Session 8. Policy Keynote Address

*By Senator Orrin G. Hatch**

Senator Orrin G. Hatch discusses the taxation of intangibles, principles of tax reform, and much more in the Keynote Address at TCPI's 14th Annual Tax Policy and Practice Symposium.

Introduction

SEN. HATCH: Thank you so much. I want to thank the Tax Council Policy Institute for inviting me here to speak with you today and for hosting this event. In an ever-more global and knowledge-based economy, a symposium dedicated to the taxation of intangible property and investments couldn't be more timely.

Standing here in front of such a thoughtful group of tax professionals, I feel compelled to note that this month marks the 100th Anniversary of the 16th Amendment to the Constitution. The 16th Amendment, as you know, authorized Congress to levy the individual income tax. Today, it's hard to imagine the American people rallying behind an effort to put the income tax into the Constitution. At the same time, it's hard to imagine America over the last 100 years without it. Whatever the case, surely the proponents of the 16th Amendment had no idea of how complicated the income tax would become. And, they certainly had no idea that so much intellectual firepower would ever gather together in one ballroom to discuss just one aspect of the income tax. It's a stark lesson in the law of unintended consequences.

So, this conference is focused on the taxation of intangible assets such as intellectual property, brands, business processes and the like. As you all well understand, those assets have become increasingly important in the global economy, and will remain important drivers of U.S. job growth and competitiveness.

Changing Nature of What America Produces

When the Ford Motor Company evolved from an idea of an assembly line technique of mass production into a global powerhouse of automobile manufacturing, you could see its growth by looking at the auto plants springing up.

By contrast, when Microsoft evolved from the ideas of a Harvard dropout and his friends to a global software powerhouse, you could see some buildings, but most of the intellectual and organizational capital was hard to see, touch or measure. And let me be clear: I greatly admire and respect Bill Gates.

The changing nature of what America produces and the investments that companies make requires careful attention in order for us to understand how the economy works and to ensure that policymakers do not impose roadblocks to economic growth.

Over much of the post-World War II period, you could tell how well the economy was doing by looking at labor productivity, or by measuring output per unit of labor input. For most of that time, economic output and labor productivity moved closely together. However, since the mid-1980s, there has been a weaker correlation between the two.

Recent research, including some by Nobel Prize winning economist Edward Prescott, suggests that the puzzling recent divergence between economic output and labor productivity can be explained

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once you account for investments in what they call intangible capital.

Intangible investments are not like the new buildings and equipment that show up on official accounts of economic output that adds to our GDP. Rather, they are assets that you may not be able to touch or easily measure, such as research and development, marketing, and worker training. These assets add value to a company, but usually are recorded as business expenses rather than capital investments.

Research by Prescott and his colleagues suggest that once you properly measure and account for intangible investments, it becomes easier to account for some of the ups and downs of GDP over the past couple of decades.

Taxation of Highly Mobile Assets

That, of course, means that policymakers should not only pay attention to the possible importance of intangible investments, but also must pay attention to how fiscal policies like the tax code affect such activities.

Sadly, while other countries have developed policies to attract intangible investment activities in their jurisdictions, the U.S. has lagged behind.

Now, I know you all are very knowledgeable about this stuff, but I think I am right in saying that one of the main problems with regard to the taxation of intangible assets is that they are highly mobile. In the modern era, a company can transport its intellectual property from Salt Lake to Dublin instantaneously. Other intangible assets such as brand names can be transported across the world by simply signing a few documents. While the importance of intangible assets has increased dramatically over the last few decades, the taxation of highly mobile assets has long been a challenge.

Indeed, the problem was recognized in the 19th Century when some argued that highly mobile assets simply shouldn't be taxed at all and that governments should raise revenues by only taxing immobile assets.

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Immobile assets, by definition, can't be moved to another jurisdiction to escape higher taxes. Highly mobile assets, on the other hand, can be moved with relative ease when taxes, regulations, and other government actions place burdens on the use and commercialization of those assets.

