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UNITED STATES DEPARTMENT OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman, Senator Baucus, and Distinguished Members of the Committee.

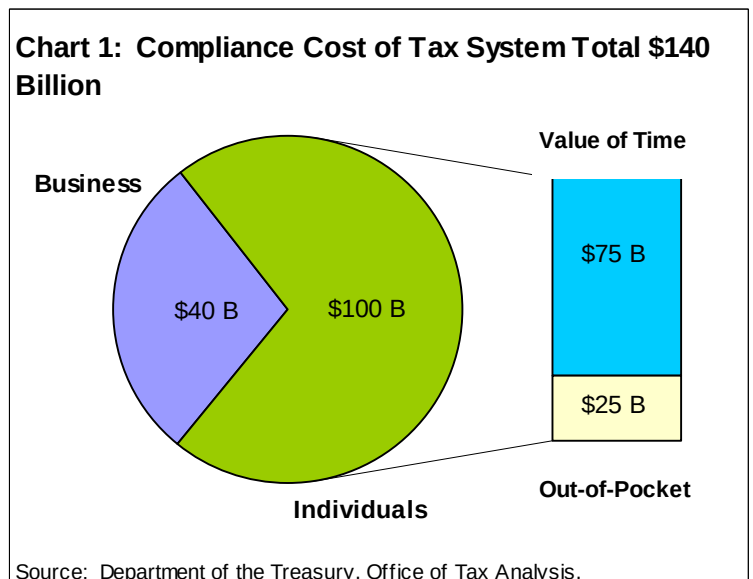
Thank you for the opportunity to appear before you today to discuss business tax reform. Tax reform is, without question, one of the most important issues facing our economy today. Reform of the federal tax on businesses offers significant opportunities for improving job and wage gains for American workers. A key consideration in evaluating approaches for reform in the business area is the relative efficiency of different policies to encourage investment, or, more accurately, to reduce the extent to which the tax system discourages investment. Also, in today's global economy, tax reform can play an important role in sustaining and improving the competitiveness of U.S. workers and businesses, as well as our ability to continue to attract capital investment from abroad.

Before focusing on business tax reform, I would first like to discuss the problems with our tax system more broadly. Then, I will focus on how the tax system affects investment and the importance of business taxation to the tax burden on investment.

The Costs of Our Tax System

Our tax system imposes very large costs on our economy. First, our tax system is extremely complex, difficult to comply with, and hard to understand. Individual taxpayers spend over 3.5 billion hours each year to comply with the tax system. To put this into perspective, this is equivalent to hiring another 2 million IRS employees. They spend so much time despite the fact that about 60 percent of taxpayers rely on paid preparers to fill out their tax returns and 25 percent rely on computer software.

The IRS estimates the compliance burden of our tax system to be \$140 billion annually, reflecting both the direct out-of-pocket costs – return preparation, tax software, fees for tax professionals, etc. – and the opportunity cost of taxpayers' time to understand the tax system, maintain records, pay their taxes, and otherwise comply with the tax system. About \$100 billion of the compliance costs are borne directly



by individuals with the remaining \$40 billion borne by businesses (Chart 1).

The tax system also imposes a particularly significant burden on the 31 million small business taxpayers who, because of their limited size, are unable to spread the costs broadly over their business operations. While an individual taxpayer spends on average 26 hours each year to comply with the tax system, taxpayers who report self-employment income spend an average of 45 hours each year to comply with the tax system – more than a full work week away from their business endeavors.

One of the best examples of complexity in our tax system -- and, in many respects, the poster child for tax reform -- is the individual alternative minimum tax (AMT). The minimum tax, enacted in 1969, was initially intended to affect a very small group of higher income taxpayers who paid no income tax by making extraordinary use of a small set of narrowly defined tax provisions. Several major and many minor changes since 1969 have transformed the original minimum tax into the current alternative minimum tax which, for too many taxpayers, is now a second income tax that runs parallel to the regular individual income tax. Today, the AMT affects 4 million taxpayers and, by 2016, without any change in the law, is projected to affect 56 million taxpayers – nearly one-half of all those who owe income tax.

The broad reach and design flaws of the AMT result in a tax system that is unfair and complex. The likelihood of being subject to the AMT rises with family size – creating a penalty for having children. Additional millions of taxpayers must comply with two parallel tax systems – even if they ultimately have no AMT liability.

