Scott Hodge: Thank you for tuning in today. I'm Scott Hodge, President of the Tax Foundation. Joining me for our weekly Tax Policy Podcast is Professor Douglas Shackelford, who is the Meade H. Willis Distinguished Professor of Taxation and Director of the University of North Carolina Tax Center. He is also the Senior Associate Dean for Academic Affairs at Kenan-Flagler Business School at UNC. Doug is also a Research Associate in Public Economics at the National Bureau of Economic Research and was a Tax Foundation Visiting Professor in 1993 and 1995 and has been a frequent participant and speaker at the Tax Foundation over the years. Thank you for joining me today, Doug.

Douglas Shackelford: Delighted to be here.

Scott Hodge: Well, as you know, the stock market has recently topped 12,000 for the first time in history, and I think that's a good opportunity to look at some of the work that you've been doing over the years in looking at the effect of tax policy on the stock market, both in terms of how stocks are priced and how much they're traded. And in particular, I've found your study that you published last summer very interesting, looking at the effect of the '97 capital gains tax cuts and how those affected stock prices, etcetera. Could you briefly summarize that study, and then maybe relate it to the recent cuts in capital gains and dividend taxes and how that might have affected today's stock market?

Douglas Shackelford: Well, as far the '97 legislation, our study showed that stock prices increased on news that the White House and the Republican leadership in the Congress had reached agreement to cut the capital gains tax rate. The share price of the average firm increased around 8 percent that week. The increase was another 1 percent higher if you were a firm that didn't pay dividends, which would be consistent with the market recognizing that investors in those firms were going to tend to receive their gains through capital gains tax depreciation.

The following week, however, the congressional tax writers announced that that day would be the effective day for the rate cut. And we found that the market then fell three percent on this news. This is what we would refer to commonly as the lock-in effect. The decline was greater for firms mostly held by individuals and by firms that had the most depreciation and suggests that these investors were either selling their shares, or the market anticipated their selling their shares sometime in the future.

So there's really, we found, two effects -- one, the stock run-up and then the stock coming back down as there was a sell off. However,

the net effect was a substantial increase in share prices. In both cases, we found that the trading volume was very high as investors, understandably, were rebalancing their portfolios.

We've also done a study of the 2003 cuts in capital gains and dividend taxes. There, we found that both dividend payments and share repurchases surged. These findings, we interpreted as evidence that the firms responded to the lower rates by flushing out some of their cash and increasing their distributions to shareholders. We also had an interesting result. We looked at the margin whether firms were shifting from share repurchases to dividends since the dividend tax cut exceeded the capital gains tax cut. And interestingly, we found that the shifts only occurred in companies where insiders -- that is, officers and managers -- held disproportionately large shares of the company. So I think a takeaway from this is that the effect of the 2003 rate cuts depended on your ownership structure. And I would guess that was probably an unanticipated consequence of the legislation.

As far as today's stock market, I personally am quite pleased with the rising prices. Unfortunately, I'm not sure my research can shed a lot of light on the increase. Changes to the tax system tend to be impounded in share prices very quickly. So my guess is a little of the recent appreciation's attributable to changes in the tax law.

Scott Hodge: Well, it will be interesting to see how this stock market run goes on or whether it tempers back. But it also kind of relates to some other work that you've done on double taxation. And you testified before the President's Advisory Panel on Tax Reform last year and talked about the growth of the non-corporate sector and non-corporate entities such as S corps and how that's eroding the corporate tax base. Tell me a little bit more about how double taxation can affect this and what Washington can do to address this double taxation issue.

Douglas Shackelford: The corporate income tax has really become a tax on publicly traded companies. Privately held, closely held firms have restructured themselves to that their profits are taxed on the individual tax return of their shareholders. Now, the question is whether we should tax publicly traded companies differently, and I think we'd all agree more heavily than privately held firms. I don't see any justification for doing so. I thought that the president's original 2003 plan to exempt shareholder taxes on profits that had been taxed at the corporate level was a step in the right direction. Instead, we got lower dividend and capital gains tax rates, which mitigated double taxation, but less effectively than the original

plan would've done, and it still retains the public/private distinction for which I don't think we can justify.

