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CONGRESSIONAL TESTIMONY

Tax Reform Would Help American Families: Dynamic Scoring Makes it More Likely

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Why We Need Fundamental Tax Reform

The country needs tax reform because the tax code is an albatross around the neck of the economy. The tax system is an impediment to a vibrant, prosperous and growing economy. This stronger growth would substantially improve the real incomes of most Americans and considerably reduce the fiscal problems of the federal and state governments.

The current tax system has high marginal tax rates that discourage work, savings, and investment. It has a tax base heavily biased against savings and investment. This reduces investment, productivity growth, real wages, and output. The current tax system distorts investment decisions making the economy less efficient since business decisions are not made on purely economic grounds. And it has extraordinarily high compliance costs due to its complexity.

Fundamental tax reform would address each of these problems and therefore promote economic growth.

Tax rates on families, businesses, and investment are too high. After the "fiscal cliff" tax increase in early 2013, American families in some states now pay marginal tax rates exceeding 50 percent. That rate includes just a family's federal and state income taxes, not the myriad of other taxes they pay. The high rates discourage productive activities like working, saving, investing, and taking on new risk—activities that are the bedrocks of economic growth.

By double taxing saving and investment at high rates, the code deters families from saving for retirement, education, a rainy day, or for any other purpose they desire.

The tax code is littered with too many politically motivated credits, deductions, and exemptions that only serve to further inhibit economic growth.

The corporate tax code is also a major inhibitor of growth. The U.S. has the highest tax rate of any country in the Organization of Economic Cooperation and Development (OECD) – a collection of the 34 most industrialized countries in the world. That high rate makes it unattractive for businesses, both foreign and domestic, to locate new investment here.

Further inhibiting investment is the fact that the U.S. is the only developed nation that taxes its businesses on the income they earn in foreign countries. This creates another disincentive for U.S. businesses to invest domestically, which further suppresses wage growth and job creation for American workers. It also encourages U.S. firms to merge with foreign firms, moving their headquarters and legal domicile abroad to avoid the impact of the U.S. worldwide income tax system.

The U.S. also has one of the worst capital cost recovery systems in the industrialized world. The tax code discourages investment by denying businesses the ability to fully deduct the costs of their capital purchases at the time they make them. Instead, it applies cumbersome depreciation schedules that raise the cost of capital, which hurts productivity gains, wage growth and job creation.

Small businesses suffer under the current system. After the 2013 fiscal cliff deal, they pay a top federal income tax rate of 39.6 percent- plus the Obamacare 3.8 percent investment income tax for passive investors or the 2.9 Medicare self-employment tax for those that "materially participate" in the management of the business. Thus, the top federal tax rate on small business income is as high as 43.4 percent. Large corporations pay a federal tax rate of 35 percent. This disparity is unfair to small businesses and put them at a disadvantage against their larger competitors.

The tax code is absurdly complicated. The arrival of personal computers and tax software has permitted the creativity of policymakers in Washington to run amok, creating tax complexities far beyond what even tax professionals could manage unaided by electronics. There are a multitude of credits, exemptions, and deductions, many of which are subject to special rules and phased-out over different levels of income. As if this was not bad enough, there is a parallel tax called the Alternative Minimum Tax (AMT), and the payroll and self-employment taxes that fund Social Security and part of Medicare. All of this complexity imposed on individual taxpayers is relatively minor compared to the torturous rules and exceptions businesses large and small must suffer.

The Elements of Sound Tax Reform: What Tax Reform Should Do

Done properly, tax reform would greatly enhance economic efficiency by accomplishing four major economic objectives:

- **Lower individual and corporate income tax rates**. Tax reform must lower rates, in particular the top marginal rates, to strengthen the economy by improving incentives to work, to save and to invest.

- **Eliminate the bias against savings and investment**. The tax code creates a bias against saving and investing through multiple layers of taxation. Tax reform must reduce, and ideally would eliminate, this harmful bias against investment by lowering the corporate tax rate, eliminating taxes on capital gains and dividends, and allowing businesses to deduct their capital costs when incurred. Moving to a territorial and border adjusted tax system is also necessary to fully eradicate disincentives to save and invest.

  Often overlooked in the tax reform debate is the fact that defining the tax base (what the tax code taxes) is as important as lowering the tax rate. Lowering rates is important, but if lower rates apply to an improper base, then tax reform could have no net benefit for the economy. Worse, if the tax base is structured poorly enough, tax reform could be a net negative for growth.

- **Eliminate Tax Preferences**. Eliminating the bias against investment would go a long way towards repairing the base, but more work is necessary to ensure the base is neutral. That means tax reform should eliminate deductions, credits, and exemptions that are not economically justified. Tax reform should eliminate unjustified policies that Congress intended to benefit particular industries like those targeted at aiding particular energy sources. The best way to avoid these problems is to start tax reform by defining a proper base first.

- **Make the tax system simpler and more transparent so taxpayers better understand how much they pay to fund the federal government**. Washington can help reduce the size of government by making the cost of government more tangible to the American people. Because of income and payroll tax withholding and the hidden costs of corporate, employer payroll and excise taxes, most Americans have little idea how much they are paying to fund the federal government or how proposed policy changes will affect them. The sheer complexity of the system makes it difficult to understand the true impact of the tax system. Simplicity aids not only the goal of transparency (because taxpayers understand the system) but also the economic goal of lower compliance costs.

  Tax reform should strive to make that cost explicit to taxpayers. Once taxpayers know how much of their hard-earned income goes to fund the federal government, they will be more willing to reduce the size of government to lessen its cost to them. A transparent code would, by definition, be simpler than the system we have today.

If tax reform achieved these objectives, the economy would enjoy sizeable gains. Although empirical work on the economic benefits of tax reform has been light in recent years, a recent analysis from the Tax Foundation shows the economy could improve significantly from pro-growth tax reform that selects the correct tax base and administers a low, flat rate.

According to the analysis, the economy could grow as much as 15 percent more over 10 years because of tax reform. After those 10 years, the average American family's wages would rise almost 10 percent.[1] That would be an extra $5,000 in the pockets of families making $50,000 per year, roughly the median income in the U.S.

A stronger economy also plays a vital role in improving state, local and federal government finances. It means higher tax revenues and lower spending needs for those temporarily distressed from unemployment. A stronger economy offering better wages and better job opportunities is also the most powerful antidote to persistent poverty and with less poverty comes fewer demands for anti-poverty spending.

What Tax Reform Should Not Do

There are pitfalls that Congress must avoid when crafting a tax reform. Those should-nots include:

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[1] Andrew Lundeen, "Slow Economic Growth Does Not Need to Be the New Normal," May 15, 2014 http://taxfoundation.org/blog/slow-economic-growth-does-not-need-be-new-normal.

- **Should not raise revenue.** Tax reform is not a way for Congress to extract more of the taxpayers' hard-earned income. Higher tax revenues run counter to tax reform's central goal of encouraging growth. Using the traditional method of estimating revenue, tax reform should result in the new system raising the same amount of revenue as the current one. Ideally, tax reform should cap revenue at its historic average measured as a share of the economy (GDP).
- **Should not impose retroactive tax hikes or tax windfalls.** Tax reform should not retroactively raise taxes as it is inherently unfair. Often forgotten, however, is that tax reform should not bestow tax windfalls either. Some taxpayers, mostly businesses, accrue deferred tax liabilities and tax assets like unused credits and deductions they are entitled to use in future tax years. Tax reform should not decrease those liabilities nor increase the value of those assets. Doing so would have little upside for growth since businesses already made planning decisions when they accrued them. Retroactively changing them is an undeserved tax windfall that has no place in tax reform.
- **Should not shift the tax burden up or down the income scales.** Tax reform should not result in any particular income group paying higher taxes, nor should any group pay less. Tax reform is not a venue for class warfare. When determining how a tax reform plan affects tax distributions, lawmakers should consider the distribution of *all federal taxes*, not just the income tax. Focusing just on the income tax would be too narrow since the other federal taxes make up 53 percent of all federal revenue.
- **Should not add new tax systems.** Some lawmakers have devoted a great deal of attention in recent years to developing new tax systems that would apply in addition to corporate and individual income taxes, payroll taxes, capital gains and dividends taxes, and various excise taxes already in place at the federal level.

