Corporate Finance: The Emerging Agenda

This is a final draft with citations of a presentation made by Jessica Einhorn, Senior Adviser at Rock Creek, on October 9, 2015.

President Obama's track record on economic growth is still unfolding as he enters the final year of his presidency. Regardless of how the U.S. growth story plays out for the remainder of this year and in 2016, initial negative GDP data released for the first quarter of 2015 brought to the fore a major campaign issue around the role of taxes in economic policy.

Despite looking at the same data, Democrats tend to favor increasing taxes while Republicans favor tax reductions. Democrats argue that tax increases offer solutions to decreasing income inequality and raising revenue for government interventions to alleviate unemployment and poverty, as well as for enhancing productivity through government-sponsored research and development. Republicans' argue that the opposite solution of reducing taxes is the right way to lift all boats, make the pie larger for more revenue, and enhance productivity through market-based research and development supported by tax exemptions or credits. Within this broader political argument, debates on corporate taxes and taxes on wealth earned by investors in corporate shares can be particularly vitriolic.

Corporations are easily vilified as nameless, faceless and unpatriotic "citizens" of the world. When high corporate taxes spur headquarter relocation to lower taxed locales, tax policies can chase corporations with double taxation by removing the exemption for foreign-earned and taxed income. The chicken and egg nature of that debate raises the temperature on both sides. With investment policy increasingly being absorbed into trade agreements, differences of opinion over corporate taxes find another route to acrimony by being absorbed into the debate over so-called free trade.

Corporate finances are another area of contention for investors. After decades of an almost singular focus on the share price as a metric of success, the public company is being called upon to broaden its agenda and focus on longer-term trends and a broader group of stakeholders.

Taxes and measures to increase the share price are about allocating profits. Yet profits are the tip of an iceberg whose depth and stability rest on increases in productivity. Recent numbers on productivity growth are disturbing.

In my discussion today, I review recent opinions and research on these related topics, with the purpose of clarifying the fiduciary duties of a public corporation. Winds are blowing in a new direction and we should harness that energy.

2015: President Obama and corporates tangle over taxes

The question of whether or not we should tax corporations and/or their investors in shares is a matter of economic policy in the United States. With tax reform likely to be a major initiative for a new Congress in 2017, both President Obama and leading legislators have staked out their positions for the future. In this early round, President Obama's focus has been on fighting back against a corporate strategy that seeks to lower taxes through a practice called *inversion*. Inversion entails an international company attempting to decrease its tax rate by relocating its headquarters to a place with lower taxes. This is accomplished through transactions where a U.S. company merges with a foreign company (which can be a subsidiary) and locates the parent company abroad to reduce taxes.

On September 22, 2014, the Obama administration cracked down on companies that tried to evade the high U.S. tax rate by shifting their headquarters to another locale. The Obama administration announced revisions to five chapters of the tax code to reduce the benefits of reincorporating with a foreign company in order to move the effective tax to a different location. The specific targeted strategies involved intra-company lending and ownership levels of control.[1]

Gene Sperling, former director of President Obama's National Economic Council, published an op-ed in the Wall Street Journal[2] on October 9, 2014 arguing that Republicans and Democrats had much in common regarding corporate tax. It was an advocate's viewpoint but it looked for areas where legislative compromises could be struck in the wake of the president's upcoming proposals.

In his State of the Union address in January 2015, President Obama put corporate tax on the agenda with a proposal that would introduce extraterritoriality to U.S. taxation of corporate income. The administration's proposals used carrots and sticks to induce U.S. corporations to repatriate profits being held abroad for the purpose of avoiding high corporate rates in the U.S. While the president's specific proposals would not find favor with a Republican-controlled Congress, there was substantial bipartisan support for reforming the corporate area of U.S. tax law. For Republicans (and some Democrats), the initiative was a baby step toward more fundamental tax reform. That broader debate now awaits the election results of 2016.