Complexity also arises from the numerous duplicative and overlapping tax provisions that involve eligibility rules that are difficult-to-understand and are more often than not phased-in or out by income or other taxpayer characteristics. The vast array of provisions available to taxpayers to encourage education spending, retirement savings, and health care, to name but a few, and the associated forms, schedules, and worksheets, present taxpayers with a complex and staggering web of choices.

The complexity of our tax system has also led to the perception by many that the tax system is unfair because it creates opportunities for manipulation to evade paying taxes. Clearly, a tax code that is simpler and more transparent would instill greater confidence in our voluntary tax system.

In addition to these compliance costs, the tax system also imposes large economic costs on our economy. It interferes with and distorts numerous decisions made by individuals and businesses such as whether to participate in the labor force, how much labor to supply, what type of job to take, how much to save and invest, whether to start a small business. These distortions can lead to an inefficient allocation of resources and hinder economic growth.

Some estimates suggest that by reducing these and other economic distortions, reform has the potential ultimately to increase the size of the economy by between 2 percent and 10 percent, depending on the reform. Similarly, the capital stock, which reflects the wealth of the nation, could rise by upwards of 20 percent. This higher capital stock can be thought of as producing an annual annuity, which in today's \$13 trillion economy, would translate into an additional \$260 billion to \$1.3 trillion in output or Gross Domestic Product (GDP). A larger economy means higher real incomes and living standards for Americans – and a larger tax base.

Criteria for a Well Functioning Tax System

In creating the Advisory Panel on Federal Tax Reform, the President outlined three goals: simplicity, growth, and fairness. While there is general agreement on these three broad objectives, there is considerable controversy about the extent to which the details of any reform plan advance these goals. It is useful to consider general principles that can be applied for our tax system.

First, the tax system should raise a given amount of revenue with the least interference in business and household decisions. This requires a tax system that is as simple, transparent and understandable as possible, and has low cost and non-intrusive tax administration.

Second, as a general rule the tax system should have a broad tax base, with low tax rates. Business and household decisions should be based on the tax code as little as possible. This means that there should be a high standard for special tax treatment that is provided only where there is clear and convincing evidence of its benefits. In general, the returns from all activities should be taxed uniformly because this leads to a more efficient allocation of resources within the economy and less economic waste.

Third, the tax system should promote a strong economy. Encouraging saving and investment is essential to promoting economic growth. A tax system that penalizes saving and investment will generally result in lower standards of living.

Fourth, the tax system should be appropriately progressive. It should provide equal tax treatment of similarly situated taxpayers (horizontal equity) and a reasonable degree of progressivity, imposing higher taxes on those with a greater ability to pay (vertical equity).

Fifth, the tax system exists in a world where capital and labor are increasingly mobile and where nations compete for investment and workers. The tax system needs to adapt and change with the increasingly global economy to maintain the competitiveness of the United States and continue to attract investment and highly skilled labor.

Finally, the tax system should be as stable as possible. Frequent changes create uncertainty and make it difficult for taxpayers to plan, while wasting economic resources and increasing compliance burdens.

Tax reform that recognizes and builds upon these principles will also meet the broader goals of simplicity, growth, and fairness as identified by the President and will help serve as a guide as we work to improve our tax system.

Investment and Business Taxes

One key tenet of public economics is that businesses do not pay taxes, people do. Businesses organize capital and labor in the production of goods and services used throughout the economy and consumed by households. Businesses, however, are owned by individual investors, hire individual workers, and sell to individual consumers. While corporations may remit tax to the federal government, it is individuals who bear the burden of business taxes. Investors “pay” business taxes through lower after-tax returns to their investments, workers “pay” business taxes through lower wages, and consumers “pay” business taxes through higher prices.

Business tax reform, the subject of today’s hearing, is an issue that can be considered in the broader context of how the tax system taxes investment. Investment adds to the productive capacity of the economy directly by adding to the capital stock, as well as indirectly by integrating new technologies and production processes. Higher investment also raises labor productivity by giving labor more capital with which to work. Policies that encourage investment, increase capital formation, and raise labor productivity are the key to higher living standards.

