corporations that were only paying VAT when they operated abroad would also pay VAT when they operated in the United States, and then you have small corporations that don't pay VAT at all that would have to pay VAT, and there are probably other transmission problems that I am missing. But it is border-adjustable automatically, so there are no border adjustment problems.

So the international consequences, if you are just thinking about international, are just a lot more certain—but that's not an endorsement; that's just a discussion of the international aspects of VAT.

I think I am exactly on time, so I don't know if that means I can take questions or not.

Do you want to just continue on?

MR. SAMUELS: No, no. Let's take questions if you're willing to take a few.

MS. ALTSHULER: Sure, I'll take a few.

Yes?

QUESTION: Rosanne, I have a question about how the border adjustment works under the GIT tax. My concern is whether that tax is basically a consumption tax plus a tariff because of how the wages are taxed at the individual level, with progressive rates and deductions, I think, for how many kids you have and how much medical care you consume and so on. So the 30 percent rate becomes 18 or something with all the deductions. But when goods are imported, it's at 30, so it looks like it is a 12 percent tariff in addition to the subtraction method VAT type or X tax type—which I don't have any problems with a border adjustment of it. Of course, there is a legality question with WTO, but to me, effectively, with all the deductions on the ages side, it looks to me like you do have a tariff, or you have discrimination against imports.

MS. ALTSHULER: Well, first of all, why are you asking me this? You are one of my colleagues, and we worked on this together.

[Laughter.]

MS. ALTSHULER: Just as an aside. I thought you were somebody who was going to ask me about the baseline.

I like to use as a starting point something that I call the "credit invoice X tax." A credit invoice X tax is a VAT. You can take the X tax, and you can take the progressive consumption tax, and it is exactly equivalent to a VAT if there is only one rate at the individual level. So that is your starting point.

I think there is a question of whether or not—the short answer is I'm not sure exactly how we would implement it. I think you would implement it at that top rate. And I am not sure if there would then be an argument that we were imposing a tariff. I think you would implement it at the top rate and just say this is equivalent to a cash flow tax with a progressive wage subsidy. I think this is for the U.S. Trade Representative to look into. There is an issue here that you are raising with the fact that a VAT doesn't allow for the deduction of wages whereas this tax does allow for the deduction of wages. So you would be giving too much of a refund at the border to the extent that you have a progressive income tax.

But Allen is going to follow up—I thought you were.

MR. AUERBACH: I have a related question. I'm not going to ask anything about the legality of things, since I don't know anything about that.

But you said that you were going to go to a territorial system under the simplified income tax.

MS. ALTSHULER: Yes.

Mr. AUERBACH: And you would have transfer pricing problems there. And then you said you were opting for a worldwide or a destination-based system under the growth in investment tax because it alleviated all the problem of transfer pricing.

MS. ALTSHULER: Yes.

MR. AUERBACH: So the question is were two different groups of people making the decisions? Why is it better to avoid transfer pricing problems under one tax base and to exacerbate them under the other?

MS. ALTSHULER: Well, we could have exacerbated them under the consumption tax, too.

[Laughter.]

MS. ALTSHULER: And to do that, we could go with an origin base, or keep them exactly the same. So I think when it came time to think about international, we said let's go into the income tax system, and with an income tax system, what type of big-picture reform—remember, the panel wasn't interested in incremental reform. It wasn't interested in going in and saying let's look really carefully at the earning-stripping [ph.] rules and see what we can do.

So they thought that the big-picture reform was not keeping the status quo, but going territorial. Territorial solves a lot of—not solves, but it has some nice efficiency properties, it has some simplification potential, but we would be lying if we didn't admit that it also had this transfer pricing problem.

So you did pinpoint a place where there are differences in the two plans, and transfer pricing is one of them. So you have chosen to—you are saying that the best of income tax world is territorial, and you are going to keep your transfer pricing problems. Now we are doing a consumption tax. What's the best there from a policy perspective?

Well, it turns out that the panel believes that for administration—GATT problems aside—for administration, destination-based is the best, and it has this great transfer pricing implication. You no longer have the transfer pricing problem.

I guess I don't see a big problem here. I mean, there were different groups.

MR. AUERBACH: Is the point that a worldwide system was judged to be unworkable under an income tax, but not under a consumption tax?

MS. ALTSHULER: Yes, yes. I don't know why you are called it a "worldwide system," why you called destination basis—

MR. AUERBACH: Well, you're paying attention to things that happen when flows cross borders.

MS. ALTSHULER: Right, and just as an side, the question I thought that you might ask me is, with the VAT, what we did with the VAT and what we had Treasury simulate for us and score for us was keeping territorial at those rates. But you wouldn't necessary have to do that. You go down to 15 percent, and you might just do worldwide without deferral. We'll ask the representatives from corporations here how they feel about it.

Yes—and then I think we should move on.

One last question, please.

QUESTION: I think this proposal is such a stimulating reform for the international taxation side, and I think it is a very big stimulus for the authorities all over the world, including the Japanese. But I think this is not so simple as you try it, and it is very complex to understand.

One element I want to ask you is about dividend exemption, and I think the reason to do this is that the foreign tax is so heavy on the profit of foreign subsidiaries, that the foreign tax credit is bigger than the tax gain for the U.S. Government. So foreign tax credit would reduce the tax amount for the U.S. authorities.

But why don't you recommend a more rigid limitation to the foreign tax credit or dividend from abroad? That is one question.

The other question is you try to have integration of profit taxation of corporations, but when the dividend of a subsidiary is taxed by the foreign government, and when is it not exempted for the shareholders of the United States, there should be a double taxation. Double taxation for that matter is not resolved, although for the U.S.-origin income, the double taxation is not there between the subsidiary and the U.S., and also between the corporate level and shareholders level, but for the dividends from abroad, still there is the double taxation.

MS. ALTSHULER: Thank you for the questions. It is nice to hear somebody say something nice about the report also.

Let me answer the second question first. I think the second question is, look, you've got a firm, and it's operating in Germany, paying taxes in Germany, possibly at—I guess Germany is changing their rates, but let's say at the same rate at the United States—they paid tax at the corporate level. It just went to a different first.

Why shouldn't that be excluded? That was a panel decision. That's a question to ask the panelists, but there was a problem of complexity. It would be very complex, and there were the excludable dividend accounts that were rejected. So I think there is complexity, and you could also say that this is a policy to make sure that you don't have double taxation, but by double taxation, you mean in the United States.

So, yes, your interpretation of that provision is correct, and again, one of the important focuses of the panel was on simplicity, and there are tradeoffs—there are tradeoffs everywhere—so this was a simplicity tradeoff.

Your second question was about making foreign tax credit rules more stringent. I'm not sure exactly what you mean by that, and within a definitive exemption system, you think the foreign tax credit rule should be more—maybe we should talk about that question afterward instead of now, because I didn't understand that.

So thank you very much.

[Applause.]

MR. HUBBARD: I am Glenn Hubbard, and I'll be moderating the next couple of sessions. I guess, whatever their formal title in the program is, having just heard Rosanne's work—and by the way, I think Rosanne has done an enormous job on this project—the way I would call the sessions to come is "Will Secretary Snow Sit for GIT"—that is this session—the next session is "Can to GIT to SIT?"

[Laughter.}

The two topics that we are about to talk about I think are absolutely central in thinking about tax reform and tax policy generally. IN this session on "Effects of Tax Reform on Foreign Direct Investment," I think we learn quickly than whenever we deal with what seem like details in the international tax code, we call into question, frankly, the entire corporate tax. We will see balances over discussions over how to think about competitiveness on the one hand versus politicians' frequent concerns about runaway plants on the other, which tax rate should we be looking at, how do we think about integration—the panel has tee'd that up, how do we think about that for foreign direct investment—and what should the norms for tax reform be?

We have two outstanding panelists on this this morning, Jim Hines and Mike Devereux, so without further ado, I'll turn it over first to Jim.

MR. HINES: I agree with the last questioner that Rosanne Altshuler's very nice presentation somewhat oversimplified the discussion of the panel's report, and I'll see what I can do to undo that in my discussion.

What I want to talk about is the impact of tax reform on foreign direct investment, and we can ask the question how does tax policy affect foreign direct investment.

There are really two channels of influence. I put them in two categories—the obvious and the less obvious. Both are important, and as the slide says, just one is a little more obvious than the other.

The obvious point is that when you change tax rates, you change after-tax returns if nothing else happens. So, for example, if you were to lower tax rates, then you improve after-tax returns, and improving after-tax returns encourages all kind of investment include foreign direct investment.

So this very simple observation carries implications for both foreign and domestic taxation. Low domestic tax rates encourage inflows of direct investment from elsewhere. The President's Tax Reform Panel devoted less ink to this point, but it is certainly true that if you make the United States a more attractive place to invest, you can expect more investment both from American sources and from foreign forces.

The second point is that heavy taxation of income earned abroad discourages outbound foreign direct investments, again for obvious reasons—if you get less of an after-tax return, of course, you can't expect people to do as much of that.

Lower foreign tax rates have stronger attractive effects for investors whose home governments tax on a territorial basis than they have on investors from countries taxing on a worldwide basis, although both are affected.

Another way to put that point is that there are some countries that effectively exempt virtually all of foreign income earned. France would be an example. And the incentives are stronger for French companies to locate their foreign investments in low-tax locations because they basically get to keep all of the tax-saving, whereas for investors under current law from the United States or Japan or places like that, you don't necessarily keep all of your tax saving in foreign locations because there is a residual home country tax that may apply, so a tax saving abroad may or may not translate into a total tax saving for the investor.

So those are kind of the obvious points. You might ask what evidence we have been able to amass in order to evaluate the significance of these incentives. There is quite a bit of evidence, actually.

The evidence consistently shows that there is considerably more foreign direct investment in low tax places and less in high tax places than you would predict based just on economic fundamentals. This should not be a shocking observation to people, but it is reassuring, anyway, that the data bear this out.

As one example which I put on the slide, if you look at the data for 1999, the small tax havens around the world accounted for less than one percent of the world's population. Tax havens are very low-tax foreign locations, and some countries have extremely low taxes. Those tax havens account for less than one percent of the world's population and about 2 percent of the world's income; yet for American firms, they account for 8.4 percent of their foreign investments, property, plant and equipment investments. I should quickly add that this is not financial investments. This is factories and business equipment and stuff like that, in 6.1 percent of labor compensation abroad.

American investments are more heavily concentrated in low-tax places than they are in high-tax places, all other things equal, and certainly there is more activity there than you would predict based on the populations or the incomes of these places. And Americans have less of an incentive to locate in tax havens than investors from France and Germany do. So we have good data on American investments, but I'm sure if we had better data on French and German investments, we would find that this is even more true for them.

It simply reflects the fact that if you can get a greater after-tax return, you have to expect that people are going to do more business activity in a place.

Much of the discussion about tax havens, these very low-tax places, is about financial transactions that are often routed through tax havens in ownership and so forth. But this evidence about the property, plant and equipment is not about that at all. There is just more economic value being produced in these places than you would expect if they were not such attract tax places.

Is there more evidence? Oh, yes. The statistical studies that Rosanne Altshuler and a number of the room have done over the years consistently find that the location of American foreign direct investment abroad is extremely sensitive to tax rate differences. A 10 percent difference in foreign tax rates—it depends on the study and the time being covered now—but 10 percent differences in foreign tax rates are associated with between 10 and 30 percent differences in amounts of foreign direct investment. It is really quite sizeable effects, and you have to look at the data cross-eyed not to see that there really are their sizeable effects. There is much more investment, all other things equal, in low-tax places and less in high-tax places.

There is also ample evidence—this is a little more controversial, although to my eye—there is ample evidence as well of the impact of home country taxation. Investors from territorial countries such as France or Germany are more sensitive to foreign tax rate differences than our investors from countries that tax on a worldwide basis, such as the United States right now. So not only are their incentives stronger, but it appears to be the case that these territorial investors are more sensitive.

Further more, tax treaty provisions such as tax-bearing appear to encourage greater foreign direct investment as well. So it really takes two to tango in the international tax area, and it is the combined effect of host country taxes and home country taxes that create the incentives that businesses appear to respond to.

So that's first the obvious bit. What is the less obvious bit? Tax rate differences encourage tax avoidance. Rosanne referred to it as sort of a side matter in her presentation, but we can think of plenty of examples of tax avoidance that do not include simply where you locate your factory. There are things like the use of debt to finance investments in high-tax countries, and the use of less debt or equity to finance investments in low-tax foreign countries. It should come as no shock that firms adjust the financing of their foreign investments in part with taxes in mind.

The tax avoidance associated with tax rate differences can then itself feed back to affecting foreign direct investment patterns. How does it work? Well, one benefit of locating in a low-tax jurisdiction is that it becomes possible to use financial or other transactions to report taxable income that might otherwise have been attributed to high-tax jurisdictions. One of the benefits of being in a low-tax place is that the income that you are able to report there is going to be taxed at a much lower rate, and if you can adjust your financing so that you change the location of your debt, for example, in order to put more debt in a high-tax place, that will increase your taxable income in the low-tax place and reduce it in the high-tax place to the advantage of the taxpayer. And that's part of the reason why low-tax jurisdictions are so popular.

What is the evidence on this? Well, there is evidence about the use of debt by American countries, and I presume it would be even more true of foreign companies if we could get the data. Ten percent higher local tax rates are associated with 2.8 percent higher debt-to-asset rations, and that is looking at American companies around the world, and studies consistently find that after-tax profit rates of American firms are lower in high-tax foreign locations.

So the pattern of where companies' investment and how the tax avoidance associated with the investments goes is sensitive to tax rate differences.

So this is what we know. The question is what are the implications for reform. How should this inform our thinking about tax reforms?

A couple of observations here. First, there is every reason to expect that fundamental U.S. tax reform would be associated with significant changes in inbound and outbound foreign direct investment. I emphasize, by the way, inbound as well as outbound. If you are in the United States, you tend to think about what would be the behavior of American companies in response to tax reform, but it is just as important to think about what is the behavior of companies from around the rest of the world, because there is a huge amount of inbound foreign direct investment in the United States, and we have to think about what would be the implications for that.

Second, U.S. tax rate reductions are likely to stimulate greater foreign investment in the United States—again, no shocker there. That's the pattern around the world. If you have lower tax rates, you increase after-tax returns, and you should expect more investment as a consequence, including more inbound foreign direct investment.

Third, reduced U.S. taxation of foreign income would have significant effects. What would these be? The first effect is that American investment abroad would become even more sensitive to foreign tax rate differences as the credibility of foreign taxes becomes less important.

So if you moved to a territorial system, a system of exempting foreign source dividends, you would expect that American investments would get to be more tax-rationalized abroad. That is, an American investor right now doesn't experience the full benefit of locating an investment in a very low-tax foreign location such as Singapore, and the incentive to do so would become stronger if you exempted dividend income earned in Singapore.

