AMERICAN ACTION FORUM

# How Reform of the U.S. Corporate Tax Code Can Create Short- and Long-Term Economic Growth

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**Introduction**

A confluence of events has pushed corporate tax reform to the forefront of the economic policy agenda. The pressing need for economic growth and the concomitant tax revenues it generates, the increasingly competitive global economy, an acceleration of corporate tax cutting amongst the other OECD countries, and the ineluctable evolution of our corporate tax code into a maze of Byzantine complexity, have created an urgency for the country to change the tax code. Ideally, the tax code would move from one that deters innovation while rewarding persistent lobbying, faddish technologies, and politically important regions of the country into one that, as the philosopher Jean-Baptiste Colbert described so elegantly three centuries ago, plucks the goose so as to get the largest amount of feathers for the smallest possible amount of hissing.

The Obama Administration[1] as well as the leaders of both the Senate Finance Committee[2] and the House Ways and Means Committee[3] have stated their intent to reform the corporate tax code by the end of 2012.

But beyond their statements attesting to the desirability for reform the three entities seem to agree on little else other than that the United States should not be the country with the highest corporate tax rate in the developed world. How far to reduce the rate, the tax incentives we should eliminate to compensate for revenues lost from a rate reduction, whether business tax reform should extend to pass-through entities, and how to treat foreign-sourced income remain contentious differences. These are not mere details that can easily be negotiated: they represent fundamentally different perspectives on the way corporations do business and what the central function of a corporate tax code should be.

For instance, the Obama Administration has been insistent since taking office and issuing the FY 2010 budget on ending the provision in the corporate tax code that allows for the deferral of taxes owed on foreign-sourced income until the money returns to the United States. The rhetoric used by the administration in articulating its position has been stark: In its view of the world, U.S. multinational corporations use foreign production largely as a way to replace higher-cost U.S. labor with cheaper foreign labor, and the net result of their foreign operations reduces domestic employment.[4] To oppose such a change in the tax code is tantamount to "rewarding corporations that create jobs and profits overseas."[5]

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[1] President Barack Obama: 2011 State of the Union Address. 25 January 2011.
[2] Applebaum, Binyamin: "Corporate Tax Reform Proves Hard to Change." *New York Times*, 27 January 2011.
[3] Cohn, Michael: "House Holds Hearing to Compare Tax Reform." *Accounting Today*, 25 May 2011.

[4] For instance, Treasury Secretary Tim Geithner testified to the Senate Finance Committee in 2010 that "substantive changes to our tax laws" are needed to "address those aspects that…encourage companies to ship jobs overseas." Jason Furman, Deputy Director of the National Economic Council wrote on the White House Blog that "One half (of the motivation for tax reform) is to end special tax preferences for creating jobs overseas." Council of Economic Advisors Chair Austan Goolsbee has said that he wants to "correct aspects of the tax code" that give US companies incentives to move jobs overseas. President Obama complained in the *Wall Street Journal* that our tax code "says you should pay lower taxes if you create a job in Bangalore, India, than if you create one in Buffalo."
[5] "Obama attacks GOP on its Attempts to Help Companies Shop Jobs Overseas." *Washington Examiner*, October 2010.

Conservatives, on the other hand, tend to treat the foreign activities of U.S.-based businesses as being motivated by the need to service overseas markets.[6] In this view, activities abroad actually create jobs in the United States that support those activities, such as in information technologies, marketing, or logistics. In other words, conservatives argue that they complement domestic activities while liberals assert that they are substitutes.

The other central philosophical difference relevant to international taxation relates to the extent to which the tax code impinges on the material decisions of businesses. Does the tax code as currently structured present a major impediment to doing business, or is it little more than an unavoidable nuisance that does not materially affect how firms conduct operations? Of course, nearly everyone acknowledges that the corporate tax code has some impact on how firms do business—witness the battle over the taxation of overseas profits—but the extent to which a high corporate tax rate actually deters how much a company invests, where it locates its operations, and how it operates remains a bone of contention.

Amity Shlaes writes in *The Forgotten Man* that President Franklin Roosevelt was outraged when he found out that businesses had deployed resources to reduce their tax bills after he signed legislation sharply increasing their taxes.[7] It is an outlook that still has its adherents among liberals, most recently manifested in the outrage generated by the *New York Times* profile[8] of General Electric's machinations to lower its tax bill.

