Unedited Event Transcript

Conference: Border Tax Adjustment and Corporate Tax Reforms

Keynote Address:
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Jason Furman: Thanks Adam for that really kind introduction, and thank you, especially, for bringing me here to Peterson. I really relied on, not just your work, but the whole Institute's work when I was in the White House. I would never leave the country without checking with Adam, and Adam would never fail to assemble a phone call or a meeting in the White House with several of his colleagues. And they would never fail to have different views on whatever question it was that I was putting to them.

Seeing no exception to that today with the really healthy range of views that you've seen represented at Peterson, and I'm not going to be an exception to that myself because I myself embody a whole range of views on this topic just in one person.

I should say I've been here for about eight-and-a-half days. I worked for President Obama for about eight-and-a-half years. So, some old habits die hard. So, if for example you hear me say something like the President after thoughtful and judicious reflection decided that he's going to prioritize TPP and when that's done do business tax reform, I hope you make the appropriate mental adjustments for what I actually meant.

So, with all of that, part of why I think I embody a multiplicity of views on this topic and I'm slightly pained by it is that same problem that a child has when mommy and daddy are fighting. And for me, mommy is public finance and daddy is macro, and they seem, to some degree, be fighting over this question.

I want to take you through what I think was the really important point that Doug [inaudible 0:05:14] began us with which is that our corporate tax system is badly broken that that really is a consequential problem and an unforced error. And if we could solve that problem without making any other problems worse, we should absolutely seize the opportunity to do it.

But then, I want to place some emphasis on that really important caveat which I saw as the thrust of the remarks that Adam made which is without making anything else worse. And I think business tax reform could play a

useful helpful role in the economy, but it’s not so exciting that I would sacrifice a lot else to get it done.

So, we need to understand both how important it is, how much we would be sacrificing and what the risks are. I think my bottom line assessment to begin in the outset is the really courageous statement that it depends. It depends on how the overall tax plan comes together. It's hard to evaluate some of the most important issues like distribution and revenue looking at only one component of a plan. You need to look at the whole plan.

And then, my second conclusion is that I have a deep seated fear that, however, elegant this idea is, I'm not confident that it's been put through the paces and the tires kicked and is ready for primetime, but that could be something that certainly today we've been doing some kicking and will continue to do so.

So, that’s a broad overview of what I'm going to say. And I'll start by providing some context and most every one of these slides you’ve seen the same point made a different way so I'll go relatively quickly.

One indicator of the brokenness of our tax system is having the highest corporate tax rate of any advanced economy. I think it's possibly of any economy except like the UAE or something complicated like that.

There's a lot of different ways to look at effective tax rates. There's a particular one which is the one that Treasury featured in its most recent report is average effective tax rates across the G7. And what you see here is that the United States is roughly in line with other countries.

This shouldn’t lead us to think the tax system is just fine but it should lead us to think that diagnosis of the problem probably isn’t that corporations are massively overtaxed in the United States just that they're badly taxed with some of them paying rates that are too high, some that are too low, or in some circumstances, too high and too low. In other words, you need to reform the system as opposed to reduce the rates.

There's another aspect of the US tax system that is exceptionally broken and that’s our international tax system. Some people call our international tax system worldwide and that’s because we tax you on your income anywhere in the world as long as you're headquartered in the United States.

There's a minor caveat to that which is that we pretend to tax you on your income anywhere in the world, but we give you a lot of flexibility in deciding where you made that income and whether you ever want to pay the taxes here. And when you give people flexibility they tend to exercise

it in their own interest, and this leads to what I call a stupid territorial system that in effect we're not taxing you on your overseas income. So, we're not actually collecting taxes from the international system, but we are creating distortions at the same time.

And in public finance, there's always a tradeoff between raising revenue and creating distortions. Here is an example of where we've gotten a tradeoff badly wrong. One manifestation of that is if you just look at the profits that American subsidiaries report in Bermuda, it's 1500% of Bermuda's GDP. The Cayman Islands, I'm sure they'd love to be first, but their falling a little bit behind at a mere 1400% of their GDP.

