THE BROOKINGS INSTITUTION

AMERICAN CORPORATE TAX EXCEPTIONALISM

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PANEL 1: TAXATION OF FOREIGN INCOME BY THE U.S. AND OTHER GOVERNMENTS

Moderator:

MICHAEL GRAETZ
Yale Law School

Panelists:

JAMES HINES
University of Michigan

PANEL 2: CORPORATE TAX BURDENS AT HOME AND AROUND THE WORLD

Moderator:

KEVIN HASSETT
American Enterprise Institute

Panelists:

DOUGLAS SHACKELFORD
University of North Carolina

Martin Sullivan
Tax Analysts

PANEL 3: IS U.S. CORPORATE INVESTMENT ABROAD BAD FOR THE U.S.?

Moderator:

ROSANNE ALTSCHULER
Brookings Urban Tax Policy Center

Panelists:

ALAN AUERBACH
University of California at Berkeley

MIHIR DESAI
Harvard Business School

PANEL 4: DOES IT MATTER IF THE UNITED STATES DEVIATES FROM INTERNATIONAL TAX NORMS?

Moderator:

JAMES HINES
University of Michigan

Panelists:

ROSANNE ALTSHULER
Tax Policy Center, Urban Institute

MICHAEL GRAETZ
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University of Michigan

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P R O C E E D I N G S

MR. GALE: All right, thanks, everyone, for coming this morning to this conference cohosted by the International Tax Policy Forum and the Tax Policy Center. I am delighted to welcome you on behalf of TPC. We are delighted to cohost this with ITPF continuing along tradition.

Our mandate today is to take on the international tax system and to understand how it works, how it could be modified, especially as it relates to taxation of multinationals. That's a big mandate, but, you know, hey, these are heady times for public policy. Peter Merrill originally wanted to have this conference between the election and the inauguration, and I in my wisdom said no, no, don't do that, the calendar will be too busy; there'll be too much going on with the new administration. Wait till February. Things will have calmed down by then.

So, you know, we managed to squeeze this event in after the passage of the Stimulus Package, after the announcement of the housing package and the financial bailout, just before the budget summit and the release

of the budget. So I guess the good news is we have a whole day to figure out the international tax system and solve that problem before we go back to solving all the other problems that the world faces.

So let me just say that everyone in D.C. is aware of how much is going on. I think international tax policy will be on the agenda. It's obviously not the first thing but it's not a set of issues that are going to go away, and a more general theme is we should not let the urgent issues that we face as a country stop us from thinking about the chronic issues that also need to be fixed.

So having said that, let me turn the mike over to John Samuels of General Electric and just close on that note. Thanks.

MR. SAMUELS: Good morning. I'd like to add my welcome to Bill Gales. Thank you all for coming. I am John Samuels and I am the head of tax at GE, but I'm not here in that capacity today. Today I'm here in my capacity as chairman of the International Tax Policy Forum, an independent group of more than 35 U.S. multinationals, and we're really pleased to be cosponsoring this conference

today.

Now, I think we have a terrific program, and I'd like to thank Bill and Rose Ann and the Tax Policy Center for helping to make the conference possible. I think you're probably all quite familiar with Brookings and the Urban Institution, but may not be as familiar with the ITPF.

How many of you have been to an ITPF conference before?

That is reassuring. That is really reassuring. How many of you not been?

That's not reassuring, but I want to speak to those of you who have not been to a conference we've sponsored, and I'd like to spend a few minutes telling you about what the ITPF is. And I think the best way to do that is to begin by telling you what the ITPF isn't.

The ITPF, even though it's a group of 35 U.S. major multinationals, 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 of tax law or policy. Indeed I doubt we could ever reach

a consensus among our diverse membership on a particular set of legislative proposals.

Instead the ITPF represents a truly unique intersection between business, the academic community, and government policymakers. It was organized in 1992 some 17 years ago with the principal mission of sponsoring independent academic research in the international tax area. Our goal was to develop over time a body of independent, objective academic research about how tax policy affects cross-border tax flows and international investments, research that hopefully would help policymakers make more informed decisions about the design of the U.S. international tax system.

Now today, under the guidance of Jim Hines, who is the ITPF's director of Tax Policy Research, was supporting a wide variety of research projects undertaken by leading academic economists 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 Jim Hines of Michigan, includes Alan Auerbach of Berkeley, Mihir Desai of Harvard, Michael

Graetz of Yale, and Matt Slaughter of Dartmouth. And we're really very fortunate to have this enormously talented group of leading academic thinkers to help guide our research program. They are the best and the brightest.

And I want to be very clear on a very important point. It's the stated policy and practice of the ITPF not to attempt to control or influence the subject matter of the research or the conclusions or outcome. Indeed I hope I don't have to tell you any good academic wouldn't -- simply wouldn't allow that to happen.

Now to date, we've sponsored or cosponsored 10 conferences on important issues of international tax policy ranging from the optimal design of a territorial tax system to the effects of foreign direct investment on the domestic on the domestic economy. And these conferences have spawned more than 30 academic papers on the economic effects of international tax policy, papers that hopefully have advanced the state of our knowledge and have contributed to a more rational and informed policy debate.

Now, today we're going to be discussing another

important and topical issue of tax policy: American Corporate Tax Exceptionalism: The Nature and Extent To Which The U.S. International Tax System Departs From International Norms. And there can be very little doubt about the fact that the U.S. International Tax System differs in significant respects from the tax systems of virtually every other major industrialized country.

For example, 21 OECD countries have adopted territorial tax regimes that exempt active business income from home country taxation. And the U.K. and Japan have recently announced their intention to adopt territorial tax regimes which would leave the United States as the only major industrialized country in the world taxing the worldwide income of its resident multinationals. And no other country in the world has adopted antideferral rules that are nearly as broad and far-reaching as the U.S. subpart F regime; nor has any other country adopted rules that are comparable to the stringent foreign tax credit limitation roles imposed by the United States.

Now, from my vantage point, it is these and other differences between the U.S. and foreign tax systems that

account for the inordinate complexity and significant economic distortions that are commonplace in cross-border transactions involving U.S. companies. And I think it's very important not to minimize or gloss over these differences, the differences between how the -- between the U.S. International Tax System and the tax systems of other countries, or to pretend that they don't exist or that they're relatively minor or unimportant, because you sometimes see in articles descriptions of foreign countries having regimes -- they followed our lead and have regimes like our subpart F regime or they have expense allocation rules like our expense allocation rules.

Nothing could be farther than the truth when you get into the details, into the weeds. These differences are real and they're meaningful, and they are matters of fact; it's not a matter of opinion as to whether these differences exist. And, as the late Senator Daniel Patrick Moynihan once said in debates about public policy, "Everyone is entitled to their own opinion, but they're not entitled to their own facts." And so I would submit we really examine the factual differences, and they're

real and meaningful.

So the real question isn't whether the U.S. tax system is different than the tax systems of other countries: The real question is whether and how these differences matter to the welfare of the United States. Are these differences between the U.S. and other international tax systems a matter of design? Or do they happen by chance, a matter of sort of historical accident?

Why is the U.S. International Tax System different from the rest of the world? Do we know something they don't? Are we smarter than they are? Well, we're fortunate to have a blue ribbon cast of participants with us today to help us answer these questions and others. In addition to the presenters themselves, the discussants include leading economists and academics with distinguished tax policy backgrounds. It will be surprising if all of the participants in today's conference find themselves in complete agreement. I'm sure several of the presentations will engender some lively and hopefully enlightening discussion.

In this spirit, I really encourage our large

and well-informed audience to join in the discussion today because at least I've usually found where there's heat, there's usually sometimes light. And we're fortunately, very fortunate, to have as our luncheon speaker today, Ed Kleinbard, the chief of staff of the Joint Committee on Taxation, who is something who has certainly thought a lot about important issues of international tax policy.

And finally, I'd like to express my appreciation to Rosanne Altschuler and Bill Gale of the Tax Policy Center, and to Peter Merrill and Jim Hines, who was research directors of the International Tax Policy Forum that made this conference possible.

So now I want to turn the program over to Jim Hines and Michael Graetz, who will start us off by explaining how the U.S. and foreign countries tax international income.

Thank you again, all of you, for coming.

MR. GRAETZ: I'm Michael Graetz, currently of the Yale Law School and soon to be of the Columbia Law School. I know that when John described the group of academic advisors as the best and the brightest, he really

didn't intend the insult that that term connotes since it was popularized by David Halberstam in describing the people in the Defense Department who got us into the Vietnam War. I will assure you that Jim and I and our other panelists of the day will try and avoid such a disaster in the course of the morning.

My task is to introduce Jim and to moderate the panel that we have up here, and I'll try and do that to the best of my ability. When Jim Hines is not serving as research director of the ITPF, he teaches at the University of Michigan where he holds a Richard Musgrave chair in economics. He also teaches at the law school and is research director at the business school's Office of Tax Policy Research. Jim is a person who likes to have more than one job at time.

He has a B.A. and M.A. in Economics from Harvard, and a Ph.D. -- no, a B.A. and M.A. from Yale and a Ph.D. from Harvard -- it's hard to keep this straight -- and has taught at many universities currently visiting at the University of California at Berkeley.

He served in the government in the Commerce

Department, I learned last night, during the Carter Administration, which tells you that he's not as young as he looks, and so with that --

MR. HINES: Yes, I am.

Thanks, Michael. What do you call -- you call these -- are these computers, this thing in front of me?

Thank you very much, and my task here today -- and thank you all for coming, and I appreciate the newcomers, the people who have not been to ITPF conferences before, when after my presentations we're going to ask all of you to come up and explain why you haven't been to one of our conferences before.

My task today is to talk about taxation of foreign income by the United States and by other governments. and what that will be is a 40-minute elaboration on what John Samuels, assisting William, accurately summarized in about a minute and a half, which is that the United States really is different than most other countries -- in fact, virtually every other country -- in the way that we tax foreign income and the way we tax businesses generally. Whether that's a good or a bad

thing to be so very different is, of course, the topic of today's conference, and I'll have a couple of thoughts on that, but I think all the speakers will have thoughts on that.

So in what respects is the United States different again? As mentioned earlier, we tax corporate income at high rates. By the way, these slides are also -- were distributed and are available. The United States taxes corporate income at high rates, you know. The statutory tax rate is rate is rather high in the United States compared to most countries. We tax active foreign business income which is becoming a rarity in the world today. Most countries don't do that.

The United States restricts the ability of American firms to defer home country taxation of their foreign income, and we limit the extent to which firms with foreign income can deduct some of their expenses incurred in the United States. We limit their ability to claim foreign tax credits in some significant ways, including this expense deduction. And, as a result of all of this, the U.S. winds up imposing a significant burden

on -- tax burden -- on foreign business activities undertaken by American firms.

That's well known. The issue is how different is that than what other countries do, and the answer is it's actually quite different, and as a result we should expect these tax differences to impact the competitive positions of American companies.

So the first notable attribute of U.S. business taxation is that we have a pretty high tax rate, but federal statutory corporate tax rate, of course, is 35 percent right now, and then if you have domestic operations, you have to pay state taxes as well, which is quite high by world standards.

The statutory rate is relevant for a number of different reasons, first because the federal statutory rate applies to foreign income that company has earned. It has not always been the case that the U.S. rate was to high compared to other countries, but things have changed over time, and now the U.S. rate looks rather high.

This slide, which is perfectly illegible to most of you, has -- I can tell you the black stuff on the left

are country names, and the very skinny numbers on the right are tax rates. And what you're supposed to see from that is that -- you can see different countries' tax rates. The United States is listed as 39.25. These are OECD data for 2008, and 39.25 is the average tax rate taking into account state taxes and the deductibility of state taxes and technically your federal taxes. And so OEC reports it as 39 and a quarter, which is about right, and that places the United States second among the 30 OECD countries, basically tied with Japan for the highest tax rates, and everybody else is quite a bit below the U.S. tax rate.

Another way to depict the same -- we can see the same information, it's even less legible now -- again I should emphasize for those who picked up the handout, it is on the handout that these are tax rates over time going from 1988 to 2008, and again these are the OECD tax rate data. And what you can see is that other countries' rates have fallen over this time. You have countries like Australia, which was 39 percent is now 30 percent, countries, you know, Germany is particularly dramatic. It was 60 -- had a 60 percent corporate tax rate in 1988;

it's currently 30 percent.

All these countries, you know, virtually every country here, has had its tax rates falling except the United States over the same period of time. The statutory rate has basically stayed the same for the last 20 years in the United States, statutory corporate tax rate, whereas in other countries, again virtually every other OECD countries there have been significant reductions in statutory rates.

One other way to depict this is for the OECD data, you can rank countries in order of tax rates, and that's what's done here in this chart starting in 1984 to 2008. As you can see in 1984 -- does this have a -- here will this help if I use a laser pointer? No, it doesn't help at all.

So in 1984, as you can see, I put a little USA next to where the U.S. tax rate is located. So those of you maybe in the front row with really sharp eyesight, you can see that the USA is about in the middle in 1984 of OECD countries for which there are data. U.S. rate at the time was 49.8 percent, and the OECD rates varied

between 62 and 33 percent. U.S. was about in the middle.

After the Tax Reform Act of '86, which, of course, lowered the statutory U.S. rate, the federal rate, from 46 to 34 percent, the U.S. was down near the bottom in 1988 among OECD countries in terms of its statutory corporate tax rate. But what has happened over the last 20 years is that the U.S. rate hasn't really changed; it's that the rest of the world's rates have fallen. So the U.S. went from being down at the bottom to being at the top just because everybody else's rates have fallen. Interesting question why everyone else's rates have fallen, but the fact is that they have.

Now, that's, looking at statutory corporate tax rates, that doesn't tell you everything, obviously, because your tax base definition is different than -- a difference over time and difference between countries, so a simple comparison of statutory tax rates has the potential of being misleading. Let's not kid ourselves. The problem is how do we actually compare countries, you know, compare tax burdens across countries given all the tax base differences? Well, we're going to have an

excellent presentation from Doug Shackelford next which takes, you know, an awfully good crack at that.

One of the difficulties of any such exercise, of any exercise that’s doing cross-countries comparisons, is that tax collections themselves are not the complete answer either. And the reason is that high tax rates induce avoidance, and that tax avoidance itself is costly, you know, and so the real burden of taxation should include the avoidance costs as well as, you know, the actual burden of the amount of money you have to pay in taxes.

So there are obviously examples of that. If you have a very high corporate tax rate, one of the things that it will do is it will lead to firms doing business activities in unincorporated form in order to, you know, avoid having to pay the tax. It'll lead to corporations using more debt than they otherwise would, you know, because that reduces your tax burden and other things like that, which won't show up in the form of higher corporate tax collections but, nonetheless, you know, represent some of the burden of heavy taxation.

So it is difficult in fraud exercise, actually,

to do the comparison of tax burdens. One thing that is clear is that the U.S. statutory rate is quite high, and almost always that's going to wind up translating also to a heavy tax burden properly calculated.

We can look at, you know, there are data over time on U.S. corporation tax collections as a fraction of GDP. It's always a little hard to know how to think about this statistic in part because of this problem of tax collections not really representing burdens, and the second problem that U.S. is a small public sector relative to most other OECD countries, and so all taxes are low as a fraction of GDP just because we have a smaller public sector, you know. But, as you can see, it goes up and down over time. For people who want to say that the corporate tax burden is low, this is numbers through 2007. Of course, all bets are off in 2008. For people who want to say that corporate tax collections are low, you point to the late 1950s or early 1960s, and you can see, you know, that the line points down. If you want to say that they're high, you can point, you know, start in the early 1980s and, you know, then it looks like you have an upward slope to

this curve.

Mostly, it would have to be said over the last 30 or 40 years, you know, it goes up and down with the business cycle, but it stayed roughly within the same range over the last 40 years. If we look more recently as U.S. federal tax revenue from corporate taxes, it's a fraction of total U.S. federal tax revenues. It bounces between 10 and 15 percent, recently about 15 percent of federal revenues, although, of course, that's going to fall with the downturn in the business cycle.

What about American taxation of foreign income, which is the topic of my talk? The United States taxes worldwide incomes of individuals and corporations, and in particular the U.S. taxes the active foreign income earned by American corporations. There is deferral for some kinds of foreign income; that is, U.S. doesn't impose taxes until the income is repatriated, or effectively repatriated, and taxpayers are entitled to claim foreign tax credits for foreign income tax payments.

There are not too many other OECD countries nowadays who are taxing or planning to tax active foreign

income of their resident companies. The Presidential Advisory Panel in 2005 published a table that is, of course, now somewhat out of date because it was a few years ago, listing OECD countries and, you know, the table looks like this again. I don't know if the country names are legible, but the column on the left are the countries that have territorial tax regimes. That is, don't tax or -- don't tax any or virtually any of the active foreign income earned by their resident companies. And on the right we have worldwide, countries with worldwide tax systems.

As you can see, it's a relatively small number. It includes the United States, but even among those countries several of them are transiting out of having worldwide tax systems right now, notably the United Kingdom and Japan. And so the United States is shortly going to be left in a position of being uniquely the only major capital- exploiting country in the world with a worldwide tax regime. That is, a system in which we tax the active foreign incomes of resident companies.

Now, the tax systems are not quite as stark as either territorial or worldwide. Of course, that's a very

broad brush distinction, and there are finer distinctions. The 2001 National Foreign Trade Council report describes the existing differences at the time among G-7 countries. And there's, you know -- well, I think it's clear from the slide -- it's in your handout. It's a reproduction from their report, basically the worldwide and territorial distinctions
survive closer scrutiny to the details.

There is an issue about how foreign tax credits are calculated. American taxpayers are entitled to claim credits for income taxes paid to other governments, and, however -- and that's done as a method to avoid double taxation. The foreign tax credit is limited, however, in an effort to try to prevent taxpayers from claiming credits for foreign income taxes paid that could then be used to offset U.S. tax liabilities on U.S. income. And so that's the scheme with the foreign tax credit limit.

But in practice, the foreign tax credit limit the details of how it's applied, in the U.S. case has the potential significantly to influence U.S. tax burdens on foreign income.

We have had different foreign tax credit limits over time, and we currently have two baskets that the foreign tax credit limit is calculated within to prevent averaging of taxes, and basically to prevent too easy a form of avoidance that might arise if you could use credits for active income to offset taxes due on passive income is the purpose of the baskets. The typical thing with the basket distinctions is that they create their own distortions, alas.

There are look-through rules for basketing income to try to determine whether income actually is passive or active. There are indirect foreign tax credits, there are re-characterization of income for loss purposes, there's a lot of details that go into the U.S. foreign tax credit rules hoping to (inaudible) requirements. I don't -- I think we're going to skip some of the details of the foreign tax credit rules.

One of the things I do want to talk about is expense allocation rules, because this is a very important set of issues. U.S. taxpayers are entitled to claim -- of course, you're allowed to claim deductions for business

expenses, and definitely allocable expenses can be deducted against the income that they generate.

The issue is, what do you do with a company that has general expenses, including the United States, and some of the company's income is earned in the United States and some of it is earned abroad? So they could have expenses for general and administrative expenses, interest expense, research and development expenditures, things like that. These have to be allocated between U.S. and foreign source for purpose of calculating foreign tax credit limits.