We believe that it is self-evident that taxes affect the decisions of businesses, although we will nevertheless take pains to make the case in the affirmative throughout this brief. A profit-maximizing firm will plan extensively to minimize its tax bill—along with other expenses--through whatever means necessary, and preventing this behavior is both impossible and undesirable. A tax code should—to the extent possible—reflect this reality.

And the reality of our own tax code is that it reduces investment by businesses in the U.S., which results in lower productivity, lower wages, employment and output as well. In short, the high corporate tax rate impacts the entire economy.

We submit that the reason for Congress to pursue corporate tax reform is that it is possible to reduce the desultory effect of our current tax code on economic growth and employment without sacrificing revenue.

## Problems with our Tax Code

### 1. The Tax Rate is High

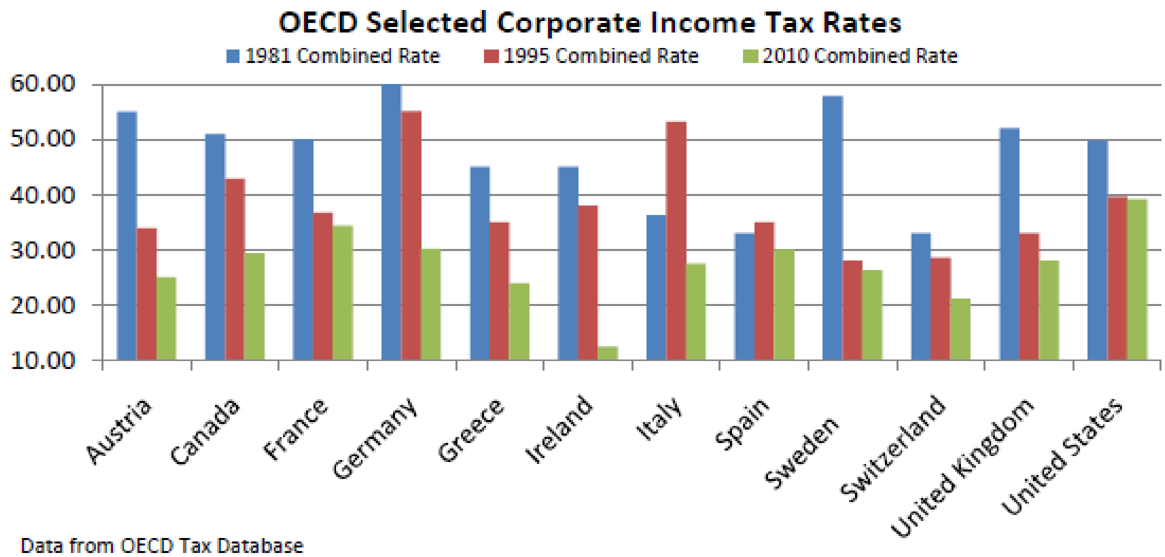
The United States currently taxes corporate profits at a rate of 35 percent, although the rate is slightly lower for companies with lower profits and reaches its maximum at profits above $18.33 million. The 50 states and the District of Columbia also impose a corporate income tax that ranges from just under five percent to twelve percent.[9] Some localities also impose a tax on corporate profits as well, which—together with the federal and state tax—combine for an average corporate tax rate of 39.2 percent on profits.[10] Of the thirty countries that comprise the Organization of Economic Coordination and Development (or OECD) only Japan currently has a higher tax rate—and their government had planned to reduce their rate to 35 percent in mid-year.[11] Around the world the U.S. corporate tax rate is exceeded only in a handful of countries, all of which are developing countries that have major extractive industries with significant foreign investment.

[6] For instance, Dave Camp said that corporate tax reform would "help companies expand their own global operations and support good-paying jobs within their own borders."
[7] HarperCollins Publishers, 2007.
[8] Kocieniewski, David: "GE's Strategies let it Avoid Paying Taxes Altogether." *New York Times*, 24 March 2011.

[9] "Corporate Tax in the United States," via Wikipedia, accessed 12 June 2012.
[10] Hassett, Kevin and Apurna Mathur: "Report Card on Effective Corporate Tax Rates." *Tax Policy Outlook*, American Enterprise Institute, February 2011.
[11] Japan has subsequently moved to postpone the rate reduction to help pay for disaster relief. See: Tabuchi, Hiroko: "Japan Will Cut Corporate Tax Rate." *New York Times*, 13 December 2010. See also: "Japan Mulls Consumption Tax Increase to pay for Earthquake Reconstruction." *Yomiuri Shimbun*, 20 April 2011.