Business taxation generally reflects only one aspect of the tax on investment. The return to an investment may be subject to several layers of tax under our tax system: business level taxes, investor level taxes, and the estate tax.

Consider, for example, a newly equity-financed investment in the corporate sector. First, corporate tax is paid on the earnings from the investment at the firm level at a top corporate tax rate of 35 percent. Second, for income paid out as dividends, another layer of tax is paid by individual shareholders at a maximum rate of 15 percent. Alternatively, shareholders pay tax at a maximum statutory rate of 15 percent on the realization of appreciation in stock value that arises from corporate earnings that are retained and reinvested in the firm. For corporate income paid out as dividends, the combined corporate and investor level tax rate can be nearly 45 percent (excluding state and local taxes). For corporate income that is retained and reinvested, the combined corporate and investor level tax rate depends on how long the investor holds his stock, but is, on average, upwards of 40 percent.

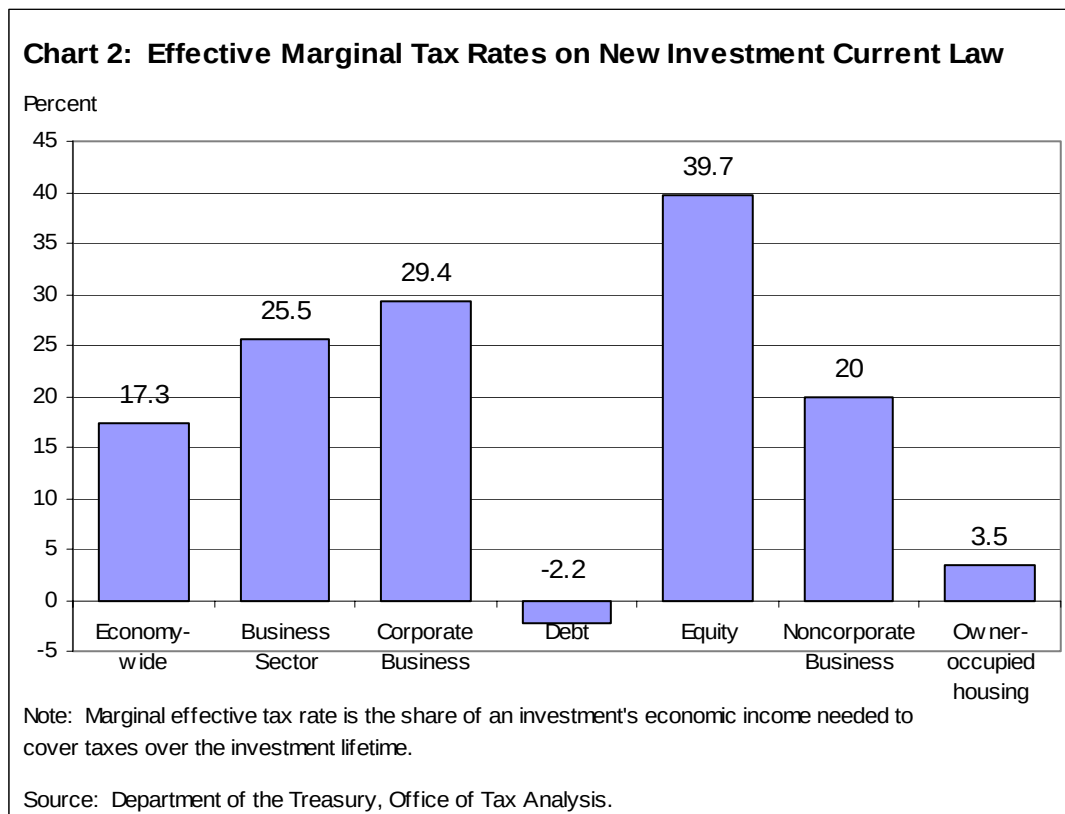
Such an investment may also be taxed yet again under the estate tax upon the death of the investor. The estate tax can also discourage individuals from saving and investing. To provide some perspective on the estate tax's economic effects, it is useful to translate the estate tax into an equivalent accrual-based income tax for individuals saving for the benefit of their heirs (i.e., bequest motivated saving). This "accrual-based tax rate" on the return to saving is the income tax rate that would leave an individual at death with a net worth exactly equal to the after-tax value of his or her estate under the current estate tax. According to Treasury Department estimates, across all taxpayers the estate tax translates into an additional accrual-based tax on the return to investment of between 5 percent and 10 percent. That is, when the third layer of tax from the estate tax is added, the combined federal tax rate on corporate profits can be over 50 percent.