It distracts you from countries like the Netherlands that Michael and I once tangled with back in May of 2009, at 15% of GDP that itself is just an extraordinary share of their GDP that's the profits of US foreign subsidiaries. That international system that's broken.

You ask about the consequence of all of this. The one vision of business tax reform is that it's about we're not investing enough in this country and we need to invest more. I think we're not investing enough in this country right now. I think we need to invest more. I don't think business tax reform is going to be the best way to get there.

You saw some of the broad outlines of what Adam presented. I think if you drill down you'll find that's largely correct. And I think it's very hard to lower the cost of investing without lowering corporate taxes, and if you do a tax reform that's paid for, that's a hard thing to do.

What, I think, tax reform can accomplish is helping not with the quantity of investment so much as the quality of investment. And that manifests itself in a number of ways.

So right now, we tax investment in different types of activities at enormously different rates ranging from a 10% tax rate for utilities to a 27% tax rate for wholesale and retail trade. And that means that decisions are being made for tax reasons not for business reasons. As an aside by the way I've had a large number of meetings with CEOs and CFOs over the years, all of whom, very strongly believe two propositions about the world one would never ever admit making any decision for tax reasons because that's terrible. They only do things for business reasons. And two, how could we design the tax code this way because it's leading to all sorts of horrible things on their part. And often it's in the same paragraph anyway.

But it's not just tax rates on different forms of investment. The tax rate on equity finance investment in the United States is the highest of any of the advanced economies and the tax rate on debt finance investment is the

lowest of any advanced economies. This leads to over-indebtedness and financial fragility.

The tax rate on corporates is higher than the tax rate on pass-throughs and another indication of the brokenness of our international system, this is in a stylized sense taken from a paper from [inaudible 0:12:19] and Groubert, but they give examples where you had a 30% tax rate for an American company invested in the United States.

If you invest it in a low tax country, you actually had a negative tax rate because you could take advantage of immediately deducting your expenses associated with that investment and never paying taxes on the income, and in a high tax rate country 13% and that distorts the allocation of capital.

The question is, how much does this all add up to and how important is it which we need to answer to set it against any cost or risks associated with changing it?

I had one more. I'm so used to talking about this issue from the government but I forgot I'm now completely liberated and can say the most politically incorrect things and I'm representing the Peterson Institute, which is not only free trade, but it's also very against the mortgage interest deduction as I learned this morning.

And one of the biggest distortions we actually have if you look at investment is business investment tax at 27% rate and investment on owned or occupied housing taxed at a negative rate. That rate differential, my guess is, leads to a more consequential distortion in terms of economic growth of capital accumulation than anything else we're talking about in the top panel here. And I neglected mentioning that as much in the last eight years, and I'd hadn't even seen that on these comments when I decided to do that -- suck up to him.

So, your question then is, how much does all of this add up to? The first set of estimates here are from two tax reforms that are commissioned that President Bush formed. It came out with two very thoughtful proposals and these were estimates by the Treasury Department.

The first was a simplified income tax. Think of it as 1986. You're sort of classic broaden the base, lower the rates. And the answer there was the long run which is like 150 years from now. You wouldn't get quite 1% of GDP. And just to be clear, like, I think a lot of economic policy is about tenths. I think anywhere we can get a tenth, we should take that tenth. We just need to understand, value that against the tradeoffs.

They also found something that a growth in investment tax which it was a cash flow tax with destination basis and border adjustment. It looks a decent amount like the Ryan-Brady blueprint that we're discussing today would have larger effects on growth and that's because it was estimated to lead to additional savings, additional investment.

It's still not earth-shattering. It's not the difference between GDP doubling every 30 years or 60 years or whatever it is. Sort of reminds me of Herbstein's old quip that there's nothing wrong with supply side economics that can't be solved by dividing by 10. With my friend Doug [inaudible 0:15:28] I think you don't need to divide by a number quite as large as 10 but you probably still need to divide.