And in practice what that means is that for American taxpayer, a company with excess foreign tax credits, any expenses that are deemed allocated against foreign income are effectively you don't get any benefit of deducting those expenses, because you can claim the deduction, but it reduces your foreign tax credit limited. It's tantamount for tax purposes to not being allowed to have that deduction. That is the U.S. system of allocating these general expenses, and, of course, there are specific formulas that are used to do this that differ slightly among categories of expense.

The fact that expenses are allocated in this way, you know, administrative expenses, interest expenses and so on, went to burdening outbound investment. And the reason is the following: A company within a given amount of administrative expense or interest expense, and additional dollar of foreign business activity reduces the deductibility of that expense against U.S. taxes if the taxpayer has excess foreign tax credits. And as a result, it imposes a tax cost that is associated with greater foreign economic activity. And so even though the system of allocating domestic expenses between domestic and foreign source, again domestic and foreign income, is not itself explicitly a tax on foreign business activity, it winds up having that impact, this expense deduction allocation system.

In addition, this system discourages taxpayers from incurring additional expenses in the United States if they happen to have a lot of foreign business activity. A company with a lot of foreign business activity, if it does an additional million dollars of administrative work in the United States, and if it has excess foreign

tax credits, does not get to deduct all of that $1 million effectively against its taxes because some will be allocated against foreign source and thereby reduces the foreign tax credit limit.

No other country had a system of expense allocation like the United States. Certainly no other major capital exporting country does. And that's because we have an elaborate and sophisticated set of rules that apply to these expense allocations and other countries don't.

Now, there are some details here in this little chart, and it involves again G-7 countries with the Netherland replacing Italy; but otherwise, as I say, it's all explained in the handout. But the expense allocation rules, you know, just are not the same for other countries.

What is the impact of expense allocation? Well, there are significant amounts of domestic expenses are allocated against foreign income each year, more than $100 billion in 2004, according to recent numbers. And so for this and other reasons U.S. firms wind up with significant excess foreign tax credits that cannot be used to reduce

U.S. tax obligations on foreign income.

If you have excess foreign tax credits, that means you are paying taxes to foreign -- in concept it's supposed to mean you're paying the taxes to foreign governments at rates that are higher than the U.S. rate. But because of the expense allocation rule, that's not necessary; that is, you can have excess foreign tax credits even though you're not paying taxes to foreign governments at rates that are in excess of U.S. rates that could be the same rate as the United States, for example. But nonetheless you wind up with excess foreign tax credits because of the way expense allocation winds up working.

So this is a sea of numbers from 1992 to 2004, and these are expenses that are allocated against foreign income. Yes, we're going to -- Bill, for next year's conference can we have opera glasses issued to participants? Okay. And he said, "Most definitely," so you've got it there.

In 2004, there were $110 billion of deductions that were allocated against foreign income for American companies of which $13.5 billion represented research and

development expenses including the United States. Forty-two billion were interest expenses and then others were $54 billion. And that's not atypical, you know, that is other years. Of course, it goes up and down but $110 billion is sort of a standard recent number. And there's differences across industries as well, and there are some industries that's held there, too.

So what these numbers tell you is that a lot of you as taxpayers face binding foreign tax credit limits, even if all -- this is all after they have done things to try to avoid winding up in this situation. Nonetheless, we have $110 billion of -- because of the, you know, partly because of this $110 billion that's allocated against foreign income and further reasons, too, U.S. taxpayers wind up with about 20 percent of their foreign taxes unused as excess foreign tax credit carryovers each year.

So in 2002, there was a $17.5 billion aggregate foreign tax credit carried forward out of $57 billion in foreign taxes available for credit that year. There were about, you know, roughly 20 percent, actually a little more than 20 percent in that case. It varies across years.

Here's a chart that goes from 1978 to 1996 with these numbers. As you can see, it's about 20 percent a year. There's a lot of excess foreign tax credits. It's not -- another way to put it is foreign tax credit limit is not some academic karyosome; it's a serious issue that taxpayers, you know -- let's not kid ourselves -- try to avoid winding up in that situation. But even after trying to avoid it, many of them do wind up in that situation of having excess foreign tax credits.

The U.S. has some antideferral regime that is well known. It was introduced by the Kennedy administration in 1962, and it represented at the time a policy compromise somewhere between accrual taxation of foreign income and, you know, a complete deferral regime. We have an intermediate regime through the subpart F provisions that tax currently certain kinds of foreign income production or income that's repatriated to the United States and other activities generate subpart F income.

There's -- it applies to controlled foreign corporations. There are a lot of details about the subpart

F regime. We haven't the time to go through them all, but, you know, there's a little snapshot here in the slides, and Michael Graetz is going to turn off the microphone pretty soon, so that's why I have to just flip through these slides very quickly and just say that the subpart F regime applies to certain foreign to foreign transactions and into other kinds of foreign activities.

One of the consequences of the subpart F regime is that it limits the activities that American firms can undertake abroad while retaining deferral, and it has the potential to restrict the ability of American firms to plan in a way that avoids foreign taxes. That's, you know, one of the costs from the standpoint of the United States is having the subpart F regime that we have is that it can penalize transactions that are designed not to avoid U.S. taxes but to avoid foreign taxes. And that's inevitable given the nature of the regime that we have.

Do other countries have similar types of rules? Well, there are different types of antideferral regimes that are out there, and they have different consequences but no country has a system quite like the United States,

and certainly not as elaborate or as refined as the U.S. subpart F system. There are differences between transaction-based and jurisdiction-based approaches. The U.S. is a transaction type approach. We don't for the most part base our subpart F regime on where foreign activities are located, although we do a little bit. And there are a number of examples from the National Foreign Trade Council report in 2001.

Go through a bunch of examples, transactions and how they would be taxed by the G-7 countries. With the United States, it won't shock you to learn winds up with the tightest regime of all of them, tightest in the sense of taxing currently many activities that other countries do not. And again I won't go through all of these examples, but the bottom line is as described, that the U.S. really does look very different in limiting deferral of home country taxation of foreign income.

Of course, we look very different in taxing active foreign income in the first place, but even after that, the antideferral regime is a lot tighter here than elsewhere.

What does this add up to in terms of the numbers? Well, this chart -- again I don't -- the numbers are perfectly legible to me. They're -- it shows how much subpart F income U.S. controlled foreign corporations report each year on their form 1118. And in 2004, which was the last year for which we have the data, it's about $50 billion of subpart F income out of current after-tax earnings an profits that are a little shy of $300 billion.

So there's a significant amount of subpart F income; that is, income that is earned by U.S. subsidiaries abroad that is taxed currently by the United States even though it's not -- it hasn't been repatriated to the U.S. in the form of dividends but nonetheless is subject to U.S. tax because of the tightness of the U.S. subpart F regime. So we're running at about 20 percent, maybe a little under of U.S. -- of income that's earned every year is hit by the subpart F regime in the United States.

Again, we don't have these data, the exact, this number for other countries. It's not reported; however, it's sure to be a much lower fraction just given the nature of their subpart F regimes compared to ours.

Okay, what is the impact? There are other differences, of course, between U.S. systems and taxing foreign income. One example I will highlight is the United States does not grant tax-bearing credits to invest, for investors in developing countries. Other major capital-exporting countries (inaudible) tax systems, every other country does grant tax-bearing credits, notably, the United Kingdom has tax-bearing agreements with 26 countries, Japan with 15. These are credits -- these are systems that permit British taxpayers to take advantage of special tax deals if they can get them in developing countries.

The U.S. has steadfastly insisted that we will not permit American taxpayers to take full advantage of special tax deals because if you get a special lower tax rate and if some country offers you a tax break, then your U.S. taxes automatically rise as a consequence because you claim fewer foreign tax credits. That's not true for British and Japanese investors in the same places. And so the net impact of all of these provisions and others is that there is a substantial U.S. tax liability

associated without (inaudible) investments by American firms, and it doesn't look the same for other countries.

How large is the U.S. tax burden? As I mentioned at the outset, it's a mistake to look only at tax collections since that doesn't really incorporate the cost of avoidance. In a very careful study that Mihir Desai did with somebody else recently, they estimated the net U.S. tax burden on outbound foreign investment for the period just before 2003-2004, and he included that including the cost of avoidance the number looks like approximately $50 billion a year.

That would be a controversial estimate, it would have to be said. It's, you know, Mihir here and his coauthor, you know, had a lot of fun back and forth with some people at the Treasury and others over this estimate, and there are those who insist that the number really should be much smaller, more on the nature of $13-or-$14 billion a year. You know, there's compelling reason to think it's $50 billion a year, but it would -- I think that for purposes today we'll call it somewhere between $13 and $50 billion a year and call it a big number, because that's what it

is.

There's a substantial U.S. tax burden associated with taxation of foreign investment, and I want to emphasize just one more time whether or not taxes are actually paid, because the burden of taxation does not require -- the government can impose a significant tax burden on an activity even though they wind up collecting little or no revenue from it. As a consequence of having the tax rules in place you wind up imposing costs in firms that have to destroy their activities or change what they were otherwise going to do and thereby incur costs. So that's where that $50 billion number comes from is incorporating those additional costs.

Okay, what are the implications of unusually heavy taxation of foreign income? You distort business production activities, and if you distort production, you wind up reducing productivity and reducing incomes, and in particular you reduce the value of things, the market value of things, that are located in the United States. If being in the United States is associated with a heavy distortion due to taxation, then you lower the value of

what is in the United States which is primarily labor. And so the cost of distorting production, of having a tax system that heavily burdens American businesses is that you wind up lowering wages and reducing labor demands in the United States.

What forms this take, well, you distort the ownership of capital assets discouraging American ownership in favor of foreign ownership if you impose a heavy on U.S. taxation -- sorry, a heavy tax burden on U.S. business activity abroad.

So what is the likely direction of policy? Well, there's a paper that was included in the packet, a recent study of mine with Larry Summers in which we look at the tax policies of the countries around the world, and what we find is that small open economies tend to use less in the way of business taxes than income taxes, and more in the way of expenditure-type taxes like value-added taxes. That is what the countries that have been exposed to globalization for a long period of time have reacted by relying less on business taxes, less on income taxes and more on value-added taxes and other type excise taxes and

other types of expenditure-type taxes. That's just an observation of what countries have done. The small countries and the open economies use more expenditure-type taxes.

Now, the United States has a pretty small public sector compared to most other countries, certainly compared to most other OACD countries. But even with our tax system, U.S. personal income taxes account for a much higher fraction of total U.S. taxes than is true for the OECD average. We're about average on corporate tax revenue, a little bit below in 2004 data, but our expenditure taxes are very low compared to other countries. We don't have a value-added tax in the United States. We have state sales taxes. We have excise taxes on things like gasoline, but they're awfully low rates compared to most countries. And so U.S. really has what you might think of as a large country tax policy. That is, our tax policies look a lot different than the small countries in the world, the ones that have been open to the rest of the world over a long period of time.

This is a table of spending tax rates, and the

U.S. is very low, the rest of the world is very high. So the tax policy challenges facing the U.S. due to globalization are the same -- you know, the ones that we face now are the same ones that small countries have faced for many years, and basically what we're doing is we're kind of catching up with the small countries of the world.

Globalization, the economic openness that is around us and is still around us even in the economic crisis that we're facing now, makes every country small, and that's why I think, if you want to look at the likely future of tax policies in G-7 countries, it probably makes sense to look at what small countries have been doing for the last 25 or 30 years. The evidence is that these small countries have been using expenditure-type taxes at the expense of business taxes and income-type taxes, and the reason is that the distortions associations with trying to tax business income, tax foreign income, and to a certain degree tax personal capital income. They become so great in an open economy that small open economies have been unwilling to use very many of them.

For the evidence that Larry and I have in the

paper, 10 percent greater population is associated with one percent less reliance on income-type taxes, and a lot of that reflects the growing popularity of value-added taxes around the world. It's probably the case that as we get through this economic crisis and look at tax policy going forward, there can be increasing pressures on the U.S. to shift the structure of taxation more in the direction of expenditure-type taxes because that is the way the rest of the world has gone.

Globalization increases the cost of using corporate income taxes and personal income taxes. Small countries have responded over relying less on income taxes, and the future of taxation probably is going to look like what small countries have done now. We have a -- there's as slowness in American policy and reacting to developments in the rest of the world. For a long time maybe that didn't very much matter because we were so important and so cut off from the rest of the world. That's not true in 2009, and it's certainly not going to be true going forward.

So U.S. policy is very different than what we see elsewhere. We have a different system of taxing foreign

income and a different tax structure in general, and at some point we're going to have to ask ourselves, do we really want these differences to persist?

MR. GRAETZ: Thank you, Jim. According to the schedule, I think we've got a minute and a half left, but I'm going to take an extra minute or two and allow some questions from the audience. I think we've got a little time to do that.

I will have an opportunity myself in the last panel to come back and talk about some of the issues that Jim has raised, particularly expense allocation, perhaps subpart F issues. But I do want to begin just by emphasizing Jim and Larry Summers' point in their paper which is that we need to think of ourselves now as if we were a small open economy in a big world.

And this is a dramatic change from the time in which our international tax rules really came into effect, and it's just worth remembering that after the 2nd World War, the U.S. essentially had all the money there was, to take Charlie Kingston's description of it. And we could have a very bad tax system, individual rates up to 91

percent, high corporate rates, and all this other stuff, and it wouldn't hobble us in the world economy because the other countries were recovering from a devastating war, and we are now at a different era. And if you look at the movement of goods, services, capital and even labor around the world, these things are moving now in unprecedented amounts. Capital flows in particular are moving in unprecedented amounts.

The world has changed because the developing countries including China and the petro countries now are the world's great capital exporting countries, and the U.K. and the U.S. are now among the world's great capital importing countries. And I think -- and I don't think that Jim would disagree -- that this is a very recent phenomenon in terms of its magnitude and one to which we haven't adjusted, and one that creates unprecedented challenges for both U.S. workers and U.S. businesses in terms of the competition that we now face from elsewhere in the world.

And this means that we can no longer be complacent about our tax system, and we can no longer have

an efficient, uncompetitive tax system and regard ourselves as still capable of winning the race.

As many of you in the room know, I argue every time I get a chance to revise our tax system and reduce our reliance on income taxes both for individuals and corporations and to substitute a value-added tax. For that the reason is that we're the only OECD country, as Jim has pointed out, that does not have a value-added tax, and although we are a low-tax country, a low-expenditure country, and we will need some more money going forward but we would still hope to remain on the low end of public expenditures, at least I would hope that we would remain on the lower end of public expenditures, we're not a low income tax country.

We have sacrificed our advantage of being a low-tax country by ignoring the ability to tax consumption and taxing only income. And this is, I think, the main element of American exceptionalism and one that we should abandon. And I think that given our fiscal situation, which is dire and growing more dire every day, the Tax Policy Center posted a paper yesterday by Bill Gale and

Alan Auerbach, which I will not -- I can't mention aloud the numbers that they suggest in terms of ongoing deficits. They're too depressing for this kind of meeting.

But we're going to have to compete for capital investments throughout the world both from domestic sources of capital and from international sources of capital. And one thing that I -- and I think, Jim, you will correct me if I'm wrong about this -- but what I recall from my learning of international tax economics is that the first lesson for small open economies, which is the way we now should be thinking about ourselves in the new world according to Larry Summers and Jim Hines, is that you should not rely heavily on source-based income taxes.

And we talk about and we have talked about it, will talk about mostly today the burdens that the U.S. corporate tax places on outbound investments. But I think it is very important at the beginning of this meeting that we also think about the burdens that a high corporate tax rate in particular imposes on inbound corporate investments. That is when other countries are looking at places either to locate their businesses or to shift

their income taxes to, we're not high on the list with our corporate rates, even though we have other tremendous advantages including more flexible labor rules, for example, than many of the other countries in the world.

And so Jim emphasized the outbound side of this, and I just wanted to make sure that we also had in mind the inbound side of this because we have huge capital flows in both directions.

But we do have time for a couple of questions from the floor if -- there's a hand up in the back, and we'll get one over here, and then we'll have to move off the stage for the next panel. But Jim and I come back at the end, this time him as moderator.

Yes? Please identify yourself.

MR. WEST: Phil West.

MR. GRAETZ: I recognized you, but I meant for the microphone. Hi, Phil.

MR. WEST: How are you, guys? Jim, two questions. One you looked at macrodata, you looked at tax rates, you looked at rules. Did you look at effective tax rates, what I think your economist called the firm level, and

compare them country to country and see how they shake out?

And second, on your slide 38, it seems a lot of the differences, this $50 billion versus $13 billion that I would have liked to have heard the fights with Harry about that number. Can you tell us a little bit more about what's behind that number and what that debate was like?

MR. HINES: Sure. Thanks, Phil. The effective tax rates of firm level, well, no one knows anything about that -- no, I'm kidding.

We have the next speaker, Doug Shackelford, is going to answer everyone's questions about that. So the short answer is I have not done it, but I've left that task to more capable hands than mine, and Doug will talk about that next.

On the $50 billion number, you asked what was behind the controversy, about, you know, whether the burden is $50 billion or $13 billion, and really what's behind that controversy is the forces of wisdom against the forces of ignorance. And it's -- no, I'm kidding. Rose Ann Altschuler can actually clear up for you all of the nature

of the controversy about that number.

The issue is whether -- is to what extent we think about the burden of the U.S. tax system, the burden that it imposes on foreign investment, how exactly to calculate that. And it's not a straightforward exercise in fairness and, you know, reasonable minds if there were any would be able to take different positions on that. The nature of the $50 billion figure really comes from the attempt by me here -- Desai and me -- to try to quantify the avoidance burden that firms are incurring in addition to the actual, you know, out-of-pocket tax burden. And that's how you get from this $13 billion figure all the way up to fifty.

And to be sure, there's a lot of potential controversy in how exactly you do that calculation. It's laid out in our --

MR. GRAETZ: Let's take the next question.

MR. HINES: Yeah. Anyway, that's the nature of the controversy.

SPEAKER: And didn't the Treasury acknowledge the prior with respect to repatriation from the (inaudible)

burden with respect to (inaudible) higher than $13 billion.

MR. HINES: John Samuels' question was, didn't the Treasury acknowledge that the significant repatriations that we had, you know, during the repatriation holiday, doesn't that suggest that the burden was higher than the $13 billion figure that they had acknowledged before? And the answer is yes, although the -- we haven't quite gotten everyone to the correct $50 billion figure yet.

MR. GRAETZ: There was a question over here. Let me just say that one other area of American exceptionalism, while the mike is being delivered, which we can all agree on is the complexity, the overwhelming complexity of the U.S. tax system. And, obviously, that is not a benefit but rather a burden no matter how many billions of dollars it might waste.

Yes?

MR. BAXLEY: Thank you. My name's Steve Baxley. I'm curious, would you view the introduction of a VAT as something that might be considered to help us as part of the solution at of the dire economic crisis we're in,

or was it something that wouldn't be considered until we're clearly on firmer footing with the economy?

MR. GRAETZ: Well, it obviously is not the moment to introduce a new tax, at least not a new tax that would be effective, until we get out of the current economic mess that we're in. But I do think -- I mean there is this question -- I was in a conference for the last two days that Reubin Aviona and Charlie McClure on behalf of the American Tax Policy Institute had on a value-added tax. And there is a debate about just when America is going to have to face up to its dire economic crisis. And my view of this is sooner than other people's estimates.