The second point is that the reforms would encourage greater U.S. investment abroad and greater foreign investment in the United States. These really go hand-in-glove together. The point is that there is a tendency to think just on one side of this equation, that if you were to embrace a reform that reduced U.S. taxation of foreign income, there is often a concern expressed that that would lead to less business investment in the United States, it really doesn't follow, and part of the reason—

[TAPE 1, SIDE B]

MR. HINES [continuing]: —you would have an accompanying increase in foreign investment in the United States. So you would wind up with basically more liquid business investment going in and out of the country, and much of the modern thinking is that that would be much to the benefit of the American economy, because that type of liquidity of business investment rationalizes things; you create more value that way, and that is more income for everybody.

In particular, there has been some recent thinking that aligning the U.S. tax system to make it look more like the tax systems of the rest of the world would have the advantage of improving the pattern of ownership of business assets around the world and therefore increase productivity and increase national income.

So in summary, there are a lot of exciting issues raised by the panel report. There is simply no question given what we know about the fluidity of business investment that these are important issues, that they are likely to have big consequences. The fact that this is a hard area to think through does not mean that the consequences are probably going to be significant, and with many of the panel recommendations, I like others have my quibbles with some of the things the panel has recommended, but the general thrust of what the panel has recommended I think would auger greatly to the benefit of the U.S. economy.

MR. HUBBARD: Thanks, Jim.

Mike?

MR. DEVEREUX: Thanks very much for much for inviting me. It is a pleasure to come over and join in the debates in the U.S. I am the light relief from Europe, and I came here expecting to talk about tax and foreign direct investment, which is the title of this particular session, but when I talked to Jim and Glenn a couple of days ago, they asked me to talk about integration, which is all European countries have different integration schemes, so I am supposed to come and talk to you about that.

The link between that and international flows may not be immediately apparent, but actually, it turns out that it is quite important. Actually, what I am about to talk to you about from evidence from the UK is that actually, the impact of the UK integration scheme really depends very much on the UK being a small open economy with international portfolio flows, at least, rather than international direct flows.

So I'll skip through most of these because Jim has already spoken about these things, and in the interest of time, I'll move straight on.

The thing I want to talk about is the integration scheme in the UK, and I want to tell you about some research I have done, and we can discuss how relevant is the U.S. case. And then I'll just finish off with a couple of comments about the proposal for the territorial system.

So we had a big tax reform in the UK in 1997. Basically, until 1997, UK pension funds—well, actually, the data is not exact here—they were 22 percent of UK equities. We add in the pension fund business of insurance companies, which is taxed in the same way, then the figure is probably closer to 30 percent. So, something like 30 percent of UK equities are owned by these funds which are tax-exempt in the UK. Not only were they tax-exempt; they were effectively subsidized by the integration scheme in the UK, so that for every 100 pounds of cash dividends paid by a UK company to a UK pension fund, the pension fund could then go to the government and collect an extra 25 pounds. So every 100 pounds is worth 125 pounds.

Effectively, that was really only liable for UK-source income. For foreign-source income, the companies had to be a tax which effectively offset that rebate, so there is tax paid, unrelieved ACT [ph.] was paid at the level of the corporation, which effectively offset that tax rebate.

So this is very like the proposal of the Tax Panel, that there be reduced-dividend tax rates or dividends paid by U.S. companies, but only out of U.S.-source income. That's effectively the same as we had in the UK.

The cost of paying this rebate was about $5 billion a year, which is about 25 percent of UK Corporation tax revenues, so it is pretty good in UK terms.

And in 1997, a new Labor Government came into power and abolished this pretty much straightaway. This was their first act in the first budget. I think they needed the money to do other things with.

So the question is what happened as a result, and there are three things we can look at—prices, dividend policy, and investments. So here is a picture of the stock market index between 1995 and 2002. The vertical line is when the tax reform took effect, and as you can see, there is a huge fall in the stock exchange corresponding to the massive removal of the subsidy—or not, as the case might be, but nothing happened to stock prices.

Now, just looking at the stock exchange index doesn't really tell us all that much. There may be other things happening at the same time. There is a paper in your package where, with some coauthors, I have tried to look in much more detail about what happened to share prices as a result of this tax reform, and there is a kind of established methodology that may people have used to look at what happens to market values on "x" div days, as the share price goes from [inaudible] div to "x" div. In principle, one can trace that and try to figure out what the implied tax rates are.

We did a lot of that work in the paper, which I won't talk about now because there is very little time, but basically, we can find no systematic change in firm valuations as a result of this tax change. Remember, this is a massive tax change for a coup of shareholders who are getting on to close to one-third of UK equities. So the question is why was there no effect.

I have an answer to that, as to why there is no effect, and this is where the international portfolio investment comes in. There is a well-known body of theory which looks at what effect we would expect on share prices for a group of shareholders who face different tax rates. Basically, what the theory says is you take a weighed average of those tax rates across the different shareholders, and it is the weighted average tax rate which ought to be reflected in the share price.

So the question here is, well, what group of shareholders are we looking at, and what are the weights. That body of theory doesn't say that the weight is proportional to the holding of the particular assets. If it did, then we would assign a 30 percent weight to UK pension funds and UK insurance companies, and we would expect quite a big effect on the UK stock market.

What the weights say depends exactly on how you model this, but the kind of common way of modeling it is the weights depend on the wealth of all investors who hold that particular stock. Now, in the context of the UK, certainly there is a small, open economy, there are people all around the world who own UK equities, U.S. taxpayers, U.S. pension funds, and people from all around the world. So the relevant question for the weight of UK pension funds in determining the stock prices of UK equities is how important they are in wealth terms in the world; what is the wealth of UK pension funds relative to the wealth of all the other investors who are holding UK equities?

I don't have a precise answer to that, but I think it's pretty small, so consistent with the theory, we get a small effect on the stock pricing.

So you can imagine what happened when the subsidy was removed—we had UK pension funds holding a relatively high portion of UK equities. The incentive to do that after the tax reform was much reduced, what we would expect is UK pension funds to start selling UK equities and diversifying more in world terms.

What was the price at which they could be able to sell those assets? Well, the answer is the price for everybody else in the world hasn't changed, as long as there are enough people out there willing to buy UK equities at more or less the same price, we would not expect any change in the price.

What we would expect is a change in portfolio holdings, and we see some of that happening. So if you compare—this is actually—the timing is not brilliant here—but in 1997 to 2000. The first line shows the percentage of the assets of UK pension funds which are in UK equities. They held just over three-quarters of all their assets in UK equities in around 1997 win the tax reform happened, and that went down. It went down a bit. Whether it has gone down as far as we would expect, I'm not sure.

The other thing you can do is look at what is the proportion of UK equities owned by UK pension funds—this is ignoring insurance companies again—and that fell, as you might expect. It's not such an attractive asset.

Conversely, who bought those shares off the UK pension funds—that's the people in the rest of the world. So the share of UK equities owned by non-UK investors went up from 24 percent to 32 percent.

Okay, that's my story of the UK. How relevant is that for the U.S. and the kinds of proposals which the tax panel has made? Well, if you go back to the theory, the weights for looking at the effect of any particular group and their tax rates on share prices depends on their relative wealth in the world, so it would depend on the relative wealth of U.S. taxpayers relative to the wealth of everybody else in the world who may own U.S.

equities. Again, I don't have an answer for that. It's probably higher than for the UK case, but it may not be that much higher.

So if you follow that kind of logic, we may not expect all that much effect in the U.S., either, from this form of integration.

Moving on—that was the effect on share prices—in another paper, we then looked at the effects on dividend policy and investment policy. Was it the case that a reduction in the subsidy—did the subsidy actually induce UK firms to cut dividends? Did it have any effect on their investments?

You might expect that given there is no effect on prices, you might expect there to be no effect on anything, really, for UK firms. That is not necessarily the case, actually, because even though UK Pension funds may not affect the prices of UK equities, they still own quite a large share of those, so as a group, they will have quite a lot of voting power within those firms. So if they wanted to impose high-dividend policies before the reform, they probably could have done so.

But what we found in essence was that there was a change in the form of dividends, especially dividends paid out to foreign-source income. But if you take the total amount of resources that UK firms use to pay dividends, which is the cash dividend plus this extra tax associated with paying dividends out of foreign-source income, there is essentially no change in that total amount of resources before and after the tax reform, and there is no effect no investment, either, which may be partly for these reasons and partly for other reasons.

So it's a kind of negative message from the UK in a sense. We have had many reforms about the integration system over the years, and trying to find significant effects of those on either dividend policy or investment or prices has really been quite hard to do. In this particular reform, we haven't been able to find any, either.

Just a couple of more minutes while I have the floor, I'll just say something about the proposed territoriality.

If you go to theory and ask what the optimal way of taxing outbound investment is, then it depends where you start, really, and it depends whether you are looking at it from a national point of view or from a worldwide point of view.

I think—I may be wrong in saying this—but my impression is that U.S. traders always talk about something called "capital export neutrality," which always seemed to me to be not entirely sensible from a national point of view anyway; it was more of a worldwide point of view. If everybody had capital export neutrality, which is like a pure, residence-based tax, then rates of return would have equalized around the world, and that would be a good thing in worldwide terms.

If you look at it from the national point of view and ask the question, well, in general and in principle, can you say either that a kind of worldwide system is better than a territorial system or vice versa. The basic answer to that is no, I think. Glenn and I wrote a paper a few years ago where we looked at various options. In some cases, a territorial system—under some parameters, the model of territorial system was better, and under other parameters the worldwide system was better.

So there is no clear guide from theory as to which way to go here. Some of the points made in the panel as to income-shifting, and I take it those weren't things that we had in the model, but they make a lot of sense.

If you look at the next slide, just to compare—since I'm the guy from the rest of the world, I thought I'd show you what everybody else does—this is data from the European Commission. So my country, the UK, also historically a big capital exporter, also have a worldwide system, more or less the same as the U.S. system. Most of the other countries in Europe, some of which are quite large and have capital exports actually have a territorial system.

I was going to make two points, and I think one has already been made, so I'll make the other point here. If you look at corporate tax rates, I think there may be an impact of if the U.S. moved to a territorial system, there may be an impact on the rest of the world, and there is a story as to how everybody else responds to the U.S. given that the U.S. is a big capital exporter with a credit system. There is a story that says basically, the optimal position for everybody else is to have a tax rate just a little bit below the U.S. And Rosanne knows this well because Rosanne has written a paper on this with Tim Goodspeed [ph.]. If you look at this—this is a picture of 1982 and 2004—the obvious thing to notice there is that tax rates have come down quite a lot since 1982. But the other thing for this purpose is that if you look at 2004, then, looking at statutory tax rates, the U.S. is more or less at the top or pretty close to the top of all those countries. This is something like 20 OECD countries.

One possible explanation of that is precisely this story, which is the U.S.'s exporting capital to most of these countries, it makes sense then, if those countries cut their tax rates, that would more or less, in due course and over the long run, be a transfer from their tax revenues to U.S. tax revenues, because when that money is repatriated, it will just pay tax in the U.S.

If the U.S. moves to a territorial system, however, it is a completely different ball game, and it may well be the case that if the U.S. did move to a territorial system, that would induce a lot more tax competition and statutory rates in the rest of the world, and we might see those rates coming down substantially.

The other point I was going to make was the relationship between moving to a territorial system and the proposal for integration, which is that you only get tax relief for U.S.-source income rather than foreign source income. But that's a point that has been made already.

So to briefly sum up, I am kind of skeptical that messing about with the integration and introducing reductions in dividend taxes will actually have very much affect. I am not particularly alarmed by a move to a territorial system of [inaudible] and the fact that it may induce more tax competition elsewhere, which of course, to me is a good thing. I am puzzled on this thing about dividends and territoriality. And one I have not had time to talk about is that I am enthusiastic about developing ideas of a destination base.

Thanks.

MR. HUBBARD: Thank you, Mike.

Before we open it up for questions, I just want to take a moment to ask both of you from an empirical perspective, what do we need to know much more about in terms of how taxes affect foreign direct investment. If you were to pick one or two elasticities that we just don't know enough about that would inform the panel's report, any views or thoughts?

MR. HINES: I actually think we already know quite a bit that isn't yet embodied in U.S. policy but is kind of embodied in the panel report.

One thing that I think we would need to know more about is exactly how this distinction between a dividend paid out of foreign source income and a dividend paid out of domestic source income would work, and how that would affect incentives to earn income in different places and incentives to pay dividends.

I had mentioned that I had some quibbles with the panel recommendations, and that would be one area.

MR. DEVEREUX: Yes, I would agree with that. We have had this system in the UK for a long time, but essentially, there is no data that we can use to actually address this question. It may be possible in the U.S., because there is more data here to address that. But I agree that would be an interesting issue to address.

MR. HUBBARD: Okay, why don't we open up to questions.

Yes, Jane—there are microphones that will be coming to each person.

QUESTION: I'd like to ask this question to Michael Devereux.

I am sitting here trying to understand how in the world there is an argument that a territorial tax system, if everybody practices it, could be more efficient than everybody practicing a resident system of taxation, since you will certainly have capital misallocated, as Jim was pointing out, to tax haven countries. And I'm sorry I haven't read your article, and maybe I need to do that, but can you give me a clue as to why that might be the case?

And secondly, Peggy Musgrave, who developed these notions of capital export neutrality and so forth, argued that if you are maximizing your own welfare, the best thing to do is to tax all worldwide income and allow only the deduction for foreign taxes instead of a credit, because in that case—if you've got no other reaction from other countries, obviously, it is an issue—then you are maximizing the social return, the sum of taxes and private return, to your own country.

So I am just very confused.

MR. DEVEREUX: Yes. Sorry I didn't have very long to talk about that one. The capital export neutrality, I am not claiming the territorial system everywhere would be globally optimal. The question I was addressing was whether that would be optimal for an individual country, not conditioned on what everybody else is doing.

And actually, there is a brief discussion of that in the report, I think, so one reason you might think that that's a good idea is if a U.S. company is competing with, say, a German company in a third country, the German country when it repatriates its income doesn't have to pay any further tax in Germany if it's a low-tax third country, whereas the U.S. company would.

So in principle, it is quite possible that a German company would therefore have a competitive advantage over the U.S. company, because it is facing a lower tax rate.

You don't sound as though you agree with that.

QUESTION: That makes sense, but it doesn't make sense why you would not do just as well not having [inaudible].

MR. DEVEREUX: Okay. I wouldn't want to claim that that's the dominant reason that you would always want to move to a territorial system, because I think there are other factors as well. But let me come back on the second point, where, yes, the well-known story of what you should do theoretically would be to have a deduction system where you would tax all fund source income under accrual, and you would allow foreign taxes to be a deduction. And that comes from a model where effectively, there is a fixed stock of saving or a fixed stock of capital which are allocating between two places—home and abroad. And in that sense, you want the rate of return on those activities to be the same.

Now, if you move away from that kind of model—that's a model there is a fixed stock of capital. If you go to a small, open economy on the other extremely, there is effectively an infinite supply of capital, so there's a horizontal rather than a vertical supply curve, and then it is a very different model. It's not clear that these two things are competing with each other anymore.

So if you want to distort one of those sectors, it's not clear that you should have an identical distortion in the other sector.

If you add onto that some kinds of strategic considerations like who you are competing with, then you can get a variety of different answers.