  These additional taxes include a carbon tax, a value-added tax (VAT), a national sales tax, and a financial transactions tax among others. An additional tax would make complying with taxes even more difficult than it already is. And, despite protestations from those that favor adding new tax systems to the contrary, Congress would undoubtedly spend the revenue a new tax would raise thereby growing the government. Such has been the experience in Europe after countries there added VATs on top of their income taxes. Tax reform should not add to the already too-big number of taxes the federal government levies today.

Non-Economic Objectives

Congress should design tax reform with certain specific non-economic objectives in mind. Any plan should limit the tax system's adverse impact on the core institutions of civil society including (1) the family and (2) voluntary associations such as religious and educational institutions, charities, and community organizations.

A just political order protects individuals' natural rights to life, liberty and property. Therefore, a just tax system minimizes the derogation of those rights by (1) imposing an equitable and reasonable burden on taxpayers, (2) being general in its application with special privileges for none and (3) respecting taxpayer rights to due process.

Chairman Camp's Tax Reform Plan

In February 2014, Dave Camp (R–MI),Chairman of the House Ways and Means Committee, , released a comprehensive tax reform plan. He chose to improve the current system as much as possible and minimize its negative impact on the economy. Such an approach generally requires lowering rates and broadening the tax base. Although it will not result in as much economic growth as fundamental reform that fully moves to consumption tax base, this approach can result in a system that is less of a burden on the economy if it makes enough improvements.

This approach usually forces policymakers into trade-offs that must balance pro-growth reforms with reforms that move in the opposite direction, thereby subduing its economic benefits. These trade-offs are especially pronounced when one works within the confines of static revenue neutrality as Chairman Camp did.

Revenue neutrality holds that the reformed tax code will raise the same amount of revenue as the current tax system. This is a sensible political constraint and is understandable when tax revenues are near their historical average as a percentage of the economy. Within the confines of the current tax system, it often means choosing between lowering rates and increasing double taxation, or reducing the tax burden on savings and investment but lowering rates only slightly or not at all.

Using a *static* revenue score further complicates reform. Static revenue neutrality assumes that the contemplated tax reform will have no positive economic effects and therefore necessitates higher tax rates within the reform effort than would be warranted if the real-world positive economic effects of sound tax policies were taken into account. Tax reform would be more effective if, instead of focusing so much on revenue neutrality and replicating the current distribution of the tax burden, it focused more on whether tax reform would make most Americans better off.

Chairman Camp chose to achieve growth by lowering tax rates and making a few other pro-growth enhancements, requiring him to broaden the tax base to make his reform revenue neutral. By accepting the current flawed base and adhering strictly to static revenue neutrality, he was forced to broaden the tax base in many economically counterproductive ways in order to achieve substantial tax rate reductions.

Pro-Growth Policies. The pro-growth changes in the Camp plan are headlined by a reduction in tax rates and the number of statutory tax brackets. The current system has seven tax brackets that range in rates from 10 percent to 39.6 percent. In addition, there is a 3.8 percent Medicare tax on wage and self-employment income over $250,000 ($200,000 for single filers), which also applies to investment income because of Obamacare. As a result, the top rate is 43.4 percent before personal exemption and itemized deduction phaseouts.

The Camp plan would reduce the top tax rate to 38.8 percent and have three marginal brackets. Taxable incomes up to $71,200 for joint returns ($35,600 for single returns) would be taxed at 10 percent. A 25 percent marginal tax rate would be added for those with taxable incomes greater than these amounts. Finally, an additional 10 percent surtax would be imposed on taxpayers with modified adjusted gross income (MAGI) above $450,000 for joint returns ($400,000 for single returns), creating a third bracket taxed at 35 percent. The plan also retains the 3.8 percent Medicare tax on employee wages and self-employment. Combining the 35 percent rate and the 3.8 percent Medicare tax results in a 38.8 percent top tax rate.

The surtax effectively creates a new alternative minimum tax (AMT) for upper-income taxpayers because it applies to MAGI. A wide range of items are added back to calculate MAGI for purposes of the 10 percent surtax, including the standard deduction, all itemized deductions except the deduction for charitable contributions, the foreign earned income exclusion, tax-exempt interest, employer contributions to health plans, defined-contribution retirement plans, and the portion of Social Security benefits excluded from gross income.

Income that is qualified domestic manufacturing income (QDMI) would not be subject to the 10 percent surtax unless, generally, that income is treated as net earnings from self-employment. Taxing retirement savings, municipal bond interest, and employer-provided health insurance could be problematic.

The top rate would apply to pass-through entities (such as S corporations, LLCs, and partnerships) that do not manufacture. Although the rate they would pay under the Camp proposal is lower than under the current system, these pass-throughs (typically small businesses) would pay a significantly higher rate than businesses that pay the corporate income tax. This would be unfair to these businesses and would create problematic incentives when choosing organizational structures.

The Camp plan taxes capital gains and dividends at a top rate of 24.8 percent, which is roughly in line with the current rate after accounting for personal exemption and itemized deduction phaseouts. It does so by exempting 40 percent of taxpayers' capital gains and dividends and then applying their marginal rate to the remainder. It also retains the Obamacare 3.8 percent tax on investment income.

The Camp plan eliminates many credits and deductions that are unnecessary for tax neutrality, including many alternative energy provisions that only serve to distort the energy market. This is a positive step toward a neutral tax code and one that also reduces complexity. The plan also correctly taxes many forms of income that are excluded from taxable income today.

Camp eliminates personal exemptions but expands the standard deduction to $22,000 for families and $11,000 for single filers. This would make filing taxes easier for many lower- and some middle-income taxpayers because it would reduce the number of taxpayers who itemize. The Ways and Means Committee estimates that the percentage of taxpayers who itemize would decline from roughly one-third to about 5 percent—a steep decline.

Camp also eliminates the deduction for state and local taxes. This deduction encourages the growth of state and local governments.

Elimination of the existing AMT and the consolidation of several tax preferences for higher education would simplify the tax law for many families.

Phaseouts Lessen Simplicity. The increase of overall simplicity would have been even greater had Camp not made other changes that added back complexity for both individuals and businesses. Some of that complexity for individuals arises from the phaseout of tax brackets and credits, which would increase *effective* marginal tax rates above the statutory marginal rates for certain income levels.

For example, the earned income tax credit is phased out for those with incomes greater than $20,000 (single) and $27,000 (joint) at a 19 percent rate. This creates a 29 percent bracket for many with incomes between $20,000 and $48,053. The benefit of the 10 percent tax bracket would be phased out by effectively creating a 30 percent tax bracket for those with taxable incomes between $300,000 and $513,600 (joint) and between $250,000 and $356,800 (single).

Thus, the plan has a patchwork of at least seven different marginal tax rates, often with lower marginal tax rates on those with higher incomes. Despite this complexity, it is still an improvement over the current morass of phaseouts in the code. However, fundamental tax reform would ideally create a code with substantially fewer or no marginal effective rate spikes.

The plan reduces marginal tax rates on average and would improve incentives for work and risk-taking. Lower rates for lower income levels would also improve work incentives for families.

Strong Business Reforms. The most pro-growth aspects of the Camp plan are its corporate income tax rate reductions and its international tax provisions. The plan would lower what is now the world's highest rate from 35 percent at the federal level to 25 percent, putting it more in line with the international average. A lower rate would encourage both U.S. and foreign businesses to invest here, resulting in more jobs and higher wages.

Camp's move away from the current worldwide system of taxing the foreign income of U.S. businesses would provide an additional and much-needed boost to domestic investment. His plan would institute a dividend-exemption regime that levies a 1.25 percent tax on the foreign income of U.S. businesses. This change from the worldwide system closer to a territorial one would benefit the economy substantially.

The Camp plan also preserves Section 179 expensing of capital costs by small businesses, allowing them to deduct up to $250,000 in capital costs each year. This is the proper treatment for all investment, reduces small firms' cost of capital, and aids their cash flow.