In recognizing this concept, most have concluded that reducing the tax burden on highly mobile assets—and particularly intangible assets—both encourages innovation and prevents the assets from being moved to other, more innovation-friendly jurisdictions. Surely, that explains the interest we see in various patent box proposals.

The U.S. is a worldwide leader in innovation. Intellectual property drives roughly 40 percent of the U.S. economy and accounts for more than half of our nation's exports. This is all true no thanks to our tax code which, as I said before, lags behind much of the world in promoting the development and utilization of intangible assets. I don't think anyone can say that our current tax system has kept up with global developments, including the growing importance of research and development and other intangible investments.

We have the unpleasant distinction of leading the world with the highest corporate tax rate. And our hodge-podge of targeted incentives can hardly be thought of as a well-designed or coherent policy toward innovation. I have been an outspoken supporter of tax policies designed to foster innovation and protect intangible assets from over-taxation.

For example, most of you probably know that I am a big proponent of the research and development tax credit. For years, I have worked alongside Finance Committee Chairman Max Baucus to expand and make it permanent and will continue to do so.

Too often, our tax code encourages American inventors and innovators to do more and more of their business elsewhere. I have supported a strong and permanent R&D tax credit because I believe that our tax code should be designed to keep U.S. innovation—and the growth and jobs that come with it—in the U.S. But, as I'm sure other speakers at this conference have noted, we can't limit our efforts to the R&D tax credit.

Tax Reform in the Current Congress

There are other challenges, including valuation and transfer issues associated with intangibles. The prospect of tax reform could allow us to confront these and other issues head on. Now, I know most of you are probably wondering about the prospects for tax reform in the current Congress. I'd like to take some time to share my views on the subject.

Once again, our income tax system is now 100 years old. Although it has been amended many, many times over the last century, I believe—and I think you'd agree—it is time for a fresh start. It has been 26 years since the last overhaul of the U.S. tax code. Since then, the code has only grown less fair, less efficient and more complex. Before we can engage in a substantive discussion about tax reform, there are two threshold matters that need to be agreed upon.

What Is Tax Reform and What Isn't?

For one thing, we need to define what tax reform is and what it isn't. From my perspective—and I believe the perspective of most of you in this room—tax reform should focus on eliminating tax preferences and deductions in order to lower tax rates. While, practically and politically speaking, this will be a difficult process, the concept is relatively straightforward.

But, there are some who have tried to redefine what we mean by tax reform. The President and others have argued in favor of simply eliminating certain tax loopholes in order to generate revenue either for deficit reduction or, far more likely, to pay for additional spending. We heard this the other night during the State of the Union. President Obama stated his support for "comprehensive tax reform." But, if you listened carefully, he made no mention of lowering tax rates. He talked about simplicity and paid lip service to economic growth. But, more than anything, he argued that we should eliminate loopholes and deductions in order to raise more revenue.

While he and others may want to call these proposals tax reform, they are nothing more than tax hikes. If anything, they would make real tax reform more difficult in the future because, if you eliminate tax preferences now in order to raise revenue, they won't be there to help lower the rates later on.

Tax Reform Should Be Comprehensive

In addition to agreeing upon the proper definition of tax reform, we need to agree that the process should be comprehensive—that is, we need both individual and corporate tax reform. In recent months, the President and many in his party have argued that we should just focus on corporate tax reform. However, given the interrelationship between the corporate tax and the individual tax, I don't know how we can reform one of those systems while ignoring the other. For example, can the decision on where to set the corporate tax rate be made without considering the tax rate for dividends and capital gains? I don't think so. In addition, if we eliminate certain business tax expenditures to lower the corporate tax rate without also lowering individual rates, pass-through entities, which represent a significant amount of our nation's business income and include many small businesses, will see their tax burdens go up. In short, though it may be a heavier political lift, we need to reform the tax system in its entirety.

Principles Guiding Tax Reform

With those threshold matters in mind, there are a handful of principles that I believe should guide our tax reform efforts.