Being a high corporate tax locale is a relatively new phenomenon for the U.S.; in 1986 Congress sharply reduced the top marginal rate from 46 to 34 percent, and then it ticked up to 35 percent in 1993, where it remains.[12] Meanwhile, the global trend has been toward sharply lower corporate tax rates: in the last twenty years every single OECD country reduced their tax rates except for the United States.[13] **Figure One** below shows how corporate tax rates around the world have gradually fallen over the last three decades. The corporate tax rate in the United States was fairly competitive in 1981, barely stayed competitive in 1995, and by 2010 had clearly become outmoded.

**Figure 1: Tax Rate Comparison**




Some research suggests that it may be the case that our corporate tax rate is actually above the revenue-maximizing rate dictated by a Laffer curve. Kimberly Clausing estimates a revenue-maximizing rate of 33 percent, which is lower for smaller countries integrated within the EU.[14] Kevin Hassett and Alex Brill estimate an even lower revenue-maximizing rate somewhere near 26 percent, a number that was eight percentage points lower than the revenue-maximizing rate in 1980, the first year of their study.[15] Hassett and Brill attribute the reduction directly to the increasing mobility of capital, which makes the global competition for capital all the more intense.

Nobel Laureate Robert Lucas remarked in an interview that reducing or eliminating the corporate income tax was "the largest genuinely free lunch I had seen,"[16] and estimated that the U.S. capital stock would be up to 50 percent larger with a more enlightened approach to taxing capital, along with higher productivity, wages, and employment to boot.[17]

### *The Effective Corporate Tax Rate is not much better*

Some economists and politicians claim that the notion that we are a high-corporate-tax state is mistaken, as the myriad deductions and credits in the tax code allow U.S. companies to escape a significant portion of taxes. For instance, Senator Max Baucus, Chair of the Senate Finance Committee, remarked at a hearing that

[12] "Historical Corporate Top Tax Rates and Bracket." Tax Policy Center, 12 April 2010.
[13] "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century." United States Treasury, December 2007.
[14] Clausing, Kimberly: "Corporate tax revenues in OECD countries." *International Tax and Public Finance* 14(2), April 2007, p. 115-133.
[15] Brill, Alex and Kevin Hassett: "Revenue Maximizing Corporate Income Taxes." AEI Working Paper #137, July 2007.
[16] Lucas, Robert: "Supply Side Economics: An Analytical Review." *Oxford Economic Papers*, April 1990, p. 293-316.
[17] Levy, David: "Interview with Robert Lucas." *The Region*, June 1993.

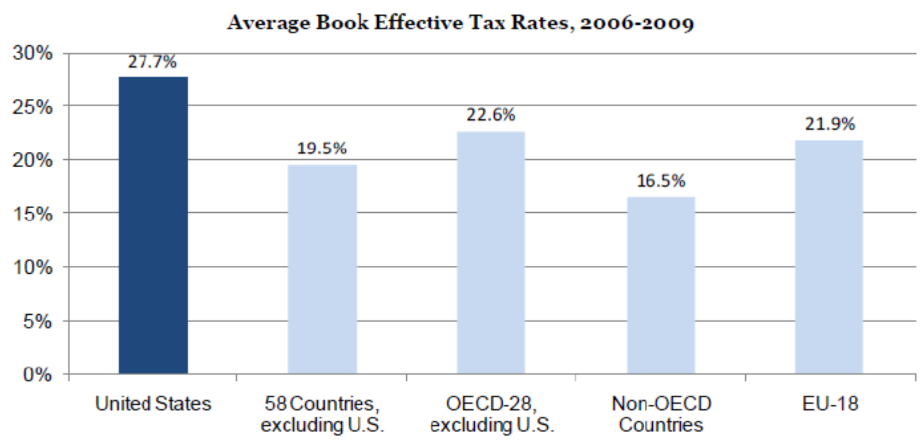
*"Some suggest that the U.S. has either the highest or second highest statutory corporate rate in the world, but the effective rate is competitive with other countries. The counter to that is…that people look at the statutory headline rate and psychologically that has an adverse effect."*[18]

It is true that the corporate tax code in the United States is replete with deductions, credits and exemptions that have the effect of lowering the tax bill for many corporations: For instance, the estimate of tax incentives for energy production alone range from $17 billion[19] to somewhere north of $50 billion a year,[20] and the Joint Committee on Taxation estimates that the lost revenue from the ten largest tax expenditures in the tax code sum to over $350 billion for the next five years.[21]

