
Scott Hodge: Thank you for tuning in. I'm Scott Hodge, president of the Tax Foundation. Joining me for our weekly tax policy podcast is Mihir Desai, who is an associate professor of finance at Harvard Business School, and a faculty research fellow at the National Bureau of Economic Research. Mihir is one of the most prolific academics today, studying business tax issues, especially as it relates to business competitiveness and international investment. Thanks for joining us today, Mihir.

Mihir Desai: It's my pleasure, Scott.

Scott Hodge: Well, let me start out having you talk about an article that you co-authored earlier this year with Fritz Foley and Jim Hines, titled "Taxation and Multi-National Activity, New Evidence and New Interpretations." Can you give me an overview of that article, and especially, I guess, it's important for Congressional staff and members of Congress to understand where the economics profession is today with international tax.

Mihir Desai: Sure. I think it's a really wonderful effort to think a little bit about what recent research has told us about how taxation influences foreign direct investments. Specifically, I think in the early 1990s, there was almost an implicit consensus or folklore that taxes were second-order or third-order in determining locational decisions for firms. And what we've been able to do is turn to the data and analyze whether that's true or not. And I think what comes out of that is an upending of that wisdom, which is that taxes are, in fact, a first order of concern for firms when they make a variety of decisions.

So, specifically, what that research shows is that taxes and corporate income taxes, but also indirect taxes, limit FDI in a fairly significant way, such that 10 percent increases in corporate tax rates are associated with seven or eight percent reductions in the levels of foreign direct investments. Second, all kinds of financing decisions, including where the firms use debt in countries, how they actually choose to repatriate to support the first-order issue, are also highly sensitive to tax factors.

And finally, that the ways in which firms organize themselves around the world is also highly sensitive to tax factors. The final piece of that that has been fun for us is a reconsideration of the role of tax havens. Typically, tax havens are viewed suspiciously, particularly because they are thought to divert activity away from nearby countries that are not tax havens. And what our research

shows is that that idea is not quite right, and it's not right for the following reasons, which is the presence of tax havens can actually make it easier for firms to invest in nearby countries that are not tax havens.

In short, that by investing in the tax haven jointly with non-tax havens, they can actually reduce their tax obligations and they invest more in the non-tax havens than they would have in the absence of the tax havens. So it was kind of fun to kind of upend that wisdom. But I think consensus now is that, A), taxes are a first-order effect of FDI, and B), there's good reason for that to be the case, which is that FDI is quite different than it used to be. It used to be, you know, FDI was just about, well, let's invest in countries that we can produce for that country. Now it's much more about a global production process, where cost factors, especially taxes, are central.

Scott Hodge:

Well, you know, there's been, of course, the big talk here in Washington recently has been on comprehensive tax reform. Ways and Means Committee held a number of hearings over the summer on this issue, and of course, comprehensive corporate tax reform is sort of a holy grail for many of us. But in testimony that you gave to Ways and Means over the summer, you kind of took a different tact, which I found interesting, and recommended a few piecemeal changes that you thought could go a long way toward improving the system and creating efficiencies, and ultimately saving U.S. businesses a lot of money. Could you give us a brief overview and then perhaps we could talk about them on an individual basis?

Mihir Desai:

Sure. So in general, let me say I too am a fan of comprehensive reform, but in the absence of it, I think it's worthwhile thinking about some more modest ideas that have, I think, big payoff. So the first issue that I try to draw attention to is the really anomalous treatment of corporate capital gains. In short, corporate capital gains--the taxation of corporate capital gains creates--effectively, a third layer of taxation. So if you thought that corporate tax was anomalous, the treatment of corporate capital gains is even more anomalous. And it's particularly anomalous given the relief for dividends at the corporate level, and it's particularly anomalous given the recent relief for capital gains at the individual level.

Investments that I talk about in that paper suggest that there are significant efficiency gains, almost \$20 billion a year, associated with some kind of relief for corporate capital gains, and that

overall stock of corporate capital gains that are in some sense not being realized because of this current system is enormous, on the order of \$600 to \$800 billion dollars. So that is, again, a real possibility for reallocating capital to much more efficient uses if that tax treatment is reconsidered.