Scott Hodge: Well, you had originally thought that their proposal was a bit overly complicated.

Douglas Shackelford: Yes, I did.

Scott Hodge: How might we, I guess, integrate the tax systems in a simpler system than this sort of Rube Goldberg method that they chose?

Douglas Shackelford: Well, I think we have to look at all of the different imputation systems that are available. The purpose here is to say, "We're gonna tax income either at the corporate level or at the individual level." Now, I completely concur that the president's original proposal, as I said, was a step in the right direction. I don't think it went all the way there because it did create these pools of income which were going to have to go through these tests of whether they had already been taxed. I would like to see something along the lines of eliminating double taxation, and I think there's a lot of options out there, but I think we've got to get from -- we've got to start with the understanding that public and privately traded firms should not be taxed differently.

Scott Hodge: Well, you know, there's nothing like record profits to bring up a lot of hysteria on Capitol Hill, and we're seeing that recently with the oil companies' record profits, and talk on Capitol Hill about trying to conform book with tax income. And one of the proposals that I took notice of was the attempt or desire to stop the companies from using the LIFO, or "last in, first out" accounting, for their inventories. And I guess the assumption was that it was helping them minimize their tax burden. But generally, what's your take on this whole notion of trying to conform book and tax accounting. I've read that you're considerably against this idea.

Douglas Shackelford: I think that, perhaps, is an understatement. I strongly oppose book/tax conformity. I'm a CPA, and I've stated before that I think you lose your license if you believe book/tax conformity is a good thing and for good reasons. It's a very bad idea because it damages both our capital markets and our tax system. It reflects, I believe, a naivety about the purpose of financial accounting. Book and tax reporting exist for different reasons. And there's no reason to think that the most useful measure of a firm's profitability for shareholders would also be the most useful measure of profitability for the taxing authorities.

Accounting exists because management needs to provide

information to outside investors. And without this information, shareholders would be very apprehensive about turning their money over to managers that they don't know. I think it's important to remember that we enjoy the largest and the most efficient capital markets in the world. Domestic and foreign investors pour trillions of dollars of capital into U.S. companies that are led by managers that they do not know. And they invest because they trust the financial information that the managers communicate about the companies.

If we went to book/tax conformity, we've got one of two options. We can either tax book income as defined by GAAP standard-setters who are outside Congress. Or firms can be forbidden to report accounting earnings to their shareholders. They'd be required to report taxable income as defined by Congress. Now, the first option isn't viable because Congress isn't going to turn over its authority to tax, and it shouldn't. The second option that is Congress setting the accounting standards would terribly damage our capital markets.

And finally, I think even if we were to establish book/tax conformity, it would not achieve the purported purpose of taxing the information that companies communicate to their shareholders because if companies could not communicate the information to their shareholders in a manner that they thought was accurate and of the highest quality, they would find other means to communicate information to outside investors. And so we could chase this book/tax conformity, but it's neither sustainable, nor is it desirable from a financial markets perspective nor from that tax system, and I would hope that we'll hear very little more about book/tax conformity as a viable option for tax policy.

Scott Hodge: Didn't I read in your testimony that the original corporate code was conformed around the GAAP?

Douglas Shackelford: That's right. It -- financial accounting--was the foundation on which the tax system was built, and that made plenty of sense. But what happened very quickly was that Congress felt for different reasons that we should have a different measure of income, and a very easy one we can think of is the accelerated depreciation. So Congress doesn't really ask the questions that financial accounting asks, which is, "What's the obsolescence of the equipment?" Congress says, "We'd like to give accelerated appreciation because we believe that would be good for the economy," which it may very well be.

So as soon as you have something like accelerated depreciation as

being good for tax policy, we now have a departure from book/tax conformity. And after nearly a century of corporate tax, we now have a lot of departures from tax and book, and I don't think that that's necessarily bad, and I think there's a good reason for continuing to have those differences. Again, we need to remember that there is a very, very good reason that we have accounting information, and it's not based on tax law. And there's a very, very good reason we have tax law, and it should not necessarily be tied to the rules that are appropriate for communicating information to outside investors.