There is some dispute as to the very nature of a tax expenditure, because it presupposes an objective income "base" that economists can all agree upon. For instance, the debate over whether accelerated depreciation should be classified as a proper allowance or tax expenditure has existed since the 1970s, not too long after the concept of tax expenditure first gained currency in political circles.[22] Stephen Entin of IRET is fond of pointing out that a strict interpretation of the original Haig-Simons definition of tax expenditures would mean that their full elimination would force the government to tax the imputed rental value of owner-occupied housing.[23]

But setting aside the matter of accounting for the precise nature of a tax expenditure, taking into account the presence of these provisions by computing the effective tax rate facing the typical business does not alter the position of the United States as a high-corporate-tax country. Computing an effective tax rate still leaves the U.S. with a corporate tax rate above that of our major economic partners.[24] **Figure Two** shows an estimate from PwC of the average book effective tax rates in the United States and the rest of the world. PwC estimates that the rate for the U.S. over the 2006-2009 period was 27.7 percent, well above the average of the largest 58 countries of 19.5 percent, the 22.6 percent average of the other OECD members, and the average of the EU nations of 21.9 percent.[25]

**Figure 2: Tax Rate Trends**




Graph from: "Global Effective Tax Rates." PwC publication, 14 April 2011.

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[18] Statement by Sen. Baucus given at Senate Finance Committee Hearing on the Administration's 2012 Budget, February 2011.
[19] Energy In Brief Report. Energy Information Administration, September 2008.
[20] Dickerson, John: "Kernel of Truth." *Slate* magazine, June 2011.
[21] "Background Information on Tax Expenditure Analysis." JCT Publication JCX-15-11, 9 March 2011.
[22] See, for instance, Kahn, Douglas A: "Accelerated Depreciation: Tax Expenditure or Proper Allowance for Measuring Net Income?" *Michigan Law Review*, November 1979, p. 1-58.
[23] Entin, Stephen: "The End of Tax Expenditures as we Know them?" *IRET Policy Bulletin* number 84, June 2001.
[24] "Corporate Income Tax Rates: International Comparisons." CBO Publication, November 2005.
[25] "Global Effective Tax Rates." PwC publication, 14 April 2011.

### *The Rise in the Global Economy Makes Corporate Tax Rates More Relevant*

The global trend toward a lower corporate tax rate has coincided with the sharp increase in trade that has occurred over the last few decades. In 1960, trade to and from the United States represented just six percent of Gross Domestic Product, or GDP. Today, total trade in goods and services amounts to more than twenty-five percent of GDP.[26] Ben Bernanke pointed out that the emergence of the Indian and Chinese economies, as well as the former communist-bloc countries, implies that the majority of the earth's population is now engaged in the global economy in some way.[27]

Why are corporate tax rates going down? First, the global economy is much more closely integrated than it was previously. The end of most non-market economies of the Eastern Bloc and their integration into the world economy, the instantaneous transfer of information via the internet, and the steady diminution of transport costs have made the competition for capital, investment, and jobs much more intense than it ever has been. To illustrate the rise in global capital flows, consider that from 1987 to 2009 US fixed investment grew from $10 trillion to $34 trillion, a healthy 5.5 percent annual increase,[28] while U.S. privately-held assets abroad increased twice as fast, from $1.4 trillion to nearly $15 trillion, or 11 percent per annum.[29] Countries are keen to do what it takes to secure higher economic growth, and creating a more hospitable corporate tax environment is one way to attract the investment necessary for growth.

There have been attempts to manage the tax competition between countries, with limited success. Ireland has withstood significant pressure to increase its 12.5 percent corporate tax rate, the lowest in the EU, to bring it more in line with the other members, and thus far has resisted making such a change.[30] The OECD has been engaged in a decade-long project to either, depending on the point of view, reduce the impact of tax havens on tax revenue[31] to member countries or else prevent countries from undercutting one another's tax rates in a race to the bottom.[32]

### *Workers Bear the Brunt of the cost of the Corporate Income Tax*

The gradual reduction of corporate tax rates across the world is more than just a manifestation of a "beggar-thy-neighbor" approach to global investment: Over the last few years a wealth of research has been introduced suggesting that the burden of capital taxation is more diffuse than was previously thought, with labor bearing the lion's share of the costs. While the corporation may be the entity that actually remits the tax bill to the government, the writer of the check is irrelevant: The burden is divided between the consumers, who pay via higher prices; the shareholders, via lower returns to their investment; and the workers, via lower wages. In other words, the corporate tax system is not nearly as progressive a way to raise revenue as commonly assumed.