Policies that Hurt Growth. By making the joint filing income bracket two times the single filing threshold, the Camp plan eliminates the marriage penalty for many Americans. However, the structure of the new earned income tax credit (EITC) would mean that those who are eligible could be subject to a marriage penalty. Moreover, the 30 percent bracket caused by the phaseout of the 10 percent bracket benefit means that those with incomes above $250,000 could experience a marriage penalty; the 35 percent bracket (due to the 10 percent surtax) means that those with incomes greater than $400,000 would also probably be subject to a marriage penalty. This result is still better than the marriage penalty under the current system.

The Camp plan limits the deduction for mortgage interest. In any tax system, if the interest received by the lender is taxable, then the interest paid by the debtor should be deductible. Otherwise, the tax system artificially raises the cost of borrowing.

Starting in 2017, the Camp plan increases business taxes by extending the length of the period over which businesses may deduct the cost of buying machinery or equipment and building factories or other structures. The plan also requires the use of straight-line depreciation. This alternative depreciation system (ADS) would nearly double the recovery period for many assets.

The U.S. capital cost recovery system is already worse than the Organization for Economic Co-operation and Development (OECD) average, and the Camp plan would make it exacerbate the problem.[2] This reduction in the competitiveness of U.S. businesses would grow over time as the adverse impact of less investment and less modern technology accumulated. The Camp plan would return the U.S. to the type of capital cost recovery system that was in place during the Carter era, before President Ronald Reagan's Economic Recovery Tax Act of 1981 lessened the problem by enacting the Accelerated Cost Recovery System.

Research and experimentation (R&E) expenses by businesses should be deductible as incurred, as should all business expenses, but research is especially important to innovation and job creation. The Camp plan would require businesses to deduct these expenses over a five-year period. This adverse treatment is mitigated slightly by retaining the R&E tax credit in modified form.

The Camp plan would require that half of advertising expenses be deducted over a 10-year period. This would deny businesses the ability to deduct these routine business expenses and thus overstate their taxable income.

Camp's plan would repeal Last-In First-Out (LIFO). This accounting method for inventories has been a permitted since the 1930s. It is simple and prevents business from paying tax on phantom inflationary gains on inventories.

The plan also includes a tax on systemically important financial institutions (SIFI). The tax, better known as a bank tax, would apply to only a few of the largest banks and other financial firms—those with more than $500 billion in assets. The tax would be 0.035 percent on those banks' assets, assessed quarterly. Sound tax policy does not single out particular businesses in certain industries for extra taxation. If there are issues arising because of how other laws affect these banks, those issues should be addressed outside of the tax code.

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[2] See Kyle Pomerleau, "Capital Cost Recovery Across the OECD," Tax Foundation *Fiscal Fact* No. 402, November 19, 2013, http://taxfoundation.org/article/capital-cost-recovery-across-oecd (accessed July 18, 2014).

Chairman Camp's Tax Reform Plan a Milestone for Dynamic Analysis[3]

Chairman Camp's plan includes a dynamic analysis from the Joint Committee on Taxation (JCT). This is a long overdue and welcome change to how tax policy is discussed at the federal level. The Camp bill will remain a hallmark piece of legislation and fundamentally change how tax legislation is evaluated by JCT in the future.

Static vs. Dynamic Scoring. Despite universal agreement among economists that taxes influence behavior and therefore affect economic growth, conventional government scores of tax policy have historically excluded the effects of behavioral changes on macroeconomic growth. This is known as "static scoring."

For instance, when JCT scores how much revenue would be raised by eliminating the tax deduction for 401(k) contributions, it acknowledges that individuals will contribute less to 401(k)s, but fails to account for the macroeconomic effects of lower contributions through reduced national savings and investment.

In "dynamic scoring," however, individual responses do not occur in a vacuum, nor are they equally offset by other responses. Rather, the changes that individuals and businesses make in response to tax policy can have a very significant impact on economic growth.

Benefits of Dynamic Scoring. Particularly as it relates to comprehensive tax reform, dynamic scoring is paramount to developing and implementing a more pro-growth tax code that will ultimately generate higher incomes for all individuals and businesses. Without dynamic scoring, it is easy for policymakers to implement economically damaging tax policy.

For example, virtually all economists agree that gasoline taxes are less harmful to economic growth than capital gains taxes. Yet static scoring would show that raising either of those taxes by equal amounts would have equally nonexistent impacts on the economy, and because gasoline taxes tend to fall more heavily on low- and middle-income taxpayers than capital gains taxes, policymakers may be more easily persuaded toward bad tax policy such as increasing capital gains taxes.

Nonpartisan tax experts have applauded dynamic scoring. Tax analyst Martin Sullivan has argued:

> Gradually, lawmakers, the press and the public would be far better acquainted with the following important and powerful economic ideas.… Marginal rate reductions are more economically beneficial than infra-marginal tax giveaways. Inefficient taxation of

[3] Rea S. Hederman, Jr., Rachel Greszler and John L. Ligon, "Chairman Camp's Tax Reform Plan a Milestone for Dynamic Analysis," Heritage Foundation *Issue Brief* No. 4156, February 28, 2014, http://www.heritage.org/research/reports/2014/02/chairman-camp-s-comprehensive-tax-reform-proposal-and-dynamic-scoring

> residential investment reduces economic growth. Overtaxation of corporate capital hinders economic growth.[4]

The use of dynamic scoring appropriately places the emphasis of tax policy on efficiency, leaving other aspects (such as fairness) to be addressed outside the tax code where they more appropriately belong.

Outside the federal government, dynamic scoring is already in play. Ten state governments—including Texas, California, and New York—use some form of dynamic scoring in their budget forecasts. Similarly, in the private sector, many businesses have incorporated dynamic forecasts into their strategic planning.

A Huge Step Forward. The inclusion of a dynamic estimate, although still not the official score, is a huge step forward toward fundamental tax reform. The discussion of JCT using dynamic scoring has been an ongoing debate for decades. Previous chairs of the Ways and Means Committee, such as Bill Thomas (R–CA) and Bill Archer (R–TX), were instrumental in pushing the JCT to include dynamic analysis.

Since 1995, JCT has begun to address the shortcomings of its tax analysis. This has included convening panels of experts to discuss dynamic scoring and working on models that can provide quantitative dynamic estimates. The director of the JCT argued in 1995 against using dynamic scoring. In 2003, the House of Representatives required JCT to provide macroeconomic analysis of revisions to the tax code. Now JCT is on record with a dynamic economic estimate of a fundamental tax reform bill.

The significance of JCT's economic estimate cannot be underestimated. The daily tax publication *Tax Notes* quotes a source saying, "Once we start down this road, it is going to be very hard to go back to a world where we only look at estimates where [gross domestic product] is fixed."[5]

Making Assumptions. The assumptions used in dynamic models are fundamental to the models' results. As such, the use of assumptions is also a main criticism against dynamic scoring because the creator or user of the model has a high degree of control over the model's projected outcome. However, economic literature provides ranges of appropriate modeling assumptions, and providing full disclosure of model assumptions would help eliminate unconventional or erroneous assumptions.

Further, static revenue estimates are subject to the same criticism on the use of assumptions. The difference between dynamic and static assumptions, however, is primarily that static revenue estimates rely on a single, universally rejected assumption that taxes have no effect on

[4] Martin A. Sullivan, "Practical Aspects of Dynamic Revenue Estimation," in Dan R. Mastromarco, David R. Burton, and William W. Beach, *The Secret Chamber or the Public Square* (Washington, DC: The Heritage Foundation, 2005).
[5] Luca Gattoni-Celli, "Pivotal Macroeconomic Analysis of Camp's Reform Tests JCT," *Tax Notes*, February 26, 2014.

individuals' and businesses' behaviors. While dynamic scoring involves significantly more assumptions, it at least attempts to predict a more accurate outcome.

Relying upon static scoring is a bit like forgoing an annual physical exam under the assumption that, despite having gained 30 pounds since last year, one's overall health has not changed. Ignorance may be bliss, but it is not reality.

Incomplete Without It. JCT's dynamic models, like any models, may be subject to criticism for their assumptions and methodology. However, it is better to be approximately correct than precisely wrong. As the use of dynamic analysis becomes more common, JCT will hopefully refine and strengthen its models to more accurately predict the actual path of the economy in response to tax changes. As this modeling effort improves, the dynamic analysis that includes revenue feedback from economic growth or decline should become as important as the traditional static revenue score.