And the reason for that is that if you look at the long-term fiscal situation, particularly given the fact that health care costs are rising two percent more a year than our output, more than GDP, and with an aging population while we may be able to get that down some, we're not likely to get it down to the same rate of increase as GDP.

You look down the road, and by 2040 or 2042, the amount of revenues we've historically collected at

the federal level are enough to pay for Social Security, Medicare, and Medicaid, and nothing else. Not the interest on the federal debt, not defense, not homeland security, not education, nothing else.

And the question, then, is, what will all of the people who are lending us money think about a fiscal situation that looks like that, and will they in fact buy 30-year bonds? Or will they in fact buy 10-year bonds? Will the 30-year bonds be sold in about 2012 or 2013? The moment the Treasury Department discovers that it's got a new bond issue coming out tomorrow that nobody wants to buy, that will focus the nation's attention in a way that has not yet occurred. So I think this is going to happen sooner rather than later.

But Reubin, for example, thinks that 2020 is when we'll have a value-added tax. But I think we all agree we're going to have to do something soon.

SPEAKER: Well, look on the bright side, Michael, by 2042, all you're going to care about is Social Security and Medicare.

MR. GRAETZ: I'm hoping that we'll be able to

care about that. And with that happy note, we'll turn this over to the next panel.

(Applause)

MR. HASSETT: We're going to move directly to the next panel. I'm Kevin Hassett, director of Economic Policy Studies at the American Enterprise Institute and Senior Fellow there now, which also means that I'm worrying more about Social Security and things like that.

And the title of this session is Corporate Tax Burdens at Home and Around the World. Before I introduce the speakers, I want to introduce a one-second editorial comment about the last session, which is that if you think that now is a terrible time for the economy, which is probably a fair assessment, then maybe the notion that you couldn't do a value-added tax now or a corporate tax change now is exactly wrong.

If everybody today by the end of the day thinks we need to have a value-added tax, if we announced this year that we're going to start one, say, three years from now, then that would ignite consumption today because people would want to consume before the tax was there.

If we announced today that the corporate tax is going down in the future, then people would want to buy their investment goods today so they could deduct the investment at the higher rate.

I'm not so sure that we're not going to see a debate like that next fall when we find that the Stimulus Package didn't really deliver us from the recession, and we're wondering what are we going to do next? So I hope later in the day other people can talk about these things.

Jim mentioned that there has been, you know, quite a bit of chart-making in the international tax community over the last few years, some of which I've participated in which shows where the U.S. is relative to other countries in corporation taxation. We've seen charts at ITPF events of the statutory rate and of the effective marginal rate, the Jorgensen user cost, and also the effective average rate, which is something that some friends of ours in the U.K. have developed.

But we've never actually seen the real hard nitty-gritty numbers, and the reason is that the tax economists with Ph.D.s in economics really don't have the

expertise required to pour through the balance sheets and calculate the what people are actually paying with the expertise that Doug can bring to the question. In fact, if any of us in the past have ever tried to do such calculations, we've always done it only after calling up Doug and begging him for time and help.

And so it's really a distinct pleasure for all of us who have been participating in the tax discussion to finally get the paper we've all been dying to see from Doug which lays out for us exactly how the taxes works out once you account for what people are actually doing. And since we're running a little bit late, the bios for Doug and Marty are in your packet. But Doug's going to present for about 20 minutes, and after that Marty will discuss his remarks for about 10.

Doug's slides are in the handout that you have in this book in the back, and so should you have trouble seeing the television screens, then you can refer to them there.

Doug?

MR. SHACKELFORD: Thanks, Kevin, that's very

kind comments. I'm guaranteed not to deliver at that level.

This is joy work where the Ph.D. stood at mine at UNC. Let me -- let's see, so let me set the stage. I was nodding off to sleep during the first presidential debate, and these words were said: McCain said, "Right now American business pays the second-highest business taxes in the world, 35 percent. Ireland pays 11 percent. They don't actually pay 11 percent, but that's pretty close.

"Now, if you're a business person you can look anyplace in the world, and, obviously, you go to the country where it's 11 percent tax versus 35 percent, you're going to be able to create jobs, increase your business, make more investment, et cetera. I want to cut the business tax. I want to cut it so businesses will remain in the United States of America and create jobs."

So Obama responded with, "Now, John mentioned the fact that business taxes on paper are high in this country, and he's absolutely right. Here's the problem: There are so many loopholes that have been written into this tax code, oftentimes with support of Senator McCain.

They actually see our businesses pay effectively one of the lowest tax rates in the world."

As I mentioned, I was a little nodding. At this point my wife says, "Who's right?" I think she thought it was maybe one of the few times I could actually be of -- contribute.

So here's what we attempt to do in this paper: We start by estimating average effective tax rates. Now, if you're used to using financial statements, companies call these "effective tax rates," so we're using "average" to distinguish them from what some people sometimes refer to as marginal effective tax rates. I'll show you where they come from in a moment. They are from companies' financial statement information. We're then going to compare those between companies that are multinationals and companies that are not, those companies operate simply in their home country.

We're going to look at those across countries. We will look at those across years, and then we're going to try to look at what the effects of the foreign subsidiaries are on those.

Now, in case you need a little break, I'll jump to the punch line, then we can go back through how you actually make sausage. Here's what we're going to find: Multinationals and domestics have roughly the same effective tax rates. Now there are stories told that, you know, the multinationals aren't paying any tax, the domestics bear all the burden. There's the other stories that the domestics don't have to face all these problems in the taxation of multinationals. Both stories may be true: if they do, they tend to cancel each other out.

The next thing that we're going to see -- Jim referred to this earlier -- is there has been a rather dramatic decline worldwide over the last two decades. We estimate about six percentage points on average or about 18 percent in the tax rates, the effective tax rates. A remarkable amount of it, about a half of it, occurred in a two-year period between '92 and '94, and I really haven't been able to figure out what went on then, but I'll show you the numbers later on. Maybe someone can help me understand that.

There is a somewhat similar decline worldwide.

The only country of any consequence we see, it didn't actually go down as India. And as a result, although the spreads differ, the order sense remain remarkable consistent. Through every year we look at Japan has the highest rates. The U.K. and European countries are above average but not a great deal. The Mid-East tax havens and Asia countries older than Japan tend to be below those, the American and European rates.

Now, here's what we actually do: We're going to have three regression equations. On the left-hand side is the actual effective tax rate out of the companies' financial statements, so if you think of General Electric, we're going to pull the actual number out of their financial statements which is the tax expense they record over their net income before taxes.

There is the tax expense is not the actual taxes paid, and the distinction is very important to make. The tax expense number is a gap-determined number which is the taxes allocable to the business activity in that year. Those taxes could have already been paid, they could be paid in that period, they could be paid in the future.

I think this number is useful in the setting. We're going to use it because we're going to look at a long period of time, we're going to look at a lot of companies, and we're going to look at countries all around the world. So I think it all averages out, but we want to be careful to say this: We do not have the actual taxes paid because they are not publicly available.

On the right-hand side, we're going to have a dummy variable for the country; we're going to have a dummy variable if they're a multinational country -- company; and then we're going to control for industry, we're going to control for year, we're going to control for size.

Our second regression is going to come in and say, well, we're going to take out our multinational control and say we will put a dummy in for every country that a multinational operates in, the reasoning being here, suppose you had a country that tended to do business in high tax countries. Then their multinationals could appear to pay high taxes. Actually, it's not that they're paying particularly high taxes, just operating in countries where high taxes are levied.

And last, we're going to come along and say, well, those averages could vary across countries, so it could be multinationals from the U.S. face different taxes if they operate in France than the German companies that operate in France. So we're going to take these three regressions and them the rest of the paper is basically pulling the coefficients off of here.

The coefficient on country will be the domestic's only average effective tax rate. We can take the beta 1 and beta 2, we add those together, and now we've got the multinational. I just mentioned that the tx rate comes from the effective tax rate. The financials, the enumerators, the total amount we make sure it's not negative. We are using total income tax expense, but when we substitute and use current income tax expense which we have for fewer countries, none of our inferences change. And lastly, we're going to require that the company is profitable.

However, when we put in the opportunity for them to lose money, the inferences aren't changed. I've probably never done a study in my life that is as robust.

Every torture machine that I can put it through is this study. So we reduce -- we test a bunch of things, but when we boil it all down, there aren't that many differences.

We have a database called Osiris. It's a fairly new database. It is by far the most comprehensive database that I have ever seen for firm, level financial information. We have companies located in 85 countries doing business through subsidiaries in 195 countries.

There is one weakness with this database, and that is that they only tell us where the subs are in the most recent use of the database. We are using March of '08 for our study. The reason for this -- the problem is because we're going to look at long periods of time. If you never had a Canadian sub and you put a Canadian sub in March of 2008, we are going to assume you always had a Canadian sub. If you had a Canadian sub for decades, you shut it down in February of '08, we are going it assume you never had a Canadian sub.

We're going to control for that a bit by focusing primarily on the most recent years. Later on we'll look

at a larger time period, but we'll focus on the period where we think the sub insufficient information will have less effect.

We look at certain countries stand alone. These are trillion-dollar economies for which we have at least 200 firm years in our study, and we're going to group all the other countries into these different ones. The Asian Tigers are Singapore, South Korea, Hong Kong, and Taiwan. The tax havens we get from another source. They include the dots as well as like Ireland, then Africa, Asia -- Asia is the countries that do not -- are not China, India, or Japan. Same thing with Europe, the European countries that aren't on the left-hand side, Latin America and the Middle East. So all 85 countries are somewhere in there.

Now we'll start with the U.S. tax rates. The blue is the domestic companies, the yellow is the multinationals. The columns we have up there are before doing any regression analysis. These are the numbers if you pulled them straight off the financial statements. So no controls whatsoever. You would find out that the domestic companies are somewhere around 27 percent, the

multinationals somewhere around 29 percent.

In our study, you could almost stop there because what we find out is the controls really don't matter. So here is the last five years of the information from the regression using our controls, and you see that both rates come down slightly, the spread is narrowed, but it is not a great deal of difference once we make those controls free, industry for year and size. This is what we get is we use the current income tax expense as opposed to the total, that is, the income tax expense allocable to that particular year. You can see again not much difference, and this is what we get if we use two decades of numbers.

So again, I look at those, and there are little minor changes but by and large, when you're sweeping across tens of thousands of countries -- I mean tens of thousands for companies across the large number of countries, I don't see that are particularly different. We are going to focus primarily on the second column that is the number used in the last five years of data that we have and estimated from the regression.

Those are the domestic rates for the countries and the groups of countries we have. Probably, as with Jim's slides, you can't read that very well, but I'll tell you what the extremes are. The lowest one is the Middle East. In virtually everything we see, the Middle East countries which I would assume because their primary source of taxes are not income taxes, they're from oil, are the lowest tax rates. On the far right-hand side, the highest ones are Japan, and as I mentioned earlier, Japan will always have the highest rates by a big margin.

If you look back on the lower end, you'll see the next ones are the tax havens, the next ones are the Asian Tigers. I don't think that comes as a surprise. If you look upon the high end, you're going to see Germany second; you're going to see France -- you'll see a lot of countries in that middle there bunched quite tightly together. You see the U.S., Europe, U.K., and again you're going to see in everything we do, basically, you've got European countries, you've got the U.S., they're grouped together just behind a bid spread which is Japan. Down on the end you'll have the Middle East, you'll have the

tax havens, you'll have the Asian Tigers, other Asian countries -- China, Asia.

Canada is an outlier. They tend to be low. Australia tends to be lower than other western countries.

And those are the numbers for the multinationals. If you look, the rank order is very similar. India would be one that would stand out as their multinationals appear to have substantially lower rates than their multinationals -- I mean than their domestics. But by and large the rank order is about the same. If you go through and test it statistically, very few of those are statistically different. If you look at the U.S., for example, that's the same numbers we saw earlier. The multinationals are just slightly higher. You look at the U.K. they're almost identical.

This is the second regression in which we came in and we said, well, maybe it has to do with the location of the subs. Maybe Japan just operates in high tax countries, we take that away it'll go away. These are the domestic rates that you just saw from the previous slide. Once we control for where they are located very

little difference. You can imply from this in some sense all companies around the world regardless of their home location are operating a similar global market.

Over time, Jim commented and I said in our conclusions, rates are falling worldwide over the two decades. Again, now, Jim was looking at statutory rates and they are declining. I'm looking at effective tax rates, and they also are declining. In fact, I would say many of the things Jim was saying my study would support as similar when you look at effective tax rates. That's Japan. As you can see, Japan coming down from 49 percent or so down to 40 percent. There's Germany. Germany has the sharpest decline of any country that we look at. Australia - also quite a decline.

As to the United States Jim pointed out we've been sort of staying the same. That's basically what we see, maybe a little bit of decline.

That's France, looks a lot like the U.S., largely flat. That's the U.K., largely flat. There's all those other European countries look a lot like France, Germany, U.S., and they're the tax havens which are low to begin

with and continue to stay low.

That solid line is Japanese domestic companies, the dotted line is Japanese multinationals. I said earlier that we find that multinationals and domestics tend to be the same. You can see there that in Japan by 2006, there it looks like it's maybe a couple a couple of percent different, but they're tracking similar along time periods. So even though they're declining, they're declining more or else together. Here's the U.K. and there's the U.S.

Now what we looked at is the last regression I referred to, is to what extent does the sub location affect the country's tax burden? So if you look at the Middle East, you remember I said the Middle East has the lowest effective tax rates by quite a bit. What this slide tells you is if you go invest in the Middle East, you will enjoy those low tax rates the Middle East countries provide. Now, that shouldn't come as a surprise, but this is some confirmation that what we're seeing holds.

So in other words, the earlier tax said if you're domiciled in the Middle East, that's where your company is headquartered, you enjoy lower rates. This says if

you're domiciled other places, you also enjoy lower rates. The yellow is -- well, I -- the yellow was Japan, the red is the U.K., and the blue is United States. Maybe you just want to follow the blue.

There's Asia, the green that's standing out there is Germany. As I said earlier, the Asian countries holding out Japan, China, and India, they tend to be low tax. If you go do business in Asia, you'll enjoy some of those low taxes. China is going to break even. You can see U.S. companies seem to cut their effective tax rates by a little bit if they're located doing business in China; tax havens, they provide a little bit of benefit. I'm going to come back to why it's not bigger than that in a moment.

Germany is sort of break even. Europe sort of break even. You see German companies that do business in Europe seem to pay higher taxes. There's France. Now we're starting to move into France. Everybody's up. Remember France is one of our higher-tax countries. The U.K. is sort of a break even. Japan, if you want to do business in Japan, you're going to pay high tax rates.

Remember, Japanese-based companies have high worldwide taxes; non-Japanese companies do business in Japan, they're going to have to pay, apparently some of those same taxes in Japan.

This one is not as we would expect, and I'm going to refer back to it in a moment just like I did with the havens. It appears if you go into the Asian Tigers, you pay higher taxes even though they have lower taxes in those places, and then the last one's the U.S. This is consistent with what Michael said earlier about if a company be located outside the U.S. comes to the U.S., we have a higher tax rate, they're going to have to pay some of those higher taxes. So the U.S. is taxing the American profits of foreign-based companies more heavily than other countries are.

MR. HASSETT: You have five minutes left.

MR. SHACKELFORD: Okay. I want to focus on the haven with the little blue. That one might be of some particular interest. I don't want to say that our measures here should be -- well, we used to say "taken to the bank," I'm not sure you want to take anything to the bank right

now.

(Laughter)

But in the U.S. that blue one says if an American company goes and does business in a tax haven, it has a 1.6 percent reduction in its average effective tax rate. So if its rate would have been 32 percent, it'll be 30.4 on average.

It's interesting -- there's another working paper out right now by a couple of coauthors, they go do a completely different analysis, and they get 1.5. So it gives us some comfort that probably somewhere in there is about what havens are worth U.S. companies. You could do your extrapolation and say if this holds across the economy, all U.S. companies have X-amount of profits, then that's about how much they're saving by being in a haven.

Okay, I'm going to repeat what we found in case all that lost you. Domestics and multinationals, about the same place: Been a decline over the last two decades about six percentage points, about 18 percent of the effective tax rates have gone down, particularly in '92 and '94 -- I forgot to point that out when we got there.

Shortfall in that time period. But the order of the countries remain somewhat consistent, maybe tightened up a little bit. Japan remains really high. The U.S. and U.K. -- I mean the U.S. and European countries a little bit above average; the Middle East, the havens, Asia below, particularly the Middle East and the havens.

So here is where we are with this study right now. I mentioned that we were surprised at how little the havens did, and we were surprised that the Asian Tigers, which have two countries, Singapore and Hong Kong, that many people would consider havens, how they actually seem to increase your taxes. So here's the issue -- and we don't have this thing solved, but I can tell you my R.A. is supposed to be thinking of this, because he's young and has all the brains -- it appears that you do not go into a country.

So our analysis assumes conditional on where you stand today. You decide, okay, I think we'll go into, you know, wherever. Let's -- Poland. So we're going to Poland, and we're in all these places, and the decision to go into Poland is independent of all other factors.

That's the way our analysis is set up. It may be that you never go into Poland without going into other places, that there is what we're calling a clustering effect. And we've done some preliminary results that show this sort of thing.

So the one we have here, Ireland, the Netherlands, Switzerland, they are sometimes put forward as countries that provide lower tax rates if you're in the European community. If you're in Europe somewhere, let's say Germany, are you also going to be in Ireland, the Netherland, and Switzerland? Is that sort of a joint package or one of those three, or is there some mixture that's optimal? That's the question that we're looking at now, and it could, once you think about this problem -- I think this is another paper, it's a little bit bigger -- if that tends to be true, then some of the things saying here you might want to back up on, because it's really not a decision to go in a country, it's a decision to go into a set of countries.

MR. HASSETT: Thank you. Thanks a lot, Doug. But before we hand it off to Marty, I just had one point

of clarification that, say your tax variable is only corporate taxes? So like there's no property tax or anything else in there, it's just corporate taxes?

MR. SHACKELFORD: Correct.

MR. HASSETT: Okay, thanks.

MR. SULLIVAN: Good morning, everybody. I'm Marty Sullivan with Tax Analysts, and I am living proof that the ITPF does not have a biased research agenda because I always come in and say things that multinationals don't want to hear, and they keep inviting me back. And I appreciate that very much.

I'm going to do three things in 10 minutes. First I'm going to review the Markel-Shackelford paper and make some comments on it.

Second, I'm going to compare it to some of my research.

And third, I'm going to stir things up by trying to relate it to the bigger policy questions that we want to address in this conference.

This Markel-Shackelford paper, as somebody who loves data, is really an excellent piece of research.

It has a wealth of facts. We were talking about facts at the beginning. These are facts that everybody who works in this area needs to know and needs to be able to explain. And it confirms some things we all suspected, and I think it gave us a few surprises.

This is incredibly comprehensive research. It has data from all over the world, the G-8 countries, and not just the G-8, the developing countries, and that's something. I try to keep abreast of world events, but, you know, G-8 is usually my limit, so it's really interesting to see all this other information.