MR. HINES: If I could just jump in, Jane didn't ask me because she knows my answer on this. The thing that's wrong—and I'll just say "wrong"—with the Peggy Musgrave of capital export neutrality is that the assumption, as Mike pointed out is you can think that there is a fixed amount of capital, and it can go to either Country A or Country B, and that is point number one—and of course, in the world, there isn't a fixed stock of capital.

The second point is that there is only one country in the world in that model. The idea is you're analyzing U.S. policy, and you are forgetting that there are any other foreign investments in the whole world in that framework.

And what is wrong with that is that when the United States changes its investments, other countries change their investments, too, including their investments in the United States. And that is the fundamental of the traditional capital export neutrality framework. It is what academics call "partial equilibrium analysis," but it is really partial equilibrium analysis, and it's not the right way to think about those issues.

MR. HUBBARD: Okay. Before we start talking dirty here, let's go on to the next question.

Rosanne?

QUESTION: Jim, I always enjoy listening to you summarize the literature and talk about the state of knowledge on this. Thank you for that.

One part of the literature that you didn't talk about directly that I'm wondering if you could highlight a little bit is the that you and Mihir and Friz [ph.] have been doing on the benefits of foreign investment for investment in the United States by U.S. firms.

MR. HINES: Oh, well, there's this question if an American company does more investment abroad, what effect does that have on the company's domestic operations. I think that's what you are referring to, Rosanne?

QUESTION: Yes.

MR. HINES: And this is something that people have wrestled with for a long time—the issue of what are the tradeoffs implicit there or, to put it differently, specifically, if you do more activity abroad, does it follow that you will reduce investment or employment or things like that in the United States. And can rapidly talk yourself into either of two propositions—well, if we make the good in France, then we aren't going to make it in Cleveland. That is Proposition 1.

Proposition 2 is if we expand our operations in France, that makes it more profitable to do your domestic operations, too, because maybe the operation in France is providing an intermediate good to final production in the United States, or the other way around, so they kind of go together. So if activities in France become more attractive, then, actually, it expands your domestic activity.

The question is empirically what is true for American companies as a whole. And you can tell anecdotes. People have proposed examples of both kinds. You shut a factory in Kansas City, and you open one in China. That happens, of course. But it also happens that you get good opportunities in Thailand, and as a result, your California operations become more profitable, and you'll expand them.

So the issue is what evidence do we have on this, and there has been some recent research persuasive to my eye that suggests that expansions abroad by American companies are associated with expansions at home, too—that is, American companies that increase their foreign direct investment abroad at the same time increase their domestic investment and employment and sales.

Now, statistically, it is very hard to tease out these effects, but again, some recent research has some good ideas about how to do that, and the evidence is actually pretty strong on that, that expansions abroad go together with expansions at home. Indeed, last year's conference talked about some of those issues.

MR. HUBBARD: And you did dovetails with Matthew Solomon's [ph.] work on employment, too.

Other questions for the panelists?

Yes, Scott?

QUESTION: According to OECD data, the U.S. corporate rate is now the highest in the world, and 10 percentage points higher than the OECD average.

The panel has only recommended a small reduction in the U.S. federal corporate rate, but moving to a territorial system, does it matter? Is the U.S. any better off under a territorial system with a high corporate rate than keeping the current system? I mean, does it make U.S. firms any more competitive?

I guess the point of this is don't we really have to address the corporate rate in the end.

MR. DEVEREUX: It makes it more competitive in the rest of the world; it doesn't make it more competitive here. I mean, if you have a territorial system, if the U.S. company is in Germany, then they'll pay the German tax rate. So it depends what you are interested. If you are interested in attracting inbound investment into the U.S., then I think a high tax rate in the U.S. is bad news, because it could go somewhere else, in terms of the territorial system and where in the rest of the world it goes, it's a different question.

MR. HINES: I take your question to be one that if we have too high—whatever that means—a corporate rate in the United States, then, do you get any benefit from embracing a territorial system. And I agree with Michael. I think you do, and the reason is that if you don't have a territorial system, one of the issues with having too high a corporate tax rate, of course, is that you discourage investment—but you also discourage foreign investment if you didn't also have a territorial system.

I take the implication of your question to be that you'd like to see both taxes reduced, but that wasn't actually the question. The question was do you get any benefit from reducing taxation of foreign income if you have too high a tax rate on domestic income. I think the answer is yes, but it may not be as good as you could get.

MR. HUBBARD: Okay. We have time for a couple more questions.

Bill?

QUESTION: This is just a follow-on since somebody mentioned competitiveness, and it's a follow-on to that question. So, why is it that we are so concerned about competitiveness abroad and not concerned as much, given that we have the high corporate rate, about competitive of U.S. corporations that export and U.S. corporations that compete with imports? To me, that is the question. It's always a problem with competitiveness, of course, because competitiveness ultimately leads to a nonsense answer because you can't make everybody competitive at the same time.

So, it seems to me that everybody is proposing to make us competitive abroad but to ignore all those other businesses that operate in the U.S.

MR. HINES: Gee, I didn't think anyone didn't want us to be competitive at home, too. Yes, of course, you want an efficient system for home taxation, and you want an efficient system for foreign taxation. Today's conference is really about foreign taxation, but I am pretty confident that many of us feel pretty passionately about home country taxation, too, that we want that to be a good system as well.

Look, do I think it is wise for the United States to have the highest corporate tax rate of OECD countries? No.

MR. DEVEREUX: If you were having this debate in Europe, the focus of it would be very different. It would all be about inbound investment and having a low tax rate. So it's a shock to me to come over here, and everybody is talking about outbound investment, which is not really on the agenda in Europe. But it is clearly important.

MR. HUBBARD: Especially for this economy that's going to have to have capital inflows on the order of 7 to 8 percent of GDP in the next several years.

Yes, sir, the final question, and then we'll move to the next panel.

QUESTION: I am a little confused about what we know and don't know. It appeared to me the view from England was that we knew a lot less than previous research than the view from Michigan, we which seemed to me—

MR. HINES: We know more in Michigan.

[Laughter.]

QUESTION: What do we know and what don't we know, and what we need to know that we don't know? Where is the research in this area, and what can the experts tell us or not tell us? Is that comprehensible? You look confused.

MR. HINES: It's comprehensible. It's not specific.

QUESTION: Well, [inaudible] capital export neutrality, capital important neutrality, territorial or non-territorial, however you denominate it. I mean, we are all willing to admit there are elasticities, and capital export neutrality in a world with elasticity can never be perfectly enforced. But given that as a parameter, it's like maximizing [inaudible] or something. But I am very confused about what we know and do not know about these systems and their relative merits and their relative effects on the flow of capital around the world.

MR. HUBBARD: Well, if I may take a quick stab at it, I think the two speakers tee'd up—this is a huge question that you are asking, one that would be a very long discussion—but I think what Mike was saying is that if you look at contemporary research outside of tax, how do firms actually behave, the whole notion of the benchmark of capital export neutrality would be very hard to square with economic theory.

What Jim was suggesting, in part based on important work that he has done, is that entirely apart from this debate over capital export and import neutrality, if one thinks about the ownership of assets being in the hands of the most efficient owners, that might be a more interesting norm.

So I think the way I would put it—and I'll let the speakers agree or disagree if they like—is that there is very little economic support from theory for these benchmarks that have been argued about for so long. In particular, there would be virtually no support for the notion that the

U.S. would have capital export neutrality is an interesting theoretical benchmark.

MR. HINES: I'm with Glenn.

MR. HUBBARD: Okay. If there are no other quick, burning questions, we'll move right on to the next panel. The panel is about transition, but we do not have a transition; we are moving on.

[Applause.]

MR. HUBBARD: Transition issues, of course, are important parts of any tax discussion. Generally speaking, in any tax reform, whether it is domestic or international, the classic question of can you get there from here comes up.

Many economists, myself included have argued over several years that transition issues are often, frankly, overstated in tax reform. We'll take the panel's temperature on this issue here.

I should say relative to the program that I am not Michael Graetz—he would especially want me to make that observation for you. But we have three very distinguished panelists to talk today—Alan Auerbach from Berkeley, Gary Hufbauer from Institution for International Economics, and Bill Randolph from CBO.

Alan?

MR. AUERBACH: I'm sorry Michael Graetz is not here; I have a longstanding debate with him about whether it is worth talking about border adjustment, because he says you can talk about it as long as you want, and nobody will ever pay any attention.

I also want to remark that I think I am moving forward in not using the green color scheme of the previous session.

So it is a worrying idea. The growth in investment tax—dare I say, the "GIT"—which was proposed by the Tax Reform Panel, as was already mentioned, would have been a destination basis, done on a destination basis, with a rebate for exports, tax on imports at the 30 percent business tax rate under that system.

That is a border-adjusted tax, as Rosanne pointed out. It's the same treatment as would occur under a VAT, leaving aside the issue of whether we would have to renegotiate our tax treaties.

There is a common belief that border adjustment helps trade because it does subsidize exports, and it taxes imports. That subsidization and taxation is accurate, but whether that would help the trade balance, which is currently quite negative in the U.S., is another issue. In fact the logic is wrong. And there are many economists who have tried many different ways to show why it is wrong, and I'm going to try, too.

The simple answer is exchange rate adjustment—or at least one simple answer is exchange rate adjustment. And the easiest way to see the argument is to consider the two pieces separately.

So first, think about an export subsidy alone. An export subsidy encourages a foreign demand for U.S. products. That increased demand for U.S. products strengthens the dollar—I think I'm on solid ground here. And a stronger dollar partially offsets the rise in exports; we would expect that as the dollar goes up, export demand would weaken somewhat, so there would be an increase but not as much. And at the same time, the stronger dollar increases the U.S. demand for imports from abroad.

So both exports and imports will go up with the strengthening dollar. So an export subsidy promotes trade in both directions, not just exports.

Now, if we move to the import tax alone, the import tax, which is the other piece of the border adjustment, obviously is going to discourage the U.S. demand for imports. That, too, is going to strengthen the dollar, because it is going to reduce the demand for items denominated in foreign currencies.

That stronger dollar is going to lessen the drop in import demand because foreign goods won't look quite as expensive as they did before, but at the same time, that is going to hurt U.S. exports.

So we are going to get the import tax not only hindering imports, but it is also going to reduce exports. So an import tax is going to reduce trade on both sides, not just imports, and cause dollar appreciation.

What happens if you add them together? Well, you are going to get appreciation from both sides, but you are going to get offsetting effects on trade—one increasing exports and imports, the other decreasing exports and imports. And the subtle thing is to show that the effects are exactly offsetting in terms of trade, that the two things together are going to be trade-neutral, and both sides contribute to dollar appreciation. So in the end, basically what you are left with is an appreciating dollar.

There is an alternative logic. That's on the trade side. You can also think about it in terms of the capital flow side. And we know from the squaring of the current account and the capital account that net exports by the United States have to be equal to net foreign investment—that is, if you think of flows of goods, net exports, and you think of flows of investment and income from investment, things flowing abroad in terms of goods and services, net exports have to be equal to non-trade flows abroad, which is equal to the net foreign investment we send abroad, net of the net foreign income we repatriate.

Those things have to be equal, and they are equal except for statistical measurement effort in the national income accounts.

Okay. If you think about that logic, that means that subsidizing exports, which is a border adjustment, has to be equal to a subsidy on foreign investment and a tax on foreign income. That is, the tax bases of those two taxes, a border adjustment where we subsidize net exports, and tax imports, which is a subsidy to net exports, has to be equal in terms of its tax base to a subsidy of net foreign investment going outbound and a tax on net foreign income.

What does that mean? That means that border adjustments amount to a tax on foreign source income with expensing of investment. That's a cash flow tax on foreign source income.

Now, as in the domestic context, where many people have compared different ways of exempting capital income from tax, there are two different ways of doing it. One is the cash flow approach, which is also embodied in the domestic context under the growth and investment tax, and the other is the so-called yield exemption approach.

We are also familiar with these equivalences and comparisons of traditional IRAs and Roth IRAs, both having the same effects on the taxation of capital income, and as in the domestic context, there is only a timing difference in these two taxes as long as the tax rates are equal over time—leaving aside the issues of transition which would affect that.

So there is not going to be any difference in the international investment incentives, either. That is, whether you simply have no border adjustments, which would be like a yield exemption approach, or whether you have the border United States, you are going to have no effect between the two; there is going to be no difference in the incentives for international investment.

So that leaves us with the fact that there are going to be no incentives for altering trade, no incentives for altering investment, so apparently no difference between an origin and destination basis. Of course, I am abstracting here from administrative issues such as were discussed earlier.

Does that mean that border adjustments are irrelevant? No, it doesn't mean that border adjustments are irrelevant; they are just relevant for different items. And there are two—asset valuation and revenue.

The asset valuation effect comes from the fact that there has to be an exchange rate adjustment, as I mentioned. Just using statistics from BEA, at the end of 2004, U.S.-owned foreign assets were $9 trillion, foreign-owned U.S. assets were $11.5 trillion—we now have a negative net international investment position of $2.5 trillion. Border adjustments at a 30 percent tax rate would imply, all other things being equal, a depreciation of foreign currencies of 30 percent relative to the dollar.

That means, assuming that all foreign assets held abroad by U.S. entities and individuals are denominated in foreign currencies, which they aren't, but just assuming for simplicity that they are, that would mean a $2.7 trillion loss to U.S. holders of foreign assets, and I think that's real money, and a compensating gain for foreign holders of U.S. assets due to the dollar appreciation.

The second effect, which is on revenues, comes from the fact that because we have a net negative international investment position, that is, because we have a net liability to the rest of the world, we're going to have to run trade surpluses at some point in the future. When, I don't know. That may be very far in the future, and it is certainly not going to be within the 10-year budget window.

But when we do, the amount of trade surpluses that we'll run—and this is an economist's slight of hand here, but we can show this—have to be equal to the present value of our current net international liability, which is $2.5 trillion. So if you multiply that by 30 percent, that means that in revenue, having border adjustments is going to cost us $750 billion. I think that differs from the short-run revenue estimate.

So in summary, border adjustments affect asset values and revenues. They don't have incentives for trade or capital flows. The answer would be more complicated during a transition. If tax rates are changing, depending on how long the transition takes and how rapidly the tax rates change, it could have an important effect or not such an important effect. But once the transition occurs, there aren't going to be any effects. Exchange rates are going to respond immediately. There is no reason why they would be sluggish.

So you have to look elsewhere for the impact of the tax reform on the trade balance and international investment. There has already been a lot of discussion this morning about how international investment flows would be affected by tax reform. They are not insignificant, but they are simply not going to come from border adjustments.

MR. HUBBARD: Thanks, Alan.

Gary?

MR. HUFBAUER: Thanks, Glenn.

I'm going to depart a little bit from the transition theme, because when Jim Hines recruited me for this panel, I told him I would talk about the little red book that we just published, and that's what I know, and it is entitled, "Reforming the Corporate Tax." It came out about the same time as the Advisory Panel Report, but with no advance information on what the Advisory Panel would say. But we agree very much that Rosanne presented today—and in fact, some of the parts, I was delighted to read in the Advisory Panel Report.