[1] U.S Department of Treasury, Treasury Fact Sheet: Treasury Actions to Rein in Corporate Tax Inversions, September 22, 2014, http://www.treasury.gov/press-center/press-releases/Pages/jl2645.aspx

[2] Sperling, Gene. "Believe It or Not, Corporate Tax Reform is Doable in 2015," Wall Street Journal, October 8, 2014, http://www.wsj.com/articles/gene-sperling-believe-it-or-not-corporate-tax-reform-is-doable-in-2015-1412808733

On January 15, 2015, the Senate Finance Committee set up a working group with a view to negotiating a possible overhaul of business taxes.[3] Democratic Senator Ben Cardin and Republican Senator John Thune proposed introducing a tax on consumption in the form of a VAT to raise revenue that would allow business taxes to be lowered and abolish the income tax on lower income groups. They wrote, "Enactment of a broad-based federal consumption tax would align the U.S. with a global trend." Others, such as Chairman Dave Camp (R, MI), proposed lowering rates for businesses and individuals by getting rid of deductions such as the mortgage interest deduction. This is not a likely strategy for politicians seeking reelection but clarifying in its simplicity. In July 2015, Senators Charles Schumer (D, NY) and Rob Portman (R, Ohio), co-chairmen of the Senate's working group on the international tax system, joined the fray with a proposal for a one-time tax on profits held overseas by multinationals. The tax would be at a reduced rate from the statutory 35% and would be used to fund aging infrastructure. It marked a growing consensus to do *something* on business taxes in the framework of broader reform.

By spring 2015, the financial press was reporting on the "perverse" effect of this cat-and-mouse tax regime, which was resulting in a "sharp increase in foreign takeovers of American groups."[4] An op-ed in the Wall Street Journal by a former chief economist at the Commerce Department explained that the benefits of tax inversion were so great that foreign groups were now buying companies. The combination of the high tax rate and the extraterritoriality had led to a doubling of foreign acquisitions "to $275 billion between 2013 and 2014."[5] The U.S. was in need of tax reform. The major elements would include reducing the rate while broadening the base, taxing only income earned in the U.S., and incentives for research and development.

The benefits of inversion proved hard to ignore. Even the most patriotic CEOs find the divergence in rates a business opportunity that begs for action. Jim Koch, CEO of the Boston Beer Company, told a Senate committee that his company is "worth more to a foreign company unburdened by the U.S. tax structure."[6] He noted that despite Treasury's new obstacles, inversion is still attractive. A dollar of pretax earnings, he says, is "worth 62 cents to his company [under U.S. ownership] versus 72 cents under foreign ownership." The caption running under Jim Koch's photo quotes him as saying, "Because of our broken corporate tax system, I can honestly predict that I will likely be the last American owner of Boston Beer Company." Koch is

[3] U.S. Senate Committee on Finance, press release, Hatch, Wyden Launch Bipartisan Finance Committee Tax Reform Working Groups, January 15, 2015, http://www.finance.senate.gov/newsroom/chairman/release/?id=2ea8c8e5-c892-4230-9d1a-db7522a920be

[4] "Tax inversion curb turns tables on US," Financial Times, March 16, 2015, http://www.ft.com/intl/cms/s/0/e1ba6eb0-ca5c-11e4-b8ff-00144feab7de.html#axzz3nS4SUw4O

[5] Kennedy, Joe. "Behind the foreign shopping spree for U.S. Companies," Wall Street Journal, July 1, 2015, http://www.wsj.com/articles/SB11760718815427544683404581068100290305890

[6] "Will Sam Adams go from Patriot to Expatriate?," Cape Cod Times, August 1, 2015, http://www.capecodtimes.com/article/20150801/NEWS/150809961

actually saddened by the business advantage and, as the controlling shareholder, he remains a U.S. company at substantial cost to himself.

The summer put new nails in the coffins of President Obama's proposals as major companies sealed deals. Coca-Cola bottlers in Europe (CCE) formed a large distributor in the UK in order to avoid repatriating large cash holdings there. Fertilizer manufacturer CF Industries acquired assets from a Dutch rival (OCI). As the FT reported, "both will create UK-based companies in so-called tax inversion deals, highlighting corporate America's desire to move its tax bases overseas."[7] The tally of inversion deals has only continued to grow.

