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THE CASE FOR CORPORATE INCOME TAX REFORM

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EXECUTIVE SUMMARY

The corporate income tax in the United States, which has remained largely unchanged since the much celebrated Tax Reform Act of 1986, is ripe for reform. The statutory tax rate in the United States is now the highest in the world, we no longer have relatively low marginal effective tax rates, and most of our international competitors have moved to “territorial” tax systems, under which the foreign source income of their multinationals is exempt from domestic taxation – in contrast to the U.S. system under which such income is subject to a residual domestic tax. In addition, the corporate income tax in the United States is widely recognized as a complex tax instrument that distorts a wide variety of business decisions, favoring certain activities and industries over others and thus lowering the productivity of capital and labor and hampering economic growth. Moreover, high statutory rates exacerbate all of the inefficiencies of the current tax system, encourage tax avoidance and evasion, and increase administrative and compliance costs. Finally, high statutory tax rates in the United States are especially harmful in the modern globalized economy, as they drive capital, especially highly mobile firm-specific capital that earns above normal returns, out of the country, and create incentives for income shifting to lower tax jurisdictions that significantly reduces US revenues.

This paper examines the case for corporate income tax reform, including both a traditional base-broadening, rate-reducing reform that would eliminate many existing business tax preferences, and a move to a territorial system. It argues that the traditional case for a base-broadening, rate-reducing reform is compelling, although important issues exist with respect to whether base broadening should include elimination of preferences for research and development and accelerated depreciation, the treatment of non-corporate enterprises, and the desirability of attempting to offset the negative effects of extending a rate cut to the income earned by existing capital. The effects of a movement to a territorial system depend on the details of the system, but are likely to be relatively small since the current system already approximates territoriality. Perhaps the best argument for a territorial system is that the current system, which maintains the exceedingly complex apparatus of taxing foreign source income while raising very little revenue and distorting MNC choices – especially with respect to repatriation decisions – seems far from desirable; moreover, alternative proposals to raise the tax burden on US MNCs (for example, by eliminating deferral) when it is already among the highest in the world would further reduce the competitiveness of US multinationals in a highly integrated world economy. A territorial system would thus represent an improvement relative to the current worldwide tax system, as it would simplify many aspects of our system of international taxation, eliminate tax disincentives to repatriation, and provide for more uniform treatment of US MNCs, while – depending on the details of its design, including any anti-base-erosion provisions – having a relatively small effect on revenues.

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The corporate income tax in the United States, which has remained largely unchanged since the much celebrated Tax Reform Act of 1986, is ripe for reform. In particular, the last three decades have been characterized by tremendous changes, as the world economy has become ever more globalized and statutory corporate income tax (CIT) rates around the world have declined, largely in response to increasing international tax competition. In addition, again in response to the exigencies of globalization, several countries, most prominently the UK and Japan, have moved to "territorial" tax systems, under which the active foreign source income of their multinationals is exempt from domestic taxation; as a result, the United States is now the only large industrialized country that utilizes a worldwide tax system, under which the foreign source income of US multinationals is taxed when it is returned to the US parent, subject to a credit for foreign taxes paid. Moreover, the CIT in the United States is widely recognized as a complex tax instrument that distorts a wide variety of business decisions, favors certain activities and industries over other, and thus lowers the productivity of capital and labor and hampers economic growth. Indeed, the need for CIT reform has been recognized by the leaders of both political parties – although, not surprisingly, the two parties differ in the details of their approaches to reform. Nevertheless, there are some common grounds for reform – for example, both parties tend to support rate reduction financed by the elimination of many business tax preferences – and other issues, while more contentious, may nevertheless be easier to resolve than other important but exceedingly difficult fiscal problems, such as reforms of the personal income tax and the major entitlement programs. For this reason, corporate income tax reform is arguably the logical next step in what is likely to be a long process of fiscal reform in the United States.