Just our broad recommendations to tick it off, and it is in Chapter 5, which the organizers kindly reproduced, in your handout.

We say that you have to scrap the corporate tax rather than incremental reform, because the politics of incremental reform seem to be impossible in the United States and most other countries.

Secondly—and here, the Advisory Panel's hands were tied—we say that there is going to be a need for more taxes in the future to pay for entitlements. That may seem obvious, but they did not have that proposition to work with, and I would like to see entitlements cut—maybe many people in this room would like to see it cut, but if a Republican Congress cannot do it, I wonder—and we say that the kind of taxes that our good friends like John Samuels and Joe Luby [ph.] here today will have to write checks to the government—it will go up from about 3 percent of GDP to about 5 percent on a very conservative estimate of the trajectory of entitlement, and including a lot of cutting in forward entitlement from the trajectory built into current law.

With that in mind, we say scrap the corporate tax and go for their national retail sales tax, or a version of a subtraction method VAT, which we call a "corporate activity tax, CAT," and each of these has its own pluses and minuses.

On the national retail sales tax—plus it is a familiar system; it is automatically adjusted at the border—I'm going to come back to border at the end of my remarks—and it is automatically territorial. I think the minuses are fairly well-known, and the state-federal overlap issue has been well-rehearsed.

On the corporate activity tax, the plus is that it is close administratively to the corporate tax, not in a bad sense but in a good sense that it is an entity-based tax, and you don't have a whole tracing mechanism as with a credit invoice VAT. And we believe you could limit it to the largest corporations. National retail sales pick up about 8 million tax-paying entities. We think you could do a corporate activity tax with about 200,000 to 300,000 tax-paying entities, and all the rest would be pass-through entities, Subchapter S partnership type of thing, which is actually the better way to tax. So the administrative burden is considerably less.

The macro efficiency effects of the two systems are, well, indistinguishable, although obviously, the presentational and the political aspects are very different. The regressivity issue which is so welladvertised in the press, can be addressed in both systems and by methods which have been outlined and I think would be known to this audience.

The key feature of going to one of these two alternatives on a much broader base is exactly what was raised in the questions in the last panel. It makes the United States a very much better place for investment both by American firms and by foreign firms in the years ahead. And obviously, tax policy is maybe not the most important thing, but it may be the most important thing that the federal government can do or one of the most important things the federal government can do; and, as has been pointed out, we are now the high-tax country in the OECD, but that's not what is really important. We are really high-tax compared to what truly happens in Brazil, China, India, and the emerging competitors in the world. And if we are concerned about future really good jobs at good wages, which I think everyone is concerned about, this is one thing the government can actually do to address that. And the key thing is to get the marginal rate down from something like 30 percent, which is where the panel ended up with something like 10 to 15 percent, which can be done.

And while I have worked in and loved international taxation for many years of my life, I mean, this business of doing something in the United States is just today far more important than the territorial system, which I fully endorse and embrace and all of the reforms that Jim Hines was talking about and so forth. But our problems at home are the problems that are serious in the horizon that any reform package that the next administration might bring up would hopefully address.

On the international side, my view in doing another book, or update of the book we did 12 years ago on this, is that there has been a tremendous amount of self-help by multinational corporations, and maybe that's not the cleanest and most efficient way, but it has done a lot to alleviate all of those things that Jane Ravel [ph.] would like to see in the tax law but are eroded away by self-help.

Let me now say just a couple more things about what Rosanne Altshuler said. On the Advisory Panel, there is so much that I like that it's hard to pick out what I like best, but I thought the two statements or two kind of themes which ran through the Advisory Panel which especially deserve commendation are that they said plainly and simply that this direct/indirect distinction is nonsense, and they embraced that. It's a theme I have argued for and many people have argued for many years, and really urged [inaudible.] But who has not argued it has ever been the Treasury.

I'm sure this was actually a big internal bureaucratic fight in the panel. It was the first time that the Treasury has ever embraced anything like border adjustment. I know Alan doesn't like that, but there are others, and I'm going to try to give the other side of the story in just a moment. And I think that's a big step in the right direction to bring the United States in line with the world.

Now I have to thank Alan for giving me some wind-up remarks here, because I wasn't really going to talk about border adjustment, but when I saw his printout of his slides, which he kindly gave us before this event, it charged me up; so thanks, Alan.

I fundamentally disagree with everything he has said and he has written.

[Laughter.]

He said it in an op-ed in the Wall Street Journal, and I imagine he'll write some more on the same theme, so let's keep it going.

The basic problem and the biggest problem—and there are four reasons why I disagree—it is really hard for economists to be agnostic about their subject. They might be agnostic about abortion and religion, but on their subject, prices, it just goes against the grain.

But there is one thing we should be agnostic about, and that is exchange rates. It is well-demonstrated at this point—it is kind of our answer to quantum mechanics; you can tell the position and the rotation at the same time—well, we cannot tell what the exchange rate is. It is as simple as that. And this is very powerfully demonstrated by some very good research, and anybody who can tell the opposite should be very rich. And I'm going to come to that in a moment.

But the macro models don't work. The best traders are essentially noise traders, who have good instincts and so forth, but they cannot tell their children how to do it, or you how to do it, or me how to do it—they know how to do it by their gut. But the macro models do not work. That's a very strong result from Rogoth [ph.] and his colleagues, and it has been replicated numerous times.

So when you put a macro model like Alan put up and entertained you with, this is nonsense that you can run this story that is told in all the textbooks—and we all took them—and believe it. You just have to be agnostic about it.

And I think the basic reason is that the exchange rate is an asset price, a long-term asset price, and all these little things you are putting in are kind of short-term movements in flows, and here, you are talking about an asset price that values big stocks.

Now, how easy is it to tell? Well, probably the smartest person alive on the investment front is Warren Buffett, and here is where he made a mistake—at least he made a mistake in timing; now, his pockets are deep enough that he can probably weather it through—but he announced about a year ago that he was going to sell the dollar, and he did, in a big amount. And look at a year later, and look at what all the economists said a year ago, including some of my colleagues across the street.

The final way, I think, to throw a little skepticism on what Alan has said is that this kind of "Chicken Little" story he told about asset prices and so forth—it's the "Chicken Little" sequel for economists—try running it backward. If you believe in that, then the United States could get a tremendous amount of wealth and general revenue by a negative tariff on imports and taxing exports. Forget the Constitutional issue; I'm just talking about getting the revenue.

Believe that, propose it, and I'm sure you will be elected to Congress.

The next point I would make on the border tax is that the political transition to a simpler system will be very much easier with border taxes than without because maybe all these business men are wrong, and they don't understand economics, and they can't follow these models and so forth. But they certainly believe it—or at least the majority seem to—and if they don't, I'd be quite happy to not have the border tax adjustment, except for two other points I am about to make in my remaining minutes.

And the proof of that pudding is we have all these value-added taxes in the world, and if this story that Alan is telling you is so great, why are they all adjusted at the border? I mean, that's an elective decision, and they all are adjusted at the border.

On the third point, the transfer pricing which Rosanne rightfully emphasized, this is an overwhelming administrative issue; it keeps a good part of K Street employed—probably Peter Merrill does a lot of this work, that that's important—but we don't really need that kind of employment in this country, and it is going to be much more severe in the years ahead as we become more integrated. This is really a major point on the transfer pricing issue.

And finally, if we can ever get our business tax system flatter and lower rates, broader-based, and raise more revenue, actually, then the challenge will be to keep it flat, and if you don't have border adjustments, it will be extremely difficult to keep it flat, because those firms which compete head-to-head on the import side or the export side will really lobby quite heavily, and they will jack up the system.

Thanks.

MR. HUBBARD: Thanks, Gary for introducing some controversy.

Alan is my teacher, Warren Buffett is my alumnus, and I don't want Peter to lose his job, so I'll weight in with others afterward.

Bill?

MR. RANDOLPH: Okay, first my disclaimer. This is really a weird—I am here, I work for CBO, but I'm not talking for CBI—this is me speaking, which I find kind of an odd statement, but it isn't in Washington; if I said "This is not me speaking," that would also be odd.

First, I would like to thank Alan for two things. One, I really have too much to say in three different areas, and Alan has already talked about two of them, so it saved me a lot of time. So I will only elaborate on those two areas. And also, I did not have slides because I was planning on having to ad lib it a little bit, and now I wouldn't have been able to use my slides anyway. So Alan said some good things.

What I am going to do is focus, of course, like some other people, on the panel options broadly, on the dividend exemption and the border-adjusted "X" tax.

The dividend exemption—there is a confluence of two events that have happened—last year's legislation and this proposal—that make for kind of a cool story.

One question that has always come up among international tax policy wonks, who think about what do you do when you switch to a dividend example, is what do you do with the old income that is accumulated abroad.

One answer is, well, you—or let me tell this by analogy. The analogy will help a little. It should be obvious, anyway.

Suppose you are in the shirt business, and you decided you want to get out of the shirt business and go into the deli business. One thing you could do is have a deli and sell the shirts in the back. That's kind of an ugly idea. There is one idea, there was a JCT proposal earlier this year to switch to a dividend exemption—they are not the first to propose this transition role—and carry the old system forward for the old dividends.

Well, that's really ugly. You've got two tax systems. It is simplified. That is absurd—two tax systems. You carry the complicated one forward, and yet another new system that is arguably complicated as well.

So another thing you could do is just give your shirts away and go into the deli business. That seems kind of stupid, but you could do that.

Another thing you could do is have a fire sale. You announce that you are going to sell shirts for—I have seen this done before—50 percent off, but that only works if you then plan to give your shirts away. Later, of course, nobody is going to pay 50 percent, so it matters what you're going to do later, so you hide them somewhere, or you burn them, or whatever.

So that gave me a great idea which goes to an old idea that was kicking around the Treasury, that you have a fire sale on all dividends, and say—let's just pick a number; this is kind of natural number in the dividend exemption area—85 percent—

[Laughter.]

MR. RANDOLPH: —suppose you allow 85 percent exemption for dividends received from abroad, just for—and this is the metric—one year. But this only works—and I never liked this idea because you can't just get rid of the shirts in this case; you still have to worry about what you do in the future, because if you exempt them in the future, nobody is going to go for the sale, so you still have to carry the old system forward, and that's a really ugly idea.

So what you could do is have a transition rule like that and implement it in advance of announcing the permanent policy. You just have it for one year.

Does this sound familiar to you?

[Laughter.]

MR. RANDOLPH: And the beauty about that is that now that we have had the transition rule, we can just wipe the slate clean, and the transition rule works.

Has anybody ever done this before—had the transition rule work in advance of following up on unanticipated permanent policy?

Anyway, I think that's really cool, and it is possibly the only favorable argument I can make for the transition rule we had this year.

[Laughter.]

MR. RANDOLPH: I'm not here talking for the CBO, again, let me remind you.

So let me just mention—I've got five minutes—just in passing, I just have to say this in Washington. Another very short-term transition issue which people don't talk about—but this is an old point; people compare the real to the ideal, they compare a real tax system to an ideal tax system, and they ignore what the tax system is going to look like next year after it has been reformed, or 20 years later after it has been hammered to death by lobbying and everything else.

What would this law look like even after it came out in legislation?

Well, there are a couple of pressures here. By some of the revenues that were done for this, we would collect revenues. And what that means, at least in a static sense, no behavioral effects, that means that somebody is going to have to be writing bigger checks to the government, and those people know who they are.

One group is the companies receiving a lot of royalties now that have them shielded by excess credits. People have talked about, well, they can do other things, there are ways to change your planning and avoid that. But one of the first ways you can do that is go to Congress and say, well, maybe we should exempt part of those royalties, or all of those royalties, too, because this is a problem. We need—you know, whatever—we need to be competitive in intellectual property rights or whatever the argument is.

Now, I don't really understand why—that wouldn't necessarily be so bad compared to the current system, because we currently in effect exempt a lot of those royalties in the case that companies shield them. So arguably, you could improve the tax system by exempting less—

[TAPE 2, SIDE A]

MR. RANDOLPH [continuing]: subsidize the export of intellectual property rights. And if we want to get rid of that subsidy, why do we need to change to a territorial system? Why don't we just make them U.S. source and tax them? Now, I'm not proposing that, but still—and the other is the interest and overhead allocation roles. There is kind of an idealized system here where people would allocate on a worldwide fungibility basis and lose all of their U.S. interest deductions. And we sort of do that for some people under the current system, but nobody does that under an exemption system. And I have an inkling that by the time this came out of Congress, it would have some ugly tracing roles that would have companies confess that they are not going to use the funds they borrow to make foreign investment, or some stupid thing like that. And tracing rules like that just don't work.

And then there is the question of what other countries will do, but that has already been said.

I just want to back Alan up, because he really needs a backup on this issue. This is actually an idea—it is interesting—that goes back to people attribute in the area of question of how tariffs and export taxes affect trade back to Abel Lerner [ph.] in the 1930s, and the thought was—and it really goes back before Abel Lerner if you look at his paper; he was just finally settling the issue, and he thought that some other people had settled it before that. But the idea was that if you have a general tax, an ad valorem tax on exports, across the board on all exports, that it would be the same economically in every way as an across-the-board tax on imports, and at the same rate. I think somebody else—Bill—asked the same rate question; if you don't do it at the same rate, of course, that does not work.

Now, Lerner—and I know you are all really interested in intellectual history—Lerner was a really smart economist who lived long ago, really, really smart. But he knew some other really smart economists, and actually, he was arguing with Edgeworth [ph.] And if you didn't understand this, to reassure you, this was in the 1890s, Edgeworth got it wrong, too. Edgeworth drew some graphs, and he got the answer he liked, they are equivalent, and then he did the math, and the math said they are equivalent. So instead of indicting economics, which he believed in, what he did was indict the math, and he wrote an article that said this shows that the use of the mathematical method—I am sort of quoting—leads to the wrong answers in economics.

Anyway, according to Lerner, Marshall—he was another economist who lived long ago, a very smart guy—he settled the issue around that same time, and what Lerner was really doing was just sort of finally, in the late 1930s. Later, just to follow up with that, I think that applied to the border adjustment for tax, I think it was Tinberg [ph.] in the late 1940s.

Anyway, I don't know if that helps you, because it's kind of a religious argument, and maybe I'm just citing the original word or something. But anyway, that's where I'll leave it. I have a lot more to say, but I don't have time.

MR. HUBBARD: Thanks.

Let me give the panelists just a minute or so in case they want to say anything to one another, and then we'll open it up to a couple of questions.

We are going to mildly deficit spend. Not all transversality conditions apparently bind, but one that will is we will have to make up some time. But we will deficit spend a little on questions.

Yes?

QUESTION: I just wanted to say on border adjustments a point about exchange rates. Exchange rates move for a lot of reasons, and we can't explain all of them, but it is a non sequitur to say that because we can't explain exchange rate movements, we can't predict how the exchange rate will respond as a result of a shift from an origin basis to a destination-based tax, all other things being equal.

They never are in the real world, which is why it really has to be a theoretical argument at some level, but it should be such a transparent effect, as I said, like the difference between the yield exemption approach and the case flow approach. Yes, you have to have constant tax rates over time; yes, if the tax rates are not constant over time, there are going to be differences.