Discussing the same deals in the Wall Street Journal[8], Liz Hoffman noted that these CEOs deny that the decisions are tax-driven. Coca-Cola says that its deal is strategic and CF Industries argues that is has crossed a threshold that prevents it from using $900 million in cash "stranded abroad." The CCE deal keeps CCE's ownership stake under the magic level of 60%, which permits access to the cash by moving the subsidiaries outside of the U.S. "umbrella." CF Industries also manages inversions for tax reasons but with too high a stake to be eligible to use its overseas cash tax-free.

Warren Buffett had to devise a different approach because Berkshire Hathaway does not have foreign subsidiaries. In March 2015, Buffett revealed in his annual report that Berkshire Hathaway has been able to defer $61.9 billion of corporate tax, thereby allowing those deferred taxes to be reinvested and earn profits.[9] The tax code encourages capital investment in sectors such as energy and infrastructure by the way it treats depreciation of assets, and those incentives were expanded in the wake of the financial crisis. Buffett described these deferral arrangements as an "interest-free loan from the government." The incentives allow a conglomerate to exit one investment in favor of another more profitable opportunity through unusual "asset swap deals."

Historical review: U.S. corporate tax policy

For a comprehensive and wonderfully readable history of taxation in the U.S., I heartily recommend Steven R. Weisman's book, The Great Tax Wars, published in 2002. For the purpose of this discussion, we begin with the legal basis for corporate taxes contained in the Sixteenth Amendment of the U.S. Constitution, adopted in 1913, which allowed the government to levy an

[7] "Deals challenge US inversions clampdown," Financial Times, August 6, 2015, http://www.ft.com/intl/cms/s/0/414ac240-3c58-11e5-8613-07d16aad2152.html

[8] Hoffmann, Liz. "Tale of Two Inversions: CCE, CF Industries Offer Study in Contrasts," Wall Street Journal, August 7, 2015, http://blogs.wsj.com/moneybeat/tag/inversions/

[9] Foley, Stephen. "The $62bn secret of Warren Buffett's success," Financial Times, March 4, 2015, http://www.ft.com/intl/cms/s/2/9c690e44-c1d2-11e4-abb3-00144feab7de.html#slide0

income tax without apportioning it among the states or basing it on a national census (as was required in the original Constitution). Corporate tax rates are found in Title 26 of the Internal Revenue Code. The present rate of tax derives from the major Tax Reform Act of 1986, a moment of successful reform, which we have not managed to emulate in the decades since. This is the benchmark reform effort, which should stand as a model for Republican ambitions in a new administration.

According to the tax foundation, U.S. corporations face the highest corporate income tax rate in the world at 39.1%. This number is calculated by taking the base of 35% federal tax rate and adding the average rate levied by states.[10] While the burden of state-level taxes is reduced by their deductibility from federal taxes, a layer of complexity and further inefficiency are added as corporations determine their headquartering within our national borders. The variability of outcomes is greatly affected by itemized tinkering and revisions. For example, at the federal level, the average corporate tax rate in 2011 declined to just over 12% (the lowest since before World War I) largely due to the lingering effects of the great recession and a bonus depreciation tax break.

KPMG provides information through 2015 on corporate tax rates in all countries[11]. In North America, the average corporate tax rate is 33.25%, brought down by Canada at 26.5% and Mexico at 30%. The average tax rate in the European Union was 22.15%, and for the OECD it is 24.77%.

According to the Tax Policy Center (a joint initiative of Brookings and the Urban Institute), the amount of revenue from corporate taxes has fluctuated substantially if we look at just the period since 2008, from a low of $138.2 billion in 2009 to a high of $320.7 billion in 2014. Estimates for 2015 come within shooting distance of the 2007 record level of $370.2 billion. In March, the Center for Budget and Policy Priorities estimated that corporate tax contributes 11% to the federal budget. So corporate taxes are far from trivial for raising revenue.