The other unique thing about this study is the information about subsidiaries. We don't normally get that in our databases, so we are able to see that companies do have subsidiaries, that they are multinationals, and most importantly, where the multinationals are.

Now, a limitation to the study -- and that's not Doug's fault, it's always the -- you know, I always want more once you -- is that we don't know how big the multinationals are. So this -- when he identifies a subsidiary in Japan, we don't know whether that's .01

percent of the multinational's business or 50 percent of the multinational's business. That's not a complaint, that's just something we need to keep in mind.

I think if I can say I found four key findings in the study, and I'm just going to -- it's such a good paper let's reiterate some of the main points. The first one is the ranking of countries by tax rate is fairly constant over time, and over different subsets of data. And here's another picture of the same. I can only -- I have to put it into pictures. I can't look at all those tables.

So here you see, and I hope you can see it, Japan leads the -- this is multinational corporations for 2002 through 2006 ranked in the order of their effective tax rate. And Japan is by far the leader, 34.8. Germany is second, 29.4. U.K. is third, 25.8. U.S. 25.6. France 24.2, and then we go down, down the line.

Now, this could be interpreted as since most multinationals are in the first five countries, this could be interpreted as maybe U.S. multinationals aren't have that big of a problem because they're sort of in the middle

of the pack here. And that would be, even though that -- I don't agree with that, because you really want to know, this is looking at the whole multinational. You want to know how the multinational is competing in its foreign operations. And so this doesn't necessarily -- this says something about the overall corporation burden, corporate burden, but not about it’s a burden when competing with other foreign multinationals.

And again, the example would be that Japanese company at the top, it might be 99 percent Japanese and one percent offshore. We really want to know about its offshore activities.

The second key finding is effective tax rates are declining over time, and I just picked out my favorite countries -- no offense to anybody from other countries -- but we can see in all these cases, Australia 30 -- we compare 33 to 21.7 percent. France 27.3 to 23.7. Germany in an enormous decline, Japan in an enormous decline, U.K. a little decline, and U.S. an even smaller decline. This confirms everything that we know.

One thing I'd like you to see, you know, is to

get another paper out of this, is I'd like to see you compare this to the statutory tax rates because if my memory serves me correctly, the statutory rates have declined in all of these countries except the United States where they've actually increased. So it's sort of interesting. I mean I think I can explain why what you see here, and so I think the divergence between the effective rates and statutory rate would tell a lot about what is going on without having to summarize the entire tax law of that country.

The third thing is effective tax rates and multinationals and domestic corporations are about the same. Well, I was surprised by this because I figure, you know, the multinationals are getting away with murder putting all their money in Bermuda. But if you look at this data, that simple notion of mine is absolutely incorrect.

Here if you look at -- this is U.K. multinationals in blue versus U.K. domestic companies. They're basically the same, declining over time but basically the same. Here's the United States where on the contrary to what my prior was, the multinationals are

actually paying more than the domestic companies by a little bit. It is sort of crunching up there at the end suggesting the multinationals are paying less at the end of the period. But it's, you know, it's -- there's that whole notion that multinationals are getting away with murder vis-à-vis domestics is not correct.

And here's Japan -- and this makes total sense, too, which is you're -- Japan being the highest tax country in the world, if you're purely domestic, your taxed higher; if you can get some operations offshore, you're going to lower your -- well, it has to be lower, so it's reassuring it's coming out that way.

Finally, effective tax rates of multinationals with subsidiaries in tax havens are lower, and this is an amazing story. I've taken the liberty of compression table 5, which had too much information for me to digest in one sitting, it's amazing how this data just tells a very clear story. And you read this chart horizontally, so if you have a French multinational, what this is saying, if you have a Japanese sub, your effective tax rate worldwide is 2.1 percent higher and 0.09 percent lower

if you have U.S. sub. If you're in a tax haven, well, that's not surprising. Your effective tax rate's going to be lower. And these other -- Asia, I don't understand exactly, I don't claim to know enough about it, but it is amazing how much lower that it comes out.

And for the United States, if you have a Japanese sub, no surprise but it's great to see it in the data, 1.7 percent higher; if you're in a tax haven 1.6 percent lower.

Okay, now I'll do the second part of -- I'm going quickly -- second part of my presentation which is I want to compare this to some of my research. I want to apologize. I did these slides about four days ago, and, of course, I revised everything about 14 times, so I'm going to skip over some since then, and I'm going to skip over this first slide because it's not correct. So ignore that one.

The blue line on this slide, this is comparison of Markel-Shackelford to my study of U.S. pharmaceutical companies both using effective tax rates, both using company data, so this is financial reporting data, and you can see my -- I was just looking for trouble. I was

looking at the pharmaceuticals who I suspected were engaging in a lot of income shifting, and so you can see this sort of steadiness up to the year 2000 and sort of a decline starting in 2000.

Now, I compared the same Markel-Shackelford data with my work in green on high tech companies. Again it's the same type of data, it's financial accounting data. And here I was looking for trouble because I was looking for the companies most likely to engage in transfer pricing, and I have a pretty dramatic decline with the green line of effective tax rates for U.S. multinationals. But again the second period starting in 2000, they seem to parallel each other.

And then finally, again another one of my studies -- I'm getting all my research in -- I compared, I made a comparable to what Shackelford did, that Doug did, and we're getting the same reading which is, in my work for 80 large U.S. multinationals, I calculated a 34.1 percent decline from '97-'99 to '04-'06, from 34 to 30, a 4.1 percent decline, which is very similar to what you have in terms of direction. You have a 3.3 percent decline.

So I think the stylized fact that I want to focus on is we've got a decline, a very significant decline, in effective tax rates over this period, and there's been no change in tax law, so what is causing that?

I'm just going to leave it on this slide. We saw that from the Markel-Shackelford study that part of that may be due to presence in tax havens or in other low-tax countries, but you really can't tell too much. I mean because of you don't have the size, you don't really know how important they are. It's just giving you some information.

In the research that I've done using financial accounting data, it seems pretty clear that most of this decline -- that is about three-quarters of this decline in the effective tax rate -- is attributable to offshore operations.

Now, then, in other research I have done we've looked at that, and we've said, well, why? Why is that? Is that good? Is that bad? What does it mean? And you have three possibilities: One is the effective foreign tax rate is declining because -- I'm sorry, the overall

worldwide tax rate is declining because foreign tax rates are declining. So multinationals aren't doing anything, tax rates are going down all around the world as Jim pointed out. And that's absolutely true, and we can absolutely confirm that.

And, secondly, because the world -- you know, we're getting more globalized -- there are just more -- the second thing that could be going on is that there are more foreign operations. So U.S. is a high-tax country. In general, the more offshore activity they have they're going to drive down their effective tax rate. So there's nothing surprising by that. But when I controlled for both of those factors, there's still a lot of unexplained decline in profitability, and I think so the reason is a lot of income shifting mostly due to transfer pricing and intercompany debt movement.

So what should we do about that? Now, in the old days I'd say, well, we need to tighten our transfer pricing rules. And let me just look in my notes here. We could tighten the transfer pricing rules. In 1993, we were a very similar situation. We were worried about

the deficit, and we were worried about multinationals. And Bill Clinton came in and said he was going to do something about it, and there was going to be $7 billion of revenue there, and everybody got all excited. But when push came to shove, nobody did anything. He tightened the penalties a little bit, and he raised a couple of million dollars, and the whole thing just went into oblivion.

So, it's very tough to tighten just, you know, generically tighten transfer pricing rules. The other thing is we can move the formulary apportionment as suggested by Avioni and Clousing in their paper for the Hamilton Project.

The other thing that might be done is we could toughen the cost-sharing rules which were the biggest loopholes. It took us five years to write those regulations. Despite all the complaining, I think they're still pretty lax.

The other thing we could do is repeal check the box. I don't think that's going to happen any time soon. So if you think about it for a minute, so which do we

do? We could instead of engaging, why bother in all this debate about transfer pricing if we do what Michael Graetz suggests, which -- and a lot of other people are suggesting -- which is just to lower the corporate tax rate anyway? It would take -- why bother, and for that matter, why bother in a big debate about capital export neutrality versus capital import neutrality if we have a lower corporate tax rate?

So I'm taking the easy way out here, which is if we are going to no longer be exceptional and we are going to reduce our corporate tax rate, and which we should do, significantly -- we should significantly reduce it -- we should have leapfrog over all of these problems. So I don't want to spend 10 more years on cross-sharing regulations and another seven years debating formulary apportionment if we're going to do this anyway within that time frame.

Now, for that to happen, I think we need to be pragmatic and not partisan.

MR. HASSETT: You need to sum up, too. You're past your time.

MR. SULLIVAN: And in conclusion, I'm going to issue a challenge to Democrats and to Republicans. For the Democrats I'd like to say get over your visceral hostility to reducing business taxes, recognize that tax rates around the world are going down and there's nothing you can do about it. And don't tell me about average corporate tax rates in the United States being relatively low. I understand that they are lower than the statutory rate, but as Jim pointed out, the burden of the U.S. statutory corporate tax rate needs to be lowered.

I mean if the rate was 75 percent and our effective rate was 15, would that be okay? You know, there are tremendous economic distortions.

Now, for Republicans the challenge is, as Michael was saying, you know, the way I looked at it, 25 percent -- or if you look at the long-term deficit, revenue trends were 19 to 20 percent of GDP is going to be collected in taxes. By the year 2020, we're going to have 25 percent of expenses of spending, and by 2030 we're going to have about 30 percent of GDP. We got to raise taxes sooner or later. It's absolutely unrealistic to propose a change

like this, which is a significant decline in effective tax rates, without telling us how you're going to pay for it.

So don't just tell us to reduce corporate taxes. Please tell us how to pay for it. On the short list of ways to pay for it is base broadening. As Michael points out in some of his work that might get you to 28 or 27 percent. Rose Ann Altschuler and Harry Grupert have pointed out that if you got rid of deferral, you can get down to 27 percent revenue. I say put them all together and get down to, you know, maybe 20.

And then I would also think what we need to look at is using the vat or a carbon tax, which also seems inevitable, and also I think in this day and age -- and this is my last comment -- we need to go back and look at corporate tax reforms like the comprehensive business income tax that broadens base by reducing deductibility of debt. Is there's anything we want to do in this current period is get the tax code out of the business of encouraging indebtedness. And that's all I have.

MR. HASSETT: Thanks a lot, Marty.

We've got a break that we're now eating into, but so if you want your coffee, maybe you can skip out and miss a couple of the questions.

I'd like to start with just one question which is that either you asked for the U.S. numbers that, you know, one reason why there might be a decline, given the sample splits that you did, is that we've got this partial expensing kicking in and so I wonder if it's possible. And the other thing is that it could be that you have firms without foreign subs. Maybe they're loading up on debt and other things like that.

So is it possible, have you looked at sort of the causes of this somewhat surprising low rate for the domestic folks? Is it are they you know, more capital intensive and using a lot of the 50 percent expensing in the year, since that sort of throws the results? Are they, you know, much more debt intensive? Things like that?

MR. SHACKELFORD: The answer is no. What we are doing now is trying to go through and collect the rate reconcili -- information which actually tells you how you get from 35 down to whatever number for each company.

And, you know, there's credits there. There is lower taxes on foreign activities is often listed.

Yes, my guess is if you're referring to things like 199, that is not going to be very important for the companies we've got. We got largest companies in the world, and so I just don't think those are relevant things. Maybe R&D credit would be an example of something that can be significant for those companies, but we don't have that detail broken down.

It's doable for U.S. companies. Once you get outside the U.S. the tax information of financial statements is sparse.

MR. HASSETT: Well, that's another paper you've got to write, because we need to see where it comes from.

So now we'll go to the floor for a few questions.

Dick Click, do you have any questions

Up here in the front? Pete, use the microphone and please state your name.

MR. MERRILL: Sure. This is Peter Merrill. A question: In the U.S., companies are not required to record their U.S. tax on their foreign income that's not

repatriated if it's intended to be reinvested. And so you would not see in the book tax rate for most companies, their future U.S. tax under unrepatriated foreign income. Is that true also for Japan and the U.K., the other major worldwide countries where that would be relevant?

MR. SHACKELFORD: I don't know the answer to Japan. I do know it applies under IFRS, and I'm guessing that since it does there, since IFRS come into world standard, it probably applies in most places, and it probably applied in most places in the past.

Unfortunately, I don't know a lot about Japanese accounting.

MR. MERRILL: Does that mean that for the worldwide companies that you're understating the tax and for the territorial, you're maybe correctly stating the tax?

MR. SHACKELFORD: That's possible if they are declaring that they're permanently reinvested but they're really not permanently reinvested. If they claim they're permanently reinvested, then they're supposed to not ever be bringing the money back, so they're supposed to not

ever be paying the tax.

Now, I do know -- I've talked with companies and "permanently" can mean things like not within the next year. So permanently may indeed not be as permanent as some of us might thing, and thus if that's the case, then it could be that we are not capturing the taxes now. Of coupe, when the money actually does come back, since it wasn't actually permanently reinvested, then the taxes would be picked up. So it could be a timing difference, and we just missed a year or two.

Now, if over time what we're seeing is permanently reinvested earnings are growing, then that would be consistent with the appearance of a decline in effective tax rate, and we're just shoving off taxes into the future on the U.S. side.

MR. HASSETT: Do we have another questions?

Well, thanks, everybody, and we now have a break for about 10 minutes.

(Applause)

(Recess)

MS. ALTSCHULER: All right, I think everybody

should come in and we should get started again, so please come in, find your seats, and we will -- we're very much off schedule, I believe, yeah. Yes.

Okay, I think -- I'm looking at my watch and we really are off schedule, and let's let me start by saying I'm Rose Ann Altschuler of the Urban Brookings Tax Policy Center, not Matt Slaughter. I don't know if that's what it says on the schedule as moderator.

We have a very interesting session, and because we're off schedule I think I'm not going to do big introductions, but we have Mihir Desai here from Harvard Business School, and Alan Auerbach from the University of California at Berkeley as the commentator. And we're talking about I think what is a controversial, at least in Washington and the Press, et cetera, topic which is whether or not corporate investment abroad is bad for the U.S. economy.

Mihir has a very interesting paper that brings to bear a lot of new research that, for instance, I wasn't familiar with on multinational firms and tries to take that evidence and help us think about this. In terms of

the paper, it was out -- it's not in the binder that you have; it's separately out there available for you to take. It's called Taxing Multinational Firms, Securing Jobs, Or The New Protectionism. And Mihir, you have 20 minutes.

MR. DESAI: Great, thanks so much. As Rose Ann mentioned, there's, you know, two different papers. There's one that's in the binder which is a more detailed study that Fritz Bowlage and (inaudible) and I conducted. And then there's this paper which I'm going to be presenting today which tried to take a broader view on this question of the relationship between domestic activities and foreign activities of firms.

So, you know, to motivate this, I thought I would put up a picture that I think captures a lot of the concern that people have. For the last 20, 25 years it featured I think two marked trends that for a variety of reasons have become coupled in the public imagination. So that upwards the little thing line which hopefully you can see even from your seats -- it's also figure 1 in the paper -- is the direct investment position of U.S. multinational firms abroad. So this is just meant to capture this rapidly

increasing level of activity that firms have abroad. And it's, you know, in the last 15 years it's amplified perhaps even more so.

During that time, the other line is meant to capture, or it actually does capture, domestic manufacturing employment. So you see on that, obviously, a decline generally, but then this really remarkable shakeout that happened beginning in the late 1990s, you know, in a manner that is quite coincident with the rapid expansion of U.S. firms abroad. And pictures like this, I think, have an inexorable kind of gravitational pull which pulls you into their where the lines cross and make you think that these trends are related. And, in fact, you know, that is a very common perception. And so this paper tries to address the degree to which that's valid or not.

So, you know, just to motivate this slightly further, I think public sentiment is kind of crystallizing on this subject, which is there is a presumed linkage between growth abroad and shrinkage at home. And you only need to look at surveys to see that. I'll quote from an

earlier study by Matt Slaughter and Ken Shevi which says that a consistent plurality to majority of Americans think that FDI in both directions eliminates jobs with the prominent concern that outward FDI and tells U.S. firms exporting jobs outside the country. Over two-thirds of Americans think that companies sending jobs overseas is a major reason for why the economy is doing better than it is. And that was a few years ago.

SPEAKER: Not doing better.

MR. DESAI: Not doing better than it is, sorry. Excuse me.

(Laughter)

It's important, yeah. So -- so if you take a look at figure 2A or in the paper you'll see that those numbers and the ratio of negative sentiments toward outbound FDI has increased.

Second, if you look at figure 2V, which I'm not going to show but I think is interesting, there's a great deal of distaste for current U.S. policies towards multinational firms in this problem, and there's a lot of appetite for people to be -- you know, there's always

an appetite fore policymakers to be doing even more. So in that sense it seems like a ripe area.

So within that broad set of concerns, the way we tax multinational firms in their foreign activity has become a large focus of this. And there are a couple of signs of that. First the system that Jim and others described earlier is often characterized as subsidizing foreign investment. This is something which you often hear in the debate, which is we subsidize firms to go abroad. And so that again amplifies these kinds of concerns.

Of course, we have various estimates of how many jobs we will lose over the next 20 years, and that also amplifies these things, and the changes that Jim and others describe abroad also makes this something of a more relevant concern.

The parallel in some sense I want to draw here is this is not unlike what has been a very historic set of patterns of attitudes towards trade, and yet for those of us who work in this area, we have until recently not fully tackled this question of what the domestic benefits are. So this paper is not about average tax rates or tax

revenues, but very much about how valid is this linkage in the popular imagination?

So and when -- I focus on three questions. I'll probably do the first one, you know, more quickly than I would have planned on in the interest of time and focus on the last two. So the first one says, you know, if you're going to be evaluating policy in this domain, you have to begin by asking what motivates firms. If you don't get that answer right, then all the policy prescriptions that come out of this aren't going to be right. And I'll try to make some points about how current U.S. policy really stems from a very unique view about what firms do and try to address if that's reasonable or not.

Number 2 is, what do we know, empirically, about whether these presumed linkages between foreign activity and shrinking domestic activity, what do we know about that? And it turns out, you know, over the last decade there's been a good amount of work on that question from all around the world, and I'll try to review some of that.

And then finally, I'll try to take on this picture I showed you initially, which is that big

manufacturing employment shakeout that we saw and that I think is underlying a lot of these concerns, what happened to multinational firms during that period? And let's just take a look.

So first, you know, I think tax policy has to being by asking what the firms do. If you don't ask what firms do, you can't really have a reasonable discussion about how we should tax them. So there have been three alternative successive theories about what firms do. And this may sound simple-minded, but, you know, really if you can't understand why they're going abroad, then it's very hard to analyze how we should tax them. So those three different ways of theories have been first the idea that they arbitrage the rate of returns. So that sound fancy, but that's like a way of saying you go wherever the return is highest, and you try to wipe out any differences in returns.

The second is this idea that they take firms' specific capabilities and they exploit them abroad. You know, the basic idea you have some kind of an intangible, and you say, well, let's go exploit that abroad just like

I did here.

