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Chairman Brady and Vice Chair Klobuchar, thank you for the opportunity today to address the issue of tax reform and specifically how carefully designed tax reform can improve the economy's performance. My name is Dr. Laura Tyson and I am a professor at the Haas School of Business at the University of California Berkeley. I served as the Chair of the Council of Economic Advisers and as Chair of the National Economic Council under President Clinton. I was a member of President Obama's Economic Recovery Advisory Board and his Council on Jobs and Competitiveness. I am currently an economic adviser to the Alliance for Competitive Taxation, a coalition of American businesses that are promoting comprehensive corporate tax reform. The views in this testimony are my own.

My remarks will focus on corporate tax reform. Fifty years ago under President Kennedy and perhaps as recently as 30 years ago under President Reagan, the American economy was the most competitive in the world, and the U.S. could design its corporate tax code without considering the global economic environment. American companies derived most of their income from their domestic operations and to the extent they were engaged globally, they were typically larger than their foreign-based counterparts.

But we no longer live in that world. Emerging market economies, falling trade barriers, and remarkable leaps in information and communications technology have expanded opportunities for U.S. companies abroad, but have also heightened global competition among companies to gain market share and lower production costs, and among countries to attract investment and jobs.

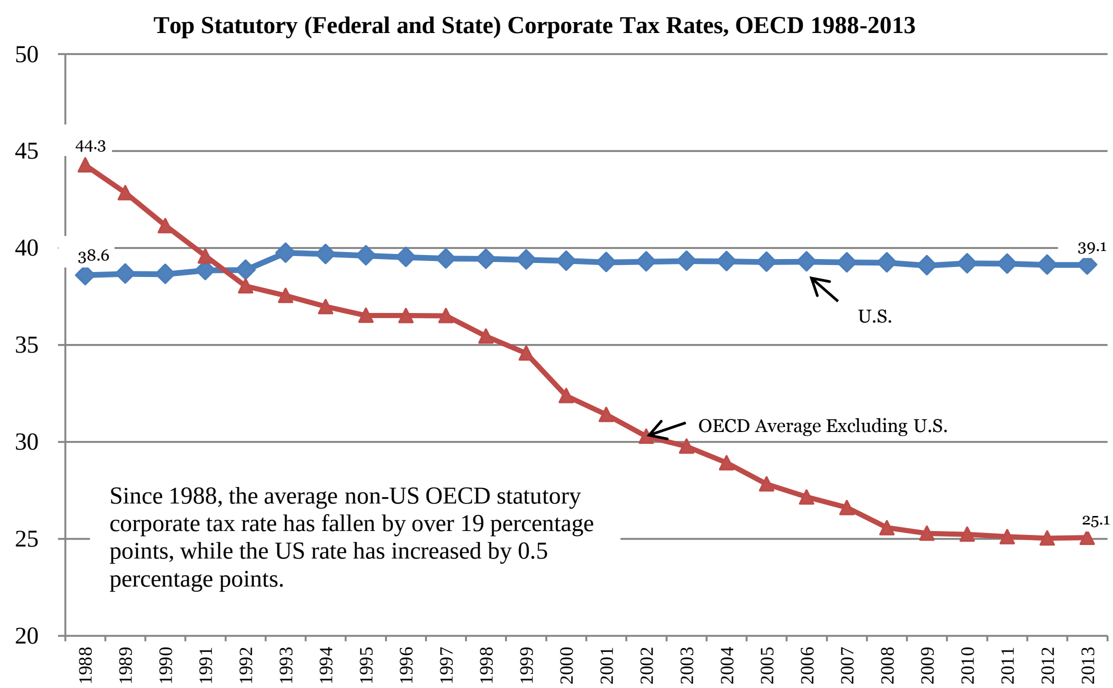
Our current corporate tax system makes it harder for U.S. businesses – small and large – to compete with foreign companies, and reduces the competitiveness of the U.S. economy as a place to do business and create jobs. As a result of numerous credits, deductions and exclusions, the current system also results in high compliance costs for businesses – estimated at $148 billion in 2005 – and undermines the efficiency of business decisions in numerous ways. There is widespread bipartisan agreement that our corporate tax system is deeply flawed and in need of fundamental reform.