Second, we can talk a little bit more about this, but I think there's reason to really reconsider the international dimension of corporate taxation. Typically, that international stuff has been really an appendage to corporate taxes, but it saves global economy, it's impossible to think about corporate taxes without thinking about the international provisions. And those international provisions are highly complex, highly burdensome, and actually may put American firms at a disadvantage when they compete to buy assets around the world. And so that research suggests that the burden associated with current systems is on the order of \$50 billion a year. And second, that this kind of new understanding of what FDI is and what multinational firms do is much more consistent with the idea of a territorial system.

The final idea I put out there is perhaps the most controversial, which is revisiting the corporate tax reporting system, and then having a rate reduction based on that, which is to say that currently we have quite a peculiar system, where firms report completely different pictures of profits to the capital markets and to the tax authorities. And what I was suggesting in some ways is that we conform those two, very likely on the basis of capital market standards, so that we could reduce compliance costs tremendously, and we could actually manage to, in a revenue neutral way, have a tax rate reduction. So those are three, I'm not sure I would say modest, but smaller ideas than fundamental tax reform, that I think have the possibility of yielding fairly large benefits.

Scott Hodge:

Well, I do want to talk about the last one, but let me go back to corporate capital gains, because I think it is perhaps one of the least studied portions of the tax code. I think, you know, we've all seen many articles about individual capital gains taxes and how those affect investment decisions and the sort of locking up of stocks and assets over time, but you found that much of the same effects happen in the corporate world because of the corporate capital gains tax.

Mihir Desai:

That's right, except I might even add that it works, and sometimes

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Scott Hodge: Is that right?

Mihir Desai: Well, it's not just that, you know, you have the lock-in effect that we know is associated with capital gains taxes. You know, which is, you don't change your portfolio like you would otherwise. But it's really tough when it happens at the corporate level, and what I mean by that is, you know, imagine a corporation that wants to, you know, optimally invest in a bunch of different things, but now they have a big chunk of a gain that they don't want to harvest because of the tax system. Well, that's really quite costly to all of us, in the sense that they aren't making efficient investment decisions that they would have made otherwise.

So while it's true that, you know, Mihir Desai, as a stockholder, might also get locked in, it's much more, you know, in some sense, harmful when a large corporation has these large gains which are not being reallocated towards their most productive use. And so that is the sense in which corporate capital gains, in addition to the fact that they are, you know, a third layer, are in some sense, even more destructive than the individual capital gains tax treatments.

Scott Hodge: Certainly, in globalization, as you mentioned earlier, is clashing with our corporate tax system, which is many, many decades old now. Let's turn back to the territorial issue, which has been somewhat controversial, because it seems as though everyone has their own definition for what that means.

Mihir Desai: Sure.

Scott Hodge: In general terms, how would that work, and then more importantly, what improvements would it have for the economy and perhaps even the competitiveness of U.S. companies?

Mihir Desai: Sure. These international provisions are some of the most arcane and burdensome there are in the tax system, but let's just try to take a shot at this. Currently, what we do is, effectively, we tax worldwide income and we provide credit, partial credit, as relief. And the proposal that we're that we're advancing is the idea that territoriality or exemption of any foreign income from U.S. taxation should be considerably better.

Scott Hodge: Why would that be better?

Mihir Desai: First, as I mentioned, these are very, very complex, arcane provisions, so there's a lot of efficiency to be gained from just

reducing complexity. Second, and I think more importantly, the current system, by our estimates, is highly burdensome, so all the distortions that it involves, for example, the decision to repatriate process is highly distorted because the system – and we saw two years ago with this remarkable level of repatriations that came back with the holiday, just how distorted those decisions were.