The Case for Corporate Income Tax Reform (Current Worldwide Tax System)

Consider first the case for CIT reform within the context of the current worldwide tax system. Much of the impetus for CIT reform in the United States comes from the simple fact that, as has been widely reported, the US statutory corporate income tax rate is now the highest in the world. This represents a dramatic change from the situation after the enactment of the Tax

Reform Act of 1986 (TRA86), when the US rate was significantly below that of other major industrialized countries. For example, after TRA86 was fully implemented in 1988, the US combined state and local statutory rate was 38.6%, which was 6.8 percentage points lower than the GDP-weighted average statutory rate of 45.4% for a sample of 18 other OECD countries. However, by 2015 when reforms recently enacted in several countries will be fully phased in, the US statutory tax rate of 39.0% will be 9.4 percentage points higher than the projected 18-country average rate of 29.6%. The relative US CIT statutory tax rate, in comparison to our trading partners in the sample, has thus increased by more than 16 percentage points over this period.

Another measure of relative tax rates is the "marginal effective tax rate," which reflects the tax burden on a "break-even" or marginal investment, taking into account not only the statutory tax rate but the other provisions of the CIT, especially the generosity of deductions for depreciation and any other investment allowances. International marginal effective tax rates (METRs) have not fallen as dramatically as statutory tax rates, as many countries have reduced depreciation allowances while reducing statutory tax rates. Nevertheless, the relative position of the United States has declined according to this measure as well. For example, in 1988 the METR in the US was 18%, nearly 7 percentage points below the GDP-weighted average of 24.9%. In marked contrast, by 2015, METRs in the US (20.2%) and the sample countries (20.6%) will be roughly equal, reflecting an increase in the relative METR in the US of roughly 6.5 percentage points. (Note that these calculations consider only corporate taxes; the relative position of the US in terms of METRs would be worse if individual level taxes on capital income were also considered.)

One of the primary problems with a high statutory tax rate is that it exacerbates all of the inefficiencies of the current CIT. For example, the CIT in the US provides a tax advantage to unincorporated firms that do not have to pay the tax, favors debt over equity finance (since interest is deductible while dividends are not), and encourages retained earnings over dividends (since retentions avoid individual level dividend taxation). The costs of such distortions increase dramatically with the magnitude of the tax rate. Moreover, because the current system includes a wide variety of tax preferences (often referred to as business tax expenditures) for certain types of investments in certain industries, it distorts business decisions regarding which capital assets to use, and distorts the allocation of capital and labor across industries, lowering productivity and hampering economic growth. In contrast, the productivity of our nation's assets and its economic

growth potential are generally enhanced with a neutral tax system that treats all industries uniformly – and a reform that results in a uniform tax system is more likely to be a stable reform. High tax rates also encourage tax avoidance and evasion and increase administrative and compliance costs. All of the factors combine to make the CIT a highly inefficient tax instrument, and these inefficiencies are worsened by its relatively high rate.

The problems associated with a high statutory rate are significantly exacerbated in a globalized economy. Two issues are especially critical. The first is that increasing international capital mobility, confirmed by numerous empirical studies, implies that high tax rates will not only reduce domestic saving and investment, but will also drive capital investment outside the US. Although problematical for all forms of investment, this is especially true for capital that is both highly mobile internationally and tends to earn relatively large profits that reflect the returns to firm-specific assets such as intellectual property (e.g., unique technological knowledge, patents and licenses, proprietary production techniques, and unique entrepreneurial or managerial skills) and other intangible assets such as goodwill and firm reputation. The above-normal returns to such investments are taxed primarily at the statutory tax rate, and much international tax competition has taken the form of reductions in statutory tax rates as countries attempt to attract such highly mobile firm-specific capital and the jobs and economic growth that it creates – often from the US, given its relatively high CIT rate.