Of course, there are many other dimensions to business taxation. Not all business investment is subject to the statutory tax rate. Tax rules generally allow faster write-off of investment in equipment than economic depreciation, which has the effect of lowering the *effective* tax rate below the *statutory* tax rate. Also, a substantial fraction of business income is not subject to the corporate income tax, but is instead taxed when passed through to owners of S corporations, partnerships and sole proprietorships, many of which are small businesses. According to Treasury Department estimates, roughly one-third of the tax on business income is remitted by owners of such pass-through entities, often at the top individual income tax rate.

Marginal effective tax rates (METR) measure the impact of taxes on investment decisions and summarize how various provisions of the tax code – the statutory tax rate, depreciation deductions, interest deductions, deferral of tax, and both the individual and corporate levels of tax – interact with and affect the after-tax rate of return to a new investment. The METR is the extra share of an investment's economic income that is needed to cover taxes over its lifetime. Because of the double tax on corporate profits, accelerated depreciation on certain investments, and many other provisions taxes can vary sharply from one investment to another. The METR is useful to highlight the effect of these differences, and for focusing attention on the level of tax on investment.

Chart 2 shows the METR on different types of investment by the type of financing and sector under the current tax system. Currently, the estimated overall effective tax rate on all investment in the economy is 17.3 percent, while the marginal effective tax rate on business investment (corporate and non-corporate) is 25.5 percent. Lower tax rates on capital income – the reward to saving and investment -- encourage more of these activities. Investment increases the amount of capital available for each worker and also increases the rate at which new technology embodied in capital can be put to use throughout the economy. More productive capital translates into higher labor productivity, and, ultimately, higher real wages and living standards.

The chart illustrates another key feature of our tax system: Investment can face very disparate tax treatment depending on the sector and financing. Investment in the business sector faces an effective marginal tax rate of 25.5 percent, but because of the double tax on corporate profits the effective marginal tax rate for investment in the corporate sector is 29.4 percent, nearly ten percentage points higher than in the non-corporate sector. Moreover, equity-financed investment in the corporate sector faces an effective tax rate of 39.7 percent, while debt-financed investment is effectively subsidized at a rate of -2.2 percent (which together provide the weighted average METR in the corporate sector).



This uneven treatment of investment across sectors and sources of financing leads to an inefficient allocation of capital within the economy, which wastes economic resources, and, ultimately, reduces living standards. The high level of tax on investment in the corporate sector, for example, discourages investment in this sector. This greater tax burden on corporations encourages business owners to choose organizational forms, such as partnerships and other pass-through entities, that face only a single level of taxation, but often at the cost of giving up the benefits of limited liability or centralized management found in the corporate structure.

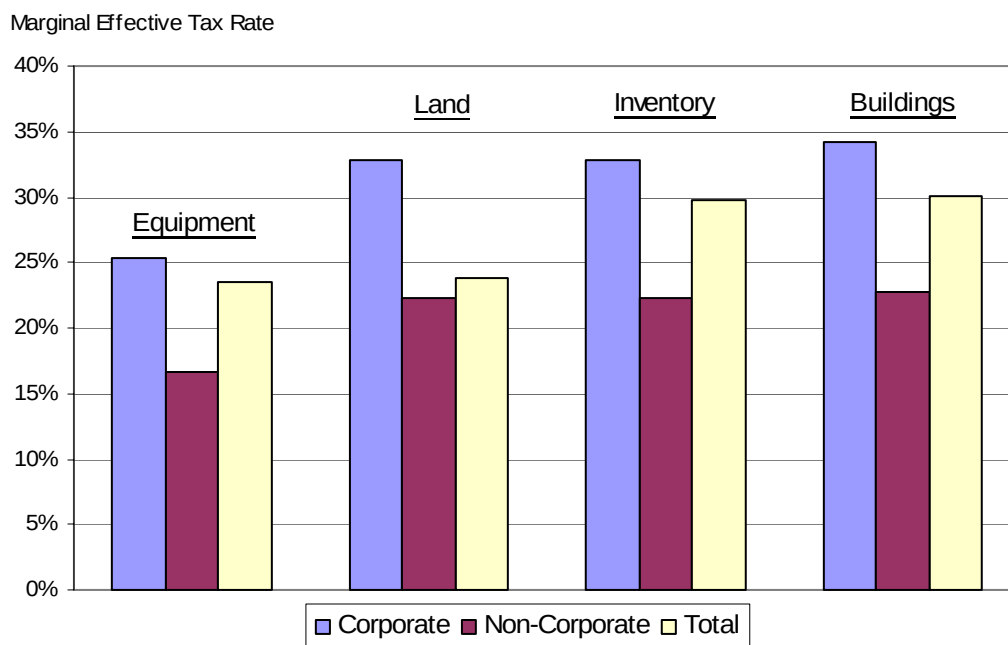
The greater taxation of equity investments leads to an over-reliance on debt finance for corporate investment. A higher debt burden increases a firm's risk of bankruptcy during temporary industry or economy-wide downturns. Business failures generate losses to both shareholders and employees, and the heightened bankruptcy risk can make the entire economy more volatile.