Taxes in the U.S. are not just about raising revenue. The battles are ideological as well as policy-oriented. A higher corporate rate may appeal to an electorate that sees rich CEOs with gigantic pay packages. Taxing dividends and capital gains has enormous populist appeal to millions of Americans who have insubstantial savings or wealth. For economists, however, corporate taxes are the most detrimental tax for growth and a spur to relocation.[12]

[10] Pomerleau, Kyle. "The U.S. Has the Highest Corporate Income Tax Rate in the OECD," Tax Foundation, January 27, 2014, http://taxfoundation.org/blog/us-has-highest-corporate-income-tax-rate-oecd
[11] KPMG, Corporate Tax Rates Table, https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html
[12] Graetz, Michael J. "The Bipartisan 'Inversion' Invasion," Wall Street Journal, September 25, 2014, http://www.wsj.com/articles/michael-j-graetz-the-bipartisan-inversion-evasion-1411687141

The campaign issue for 2017

In July, the issue of corporate taxes made headlines due to activity in Congress and a prominent mention in a speech made by Hillary Clinton on July 21, 2015.

In mid-July, senators Rob Portman (Republican, Ohio) and Chuck Schumer (Democrat, New York) agreed on a bipartisan initiative to link corporate tax reform with increased infrastructure funding. This was their response to the combined federal/state tax rate of 39.1%, 14.5% higher than the average across 34 OECD countries. Moreover, many competitor countries have cut their corporate taxes since 2000. As noted above, U.S. corporations are building up cash balances abroad, which they cannot bring home to spur investment because of the high tax that would be collected. So Portman and Schumer proposed levying a one time "deemed repatriation" that would fund much-needed highway investments in the US. Under the proposal, Treasury would simply declare that money parked overseas incurs a U.S tax liability whether or not it is returned home, but at a lower rate. While Republican supporters of tax reform would much prefer a clean overall tax bill, the compromise even won the support of the Wall Street Journal's editors because damage from the current rate is so severe as to require an immediate remedy.[13]

Neera Tanden and Blaire Effron of the Center for American Progress released their own proposal in a paper published June 30, 2015, How to Foster Long-Term Innovation Investment.[14] The authors noted that economic theory is premised on long-term investments but that horizon is tough for CEOs to implement in the face of activist investors who look for short-term spikes in share prices. They argue that "a policy agenda that takes steps to incentivize business research and development, rethink patent law, and systematically support investment in employees—and then encourages investors to take advantage of these initiatives by shifting tax policy to reward long term investment—would make longer term investments more attractive."

Hillary Clinton then made the issue one of her own for the 2016 election, calling for an end to "short-termism" in corporate behavior. In Clinton's proposal, corporate tax rates on investors would be subject to a sliding scale of three different rates depending on how long the investment is held. Investments held less than a year would be subject to a full income tax, which tops out at 39.6% for high earners, who are also subject to the 4.5% surcharge on capital gains under the Affordable Care Act. Held medium-term, the rates would drop to 36%.

[13] " A Tax Reform for Highways Trade?," Wall Street Journal, July 13, 2015, http://www.wsj.com/articles/a-tax-reform-for-highways-trade-1436741561

[14] Effron, Blaire and Tanden, Neera. "How to Foster Long-Term Innovation Investment," Center for American Progress, June 30, 2015, https://www.americanprogress.org/issues/economy/report/2015/06/30/116294/how-to-foster-long-term-innovation-investment/

Thereafter, the statutory rate would decline by four percentage points per year until reaching the current long-term rate of 20% at six years.

In press commentary, it was noted that Hillary Clinton's proposal was crafted to tax the rich and leave the rest.[15] The proposal excludes investments in IRAs and, of course, tax-exempt institutions such as pension funds. Reportedly, less than half of investments are held in taxable accounts. Congress has altered the top rate or other provisions for individuals 20 times since the income tax was introduced in 1931. The idea that wealthy investors would change their behavior due to the new tax and, through that pressure, bring about corporate long-term investments, is unpersuasive. It is a wealth tax, pure and simple.

Edward Luce of the Financial Times[16] declared the proposal a bold idea to take on economic short-termism. He describes the problem well: The level of investment is at its lowest since 1947; for every dollar a public company invests, it is returning $8 to $9 to shareholders; healthy profits and low cost of capital makes this poor timing; betting on 2% growth is a self-fulfilling prophesy. However, Luce concludes by saying that this strategy will fail for lack of impact so long as CEO pay is linked to share price.