The second critical problem with a high statutory tax rate in an international context is that it encourages income or profit shifting. There is also much empirical evidence that confirms that modern multinational corporations have become very adept at reducing their overall tax liability through income shifting – moving revenues to relatively low tax countries and deductions to relatively high tax countries. A wide variety of mechanisms are used to shift income, including locating patents and other intangible assets in low tax countries, using loans between affiliated companies in high and low tax jurisdictions, and judiciously pricing intermediate goods that are transferred between affiliates in low tax and high tax countries (transfer pricing). Income shifting is especially problematical because such "financial reallocation" is easier to accomplish than physical reallocation of capital assets and represents a pure loss of revenue to the high tax country. Some estimates suggest that income shifting currently amounts to 15-30 percent of the potential CIT base in the United States. Because income that is shifted is generally taxed at the statutory rate, the desire to avoid the negative

effects of income shifting has provided additional impetus to the downward international trend in statutory tax rates – a trend that has not yet extended to the United States.

Thus, in addition to providing for a more efficient and neutral tax system that would be conducive to economic growth, reduce incentives for tax avoidance and evasion, lower administrative and compliance costs, and also create the perception – and arguably the reality – of a fairer business tax system, a reduction in the statutory tax rate in the US would reduce incentives for both foreign investment of firm-specific capital and income shifting. Given currently low levels of foreign tax rates, including extremely low rates in the tax haven countries, a sizable rate reduction would be required to significantly reduce these incentives.

The Case for a Territorial Corporate Income Tax System

We consider next the case for a territorial tax system that would largely exempt from US tax the active foreign source income of US multinational corporations (MNCs). For example, the discussion draft put forward by House Ways and Means Committee chair Dave Camp would provide a deduction for 95% of dividends paid by a US subsidiary to its parent firm, resulting in an implicit tax rate of 1.25% on active foreign source income if the post-reform US CIT rate were 25%.

As noted above, the case for a territorial system is usually made in terms of "international competitiveness" – because US MNCs face a residual US tax when the earnings of their subsidiaries are repatriated (sent home to the parent firm), they are at a disadvantage when competing abroad with multinationals based in other nations who are not burdened by such a residual tax under their home country territorial tax systems. In addition, the residual US tax discourages repatriation of foreign source income and thus may limit the funds available for domestic investment; indeed, many companies have accumulated large stocks of unrepatriated profits abroad. Maintaining such funds abroad may also distort investment decisions (e.g., causing tax-induced purchases of foreign capital assets). More generally, the current system is highly complex, imposes significant compliance and administrative costs, and distorts MNC decision making while collecting little revenue. Nevertheless, the case for a territorial system depends on the specific details of the reform proposed, as a reduction in the combined foreign and domestic tax rate on foreign source income would encourage MNC investment abroad, and the tax revenues from such investment would accrue entirely to foreign rather than US residents. For a move to a territorial system to be desirable, other benefits must outweigh these costs

(which, it should be noted, decline with significant reductions in the US CIT rate). Beyond improving the international competitiveness of US-based MNCs and reducing disincentives for repatriation, these benefits can be grouped into two general categories.

The first reflects the benefits of multinational investment abroad. Beyond higher after-tax returns to the shareholders of the MNCs, these include: (1) greater investment and labor demand in the US to the extent that the foreign investment requires supporting domestic activities, (2) lower domestic prices as US MNCs take advantage of economies of scale when they serve foreign as well as domestic markets (this effect may be especially important if the investment is in firm specific capital that earns above normal returns on the intellectual property or other intangible assets the firm has developed) and become among the dominant firms in these markets, and (3) the efficiencies that arise when the ownership of a productive asset abroad is not distorted by a US international tax system that favors foreign firms, especially if the asset would be better utilized by the US MNC.