The tax system also discourages corporations from paying out earnings through dividends because dividends are more heavily taxed than capital gains generated through share repurchases or retained earnings. The payment of dividends may improve corporate governance by providing a signal to investors of a company's underlying financial health and profitability. Regular dividend payments also may be one way for shareholders to ensure that managers reinvest only in projects that raise shareholder value.

Also, without the reduction in the double tax on corporate profits enacted in the Jobs and Growth Act of 2003 -- the top 15 percent tax rate on dividends and capital gains now in effect through 2010 -- the uneven treatment of investment reflected in Chart 2 would be even more pronounced. Lower taxes on dividends and capital gains have moved the tax system to more equal treatment of debt and equity, of dividends and capital gains, and of corporate and non-corporate capital. This move increases economic efficiency because it promotes an allocation of capital based on business fundamentals, rather than tax considerations.

The current tax system also taxes the return on investment of some assets much more heavily than the return earned on other assets. This uneven treatment discourages investment in high-taxed activities. As shown in Chart 3, investment in buildings, land and inventories is discouraged relative to investment in equipment. Also, as noted above, business investment, particularly in the corporate sector, is generally taxed more heavily relative to other investment. This uneven tax treatment reduces productivity because tax considerations compete with market fundamentals in guiding investment decisions.

Chart 3: Investment is Taxed Differently by Asset Type and Sector



Note: Marginal effective tax rate is the share of an investment's economic income needed to cover taxes over the investment lifetime.

Source: U.S. Department of the Treasury, Office of Tax Analysis.

A clear theme emerges: The tax on investment income discourages capital formation. Furthermore, the disparate treatment of investment income by the tax system means capital is inefficiently allocated throughout the economy. Business tax reform that focuses on reducing these tax distortions could increase the productive capacity of the economy and increase living standards.

Towards a More Rational Taxation of Investment

There are a number of different policy avenues for influencing the tax on capital and treating different types of investment more uniformly, each with its own set of inherent tradeoffs. The corporate tax rate, the individual tax rate, how quickly investment is written off, the tax on investment returns received by individuals, and the tax treatment of interest all influence the cost of capital. One consideration in evaluating these policy levers is to what extent a particular change provides windfalls to taxpayers because it rewards past decisions. Another consideration is to what extent a change will have large impacts on the market value of assets if new investment is treated differently than existing capital.

Consider, for example, the choice between allowing faster write-off of investment versus lowering the corporate tax rate. Both policies can have a profound effect on effective marginal tax rates and encourage investment. Faster write-off of business investment reduces the role taxes play in investment decisions by reducing the tax on the investment return at the margin. Full expensing of investment (e.g., immediate write-off) completely removes taxes from investment decisions. The value of the deduction in the year the investment is placed in service will exactly offset (in present value) the tax on the expected return to the investment over its life. Consequently, any tax paid on returns above the expected return will have no effect on the decision to make the initial investment. In this way, taxes are removed from the investment decision. One important aspect of expensing is that tax may be paid on higher than expected investment returns, but these taxes will have no effect on the initial decision to make the investment. Another important aspect of expensing is that it is inherently prospective, thus benefiting new investment, but not investment that has already been placed in service.