And then finally, there's as newer idea that I think is really promising, which is that firms that are very high productivity firms are the ones who go aboard, and they go abroad because they're high productivity and because they can then absorb the costs associated with going abroad. Each of these views maps to different policy prescriptions. So when you sign up for a policy, you're signing up for a point of view about what firms do, and that's the linkage I want to try to establish here.

So the most traditional idea has been this idea of arbitraging return differences. So this is the idea that firms think about -- they look around at returns around the world and they send capital to wherever returns are highest, and as a consequence that returns get equalized around the world. So that's one basic idea of what these firms are doing.

What comes out of that, largely what we have, which is the idea that we're -- have been very influential in this domain, which is capital export neutrality or national neutrality, which is that you end up with

worldwide regimes like we have. In this case, the theory would suggest unlimited credits or deductions, what we end of having is a system with partial credits but otherwise something that falls out from this basic world view.

So as I mentioned just briefly, the influence of this is pervasive in U.S. policy and in a wide variety of ways. The underlying assumption here that I want to draw your attention to is that dollars go here or they go there. That's the nature of arbitrage, right, so, you know, you see a return there, it's higher than the return here, you send capital there instead of putting it here. So that's the underlying in some sense idea behind that. You have substitutability which is they always to there or they go here. And why? It's the arbitrage return differences.

One of the interesting policy implications is that this world view gives rise to the idea that if we don't have a worldwide system, we're subsidizing them. So it gives rise to that either the exemption systems are actually subsidies to foreign investment. Why? Well, if we give them an exemption system, then they will go

aboard even more than they should. And so that's the sense in which this world view gives rise to this idea that not taxing foreign investment or foreign income's the subsidy.

So what's the problem with this set of ideas? As I mentioned, they're incredibly pervasive. I think there are several problems. You know, the biggest one is the first one, which is, as it turns out, firms don't appear to be that sensitive to return differentials. The big puzzle in life is why capital -- and this is also known s the Lucas Paradox -- why capital doesn't go to places where returns are so high? This is a mainstay problem in macroeconomics, and this theory is kind of built from the idea that they do. So the first order in empirical reality check doesn't appear to go that well.

The second is that all the recommended policies -- for example, countries in their own interest should be taxing worldwide income and providing a deduction for foreign taxes -- that, too, is found nowhere in the world. So second empirical reality check would suggest that that is not terribly good.

And then final reality check is, you know,

multinational firms once might have been the mechanism by which there was an arbitrage possibility. And figure 3 in the paper just shows how FDI compares to foreign portfolio investment. So in the '60s and '70s, the dominant way Americans got exposure to the world economy was by investing in multinational firms like IBM or General Motors, or whoever.

What's happened today? The dominant way Americans get exposure to international markets is by using mutual funds, stock investments, other means. So the idea that firms are arbitraging while we now have these instruments that are so much better at arbitraging rate of return differentials, and they're so wide present I think is also a problem for this world view.

So the second world view is something that I think is a little more palatable and something that Jim and I have tried to advance in the literature, which is that firms go abroad not just because they hunt around and see return differences; the go aboard because they have something good and they want to exploit it somewhere else. So think about a brand, think about a patent, think

about anything that some process, production process that you have, you want to exploit it abroad.

So what should you do if that's what firms are doing when they go abroad? Well, then it turns out the policy prescriptions are quite distinct. Policy prescriptions are actually more along the lines of exemption. So self-interested countries should pursue exemption. If you're interested in worldwide welfare, a lot of systems that would have all countries do the same thing can have that same idea as well.
Well, of course, given what Jim said earlier and the widespread nature of exemption, that would probably be exemption for the U.S. as well.

The underlying assumption in this kind of body of work is that who owns what matters. So it really matters if I own that factory or if you own that
factory. Why? Because I have different firm advantages that you do, and so whoever has the best firm advantages for exploiting that factory should be the one who ends up owning it.

So that’s why you end up with a system that looks a little bit more exemption.

In this world view, FDI or multinational firm

activity is largely about, almost exclusively about transferring ownership claims. So that's why you end up with the world of these kinds of policy implications.

The final story here is this is something that this world view is, I think, pervasive in the academe. Anybody who studies multinational firms believes this. I think that's not an understatement. And I think it's pervasive in the business community. It's evident in policy around the world with the exception of the U.S.

The difficulty here is that it rests on the degree to which FDI is really about ownership claims or if it's about flows. And it raises the question that what if FDI is lost investment? What if instead of just kind of buying stuff over there and financing it abroad, what if I also have some lost investment, which is a topic I'll return to?

The final kind of wave of theorizing about firm behavior is this most recent wave. I think it's really interesting. I'll just mention it briefly because the policy implications have not been worked out fully.

The basic fact here is that productivity varies widely across firms. So within a given narrow industry you'll see productivity vary by two times. Some firms are just very good, and some firms are very bad.

Well, what's coming out of this literature is there's a hierarchy. The low productivity firms are domestic firms, the next highest productivity firms are exporters, and the high, high productivity firms are the multinational firms. And the ones with the most multinational operations are the highest productivity of all. So there's like a very strict hierarchy.

Now the way to understand this then is to say that only the best firms can actually or only the most high productivity firms can afford to be multinational because it's costly to go abroad.

Again, this is a very pervasive set of ideas in international trade. It's kind of, I think, empirically very solid and now more and more theories about this. It's had very little application to policy.

In the paper, I sketch out what I think are some of the applications or how it would shake out to policy. But suffice it to say you're effectively taking the most productive firms and taxing them, and when you do that you reallocate production. You reallocate production away from the high productivity firms towards the low productivity firms, causing a decrease in overall productivity. And this is something that's kind of absent from other models of this, and so I think it's a very

promising area.

Roughly speaking, what comes out of this is alternative policies, either worldwide exemption, whatever you want. If you're going to sign up for it, you have to map it to some idea of what firms are doing.

Current U.S. policy is really only consistent with arbitrage. So if you're going to sign up for the worldwide system, you're really signing up for the idea that what firms is doing is arbitraging, and, if you believe that, then I think you're okay. The problem is I think that view is somewhat discredited.

This arbitrage view is also the support for this idea that there is substitutability. So let me just tell you a little bit about what we know about the degree to which there is this kind of substitutability.

As the theory, the empirical work begins in a very macro-esque, kind of, fashion which is let's regress investment at home on how much firms do abroad. Unsurprisingly, those kinds of regression yield inconclusive results. So some folks say that there's complementarity between investing abroad and investing at home. Other folks say there's substitutability. When you invest more abroad, you invest less at home, and this is also true of employment and other kinds of numbers.

Fortunately, in the last decade, we've actually gotten a hold, the economic community broadly as gotten a hold of firm level analysis that allows us to tell more. It's not all great, though, in the following sense. Now if you start doing analysis at the firm level, you have a whole set of new concerns.

And what do I mean by that? You have concerns that firms might differ in unobservable ways. By that, I mean that firms that are purely domestic might just be different than firms that are multinational firms. So people have dealt with this in kind of several different ways.

I'm going to run through this pretty quickly in the interest of time, but you can see the rest of it, if you're interested, in the paper.

The first solution is let's look at this at the industry level. Let's aggregate up a little, and maybe we'll get around this problem. Some Germans have looked at this, using micro data from Germany. They find no evidence of substitutability, and they find, if anything, complementarity. So this, again, means that the more firms invest abroad the more they're investing at home.

Even when they look at FDI that is supposedly cost-motivated -- I'm going there because costs are lower

-- that too does not look like substitutability when you actually look at the underlying stories.

I'm going to do this really fast.

You could match domestic and multinational firms. There are studies from Japan, Austria, France, Germany and Italy. This is kind of remarkable. I wasn't fully aware of this before I tried to write this paper. It's really quite comprehensive, different authors using different data sets, all basically never finding any evidence of substitutability and all effectively finding complementarity which is firms that go abroad increase their domestic growth rates relative to other firms.

And, by the way, there's one interesting fact that also comes out of this. There's no difference when you expand to developing countries relative to when you expand to developed countries. Often the fear is, well, firms now are investing in developing countries and that's different. At least from these European studies, no evidence.

The paper that's in your binder says let's look at it differently. Let's try to instrument for foreign growth. I'm not going to into what that exactly means in terrible detail. I'm sure that will be

heartbreaking. But what that basically tries to say is let’s get around the identification issues in a different way, and it tries to say, well, if you kind of isolate the exogenous part of foreign growth, then maybe you can say something precise.

These results are broadly suggestive of complementarity and very hard to find any evidence of substitutability. So, given the aggregate trends and this fear, it’s surprising that it’s so hard to find evidence of substitutability.

There are a few studies that have found substitutability, and they’re in the paper, and you can take a look at them. What’s common about them is they never find substitutability on average. They basically say, well, for certain kinds of FDI there is some evidence of substitutability.

I think the Harrison-McMillan paper is the best of this bunch, and they use U.S. data. They find substitutability amongst a very small class, not a very small but a relatively small class of FDI, and the effects are, in their words, very small. So it’s just very hard to find these effects of substitutability.

The final thing I just try to do quickly is, well, econometric evidence is convincing some but not to

all. So let's just look at the raw numbers, and let's see if we can see something interesting.

So here's the raw numbers from the late 1990s and early 2000s. That was, again, that period of what I termed, in the paper at least, the manufacturing shakeup. Can we learn anything about these aggregate trends?

So the first thing to note, and I think this Figure 5 in the paper. The first thing to note is that if anything on some metrics -- this plots, by the way, foreign operations of U.S. multinational firms versus their domestic operations, how have they grown. Okay. Simple, a very simple-minded picture.

On some metrics like assets and sales, they've grown at comparable rates, really no difference. On some metrics, the foreign operations have grown much more, for example, net income. So profits abroad have grown much faster than domestic profits.

On other metrics, domestic operations have grown faster. So, in fact, employment compensation has grown faster domestically than it has abroad, which, in some sense, employment compensation is obviously an important number if you think about that as wages and what you're concerned about.

Of course, what people are really worried about is employment or, in the Washington jargon, jobs. So what do the employment numbers suggest? And the employment numbers suggest kind of precisely what this concern is.

So the top set, the top figure in this slide is all industries which shows a leveling off U.S. multinational firm domestic employment around 1990s and then a slight decline.

If you look at manufacturing, which is that bottom picture -- it's also in the bottom right-hand corner of Figure 5 -- there, it's more dramatic. So, foreign employment increasing and domestic employment and manufacturing for multinational firms decreasing. It's exactly what I think people perceive as the problem.

So what you want to ask, of course, is if that's the right question. Now one could look at that and say: See, foreign operations are growing and domestic employment is shrinking. So, QED.

If you look a little more closely, it's not quite so clear. And so, this dramatic manufacturing shakeout that happens during this period is accompanied by, if anything, an increase in the relative share of U.S. multinational firms. So that's a way of saying something dramatic happened in manufacturing.

If anybody exited, it was the domestic players who exited, and the people who actually maintained a higher employment share were the multinational firms, and it's a pretty significant change. So, from 1998, U.S. multinational firms had 49 percent of the manufacturing base, employment base. In 5 years, it grew to 56 percent. It's a pretty important kind of relative increase in the importance of multinational firms exactly during this period of this manufacturing employment shakeout.

I won't do this.

So, just to wrap up, I think from a theory perspective the arbitrate intuition that actually undergirds our policy and the fears of substitutability I think is fairly discredited.

Alternative views that really emphasize productivity and what firms do actually allow for complementarity and would lead to policies that are very different, in particular, exemption.

Empirically, it's pretty hard to find evidence of substitutability at all, and even the recent U.S. experience is not terribly consistent with that.

The broad story I want to end with is the formulation that is pervasive, which I think is that taxing multinational firms saves domestic jobs, I think that's

incredibly alluring, but it's about as alluring and as valid as many protectionist sentiments. I think we should make that mapping in our minds a little bit more than we do.

The required formulation is one that actually allows people to understand that firm success abroad is twinned with firm success domestically, which is the kind of theory and formulation that many other countries have used in thinking about this problem.

Sorry for any wait.

MS. ALTSHULER: Okay. Well, thank you very much.

Let's move right on to Alan Auerbach's discussion of Mihir's presentation and paper.

MR. AUERBACH: Thanks very much, Rosanne, and to ITP for having this conference.

Let me launch right into what I see as the paper's main points:

First, that traditional U.S. tax policy toward international transactions is motivated by what Mihir calls an arbitrage view of the behavior of multinationals.

Second, multinationals don't behave the way envisaged by this world view. So tax design should reflect this difference.

And, third, that transfers of activities abroad

by U.S. multinationals is not an important source of the loss of good U.S. jobs.

Now my views of these three points would be it’s hard to know what traditional U.S. tax policy is motivated by.

Second, I would characterize the arbitrage view as not being based on a particular view of multinational behavior but rather on ignoring the existence of multinationals. It doesn’t really think. I mean it’s a view based on exports of capital by the home country and not really on the behavior of multinationals.

And, third, multinationals may not be bad for U.S. workers, and Mihir provided evidence to suggest that. But globalization is bad for some of them and good for others, globalization as distinct from the behavior of multinationals companies.

So let me explore these three key points in more detail.

First, the origins of U.S. tax policy. By now, we’re very familiar with this capital export neutrality, national neutrality view of the world which says you want equal tax rates on U.S. capital income wherever that income is earned. Now, depending on the perspective you take, a perspective of worldwide welfare of national welfare,

you'll come up with a different answer regarding how you should regard foreign taxes.

Under capital export neutrality, looking at worldwide efficiency, you'll want to include foreign taxes in the calculation and give a credit for them.

And, under a national neutrality point of view, you won't. You'll just treat foreign taxes as a cost. It's something you don't get the benefit of, and so you shouldn't take them. You shouldn't credit them in your calculation.

I should note, importantly, that this same logic, that is the logic that underlies the capital export neutrality and national neutrality concepts, also calls for no source-based taxation. It's definitely the case that you don't want source-based taxes under this kind of regime. And it also assumes that we're looking at a small country that has no impact on the terms of trade.

Now if you're a large country, at least if you're looking at national neutrality where being a large country would matter. Under the capital export neutrality approach, it wouldn't because you're interested in the world and not just in the home country.

But if you're just interested in the welfare of the home country and you're a large country and you can affect the terms of trade, then the same argument that

comes up in the optimal tariff debate about tariffs being bad for the world but good for you comes in this case too, and you want to have tariffs on capital. You want to behave as a monopolist with respect to capital exports and restricting their supply to drive up their price, and you want to be a monopsonist when it comes to buying capital. That is, to capital importing, you want to drive down its price.

You want to improve the terms of trade in your favor. You can't do that if you're a small country. But, if you're a large country, you do.

What does that imply under the national neutrality norm? You want even higher taxes on outbound investment. That is not even no credit, not even a full deduction for foreign taxes. This does give rise to a positive tax on inbound investment. That is some source-based taxation, not necessarily full and almost certainly not full.

So does the U.S. tax system look like what would be called for by capital export neutrality, by national neutrality for a small country or a large country? Well, to anticipate the alternative norms that Mihir and his co-authors have developed, and, pardon my French, but the answer is *non*.

We have full taxation at source. We have tax credits but with limits. We have deferral which doesn't come up in this discussion.

Now Mihir offers a pallid defense of the actual system as sort of trying to get at capital export neutrality or national neutrality, given all kinds of other constraints, revenue constraints and so forth, but his heart is not really in it. And, frankly, I think that shows good judgment.

So there's no way to justify the U.S. tax system in terms of traditional norms. It's frequently said, well, because the U.S. tax system is the way it is, because we've adopted a capital export neutrality approach, and that's not true.

Okay. Multinational behavior, Mihir's second point. Would achievement of capital export neutrality or national neutrality call for true worldwide taxation of multinationals? That is not what the U.S has but what we might have in this ideal world.

And, yes, if multinationals are simply conduits for domestic saving, for then taxing the income of multinationals, it's equivalent to taxing residents directly.

I should say this would be true even under the

newer theories of trade. That is complementarity of foreign activities and domestic activities, substitutability. It doesn't really matter. If we're really just talking about companies as being conduits for U.S. resident investors and we decide we want to have capital income taxes, then those capital income taxes should apply uniformly regardless of whether you're thinking of new trade theory, old trade theory or any theory.

Now it might lead you to wanting lower capital income taxes because there might be a bigger cost to imposing capital income taxes depending on the theory of how companies behave and take advantage of productivity of worldwide operations. But I don't think there's anything about the new theories that would lead you away from having uniform taxation.

That's something of a moot point because, in general, multinationals violate these assumptions in two important respects. They can move, so their own residence isn't fixed. And, even if they don't move, they can raise funds abroad. And so, either way, because of both of these factors, it doesn't make sense to think of multinational companies as serving as conduits for domestic savings.

So it requires its own theory. We can't use

the theory that we have from thinking of multinationals as conduits.

What does this theory say? Well, it depends on how one models behavior of the multinationals. In the theoretical discussion in the paper and also the discussion of his own empirical work with colleagues and other papers that Mihir and his colleagues have written, the paper focuses on the efficiency of capital ownership.

Now if the efficiency of capital ownership is all that's at stake, then we are led to these concepts of capital ownership neutrality or national ownership neutrality corresponding loosely to capital export neutrality and national neutrality. That is if we're really just allocating the assets in the world, we want the assets to be in the right hands.

But the assumptions necessary to make you only care about the efficiency of capital ownership are extreme. So empirical analysis is needed to determine the extent to which taxing multinationals affects capital allocation as well as ownership allocation.

Mihir talked about this a little bit. He said, and I think a quite fair characterization of the literature, that foreign and domestic activities of multinationals generally seem to be complements and not

substitutes. There are some decisions, perhaps horizontal decisions, where to locate a plant at the same level of activity, that might be substitutes depending on the paper one looks at, but overall the complementarity seems to dominate.

Now I should add that this is certainly helpful if one likes CON or NON as a norm, but it’s not necessary. For example, if you lowered taxes on the foreign income of U.S. companies, that might cause U.S. companies to move their activities abroad. Maybe substitutability as opposed complementarity would hold. But then you could have other companies entering the U.S. market to own U.S. capital, and under that assumption you would still think that the ownership neutrality approach would make sense.

So you don’t need these results about complementarity to think that looking at ownership neutrality is a good thing. It’s just that this gives you a more direct mechanism by which the U.S. capital stock won’t disappear.

Now, finally, the final point, multinationals and globalization. A Mihir said, you can look at regressions, and if you’re not convinced by that, then you can look at simple graphs which presumably contain,

in some ways, more. It tells you, gives you an idea of what's going, but it doesn't really give you a model. They suggest that U.S. jobs aren't, at least there's an argument you can make that U.S. jobs aren't being transferred abroad through the activities of multinationals.

Should this placate U.S. workers? Well, I guess Mihir would agree that the evidence he presented here is suggestive but not definitive. But, more importantly, it's only part of the picture.

First of all, we, as economists, like to think that market equilibrium involves not just quantities but prices. So as much as we're in Washington and we want to look at jobs, which is a quantity, we might want to look at prices or, in this case, wages.

International location decisions in addition to whatever effect they might have on jobs could exert downward pressure on wages if there are big international differences in wags. So we might not see it as much in job allocations, but we might see it in wage growth. And certainly know what's been happening to the income distribution in the U.S.

The second point I would make here is that not all international activity involves U.S. multinationals. So we're interested here in

multinationals and U.S. multinationals, and so we're talking about them, but there are other international linkages. There are foreign multinationals, and we're not really talking about the taxation of them.