Promoting Economic Growth and Improving America's Competitiveness

First, tax reform should be aimed at promoting economic growth and improving America's competitiveness. If done correctly, tax reform would reduce the number of economic distortions in our current tax system and eliminate impediments to growth and job creation. As I mentioned, we have the highest corporate tax rate in the developed world. This is a drag on American competitiveness and puts American companies at a disadvantage in the world marketplace. One of the primary goals of tax reform should be to reduce that to a level that will give American companies a fighting chance in the international arena. Doing so will also spur entrepreneurial activity and the economic growth that so often accompanies it.

In addition, thanks to our worldwide taxation system, American companies with operations overseas are penalized when they repatriate foreign earnings to the U.S. We need to establish a territorial tax system to place American companies on equal footing with their foreign competitors when they do business outside the U.S.

While this seems like common sense, this view is not shared by everyone. Some people, in an effort to prevent highly mobile and intangible assets from escaping the U.S. tax net, have proposed making the current U.S. worldwide tax system stronger. They propose taking our current system of worldwide taxation with deferral and abolishing deferral. That way, they argue, there would be no incentive to move assets out of the country—the tax burden would be the same either way.

However, what these proponents of a pure worldwide regime with no deferral fail to recognize is that U.S. businesses can easily incorporate outside of the United States. Incorporating outside of the U.S. can be just as easy as migrating one's intangible assets elsewhere. This would allow businesses to escape the U.S. tax net even with a new, stronger worldwide taxation system in place.

Some have also proposed that we treat businesses incorporated outside the U.S. as still being U.S. corporations if they are managed and controlled here. But, that doesn't really help either. Corporate officers and managers can migrate outside the U.S. with relative ease. Or, in the alternative, companies can just start hiring their managers from other countries, which is something we don't want to encourage.

So, the answer is clear, if we want to promote economic growth and help our businesses compete, we need to leave our worldwide taxation system behind.

So, the answer is clear, if we want to promote economic growth and help our businesses compete, we need to leave our worldwide taxation system behind. Any attempt to fix these problems by strengthening our worldwide tax net would fail to solve the problem. If we can lower the corporate tax rate and transition to a territorial tax regime, we'll retain business in the U.S., provide for more American exports to global markets, and encourage businesses to reinvest capital in here rather than abroad.

Fairness and Simplicity

Second, we need to focus on fairness and simplicity. The income tax base has become riddled with exemptions, exclusions, deductions, and credits. The tax base should be broadened as much as possible so that we can lower and flatten the tax rates.

I don't have to tell any of you how complex the U.S. tax code has become. Like I said earlier, this year marks the 100th birthday of our tax code. Over the last century, it has grown to almost four million words. There have been nearly 5,000 changes to the tax code in the last decade alone. All told, American taxpayers spend about $168 billion a year just to comply with the tax laws. Put simply, reducing the number of tax expenditures and lowering the rates will result in a fairer and simpler tax code.

Revenue Neutral

Third, tax reform should be revenue neutral. Should we begin this process in earnest, there will be a temptation to use the term "tax reform," to chase a revenue-raising goal, rather than goals of efficiency, fairness, and economic growth. As I mentioned earlier, there are many on the other side who already want that to be the focus of our tax reform efforts. We should avoid such temptation.

Over the last 40 years, federal revenues as a percentage of GDP have averaged just under 18 percent. While our economic troubles have caused that percentage to drop over the last few years, most projections put revenues at 18.5 percent of GDP by 2015 and even more beyond that time. In other words, revenues are already set to return to levels that are above the historical average. So, it is not necessary that we use tax reform as a means to go after additional revenues.

Furthermore, during the recent presidential campaign and in the debate over the so-called fiscal cliff, America had a national debate about tax rates and revenue. At the end of that debate, Congress passed a bill that, when all is said and done, will raise more than $600 billion over the next 10 years. Now, from my perspective—and, I believe, the perspective of most in my party—the debate about tax revenues and our baseline for revenue-neutral tax reform has been established.