Dynamic Impact of the Camp Proposal. As estimated by the JCT [6] and The Heritage Foundation's Center for Data Analysis (CDA)[7], the Camp plan is modestly pro-growth in the traditional 10-year budget window.

Because the Camp plan does not implement its adverse capital cost recovery provisions until 2017, there will be an initial rush to invest before the new rules take effect. CDA analysis shows that by 2020, all increases in investment from the rate cuts evaporate and then investment begins to fall rapidly.

It is questionable whether the Camp plan will remain pro-growth outside that 10-year window. Growth is boosted in the early years after the plan goes into effect because tax rates are lowered immediately. This strongly boosts work incentives and has a positive impact on economic growth. However, the economic damage from base-expansion policies that increase double taxation and impede investment will slow growth years later when the capital stock is less than it would have been had these changes not been made. It is likely that once those negative effects are fully in place, they will more than offset the positive effects from the modest tax rate reductions and growth will be negative.

Ways to Improve the Camp Plan. According to the JCT's dynamic estimate, the growth effects of Camp's tax reform plan could increase tax revenues between $50 billion and $700 billion—an exceedingly wide range. Assuming revenue came in at the upper end of the range, that money could be used to offset some of the anti-growth policies in the plan. For instance, reversing the most harmful tax increases on investment—the changes in depreciation, amortizing research and advertising expenses, and abolishing LIFO inventory accounting—would reduce revenue by $711 billion. This would make the Camp plan more pro-growth.

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[6] Staff report, "Macroeconomic Analysis of the 'Tax Reform Act of 2014,'" Joint Committee on Taxation, U.S. Congress, February 26, 2014, http://waysandmeans.house.gov/uploadedfiles/jct_macroeconomic_analysis_jcx_22_14__022614.pdf (accessed July 18, 2014).

[7] Rea S. Hederman, Jr., Rachel Greszler and John L. Ligon, "Heritage's Macroceconomic Estimate of Camp's Tax Reform Proposal," *The Daily* Signal, February 26, 2014, http://dailysignal.com/2014/02/26/heritages-macroeconomic-estimate-camps-tax-reform-proposal/.

Camp also followed the JCT's rationale that extending the roughly 50 tax policies that expire regularly—known as tax extenders—is a tax cut. This required him to generate an unnecessary $1 trillion in his plan. That revenue could also be used to offset anti-growth policies in the plan.

How Tax Reform Would Make Filing Taxes Better for Families

Tax reform would make filing taxes easier for American families. Every year as April 15 approaches, families all over the country scramble to find documentation for their incomes and any expenses they incurred that might be deductible, creditable, or exemptible. It is a day of consternation for most families because of the mind-numbing complexity of completing this annual task.

The best that can be said of Tax Day is that it provides a yearly reminder of just how convoluted the tax code is and how much damage it does to the economy. It should also serve as a periodic reminder that filing taxes does not have to be this way. Tax reform, if done right, would help Americans in numerous ways.

Raise Their Incomes. The biggest difference taxpayers would notice would be increased annual incomes. Families would see their incomes grow because tax reform would lessen the severe disincentives that the tax code currently imposes on the fundamental activities of economic growth—working, saving, investing, and taking on risk. This would allow the economy to grow stronger, which would mean more opportunities for Americans at all income levels to find higher-paying jobs and earn larger wage increases.

Done correctly, tax reform would also mean that families earn more but would not pay higher marginal tax rates on their higher earnings. The tax code would not punish families as it does today for being more successful and for earning higher compensation because they are more productive.

Simpler to File. Since tax reform would make what is taxable—i.e., the tax base—easier to define and would have at most only a few deductions and credits necessary to maintain neutrality, filing taxes annually would be immensely simpler for all families.

There would be no need for pricey software, and only those families with the most complex financial arrangements would require paid tax preparers. Highly skilled lawyers and accountants could put their considerable talents to more productive uses, which would further boost the economy.

Increased Fairness. A renewed confidence in the fairness of the system would result because of the more easily understandable tax base and minimal number of deductions and credits. Tax liabilities would be more transparent because there would be few if any ways for taxpayers with more knowledge of the tax code (or ability to pay accountants and lawyers who have it) to lower their tax liability in ways that are largely inaccessible for average taxpayers.

It would also be readily apparent that everyone was paying their fair share. Families with similar financial circumstances would be confident that they were paying similar amounts of tax. It would also be clear that higher-earning families were paying commensurately higher taxes. High earners pay almost all federal income taxes today—the top 10 percent of earners pay 71 percent[8]—but because the tax code is so convoluted, many believe they get away with paying less than they rightfully owe.

Less Influential Government. The government would be less influential in citizens' personal decisions because taxes would no longer pick winners and losers in the market, nor would it seek to reward or punish families for making certain economic decisions.

For instance, no longer would taxes reward taxpayers who choose to purchase certain government-determined environmentally friendly products or make it relatively more appealing to provide childcare outside the home. Taxes would not influence the decisions of families to have a second earner enter or stay in the workforce. Families would make these decisions based on market considerations and the unique preferences of every family.

Reduced Chances of IRS Abuse. The IRS has the almost impossible job of trying to enforce the incomprehensible tax system Congress has created. However, that does not excuse the agency for its behavior in targeting certain conservative groups for enhanced and unwarranted scrutiny. Those actions badly damaged its credibility, which is regrettable because most people who work at the IRS are hardworking and dedicated professionals who do not deserve to be tarred with the misdeeds of others.

Nevertheless, the IRS will need reform to restore its credibility. Although there will always be the need for a revenue-collecting agency, tax reform should significantly curtail the mischief in which the agency is able to engage.

The job of determining taxpayers' taxable income and whether they paid the proper amount of tax on it would be simplified, meaning the agency could significantly shrink in size. A smaller agency would lessen the chances of bad behavior. Although taxpayers would likely still have to provide some personal information to the agency, it would be far less than they have to report today, which would further reduce the ability of the agency to act improperly.

A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers

An intense debate is raging over the proper way to repair the broken system the U.S. uses to tax its international businesses. The recent spike in U.S. businesses inverting (merging with a foreign business and moving the combined business' headquarters overseas to avoid the U.S. worldwide tax regime) is the latest evidence of the problems with the current system.

There is widespread agreement that the current system destroys jobs and suppresses wages for U.S. workers. However, there is a sharp division about how to fix the system's shortcomings. One side argues for strengthening the current worldwide system that taxes U.S. businesses on the income they earn in foreign countries. The other side argues for a territorial system, which would mostly exclude foreign-earned income from U.S. taxation.

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[8] The Heritage Foundation, "Reduce the Tax Burden," *Federal Budget in Pictures 2014*, Chart 1, http://www.heritage.org/federalbudget/pdf/2014/top10-percent-income-earners.pdf.

Strengthening the worldwide system would be disastrous for U.S. workers because it would drive U.S. businesses and their jobs overseas. The U.S. needs to abandon the worldwide tax system, not strengthen it, because it is not neutral and therefore reduces investment by U.S. firms at home and abroad. In stark contrast, a territorial system is neutral to investment, meaning that it neither discourages nor encourages the amount or location of investment.

Congress should scrap the worldwide system and move to a territorial system like almost every other developed nation has. Such a policy improvement would be a boon for U.S. workers by removing the worldwide system's disincentive to invest and its barriers to international competitiveness.

Chairman Camp's plan is a major advancement toward this goal because it would institute a partial dividend exemption regime that would essentially establish a territorial system. The move to a territorial system is one of the main drivers of increased growth that would result from the Camp plan in its first 10 years of implementation.

The U.S. Worldwide Tax System. The U.S. worldwide system taxes the domestic and foreign income of businesses with U.S. headquarters. Businesses can claim a "foreign tax credit" for taxes that their foreign subsidiaries (incorporated entities) or foreign branches (unincorporated entities) pay in other countries. This credit limits double taxation. Where the foreign tax rate exceeds the U.S. rate, no U.S. liability is generated. In the more common circumstances where the U.S. tax rate is greater, U.S. businesses owe a residual tax on their foreign earnings equal to the difference between the U.S. tax rate and the tax that their subsidiaries paid in the foreign country where they earned the income.