The second estimates are from a more stylized model done by Altig, Auerbach, Smetters and others. And you see there that if you go to a proportional consumption tax, you get potentially very large effects, but that's completely proportional. No exemption. No anything. The same rate for everyone which not even a flat tax would do.

And most importantly, most of those gains are being generated by the assumption that that consumption tax is confiscating all of the old capital in the country, that you're losing switching from depreciation to expensing. And if you've made an investment yesterday, those depreciation allowances you're expecting to get you no longer get and you take all that money and plow it back into the tax system.

Once you switch to something like a flat tax and you provide that type of transition relief and it's absolutely inconceivable that Congress would ever do anything that didn't have some type of transition relief and it didn't have some type of graduated rates built into it, you get effects of it more like half a point after a decade, 1.9 after an infinite horizon. And even that is a stylized version of a best case version of reform before you've exempted the oil refineries and whatever else you've done.

So, to me that all is meaningful, worth trying to pursue, but the question is what the other costs are.

So we put two other concerns down on the table. One concern is the medium and long run deficit. Our deficit as a share of GDP is about 3% right now that's roughly consistent with debt being stable as a share of GDP. I'm broadly speaking, I'm comfortable with that. I'm much less comfortable that a decade from now it's projected to rise to 5% of GDP.

From my own perspective, I wouldn't drop everything to do something about this problem. There's a lot of different problems we face, but I

certainly wouldn’t do anything that would make this problem worse especially on that medium and long run time scale.

And then the third issue is we just have a very high level of inequality in the United States and this is illustrated by the top 1% income , but we can look at GINI’s or whatever other data you want.

So, the question then is you have these gains that we estimate, what are the costs for these? And with that, I'm going to dive a little bit more deeply into border adjustment and then go back, zoom back out.

There's a number of arguments people make for border adjustment that are either fallacious or weak. The first is that everyone else is doing it so we should too. I don’t think we need to spend a lot of time on that. The second is that it improves US competitiveness. This is an argument that the authors and proponents of it have deliberately assured.

The third is worth spending another second on which is the claim that it's a necessary part of a cash flow and consumption tax. There's a lot of economists who are convinced that a consumption tax is the right base or a cash flow tax is one way to implement it. It's not a universal view, but it's a semi-common view.

Sometimes you hear a set of arguments made for consumption tax and say that’s we should have destination basis border adjustment. Most of the leading consumption tax proposals to date though have not had this feature. Hall and Rabushka’s flat tax didn’t have this feature; David Bradford who was the most thoughtful developer of ideas in this area didn’t have it. And Carroll and Alan Viard came out with a proposal a few years ago where they went very carefully through this question and they had a pure consumption tax and did it on an origin basis not a destination basis.

So, these are two logically separable questions and you could come to different views on either one of them. And then, the last which I'm going to come back to and spend time on is that it raises a lot of money in the budget. I think that is potentially an important rationale for it in Congress as I'm going to argue not only is that a fallacious argument for it, but I actually think that’s one of the most important, to me, arguments against adopting destination basis border adjustment. And one of the things that worries me the most about it. So, I'll come back to them.

So, what I'm going to do next is something I've only done once in the last eight years which was to use clipart to illustrate this set of points. The last time I did this was in the Roosevelt Room for President Obama and he made fun of me. So, you should be nice.

I should say this comes out of -- we spent a lot of time struggling with these issues which is run the international taxation in the Obama administration and, in particular, I want to single out Michael Mundaca who was the Assistant Secretary of the Treasury for the President's first term. And we used to spend huge amounts of time with him sort of patiently like trying to explain these things to me hoping that like at least a bit of it would sink it.

There's no question that the current system was problematic for the reasons that I said before. The question was what would a better system look like? And the problem is you're trying to do a lot of different things at once.

As I said before, you want, in sense, a neutral tax system. You want to tax investment and utilities at the same rate that you tax investment and retail trade; or you want to tax debt finance investment at the same rate as equity finance investment.