For instance, the Congressional Budget Office published a paper that estimated that labor bears about 70 percent of the tax burden, mainly by reducing investment—as a result lowering productivity and wages as well.[33] Roseanne Altschuler, Benjamin Harris and Eric Toder find that the corporate income tax in an open economy raises the cost of capital by much more than it lowers the returns to shareholders—implying that labor bears most of the burden.[34] Apurna Mathur and Kevin Hassett find a strong and significant negative correlation between corporate tax rates and

[26] U.S. Department of Commerce, International Trade Administration: Trade.Gov.

[27] Address by the Hon. Ben Bernanke to the Federal Reserve Bank of Kansas City's 13th Annual Symposium at Jackson Hole, Wyoming, August 25th, 2006.

[28] Bureau of Economic Analysis, National Economic Accounts, Table 2.1

[29] Elena L. Nguyen: "The International Investment Position of the United States at Yearend 2009." *Survey of Current Business*, July 2010, p. 9-19.

[30] Malloy, Thomas and Fionnan Sheahan: "French Stance puts cut on Bailout in Jeopardy." *Irish Independent*, 8 June 2011.

[31] Edwards, Chris and Daniel J. Mitchell: "Global Tax Revolution: The Rise of Tax Competition and the Battle to Defend it." Cato Press, 2008.

[32] See, for instance, "Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee of Council Affairs." OECD publication, 2000.

[33] Randolph, William C.: "International Burdens of the Corporate Income Tax." CBO publication 2006-09, August 2006.

[34] "Capital Income Taxation and Progressivity in a Global Economy." Urban Institute Publication, August 2010.

wages,[35] a result that Mathur and Matthew Jensen suggest is quite robust as well as consistent with the rest of the recent literature that has looked at this issue.[36]

Jane Gravelle and Kent Smetters take issue with what they call the "conventional view" that labor bears the brunt of the burden of capital taxation, suggesting that the distribution depends on the assumptions made regarding the impact of greater global economic integration on savings rates, or how corporate taxes impact savings rates. They admit that even under their own model, not-implausible parameter assumptions can imply that labor bears the brunt of the corporate tax burden as well.[37]

Regardless of the metric used, the U.S. is a high-tax country for corporate investment, and a large part of the burden is borne not by the owners of capital but by workers via lower investment, productivity, and wages.

## 2. Our Tax Code is Complex

The myriad tax breaks, deductions, and credits that litter our tax code mean that our tax rate needs to be kept higher to collect the necessary amount of revenue. These complications impose a number of different costs on our economy.

For instance, Gregory Hayes, the Chief Financial Officer of the United Technologies Corporation, recently testified to the House Ways and Means Committee that their federal tax return alone is 19,000 pages and that their headquarters house a dozen IRS agents who continuously audit the company's tax filings. General Electric employs nearly 1,000 tax lawyers to comply with the tax code,[38] and their tax code in 2006 was 24,000 pages long.[39] Fortune 500 companies feel the continued presence of the IRS, and the number of tax staff who work for Fortune 500 firms amount to a medium-sized city.

The U.S. corporate tax system costs businesses an estimated $40 billion per year in compliance costs, according to a Treasury Department Study.[40] In its 2004-2005 tax department survey, the Tax Executives Institute found that one-third of the 1,400 companies it surveyed had tax department budgets of between $1 and $5 million annually,[41] while Joel Slemrod and Marsha Blumenthal estimated in 1995 that the tax compliance costs of Fortune 500 firms averaged $2 million annually.[42]

Small businesses also face challenges in navigating the tax code. The National Federation of Independent Business (NFIB) conducted a survey in which "tax complexity" ranked as the fifth most severe problem for small business owners out of 75 assessed business problems.[43]

At over 3 million words, and with 4,426 changes to the tax code over the past 10 years, it's no wonder that companies have difficulty interpreting it and 100,000 IRS employees have difficulty administering it.[44] Corporate income taxes owe their complexity in part to the variety of deductions, credits, or other incentives businesses can take for different types of activities that have perceived social or economic policy goals. These include tax provisions made available to companies regardless of industry, industry-specific tax provisions, and provisions aimed toward aiding state and local governments or serving social policy objectives.[45]