As a result of the worldwide tax system, U.S. businesses are expected to pay the same amount of tax on income that they earn abroad as they would if they earned that income in the U.S.

U.S. businesses owe tax on their foreign earnings in the current filing period when they earn that income through a foreign branch. However, when they earn "active" income (income they earn by selling a good or service) through a foreign subsidiary, the income is generally subject to U.S. tax only when dividend income is remitted to the U.S. parent. Because of this, the foreign tax liability is said to be "deferred."

This treatment parallels the tax treatment when a U.S. parent corporation receives a dividend distribution from a domestic subsidiary. Deferral of foreign earnings is therefore proper and normal as a matter of tax policy design and has the additional benefit of lessening the damage to international competitiveness and domestic investment that the worldwide system causes.

The Territorial Tax System. In contrast to worldwide taxation, a territorial system taxes businesses on only income earned within a country's borders. It applies to all businesses that operate within a country's boundaries, whether that business is headquartered in that country or another.

Instead of a pure territorial system, most countries use an exemption system under which foreign income is mostly exempt from taxation. The exemption is generally 95 percent of foreign earnings. Chairman Camp's plan would set up a 95 percent exemption system for the U.S.

The exemption system is a simpler way of denying businesses an extra tax benefit that would occur from allowing a deduction of expenses incurred earning foreign income. Since they are not paying tax on that income under a territorial system, they should not receive deductions for expenses incurred in earning it. Taxing a small portion of foreign earnings serves as a proxy for those expenses. Such a system is easier to apply than forcing businesses to somehow separate expenses incurred in earning exempt foreign income from expenses generated earning taxed domestic income.

A Neutral Tax Policy. Neutrality is the guiding principle of sound tax policy. It holds that taxes should influence the economic decisions of individuals and businesses as little as possible. If neutrality is defined from the standpoint of where a business earns its income, taxing businesses the same regardless of where they locate their operations could make sense. Such an analysis supports a worldwide tax system.

However, neutrality is not concerned with *where* businesses earn their income. Market demand and the nature of a business's functional operations rightfully determine location. Rather, neutrality is about minimizing the influence of taxes on the returns to business activity. That way taxes do not influence businesses' decisions.

Therefore, true tax neutrality is defined with respect to a particular business activity, such as an investment's timing, location, and amount. In the case of business investment, true tax neutrality is defined with respect to a business's investment decisions, not the business itself. A tax system violates neutrality to the extent it raises the minimum required pre-tax return on an investment and thus influences the business's decision-making process regarding an investment.

Worldwide Tax System Reduces Investment. The U.S. worldwide tax system is the wrong policy because it is not neutral. By seeking to tax the location where businesses earn income equally, it reduces the extent to which U.S. businesses invest in foreign markets.

Before deciding whether to invest abroad, a U.S. business looks at all of the costs it would incur and the potential income it would earn by moving into a new market. All of the different variables go into determining whether the return from expanding into the new market would generate the return that the business requires for taking that risk. The business will make the investment if the estimated return matches or exceeds the rate it requires.

The worldwide tax system in the U.S. makes it less likely that the new investment's estimated rate of return will match or exceed the business's required rate of return because the U.S. tax on its foreign income raises the return required to justify the new investment. This applies whether the business is deciding to expand in a specific new country or determining the location of a new investment that it could place in several possible countries.

Even though a higher required rate of return under the worldwide system makes fewer investments viable, supporters of the worldwide system argue that the foreign tax credit and deferral mitigate the tax system's disincentives for U.S. businesses to invest abroad. While this is true, mitigation is not elimination. A tax-based disincentive persists.

Even with deferral, the extra tax under the worldwide system does not change the investment calculations of a business seeking to meet new demand abroad. The extra U.S. tax imposed on its foreign income from the worldwide system remains a cost to the U.S. business even though it does not owe the U.S. tax right away because it must report the accrued liability on its financial statements. It therefore still reduces the investment's estimated profitability.

U.S. businesses can mostly remove that accrued tax liability from their financials by establishing their intent to invest foreign-source income abroad permanently, but doing so makes it extremely difficult for them to ever bring that income back to the U.S. Rather, businesses generally decide to permanently reinvest their foreign earnings after they earn them. It is unlikely that they would ever decide not to bring their foreign earnings back to the U.S. before making an investment.

Because the worldwide system causes some potential investments to fall short of meeting the required rate of return, it causes U.S. businesses not to make investments that they would otherwise have made if the extra tax had not interfered. While the worldwide tax system does not prevent all foreign investment, the extra tax it applies stops the marginal investments that do not meet the higher rate of return.

Taxes matter at the margin, and the worldwide tax system is dissuading a multitude of U.S. businesses from making potential investments that they would otherwise make. Because it reduces investment, the worldwide system destroys jobs and suppresses wages for U.S. workers.

The Superior Territorial System. In contrast, under a territorial tax system, U.S. businesses would mostly factor in only the taxes they would pay to foreign countries before making a decision on whether to invest abroad. U.S. taxes would be a minor and insignificant factor in the decision, assuming a partial exemption system. Almost totally eliminating U.S. taxes from the business investment decision would increase investment because marginal opportunities that currently fall short of the required return under the worldwide system would become viable because the extra U.S. tax would no longer factor into businesses' investment decisions.

That investment would allow U.S. businesses to meet their global demand more efficiently and allow U.S. businesses to form stronger corporate synergies that would further enhance efficiency. As explained below, these efficiency increases would greatly benefit U.S. workers.

Compared with the current worldwide system, a territorial system would also increase the competitiveness of U.S. businesses. Foreign businesses unencumbered by the worldwide U.S. tax system are free to make investments that the U.S. worldwide tax system makes unprofitable for

U.S. businesses. In these situations, U.S. businesses decline in standing compared with their foreign competitors because foreign businesses enjoy increased earnings and enhanced global efficiency from making investments that the U.S. worldwide system forces U.S. businesses to forgo. A territorial system would free U.S. businesses to make those investments so they can match the increased earnings and efficiency of their foreign competition.

Territorial Taxation in OECD Countries. Only six other countries in the Organization for Economic Cooperation and Development (OECD), a group of the 34 most highly developed nations in the world, employ a worldwide system for taxing their multinational businesses: Chile, Greece, Ireland, Israel, South Korea, and Mexico.[9] The other 27 have mostly territorial systems achieved through the exemption method.

Each of these six countries has a top corporate income tax rate that is lower than in the U.S., which is unsurprising since the U.S. has the highest rate in the OECD. The U.S. rate exceeds 39 percent when the federal tax rate of 35 percent and the average rate of the states are combined. Most states do not tax foreign income, so the 35 percent federal rate is what matters in international tax issues. However, the 35 percent federal rate is still the highest for central governments in the OECD and well above the rates in the other countries with worldwide systems.

The U.S. rate far exceeds the 25 percent average rate of the other 33 countries in the OECD. The top rates in all the countries with worldwide systems match or are lower than the average rate in the OECD, except for Mexico (30 percent). The rates in Chile (20 percent) and Ireland (12.5 percent) are considerably lower than the OECD average.

Like the U.S., the six other countries with worldwide tax systems provide their businesses with a credit on the tax that they pay in foreign locations. The comparatively lower rates in these countries, combined with their foreign tax credits, means that their worldwide systems are a minor issue because their businesses pay little, if any, additional tax to their home countries on their foreign income. They effectively have territorial systems because their rates are consistent with OECD norms.

The U.S. worldwide system is more damaging to U.S. businesses than to businesses with headquarters in other worldwide taxation countries because of the high U.S. corporate tax. The high rate and worldwide system require U.S. businesses to pay an additional tax to the U.S. on their foreign earnings in every other developed country in which they earn income. Although the ability to cross-credit excess foreign tax credits offsets some of the extra tax, cross-crediting does not lessen the worldwide system's negative impact on business investment because its mitigating impact occurs long after businesses decide whether a new investment matches its required return.