Rewarding a long term view

The allocation of profits has been a favorite topic for activist investors and corporate governance gurus (emanating from research by business school faculty), who seek to influence corporate boards and management. For a long time, the mantra was to align corporate management with shareholder interests by insisting on simplistic links between executive remuneration and the level of the share price increase over some current period. The fact that this meant executive pay would rise when the stock market was at its frothiest was mostly ignored. There was little appreciation of the role of beta in share-price-based remuneration. For three decades, the "market fundamentalists" held the field uncontested. The result was aggressive campaigns to "encourage" share buybacks to reduce the number of shares, which are divided in the price or earnings per share ratios. To a much lesser extent, this also put emphasis on dividend growth. In either case, the shareholders are earning higher returns.

[15] "Checking Clinton's Capital Gains Tax." Wall Street Journal, July 27, 2015, http://www.wsj.com/articles/what-would-clintons-capital-gains-tax-mean-for-you-1437761670
[16] Luce, Edward. "Hillary's war on quarterly capitalism," Financial Times, July 26, 2015, http://www.ft.com/intl/cms/s/0/0cb6c12a-321a-11e5-8873-775ba7c2ea3d.html#axzz3nSEfGtBz

Recently, there has been a more thoughtful and longer-term view of building shareholder value. An excellent example is an op-ed in the Financial Times[17] by thoughtful business professor John Kay. The column was titled "Good corporations should drive the economy." I like this excerpt:

> "The profit-making corporation is, should be and will remain the central institution of the modern economy. But that does not mean the purpose of a profit-making corporation is to make a profit; we must breathe to live but breathing is not the purpose of life. The purpose of a corporation is to produce goods and services to meet economic and social needs, to create satisfying and rewarding employment, to earn returns for its shareholders and other investors and, to make a positive contribution to the social and physical environment in which it operates."

This is a breathtaking expansion of the purposes for which a corporation should strive, after decades during which share price encapsulated the sum total of shareholder value. If accepted, this broad set of goals would set off a revolution in many boardrooms in 2015. The change in view is attuned to a new social environment, which arose as the "go-go" economy disappeared further into history and a new generation of investors and managers attained senior status. Raiding the vaults to get more cash is no longer fashionable. Other longer-term approaches are being examined.

The recent backlash against the short-term outlook of activist investors who press for using profits to buy back shares is giving rise to a set of proposals that seek to use tax mechanisms to incentivize corporations and investors to take a longer-term view.

In the background of this debate is the puzzle of why rates of growth in productivity appear to be declining. As Alan Blinder explained in the fall of 2014[18], productivity levels move in long cycles. The "Golden Age" came after World War II, in which we averaged 2.8% per annum. From 1973-1995, it was half that. Then, in 1995, we had an upswing over a 15-year period. Four years is too short a time to mark a change but this decade has seen productivity growth plummet to only 0.7%. If we revert to a very long-term average of 2.3%, potential GDP would grow at 2.5% per annum. At 0.7%, potential GDP will grow at less than 1% a year. This is a huge loss in growth.

By the summer of 2015, the "productivity puzzle" was no better explained, but it was getting a lot of attention. As numbers for the first two quarters were finalized, the Wall Street Journal reported that economists and policy makers "on both sides of the Atlantic point to lackluster

[17] Kay, John. "Good corporations should drive the economy," Financial Times, May 12, 2015, http://www.ft.com/intl/cms/s/0/06f681ca-f887-11e4-be00-00144feab7de.html#axzz3nSEfGtBz

[18] Blinder, Alan. "The Unsettling Mystery of Productivity," Wall Street Journal, November 24, 2014, http://www.wsj.com/articles/alan-blinder-the-unsettling-mystery-of-productivity-1416873038

long term investment to explain paltry productivity gains and meek economic growth."[19] In mid-July, the White House budget mid-session review cut the growth forecast for 2015 to 2%.