Scott Hodge: Well, I wanted to get back to the issue of -- you mentioned income as the basis of the tax system and Congress's attempt to define income. And you had a very, very interesting question in your testimony before the tax reform panel. You asked, "Is an income tax feasible in the future?" And as the new economy is obviously making the income tax -- or challenging the income tax with electronic commerce and the rise of other types of products, what type of tax system should we have in electronic age? And is basically the corporate income tax sort of a victim of our modern economy?

Douglas Shackelford: I think it is. I think to fully understand the question really relates back to your previous question. We need to understand that the tax system was built on top of the financial accounting system, and the financial accounting system was designed decades ago -- it came about over time -- with a bricks and mortar economy. And one of the reasons we chose to tax income was companies were already measuring income, again, in a bricks and mortar type world.

Nowadays, the accounting system is struggling to define and measure income for book purposes, and so we shouldn't be surprised that the tax system is also struggling to define and measure income for tax purposes. The reason is that the key factors for production today are not bricks and mortar. They are extremely mobile. They are principally things such as brains or intangibles or information or technology. The thorny accounting problems today involve realized and unrealized intangibles. Many of the core assets that a company has, for example, its brand name or the high quality of its labor force, are not on its balance sheet. In the old days, you couldn't easily dismantle a plant, so the balance sheet reflected some stability in the balance sheet. Today, with intangibles, you can use profits, as we know, around the globe very easily.

So the difficulties that we've got would measure in income at the financial accounting level are also creating a week foundation on

which to measure income at the tax level.

Now, that's the easy part -- talking about the past and where we're at. Where do we go? Let's just assume we did not want to tax income because we concluded that the foundation was irreparably damaged. Then, I think we have to look for the logical alternatives to that, and obviously, before long, you're going to end up with a consumption-based system. It will void some of the difficulties with measuring intangibles. Of course, it brings a different set of issues, and those things ought to be balanced off.

But I think long term, unless financial accounting theorists can develop some superior measures for measuring book income, the tax system that's overlaid based on income is going to increasingly run into problems. And at some point, we're going to have to face those problems. When I spoke with the tax reform panel, I compared it to a person who's aging. I do not think that we are at the nursing home stage. I don't think we're on life support, but I think we are aging as a tax system that can be built on a financial accounting system that measures income. And at some point, we are going to be elderly and fragile and have to look other places.

Scott Hodge: Well, I have to conclude with kind of a funny tale, a speech you gave at the Tax Foundation's annual conference a few years ago, and you were talking about some of the research you had done. And I still remember the look on a lot of corporate tax executives when you mentioned how you were able to actually review corporate tax returns for your research, and I understand that the IRS is now limiting some of that access. And what effect is that having on the ability of scholars to do good work on corporate taxation? And what's been the fallout, I guess, of that revelation?

Douglas Shackelford: Well, I remember that day as well, and I was glad to escape alive. I -- you were right. There has been a significant restriction in the ability of researchers to look at actual tax returns, and I think that that is a very bad development. Society benefits from knowing the answers to questions like those you've been raising. I know the Tax Foundation believes that because it's funded many important studies of questions of critical nature in our tax system. Unfortunately, many of the most important questions can't be answered with publicly available data.

The few researchers -- and I should stress there's very, very few who have gone through all the clearance and have actually had access to actual tax returns -- have been bound by the same confidentiality requirements that IRS employees are. There has been no disclosure of confidential information. Before you can

release any information based on IRS data, you have to get clearance from the service, and that is a very tight screening process.

Scott Hodge: Well, so companies should not be so worried because of those safeguards.

Douglas Shackelford: I agree completely. And what I believe is that research has helped us better understand the tax system. If we don't have access to that, then what we're gonna do is ask our researchers to use poor information -- for example, financial statements -- to guesstimate what's going on, and A) we're going to have those researchers reach conclusions that are erroneous because they don't have good information, and B) it's going to lead to where tax policy's not as good. So I think it's in everyone's interest, including those corporations that perhaps were somewhat horrified to know that researchers could gain access -- I think it's in everyone's interest that we have that access.

Scott Hodge: Well, Doug, thank you very much for joining me today. It's been a very, very interesting discussion, and I look forward to reading your research in the future.

Douglas Shackelford: Thanks, Scott.

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