

Tax Foundation's "Tax Policy Podcast"
Episode No. 10
October 10, 2006

Scott Hodge: Welcome. I'm Scott Hodge, President of the Tax Foundation. I am pleased to have with me today Dr. Robert Carroll. Dr. Carroll is currently the Deputy Assistant Secretary for Tax Analysis at the Treasury Department, where he provides economic advice and analysis on all aspects of the economics of federal taxation. He is responsible for the development, analysis, and implementation of tax policies and programs. Prior to joining the Treasury, Dr. Carroll was a Visiting Scholar at the Tax Analysis Division of the Congressional Budget Office, and he served as a Senior Economist with the President's Council of Economic Advisors, I believe under Glenn Hubbard--is that correct, Bob?

Robert Carroll: Yes, that is.

Scott: Well great. Thank you for joining us today. I was really intrigued by some testimony you gave at the Senate Finance Committee recently about business tax reform, and you outlined some of the problems that you have identified, that U.S. businesses are facing in our current tax system, and what costly effects that those have, and how burdensome they are. Could you share with me, today, some of the things that you identified in that testimony?

Robert: Sure. I think in talking about business tax reform, a couple of points should be made.

First, I think it is useful to think about tax reform more generally, and think about, more broadly, the ways in which the tax system imposes costs on our economy. Economists often think of--and people who are interested in tax reform will often think in terms of--how complex the tax system is, and the distortionary effects it has on decisions made by individuals and businesses. The tax system today is, of course, very complex. It imposes very significant compliance costs on the economy.

The IRS estimates that those compliance costs total up to about \$140 billion a year, spread between both individuals and businesses--about 100 billion borne by individuals, about 40 billion is borne by businesses, in just compliance costs associated with the very vast complexity of the tax system. And that is kind of a summary way of encapsulating the some 600 billion hours that taxpayers spend to comply with the tax system each year.

The tax system also interferes with economic decision making in very important ways. It interferes with the ways in which households make decisions, and the ways in which businesses make decisions, and those economic costs are very, very significant. Economists have estimated that a fundamental reform to the tax system could increase economic growth by some two to ten percent. In a \$13 trillion economy, that translates into, ultimately, a higher level of GDP, and an increase in the size of the economy by some \$260 billion to \$1.3 trillion each year, in the long run.

So the economic costs are actually very substantial, and larger--much larger perhaps--than the compliance costs that folks often think about.

Scott: That is pretty extraordinary, to see that kind of effect, and I think that that would be pretty compelling for Members of Congress and lawmakers to take into account; but as they move forward, and if we can get the ball moving on tax reform, what are some of the principles that you have identified, that they should be keeping in mind as we go about reforming the tax system?

Robert: Well, in conversations on tax reform, individuals often focus on the very broad objectives of simplicity, growth, and fairness, and these are the objectives the President laid out when creating the President's Advisory Panel on Federal Tax Reform, a year-and-a-half ago or so. But I think it is useful to think about principles that one could adhere to as we consider approaches to tax reform in the context of the three broad objectives of simplicity, growth, and fairness.

One principle would be that the tax system should raise revenue with the least possible interference in business and household decision making. Another principle would be that the tax system should have a broad base, with low tax rates. A third might be that the tax system should promote a strong economy by promoting savings and investment; and the tax system should be appropriately progressive, and provide equal tax treatment of similarly situated taxpayers.

Also, 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.

Scott: Well this was the point of your testimony I found most interesting. As you point out, the economy is changing so dramatically on a global basis that we need to keep that in mind as we go about reforming the tax system.

Robert: Absolutely. The United States is increasingly linked to a world economy through trade and investment. Domestically-based multinational businesses and their foreign investment are very important; they help bring the benefits of global markets back to the United States by providing both jobs and income.

Like all firms, multinational firms have to choose how much and where to invest, and the tax system is very important to those decisions. Multinationals also have to decide where to locate their headquarters, their intangible assets, their R&D, and their decisions often affect which countries are going to reap the benefits from the multinationals' operations.

As I said, the tax system can have a very profound effect on these decisions, and ensuring that our tax system is competitive in the world economy is really very crucial for the United States to continue to attract capital and create the jobs that will help, and also help increase the living standards in our country.

Scott: But you pointed out something very interesting, and some--I thought--very new data that I had not seen, about how the tax system imposes different effective tax rates on different types of new investment. Could you tell me about that? I thought that was very interesting.