Productivity is key to growth but it is also devilishly complicated to measure as we move from a manufacturing economy to the digital age. If software reduces the need for capital investments, displacing them with intangible investments like research and skills training and patents, our measurements will overlook at least part of the explanation. Cloud computing that is outsourced displaces desktop computers, which cuts capital investment but increases highly important data usability. The puzzle is why increased efficiency in production and innovation do not show up in current productivity numbers. "The future could be brighter than thought—and productivity higher than currently estimated."[20]

For venture capitalist Vinod Khosla, productivity is an "obsolete concept." McKinsey & Co. has compiled a list of 100 disruptive technologies. Some argue that if time is freed up for consumers with non-measured improvements, they will have more time for market-based activities like shopping, which will eventually translate into GDP. An interesting hypothesis is that the puzzle resolves itself if we assign the mystery gains to account for lower inflation and suppressed wages—two issues that continually appear in financial coverage.[21]

Larry Fink, CEO of Blackrock, the asset management firm with nearly $5 trillion in assets under management, has attracted a great deal of attention with a proposal of he made on March 31, 2015.[22]

Fink sent a letter to the chairs of S&P 500 firms proposing that the holding period for investors seeking long-term tax treatment should be lengthened from one year to at least three years, and that the level should decline potentially to zero after ten years. It is a stunning argument.

Fink decries the pressure on executives to perform in the short term at the expense of "building long-term value." He says that the pressures come from activist investors (e.g., Carl Icahn) seeking immediate returns, the ever increasing velocity of capital and the media attention now paid to breaking news in the 24/7 landscape. He calls on public policy to take a stance against this onslaught.

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[19] Adam, Nina. "Business Investment is Changing its Stripes," Wall Street Journal, August 16, 2015, http://www.wsj.com/articles/business-investment-changes-its-stripes-1439750845
[20] Ibid.
[21] Aeppel, Timothy. "Silicon Valley Doesn't Believe U.S. Productivity is Down," Wall Street Journal. July 16, 2015, http://www.wsj.com/articles/silicon-valley-doesnt-believe-u-s-productivity-is-down-1437100700
[22] "BlackRock CEO Larry Fink tells the world's biggest business leaders to stop worrying about short-term results," Business Insider, April 14, 2015, http://www.businessinsider.com/larry-fink-letter-to-ceos-2015-4

Fink steps forward as a representative of his investors, whom he describes as overwhelmingly long-term in their needs, such as retirement income. He promotes investment in "innovation, skilled workforces, and essential capital expenditures to sustain long-term growth." He calls on CEOs to "clearly and effectively articulate their strategy for sustainable long-term growth." In terms similar to those of John Kay, he writes "corporate leaders' duty of care is not to every investor or trader who owns their companies' shares at any moment in time, but to the company and its long-term owners." In that context, he proposes to redefine long-term gains in the tax code and reward long term holding periods on a scale that is way beyond any previously considered. He calls on public company boards to become the "first line of defense against short-term pressures." Blackrock is a huge shareholder and he notes that the company does and will engage with directors during proxy season. It is a tactfully put but not subtle message.

Another approach is to link executive pay to something beyond the share price. Andrew Smithers of the Financial Times[23] suggests linking bonuses to increases in productivity, not just to profits. He notes that initiatives to increase the efficiency of capital through cuts to labor and wages have run their course. Investment in more capital per employee is the next option for enhancing productivity. Low growth and reduced innovation in technology suggest poor timing for investments but Smithers counters that collapsed interest rates have reduced the cost of capital and present an opportunity to invest in the future.

Finally, writing in the Financial Times, Dominic Barton and Mark Wiseman[24] penetrate the veil and say the problem resides with the *way the asset managers are paid*. If you link their remuneration to longer-term outcomes, rather than annual returns, you will have travelled a good distance toward supporting investment by CEOs.

Escaping the activists

On Oct. 29, 2013, Michael Dell, chairman of Dell, Inc. (a company he founded) announced the completion of an acquisition of his once-iconic technology company. Dell joined forces with Silver Lake Partners to accomplish the largest privatization in history. The privatization was a response to the challenge posed by activist investor Carl Icahn.