One thing that is definitely true is that in present value, the revenue from having a destination-based tax is negative. That has nothing to do with exchange rates; that just has to do with trade flows, and it has to happen. It won't happen in over 10 years, so people who use a 10-year budget window may think that border adjustments gain revenue, but in the long run, they have to lose revenue, and it has nothing to do with exchange rates.

MR. HUBBARD: Any comments from the panel?

MR. HUFBAUER: I just want to ask Alan does he believe—what about turning this around and let's subsidize imports and tax exports, to play your arithmetic backward. We'll get a lot richer on your long-term effects—and I have to say I do disagree with your view about the long term given the position of the United States. Well, maybe ultimately, but the United States could be a net importer of capital for a very, very long period of time given our institutional features, which might crumble, and then it won't be, and given our competition in the rest of the world, which may lag, may lead.

MR. AUERBACH: And we can be a net borrower; we can have very large government deficits for a long time, and I think we have demonstrated that. But that doesn't mean that in the long run, we will be able to do that.

I guess I would say in terms of what to do about border adjustments, I think Rosanne said that having a destination basis for the growth in investment tax was something that was decided on to avoid transfer pricing problems. That's fine. I think border adjustments implemented for reasons of administrability, tax compliance, and so forth, that's fine. I just don't think that the main focus should be on promoting trade.

MR. HUBBARD: Okay. Why don't we open it up to all of you.

Yes, ma'am. There is a microphone coming.

QUESTION: Thank you.

You sort of just started addressing this, but in terms of the exchange rates, I understand the theory of how you expect them to react to the system, but how do you take into account currencies that are either pegged to the dollar or that do not float entirely freely on market reasons.

MR. RANDOLPH: It's a good question. I don't know what would happen to small currencies. This would be a more important issue if there were large trading partners with the United States which had this situation.

MR. HUBBARD: Which is referring to China, which would qualify as a large trading partner with the U.S.

MR. RANDOLPH: Well, the question is what China's peg would be after the introduction of export border adjustments. That is actually something that I'm not sure I can answer, and it would depend on how they responded.

You could also have, mind you, one way border adjustments might not be neutral would be if the Fed's policy changed. That was on one of the slides I cut out. Yes, there are complications to the story if, for example, you had different monetary—monetary authorities can make border adjustments not be irrelevant.

MR. HUBBARD: Also, I should say that in the next session [inaudible] precisely this topic, and we may come back to it.

Other questions? Yes, ma'am.

QUESTION: When I saw the title about transition effects, I somewhat expected to see accounting issues come up, although I know this is not an accounting conference at all, and I just want to refer to the analogy of the shirts and the deli switch, that the wealth effect of what happens to the shirts may or may not be reflected in the same way in the financial accounting that has effects on those capital markets.

I just want to raise as a comment that I think accounting issues become important, especially for large multinationals that are the big stock of our capital markets here in the U.S.

PANELIST: If I could leap in on that, it's true that we didn't discuss it, but the big issue in any switch to the advisory panel or what other people are recommending, including ourselves, is if you are going to expense capital equipment, which I think everyone has in their model, then what do you do about all the capital assets which have not been depreciated out; and that is a multi, multi-hundred-billion-dollar issue of how you deal with that. And I will not wrestle with it except to identify that that is the transition effect which is no doubt the biggest for any major change in the way we now tax corporate income.

MR. HUBBARD: Yes, Peter?

QUESTION: The previous speaker I think is raising an excellent point, and it goes beyond just appreciation. If you from an income system where you have accrual accounting to a cash-based system, you have, for example, accounts receivable. These are very large numbers on the balance sheets of companies where you have recognized the income for tax purposes under the current system. And you go to the new system, you receive the cash, you pay tax on the same income twice. So if FASB, the SEC and our accounting standards decision-makers say that you still have to do financial accounting with deferred tax accounts, this is a gigantic, gigantic issue.

My question, actually, is for Alan. A lot of countries have border-adjustable VATs, as you pointed out; they raise the rates on those. We've got a lot of observations potentially to see what happens actually in the equilibrium adjustments to higher, destination-based taxes.

My impression is that the adjustment for VATs is primarily the price level goes up. There is accommodation; the price level goes up after the VAT is introduced, and exchange rates actually do not adjust; whereas I think that might not be true in the way the border adjustable "X" tax works. I wonder if you could comment on that.

MR. AUERBACH: You are right, and I should have said exchange rates adjust or prices adjust. It is the real price that has to be a concern.

You can't use—this isn't exactly the question you asked, but it may have been implied—you can't use evidence from what happens to real prices when there is, say, an increase in a border-adjustable VAT, because two things are happening at the same time. One is the border adjustment is increasing, and the other, the consumption tax rate is increasing. That's a real effect, and we expect that to have real effects. And indeed, as many people have pointed out, you would expect, say, a shift from income to consumption taxation to improve the trade balance by increasing national saving. So if we saw national saving go up in an instance like that, it wouldn't be a demonstration that border adjustments promote trade. It would be a demonstration that consumption taxes promote trade.

MR. HUBBARD: Okay, I think we have time for one more question if anybody has a question.

[No response.]

MR. HUBBARD: If not, then thank you very much to the panelists.

[Applause.]

MR. HUBBARD: As we are ending a bit later, I propose we come back at 25 past the hour.

[Short break.]

MR. HINES: We're going to get started now.

The third panel concerns the effects of tax reform on international trade flows. Now, I know you may think that the previous panel completely sewed up those issues, so there is no further discussion needed; but what I am hoping is that this panel will be able to fill in one or two details—no, I'm kidding. I think there is a lot of well-placed interest in issues about the effects of tax reform on international trade flows. The

United States has what might be called an international trade flow situation right now, and if you were to embrace a fundamental tax reform, whatever effect that fundamental tax reform might have on international trade is potentially extremely important to the United States' economy.

So we are going to learn the answers now, and the first person we're going to learn the answers from is Mihir Desai from Harvard University.

MR. DESAI: Thanks very much, and thanks for the invitation to be here.

As Jim noted, this is a panel about tax reform and trade, and I think the subtitle for my talk is probably more accurately, "The things you think matter don't matter, and the things that you don't think have mattered actually are the ones that are critical."

So in the process, what I want to take you through is debunking some ideas, including some that have already come up.

First, I just want to motivate this with some pictures and facts, and I think they will tell you something about investment and trade and their relationship that might be new to you.

The second is talking about the channels through which tax reform can actually influence trade patterns. This came up briefly at the end of Alan's comments, and I just want to revisit this. It is a useful way to think about exactly what the channels are that are going to be offered as opposed to the ones that are not. We'll revisit some very basic national income accounting to make sure we understand why those facts are true. And then, finally, I'll talk a little bit about this old chestnut about border tax adjustments and give another pass at trying to explain what the logic for that is, and then talk a little bit about the research that Jim and I have done on that issue.

First, some facts. This is the gap that Jim referred to that is motivating at least this part of the panel, which is widening trade deficits and the concern about the sustainability of this. And the question, of course, is what role would tax reform have in either reversing this or changing it or just impacting it in any conceivable way.

So I want to show you two pictures that may be a little bit less intuitive or obvious to you. That is one you have seen, and this is one you may not have seen—and in fact you may not be able to see now—

[Laughter.]

MR. DESAI: —so let me just take you through what this is.

This is a share of total trade for the United States from 1987 to 2003 that maps the fraction that is what we call "intra-firm trade" as opposed to non-intra-firm trade, or arm's-length trade.

So what this shows, if you can see it, is that green line up top, which you typically think of as trade, which is arm's-length trade, is only about two-thirds or 60 percent of total trade. The rest of it—and it is sizeable and steadily around 35 to 40 percent of trade—is intra-firm trade. What do I mean by that? I mean two kinds of things. I mean Ford selling to Ford Europe, or Ford selling to Ford Japan, or vice versa, and similarly, Honda selling to Honda America and Honda America selling on to Japan.

So there is a large chunk of trade which is not in the frame that you might have thought of, which is this arm's-length, but is this intra-firm trade.

So the first kind of critical thing to realize is that one margin that we haven't talked about that might actually influence trade patterns is just the impact on investment decisions of firms.

So it might just be the case, as Jim suggested, that we, for example, cut corporate tax rates in the United States, we might see additional investment by foreign multinationals in the U.S., which could change part of their trading behavior.

And in fact the next slide suggests—which is also a little bit complicated to see—also suggests that actually, there is a good amount of heterogeneity.

So if you take these three kinds of trade—arm's-length trade, intra-firm trade done by U.S. multinationals—think Ford—and inter-firm trade done by foreign multinationals—think Honda—there appears to be some significant variation between those.

What do I mean by that? So the green line is the—sorry—this is the share of the total trade deficit and how it is composed of by these three types of trade. So the green line, which hopefully, you can see, is the non-intra-firm share, so roughly around 50 percent of the trade deficit is that kind of trade.

But what is interesting to note is that, first, there is a sizeable chunk of it which is foreign multinationals running a deficit from the perspective of the United States, and in fact for the last several years, they have comprised about 50 percent of the trade deficit.

So that a significant chunk of what is going on, at least in the overall trade position, is the role of these multinational firms. One could conceivably see how, for example, reduced corporate tax rates in the United States might lead to altered production decisions which might change that balance.

The second point I want to make about it is the blue line, which historically was below zero. That's another way of saying the blue line being U.S. multinationals. They were inside their firms, historically, at least, running a surplus, and then, over the last five years or so have started to run a deficit as well.

So there are some interesting patterns here that suggest that part of what is going to happen with tax reform is going to be changed investment decisions by these firms, which in turn can have impacts on the trade patterns.

For example, we might imagine, just to go back to the earlier discussion about going to a territorial system, shifting potentially more investment abroad, which in turn could stimulate more imports from the

U.S. perspective, and also similarly could stimulate more experts if we believe in these kinds of integrated production networks that are driving these multinational firms.

So all of this is a way of saying that both transfer pricing responses and investment responses by multinational firms could end up being first order in terms of dictating the composition of the trade deficit and the magnitude of the trade deficit—again, something which hopefully you might not have thought about before, but this is part and parcel of what multinational firms are like today.

My god. I apologize for this. Before it got screwed up, it was bad; now it is really bad.

[Laughter.]

MR. DESAI: Let me just tell you what this says. There is a handout where it looks much better, which you can find outside.

So when I teach this to folks, I always find this very confusing, and maybe this is why.

[Laughter.]

MR. DESAI: It seems quite confusing, and I think it is very useful to revisit some very, very basic national income accounting to understand why it is that some things are going to matter for trade flows and other things are just not.

So here is a simple statement about what comprises national income—consumption, investment, government expenditures, and net exports, net exports being exports less imports.

You rearrange some terms, and quickly, you can impose taxes as well. You quickly get the intuition that the trade balance is a reflection of differences between savings and investment.

So, when we think about this, we always tend to think about policies that impact net exports as being the ones we should be thinking about; but in fact that's a question about what impacts the structural imbalance that we have today between savings and investment.

So the first place to look for thinking about how tax reform is going to impact trade patterns is not on border adjustability, for reasons we will talk a little bit more about, but are on this kind of imbalance.

So—I know this is a mess, and you can revisit this if you like; it's actually fairly straightforward—but really, when you think about trade balances, you should be thinking about savings and investment, and as a consequence, when you look for the effects of tax reform, you should look there as opposed to anywhere else.

So when we see trade deficits as we see today—and this is why people come to very different conclusions about trade deficits, whether it means that we are all gluttonous and not saving enough, or that we are just a wonderful place to be investing.

We should think about how tax reform can impact the net export position really through savings and investment. So the first-order effects that we should be thinking about are, potentially, as Rosanne highlighted and I think Eddie Lazear will highlight, about the other parts of tax reform, particularly reduced taxes on savings, as being something that could actually influence trade patterns.

The corollary to all that, of course, is that things that don't influence savings and investment can include trade deficits.

So this is a way of saying that—and again, something that you might not have thought of—which is the sorts of things that are nominally about trade, like border adjustments, and some of these structural things that are actually going to dictate impacts on trade.

So we have talked a bunch about this. I'm going to take my pass at this chestnut and then fail as well, and we'll see how it goes.

So the idea of border adjustments, of course, as we have talked about is really part and parcel the idea of taxing consumption within jurisdictions. The basic thing that comes about for border adjustment is that you end up taxing imports, and exports get rebased.

Now, this just irresistibly suggests that this is an export subsidy. There are basically two views here. There are views that say, well, this has got to be an export subsidy. Why? Well, because exports are getting rebates. This is simple. And then, there is the alternative view which you have already heard expressed, which is that it has to be neutral because prices move.

I'll just walk you through that second point of view, and then I'll walk you through some evidence about whether it is true.

First, why is it that we think so strongly that it doesn't matter, that border adjustability is in fact something that ensures that a VAT is going to be trade-neutral?

So the first point is just to revisit the previous point, which is that things that don't influence savings and investment can influence trade deficits.

So just to reiterate, if these border adjustments are not things that are going to impact savings and investment, we shouldn't expect them to have trade effects.

Second—and this goes to Alan's point and this question about fixed exchange rates—we tend to think in quantities, but what we don't tend to think about is prices. And it is all about price adjustments.

My final pass at trying to explain this is to think about what it would mean if you had a value-added tax without that curious system of border adjustments, or what seems curious. Well, imagine that you exported a widget, and then you reimported that widget. Without that rebate, that roundtrip trade would be taxed. So in fact, a rebate is a way of making things trade-neutral. This is something that Alan expressed as well.

I think it is easiest to think about a very simple roundtrip trade. You export a widget, you reimport it, and if you didn't have that rebate, this would actually end up being a tax roundtrip trade.

So with a rebate, in effect, the roundtrip trade has not tax implications.

Okay. The final thing I want to talk about is that, as I suggested, first-order effects are things that you may not have thought about, which is the relationship between trade and investment because of these multinational firm decisions about investment and trade. Second are these structural imbalances which are going to be addressed by other parts of the tax reform.

And then, third is this idea about border adjustability. I'll just give you a third point of view. I suggested there were two points of view about border adjustability and VATs, the first being that it is going to be promoting exports because it just looks so much like an export subsidy, and I think that that is wrong for reasons that we have talked about. Second is that it is neutral, which I think in theory.

There is a third possibility which is that these things are trade-retarding, and how could that be the case. This goes to some of the thing that I think people have talked about, and Jim and I have done work on, and I just want to mention them briefly.

Alan mentioned two possibilities that would be associated with border adjustability—revenue consequences and asset valuations. In practice—and Mick [ph.] knows a great deal about this—there are several ways in which VATs get implemented that can have trade effects, and I'll just enumerate them so you get at least some sense of it.

One is when you implement a VAT, what ends up happening typically, or can happen, is the tradable and nontradable sectors get treated unevenly, and that's just because of things that happened in the legislative process of putting in a VAT. That can end up having some trade consequences that could be unanticipated.

So that is one reason why VATs, which might appear to be trade-neutral by the logics that we talked about may not be.