Robert: Well this is a very important point, that the tax system generally treats a lot of different activities differently, and when economists say that large economic gains can be realized from tax reform, the two to ten percent ultimate increase in the size of the economy that I mentioned before, that translates into \$260 billion to \$1.3 trillion, those gains come from basically introducing more uniform treatment of economic activity in the economy. The tax treatment of investment is one of the areas where there is potentially very non-uniform treatment in the economy. The investment is subject to tax in many different ways under the current tax system of course. A lot of investment is subject to the corporate income tax, investment that occurs through the corporate sectors is subject to the corporate income tax at a rate up to 35%.

But a lot of investment is also subject to a second layer of tax, corporate investment that's then paid out in the form of dividends by corporations or retained and then realized by investors in the form of higher capital gains, or of course subject to the investor level taxes on dividends and capital gains.

Then some investments are also subject to a third layer of tax in the form of the estate tax; investments that are very successful that lead to an accumulation of wealth are then again subject to this third layer of tax in the form of the estate tax.

And this combination of layers of tax on businesses results in non-uniform treatment of taxation. Pass-throughs or other small businesses are subject to tax through the individual income tax. One interesting fact that a lot of people should perhaps pay a little bit more attention to is about 35% of business taxes are actually paid by pass-throughs, S-corporations, sole proprietors and partnerships, which are often small businesses. The owners of those businesses pay tax at the top individual rate, so keeping an eye on the top individual rate is very important.

Scott A. Hodge: Well, I want to shift back to you mentioned the top corporate rate of being 35%, but when you add state and sometimes local taxation the U.S. has now one of the highest overall corporate tax rates, at least in the OECD if not among most industrialized countries.

And I interviewed the economist Marty Sullivan recently, and he said that America is falling behind simply by standing still as many, many countries across the globe are cutting their corporate tax rate to attract investment and basically lured away from high techs countries such as France and Germany. Do you see a mood out there to cut the corporate tax rate and can we boost our competitiveness simply by doing that, or do we need much more fundamental reform?

Robert: I think it's a very important issue in international competitiveness. The United States has a high statutory tax rate relative to its major trading partners. If you look at the

G7 [week in the unit U.S.] we have, in effect, including state level taxes, about a 39% tax on corporate income, and that's versus -- on a statutory rate -- versus the 36% on average among the G7 countries; ours is clearly, clearly higher.

And as you alluded to, our major trading partners have reduced their corporate tax rates over the past several years with the average statutory tax rate in the G7 falling from about 40% to 36%. So we were kind of even. The point of that we were kind of even a couple of years ago with the G7 when you look at the statutory tax rate. Now we are lagging behind. Germany has lowered its top rate from 40% to 25%. Italy lowered its top rate from 37 to 33. Canada lowered its top central rate for service businesses from 28 to 21. So we are beginning to lag behind.

Some economic decisions that businesses make, particularly let's say where to locate their headquarters and some other important decisions that have important spillover effects to the economy are very much affected by the statutory tax rate; that's what companies often look at.

In terms of trying to attract investment to the U.S., it's also important to keep an eye on the average tax rates which might be affected by the ability of companies to write off investment. In my testimony, when I testified two weeks ago before the Senate Finance Committee on the subject, allowing expensing of investment has often been found to be a very efficient -- rather efficient way to promote investments. That's another policy that I think folks need to look at very, very carefully and very seriously.

Scott: Well, obviously in wrapping up I think everyone's aware that the window of time, if you will, for the administration to achieve more tax reform is closing; we're in the last two years of the administration. What do you think you can realistically accomplish by the end of the term, and well, I guess the bigger question is, do you see a willing partner in Congress?

Robert: Yes, I think it's pretty clear that Congress is very interested in tax reform, hearings in tax reform have been held in the House and the Senate. More hearings, as I understand it, are planned. A number of members have introduced specific tax reform plans. A real dialogue is getting underway in the Congress.

Now, Treasury we of course have a new secretary and he's still working to develop his priorities, and the country faces a number of important challenges, not only on the tax front but we also face very large fiscal imbalances in the future that need to be dealt with; entitlement reform, reforming Medicare and the Social Security system are both important to dealing with this longer term problem, and over that -- the administration will be evaluating over the coming weeks and months exactly what it should focus on over the next two years in office.

Scott: Oh Bob, I want to thank you for spending some time with us today, and I know you have an incredibly busy schedule. I encourage people to either go to the Senate finance website to see your testimony, and I'm sure it's on the Treasury website as well.

Robert: Great. Well, thank you very much.

Scott: Terrific. Thank you again.

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