[35] Hassett, Kevin and Apurna Mathur: "Taxes and Wages," *AEI Working Paper*, July 2006.
[36] Mathur, Apurna and Matthew Jensen: "Corporate Tax Burden on Labor: Theory and Evidence." *Tax Notes*, 6 June 2011.
[37] Gravelle, Jane and Kent Smetters: "Does the Open Economy Assumption Really Mean that Labor Bears the Burden of a Capital Income Tax?" *Advances in Economic Analysis and Policy* 6(1), 1 August 2006.
[38] Kocieniewski, David: "GE's Strategies let it Avoid Paying Taxes Altogether." *New York Times*, 24 March 2011.
[39] "IRS E-file Moves Forward." IRS Newswire, May 2006.
[40] Cited in: "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century." Office of Tax policy, U.S. Department of the Treasury, 20 December 2007.
[41] "TEI Publishes Survey of Corporate Tax Departments." Tax Executives Institute, Inc., News Release.
[42] Blumenthal, Marsha and Joel B. Slemrod: "The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications." *International Tax and Public Finance* 2(1), February 1995, p. 37-53.
[43] Dennis, William J.: "Small Business problems and Priorities." NFIB Research Foundation, June 2008.
[44] See Testimony of Nina Olson before the House Committee on Ways and Means, 20 January 2011.
[45] Hodge, Scott: "Putting Corporate Tax 'Loopholes' In Perspective." Tax Foundation. August 2010.

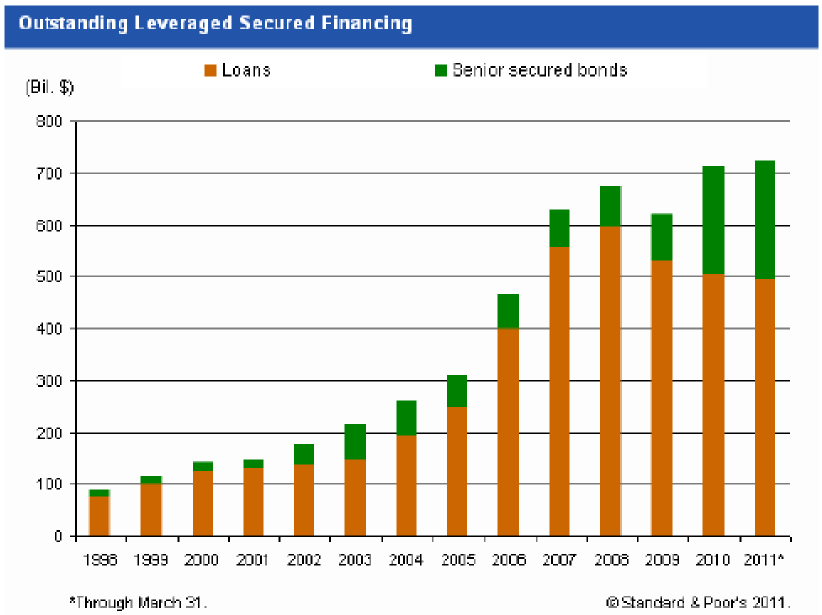
## 3. Our Tax Code Contains Pernicious Incentives

### *Layers of taxation create distortions*

The U.S. taxes corporate profits early and often. Someone who wants to invest first sees that money taxed when it is earned: Once it is invested, the company has to pay a tax on the returns in the form of the corporate income tax and then, after the company returns a portion of what's left to the shareholder, the government imposes a tax on any dividends received or on the capital gains realized. If the investor leaves a substantial estate, that money will be taxed yet another time. The multiple levels of taxation exacerbate an already-high tax on savings and investment, dampening both while also impacting corporate decision-making as well.

For example, it is well known that corporate taxes encourage debt financing by allowing corporations to deduct interest but not dividends or retained earnings. In contrast with debt financing, equity financed investment is taxed twice: first under the corporate income tax and again under dividend and capital gains taxes. As a result, corporations hold much more debt than they otherwise would, which in certain circumstances can create problems, especially when refinancing becomes difficult.

**Figure 3: Corporate Debt Trend**




Graph from: "Lookout Report: The Stage is Set for A Sixth Consecutive Double-Digit S&P 500 Earnings Growth." Standard & Poor's, April 8, 2011

**Figure Three** shows the trend toward increasing corporate debt.

Encouraging debt is merely one manifestation of the distortions created by the corporate tax code. Capital gains taxes lead to a variety of corporate planning strategies by raising the cost of capital, locking in assets, and complicating transactions. Policies such as taxing dividends more than retained corporate earnings can distort corporate distribution policy and potentially send misleading market signals.