One difficulty with faster write-off of investment or expensing is the disparate treatment between old and new investment. Because new investment receives more favorable treatment, the market value of existing capital may in some instances fall relative to new investment. This gives rise to the potential need for transition relief to address changes in asset values that result from the disparate treatment of existing capital and new investment. Corporate rate reduction, in contrast, avoids this difficulty because it applies to the return from both existing capital and new investment.

In contrast to faster write-off of business investment or expensing, reducing the corporate tax rate lowers the tax on the full return to investment, regardless of whether it exceeds the expected return. Also, corporate rate reduction benefits old and new investment alike. Thus, prior investments also benefit.

The various policy levers listed above can be contrasted by comparing how much they would encourage investment per dollar of revenue cost. This “bang-for-the-buck” calculation takes into account the extent to which the various policies focus on encouraging new investment, or instead also reward investments that would have been made absent the policy change. Table 1 ranks the policies by their relative “bang-for-the-buck”. The “bang-for-the-buck” depends on the degree to which investment is responsive to tax changes. But the focus here is on the relative effectiveness of various policies. Thus, the table shows the “bang-for-the-buck” of each policy relative to expensing.

Table 1: Comparison of "Bang for the Buck" of Alternative Investment Incentives

	Effective Marginal Tax Rate on Investment	"Bang for the Buck" Relative to Expensing 1/
Current Law	17%	
Policy Change:		
30% expensing of all investment	13%	100%
Expand tax free savings accounts 1/	12%	65%
Corporate tax rate lowered to 25%	15%	60%
Tax rate on dividends and capital gains lowered to 10%	16%	60%

Source: Department of the Treasury, Office of Tax Analysis.

1/ Reflects the change in the investment incentive divided by the revenue cost of each policy assuming a constant growth rate of investment over time. Estimates presented relative to expensing for ease of presentation.

2/ Replaces existing tax-free savings accounts with the President's Advisory Panel on Federal Tax Reform's proposal for Save for Families and Save for Retirement Accounts (each with a \$10,000 contribution limit).

Not surprisingly, expensing of investment provides the largest “bang-for-the-buck” because it focuses the tax benefit on new investment. By contrast, lowering the corporate tax rate has a smaller “bang-for-the-buck” because it reduces taxes on the return from existing or old capital as well as on that from new investment. The expansion of tax preferred savings accounts has a relatively high “bang-for-the-buck” because it also focuses the tax reduction on new savings.¹

¹The “bang-for-the-buck” estimates depend importantly on a variety of assumptions. Two assumptions are highlighted here. First, the calculation for the lower tax rate on dividends assumes that dividend taxes reduce the incentive to undertake corporate investment. Under some theories of the firm, dividend taxes

Of course, there are a host of other considerations at play in evaluating these various policies. As discussed above, changes in the market value of existing assets and the possible need for transition relief is one important consideration. Some of the policies also address multiple distortions. As discussed above, the lower tax rate on dividends and capital gains, for example, results in more equal treatment of corporate and non-corporate capital, but can also help improve corporate governance and reduce the economy's exposure to bankruptcy and financial risk during periods of economic weakness.

International Competitiveness

The United States is increasingly linked to the world economy through trade and investment. Domestically based multinational businesses and their foreign investment help bring the benefits of global markets back to the United States by providing jobs and income. Like all firms, multinational corporations choose how much and where to invest. Multinationals also decide where to locate their headquarters, intangible assets, and research and development, and their decisions often affect which countries reap the majority of benefits from the multinational's operations. The tax system can have profound effects on these decisions.

Ensuring that our tax system is competitive in the world economy is crucial for the United States to continue to attract capital, create jobs, and further increase living standards. To provide some perspective on how the United States compares to its major trading partners, Tables 2 and 3 compare statutory, average and effective tax rates for the United States with other G-7 countries. The comparison to the G-7 countries is particularly relevant for investment that requires

Table 2: Comparison of Statutory Corporate Tax Rates to Among G-7 Countries

Country	Statutory Corporate Tax Rate		
	2000	2006	% Change
Canada	45%	36%	-20%
France	38%	35%	-6%
Germany	52%	39%	-25%
Italy	37%	33%	-11%
Japan	42%	42%	0%
United Kingdom	30%	30%	0%
United States	39%	39%	0%
G7 Average	40%	36%	-10%

Source: Department of the Treasury, Office of Tax Analysis.

reduce share values rather than discourage investment. Calculations based on this alternative view of the firm would generate a smaller "bang-for-the-buck."