The developed world has mostly abandoned worldwide taxation in favor of territorial taxation because of the worldwide system's harmful economic effects on investment. Those in favor of

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[9] Diana Furchtgott-Roth and Yevgeniy Feyman, "The Merits of a Territorial Tax System," Manhattan Institute for Policy Research *Issues* No. 29, October 2012, p. 2, http://www.manhattan-institute.org/pdf/ir_29.pdf (accessed March 7, 2013).

strengthening the worldwide system usually fail to acknowledge this important fact that gives real world credence to the superiority of territorial over worldwide.

Creating Jobs and Raising Wages in the U.S. In addition to allowing their businesses to maintain their global competitive edge, a chief benefit that other developed nations realized from switching to a territorial tax system is more jobs and higher wages for their workers that arise from their businesses increasing investment.

The best way to illustrate how a territorial system in the U.S. would create jobs and raise wages is through an example.

If a hypothetical Ohio manufacturer of automotive tires wants to invest in Germany because its market researchers have perceived growing demand for their tires there, the business can best meet that demand by having a domestic presence in Germany. Any time the product of a U.S. business experiences higher demand that justifies new investment, it is good for the business and its domestic workers because it means growth that benefits them both.

The U.S. business would likely open two subsidiaries to serve the German market better: a distributor to sell tires in the German market—and perhaps in the rest of Europe and beyond—and a manufacturer to make the tires to sell to the distributor. For the German distributor and manufacturer to function, they would need services and intangible intellectual property ("intangibles") provided by the U.S. parent company.

Some specific examples of intangibles that the U.S. parent tire business would license or sell to its German manufacturing subsidiary would include:

- The design of its entire line of tires,
- The manufacturing process for the tires, and
- Business practices used to ensure the quality and consistency of its tires.

The German distributor would also license or buy intangibles from the U.S. parent. Some of these items would include:

- The tire company's brand name,
- Branding practices,
- Customer relationships, and
- Business relationships, such as with car companies.

The German distributor and manufacturer would also need a host of services that the U.S. parent would provide. These are services that the German subsidiaries would need to provide on their own or pay other companies to provide if their U.S. parent did not provide them, such as:

- Procurement,
- Management,
- Executive functions,
- Human resources,

- Employee training,
- Treasury,
- Finance,
- Accounting,
- Legal,
- Government affairs,
- Public relations,
- Communications,
- Logistics, and
- Information technology.

In addition, the U.S. parent would provide the German manufacturer with additional services such as engineering and quality control. To the German distributor, it would provide marketing, advertising, sales support, and customer support.

The U.S. parent's provision of intangibles and services to its German subsidiaries would create jobs in the U.S. and raise wages for the U.S. parent's current employees. First, the parent's existing workforce would provide the services listed above. They would also work with the German subsidiaries to use the intangibles properly, whether the U.S. parent licensed it or sold it to its German subsidiaries.

The wages of employees of the parent business would rise because their productivity would increase. Their productivity would necessarily rise because of the increased efficiency that would result from new investment and from the corporate synergies that would result from the business more seamlessly meeting its customers' demands. Higher productivity is the key driver of higher wages.

The U.S. parent's expansion into the German market would create new jobs as its German subsidiaries grow more quickly. At some point, its existing workforce would run out of the capacity to meet the growing demands of the German subsidiaries. At that point, the parent would need to add new workers so as not to slow the growth of its German businesses.

From the sample of services and intangibles provided by the U.S. parent, expansion into the German market would clearly create highly skilled, high-paying jobs in the U.S. For instance, it would need more scientists and researchers to maintain and improve its intangibles; engineers to help the German manufacturer with the machinery needed to make the tires; more marketing experts, sales personnel, and business services professionals to help the distributor sell the tires; and more managers, executives, human resource professionals, finance experts, accountants, lawyers, communications experts, technology experts, and government affairs experts to help both subsidiaries with these respective business functions. These are just a sampling of the good jobs that the U.S. parent would create because it invested in a foreign country.

The increased wages and creation of new jobs resulting from a U.S. business expanding abroad are powerful examples of how globalization and integrated worldwide production generate benefits for U.S. workers by allowing U.S. businesses to increase both foreign and domestic investment.

These jobs are from a hypothetical anecdote. Academic research confirms that these beneficial effects accrue domestically in the real world when U.S. businesses expand abroad. In fact, the research finds that for every 10 percent U.S. businesses increase investment abroad, their domestic investment increases 2.6 percent.[10] That investment is necessary to support the new investment abroad with the provision of services and intangibles. More domestic investment results in more domestic jobs.

More investment also means higher wages for domestic workers. The same research also shows when businesses increase what they pay workers at their foreign subsidiaries by 10 percent, the wages of their domestic workers rise 3.7 percent. The wage increases result from both increased domestic investment and the increased productivity of workers as described above, both of which occur because the U.S. business invested abroad.

A territorial tax system makes it more likely that the hypothetical U.S. tire business would invest in Germany and that U.S. workers would experience the higher wages and increased job creation because of that investment. In contrast, the worldwide tax system forces businesses to forgo many similar investments, precluding U.S. workers from enjoying those benefits.

Net Job Creation. Some argue that a territorial system would create an extra incentive for U.S. businesses to invest overseas, but this is incorrect. Instead, a territorial system would remove a disincentive created by the current worldwide system. A territorial system is neutral to investment decisions because, by taking U.S. taxes mostly out of the equation, it provides neither incentives nor disincentives for businesses to determine where to locate their resources. Eliminating a disincentive is not the same thing as creating a new incentive.

A territorial system certainly creates jobs overseas, but that is only half the story. During the 2012 presidential campaign, Vice President Joseph Biden, reflecting the Obama Administration's preference for harmful worldwide taxation,[11] famously quoted a misleading academic study that found that moving to a territorial system would create 800,000 jobs in foreign countries.[12] The implication was that U.S. businesses would create those jobs in foreign countries instead of in the United States. The analysis ignores that these jobs would be created to meet new demand in foreign countries—an improvement in efficiency that the worldwide system largely prevents today.

Of course, as more authoritative academic research cited previously shows and the example above makes clear, increased foreign investment would result in more investment in the U.S. That investment would lead to more jobs and higher wages in the U.S. The study that Vice President Biden cited fails to mention that, while investment by U.S. business creates jobs overseas, it also results in jobs at home.

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[10] Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy*, Vol. 1, No. 1 (February 2009), pp. 181–203.

[11] ABC News, "Transcript: Vice President Joe Biden's DNC Speech," September 6, 2012, p. 4, http://abcnews.go.com/Politics/OTUS/transcript-vice-president-bidens-democratic-convention-speech/story?id=17178040 (accessed July 21, 2014).

[12] Kimberly Clausing, "A Challenging Time for International Tax Policy," *Tax Notes*, July 16, 2012, http://services.taxanalysts.com/taxbase/magdailypdfs.nsf/PDFs/136TN0281.pdf/$file/136TN0281.pdf (accessed July 21, 2014; subscription required).

References to lost U.S. jobs also fail to note that U.S. businesses would rarely create those jobs in the U.S. regardless of the tax regime in place because they will seldom make the same investments in the U.S. as in foreign markets. U.S. businesses would create new jobs abroad and at home to take advantage of new opportunities in growing foreign markets. The jobs that the U.S. economy gains from increased investment because U.S. businesses expand abroad are all a net gain.

Driving U.S. Businesses Abroad. Despite the ample benefits that would accrue to U.S. workers from moving to a territorial system, a strengthened worldwide system remains the policy preference of many policymakers. Those who favor this approach usually propose strengthening the worldwide system by reducing or denying businesses the foreign tax credit and deferral. They also often support instituting a minimum tax rate on all the foreign income of U.S. businesses, either in place of limiting deferral and the foreign tax credit or in addition to those harmful measures.

During the 2012 campaign President Obama often said that he wants to close loopholes in the tax system that encourage U.S. businesses to ship jobs overseas. Since no such explicit policies exist, he was likely referring to the foreign tax credit and deferral. Arguing that the foreign tax credit and deferral encourage businesses to move jobs overseas gets the economics exactly wrong. They exist to lessen the damaging impact of worldwide taxation.

Applying these policies would be devastating for U.S. workers. Rather than miss out on even more opportunities to increase their competitiveness and profitability, many businesses would seek ways to avoid the even higher residual U.S. worldwide tax that would result.