There's trade. Indeed, when one thinks about the traditional trade models, you didn't have multinationals in those models. You had one country trading with another, and you had the Heckscher-Ohlin theorem that told you how you got equalization of wages in the two countries without any capital flows at all.

Now, of course, that's probably not good news at least for some kinds of U.S. workers, and it doesn't involve the discussion of multinationals at all. Even if U.S. multinationals are good for workers, they're part of a larger global environment in which U.S. individuals must now compete.

So, to whatever extent the story Mihir told is true, that doesn't necessarily imply anything about how people with protectionist sentiments will feel after considering the paper.

What's the bottom line for taxes? Well, first, there's no obvious case for the U.S. tax system now, but that's not news. One could have said that 30, 40 years ago. So, enough said about that.

Is source-based taxation the answer? Well, it's not as bad as some people think but perhaps for a different reason than others might suggest.

I would say it's not as bad as some people think because to a large extent we're already there, except for a lot of distortions. That is we don't collect a lot of revenue from what we call worldwide taxation, given that we have foreign tax credits, given that we have deferral, but we do cause a lot of tax planning and a lot of shifts in activities that we might consider undesirable.

So you might say, well, you could be agnostic about whether source-based taxation is the best of all possible systems, but you might conclude that it's still better than the system we have now.

On the other hand, source-based taxation has its own problems that are not really the focus of this paper and not discussed here, and adopting source-based taxation simply because it's better than the mess we have now is a fairly limited policy reform discussion.

I think really if one is really seriously thinking about actively adopting source-based taxation as opposed to passively doing it by letting things unravel to the point that this is basically what we're doing, we should do two things.

First of all, we should consider the reform of corporate taxes in conjunction with the taxation of individual investors. After all, the original capital export and national neutrality norms derive from thinking about residence-based taxation, and we are really there thinking about U.S. resident people. I know that in the tax law jargon corporations are persons, but I refuse to accept that characterization.

Second, we should, in thinking about taxation at the corporate level, not simply use the current tax system as the only alternative when thinking about what we could do. We should weigh source-based taxation against other -- in bold here -- sensible alternatives. So I'm suggesting that there may be sensible alternatives even if the current tax system is not one of them.

MS. ALTSHULER: Thank you very much, Alan, and thank you for staying on time. I was just making a zero for you.

We haven't had a lot of time to go to the audience for questions. So why don't we take a few questions right now? Otherwise, we can see if Mihir has anything that he wants to say to respond.

Questions?

Yes, Tom Nubig. Wait for the microphone.

MR. NUBIG: Mihir, you were suggesting that if multinational corporations are going abroad to take advantage of their firm-specific capabilities, that the tax policy norm might be exempting foreign source income. It seems like the optimal tax theory is saying that if there are firm-specific capabilities, those are rents and therefore they should perhaps be taxed very heavily.

MR. DESAI: Sorry. So should I respond to Alan as well?

MS. ALTSHULER: Go ahead.

MR. DESAI: In general, well, thanks to both of you for the comments, especially Alan.

A couple quick thoughts: One is I guess if I'm accused of being too generous towards current U.S. policy by giving it more of an intellectual foundation than it deserves, I agree. Having said that, I do think these ideas are very influential in ways that are pervasive. I don't think it necessarily rationalizes what we do, but I think it is important to at least think about where they come from.

There are a lot of other points in Alan's comments I won't address right now. But just briefly on this globalization point, I didn't mean to suggest that all

of this suggests that we should embrace globalization in all its many hues. All I meant to suggest is that we should think about tax policy towards multinational firms in a way that acknowledges these employment concerns and in a way that perhaps considers parallels to other sentiments that are, effectively, protectionist and try to draw that link in a way that's not inflammatory and somewhat responsible.

And then on Tom's question, that's fair. I think rents are things that we tend to be thinking of taxing in an optimal tax land. Of course, it depends in part where those rents are being exploited and how they're being exploited. Specifically, if you think about national welfare, you may come up with slightly different answers, but I agree with that.

In the new trade models, these rents don't actually result. These high productivity firms, it's interesting, they don't actually result in rents. They just result in kind of passing along a lot of welfare gains as well through their high productivity, so, passing on to consumer welfare gains.

So you can think about it that way as well. But I take your point, generally, yes.

MR. NUBIG: Well, I disagree with the optimal

tax theory.

MR. DESAI: Right.

MR. NUBIG: It’s labeling them, rents. I think it’s calling a lot of things, rents, and assuming there’s no behavioral effects.

MR. DESAI: Well, for sure. I mean there are two questions there. One is behavioral effects, and the other is just definitional which is: You see a high return. Is that a rent?

It’s not clear, and identifying rents in the real world is a very, very hard thing to do. Usually, it’s just equated with high returns which clearly isn’t right and, in fact, can result -- if you take that view, it can result in destroying a lot of incentives for very high payoff activity.

So I share that, yes.

MS. ALTSHULER: Are there other questions or should we just move on to the next?

I don’t see other questions. So that gives us an opportunity to try to catch up. We’re moving to the panel discussion right now. There’s no break.

(Applause)

MR. HINES: Thank you. We have one more session before lunch. We're going to have a panel discussion.

We have an extremely distinguished panel that I think and I will all benefit from hearing from. To my right is, to my left I guess, is Rosanne Altshuler. She is a Senior Fellow at the Urban Institute and co-directs the Urban-Brookings Tax Policy Center which co-sponsored today's conference. She is a professor at Rutgers on leave. Prior to that she taught at Columbia. She was Senior Economist on the President's Advisory Panel on Federal Tax Reform in 2005, was editor of the National Tax Journal for 6 years, and is a very distinguished contributor to this literature.

On the other side of Roseanne is my Michigan colleague Reuven Avi-Yonah. He is the Irwin Cohen Professor of Law at the University of Michigan Law School. He directs the University of Michigan International Tax LLM Program or Graduate Program on International Taxation. He was a professor at Harvard Law School before that. He practiced in Boston and in New York and is extremely widely published on international tax matters.

This guy over here is called Michael Graetz. He is -- how do we describe you right now, Michael? He is the Justus Hotchkiss Professor at Yale Law School but moving to Columbia Law School. In the spirit of having trouble keeping a job, Michael taught before Yale at USC,

he taught at Cal Tech and he taught at the University of Virginia. He has worked in the government on several occasions, most recently in the Senior Bush administration, and is also an extremely active contributor to the literature and contributor to ideas in this area.

What these distinguished panelists are going to tell us about is does it matter if the United States deviates from international tax norms, and we are going to start with Dr. Altshuler. Roseanne?

MS. ALTSHULER: Thank you, Jim. This is a big question and it's certainly not an easy one to answer. What I want to do is just quickly review the current system. I know we've been there today, but I just want to go back to it because I think it's important.

As has been stressed so far this morning, we do have a worldwide tax system. Dividends are taxed at the U.S. rate when they're repatriated and receive credits for foreign taxes. What about other developed or OECD countries? Jim went through this. It's not straightforward to classify what they do, but according to the information that was provided to the President's Advisory Panel on Federal Tax Reform by the OECD which Jim put up that was very hard to read, as of the summer of 2005, there were only nine countries that applied home

country taxes to dividend income received by resident corporations. So there were only nine foreign tax creditor worldwide countries.

What's happened since 2005? Of the nine, the Czech Republic seems to have adopted a dividend exemption system for E.U. and treaty countries in 2008. Poland also allows dividend exemption for E.U. and European Economic Area countries that meet certain holding and participation requirements. So these two countries have moved toward dividend exemption. That leaves us with seven. Of the seven as know, the U.K. and Japan have announced intentions of going to dividend exemption. New Zealand is also considering moving to dividend exemption. So just to be clear to everybody, this leaves the U.S., Iceland, if it's still around, Korea, and Mexico with foreign tax credit systems.

What about the corporate statutory rate? As we learned today, the U.S. statutory corporate rate is out of line with other OECD countries. Many have recently enacted reforms that reduce their rates even further. But as Doug Shackelford pointed out, there is much more to a tax system than whether it's classified as worldwide or territorial and the corporate statutory rate. Jim stressed this but he didn't really put together all of

the components because he didn't have time. Let's really look at the current system. Again it's important to do this.

It's really not accurate to describe it as being worldwide, and I think Alan kind of brought that point out. By maintaining deferral indefinitely, a taxpayer can achieve a result that's economically equivalent to 100 percent exemption of income with no corresponding disallowance of expenses allocable to the exempt income provided that the taxpayer has excess foreign tax credits, doesn't repatriate their earnings and doesn't run afoul of subpart F or other antideferral rules. So these firms have under the current system dividend exemption with no allocation.

In addition, taxpayers that repatriate high tax earnings can also use excess foreign tax credits arising from their repatriations to offset U.S. tax on lower tax items of foreign source income such as royalties that would be received from using intangible property in a low tax country. So for these reasons, I know it's technical, in many cases the present law worldwide system can actually yield results that are more favorable to the taxpayer than the results available in similar circumstances under territorial exemption systems used by many of our partners

but it's very costly to achieve this result and this is something that comes through in Doug's effective tax rate calculations. You saw that the U.S. effective tax rates are very similar to countries that have dividend exemption systems, so again to classify our system as being worldwide or territorial is extremely difficult. Before I move on and talk about what we should be doing, I want to stress what the Joint Committee on Taxation wrote in 2005 in their recommendation to adopt a dividend exemption system. They wrote, "The present law system creates a sort of paradox of defects. On the one hand, the system allows tax results to favorable to taxpayers in many instances as to call into question whether it adequately serves the purposes of promoting capital export neutrality or raising revenue. On the other hand, even as it allows these results, the system arguably imposes on taxpayers a greater degree of complexity and distortion of economic decision-making than that faced by taxpayers faced in countries with exemption systems arguably impairing capital import neutrality in some cases." For this reason the JCT and the President's Tax Reform Panel recommended dividend exemption with expense allocation rules.

I think the question here is does it matter if the U.S. deviates from international tax norms. As we

begin to think about whether we should adopt dividend exemption because that's the norm and do so with no or very loose allocation rules because that's the norm, we should step back and contemplate what we know about the impact of the current tax system on multinational corporations and what we know about the effect of the current tax system on multinational corporations is that it's distortionary on very, very, many margins. The location of real assets is mobile. It's sensitive to differences in tax rates across jurisdictions. It's become more sensitive. The location of intangible assets is mobile across jurisdictions in response to differences in tax rates. It's become more mobile. We know income shifting is getting worse. We know that the repatriation tax is burdensome. We know that the location of headquarters is mobile and that new companies have chosen to incorporate outside the United States. So all this suggests to me that the current system is extremely distortionary. It's not providing capital export neutrality to firms. Some firms can use self-help to get themselves to territorial taxation, other firms can't, but it's very, very costly.

What should we do? Should we simply adopt the average system of our competitors? I think here the answer

is not necessarily. I think it matters what other countries are doing, but I think that what we should be doing is looking at improving our system for taxing cross-border income with an eye to what's going on in other countries. The question is not should we do what they're doing, but can we come up with a system that's more efficient than the current system? The goal of course should be efficiency, productivity growth, which will raise the standard of living of U.S. citizens. What I'm trying to say here is that we want to minimize distortions.

To do this, it means that we have to be aware of the statutory tax rates at home and around the world. Why? Because as has been stressed so far in this conference, this is what drives tax planning incentives, and this goes back to what Marty Sullivan was saying. Yes, it does matter what the other countries are doing. The statutory rate differential is really driving a lot of planning incentives. Do we need to therefore adopt territoriality to deal with the statutory tax rates? No, not necessarily. So we need to look at statutory rates, but we also need to look at what Doug was looking at. We need to look at how the system affects effective average tax rates for investment abroad since investment abroad is often a discrete decision. And we need to look also

at effective marginal tax rates for investment abroad. What we need to do is look at sensible alternatives as Alan would say and look at what the sensible alternatives mean for differences in statutory rates, average effective tax rates and effective marginal rates. Again going back to what Doug Shackelford showed us, it doesn't matter that we're territorial versus worldwide. The average effective tax rates were very similar for countries that had worldwide -- they were similar -- Doug told us that there weren't statistically significant differences.

So there are three broad choices that I would consider. All I think are improvements to the current system. I have written about this with Harry Gruber in the past. I think territorial taxation is an improvement on the current system. However, if we adopted territorial with no allocation rules, we would have negative marginal effective tax rates and I think we need to sit back and say why are we subsidizing foreign investment. There may be good reasons to do that, not just complementarities, you need to have some sort of a positive externality story I think. If we do territorial, would we keep the 35 percent rate? If so, then I don't get it because we're going to have a bigger problem with transfer pricing at the 35 percent rate. And also the 35 percent rate does nothing

in terms of inbound investment which has been stressed this morning which is also important. So territorial is not the answer necessarily. You can go territorial, but you have to also think about where you're going to keep that 35 percent rate. What does territorial do? It does get rid of the repatriation distortion and that's a good thing. As I said, it's better than the current system.

Another option on the other side of this is worldwide taxation at a much lower rate but with no deferral, no expense allocations and possibly higher individual tax rates in capital income to pay for the corporate tax rate cut. This type of reform would reduce the distortions along a number of margins, location, repatriation, tax planning, but depending on how high the corporate tax rate is, it could lead us to the loss of headquarters. It could lead us to the loss of U.S. firms and that's a problem. So that's worldwide taxation at a much lower rate but trying to get revenue neutrality for instance with a higher rate on capital income at the individual rate.

An intermediate option and I think probably the one that makes the most sense is using a VAT, adopt a VAT and use the income from the VAT to lower the corporate statutory and individual statutory rates. The President's

Advisory Panel scored a reform that would have been revenue neutral according to the administration's baseline back in 2005. This was in a chapter of the report that nobody seems to have read. The staff was very, very excited about it. In fact, I considered having T-shirts made up. We called it the 15-15-15 Plan. The exercise suggested that a European style VAT with a broad base and a tax exclusive rate of 17.6 percent, which tax inclusive would be 15 percent, could be combined with a top corporate statutory rate of 15 percent and a top individual rate of 15 percent for revenue neutrality. The panel's option would have included dividend exemption with allocation rules, but at the 15 percent rate I'm not sure how much it matters if you're territorial worldwide. This type of a reform having this lower rate would decrease tax planning and income shifting incentives so it would reduce the distortions, they wouldn't go to zero, and at the same time encourage inbound FDI. Except for the low statutory tax rate, it turns out that this recommendation that I'm putting forward follows the international norm because you would have a VAT, but that's not why we give the reform such a high grade. It's not because it follows what other countries are doing. It's because I think it's a reform that makes the tax system more efficient and so I think

it's a good reform.

I want to lay out a few questions in my closing minutes of which I have none.

MR. HINES: Closing seconds.

MS. ALTSHULER: Seconds. Do the international norms matter or does the end result in terms of rates matter, statutory, effective, average, and effective marginal rates? If we decide to lower tax burdens on U.S. multinationals, does it matter if we do it the same way as other countries? And what about inbound investment? Does it matter there if we deviate from international norms? And if other countries are going to subsidize foreign investment, should we?

MR. HINES: And for the answers we have Professor Avi-Yonah.

MR. AVI-YONAH: I don't know if I have any answers to that. Thank you, Jim, for inviting me. I don't know if after this I'll ever be invited again, but let's see.

The first thing to do is since I'm a lawyer I want to quibble with the use of the word norms here. A norm to me is something that is potentially binding on us so I think that it's things that cause us to behave differently. Nondiscrimination is a norm. We don't like

to appear to be discriminating. The -- standard is a norm. When we introduce profit matters we claim to be following the -- standard -- is a norm. I don't think we will have --- because of that. The setting of rates even territoriality versus worldwide as I'll talk about in a moment, I don't think those are norms. I think we can pay attention to what other countries are doing. Sometimes it has practical effects. The decision what we do is wholly up to us, and in that I agree with Roseanne.

Going from the top to the bottom, the biggest question that was raised today is what about the tax mix. As was mentioned many times, we rely more on income taxes. Other countries have VATs. The other point of course is that we have a much lower tax to GDP ratio than other countries, other countries tend to have VATs on top of the income tax. There has been suggestion of substituting more taxation of consumption for taxation of income. I don't have any problem with that. In fact, I would favor it. I imagine Michael Graetz might talk about this a little bit because that's his idea. My only concern is that we need more revenue and we'll see how we deal with that. I think eventually we'll have to end up with something a little bit of a higher rate of taxes to GDP if we proceed with current trends. So that's at the very kind of high

level.

Second, the corporate tax rate, again, I have no problem whatsoever in lowering the corporate tax rate. I in fact have written a paper with -- suggested lowering the corporate tax rate. That would reduce pressure on transfer pricing, et cetera, and that's fine. I'm not sure that what other countries have done is to my mind particularly relevant to this exercise but I think it's plausible. Again the issue is to where to make up the revenue. Obviously if we do have a VAT, a pretty small VAT can substitute for the entire corporate tax. I think there are other reasons why we will maintain the have the corporate tax but that's not the subject of this panel.

The third issue, and here I have to respectfully disagree with my host, Jim, and also John Samuels. I think that on this there are facts and there are facts and some facts are more fact-like than others. This is the issue of -- and what other countries do and whether we should listen to what other countries do. I teach comparative CFC rules in Europe where all the Europeans are and whenever I suggest -- which I teach in detail -- they laugh at me. If you really want to know, ask people like the people who worked at Chrysler when it was owned by Daimler when they had to be subject to both the German rules and the

American rules at the same time for the -- the reality of the matter from my perspective is that our rules are different of course because we -- and mistakes what other countries do, but I don't think they are tougher. This is borne out by the way by the Shackelford data -- effective tax rate are very similar. There is no competitive disadvantage as far as I can see. They do things differently. They don't redeem dividends, for example. So if you treat subsidiaries as if they are branches then you don't tax dividends of course, you just include immediately everything that is due tax and you don't include everything that you don't tax, you exempt that, but you don't care about dividends because dividends are disregarded within the corporate form. They do things that I think we may want to consider doing like explicitly taking into account what the effective foreign tax rate is or -- it should be the effective I think -- when considering whether to exempt income or not and they have all kinds of proxies like that, black lists, white lists, whatever. We don't do that. We do it for purposes of kicking things out of -- we don't do it for -- inclusion. I think that might be a reform that made sense. It would certainly simplify things and would reduce something of the $50 billion tax burden. I should say on that by the

way that Jim has his own previous studies that show about a very low effective tax rate on foreign investment of U.S. multinationals. That doesn't take I think the compliance burdens into effect but you can deal with -- a lot of the compliance burdens has thing to do with our crazy transfer pricing rules and stuff like that that I think could and should be simplified.

Finally, I think the key issue for discussion today as a practical matter is this dividend exemption proposal. I can see the advantages to that. Certainly the 2005 1-year experience was interesting in this regard. There is no question that the dividend repatriation tax raises little revenue and has a significant behavioral effect. So from that perspective I have said previously that I would favor a dividend exemption regime. But I do think that any move in the direction of territoriality does put more pressure on transfer pricing, and in this I agree with Roseanne and I also agree with Ed Kleinbard. And that if we do in that direction especially if we don't reduce the rate then we need to really think hard about what to do about transfer pricing, cost sharing and all the rest of that mess because if we have any kind of move toward pure territorial taxation which doesn't pay attention to transfer pricing and sourcing I think raises

losing much more revenue than we could ever potentially gain by abolishing deferral. In that sense I think you really need to be careful. Thanks.