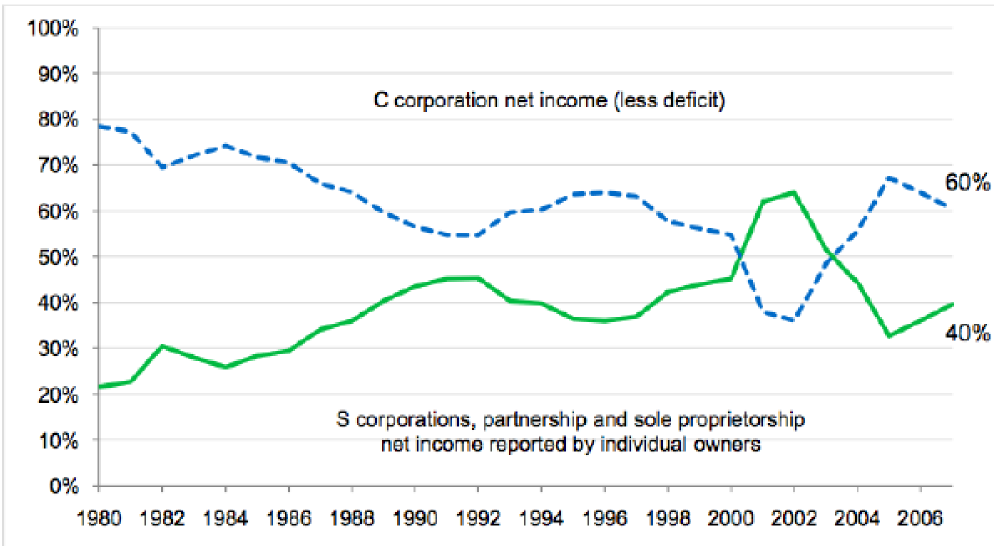
In addition, the tax burden on corporations discourages the corporate form itself and instead encourages investment in less-heavily taxed forms such as partnerships or in non-business assets.[46] Mark Weinberger and Eric Solomon testified to Congress on the influence that the heavy taxation on corporate earnings has had on shifting business activity toward S corporations, partnerships, limited liabilities, and sole proprietorships, pointing out that the United States has the second largest non-corporate sector among the OECD countries,

[46] "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century," Office of Tax policy, U.S. Department of the Treasury, 20 December 2007.

surpassed only by Mexico.[47] **Figure Four** illustrates the general trend in the formation of pass-through entities of the United States:

Not only are companies with the highest growth potential encouraged to invest outside of the U.S., but companies are actively avoiding attractive U.S. investments in order to evade the repatriation tax.

**Figure 4: U.S. Pass through and C Corporation Shares of Business Income. 1980-2007**




*Sources: Internal Revenue Service, Statistics of Income, Corporate Source Book and Individual Tax Returns (publication 1304), various years.*

Graph from: Testimony of Eric Solomon and Mark A. Weinberger before the committee on Finance, March 1, 2011.

### *The corporate tax code pushes investment abroad*

The corporate tax code distorts the international behavior of U.S. firms, the most costly manifestation of which is the fact that the U.S. system of worldwide taxation plus deferral of taxes on foreign-sourced income has trapped approximately $1 trillion of capital abroad. A 2007 study by Fritz Foley and a team of economists estimated that the median firm facing an average repatriation burden holds 47 percent of its cash abroad, while the median firm with a below average repatriation tax burden holds 26 percent of its cash abroad. They also find that technology companies and other high-growth companies as well as those with a high level of spending on research and development are particularly sensitive to the tax costs of repatriation. [48]

Another study by John Graham, Michelle Hanlon, and Terry Shevlin uses a survey of senior tax officers from over 400 corporations and finds that 20 percent of these companies reported investing foreign earnings in assets with a lower rate of return than they could have received in the U.S.[49] Forty-four percent of companies surveyed indicated that they had raised debt capital in the U.S. to avoid paying the repatriation tax.

In addition to affecting the investment decisions of firms already headquartered in the U.S., high corporate taxes discourage companies from incorporating in the United States to begin with. It is no coincidence that the new Deutsche Borse AG/NYSE Euronext group has incorporated in the Netherlands, with a corporate tax rate of 25.5 percent, rather than the United States with its combined 39.2 percent tax rate, or in Germany,

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[47] Testimony of Eric Solomon and Mark A. Weinberger before the committee on Finance, 1 March 2011.