The worldwide system only applies to businesses headquartered in the U.S. If a U.S. business moves its headquarters abroad, it would still owe tax on income earned in the U.S., but moving its headquarters to another country would avoid the extra tax on foreign income. The U.S. has strong anti-inversion rules that make it difficult for a business headquartered in the U.S. to move its headquarters to another country, but little prevents U.S. businesses from selling themselves to foreign-owned businesses. Or, as recent events illustrate, U.S. businesses can merge with foreign businesses to facilitate the inversion process.

When a business moves its headquarters to another country, it takes high-quality jobs with it and leaves a palpable absence in the communities it once inhabited. Businesses often become synonymous with the cities in which they are founded and grow, such as Microsoft and Seattle; Nike and Beaverton, Oregon; Apple and Cupertino, California; FedEx and Memphis; Coca-Cola and Atlanta; and GM, Ford, and Chrysler and the city of Detroit.

Until recently, Anheuser-Bush and St. Louis would have been on that list. However, in 2008, Anheuser-Bush merged with InBev, a Belgium beverage company. In part because of the high corporate tax rate in the U.S. and the worldwide tax system, the newly merged business placed its headquarters in Belgium. Consequently, St. Louis lost executive and other quality jobs that left for the new Belgium headquarters. It also lost the community involvement of Anheuser-Busch and its employees working in the headquarters.

A stronger worldwide tax system could similarly drive more U.S. businesses to put themselves up for sale to foreign businesses and move their headquarters abroad with the same damaging impact on and destruction of quality jobs in the communities that they leave behind.

Misunderstanding Outsourcing. Those who favor a stronger worldwide system often claim—albeit wrongly—that it would prevent U.S. businesses from outsourcing production and thereby shipping U.S. jobs overseas. U.S. businesses outsource by moving certain business functions, often manufacturing, to foreign countries where they pay lower costs for those activities.

Their concern is misguided because the tax system does not cause U.S. businesses to outsource. The lower costs, mostly lower labor prices, are the motivating factor. Advances in information technology and reductions in transportation costs have enabled some U.S. businesses to further reduce the costs by producing their products overseas. Businesses that use other nations' comparative advantages become more competitive.

These developments are part of a long-term change in the global economy that benefits U.S. consumers through lower prices, but they cause short-term and medium-term pain for workers in industries that outsource. This phenomenon is not new. The economy frequently experiences structural changes that cause short-term unrest by uprooting previous ways of doing things, but ultimately help to fuel expansion. U.S. economic policy—tax policy included— can do little to change the powerful force of globalization, even if it were beneficial to do so. Strengthening the worldwide tax system will not stop most businesses from outsourcing because the gains in competitiveness from outsourcing will usually far exceed the extra tax cost.

Anti-Base Erosion and Earnings Stripping. Although a territorial system would not create an incentive for U.S. businesses to move jobs overseas, it does need certain policy safeguards to protect the U.S. tax base from erosion.

Examples abound in the press of U.S. businesses engaging in elaborate schemes to shift money between foreign affiliates. Ultimately, this movement of income results in it arriving in countries where they face little or no tax. The arrangements have eye-catching names such as the "double Irish with a Dutch sandwich."[13] The unstated implication of such reports is that U.S. businesses set up these complicated systems to duck U.S. taxes.

Supporters of worldwide taxation use the public outrage about these little understood arrangements to argue for strengthening the worldwide system. For example, the Senate Permanent Subcommittee on Investigations called on Apple CEO Tim Cook to explain how Apple pays such a low amount of tax on its foreign income. That committee took advantage of the hearing to make it seem like Apple, by virtue of its tax arrangement in Ireland and other

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[13] Charles Duhigg and David Kocieniewski, "How Apple Sidesteps Billions in Taxes," *The New York Times,* April 28, 2012, http://www.nytimes.com/2012/04/29/business/apples-tax-strategy-aims-at-low-tax-states-and-nations.html (accessed July 21, 2014).

foreign countries, is dodging U.S. taxes. For instance, Senator Carl Levin (D–MI) claimed that Apple's foreign tax strategy was reducing tax collections in the U.S.[14]

The indignation from such news reports and the Senate hearings is generally misplaced. The money U.S. businesses shift between foreign affiliates is not income that they earned in the U.S. It is income that they earn in foreign countries and then shift between those countries to minimize their *foreign* tax liability. A U.S. business, such as Apple, for the most part cannot earn income from the sale of tablet computers in the U.S. and shift it to a foreign country without paying U.S. tax on the income. To do so would be illegal tax evasion.

Eventually, the foreign income often ends up in jurisdictions that levy little or no tax on the income because businesses use the differences in foreign tax laws to minimize their tax bills—U.S. tax law included. U.S. "check-the-box" rules allow businesses to shift foreign income to low-tax jurisdictions more easily. The businesses leave their foreign income there indefinitely and do not pay U.S. tax on it because of deferral the same as if they earned the income in a country with higher taxes. The income that accumulates in these low-tax countries is usually generated by intangibles that the businesses sell to subsidiaries there. Those businesses usually have no functional operations other than as entities that own, assume the risk, and possibly fund the upkeep and development of intangibles.

While the indignation in the U.S. is for the most part misplaced under the current worldwide system, the issue could become a more pressing problem under a territorial system because U.S. businesses would have a larger incentive to move more of their intangibles abroad to subsidiaries in countries with lower tax rates. Under a territorial system, businesses that can move more of their intangibles overseas, instead of gaining an indefinite reprieve from U.S. taxes as under the current worldwide system, would receive a permanent one. If U.S. businesses can sell their intangibles to their foreign affiliates at prices that are too low and thereby create an incentive to sell them more intangibles than a neutral tax system would suggest, they would erode the U.S. tax base, reducing U.S. tax collections for a given set of tax rates. This would push tax rates higher to collect a targeted amount of revenue, such as the historical average of 18 percent of GDP. Higher rates are the antithesis of pro-growth tax policy. Policies that curb such abuses are vital for a properly functioning territorial system and for maximizing potential growth under a reformed tax code.

However, there are no widely accepted methods for determining the value of many intangibles that businesses sell between their various entities, especially newly developed intangibles. Intangible property typically is unique in nature and generates income that is difficult to isolate and highly speculative at the time of the sale or license. Thus, unlike tangible property, intangible property is generally not sold in open markets that would help to establish market-based prices.

These factors make it difficult to establish a fair market price between two unrelated businesses. The amount of intangibles owned by foreign subsidiaries varies by industry and function of the

[14] Teresa Welsh, "Are Apple's Tax Shelters an Outrage?" *U.S. News & World Report*, May 21, 2013, http://www.usnews.com/opinion/articles/2013/05/21/is-carl-levin-or-rand-paul-right-on-apples-tax-shelters (accessed July 21, 2014).

various subsidiaries. There is no way to create an overarching rule to dictate where and in what quantities intangibles should reside. Despite these difficulties, properly accounting for intangibles is essential in both territorial and worldwide tax systems, and it will likely become even more important because intangibles will likely become a bigger part of business profitability as technology expands its share of the economy.

Stricter transfer pricing policies governing the sale of intangibles would likely not address this problem because of the inherent difficulties in valuing and determining the proper location of intangibles. The sensible way around this dilemma is to set broad policies that allow the U.S. to tax income businesses earn from intangibles if the business pays little or no tax on that income. In other words, the U.S. would tax intangible income if a business moves its intangibles to a low or no-tax country where they generate little or no economic activity. This assumes that U.S. tax authorities can properly identify such income. Such policies would greatly reduce the incentive for U.S. businesses to improperly move intangibles abroad and erode the tax base under a territorial system.

The Camp plan would tax foreign intangible income earned in foreign countries as current U.S. income at a reduced 15 percent rate. The taxable income would be calculated based on the foreign subsidiary's depreciable tangible property. U.S. parents would then be able to deduct 40 percent of that figure if it is sold for use, consumption, disposition, or to provide services outside the U.S. This is a viable way around the difficult problem of accurately pricing intangibles that would curtail the incentive for U.S. businesses to sell too much of their intangibles abroad to escape U.S. tax under a territorial system.