And then finally, there are these notions that have been bantered around about what is efficient, and typically, what's been talked about is that there's something called capital export neutrality. And that idea is that, you know, you have efficiency because you provide with these credits, and that was how the U.S. tax system was oriented. What we've shown in recent research is that those welfare standards or welfare benchmarks don't really conform to more modern ideas of what corporations are doing. So what tax systems should really be oriented towards doing is making sure that ownership is as efficient as possible instead of making sure that capital flows to the right places.

And if you think about that perspective, that in fact, territoriality, which is a system that's used by many countries in the world, is actually the most efficient. So I think there are reasons to think about it from a complexity perspective. There are reasons to think about it from a distortion perspective. And finally, there are reasons to think about it from a kind of optimality or welfare improving perspective. All of those, in my mind, point towards territoriality.

Scott Hodge:

Well, on one of your last recommendations, reconciling book and tax profits, I interviewed Professor Douglas Shackelford about this, and I think he testified much about the same time that you did, that he was against this because he didn't want the Federal Accounting Standards Board, FASB, to dictate the tax base, nor did he want Congress to start meddling in accounting rules. I can see both sides of this argument. You know, where do you differ with Doug, and I guess, generally, what's your basic case for this?

Mihir Desai:

Yeah, well, I there's perhaps a difference in emphasis. So what I think is the massive gain to be had is associated with compliance costs, which would be, you know, fundamentally, completely different than they would be otherwise. Currently, U.S. corporations re burdened with quite high compliance costs for just filing their tax returns, regardless of whether or not they're paying taxes. Second, I think there's – I put a great value on having lower marginal rates, and if we can have a lower marginal rate on this

kind of book income base, I think there's remarkable gains to be had. That's one of the big lessons in economics, which is efficiency losses increase as marginal rates get higher and higher in a non-linear way. So that, I think, is also a big emphasis.

And then the final thing that I really value is the idea they by forcing firms to pay taxes on their book income, we have a more credible picture of what firm profits are. And we've learned over the last decade or so that, you know, firm profits are hard to figure out, and in some sense, the tax system is currently making it worse by allowing firms to characterize profits in two different ways. Profits should be profits, and there really is no reason for there to be two definitions of profits. Accounting's developed in a wonderful way to create good, new definitions of income, and we should be following that.

The main concerns with it, from Doug's perspective as I understand it, are, one, that there would be somehow underreporting of profits to capital markets, to avoid taxes. Frankly, you know, I don't think that's a major concern, insofar as most firms are – have a real incentive to inflate profits, and now we, in some sense, have a built-in – we would have a built-in mechanism for depressing that. So I don't see that as a major concern.

Scott Hodge:

Let's, I guess, wrap up by getting back to the rate issue. I think it's pretty well known that the U.S. has, really, the second highest overall corporate tax rate in the OECD, next only to Japan. But now Japan is now rattling about lowering their corporate tax rates. We've seen moves in Germany, Spain, and other European countries to do the same, and yet ours continues to stay the same. We've had no changes since, really, the early 1990s. Are we in danger of just simply falling behind by doing nothing?

Mihir Desai:

I think that's right, and I think there's a complacency about this question which is quite harmful. I think it's worth thinking about why, in some sense, we've become, you know, complacent about this. I think the first reason is, frankly, because some of our larger competitor economies have been in the doldrums, so we haven't been aware of what their powers can be when they revive. And so their tax rate changes haven't struck us as being terribly important. That, of course, will change as their economies revive.

I think the second reason why we've been very complacent about this is that a lot of firms have figured out ways to kind of get

around this, and you know, and effectively get themselves help from the tax system. And that, too, is not in anyone's interest. So reducing our marginal rates has the potential to both make us more competitive, but I think also to change a number of less benign incentives that are part of the corporate tax system. I think that's a first order of concern going forward.

Scott Hodge: Well, Mihir, this has been extremely interesting, and thank you very much for joining me, and I hope that members of Congress and congressional staff begin to take notice of some of the great work that's being done by you and others, because it speaks a great deal to the needs to make some pretty substantial changes in our tax system.

Mihir Desai: Great. Well, thanks, Scott. It's a pleasure to speak to you about these issues.

Scott Hodge: Thank you.

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