The second is that the infrastructure of building a VAT, which is these rebates, can be problematic, and those rebates can be problematic particularly in settings where there is high inflation. By that, I mean if you are waiting six months in Argentina for a rebate, it is nontrivial, so that too can have an important effect. So that in those settings can actually be trade-neutral for those reasons.

The final reason is—and this is something that Rosanne alluded to—it kind of depends on how you think about the VAT as replacing something or tacking on to something. So if you are replacing something which has trade effects with something that is trade-neutral, you may observe things that are actually an influence on trade.

So just in conclusion, I think it is useful, it is very tempting and alluring, to think about border adjustments as the place where the action is. Hopefully, this gives you a sense that that is not actually where the action is, but it nonetheless can be extremely important for trade patterns.

MR. HINES: Thank you very much.

Our next speaker is Michael Keen, from the International Monetary Fund.

MR. KEEN: Am I in control now of the ship?

A VOICE: Yes.

MR. KEEN: Okay, great. Thanks very much.

MR. HINES: The IMF is always in control.

MR. KEEN: Actually, that's perfect.

Thanks. I just have, as you'll gather—well, I said I had some points to make on some trade implications of corporate taxes. I thought I had two when I started the day. Now I think I have one, because I think Mike mentioned one of the points, and after Mihir, I think maybe I have zero. But I'll keep going anyway consistent, too, with the IMF.

[Laughter.]

MR. KEEN: I want to say that the first of the two points really is, I think, picking up very directly from some of Mihir's points, which is simply to make the point that the evidence is corporate tax changes matter for trade flows. And we know clearly—we have seen it very clearly today—that there is this continuing controversy to the trade impact of the VAT and also of corporate taxes. And of course, a natural thing to do is we start to look at the evidence.

We know that on the VAT, for example, theory projects no impact on trade subject to the caveats that Mihir mentioned, and of course, as well as arguing about a matter of principle, we can just go to the data—practical people have trouble believing this, I think—and what does the evidence say? This is certainly something that Mihir and Jim have worked on, and in your binder, you'll find a paper jointly authored with a colleague at the IMF, part of which really looks at the empirical evidence on the impact of VATs and corporate taxes on trade patterns or net exports in OECD countries for the last, I think it is about 20 years or so; and the evidence pretty much for OED countries—it's just a fact that you can't really find much evidence that changes in the rate of VAT, introduction of the VAT even, or revenue reliance on the VAT is a slightly more complicated story. But the best story you can tell is that there is really no discernible impact either on not exports, which is what we look at in the paper that you have, or on gross imports.

What about corporate taxation. The theory here really picks up very much from his point that we have to think about how corporate tax changes affect this savings/investment balance. And here in part, the story is actually more complicated, intrinsically more complicated, I think, than for the VAT, because with corporate tax reforms, they are inherently talking about dynamic effects, effects that change over time.

So if we think, for example, about what would be the effect in the increase of a source-based corporate tax, a territorial corporate tax, what happens if the rate of that tax would go up? Well, the prediction would be that in the short run, you are going to have basically a capital outflow or a smaller capital inflow than you otherwise would have had; for tax reasons, capital goes abroad. The counterpart of that is an increase in net exports—you can think of that as being to pay for that. Then, you get a recovery of net exports in the longer term, because now we have more capital income coming in from abroad, because now we have more capital overseas.

So you can see that already, we have this slightly complicated theory that predicts a slightly complicated dynamic effect, this kind of reversal of the effect, and then, ultimately, the whole thing should wash away because we know that in present value, net exports are going to sum to zero.

So what about the evidence. Well, the evidence quite surprisingly, given this is quite a complicated pattern, is that you find exactly that, and you will find that spells out a little bit in the paper—here, I have put some results, which of course, you can't read; this isn't actually here for you to read, but to give some kind of credibility to what I am saying. But you will find the numbers in the package, and you may just be able to make out, for example, in the last column, that the CITR variable in the second row comes in as positive, but then, in the third row, it is coming in negative. And that is precisely telling you the kind of reversal of effects that theory predicts.

This is all statistically significant and fairly robust. You get the same thing whether you look at changes in corporate tax rates, changes in corporate tax revenues.

So in some sense, it certainly in contrast to the VAT. It is not at all hard to get some quite strong effects of corporate tax reform on patterns of net exports, and they do have this rather complicated time structure, but very much, I think, emphasizes Mihir's point about you have to think about the impact on savings; savings and investment is really what we need to think about.

The second point I wanted to make, which is the one I think Mike Devereux touched on in his remarks, is really much more from the IMF perspective, that when we think about corporate tax reform or tax reform in the U.s., we think probably first about what does that mean for the rest of the world, and we think about the movement to territoriality, and the answer there is a move toward fully-fledged, full-blown territoriality in the U.S., could matter really quite a lot for the rest of the world.

To set the scene, you can think in a way of the foreign tax credit as being quite similar, having some similarities, to a budget transfer, to budgetary support to other countries. If you think about, for example, the advice you would give to a developing country about, well, what rate should they set their corporate tax is, a key consideration is, well, there is no point setting it at zero or very low, because you want to set it high enough to soak up these foreign tax credits, and in some sense, it becomes almost like budgetary support to other countries including, of course, some developing countries that we care about a lot at the Fund.

And we are talking big numbers here, if I've got my numbers right. The foreign tax credit is much bigger, for example, than U.S. official aid. In fact, the number for the $17 billion at the end is wrong—I think it is nearer $10 billion, so I should change that before anyone corrects me. So it is a big number, and it matters a lot for countries in the rest of the world.

Perhaps more to the point, the foreign tax credit to a large degree, for the reason I was just mentioning, acts as a brake on tax competition in the rest of the world. So again, because it's very tangible when we advise other countries what kinds of tax rates they should have, clearly one argument that is keeping the advised tax rates higher than they otherwise would is the prospect of soaking up some U.S. foreign tax credits.

For example, when countries think about having tax holidays, which one might not like for many reasons, one of the many arguments against it—and I shouldn't say it is the only one, because there are many arguments against it—is precisely to say, look, this is just a gift, or you are foregoing a gift maybe is the better way to put it in terms of being able to extract some revenue without necessarily driving investment abroad.

So without that, we would expect tax competition to become more intense in the rest of the world, which is a concern potentially for other countries, because we know that developing countries, for example, actually rely much more heavily on their corporate tax revenue as a source than do many developed countries; that for them, the corporate tax revenue really is a big chunk of their total receipts. So anything that endangers that is clearly a problem for these countries.

At the same time, for example, as they are having revenue problems from trade liberalization, the last thing they need in a sense is pressure on their corporate tax revenues as well, which there are signs that that is already happening, that corporate tax revenues are being eroded in developing countries, and I think this would clearly give it a further downward twist.

And of course, at the end of the day, with an intensification of tax competition in the rest of the world, that could then impact on the U.S. directly. Many of the more academic of you will remember the paper by Roger Gordon which argues that one of the reasons for giving foreign tax credits is precisely because that helps to keep up tax rates in the rest of the world, and in some sense, alleviates a wider problem, is important in sustaining an equilibrium where rates don't get competed down to everyone's mutual harm, including that of the country that is giving the credit.

So I'm not saying that this should be the overriding consideration in thinking about these things in the U.S., but I think this is clearly something that, for people like us who think of these things in the rest of the world, is clearly one of the important aspects.

With that, thank you very much.

MR. HINES: Thank you, that was great, and of course, we always benefit from the perspective of the rest of the world.

Now, for the parochial United States' perspective, we have Matthew Slaughter from the White House Council of Economic Advisers.

MR. SLAUGHTER: I appreciate the chance to be here today, and one thing I will emphasize is that I used to have a day job at the Tuck School of Business at Dartmouth, and I am on leave from there and currently serving as a member on the President's Council of Economic Advisers, so speaking as that person to you today.

Before we go to that, can we click back to the Introduction?

In thinking about trade on this panel, Mihir talked a bit about savings and investment issues in kind of a macro perspective and its global imbalances, and I want to build on that and, maybe as the last speaker before we turn to lunch, remind ourselves, building on the detailed discussions we have had about particulars of if there tax policy "X" what is going to be the implication on outcome "Y," talk a little bit about the broad perspective and remind ourselves of the overriding goal of the Tax Reform Panel that has stimulated this discussion.

So the first thing I'd like to do is thank Rosanne and thank Eddie Lazear and other colleagues who were on the Tax Reform Panel for generating that document and bringing us here today and doing a lot of stimulating discussion and hopefully moving us on a discussion that our country, probably in a lot of senses, needs to have about what we want tax policy to do.

Along those lines, I want to remind us before I go to a couple of pictures that I have of the title of the Tax Reform Panel Report, which is "Simple, Fair, and Pro-Growth." And the devil is in the details—if you go back to the cover letter that was given to the President with the submission of the report, one of the phrases that caught my eye was that they took to hear the goal of trying to "emphasize simplicity, fairness, and to remove impediments to growth." So let that phrase hang out there with "removing impediments to growth."

And then we think about what evidence do we have in the world, maybe in the past, on what tax reform has looked like and how that links to this broad goal of impediments to growth.

So with that, I put together a couple of pictures. So, to get us ready for lunch, I thought we could try to play a little "Final Jeopardy."

I have a picture of a particular U.S. industry. I'm not going to tell you what industry that is right now, but I want to show us a picture. It's sort of a tale of two generations of a U.S. industry.

I'm not sure everybody can read this, so let me tell you what it is. On the vertical axis is percent, and on the horizontal axis are years, and I've got a generation here from 1960 to the early 1980s. And what I have are three lines here. The pink line is exports to the share of output. So this is exports from the U.S. in this industry to the entire rest of the world expressed as a share of value-added output for that industry.

In dark blue here are imports coming into the United States from the rest of the world in that industry, again expressed as a share of GDP.

So the yellow there is the difference between the two, or the net trade position for the U.S. industry with the rest of the world.

And this is the tale of a generation where imports are rising a bit during this time period, especially as we moved into the seventies, but exports started out higher and were rising more. So we ran a positive and rising trade balance with the rest of the world in this industry.

I think a lot of us would look at this picture, and when we think about international trade and global engagement more generally, it's kind of a comforting picture.

So that's the first generation, and here is the next generation for this industry. What you see in pink is that exports to the rest of the world continue to grow, so that by the year 2000, the last year that I have here, exports show a value-added output of the United States in this industry was 100 percent.

But I think the striking thing in this picture is that imports coming into the U.S. from the rest of the world just exploded. Starting in the early 1980s, imports grew much more quickly than did exports. By the year 2000, imports coming into the U.S. as a share of value-added output in the U.S. was 200 percent of GDP. So the difference, then, the trade balance—the trade surplus remained positive but shrank, so that by the late 1980s, we were running a trade balance with the rest of the world, this industry, and then we started rising large and emerging trade deficits with the rest of the world.

Mihir pointed out today that the aggregate trade imbalance for the U.S. is about 6 percent of GDP, give or take, for calendar year 2005. For this industry, by the year 2000, we ran a trade deficit with the rest of the world of 100 percent of GDP. It is just an industry, but it is a big trade deficit.

In dollar values, the trade deficit in this industry that year was about $35 billion. So now, the obvious question is what industry is this.

Any guesses?

[No response.]

MR. SLAUGHTER: When I have shown this to groups in the past, I hear a lot of answers like textiles, apparel, footwear, automobiles, steel, some agricultural commodities. What it actually is is computers and office products. It's SSE357, if you know the old SSE codes.

If you look at similar industries in the U.S., say, for example, semiconductors and related components, which was SSE367, you see a very similar picture as well, which is of an exploding trade deficit during the second generation, and in those two industries together in the year 2000, we ran a trade deficit with the rest of the world of about $60 billion.

So what was going on? I think all of us know the anecdotes of what was going on at the micro—

[TAPE 2, SIDE B]

MR. SLAUGHTER [continuing]: —involved, which was when a lot of personal computers and that information technology was first invented in the early 1980s, we did a lot of manufacturing production in the United States; literally, there are production facilities on Sandhill Road in Silicon Valley. And we kind of chuckle at that now, because we know that very little of that value-added is produced inside the U.S. borders anymore. It is produced in these global production networks that were emerging during the time period of the second generation that I have here, and the mix of things that was getting down in the United States changed dramatically. We had discussion earlier about whether expansion abroad substitutes or complements what is done in the United States and those sorts of things, and I think this is a vivid example of that kind of outcome.

Now, what does this have to do with tax reform? The question that I'll put on the table is what was the world's only industry in the 1990s to eliminate all tariffs? Not surprisingly, it wasn't steel or autos, given what industry this is—it was information technology.

So the Information Technology Agreement in the World Trade Organization had a comprehensive move to free trade among all signatory countries from 1997 through 2001. This covered basically every country in the world that had any IT hardware production of intermediates, capital goods and final goods. So the actual agreement covered over 200 different intermediates and capital goods and final goods.

What was interesting is if you look at the political economy of the ITA, along the way, before the ITA actually was codified in 1995-1996 and went into effect after that, during the 1980s and the early 1990s, there are a lot of countries involved in emerging global production networks that had bilateral liberalizations or regional liberalizations in this industry or unilateral liberalizations. So think of the ITA actually as kind of a codification of an ongoing process of tax reform—granted, a very different kind of taxes. We are talking about border taxes here. But I give this just as an example to have in our heads when we think about the big picture goal of the Tax Reform Panel, where again, the title is "Simple, Fair, and Pro-Growth."

Now, what does this have to do with economic growth—and I think this is my last picture. What about the overall economy and what does it have to do with economic growth?

An interesting fact is that since 1995, growth in labor productivity and thus real living standards in the U.S. has accelerated dramatically. So, as I think a lot of folks in this room know, there has been this resurgence of labor productivity growth in the United States.

So, from 1973 to 1995, the average annual rate of growth of labor productivity, measured as output per worker hour in the non-farm business sector was about 1.35 percent per year.

Since 1995, that has accelerated. The growth rate in the subsequent decade from 1995 has been 2.92 percent per year. It has actually accelerated since the year 2000. Over the year 2000, the rate of growth of labor productivity has been 3.28 percent. And this year so far, it's looking like labor productivity growth in the U.S. barring some surprise in the Fourth Quarter, will again be well above 3 percent.

Why does this matter? This matters because of the miracle of compound interest in terms of how fast living standards increase. So with the old rate of productivity growth of 1.35 percent per year, it took about 52 years for living standards in the United States to double. At the rate of 2.92 percent per year, you're down to 24 years for living standards to double. So just rolling this out, these seemingly small differences have big implications for, again, the big picture goal of the Tax Reform Panel, thinking about removing impediments to growth and how to help raise living standards in the United States.

How does this link with IT? Well, in case you don't know, there has been keen interest among policymakers and the business community to understand what has driven this acceleration in labor productivity in the U.S. And fortunately, we've got some pretty good data in the U.S., so you can slice up these aggregate statistics by industries, and a lot of economists have looked at this, and there is an emerging consensus that IT firms have really been at the core of the productivity boom, at least for the first half. The past few years, we still don't have all the complete data to fully understand what is going on with this 3-plus percent rate of labor productivity growth. But for at least the 1995 to early 2000 period, IT firms had an acceleration in their rate of productivity growth, so greater productivity of IT firms themselves, and that simulated greater us of IT capital investment elsewhere in the economy and, a lot of people have argued, has stimulated productivity growth in other industries, because along with buying the new capital goods of IT hardware and related software, they have reorganized their production a lot.