Whether the U.S. wisely adopts a territorial system or tweaks the existing worldwide system, anti-base erosion policies will continue to need the backing of policies that prevent earnings stripping. Earnings stripping occurs when U.S. businesses take on large amounts of domestic debt to finance income produced in foreign countries with lower tax rates than the U.S. The U.S. business can deduct the interest on the debt which lowers its U.S. tax. Meanwhile, foreign subsidiaries can use the borrowed capital to invest and increase their earnings. Such an arrangement artificially shifts income to lower-taxed countries. The Ways and Means draft proposal handles this issue by denying U.S. businesses interest deductions if its indebtedness exceeds 110 percent of their combined foreign subsidiaries indebtedness or if its net interest expense exceeds 40 percent of its taxable income.

Repatriation Holiday No Fix. Supporters of territorial taxation routinely argue that the U.S. needs such a reform to allow businesses to repatriate their foreign earnings to invest domestically. They use the same justification to support a repatriation holiday that would absolve U.S. businesses of paying tax that they previously accrued on foreign-source income. While there is certainly nothing wrong with businesses bringing more income back to the U.S., eliminating the lockout effect in which businesses keep foreign earning abroad to avoid U.S. tax alone will not spur job creation and wage growth because it is backward-looking.[15] However, changing to a territorial system on future profits will unlock investment at home and abroad that

[15] J. D. Foster and Curtis S. Dubay, "Would Another Repatriation Tax Holiday Create Jobs?" Heritage Foundation *Backgrounder* No. 2610, October 4, 2011, http://www.heritage.org/research/reports/2011/10/would-another-repatriation-tax-holiday-create-jobs.

the current worldwide system is holding back. That new investment will improve the efficiency and competitiveness of U.S. firms and spur U.S. job creation and wage growth.

Tax Reform Should Eliminate the Deduction for State and Local Taxes

What tax reform should do with the deduction for state and local taxes is one of the difficult questions in tax reform. Tax reform should eliminate the state and local tax deduction because it encourages state and local governments to raise their taxes higher than they would without it. If tax reform eliminated the deduction, state and local governments would face stronger pressure to keep their taxes low. Chairman Camp's proposal wisely does away with the deduction.

Violating Neutrality Appropriate in Certain Circumstances. The purpose of tax reform is to free the economy to grow stronger by setting a neutral tax base and by lowering tax rates in a revenue-neutral manner to improve incentives for families, businesses, investors, and entrepreneurs to engage in productive activity.

The principle of neutrality holds that taxes should not influence the economic decisions of taxpayers. To maximize economic growth, tax reform should institute the most neutral tax code possible. However, there are instances where violating neutrality is appropriate.

One is when a historical anomaly makes it unavoidable. This is the case with the exclusion for employer-provided health insurance. The exclusion is a historical artifact dating back to World War II. Because eliminating it without other reforms would create major disruptions in the health insurance market, sensible tax reform plans either retain the exclusion or better provide credits for families to purchase health insurance.

Another instance is when the benefit of a particular policy justifies its harm to neutrality. Retaining the Earned Income Tax Credit to encourage low-income families to improve their situations is an example.

Tax reform should also eliminate neutral policies that have negative unintended consequences that are greater than the harm that would be done to neutrality from their elimination.

State and Local Tax Deduction Is Neutral but Should Be Eliminated. The tax code allows taxpayers to deduct certain state and local taxes, including income taxes, sales taxes for residents of states that (wisely) go without an income tax, real estate taxes, and personal property taxes. State and local income taxes makes up about 95 percent of all state and local tax deductions.[16]

According to sound tax policy theory, the deduction is neutral because taxpayers should not have to pay tax on income they do not spend or save. State and local taxes deprive taxpayers the ability to do both with the income they claim.

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[16] Internal Revenue Service, "Individual Complete Report (Publication 1304), Table 2.1, Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, by Size of Adjusted Gross Income, Tax Year 2011," http://www.irs.gov/file_source/pub/irs-soi/11in21id.xls (accessed July 21, 2014).

However, the rubber of tax policy theory does not always hold up when it meets the rugged road of economic reality. When it comes to the state and local tax deduction, the harmful negative unintended consequence it creates in the real world outweighs the benefit of ensuring taxpayers do not pay tax on income they cannot spend or save.

The deduction therefore is another circumstance that warrants violating neutrality, and that is why tax reform should eliminate it.

Deduction Encourages State and Local Governments to Raise Taxes. The harmful unintended consequence of the deduction is that it encourages state and local governments to raise their taxes. Higher taxes allow state and local governments to grow larger because they spend up to the maximum amount of revenue they can collect.

The deduction encourages state and local governments to raise their taxes because it transfers a portion of their tax burdens from their residents to the federal government. For instance, for every dollar a state taxes a family paying the 33 percent federal marginal tax rate, the family effectively pays only $0.67 of the state tax, because the deduction on the family's federal taxes reduces their federal tax bill by $0.33.

This reduction in the "price" of the state's taxes encourages states to raise their taxes higher than they otherwise would, because taxpayers offer less resistance since they do not pay the full cost of the higher taxes. Taxpayers are more willing to accept higher taxes because of the deduction in the same way consumers are more willing to buy a product or service when prices fall.

However, there is no related reduction in the size of the federal government from the reduction in federal revenue due to the deduction. The federal government can and does borrow freely, so Congress sets spending amounts irrespective of tax revenue. State and local governments have much less latitude when it comes to borrowing, so their spending must more closely match their tax receipts.

If the deduction were eliminated in tax reform, the total amount of taxes taxpayers pay would likely not change. Tax reform should be revenue and distributionally neutral, meaning taxpayers would likely pay around the same amount of federal taxes as before, but their federal taxes would no longer effectively reduce the burden of their state and local taxes.

Faced with newly shouldering the entire burden of state and local taxes, taxpayers would markedly increase their opposition to state and local tax hikes. Taxpayers would also likely make stronger efforts to reduce their existing tax burden. Combined, these effects would help restrain the tax burdens of state and local governments.

Highest-Taxed States Would See Most Pressure. The highest-taxed state and municipalities would likely see the strongest efforts by their residents to lower taxes. Taxpayers in high-tax-burden states tend to have higher incomes. For instance, according to the Tax Foundation, New York, New Jersey, and Connecticut have the three highest state and local tax burdens and rank in the top five in terms of per-capita income. Most other high-tax states also have relatively high per-capita incomes.[17]

Higher-income taxpayers also overwhelmingly claim the deduction for state and local taxes. According to IRS data, taxpayers with adjusted gross income over $100,000 claim almost 76 percent of all state and local tax deductions.[18]

These data show that while taxpayers in high-tax states pay a hefty amount of state and local taxes, they also see that burden reduced the most because of the deduction. If tax reform eliminated the deduction, these taxpayers would see the biggest increase in their effective state and local taxes. They would likely put the most pressure on their state and local governments to stop tax increases and apply the most pressure on those governments to reduce their high taxes.

Lower Rates an Added Bonus. Eliminating the state and local tax deduction should be done only within the context of overall tax reform. Congress should not eliminate it (for instance, through "loophole closing") without other offsetting tax changes. To do so would be an unnecessary tax increase.

Eliminating the deduction in revenue-neutral tax reform would allow for even lower marginal tax rates for families. The state and local deduction reduces taxes by more than $1 trillion over 10 years.[19] That revenue would provide for substantial additional rate reduction. Lower rates enhance the growth-promoting potential of tax reform, which is an added bonus of eliminating the deduction.

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[17] Elizabeth Malm and Gerald Prante, "Annual State-Local Tax Burden Ranking: New York Citizens Pay the Most, Alaska the Least," Tax Foundation, October 2012, http://taxfoundation.org/sites/taxfoundation.org/files/docs/BP65_2010_Burdens_Report.pdf (accessed July 22, 2013).

[18] Internal Revenue Service, "Individual Complete Report."

[19] Office of Management and Budget, *Budget of the U.S. Government, FY 2014, Analytical Perspectives*, April 10, 2013, p. 261, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/spec.pdf (accessed September 10, 2013). Adding the score of deductibility of state and local taxes and the score for real estate taxes on owner-occupied property reduces tax revenue by $435 billion over five years. A traditional budget window is 10 years. The revenue reduction for these policies would grow in the second five years of a 10-year window enough to put the total revenue reduction in a 10-year window over $1 trillion.

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