It turns out on the international side, you want to do a couple of different things and it's hard to do them and be neutral on all of them at once. So, the first of these, roll the clipart, is what's called capital export neutrality. And this goes back, way back right on to the 60s or maybe earlier. The idea is that you have a factory, you're deciding whether you're going to set that factory up in the United States or China, and you want that decision made for an economic reason. Locating that factory where it makes the most economic sense, not a tax reason.

And if you face a different tax rate in the United States than you face in China, you might end up making that decision for tax reasons and in particular if you face lower taxes in China that could be an additional motivation for locating there.

Of course, there's a ton of reasons to locate to China whether it's cheap labor because you economically need to access the local market or because they've made you, in order to access the local market, but you wouldn't want taxes being on the scale.

This says you want a worldwide tax system. You want to tax multinationals at the same rate whether they produce in the United States or produced abroad, give them a credit against the tax they paid abroad. So you're not taxing them extra and then they'll make things for economic reasons.

There's another thing that we care about though and that's something that Jim Hines and Mihir Desai called capital ownership neutrality. And here

think there's a factory that’s going to be in China, nothing is going to change that. It's going to be there because it's serving the local market or because that’s the right place in terms of wages. And the question is, is that company going to be a subsidiary of a US company or of a British company?

Here, what you’d like is a territorial system where either flag, they're going to pay the Chinese tax rate, but they're not going to pay anything extra. And if you're paying anything extra to the United States than you would to the UK that gives the UK company a competitive advantage, allows them to have more efficient global supply chains that are undistorted by taxation. So, this gives you exactly the opposite answer.

A third thing we care about is where your profits are located and in particular, are they coming from like some tropical island or are they coming from the United States. I mean, in here neither system is perfect.

If you have worldwide taxation, it gets rid all of the incentives around transfer pricing, debt stripping, location of intangibles, et cetera. Because no matter where you make your profits in the world, you're paying your taxes here. Except to this one problem, you’d love to move your headquarters out of the United States to get out of that system.

Territorial is the opposite. You don’t mind where your headquarters is. There's no reason not to leave them in the United States especially when we're so generous and lenient in our enforcement of interest stripping, location of intangibles, and to some degree transfer pricing.

This all gives us the argument for using destination rather than origin for international tax. We sat there staring at this, thought there was no perfect answer and our answer was to use a minimum tax which sort of that had all these problems, but didn’t have any of them quite as big.

The argument for destination basis is that rather than tax things that are responsive to taxation like the location of production, the location of ownership, and where you report your profits, you should instead follow just the traditional Ramsey rule and tax things that aren’t going to be responsive to taxes that are more and elastic. And in particular, if you're taxing sales, it's not like you're all of a sudden you're going to sell your car in China instead of in the United States, you can continue selling your car in both places.

So, just to summarize what I said because I think it is important to start with this appreciation of the elegance of it, there's all these different things you care about where to located production, where your subs are, profits, et cetera, the current system gets all of them wrong.

The worldwide system gets two of them right and gets two of them badly wrong. A territorial system gets a different two of them right and gets another two badly wrong. A minimum tax, which is what we developed in the Obama administration, again, with Michael, says we're not going to get anything exactly right, but we're not going to get anything really badly wrong either. And under a sort of some notion of convexity, it's a little bit better to get a bunch of things a little wrong and some things badly wrong. And the destination basis gets all four of those right. This relates to the aesthetic of the tax system that Adam referred to possibly with less a fuse of respect than I'm doing now.

Destination basis raises a whole bunch of tax policy issues that I'm not really planning to discuss today. This is an incomplete list as the idea gets vetted and discussed. There'll be more. Some of this we've heard about earlier, the direct sales to consumers, tourists, retirees, internet, education, hospitals, et cetera. More firms that have unrecoverable losses. If you export a lot, you are excluding your export revenue. You might have what appears to be losses in the system. You need to get money back from the government.

Impact on the global tax system because there'd be a big incentive to shift income to the United States. A really thorny issue and this comes more from the cash flow side than destination side. This treatment of financial transactions, and my guess is Bill Gale and some of the other people in this room could add a whole bunch of other issues as well.