[23] Smithers, Andrew. "Executive pay holds the key to the productivity puzzle," Financial Times, May 28, 2015, http://www.ft.com/intl/cms/s/0/64b73a8e-0485-11e5-95ad-00144feabdc0.html#axzz3nzTLMqor
[24] Barton, Dominic and Wiseman, Mark. "The cost of confusing shareholder and short-term profit," Financial Times, http://www.ft.com/intl/cms/s/0/bce20202-d703-11e4-97c3-00144feab7de.html#axzz3nzTLMqor

A month later, Dell published an op-ed in the Wall Street Journal[25] to explain his case. He begins by extolling the role of public markets in providing the capital for Dell, Inc. to "grow and thrive" in its formative years. The problem, Dell complains, is "when customer and shareholder interests diverge." After 25 years as a public company, Dell opines that his company saw big opportunities that could only be exploited through greater innovation and investment. However, it faced an "affliction of short-term thinking that drove a wedge between our customer and investor priorities." Dell refers to a survey by McKinsey & Co. and Canada Pension Plan Investment Board of more than a thousand board members, where "86% declared that using a longer time horizon to make business decisions would positively affect corporate performance in a number of ways, including strengthening financial returns and increasing innovation. "

He goes on. The divergence is most obvious in the case of "certain" activist investors. These investors are looking for arbitrage and they pursue it by taking a sizable position, demanding influence on the board, agitating for certain actions and then they cash out when they have gained their profit. He cites an article in the Harvard Business Review by Jay Lorsch regarding the significant risk that this type of activist investing will weaken the competitive position of the company. Dell hails the freedom of being private—no more in-quarter pressures, no more trade-offs between the short and long terms. The results for Dell are "several hundred million dollars invested in such long-term areas as cloud and data analytics."

Of course, going private is not a panacea. Indeed, private equity has evolved into an industry that is particularly adept at acquiring companies with low debt to equity ratios, burdening them with huge amounts of debt and then refloating them with levered gains on the investment. The investments typically are structured as partnerships, with general partners earning fees and advantaged participation in the investment pools they sponsor.

As general partners in the funds, they are able to claim their business returns as capital gains, not income, thereby locking in the very favorable tax rates on long-term investment gains held for just a year, which top out at 20%. President Obama's proposal to raise the capital gains tax to 28% (still favorable to income) had no chance of becoming law in the Republican-led Congress.

Here is how Eileen Appelbaum of the Center for Economic Policy and Research describes the tax advantage: "The leverage used to acquire the portfolio company alters its debt structure, increases its debt, and, because of the favorable tax treatment of debt compared to equity, reduces the company's tax liabilities. Lower taxes raise the bottom line and increase the value of

[25] Dell, Michael. "Going Private Is Paying Off for Dell," Wall Street Journal, November 24, 2014, http://www.wsj.com/articles/michael-dell-going-private-is-paying-off-for-dell-1416872851

the company by 4 to 40 percent[26], thus increasing the returns to private equity without increasing economic value."[27]

Research studies of corporate taxes

The impact of corporate taxes on the economy garners substantial interest from the academic community, as evidenced by working papers published by the National Bureau of Economic Research, which are available online. Here is a quick guide to recent papers:

- Ljungqvist and Smolynasky (Working Paper No. 20753, December 2014) explain how challenging it is empirically to link corporate taxes to employment or income outcomes in the economy. They compare contiguous counties straddling state borders, where corporate rates vary. They conclude that "increases in corporate tax rates lead to significant reduction in employment and income" but they find little evidence that a cut in the rate boosts employment, except during recessions when a cut leads to significant increases.

- Fehr, Jokisch, Kambhampati, and Kotlikoff (Working Paper No. 19757, December 2013) simulate the elimination of the corporate tax in the U.S. and find such dramatic increases in the model's levels of output, investment and wages that the tax is nearly self-financing.

- Longstaff and Strebulaev (Working Paper No. 20372, August 2014) study the relation between leverage and corporate tax rates and they find strong evidence that changes in leverage are "directly related to changes in corporate tax rates for all but the smallest firm," which face financial constraints.