MR. HINES: Thank you and, no, we won't invite you back again. I'm kidding. Of course we will. Professor Graetz?

MR. GRAETZ: Not surprisingly, I want to endorse Roseanne's idea of using a value added tax to lower individual and corporate rates. For those of you who have $20, I have a book available on Amazon.com for detailing such an idea.

I want to go back to what Reuven said about norms, and there has been a lot of talk about norms throughout the day. I don't agree that arm's length pricing is a norm. It seems to me it's a technique. But here is what I would say about this, and this may seem obvious to people who are not deeply into the international tax literature, but you have to take into account the history here. There have been lots of norms proposed. We saw capital export neutrality, capital import neutrality, capital ownership neutrality from -- and Jim and we know that you can't achieve both capital import and capital export neutrality simultaneously in the absence of harmonized tax rates and tax bases. Therefore, international tax policy is a

compromise between two conflicting norms or at least has always been described as that and therefore it's a mess and you can compromise anywhere you want so it's very hard to rationalize it which is why Alan and others are puzzled about what it really is about. They know what it's about, but it is puzzling.

For me, I think the question for international tax policy is what is the policy that will best serve the improvement of the national welfare, the welfare of U.S. citizens and residents. That is actually the question for most policies I think that the U.S. government has control over and I think that should be the fundamental question that we're asking ourselves, and then I would agree with Roseanne that we should keep an eye on what others are doing in a global world that we talked about in the first panel and have talked about all day because it's essential to do that and we clearly have got fundamentally incoherent and unduly complex rules.

The choice between worldwide and territorial that we've talked about so much has been talked about in terms of a conflict between capital import and capital export neutrality. It seems to me this is the wrong way to talk about it. And I actually come out where Roseanne does which is that the key problem with the worldwide system

is not competitive disadvantage so much at the moment as it is that it creates a barrier for multinationals who make a lot of money abroad to reinvest the money in the United States. Why would we want to do that? It's a mystery to me. Therefore I believe an exemption system that doesn't do that to the current system that does do that. So that getting rid of a stupid barrier seems a good idea and I think that's probably why the other countries have done this and one reason to keep an eye on them is that they probably are acting pretty much on the whole usually in the interests of their citizens and residents. It would be surprising if they weren't.

I also want to say that there are important distinctions, and where I want to mention, I mentioned it earlier, this reliance on consumption taxes. We really are inhibiting our own potential for economic growth by now using those more. But I want to talk about two of the issues that have come up in international tax specifically. One of them is the subpart F regime that Jim spent so much time on and that Reuven has talked about. Here I think the essential question is the base company rules and the question about operations of active business income abroad. That's where we are more different from other countries than anywhere else and whether they're

more or less burdensome, they are different. They're different in ways that inhibit the ability of a U.S. multinational to have a distribution company in one country rather than in many countries which doesn't seem right to me. Here the question is should we be worrying about U.S. multinationals stripping income out of foreign countries, and capital export neutrality would say yes. Some of the ideas that were advanced at the end of the Clinton administration, people in the business will know them as revenue rulings 9811 and 9805 as I remember it, suggested that this was a bad thing for the U.S. I happen to be of the view that if U.S. multinationals which are largely owned by U.S. people can take money away from foreign governments and put it in our pockets, that's not all bad. So I think we do need to reconsider those kinds of rules that are inhibiting sensible organization of U.S. multinationals for business reasons elsewhere in the world whatever else you do.

On allocation of deductions which is the other big issue that has been talked about, this is more complicated. I do want to say that in the book I have an article. It is eight pages long. It has no big E's, those questions that Doug put up. It has no tables that are difficult to read. It is grounded around a simple

example. It talks about interest allocation. It does not talk about R&D allocation or headquarters expense allocation. I think those are different. I think when we start talking about R&D, there's a big reason to try and encourage R&D in the United States. I think when we're talking about corporate headquarters, there's a big reason to encourage corporate headquarters in the United States. There seems to me, this is a perfect moment to say this, less reason to encourage lots of borrowing in the United States. So I think you've got to analyze this separately and not just say they're all the same and let's lump them the same. I think we need different rules.

I won't go through this because I don't have time even though it's short to talk about interest allocation at great length, but I do think the examples that I go through are important in the following sense. They show that there really are two problems here. One problem is that if you allow interest deductions in the U.S. for foreign investments, you are as Roseanne said especially when you're a high tax country and the foreign investments are in a low tax country, you are subsidizing those foreign investments. I know Jim doesn't that, but that's a debate we'll have at another time. But you're creating a negative tax rate on the overall situation.

If you disallow those deductions in the U.S., you're doing something else in the other direction that's also bad which is that you're double taxing that income and the reason for that is that the borrowing in the U.S. will not produce interest that will be allowed to be deducted in the source country. The example I give is a high tax country that you borrow in and a low tax country that you invest in and the example is one of a 15 percent rate in the low tax country, and what you do by allowing the deduction of interest here and them not allowing the deduction of interest is they're essentially getting a 45 percent rate on net income by taxing gross income and so they're getting the benefits of a lot of taxation, and what the article demonstrates which I think has not been clearly demonstrated in the literature before is that one of the problems is that there's a shift of revenue from the residence country to the source country and we're transferring revenues to them for no good reason if we're the high tax country which we happen to be at the moment even though we shouldn't be. Of course lowing the tax rate is one way to deal with this problem. I urge in the article that since there are problems on both sides of this equation, one must really think carefully about a multilateral situation to this. I'm not defending our

water's edge allocation rules. They make no sense. They've never made any sense. I don't know if anybody has ever argued they make any sense. It was a revenue grab in 1986. Anybody who knows the history knows that. But if everybody did worldwide allocation and the source country allowed deductions and the residence country allowed deductions on worldwide allocation bases, you'd eliminate a lot of issues about income stripping and the like that we have as a source country, that everybody has, and you'd reach a result that was a pretty good result for both the source country and the residence country. How do we get there is a difficult problem and there is a problem with moving unilaterally in the current global economic climate, and I call for a multilateral solution. What do I mean by that? I mean this is an issue the OECD could carve out and really deal with seriously. The European Union could carve it out and deal with it seriously and make some progress. And we could begin insisting in bilateral treaties on the source country allowing interest deductions on this basis at least in some way. I don't trace out how you can do this, but I think it's important. In that sense it does matter what other countries are doing. The question is who should take the hit for this and under what conditions and at what cost. So it's a

much more complicated question I think than we have had time to talk about today but I think it's really important to think about.

I want to close with one other -- I've got 1 minute. Right? I've got no minutes, but Roseanne took a minute. I'm going to take a minute. I know everybody wants to go to lunch, but it's only 12:25 and you're not in any position to scold me for taking a minute. I have 30 seconds.

MR. HINES: Thank you very much.

MR. GRAETZ: This is very important though. One place where America is exceptional, American exceptionalism, is that we have the most unequal distribution of income than any of the industrialized countries at the moment and that means that we've got to take into account the ability to have a system which is fair to U.S. citizens and residents. When I said system notice I didn't say tax system. I think the tax system needs to be fair. But I also include government spending of the ability to provide the kind of social safety net and social insurance that we need to provide. The wisdom of Franklin Roosevelt was that the American people are all better off if they all contribute to a system that provides progressive benefits, and he called it Social

Security which has been the most enduring tax and spending system in the United States. So we have to think about our individual tax system. This is Roseanne's point I think and to some extent Reuven's as well. We have to think about our individual tax system as well as when we think about our business tax system because we've got more than one problem as a nation.

MR. HINES: Thank you. As you can see from this discussion, thoughtful panelists on all sides agree that the United States has a perfect system of taxing income currently and that no changes whatsoever are needed. That may be a bit of an exaggeration I guess. I expect that there are questions that people might have for the panelists. Professor Graetz has graciously left us a couple of minutes for questions.

MR. SAMUELS: Thank you. John Samuels. First, Reuven, the good thing about our dispute that it's factual or empirical, that is, there's an answer to it: do other countries' subpart F regimes have the reach of taxing active business income the same way the U.S. does? You may teach it. I live it. I can tell you they're not nearly as broad or far reaching, not just the foreign based company sales and services rules that Michael describes, but the CFC look through rules and the active financial rules,

to be continued or we'll continue our discussion. On the exemption system, moving to an exemption system, I think Roseanne you can't have it both ways in the sense of transfer pricing. If today's current U.S. worldwide system is the equivalent of an exemption system, then we have a big transfer pricing problem today which I agree with, but I don't think it's any more acute in an exemption system if you are right that today's system is the equivalent and I do think transfer pricing really is all around intangibles and something that both we and other countries need to concern ourselves with. But I would also point out that foreign countries seem to be able to manage the transfer pricing in their territorial regimes or not be concerned about it or at a minimum I think the tradeoff from eliminating the distortion on the repatriation of foreign earnings is worth whatever incremental pressure there is on transfer pricing. So I don't really think there's much incremental pressure on transfer pricing, not to say that transfer pricing isn't a problem.

MS. ALTSHULER: I should have said that transfer pricing gets worse to the extent that there is a repatriation burden under the current system. If you don't think there's a repatriation burden under the current system, then there is no change in transfer pricing

incentives. But to the extent that there is a repatriation burden that's going to be lifted, then transfer pricing incentives get worse. And as other countries are lowing their rates, the income shifting problem certainly gets worse if there is a burden to the repatriation tax which I think there is. So maybe the other countries don't have the same problems because their rates are lower.

MR. SAMUELS: Maybe, but I don't think people don't to overseas or invest overseas to avoid what would be a potential repatriation tax. Accounting ends up running the world, unfortunately, and if you invest overseas and you think you may want to bring the money back, all you do is set up on your books a residual U.S. tax and then you can bring it back. It's the companies that don't set up the residual tax that find themselves locked in.

I had a second comment on the exemption system and that is this expense allocation question and negative tax rates. I would briefly point out that, and whether we're subsidizing foreign investment, no country in the world allocates its expenses in any meaningful way to their exempt system, nor did the U.K. or Japan when they had their worldwide systems. The U.K. considered in moving to its territorial regime whether they should adopt an

expense allocation regime and decided not to explicitly. You might ask why, and they certainly will have a negative rate on their foreign investment. I would submit there may well be externalities that justify it in the minds of the governments of the world. We have negative rates here on domestic investments that abound. Start with your house, depreciable equipment, it's debt financed at a negative rate. International tax isn't about revenue collection. Neither we nor any other country collects much revenue from cross-border transactions. I think it's about capital flows and standard of living of your residents and the success of your multinationals based in your country and not so much about revenue. If we wanted revenue we could repeal deferral and have it be subject to a 35 percent rate. No country has ever suggested doing anything like that.

MR. HINES: And we'll take it that you're not suggesting that right now.

MR. GAERTZ: May I say one thing about this? That is that what makes the transfer pricing as bad as it is and continues to be bad and what makes this allocation issue as difficult as bad as it is the relationship of statutory rates between the U.S. and other countries. Roseanne said this at the beginning but it's really worth

emphasizing. It's not enough to look at average rates or these other kinds of things. The statutory rate turns out to be hugely important. A good reason for getting ourselves down on the corporate statutory rate is to that the transfer pricing will operate in our favor instead of against us and that people will locate their interest deduction somewhere else and their income here.

MS. ALTSHULER: On negative effective marginal tax rates, fine. Yes, we do have them today and all I'm saying is that let's be honest that we have them, why we have them and justify them. And actually I want to think a little bit more about this, but if we're going to have what's going to be a complicated system, territoriality is not a simple system and Michael has a great paper on that with Paul Easterhouse, if we're going to have this complicated system generating negative effective tax rates, show me why we should do that at a 35 percent rate and not just go down to zero. I'm not objecting to the negative effect of a marginal tax rate, I'm objecting to the way we get there and objecting to having that be hidden instead of out in the open.

MR. AVI-YONAH: Just one last comment. As many of you know, the U.K. proposed adopting an exemption system and suggested that they might do something about tightening

up subpart F and the result was a spate of -- to Ireland. So I think we need to be careful about the details of what we're doing.

MR. HINES: Some would say that this panel of very thoughtful observers has raised more questions than it answers, and that might be a correct interpretation, but fortunately the conference is not over. We have the man with all the answers who is going to be our lunchtime speaker and that is Ed Kleinbard. So what I propose we do is thank our panelists and then go off to lunch and come back and at 1 o'clock -- why don't we bring our lunches back to the seats so that we can mess up the auditorium here at Brookings and then we will have Mr. Kleinbard speak to us? Thank you to the panel.

(Recess)

SPEAKER: Please take your seats. It looks like not many people have spilled on the furniture so Brookings may have us back, and even Reuven, wherever he is. It's my pleasure to introduce our luncheon speaker, somebody I have the highest regard for and I think many of you who know him I'm sure do also, Ed Kleinbard. Ed was a leading lawyer if not the leading lawyer in New York City at a law firm, Cleary Gottlieb, a great firm, and while he was there wrote prolifically. All you have to do is look at

his bio on pages 155 and 156 of this book and you'll get a sense of his accomplishments. He left the practice of law to come to the Joint Committee Staff to be the chief there. I don't know whether it was 1 year ago or 2 years ago. It may seem like 10, Ed. I don't know. He has really shaken up the Joint Committee. He's taken on a lot of the sacred cows. He opened up the revenue estimating process. He reexamined the status quo of the tax expenditure budget, and he is now going to think about distributing the corporate income tax or the incidence of the corporate income tax. So he has really made an enormous contribution to the tax process and we're all very fortunate that he was willing to come to Washington, and we're even more fortunate that he's here to talk to us today at lunch. I asked him what he was going to talk about and he refused to tell me, so it will be a surprise. Ed, thanks for coming.

MR. KLEINBARD: I'd like to actually like to begin with two excuses and apologies. First, obviously everything I say today are my thoughts only. I always say that, but today I actually mean it. I intend by Monday to deny everything I've said here today. I actually managed to fall from the top of a step ladder yesterday evening in my apartment which was a rather remarkable thing to

do, and so I am going to claim a contusion as an explanation for all of my remarks. So if I cause offense, it's not really me speaking, it's the blood clot.

Second, I was very taken by something Marty Sullivan said I realized I also have in fact exported all of my capital to Bermuda. And when my son and his girlfriend and my credit card return at the end of the week, things I guess will be restored to normal in the balance of payments.

With those by way of background observations, I want to talk today on the theme of tax -- given that this is a gathering to discuss U.S. tax exceptionalism, I want to talk a little bit about the theme of tax expenditure exceptionalism. The U.S. system is exceptional in a great many respects of which the taxation of foreign direct investment is just one small example. Most fundamentally as we heard from some of the speakers this morning, the total U.S. tax burden as a percentage of GDP, more directly, the size of the public sector, is exceptionally low compared with many of our peer countries. The U.S. does not rely very much on consumption taxes as we talked about extensively, and maximum personal income tax rates are relatively low. And only about one-half of American business income is derived through the

corporate sector. I therefore take a little bit of exception with the premise of the conference's title as opposed to some of the substantive discussion here which by looking at only one component of American tax exceptionalism can be argued to be a bit more argumentative in its premise than might be immediately apparent.

I want therefore to open things up a little bit and talk about this other aspect of American tax exceptionalism about which I have been brooding extensively for the last few weeks, what I term American tax expenditure exceptionalism. As you know, the JCT staff has worked a great deal over the last year or so using a lot of its free intellectual capital to reinvigorate tax expenditure analysis, and some of you have heard me talk on this topic before, but to my way of thinking, very recent developments have made the question of tax expenditures even more relevant. I therefore want to offer a few tentative thoughts today about how the U.S. employs tax expenditures, and where I can, compare that with the situation in some of our peer countries.

First, just to remind all of you, what are we looking for here? What are the lessons that we hope to draw from tax expenditure analysis? I think the way just to remind everybody with a very, very simple thought

experiment of a happy country with a productive sector that comprises only fruit and vegetable growers, sort of like the United States in 2011, a gross national product of this little country in my example is $10,000. It has a 10 percent tax rate because that's the kind of high-level math I can do, so that would be $1,000 of tax, and with 10 fruit and vegetable growers each producing $1,000 in value and paying $100 in tax. This struck me as an extraordinarily realistic example. The kumquat producer comes forward and convinces the Congress that kumquats deserve special tax incentives and therefore receives an exemption from tax for income derived from kumquat production. This counterfactual imposes fiscal discipline in the form of pay-go. So the other nine remaining fruit and vegetable growers get an 11 percent tax hike and they $111 each. If we don't think in tax exemption terms, what do we see? We see the GNP is the same. We haven't accounted for any behavioral consequences yet. Let's just keep that simple for the moment. Tax revenues are the same. So nothing has changed in the economy, and that in fact is the way many people outside of this room tend to think about our fiscal processes.

But in fact that's completely wrong. Things of course have changed. First, and to me most interestingly,

the government just got bigger even though its share of nominal revenues of the country has remained constant a $1,000 of total tax revenues. The reason is obvious. We have a new kind of handprint of the government on the private sector in the form of the differential taxation of kumquats as opposed to other fruits and vegetables. This silly example explains an awful lot of what was said this morning. It helps to explain why the United States as we'll see in a minute when we talk about numbers is both a high-rate and low-collection country and we're going to see that the numbers that we're going to talk about are staggeringly large.

Second, of course, we've directly affected kumquat production and consumption. That was the purpose of the exemption. The kumquat growers have convinced the Congress that everyone will be healthier if only they had more kumquats. We've lowered the price of kumquats or increased the profitability of kumquat production. Something is going to happen and presumptively the price of kumquats will change or the price of other fruits and vegetables will change. That's a first-order consequence of every tax exemption, and I would say obviously as a general matter those of you who are economists in the room tend to be rightly skeptical of nonmarket-setting price

mechanisms. That's effectively what we've just done. We've created a price mechanism that is different from that which will be reached by the market.

Next if we were to take the kumquat subsidy and hold it up to the light or hold a kumquat up to the light, you can ask a lot of important questions about how the subsidy actually works. Is the tax system the best way to deliver the subsidy? Can the IRS enforce the distinctions that the law now contemplates? Can IRS agents distinguish between a kumquat and a kiwi, for example? I know I can't. In short, we have a great many policy levers available in government. We have regulation. We have appropriations. We have taxes. Are we using the right policy lever to accomplish our purpose? There's an awful lot by thinking in tax exemption terms. In our big paper on the topic we summed up on the themes of transparency, targeting and certainly and these go to the points that Michael made very effectively this morning about the Baroque complexity, maybe that's not fair to the Baroque Period, the Rococo complexity of the tax system. This is the explanation of that Rococo complexity.

Next we go back to the example where we talked about what happened to kumquat prices, but look what happened to everyone else. It's not just the kumquat

producer who's gotten lower prices or higher profits. Everyone else's tax rates have gone up. And there is something really important to notice which is no matter how beautifully implemented a tax is, there is always dead weight loss associated with taxation which is just a fancy way of saying that there are transactions that are rational to take place that would take place in a world without taxes and they become unaffordable in a world with taxes so society as a whole is less wealthy to that extent, that is, we are less wealthy by an amount that is greater than the transfer of money from the private sector to the public sector. That's what a dead weight loss means. And it also turns out that dead weight losses go up faster than taxes go up. This is not abstract theory. This is I think hard economic science on which there is abundant empirical literature.