I don't think any of these is fatal because any tax system has a set of problems like this. Certainly, our current one does; certainly, a minimum tax does, but I think you want to work through these and evaluate them, but ultimately we are choosing between imperfect options.

The questions that worry me more are some of the bigger macro ones that we've been discussing. We've had a big discussion about whether the exchange rate would adjust and it's worth just putting a picture to look at what that adjustment would look like.

I'm assuming this is all done with a 25% tax rate. If you had a 25% tax rate, the currency would actually need to move by 33% in order to keep the price of imports and exports unchanged because your tax will take you down to 75. You need to get back from 75 to 100. That would mean jumping from that blue line to the red dot, the likes of which if it happened overnight, we've certainly never seen before.

I don’t think New Zealand has seen it before, not that I've gone through New Zealand in any degree of detail, but even if they did, if you saw this happen to United States, the ramifications would be enormous.

I think Adam spent a lot of time talking about the ramifications if you didn’t adjust. It's important that even if you did fully adjust, there's a whole set of ramifications for people that borrowed in dollars from foreign countries; the effect on the assets that foreigners have denominated in US dollars and conversely, the effect on the asset values of Americans who have foreign earnings.

So, jumping to that red dot, I think it would be comforting in one respect that you’d lose some of these inter-industry differences that we've talked about, but raise a big set of issues. And then, there's that yellow-orange, whatever it is dot, a partial adjustment. And there you get somewhat less of all that international disruption associated with exchange rate, but you get all the types of industry effects that we've been talking around so much this morning.

I have to say if you ask me do I think there’ll be something like complete adjustment in something like an orderly fashion in something like a short period of time, I think I might put like a 75% chance on that. If I were in the retail industry and I thought there was a 25% chance that that wasn’t going to happen, I would be rather agitated about this proposed shift in the tax system.

So, in some sense, everyone can be right here and that probably you will adjust. And oh by the way, probably still leaves a large consequence multiplied by a large probability for a large fraction of the economy.

So, that’s the first set of issues. The second, I won’t reprise, which Chad talked about, but again I don’t know if this is 220 billion. I think there’s some version where this was more when you added up the import and export. If it's less that happens right away if it happens later.

But, the intent can’t be unrelated to the way in which other countries respond and the way in which possibly even the WTO rules. And you saw this a little bit with the immigration order this past week where there was a stated intent for a year straight and then just like they coincidentally happened to have chosen these seven countries based on an objective reading of where recent terrorist attacks have emanated from in the United States.

You can’t separate that order from what was obviously the intent and here if you had Alan Auerbach as president and he was out there giving speeches about how this is basically a VAT with a wage credit. It's

possible that the way other countries would react would be rather different than the way it's being described right now or it is being described as a penalty on imports and as a subsidy for exports. And so this strikes me as quite large.

The next issue I want to get down to is one that we didn’t actually discuss this morning and I think it's quite important and it's one that I think a lot of these issues on destination basis, there's a lot of debate over and all sorts of people disagree. This is one where I think everyone actually agrees. If you read Alan Viard at AEI had a nice piece last week where he said, “How much money do you raise from border adjustment? Nothing.” Alan Auerbach says the same thing.

If you look at a 10-year revenue score, border adjustment raises NTPC $1.2 trillion over 10 years. That’s 0.4% of GDP. If you are constructing a revenue neutral plan, that particular component of the plan could pay for, by definition, 0.4 percentage points of GDP, which I think is about 10 percentage points of corporate rate reduction.

Here is the problem and Morry should get up and correct when I get this badly wrong, we're going to have a really hard time running a trade deficit indefinitely unless we have increasingly high returns on our foreign assets relative to what foreigners are getting here, and the associated capital gains on those assets.

To our first approximation, I think it probably make sense to think of, in present value, the trade balance as roughly zero. So, we gain that 0.4% of GDP in the first decade because we're running a trade deficit. Eventually, that’s going to reverse so we can repay it. We don’t know when that’s going to happen, but in present value, it gets you to about zero.