Second, the "bang-for-the-buck" calculation for the expansion of the contribution limit for retirement accounts assumes that increases in these accounts represent marginal increases in funds available for investment. But contributions to these accounts are capped, so that for some taxpayers the expansion of the contribution limit might have little effect on the incentive to undertake an additional, marginal investment. Once the tax free saving account is fully used, additional, or marginal, saving would be taxable and the "bang-for-the-buck" would be smaller.

higher skilled labor. A comparison to China, India, and other developing economies might be more relevant for investment that is more closely related to low-skilled labor. However, the data for these comparisons is not widely available and, moreover, differentials in the cost of labor, not the tax system, are likely to be more important.

As shown in Table 2, the United States has a high statutory corporate tax rate relative to the G-7 – 39 percent in the United States (including state level taxes) versus 36 percent, on average, among G-7 countries. Also shown in the table are the reductions in corporate tax rates among G-7 countries over the past several years, with the average statutory corporate tax rate falling from 40 percent to 36 percent. Three countries enacted sharp reductions in corporate tax rates during this period Germany lowered its top rate from 40 percent to 25 percent, Italy lowered its top rate from 37 to 33 percent, and Canada lowered its top central rate for service industries from 28 to 21 percent (thereby equalizing it with the manufacturing and production sectors). The corporate tax rates in Japan, the United Kingdom², and the United States were largely unchanged, while France’s reduction in corporate tax surcharges somewhat lowered their rate somewhat.

While the statutory corporate income tax rate is the headline measure for a country, it does not indicate the breadth of the corporate income tax base, nor does it reflect how heavily corporate income is taxed at the investor level. A country’s statutory tax rate, however, is important for determining the incentive for multinational corporations to allocate income and expenses across their subsidiaries for purposes of complying with the U.S. tax system.

Table 3 also shows the effective marginal tax rates, similar in concept to the effective tax rates described earlier, and average tax rates, which show the ratio of corporate-source tax receipts to total corporate income. Both of these measures provide a more complete picture of the tax burden on investment by capturing in different ways the breadth of the tax base. The effective tax rates are more focused on the effect of the tax system on marginal investment decisions, whereas the average tax rates reflect the overall burden of

² The United Kingdom enacted successive tax reforms during the 1990s, which brought its corporate rate down from 34 percent in 1990 to 30 percent by 1999.

the tax system on the corporate sector in each country.

Table 3: Comparison of US Corporate Tax Rates to G7 Rates

Country	Statutory CIT	Corporate METR	Integrated METR	Corporate ATR	Integrated ATR
Canada	36%	14%	56%	18%	25%
France	35%	11%	40%	20%	26%
Germany	39%	24%	60%	7%	16%
Italy	33%	-1%	14%	14%	27%
Japan	42%	33%	49%	16%	18%
United Kingdom	30%	15%	47%	27%	38%
United States:					
Current Law	39%	14%	44%	13%	24%
Without the '01/'03 Tax Relief	39%	14%	56%	13%	NA
G7 Average	36%	16%	44%	17%	25%

Source: Department of the Treasury, Office of Tax Analysis.

Notes: CIT = corporate income tax rate, METR = marginal effective tax rate; ATR = average tax rate.

The effective and average tax rates for the United States tend to be close to the average for the G-7 countries whether at the corporate level or “integrated” to reflect both corporate and investor level taxes. Importantly, the “integrated” effective tax rates in the United States would be considerably higher – 56 percent – than the G-7 countries without the lower tax rates on investor level taxes enacted in 2001 and 2003 now in effect through 2010; that is, without the tax relief enacted in 2001 and 2003 the United States would be a relatively less attractive place to invest relative to other G-7 countries.

Thank you again, Mr. Chairman, Senator Baucus, and Members of the Committee for the opportunity to appear before you today. We look forward to working together with this Committee and others in the Congress on this important issue. I would be pleased to answer questions from the Committee.