- Yagan (Working Paper No. 21003, March 2015) looks at how the dividend tax cut of 2003 affected investment and estimates that the effect was zero. This is in contrast to an immediate impact on payouts to shareholders. Yagan's findings challenge links between cost of capital and investment levels or undermine models in which dividend taxes affect the cost of capital. Either way, it argues against the cuts as a macro tool.

[26] Kaplan, Steven N. and Stromberg, Per. Leveraged Buyouts and Private Equity. June 2008, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1194962

[27] Appelbaum, Eileen. "How Does Private Equity Make Money?" Next New Deal, The Blog of the Roosevelt Institute, June 12, 2012, http://www.nextnewdeal.net/rediscovering-government/how-does-private-equity-really-make-money

So one study says that increases hurt the economy but once the adjustment takes place, a decrease has no stimulus effect. Another finds that a zero rate would be a great stimulus. A third finds that interest deductibility stimulates taking on debt. And the last finds the dividend tax cut to be a poor instrument for stimulating the economy.

How to proceed?

I began my work with the opinion that corporate taxes should be abolished. In the summer of 2014, Sheila Baird published a piece in Fortune magazine[28], which stated that view boldly and clearly. I will cite her opinions by way of conclusion.

Baird writes at the time of the blow-up over tax inversion. She mocks the notion of villainous traitors and says that telling a company to ignore foreign tax “dodges” is “like telling a toddler to keep his hands out of a cookie jar in easy reach.” She calls for fundamentally rethinking our corporate tax system.

Rather than tinker with the rates, Baird calls for abolition of corporate taxes. The effects: “We would dramatically decrease the cost of doing business here, ease pressure on U.S. wages, bring back jobs, and repatriate an estimated $2 trillion in corporate profits now sitting overseas to avoid our top 35% tax rate.”

Baird argues that the present system actually favors the rich because we lower the tax on capital gains and dividends to vitiate the double taxation. Her answer (and she has allies) is to tax dividends and gains at the income tax level and tax only the shareholders, not the companies. She rejects the argument made by conservatives who link the advantaged rates to higher investment and job creation. She declares that links between investment returns and growth are not robust. She also takes note of corporations borrowing (with deductible interest) to increase dividends.

Baird goes on to stipulate how she would find the resources necessary to cover a revenue loss of $350 billion. She argues that taxing investment income at ordinary rates would raise $90 billion and reforming the tax code to cap tax breaks and close loopholes could add another $220 billion. (Martin Feldstein has made similar recommendations in writing for the Wall Street Journal.) Baird also adds a three-cent tax on every hundred dollars traded, which contributes $35 billion annually. (Of course, the disincentive could result in reduced trading, which would reduce the revenue effect). She emphasizes the positive effects on employment and wages that would result from bringing the money home.

[28] Baird, Sheila. “Why getting rid of the corporate income tax makes sense,” Fortune, August 14, 2014, http://fortune.com/2014/08/14/ending-corporate-income-tax/

Enhance financial stability

My goal for abolishing corporate taxes is to *enhance financial stability* by ending the advantage of debt over equity by abolishing the corporate tax altogether. Without a tax, the deduction of interest is meaningless. The tax code should not incentivize corporate fiduciaries to leverage their balance sheets in the good times only to be left with the damaging results when the inevitable turns in the business cycle, or worse, appear.

Corporate executives today have their decision-making unduly clouded by tax and accounting rules. In effect, they are managing three different income statements; one based on cash earnings, one based on GAAP accounting and one showing after-tax distributable income. It would be a great advantage to U.S. companies and their workers if CEOs could manage simply for economic efficiency, with allowances for labor protections, such as minimum wage, as determined by the electorate.

If we cannot achieve a zero rate, I would strongly favor limitations or abolition of the interest deduction in exchange for a reduction in the corporate tax. I would also close the loophole for private equity, which treats the partners' earned income as capital gains just because it is invested alongside limited partners. The lobbyists are strong on this one and the initiative has been beaten down in the past.

The United State already has great competitive advantages as a host country for investors. We should get rid of the self-inflicted disadvantages of corporate taxes and seek to lengthen the time horizon under consideration by those making investment decisions. Perhaps it will take generational change in management, in boardrooms and in government. Generation X, our future president and Congress should take advantage of the growing support for reform.

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