I believe there are ways to reform the corporate tax system that will strengthen the competitiveness of U.S. companies, make the U.S. a more attractive location for investment, and promote simplicity and efficiency in the tax code without increasing the deficit. In the remainder of my remarks, I will suggest changes to current tax rules affecting both the domestic and the foreign-earned income of U.S. corporations to achieve these objectives.

Before turning to these changes, I want to use an example to illustrate how the current system undermines the competitiveness of U.S. companies. When a U.S. company sells shampoo in Asia, it is competing with shampoos made by its foreign competitors. The price of the shampoo to the consumer has to be competitive. However, a Dutch company pays zero tax to the Netherlands on the sale of its shampoo in Asia, whereas the U.S. company is subject to tax on its Asian income when repatriated. This puts foreign subsidiaries of U.S. companies at a competitive disadvantage among foreign competitors.

Domestic Tax Reform

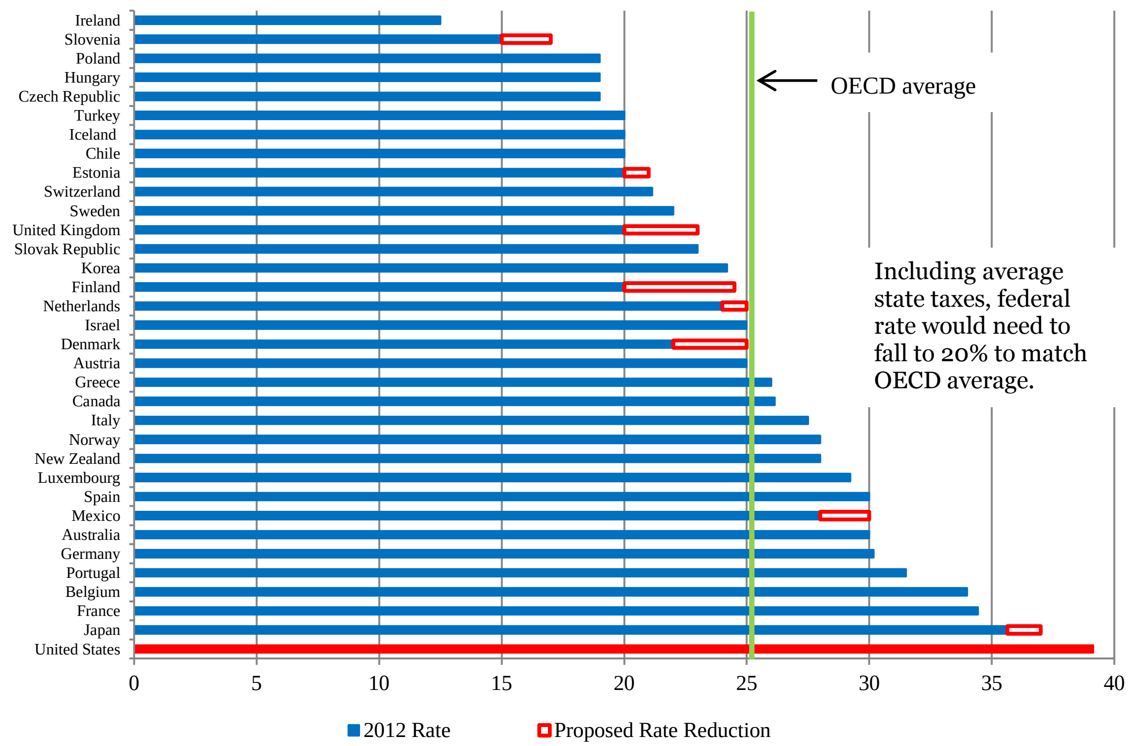
After its 1986 tax overhaul, the United States had one of the lowest corporate tax rates among OECD countries. Since then, these other developed countries have been slashing their rates in order to attract foreign direct investment and discourage their own companies from shifting operations and profits to low-tax foreign locations. In the most recent and audacious move, the British government has embarked on a plan to reduce its corporate tax rate from 28% to 20% – one of the lowest in the OECD – by 2015. And this year the British government instituted a special 10% tax rate on income from patents.



Source: OECD Tax Database

The U.S. now has the highest corporate tax rate of these countries. Even after accounting for various deductions, credits, and other tax-reducing provisions, the effective average and marginal corporate tax rates in the United States are higher than the OECD averages.