Tax Code Certainty

Fourth, tax reform should bring more permanence and certainty to the tax code. So many provisions—

like the R&D tax credit, for example—expire every few years, forcing Congress into a continual debate over which provisions to renew and which ones to let expire. Individuals and businesses should be able to rely on and plan around the provisions of our tax code without wondering whether they're going to change the next year. This lack of certainty is an impediment to job growth at a time when unemployment is unacceptably high. Tax reform, when it is finished, should be permanent to allow families and businesses to plan for the future.

Incentives for Savings and Investment

Finally, tax reform should provide incentives for savings and investment. Many aspects of the current U.S. tax code discourage individuals from saving and investing. This hinders long-term growth and economic stability. And it is unfair to future generations for the federal government to engage in outsized borrowing from the future in order to fund current government consumption.

Reforms should be aimed at providing a system that is more favorable to savings and capital investment than our current tax system. Those are the things that lead to increased standards of living in the future. Now, I know these are broad concepts and that I'm only giving you a 35,000-foot view of what we want to accomplish with tax reform. I'm not limiting the discussion so I can keep my powder dry. This is simply where we're at in the tax reform discussion.

I'm not under any illusions that this process is going to be easy. This will be a difficult task, politically speaking. As you undoubtedly know, many of the largest tax expenditures also happen to be the most popular. Eliminating popular tax preferences will be difficult, but we need to make the case to the American people that they'll be better off with lower rates and fewer deductions. It won't be accomplished without compromise from people on both sides of the aisle. I'm willing to work with anyone, Republican or Democrat, to get tax reform done.

Despite some differences in our tax reform goals, I believe there is real bipartisan momentum to get something done this year. And, I'm hopeful that, in the coming months, as we debate our nation's fiscal future, we can provide a path toward meaningful reforms.

Concluding Thoughts

Of course, the tax reform debate is only part of the larger discussion about our nation's current fiscal predicament. While tax reform is a vital part of the effort to put our nation on sound economic footing, I believe it is equally vital that we get federal spending under control. And don't let anyone try to fool you into believing that the federal government is almost done with what is needed to ensure fiscal sustainability.

Anyone who takes a careful look at our federal finances should be very nervous. We have had four consecutive years with trillion-dollar deficits, which is unprecedented. The debt limit alone, over the last four years, has been increased by over $5 trillion, or an average well over $1 trillion a year. And debt is projected to grow in an unsustainable way over the longer-run by objective, nonpartisan analysts like the Congressional Budget Office.

Anyone who seriously looks at the causes of our unsustainable fiscal path knows that runaway and unbridled entitlement spending is our main problem. Absent reforms to our major entitlement programs—Medicare, Medicaid and Social Security—our deficits and debt will continue to be unsustainable.

Over the next 10 years, the federal government will spend $12 trillion on Medicare and Medicaid alone. That's $12 trillion on just two programs. That's more of the entire economies of Germany, France, the UK, Italy, and Spain combined. By 2035, if nothing is done to slow the rate of growth in these two programs, they will consume roughly 10 percent of our entire economy. And, that's just Medicare and Medicaid. We also need to worry about Social Security. Over the long-run, Social Security has nearly $21 trillion in unfunded liabilities.

That's $21 trillion in promises made by Social Security that cannot be honored without changes to the existing structure of the system. That includes promises made to younger generations of workers that cannot be kept if we do not reform Social Security.

Some of my colleagues argue that we don't need to do anything to Social Security. They couldn't be more wrong. Now, I don't want to delve too far into the debate over federal spending and entitlement reform because I know that it is not the focus of your conference. I just believe that it's difficult to talk about tax reform without at least mentioning the other major elements of the fiscal equation.

Let me just say this. Intangible investments that many of you in this room make are what will help provide growth in jobs our economy. While some may call them investments, new and expansive federal spending programs are not, in my view, the path to a vibrant, dynamic, and growing private sector.

I hope to work to enhance your efforts, and one of the best ways to do that is to ensure that you, rather than the federal government, are rewarded for your work, investment, and productivity. Ultimately, that will mean pro-growth tax policies which, as this symposium recognizes, need to include policies that promote private investment in the growing stock of intangible capital.

Thank you, once again, for having me here today. God bless you all.

Endnotes

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