The second benefit is related to the stock of unrepatriated profits currently held abroad, which is estimated to be on the order of $1.7 trillion. The move to a territorial system might include a one-time tax on this stock, a short-term revenue raiser recommended in the Camp discussion draft. Beyond that, a move to territorial would encourage repatriation of these funds. The economic effects of such repatriation are currently a subject of debate. It seems likely that one effect would be a reduction in the domestic debt of US MNCs, as they replace such debt with repatriated equity that had been deployed abroad to avoid paying the US tax on repatriation; this would have the effects of reducing the costs of maintaining an excessively large stock of US debt. Roughly 60 percent of such funds are in cash or cash equivalents and would be the most likely to be repatriated. Some studies suggest that most if not all of these funds would be distributed to shareholders and then reinvested, with little change in the overall pattern of investment; such a result would be consistent with standard economic theory. Under this view, the main effect of the repatriation would be an increase in US tax revenues due to the taxes paid on the distributions. However, other evidence suggests that some of the distributed funds might be consumed, or invested by firms that are currently cash constrained and cannot make investments that they would make with tax-free access to unrepatriated profits that are held abroad.

In any case, although the effects of a move to a territorial system are arguably positive, they would not appear to be especially large, since the current tax system – which is characterized by deferral of US tax liability until the funds are repatriated to the parent firm, a foreign tax credit for taxed paid abroad, and cross-crediting so that taxes paid in high tax foreign countries can be used to offset domestic tax liability on income from low tax countries – already approximates a territorial system. As a result, the current residual US tax on foreign source income (including the current tax assessed on "Subpart F income" such as interest and dividends) is already quite low, perhaps on the order of 3% (and would be lower still if CIT rate reduction were enacted). The average additional costs associated with keeping the unrepatriated profits abroad have been estimated to be roughly of the same order of magnitude (although they are significantly larger for MNCs with a large stock of such profits). At the same time, arguments which suggest that a move to territorial would result in huge revenue losses and dramatic movements of capital abroad seem overstated, given that the current residual burden on such movements is already quite low. In any case, concerns about such reform-induced movements could be addressed with a variety of base-erosion measures, such as those proposed in the Camp discussion draft. Finally, it must be emphasized that the effects of a move to a territorial system would depend on the details of the system enacted, including the treatment of royalties paid by US subsidiaries to their parents (much of which are currently shielded from tax by excess foreign tax credits) and any allocation of costs incurred by the US parent firm to income earned by its foreign subsidiaries.

Thus, we believe that the positive effects of a corporate income tax reform in the US might well be enhanced by a simultaneous move to a territorial system; however, the effects of implementing territoriality are tenuous and seem likely to be small in the aggregate. Perhaps the best argument for a territorial system is that the current system, which maintains the exceedingly complex apparatus of taxing foreign source income while raising little revenue and distorting MNC decision making – especially with respect to repatriation – seems far from desirable; moreover, alternative proposals to raise the tax burden on US MNCs (for example, by eliminating deferral) when it is already among the highest in the world would further reduce the competitiveness of US multinationals in a highly integrated world economy. A territorial system would thus represent an improvement relative to the current worldwide tax system, as it would simplify many aspects of our system of international taxation, eliminate tax disincentives to

repatriation, and provide for more uniform treatment of US MNCs, while – depending on the details of its design, including any anti-base-erosion provisions – having a relatively small effect on revenues.

These arguments make a compelling case for a CIT reform that would dramatically reduce the CIT rate in the United States, and suggest that a move to a territorial tax system may be desirable as well. We turn next to the design of such a reform.

Design Issues in Corporate Income Tax Reform

A blueprint for many of the critical elements of CIT reform is provided by TRA86, which followed the classic prescription for a base-broadening, rate reducing tax (BBRR) reform by eliminating various tax preferences, including an investment tax credit and accelerated depreciation, to finance a reduction in the CIT rate from 48% to 34%. Both the US Department of the Treasury and the Joint Committee on Taxation each year publish extensive lists of business tax preferences, some of which are fairly general preferences and others that are specific to certain industries. Although elimination of these preferences would no doubt be controversial, a significant CIT rate reduction – which a static analysis suggests would be on the order of 7-10 percentage points – could be financed with their complete elimination; such an approach should serve as the benchmark for evaluating potential BBRR tax reforms.