Corporate Tax Rates (Federal and State) in OECD Countries, 2013



Source: OECD Tax Database

Cutting the corporate rate to a more competitive level would encourage more domestic investment by U.S. and foreign investors. Capital has become increasingly mobile, and differences in national corporate tax rates have a growing influence on where multinational companies locate their operations and report their income.

Higher investment in the U.S. by both domestic and foreign companies would boost economic growth, while the resulting increase in capital – new businesses, factories, equipment, and research – would improve productivity. That should, in turn, boost real wages over time.

The pro-growth rationale for reducing the U.S. corporate tax rate is compelling. But rate reduction – at least as estimated under the conventions used by the Joint Committee on Taxation and by Treasury – is costly, perhaps on the order of $100 billion or more per percentage point over the next 10 years. By scoring conventions, such calculations ignore the stimulative effects of a cut in the rate on future economic growth. Although I believe these effects are significant, I am not convinced that they would alone be sufficient to offset the lost revenues from a reduction in the rate of to a level comparable to that in other OECD countries.

So how should we finance a rate reduction large enough to have a significant effect on the competitiveness of U.S. companies and on the competitiveness of the U.S. as a location for investment without increasing the deficit? Like most economists, I believe that we can and should pay for such a rate reduction by broadening the corporate tax base through the elimination of tax breaks and preferences. This approach would also reduce the complexity of the tax code and increase its efficiency. The current system of deductions and credits not only reduces corporate tax revenues, it also results in large differences in effective tax rates across economic activities and these differences affect investment decisions, often with harmful effects on productivity and growth.

Combining rate reduction with base broadening is the approach adopted in the 1986 corporate tax reform enacted under President Reagan and it is the approach advocated by numerous independent commissions on competitiveness and deficit reduction and by the Obama Administration.

Given the importance of the statutory corporate tax rate in influencing the location of highly profitable and mobile capital, a significant reduction in this rate paid for by broadening the corporate tax base can achieve meaningful efficiency gains and boost economic growth. And over time as growth increases a revenue-neutral corporate tax reform will increase corporate tax revenues and reduce the deficit.

International Tax Reform

In addition to reducing its corporate tax rate, the U.S. needs to reform the way it taxes the foreign earnings of U.S. companies.

With 95% of the world's consumers located outside of the United States, American companies need to have a presence in foreign markets in order to be able to compete there. For companies trying to sell and service escalators, most of the growth potential exists in areas where construction is robust, such as Asia. If a U.S. company wants to be selected to install and service an escalator in a building abroad, it must have maintenance and engineering staff on the ground in the country where the building is located. And if the U.S. company isn't established in the foreign jurisdiction, a non-US competitor will likely win the business.

Every other G-8 country and 28 of the other 33 OECD member countries have adopted modern international tax systems that generally allow their internationally-engaged companies to compete globally and reinvest active foreign earnings at home without paying a second tax. This approach, referred to as a participation exemption or territorial tax regime, is grounded in the principle of capital ownership neutrality – that is, the ownership of a foreign company by a domestic company should not result in greater taxation of its active income than ownership of that company by a foreign competitor.

The United States, by contrast, taxes U.S. multinational companies when they repatriate active income earned abroad by their foreign subsidiaries, with a credit for foreign taxes imposed on this income. With the adoption of territorial tax systems by the United Kingdom and Japan in 2009, and by thirteen other OECD member countries since 2000, the U.S. international tax system now lies far outside of international norms. Indeed, of the companies that appeared on the Global Fortune 500 list in 2012, 93 percent of the foreign companies that compete with U.S. companies were headquartered in territorial countries. Only two OECD countries have ever switched from exemption to foreign tax credit systems - Finland and New Zealand - and both subsequently reinstated exemption systems.

The current worldwide approach to corporate taxation in the U.S. puts globally-engaged U.S. companies at a competitive disadvantage. They cannot bring profits from their foreign affiliates home without paying the high U.S. corporate tax rate, while foreign-based competitors pay only the local tax rate on such profits. The combination of a high corporate tax rate and a worldwide approach to taxing the foreign active earnings of companies reduces the attractiveness of the U.S. as a place to locate the headquarters of global companies.

As a consequence of both U.S. taxation of repatriated foreign earnings and the high U.S. corporate tax rate, U.S.-based multinational companies have a strong incentive to keep their foreign earnings abroad. Indeed, their non-U.S. affiliates currently hold an estimated $2 trillion in accumulated foreign earnings.