To a second approximation, I would think that with $8 trillion of net external liabilities in the United States right now though we might even eventually have to repay those or repay at least the interest on those, that’s more than 40% of our GDP right now which is we're an unusual country so we can do unusual things. But it happens to be an unusually large one that we should be a little bit worried about if that reversed itself over an infinite amount of time that means we’d have to pay an extra 0.3% of GDP back in terms of a trade surplus to pay this money back. So, border adjustment over that horizon would lose money.

What that says is while it's balanced in a 10-year window on an infinite horizon basis, it's lowering revenues by about half a percent of GDP. I want to put that in context for you. There's been an awful lot of ink spilled on social security and its long run imbalances. Those are a little bit more than a percentage point of GDP. So, if you're worried about social

security's long running balance, you should be sort of half as worried about the impact this would have on our long run fiscal future. This is the Peterson part of my talk.

Another way is that the CBO estimates the fiscal gap at about 2% of GDP so this would make our long run fiscal problem about 25% worse than it is today.

This scares me a decent amount because it's sort of less obvious what's going to correct this. A lot of the impact on this industry and that industry and another things. There's a set of voices for them. The set of voices looking at the effects outside the budget window aren't always quite as strong as say the oil refiners.

The last thing is at the end of the day, this really all comes down to what the impact is on households. I wish I could present you with a confident answer to that, but I think it's really complicated and you want to know a few different things. You want to know the direct incidence of the taxes. You want to know how it's going to affect the economy and affect before tax incomes. You want to know how it's going to affect labor lease or other things, savings. I should've put it on this list which has an impact on welfare.

And then if the tax cut isn't paid for when it's first passed, it doesn't mean it's never going to be paid for, it just means we don't know how it's eventually going to be paid for and a lot of the impacts on households are going to depend not on what Congress passes this year, but what happens later. Do social security get cut more to make up for it or do taxes on high income households go up more to make up for it? And the incidence depends very much on that.

All of these are very difficult and depend on the plan as a whole. You never want to take a big complicated tax change and look at the distributional impact of one piece of it. You'd want to look at the plan as a whole.

There's the set of problems associated with this, which you have in the issue brief today and have been talked about. There's another set of tax policy perspectives that what you see here is basically a shift of taxation away from the normal return of capital and towards a super normal return, rents and all of that that are captured by this. That's actually in some ways more progressive than the current corporate tax system and I'm happy to talk much more about all of these if there's any interest, but it's complicated is certainly fair for this.

If the proposal was a net present value tax reduction, my own personal feeling is that the incidence of how that deficit increase was eventually financed and repaid would swamp any of the distributional tables that we'd look at the day the tax plan is passed and that they would largely be adverse.

And then the final thing I'd say is that the entire theory behind a cash flow destination based tax system is that you don't want to tax the normal return to capital because that distorts people's intertemporal consumption choices, reduces savings, and hurts the economy.

But, you do want to continue to tax the supernormal returns. The returns you get from for example your monopoly power that you could get through things like rents on your brands or oligopoly or whatever else.

So, I can't for the life of me, understand why you would be combining this type of change with the dramatic reduction in the tax rate at the same time because that dramatic reduction in the tax rate itself would be more regressive than reducing the corporate tax rate in the normal setting where it applies to a blend of normal and supernormal returns.

Here, it would only be giving a windfall for investment that was made in the past for monopoly power and for luck, three things that don't need larger subsidies than they already get today.

I'll conclude with an agreement with where Doug [inaudible 0:40:05] started us out. I think the business tax system is really in need of reform. I think it's really possible to do it in a way that is genuinely revenue neutral over the short run and the long run. It gets possible to have an international system that either raises more revenue than the current system with the same distortions or raises the same revenue with fewer distortions or some combination of the both.

But I don't think you can even start to have that conversation unless you have as its premise that you're not going to make our corporate tax problem better by making our deficit problem or our distributional problem worse.

If you're willing to start from the premise that you're not going to make those two worse, then I think there's all sorts of really important and timely conversations to be had.

If you're not willing to stipulate those two then I don't see any hope to come up with something that at least I would think was a good economic policy. Thank you.

[Transcription ended at 0:41:19]