So the point that I will make in trying to draw this together is again, per the previous picture, these highly successful IT firms are among the most globally-engaged firms that the U.S. economy has. So when we are thinking about productivity growth, what you see is that I think the strategies this IT firms have implemented for establishing, expanding, and changing the mix of what they do around the world has been central to fostering the productivity growth that they have enjoyed in the United States.

You see it not just in trade flows, but per some of the discussion we have had in the panels, you see it on foreign direct investment as well. If you look at, for example, the share of employment of U.S.-headquartered multinationals, that's abroad in their foreign affiliates, so take a look at the global employment of U.S.-headquartered multinationals. What percentage of those employees work outside the U.S. in the affiliates? IT facilities have today in the neighborhood of about half of their total employment abroad in affiliates. That is a much higher share than you see for other industries, other manufacturing, or definitely the broader service part of the U.S. economy.

And again, this nexus that some of the speakers have alluded to of the intersection between companies that are involved in international trade and companies that are involved in foreign direct investment, the point is well-taken when we think about, again, this broad goal of raising growth in living standards of the United States. There is now a prepo9nderance of evidence that from most countries, the U.S. included, there is a real dispersion among performance among companies, and the ones that are globally engaged through trade and foreign direct investment tend to be better performers on a lot of the measures that we look at. Cause and effect seems to go both ways, kind of describing what economies look like. On a lot of issues, these are the important companies that we have in the U.S. economy.

Just one fact that I'll give you on that—we talk about inward and outward foreign direct investment. So if you look at the U.S. economy, the best data that we have from the Commerce Department runs only to 2002. From the year 2002, if you count up all the private sector employment in the United States, a little under 25 percent of people in the private sector in the U.S. that year worked for either a U.S. parent of a U.S.-headquartered multinational or for a U.S. affiliate of a foreign-headquartered multinational.   So about one in four people in the private sector were working for a multinational company.

So multinationals account for about 25 percent of the jobs, but in that same year, they accounted for over 73 percent of all the exports that went out of the United States this year—so it's a broader measure. And here is inter-firm trade, because I'm not looking at the partner on the other side. And they accounted for an astonishing 86.7 percent of all the international R and D done in the U.S. that year.

So I'll close by again thanking the Tax Re3form Panel and pointing out that the broad picture that hopefully we'll all keep in our heads are these issues of how does tax reform, like other dimensions of public policy, fall into this ultimate goal of raising living standards and fostering economic growth.

With that, I will stop.

MR. HINES: Thank you.

We are a couple of minutes over time. I would normally like to have an opportunity for questions right now, and I hope we can have one or two, but just remember that we are eating into our lunch time, and let me quickly add that in the 7 minutes that we are overtime, the U.S. current account deficit has increased by $10 million.

So if there are one or two questions, I'm sure our panelists would be happy to answer them.

Yes?

QUESTION: This is a question for Keen.

I think you were expressing the view that the advice of the IMF to developing countries was to take a gift from the U.S. and some other treasuries and to maintain their corporate tax rates at similar to the U.S., maybe the UK, Japanese level, countries that have foreign tax credit regimes.

It seems like a lot of developing countries have entered into tax-bearing agreements where, bilaterally, they are saying, "Please, we want a territorial system with respect to our trading partner that has a worldwide tax system."

Why do they enter into tax-bearing agreements and forego the gift?

MR. KEEN: Well, I think I should say two things. One, I wouldn't want to give the impression that this is the key principle around which we base all our advice to developing countries.

I think it is certainly true that amongst the considerations, we would say—we have a long list of things to say about rates, but certainly thinking about rates relative to the U.S. is important.

On tax-bearing, it's not entirely clear. I think political economy has a lot to do with this, and developing countries do seem to like tax holidays of various kinds. For some reasons, tax holidays are something that we particularly dislike in developing countries, and I think there is simply a lot of political economy that they think holidays send a good signal, and we think they send a bad signal; and I think that then leads them into thinking about [inaudible] arrangements of that kind.

But I think it's more a political economy issue than anything else. But on the other hand, tax-bearing is becoming less and less common, I think is our impression, so it is not a huge concern typically with these countries. But I think there are a lot of political economy issues that we don't quite understand in the policy-setting in developing countries. That's certainly true.

MR. HINES: Plus we can all agree that holidays are festive, so that may be a consideration, too.

Rosanne?

QUESTION: I agree that tax competition could get more intense if we were to go to a territorial tax system, but I wonder how much more intense than where we are right now.

Jim Hines gave us a very nice review of the literature on how multinationals respond to taxes, and they are incredibly responsive to differences in tax rates around the world. That suggests that what the U.S. is effectively running is a territorial system. If you have a worldwide system, then those taxes should not matter at all, and the idea that you can just set your tax rate to be just a little bit below the U.S. and take that for a tax credit gift is right. But that's not the current system. It is credit with deferral, and we see that firms are incredibly sensitive.

So I just wonder how much more the U.S. going territorial is going to unleash in terms of tax competition.

MR. KEEN: I think that's a very fair point, and what we have at the moment may not be that far off territorial. And in fact, indeed, the first set of results I presented tend to say that corporate taxes around the world act like territorial, because if they weren't territorial, the theory I gave you actually goes in exactly the opposite direction. So if they were really worldwide, the sign pattern would be reversed.

So I agree that to some extent I was overstating the case by pretending that the U.S. has it. And I think I would also say that, again, downplaying the extent to which this is a central feature of our advice, we know that life is more complicated than that and that basically, there is deferral, and everybody in the room is going to find a way around anything we can do.

So I think those are all fair points. I think, nevertheless, it is a reasonable policy concern, partly because of the point I was making before, that we know that many of the countries that we deal with in the coming years are going to have problems adjusting to trade liberalization; they are going to have real revenue problems adjusting to trade liberalization, and really, anything that potentially adds to that pressure no those countries I think is a reasonable cause for concern. I am not saying—I mean, I think you are right. We don't know, really, how important this is, but I think it is something that at least from our perspective would factor into the debate.

MR. HINES: Yes?

QUESTION: I just couldn't resist following up on that, which is had the Tax Reform Panel commission elected instead to try to go to a worldwide system and to end deferral, then the implication would be it would help or reduce this existing competition; right?

MR. KEEN: I think that's true, that logic, yes.

MR. HINES: Does anyone else have criticisms for Mr. Keen or the President's White House or Mihir Desai, for that matter.

[No response.]

MR. HINES: Okay. We are now going to proceed to lunch in just a moment.

The program is concluded now, and I would just ask you all to join me in giving a round of applause to our presenters and discussants for a really stimulating event.

[Applause.]

MR. HINES: Lunch is going to be served immediately next door, so I suggest you go promptly, grab a seat, and get some food.

MR. HUBBARD: And we have a lunch speaker, Eddie Lazear.

MR. HINES: Yes, we have a luncheon speaker, so please get seated, and Glenn is going to introduce him.

LUNCHEON ADDRESS

MR. HUBBARD: I know the logistics of the room make this somewhat difficult.

It is my pleasure to introduce our luncheon speaker, and he can take questions on his own after his remarks—Eddie Lazear. Eddie is someone I have known for many years. He is Jack Steele Parker Professor of Human Resources Management and Economics at Stanford, GSB. He is a Senior Fellow at the Hoover Institution. Prior to 1992, Eddie was a professor at Chicago GSB, and I think of him as a classic Chicago micro economist, which I intend as a high compliment if you don't understand what economists say when they are talking. By that, I mean someone with wide-ranging interests in micro, particularly in Eddie's case, in labor markets and personnel issues, micro theory, theory of pricing and marketing policies, discrimination and affirmative action.

Eddie's book, "Personnel Economics," truly has shaped the teaching in every top business school about incentives in the labor market—I hope you have made money on it to boot—and his numerous teaching awards and general lecture invitations certainly highlight his draw as a speaker, as you will see in a few minutes.

For our purposes today, if course, tax policy is not the variable "T" that goes in equations, and that is not what it is to Eddie, either. He provided much of the intellectual fire power that we have seen in President

Bush's Tax Reform Panel, and as the panel's report is now going to be undergoing review and consideration by the Treasury Department, at ITPF, we thought this would be a great time to get Eddie's observations, particularly on international tax policy but also on the big picture of what the Tax Reform Panel is trying to do.

So, Eddie, without further ado welcome, and thank you.

[Applause.]

MR. LAZEAR: Thank you, Glenn.

I would just like to say that this has been a very interesting conference. I have really enjoyed it. This is not a group that I normally get to meet with, and it has been terrific, very stimulating, and really a high level of intellectual activity, and I hope we can continue that at lunch.

Last night when I came in, I had a drink with Rosanne, and she told me that I should preface my talk by telling you that I'm not a tax expert. And it didn't sound like a compliment, but I know Rosanne well, and I know that by Rosanne's standards, it was a compliment. I think her logic was that you guys would cut me some slack by saying that, but after seeing the questioning this morning, my guess is that you are a "take no prisoners" crowd, so we'll just see how it goes.

This set of comments is essentially at a higher level than you were this morning. I think in some ways, we kind of reversed it, because you were talking at a pretty detailed, very specific level, and what I want to do today is talk a little bit about the Tax Reform Panel and what we came up with and what some of the logic was behind it and what we hope that we will be able to do if any of our suggestions are accepted.

As you know, this was a committee that was formed by President Bush almost a year ago. We are hoping that tax reform will become a key item on the agenda for next year. The mission, of course, was to simplify, to create growth, and to generate a plan that people would view as fair.

We can up, as you know, with two plans—the Simplified Income Tax and the Growth and Investment Tax. Someone mentioned that it's probably not a very good idea to call growth and investment a tax. You think of those things as being a bit oxymoronic. But anyway, that's what we ended up with.

The constraints that we faced—and these are important, and my guess is that I'll get some questions about this afterward—the constraints that we faced were the following.

First, we had to present a plan that retained the income tax. Second, we did have to retain mortgage deductibility, at least in some form. Third, we had to retain charity deductions in some form. And fourth and most important, the plans had to be revenue-neutral.

When we say "revenue-neutral," that depends on what your assumptions are about what future revenue is going to look like, and there are a lot of things that come into play there, not only estimates of what

GDP is going to look like in the future, but also what we assume about policy.

The two key ones—and I think what I'll do is hold off on this until after, because I think some of you will probably ask me this in the question and answer session—were assuming that the President's tax cuts would be permanent—that was an assumption that we were supposed to make—and second, implicitly assuming that the AMT patch was going to expire. Okay. Now, I say that implicitly, because we were not given any instructions at all with respect to the AMT, and that became an important source of debate within the panel.

So, as I said, let me just hold off on that, and I'll be happy to return to it afterward.

Anyway, we had to create a plan that was revenue-neutral.

The theme that we started out with is that the purpose of the tax is to raise revenue. It is not for other things. It is not to subsidize cranberry farmers in Massachusetts or some other worthy cause. Those things may be good ideas, but we felt it was better to try to keep those outside the system, outside the tax system. A tax system tends to make those kinds of incentive devices less than transparent, and we didn't think that was an appropriate way to go.

Once you start talking about reform, the first question—it seems to me the first question—that one should ask is: Why do you want to reform? What's the problem? If you're saying you're going to reform something, you have to state what the problem is in the first place, because if there is no problem, then there is no need to reform.

So let's think about what the problems are, and I think the way you want to judge the report is to ask whether we have accomplished our goals in terms of solving these problems or at least addressing these problems head-on.

So what are the problems?

The first one, of course, is that the current tax system is burdensome. It's a mess. It's costly. It's difficult and so forth—and that's the obvious one.

The second one that is obvious to this crowd is that there is very little saving in the United States and the tax system does not work in the direction of encouraging saving or removing impediments to saving is probably a better way to put it.

Another problem that one might be concerned about is too little investment. Now, investment rates in the United States have not been low, but on the other hand, we do worry about competitiveness—that came up in a lot of the discussion this morning—and also when we think about investment, what we want to do is have the efficient amount of investment, and if the efficient amount of investment is higher than what we have now, that is a problem.

How about work discouraging work, labor supply? That is obviously a key issue when you are talking about marginal tax rates, high marginal tax rates. At one point, there was a country that had tax rates of 89 percent. Most of you are not old enough to remember that country, but I am. That does not encourage a lot of labor supply.

Related to that is investment in human capital. Human capital is extremely important in terms of economic growth, and this country has done pretty well in terms of human capital, but we wanted to make sure that the tax system would not be so progressive so as to discourage investment in human capital.

Actually, let me pause on that one for a second because that's pretty close to my heart. When I first started out thinking about this, I was pretty concerned about that. And one concern that kind of comes from another side of work that I do is that when we think about human capital in the U.S., you think about the problems in human capital in the U.S. as not being among the people in this room or the people that most of us know, but rather at the lower ends of the income distribution.

So the question was: Is there much that we could do with the tax system that would change the level of investment among low-income, low-educated people in the country, because that is where the big problems are. The people who go on to college and go on to graduate school do pretty well, and investment in that level looks pretty good.

My feeling was that that was probably not a major focus for us, not because it is not important, but because there wasn't a lot of elasticity there. There just simply wasn't a lot of mileage that we could get. It's not the case that people who are dropping out of high school would go on and get Ph.D.s if only the tax rates were different. It's just not a big deal.

So we didn't focus too much on that, and we actually moved away from thinking about human capital even though it is, as I said, close to my heart.

Another goal was fairness. Now, fairness is in the eye of the beholder, of course, and what we ended up doing almost just as a result of the process was coming back to the notion that the current system was one that we would deem fair in terms of tax burden distribution. And that's not because the current system is necessarily fair, but the thing that that has going for it is that the current system is the outcome of a political process by elected officials. And as a result, we felt that deviating from that, taking a nine-member panel and deviating from that, was really going beyond our marching orders. We really didn't feel that that would be a good thing to do. So we actually worked very hard to make sure that the plan generated a distribution of tax burden that was not very far off from the current tax burden, so you see in the rate structures that we have that embedded, and it was an explicit goal.

Remove investment distortions—corporate organizations are taxed differently than partnerships, which of course are taxed different from housing. That creates distortions, obvious ones. Pushing debt-over-equity kinds of financing is another distortion, obviously kinds of distortions that we wanted to eliminate, so trying to bring about as neutral a system as possible.

And then, finally, international competitiveness, which of course is close to your hearts and something that we felt would be important as well, and many of the things that we talked about this morning relate directly to that, and I probably won't go there; I think Rosanne did a good job of handling our views on that.

What about relative importance? Well, when we started doing our hearings—and we did a bunch of these hearings around the country which were kind of fun, actually; some of them had people in the room participating in them, but some of them, we just had "man on the street," "woman on the street"—and the thing that came up over and over again was the obvious point that the tax system was burdensome. That's what people think about when they say, oh, yeah, if you talk to your neighbor about why do we need tax reform, it's because it takes me two days to fill out my income taxes. And it really does—if you think about the amount of resources spent on filling out taxes total, taking all sides into account, estimates are somewhere about one percent of GDP. So you are basically spending two days a year not just working for the government, but working to fill out your taxes. That's a big deal.