These earnings are "locked out" and unavailable to finance investment and job creation in the United States without incurring significant additional U.S. taxes. Moreover, U.S. companies incur efficiency costs from the suboptimal use of these earnings and from higher levels of debt than would be necessary if their foreign earnings could be repatriated without incurring additional U.S. tax. Treasury economist Harry Grubert and Rutgers economics professor Rosanne Altshuler estimate that the hidden efficiency costs of the U.S. international tax system averages about five percent of the trapped foreign cash of mature U.S. multinational companies. These costs are a drag on their competitiveness.

A participation exemption or territorial system similar to those in other developed countries would allow U.S. multinationals to put their foreign earnings to work in the United States and to compete more effectively in foreign markets, which today represent 75 percent of the world's purchasing power and which will become even more important in the future.

Preliminary results from a study I am conducting at the Berkeley Research Group, an independent research and consulting group, with financial support from the Alliance for Competitive Taxation, suggest that exempting 95-percent of the active foreign income earned by the foreign subsidiaries of U.S. companies from U.S. corporate taxation would increase U.S. employment by about 150,000 jobs a year on a sustained basis, with a short-term employment gain nearly 10 times larger. These gains in employment are the result of a significant increase in the repatriation of income by foreign subsidiaries. Repatriated funds would boost U.S. employment and growth through an increase in the parent companies' economic activities in the U.S. and through distributions to their U.S. shareholders, who in turn would increase their investment and consumption.

Adopting a hybrid participation exemption or territorial system similar to those in other developed countries would address the competitiveness disadvantages, the "lock-out" effect, and the inefficiencies of the current U.S. worldwide approach. However, such a system would not reduce the incentives for U.S. multinational companies to structure the transactions between their U.S. operations and the operations of their foreign affiliates in ways that shift their profits abroad to low tax jurisdictions. Recent Congressional hearings have focused on the incentives that U.S. companies face under present law to shift reported profits to lower tax foreign jurisdictions, in some cases through the transfer of intangible property and risks to foreign affiliates.

Income-shifting incentives exist in both the current U.S. system and in territorial systems and have become stronger over time as a result of several factors including: the increasing globalization of business activity; the rising importance of intangible capital that is difficult to price and relatively easy to move; competitive cuts in corporate tax rates; and the availability of tax havens. As a result, income shifting and the resulting erosion of domestic corporate tax bases have become major policy concerns throughout the OECD. In response to such concerns, OECD countries with both worldwide and territorial systems have developed a variety of techniques to curb base erosion including transfer-pricing rules based on OECD guidelines, "exit" taxes on outbound transfers of appreciated property, limits on interest deductibility, and domestic taxation of passive and certain types of mobile income earned by foreign subsidiaries. Territorial systems with such features are referred to as hybrid territorial systems. The current U.S. worldwide system already has all of these features.

The OECD recently announced a 15-point action plan to develop coordinated national measures to further restrict opportunities for multinational companies to reduce or avoid taxation on cross-border income.

As part of comprehensive corporate tax reform that includes a revenue-neutral rate cut, the House Ways and Means Committee is currently considering a hybrid international reform that would follow the participation exemption or territorial systems of other OECD countries and would include additional measures to counter tax-base erosion and income shifting. Lowering the high U.S. corporate tax rate by itself would reduce the incentives for both U.S. and foreign-based companies to shift income from their U.S. operations and erode the U.S. corporate tax base.

Among the anti-base erosion options included in Ways and Means Committee Chairman David Camp's international tax reform discussion draft is an innovative proposal that rests on the "destination principle," with the tax rate on intangible property income based on where products are sold. This option would significantly reduce incentives to move intangible property or manufacturing abroad for tax reasons by offering a low 15-percent rate on income from intangible property owned in the United States and used in connection with providing goods and services sold in foreign markets. This is a form of the "patent box" regimes recently put in effect by seven EU member countries and China.

Conclusion

The U.S. last reformed its business tax code in 1986, when it had one of the lowest corporate tax rates in the world and the competitive dynamics of the global economy were very different. It is time for another comprehensive corporate tax reform that, without increasing the budget deficit, reduces the tax rate, broadens the tax base, makes the corporate tax system simpler and more efficient, and adopts a hybrid international system with effective safeguards to protect the U.S. tax base.