Several issues would have to be addressed in designing such a reform. The first is whether base broadening should be extended to include elimination of expensing of research and development expenditures and the research and experimentation credit. Even under a "pure" income tax, such provisions can be justified to the extent that there are benefits to society as a whole – e.g., more technological innovation and/or faster economic growth – beyond the financial rewards received directly by the business performing the research and development. Thus, consideration should be given to retaining a well-designed tax preference for research and development, that is, a preference that is carefully targeted and commensurate with the external benefits of such activities. It should be noted, however, that designing such a preference is difficult, creates complexity, and limits the amount of CIT rate reduction that can be attained.

A second issue is whether some accelerated depreciation should be retained. Accelerated depreciation is a general tax preference in that it is fairly widely applicable rather than concentrated on a few businesses. Moreover, because it is directly tied to investment, it is more likely than other preferences to result in increased investment, a larger capital stock, greater

productivity and thus higher wages, and greater economic growth. Accordingly, consideration might also be given to retaining some accelerated depreciation (beyond that required to offset the effects of inflation that arise because firms get deductions for depreciation based on the historical costs rather than the replacement costs of depreciable assets). Again, some caveats are in order. Most importantly, accelerated depreciation is needed only for equity-financed investments that do not benefit from the deduction of interest expense, so that the amount of acceleration – which applies to both debt and equity financed investment – should be limited. In addition, designing a neutral system of accelerated depreciation is complex, and retaining some accelerated depreciation allowances limits the amount of CIT rate reduction that can be attained.

A third issue is the treatment of pass-through entities that are not subject to the corporate income tax, and are instead taxed under the personal income tax system; these include subchapter-S corporations, partnerships, limited liability businesses, and sole proprietorships. The simplest approach would be to extend the elimination of business tax preferences to pass-through entities. However, because pass-through income is subject to personal income tax rates, lowering the tax rate applied to such income would be difficult. Because such entities currently are tax-favored relative to corporations, reducing the relative tax advantage would be desirable in that it would provide for more uniform tax treatment of corporate and pass-through entities. Such an approach may be difficult to implement politically. Possible alternative approaches include not extending base-broadening to pass-through entities or providing them with an offsetting tax preference, such as increasing the extent to which they qualify for expensing.

Fourth, the most difficult problem associated with a BBRR reform is that the rate reduction is extended to existing capital and thus confers a large windfall gain to current owners. This results in a significant revenue loss, limits the extent of rate reduction that can be financed with base broadening, and increases the cost of capital which creates disincentives to new investment and limits the growth potential of the BBRR reform. This problem is exacerbated to the extent that (1) the current tax system provides for accelerated depreciation (which implies that the income associated with deductions taken at the high pre-reform tax rate will now be taxed at the lower post-reform rate), and (2) assets that earn above-normal returns are currently located in the US and are being taxed at high rates. A potential solution to this very troublesome problem is the "windfall recapture tax" that was proposed during the discussions surrounding TRA86, which would apply the relatively high pre-reform rate to some of the income accruing to

capital existing at the time of enactment of reform. Although such an approach would be extremely controversial, it would have important benefits as it would reduce the windfall gains and revenue losses associated with a rate reduction and thus would allow more revenue to be used for CIT rate reductions on future investments, which would spur capital formation, increase labor productivity and wages, and promote economic growth.

Finally, as discussed above, if a movement to a territorial system is included as a part of corporate income tax reform, its effects will depend on the details of the system, including the treatment of expenses that might be allocated to foreign source income, as well as the treatment of royalties paid to US parent firms. Moreover, with effective base-erosion provisions, the revenue losses from any increased income shifting, especially of income attributable to intellectual property, should be limited.