On the other hand, if we think about growth, and we ask how much can we gain from making the economy grow, the estimates are that if we adopt an efficient tax system, we could have anywhere from 5 to 7 percent higher GDP in steady state.

So you are talking about something like reducing the cost of tax burdens, say, by half. You get a half percent of GDP. Whereas if you could do something to increase growth, we're talking about something that is an order of magnitude different.

So growth is really the story here, and that certainly in my mind was the most important goal at least in going into that. That's what I kept thinking about and what kept pushing, and I think Jim Puterba [ph.], the other economist on the panel, felt the same way, and I don't think we have any opposition from Rosanne or others of our colleagues on the staff.

What about the kind of tax structure—consumption or income? As you know—and I don't have to tell this crowd—consumption taxes have a lot of things going for them. They are neutral in many respects. They have a lot of advantages in terms of not discouraging saving; it doesn't tax investment, doesn't favor one form of business over another, and doesn't favor one type of financing over another. All of those things are great.

There were a couple of people who argued for income taxes. Bill Gale, who isn't here today, I guess, was probably the strongest proponent in one of our hearings. And some people feel that income taxes are inherently fairer.

I guess my personal view is I just don't feel that that is a strong argument—and I wish Bill were here to contradict me—but consumption and income are highly correlated, so as long as you have a consumption tax that is sufficiently progressive, I think you get 98 percent of the way there, and if you can save on the distortion, kind of getting the other 2 percent just didn't seem to me to be personally worth it. So that was the tradeoff that we made.

We talked about other kinds of consumption taxes. The obvious ones are the VAT and the retail sales tax. We didn't go down the path of the retail sales tax, although many find it attractive, and it does have some very attractive features. I actually like it. I think there are a lot of things that it has going for it.

The reason we didn't go that way is that when we did the calculations, when we figured out what we would need to do in order to create a revenue-neutral sales tax plan, the rates just simply seemed too high. We were in the neighborhood of mid-30s, tax exclusive. And it also meant that in order to get a tax burden distribution that looks anything like the current tax burden distribution, we would have to run an enormous transfer program, and that program would involve about $600 billion a year passing through government hands.

Now, some of us who don't like to have a lot of money passing through government hands were worried that those funds might someday be subverted for other purposes. So that was another negative, I think, that was associated with this plan, and I think it's a legitimate one. That was basically why we came out against it.

The VAT, on the other hand, I think had much more support within the panel. It did not get elevated to the point of one of the plans that we actually presented, but I think we did a pretty good write-up of the VAT. If the President wanted to go that way, I think there would be enough material in the report that he could actually do that.

Again there were political economy concerns no the VAT. You have heard them expressed before; I don't have to tell you what they are. People worry about it being a money machine, and other people worry about it being too aggressive, so then you have to couple that with another large transfer program or some kind of an income tax program.

Those are the arguments that were made, and in the discussion in the panel, we just could not come to agreement on proposing it, and that's basically where we left it.

But virtually everybody said, Oh, if we had our way, if we were dictators, and we could make this thing work, that would be our plan. So that conceptually, it was the best plan.

All right. The two plans that we did present were the Simplified Income Tax and the Growth and Investment Tax. The Simplified Income Tax is a three-rate structure—15, 25, 33 percent. Both plans eliminate the AMT. The AMT, by the way, is just hated. One thing we learned in doing these hearings is that people hate the AMT. Whether it hurts them or not, they just hate it. There is something just odious about it—the fact that you go and compute your taxes, and then at the end, they say "Gotcha. It's more than you paid in under the old plan, and that's what you have to pay." People just dislike it. So we figured the only thing to fly at all was to eliminate the AMT, and that was quite costly, and this again comes back to the patch. It is not that costly if we don't build into our assumptions the fact that the patch is going to expire. But once you assume that the patch is going to expire, and that you are going to have this revenue from the AMT, you've got to make that up somewhere, and that was a serious constraint for us and caused us a lot of heartburn, unfortunately. It was really the biggest problem that we faced.

So what we did was we presented a plan that simplified and reduced the amount of deductions. We did keep mortgage deductibility, but we proposed a cap at 1.25, the FHA limit. The big thing, though, was not so much the cap. The cap affects only about 5 percent of the country, and I know every one of those guys, because they live in California in Silicon Valley, so I've had a lot of death threats out there. But it's not so much that. The other thing is that it actually moves in the direction of making the deduction much more progressive in the sense that it gives credits and credits to people who wouldn't otherwise itemize their deductions.

So that is a different kind of structure, and it also means that the rate is 15 percent rather than the marginal rate, so that is significant—even if you're not above the cap, that's pretty significant if you have a good-size mortgage, and that will affect people, and it hasn't been universally popular.

[Laughter.]

We also allowed for charity deductibility at 15 percent. And the other big one was capping health care deductibility at the employer level at $11,500 for families and $5,000 for individuals. That is a novel concept in the sense that people have been reluctant to play around with that, but I think that introducing the notion that there should be a cap, there should be some individual responsibility for health care costs, is one that we wanted to build into the plan.

The numbers are actually quite high, and the reasons we came up with that number were two. One, it is close to the average, and second, it was the number that I think Congress gets right now. So that was kind of a convenient number to use.

The number, actually, from an economic point of view is too high. The reason it's too high is that if you think about it, the average amount right now already builds into affect the distortion that takes place because it is tax-deductible, so people are already consuming too much of it. So in some sense, we should have a lower cap if we are trying to think about efficiency, but we don't.

All right. The growth and investment tax has many of the same—oh, I'm sorry. There were three saving plans associated with the Simplified Income Tax.

One is Save at Work, Save for Retirement, and Save for Families. The Save for Families one is a big one because it means that a family can put aside as much as $10,000 per year per person, so that's a lot. A family of four could save $40,000 a year. What that basically means is that almost all families in this country can save tax-free. That doesn't mean that all dollars are saved tax-free, of course, because the bulk of dollars is going to be saved disproportionately by high-income people. But it does mean that most families can save tax-free. So that, I think, moves the ball forward considerably in terms of saving.

Okay. The growth and investment tax—it is very similar in most respects to the Simplified Income Tax, but it changes a couple of features. The first feature that it changes is that the top rate goes from 33 percent down to 30 percent. And we think of it as creating a consumption tax out of an income tax.

Now, Glenn just beat me up on that, and we have been beaten up on that before, because what we ended up with was a tax that's really not quite a consumption tax.

What we started out with conceptually was a consumption tax, something very close to David Bradford's "X" tax, where the key feature is full expensing of capital, of investment. That's really the thing that turns it into a consumption tax.

So that is a big deal, and we think of that as being probably the most important component of the growth plan. Why is that? Well, if you just think about it for a minute, suppose you are going to build a high-rise, and it's going to cost $50 million, and you were going to depreciate that over 39 years, and now what you can do is you can expense it just today. That's a big difference. That's not a trivial matter. That's a big deal.

So being able to expense would have, we think, a quite large effect on investment and on growth in this country.

We had to move away from that, to be honest, for a variety of reasons, some of which were political, some of which just reflected differences in opinion on the panel about the way capital should be treated. So we coupled that with 15 percent tax on capital income at the level of the individual. That is why Glenn says, "Well, you really shouldn't call it a consumption tax," and he's right—we really shouldn't—because it is no longer a pure consumption tax. It is a hybrid tax. But conceptually, we started out with a consumption tax, and in fact, if the President wanted to, he could simply take our tax and say we're going to knock off that 15 percent taxation of capital income, and then you are back to a consumption tax. That's why we set it up that way, so that the basic conceptual framework would be there.

The business taxes that we have in mind are cash flow taxes. Super-normal returns would be taxed at 30 percent, but the normal returns, of course, because you have full expensing, face a zero tax rate at the level of the firm. There is taxation again, because of this 15 percent aspect.

What that does is it changes the effective tax rate on new investment from 17 percent down to about 6 percent. That was Treasury's estimate for us. And that's a big deal, and that is again where we think the growth effects come from.

We also allowed for some transition relief—I don't see Alan; Alan probably took off—he left, okay. Alan provided some estimates on this in his Wall Street Journal piece—is Gary here? I think his critic took off, too. Okay. Anyway, in that piece, Alan suggested that the growth could be as high as 9 percent, but if you gave transition relief, of course, you would eat it all up.

So the question was how much transition relief should we allow? We allowed for about $400 billion of transition relief in the plan, and we felt that was necessary in order to prevent businesses from going under in the short run, from having housing take too hard a hit in the short run, and individuals being hit by it too much.

Let me conclude, then, and turn it open to discussion. So what did we come up with? Well, we came up with two plans which are simple. We now have a form that used to be two pages—the standard 1040 Form was two pages—now it shrinks to about half-a-page. We have 54 pages of extension forms that now shrink down to 10 maximum.

So there is pretty significant simplification there. Both plans are pro-saving. The consumption plan is very much pro-investment, again bringing the rates down from 17 percent to 6 percent. And we think of both of them as being inherently fair, because they do create a tax burden distribution that is very similar to the one that we have right now.

Why don't I stop there and turn it open to the discussion and take any questions or thoughts.

QUESTION: What methodology did you use to do the distribution and consumption tax? Did you allocate it by consumption, or did you [inaudible] in some other fashion?

MR. LAZEAR: I actually should get Rosanne to help me on this, but the big issue here was how you treat the budget side of it. It's not so much the individual side, because you have that directly from the returns. The question is what is the incidence of the business tax? And Treasury assumed that business taxes were passed on to capital owners, so that's how they scored it. You could say—it depends on what you're going to assume about elasticities, because you could say labor might take some of the hit there as well. But the assumption was that it went through owners.

QUESTION: [Inaudible question; no microphone.]

MR. LAZEAR: Possibly, yes. Well, there are different ways to score it. Just in terms of scoring, there are a lot of general issues, actually, if you'll allow me to digress for a minute on this.

One question was should we do dynamic scoring, which in some sense is a bigger issue than some of the details of the incidence of the business tax. In terms of the actual numbers, that's a big deal.

And we decided against doing dynamic scoring primarily because we felt that—well, there are two reasons. One was we were afraid that by bringing in dynamic scoring where we built into our revenue estimates growth assumptions about the economy, we were afraid that people would say this is really a tax cut, and they are sort of disguising the tax cut by assuming some growth that who knows if it will be there or not. That was really the main problem.

The second problem was that we didn't believe that Treasury would do it. So after the Tax Panel is done and gone and we disappear, Treasury takes over, and we don't have any control over what happens from then on. So if we do something that they don't like, and we knew they didn't particularly care for that, what ends up happening is they undo the assumptions. If Joint Tax does it a different way, Urban Institute—other people are going to score these things. But Treasury is going to be central in terms of what actually happens as far as the President is concerned, so we just decided to be careful about these issues and just to take their assumptions and take their methods as given. And that was the reason for it.

Go ahead, Rosanne.

MS. ALTSHULER: In the Appendix, there are some tables that use alternative incidence assumptions.

QUESTION: I haven't read that far yet.

MS. ALTSHULER: You haven't gotten there yet. Well, you'll be very interested to see that there is one set of tables that allocates half of the corporate-level tax to labor and half to [inaudible].

QUESTION: But none that does [inaudible] allocate the consumption.

MS. ALTSHULER: We didn't; no, we did not.

QUESTION: I have a question that may be better addressed to Rosanne, too; I don't know.

MR. LAZEAR: That's okay. Everything is better addressed to Rosanne. We are the faces; they are the bodies.

[Laughter.]

QUESTION: Mike Devereux actually put this up on one of his slides but I don't think he addressed it, which is why in deciding to provide dividend relief to U.S. shareholders did you deny relief to income earned in a foreign country?

Let's assume that the data shows 35 percent tax in the UK, and repatriated—

MR. LAZEAR: The logic on that, the logic for treating corporate capital, U.S. corporate capital, different from other capital, was simply the sort of closed system idea. So the notion was that corporate profits in the United States are taxed directly by the business tax, but sources outside the United States are not taxed directly by the business tax.

Now, there are indirect effects, of course, through the credit system and through other systems. So one could argue that if you sort of built this into a more general equilibrium analysis, it is conceivable that you would actually want to give some credit, maybe not at the same rate, but some credit to investment outside as well.

But Rosanne answered I think for simplification reasons in large part, we decided not to go down that path and decided that the best way to do it would be just to say, look, if it is taxed at the corporate level in the United States, we don't want to double-tax it. That was the main problem that we were trying to fix. It doesn't mean there were other problems that we should not have addressed as well, but that was the central rationale for it.

I don't know if that satisfies you—go ahead, yes.

QUESTION [No microphone]: But if it were a simplification issue, you surely wouldn't want to have a regime where you've to know whether dividends are coming from foreign or domestic—that's a complication all over the place.

MR. LAZEAR: Well, that's true. But what you're saying is as long as you've got to trace where the revenue is coming from, where the profits are coming from, you might as well—it doesn't have to be zero. You're saying the rate doesn't have to be zero; if you know it came from outside, you could tax at any rate you want.

I think, again, there is sort of a one-size-fits-all issue here, so the question would be, okay, what rate would you apply to the stuff outside. It's going to be country-specific, right, because—is the credit binding or not—that's going to be firm-specific.

So it is not an easy thing to do, and I think we just felt it was sort of beyond the level that we can reason through. It doesn't mean that someone drafting very detailed legislation might not think about this issue; I think they could, and it would be perfectly reasonable to do it.

Yes?

QUESTION [No microphone]: You could have done what a lot of other countries that [inaudible] corporate double tax have done, which is to say "except if the dividends do not exceed the amount of domestically taxed income." They would be exempt.

MR. LAZEAR: Right.

QUESTION [No microphone]: So you stack it first against the domestic income, and beyond that, it's taxable. That actually would have a number of desirable [inaudible].

MR. LAZEAR: Yes. And again, I think that's the kind of thing that—my guess is that when we pass this on, and we get to—we really didn't think about most of these things at that level of detail, but that didn't mean that we didn't think it was relevant; it was just that we didn't have the scope to do it. So we left a number of things open.

Another one that we left open—and I digress a bit here, but this is a really important one for the United States—is financial institutions, treatment of financial institutions versus real businesses, non-financial businesses.

The big problem with the growth and investment tax structure is that financial income is treated as non-transaction from the point of view of a real business, but it is treated as the heart of the business if you are a financial institution.

So, for example, you can't deduct your interest if you are a real business, but you can if you are a financial institution. That's part of what goes on there. So once you have those kinds of differences, you have an incentive to go one way or the other. That is something that we need to address.

We talked about potential ways to get at it, but we didn't go through the details of it—and as I said, I'm not embarrassed that we didn't because I just don't think that that was the nature of our job.

QUESTION [No microphone]: No one else has figured it out, either.

MR. LAZEAR: Other comments, questions?

[No response.]

MR. LAZEAR: Well, we can stop or—I think you guys are out of gas.

Okay, thanks very much.

[Applause.]

[Whereupon, the proceedings were concluded.]