So one consequence of tax exemptions is increased taxes on everyone else, on those not clever enough to be first in line at Congress and that in turn produces a whole second set of distortions to the economy, the first order distortions being to kumquats, the second order being the dead weight losses that are visited on everybody else who pays for the kumquat subsidy. That's why I emphasize, and I'm looking around the room right

now for my takeout whoever you may be. The only thing you need to know as chief of staff is to spend is to tax. Milton Friedman's great aphorism said it all. We will tax and we exempt one class of production from tax, that just means more tax for everybody else.

Finally, not relevant to today, we can use tax exemption analysis to help identify other than economic efficiency that might explain the purpose and success of tax expenditures. That's why in our big paper we took tax expenditures, the component we call tax subsidies, and divided them into categories of tax transfers which are refundable credits, social spending and business spending. The purpose of that is to help start to ask the questions what reasons other than economic efficiency might be driving this or that particular subsidy and there are lots of good social reasons. It is important to understand that tax expenditures are not bad, but they're not good. They are just facts. And the question that has to be asked in every case is what is the purpose of this form of synthetic spending? Is this the most-efficient way to do it? That is just a long parenthesis to remind everybody about why we care about tax expenditure analysis in general.

Second, let me talk a little bit about where

is the United States today. The Congressional Research Service just published its "Biennial Tax Expenditure Report." It's 950 pages long. That by itself is a data point I think that tells us something about the U.S. addiction to tax expenditures, a 950-page report. I've read it cover to cover, but I doubt very many of you have. The Congressional Research Service does something very useful which it sums up some of our data in a simple summation that we refuse to do because we're highly principled economists, so they tell us that there are 247 identified tax expenditures in the latest JCT "Staff Expenditure Report" which put out October 31. It's all on our website. Quite interestingly according to them, the simple sum of all of those tax expenditures for 2008 is about $1.2 trillion. I'm very grateful for them to have done this. First of all, it saved from doing the addition. Second, we refuse to add up the numbers because each of our estimates is a stand-alone estimate for that particular exemption expenditure. If you were in some entirely mythical world to repeal every tax expenditure which doesn't make sense, remember, many, many, many of them are in fact good policy, the fact that they happen to be through the tax system is because the tax system is the most efficient way of delivering a particular form

of federal subsidy, but if were you for whatever reason to eliminate every tax expenditure, there would be interactive effects, therefore we don't add up the number. The Congressional Research Service did so I can refer to their number of $1.2 trillion and observe that there may be interactive effects, but $1.2 trillion now give or take is still a really big number. How big is it? It's 8-1/2 percent of GDP in 2008. And by the way, $1.2 trillion was more than we collected in income tax. Tax expenditures, the simple sum of tax expenditures for 2008, exceeds the income tax collections of the United States for 2008. So, yes, you can simply add them up, but if you just take a peek you conclude it's a really big deal.

What have we done since those numbers? We've had the stimulus legislation, and the stimulus legislation contained depending on how you count about 50 tax provisions. There was one revenue raiser. There was the AMT patch. There were a few items that had negligible effect one way or the other. But the remainder were basically all tax expenditures. In some cases they were additives to existing expenditures. In some cases they were new ones. There's nothing wrong with that. The purpose of this was to spend money. Right? That was the purpose of the legislation. So to observe that there are

a great many tax expenditures in the stimulus legislation by itself has no content. It would be contrary to the purpose of the legislation of that weren't the case.

But what is troubling if you go back to my little kumquat example for a moment is the fog of confusion that surrounds the debate about how much of what was done was an exemption provision and how much was spending because in fact the answer it was all spending in an economic sense. It was all spending in that its purpose is to put money in Americans' pockets over the short term. Some of the spending is delivered through the tax system. Some of the spending is delivered through the appropriations process. But the entire purpose of the exercise was to spend. And yet we now have an rhetorical confusion that I believe is something that will be quite damaging in the long term to tax reform and to the tax debate generally we've managed to get ourselves quite confused as to what is the difference between a tax provision and a spending provision. These are distinctions without a difference. They are terms that are used. The deficit is whatever the deficit is and whether we get there by reducing tax revenue collecting or spending more money, the net is the same. I think as a result people get quite invested in doing things one way when it might not be the most efficient

or in thinking that they're doing something different from what they are. Targeted tax relief. What the heck does that mean? Targeted tax relief is a tax expenditure in general, is a form of spending and we have managed I think to get ourselves quite confused as to the difference by virtue of not focusing on what are straightforward applications of tax expenditure analysis.

Finally let me come back to my promise at the very beginning that I was going to talk about American tax expenditure exceptionalism and try to say the little that I can about where we are relative to other countries. The data in this respect are very difficult to come by. Once again I have to be quite thankful to the work done by the OECD in this regard. And if you look deeply into their website you can find a very nice PowerPoint from the middle of 2008 by Joe Manarak, and I relied on that for some of the points I'm about to make. But it's interesting how little work has been done in this area. And I have dibs on it, so for those of you who are academics in the room, I've copyrighted, trademarked the term tax expenditure exceptionalism so my group can do it first.

The very short answer is that it turns out, and this is quite interesting, every country is addicted to tax expenditures. There is something about tax

expenditures that works as a matter of political economy universally which I've found interesting. But nonetheless there are a few hints in the data that are available that the United States is exceptional. The U.K. for example, I pulled off from their website. The U.K. Treasury has a wonderful website and I pulled off their 2008 budget. The 2009 budget doesn't come out until April. So for the 2008 budget from the U.K., they list two corporate tax expenditures, R&D credits and credits for the motion picture industry because the motion picture industry apparently is effective around the world at telling every country that they're going to move somewhere else if they don't get credits. Those are the only tax expenditures that the U.K. in their list of principal tax expenditures thought were worth observing at the company level tax. The United States, the top 10 business tax expenditure if you were to do the simple sum which you're not allowed to do, but if one of you were to do it and tell me the number for 2008 would be over $80 billion for the top 10 business tax ones. The U.K. in the OECD PowerPoint presentation comes out at the top of the heap. In the same way Japan led the pack on corporate tax rates, the U.K. leads the pack on tax expenditures but most of their tax expenditures are classic pension relief measures

designed in part to mitigate high individual tax rates in the U.K. You see very little of it goes to the kumquat producers in the U.K. who need special incentives you would think given the dreary weather. So the U.K. in the charts is ahead of the United States, but when you look at the kinds of its tax expenditures, they are loaded in the direction of individual relief typically as I say for pensions.

After the U.K. it won't come as a surprise in the handful of countries for which we have data readily available, the United States is sort of in the next group along with let's say Canada. Germany on the other hand is at the other end of the spectrum. If we have in the United States in 2008 8-1/2 percent of our GDP devoted to tax expenditures and in this study which used 2007 data and used a more incomplete list they had us at 6 percent, I think we actually rise to number one in the world with the 2008 data, Germany runs its government with tax expenditures in the neighborhood of one-third of 1 percent, and the Netherlands is also very low. Canada is quite similar to us in order of magnitude but it's almost all what we would classify as social spending. And Korea again is lower than the United States and Canada and a bit above Germany and the Netherlands.

It turns out that lots of countries have run into the same kinds of issues that we have. First how to measure tax expenditures. There is one place where there seems to be universal agreement which is we all measure it by reference to foregone revenues which is a static measure. We don't take into account the dynamic behavioral consequences that we would take into account if we were doing a revenue estimate. I think we're all driven to do that by universal time constraints that fiscal authorities have to face. We all struggle with definitional issues. At the JCT staff, our large publication last year was really an effort at redefining how we would go about identifying tax expenditures. Different countries have come to different conclusions. Korea and Japan do it by simplifying identifying. They have no published baseline or statement as to what are their guiding principles. France has an interesting process by which a tax expenditure when it gets old enough and mature enough becomes part of the baseline so their baseline constantly evolves. And we all have issues of whether our budget systems can be gamed by taking items that would in a world that was completely seamless that might go through the spending side and instead routing them through the tax expenditure side. For example, Sweden

imposed a number of years ago hard caps on its spending program and they were very, very effective because the entire Swedish budget turned into a tax expenditure thereby completely destroying the Swedish budget process and requiring a complete rethink of the rules because they had forgotten that you can spend through the tax system through tax expenditures almost as effectively as you can spend through direct appropriations so by failing to plug that loophole and by having budget constraints that were binding on spending, they simply drove the entire budget process into the tax expenditure. Canada tried to address that in a head-on way by developing what they called the Envelope System. The way the Envelope System works is that they would tell agencies you have so many dollars to spend, spend it directly or spend it through the tax system, it's your choice, but it's a fixed number of dollars, and that system I guess because it was too effective has since been abandoned.

So where are we? These are a few data points but they suggest to me that we are from the little data that are available exceptional. The amount of our economy that we spend through the tax system is very, very high. It means that the government in the sense of our handprint, the public sector's handprint on the private economy is

much larger than is commonly reported. And it means in turn the kind of distortions to which Roseanne referred earlier are more endemic. There are many, many uses for tax expenditures. They are a completely neutral concept. But what is not fair is to suggest that simply because something appears as less money collected that therefore it is immune from discussion or analysis. I think what we see is that the United States probably when we have more data and more studies will emerge as my intuition is as quite exceptional in the number of business-related tax expenditures, what we call business synthetic spending in our new taxonomy at JCT. These numbers are sufficiently large and the economic and fiscal situation sufficiently serious that I think it behooves all of us to think more intently about not just where is the United States in respect of foreign direct investment, exceptional there, but is our process and our government exceptional as well in our use of tax expenditures. With that I'll stop and I'll be delighted to take any questions. Marty?

MR. SULLIVAN: Marty Sullivan. I noticed in the stimulus bill in one of those 50 or 60 provisions the low-income housing credit was given the option of using -- I didn't quite understand it, but there was an option of using a grant instead of a credit. I was wondering

if you thought that was a major change.

MR. KLEINBARD: It's that marvelous? It's the most marvelous pedagogical device.

MR. SULLIVAN: If you could explain.

MR. KLEINBARD: I should explain what pedagogical means? The way it works is you start with the insight that we want as a social matter to subsidize low-income housing. That is a social agenda. It is directly responsive to the income inequality points that Michael made. We said we could give grants, the U.S. government could give grants either directly or through states to encourage building rental housing for low-income Americans. Instead of doing that through the grant, although we have actually a grant program as well, we created sort of a long side complementary to or in competition with depending on whom you want to believe a grant program, a tax program low-income housing credit under which dollars' worth of tax credits. Think about that. It's a tax system but it's just X billion dollars of tax credits are allocated to states. The states in turn allocate them to developers. And as a result of those subsidies developers then form investment partnerships. The investment partnerships go out and build low-income housing projects heavily regulated on rents they can charge

and the states choose them in the same way they would choose grant recipients and the investment partnerships get these tax credits. Now in a world where there isn't as much income and therefore as much tentative tax liability floating around, the decision was made quite sensibly that low-income housing was in jeopardy and so we offered states the opportunity to take the tax credits that were substitutes for direct grants the first time and cashed them out and get cash when can we used as direct grants. So we have completed the circle of low-income housing and it's a perfect pedagogical device to see that in some cases the way the tax expenditure and the direct spending in fact can be substitutes. It's not always the case but this is one case where in fact they are in fact pure substitutes.

MR. GRAMLEY: My name is Jeff Gramley. I get the sense that you might be speaking to the choir here in terms of tax expenditures.

MR. KLEINBARD: I'm sorry. Quick. Get somebody in from the street.

MR. GRAMLEY: My curiosity concerns the extent that maybe members of the JCT are going to become --

MR. KLEINBARD: The least bit swayed.

MR. GRAMLEY: -- educated by you. Have you given

that any effort?

MR. KLEINBARD: This is my apostolic mission. Yes. What's the next question?

MR. NEWBIG: Tom Newbig. One of the important changes you made to the JCT expenditure budget is changing the baseline and one of the changes is no longer treating deferral as a tax expenditure. Could you explain that change?

MR. KLEINBARD: It's a little bit more complicated than that. I don't know if people could hear it, but Tom was asking about our change to the baseline and doing tax expenditure analysis and what the heck were we doing making deferral, the very topic that we're talking about today, not a tax expenditure. Did John Samuels get to me I guess was the question. So it's a little bit more complicated than that. The heart of our work product in 2008 was the realization that tax expenditure analysis was just stuck and it was stuck because it was viewed as intellectually bankrupt by academics both in the law schools and in the economics departments and it was viewed as intellectually bankrupt because it did not have any first principles by which it defined the normal tax which was the baseline that was formerly used. The normal tax bore an uncanny resemblance to what Stanley -- would have

done if only it weren't for those pests on Capitol Hill. That's fine. Everybody is entitled to his view as to what the tax system ought to be. But there was I think a legitimate reaction that the elevation of that to the title of normal tax and so the implicit shaming that then followed was really quite inappropriate. So we said we have to get rid of these normative values associated with our baseline and we cast about what to do instead. It turned out that we had a great baseline right in front of us which was the Internal Revenue Code, because in almost every case, 95 percent of all the tax expenditures turn out to be explicit exemptions from a general rule that itself is on the face of the Internal Revenue Code. So we said we are going to take the bulk of tax expenditures which are literally 90-something percent of them and simply call them tax subsidies, that's a new term, and within that world of tax subsidies we are going to discover those tax subsidies by looking to the face of the tax law itself and looking for explicit exceptions, and there are a few places we can disagree a little bit but not really and not very much and you can only do it because you're a whiner or because you have to do a Ph.D. dissertation. It serves no real purpose like most Ph.D. dissertations.

Having done that, we said subpart F, for example,

or debt equity or a dozen other really important questions you can't resolve by looking at the face of the code. The code doesn't tell you what we should do with foreign earnings. On the one hand they're not in the consolidated group. There is no basis for consolidation. They're separate companies. We have the Moline Properties type doctrines. On the other hand, I never understood what the other hand was, but people felt that -- so we said we're just going to get into that. So what we did instead was we took what we thought were important and interesting issues that had significant distortive effects on the economy and we clearly have that in this particular case with our current subpart F regime for the reasons Roseanne emphasized in remarks this morning, that we have in effect this lockout, I refer to it as the lockout effect, where we try to keep money out of the United States to avoid repatriation costs. We have this very important lockout effect that is very distortive to the economy, so let's just talk about it in those terms. Let's not figure out what's the norm. Let's just talk about it in terms of here is an example of a distortion, an economic inefficient, a classic economic inefficiency, and let's just talk about it in those terms. What would the solutions be? What are the issues raised by the solutions? We wrote a pamphlet

to that effect, 5508 I think is the number, and we said we're not telling you what the answer is. We're not telling you what the norm is. We're just saying there is a demonstrable distortion in the current system. It's really large enough to get your attention, tax writing committees. Here are two possible solutions, the territorial system, a full inclusion system, both solved the lockout problem. They solve it in completely different ways but they both solve it. Here are the pros and cons, at least some pros and cons, to get you started. Good luck. God's speed. Let us know where you come out. And that's sort of the way we want to approach those kinds of questions going forward as just classic exercises in economic efficiency and try to get out of the business of shaming. I leave that to my mother. Is that it for questions?

MR. MERRILL: This is Peter Merrill. One of the things that the joint committee did in its new presentation of tax expenditures was to include negative tax expenditures like FRPTA (?) for example.

MR. KLEINBARD: Yes.

MR. MERRILL: Do you want to say a little bit about why you did that? Because you wouldn't think of that as part of a spending type budget to have negative tax expenditures.

MR. KLEINBARD: Again my interest is what I call the handprint of the public sector on the private economy and what one wants to get to if you're charged with a nonpartisan economic type role is to point out places where the system has distortions, ripples, folds, canyons, chasms, mountains, in the tax landscape and then let people decide what to do about them. Negative tax expenditures struck us. There was a significant subcomponent of the academic literature that criticized us for not doing it so we said let's take away one thing for them to criticize us for. I'm sure they'll find a new one. They are just as distortive. They may serve a purpose, but in each case the distortion is obvious. Now let's ask whether the purpose is appropriate. So it struck us as completely consistent with the economic efficiency goals that are really the underlying driver of all this. John Samuels?

MR. SAMUELS: Ed, I inferred from your remarks that there were some tax expenditures that you thought were -- or some subsidies that were best delivered through the code.

MR. KLEINBARD: Absolutely. Clearly

MR. SAMUELS: What are the characteristics of those? And do you have any examples of those?

MR. KLEINBARD: The earned income tax credit

would be I think a good example. Typically the ones that are best delivered through the code have broad reach so you need to get a lot of people into the system without creating a new parallel bureaucracy. They have income or wage or family criteria that define the benefits that are information that is already being collected by the tax system. So in those cases the incremental burden to the tax system would be materially lower than creating a parallel bureaucracy to deliver the same benefits, and we're already collecting the information.

SPEAKER: (inaudible)

MR. KLEINBARD: I don't fund it. It turns out that this whole theme, and it turned out, and I didn't know this, that the phrase making work pay is sort of a standard term in the literature outside the United States, that making work pay subsidies is again a universal phenomenon among countries and that most, not Germany of course, but most others do deliver it through the tax system just the way the United States does I think for the reasons I've identified. I don't know that you have to do that for some of the energy programs for example. I don't know that you have to do that for tax credits that the Department of Energy then decides how to allocate. The case there is obviously a more tenuous one. Each one has to be looked

at on its terms. But when you're trying to reach millions of Americans, you define the benefits by reference to their income and their family size all of which is data we already collect, it's a very straightforward exercise to run it through the tax system. Maybe we'll do one last question because I think everyone is getting quite restless and who can blame them?

MR. BROSTIK: Mike Brostik. You noted that about 95 percent of the tax expenditures are functionally equivalent to spending programs which seemed to suggest that they are transfers to the recipients of those benefits, but you have a subcategory that you called transfer payments. What's the distinction there?

MR. KLEINBARD: To be clear, I didn't mean to suggest that 95 percent of them are the functional equivalent of transfer -- there are lots of cases that will be quite difficult to translate into spending terms. Accelerated depreciation is very difficult to translate into grants. One could do it but it would be a very awkward and artificial construction. What I meant to say was that 95 percent of the tax expenditures, what we call tax subsidies, are apparent on the face of the Tax Code. That is, they are explicit exceptions. Subsection A says do this. Subsection C says except for farmers or except for

REITs or whatever. I just told my staff just read every subsection C in the code and that's how we got the number up higher than it used to be. The tax transfer category is quite small. I'm not convinced, and I would really welcome in particular written comments on our taxonomy. The tax transfer category are simply the refundable credits so it's ones where you're getting back from the system more than you paid in tax and that's because there's a lot of attention paid in Congress to the idea that tax subsidy or tax expenditure that produces a negative tax, that really is spending and in fact that's how it's scored by CBO and so therefore we kept that category separate. But whether that's appropriate in the tax expenditure context where our purpose is a little bit different, that's a fair question that we'd really welcome debate and thoughtful papers on. I think with that I'll thank you all and let you get on with your afternoon.

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