[48] Foley, C. Fritz, Jay Hartzell, Sheridan Titman, and Garry Twite: "Why do Firms hold so much Cash? A Tax-Based Explanation," *Journal of Financial Economics* 86(3), December 2007, p. 579-607.

[49] Graham, John R., Michelle Hanlon, and Terry Shevlin: "Barriers to Mobility: The Lockout Effect of U.S. Taxation of Worldwide Corporate Profits," *National Tax Journal* 63(4, Part 2), December 2010, p. 1111-1144.

where it would face a combined 30.2 percent tax rate.[50]

U.S. companies expend significant resources in order to escape the burdens of U.S. taxation. Because the United States taxes corporations chartered in the U.S. on both their domestic and foreign-source income, but foreign-chartered corporations only on their U.S.-source income, many U.S. firms have used inversions as a means of avoiding foreign-source income taxes.[51] An inversion involves creating a new foreign corporation in a low-tax country that becomes the headquarters of the firm's foreign operations. Inverted firms can also use "earnings stripping" to shift U.S. source income to the foreign parent through lending between the two entities.

Other techniques for shifting income to low-tax jurisdictions include transfer pricing to strategically price goods and services between affiliates so that the bulk of a firm's profits are realized in the low-tax state, using hybrid entities that allow companies to be recognized as corporations only in certain jurisdictions, and employing cross crediting to increase the foreign tax credit limit.[52] Legislation has attempted to address many of these tax avoidance mechanisms, yet their variety and complexity testify to the lengths corporations will take to lower their U.S. tax burden. The U.S. tax code both discourages investment in the U.S. and results in a waste of economic resources.

### 4. Our Tax Code Inhibits Economic Growth

In addition to making U.S. companies less competitive and encouraging them to locate elsewhere, a wealth of recent empirical research also suggests that the high corporate tax rate in the United States serves to increase the user cost of capital, slowing investment, productivity, and with it economic growth. Jens Arnold and Cyrille Schwellnus explain in a 2008 OECD study how corporate taxes affect investment decisions, concluding that the result is a lower rate of return for innovative but risky investments, reducing both innovation and risk-taking.[53]

A variety of recent studies have confirmed an inverse relationship between corporate tax rates and economic growth. For example, a 2009 World Bank study links higher tax rates with lower investment and entrepreneurial activity.[54] The OECD report by Arnold and Schwellnus estimates that a 10 percent increase in the user cost of capital lowers investment by 7 percent, and from that infers that lowering the corporate tax rate from 35 to 30 percent would increase annual productivity growth by 0.4 percent per year.[55] Young Lee and Roger Gordon estimate that a ten percentage point reduction would increase productivity growth by somewhere between 1.1 and 1.8 percentage points. The implication of this research, suggests William Gentry and Glenn Hubbard, is that the corporate income tax is in a very real way a "success tax" that falls disproportionately on firms that have higher than the average productivity growth.[56]

Recent research also suggests that the corporate income tax has a higher cost on the economy than other forms of taxation. Another OECD study, this one by Asa Johansson, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartia, found that of all ways to generate revenue, corporate taxes have the most harmful effect on economic growth, followed by personal income taxes and then consumption taxes, an ordering echoed elsewhere.[57]

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50 See Van Tartwijk, Maarten: "Why Incorporate in the Netherlands? It's Less Taxing." Wall Street Journal, 15 February 2011; also see Scott Hodge, "Daimler-Chrysler Déjà vu." Tax Foundation, 17 February 2011.
51 Marples, Donald J.: "Firms That Incorporate Abroad for Tax Purposes: Corporate 'Inversions' and 'Expatriation.'" Congressional Research Service, 5 March 2010.
52 Marples, Donald J.: "Firms That Incorporate Abroad for Tax Purposes: Corporate 'Inversions' and 'Expatriation.'" Congressional Research Service, 5 March 2010.
53 Arnold, Jens and Cyrille Schwellnus: "Do corporate taxes reduce productivity and investment at the firm level? Cross-Country evidence from the Amadeus dataset." OECD Economics Department Working Paper No. 641, September 30, 2008.
54 Djankov, Simeon, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer: "The Effect of Corporate Taxes on Investment and Entrepreneurship." *American Economic Journal: Macroeconomics*, 2(3): 31–64, July 2010.
55 Arnold, Jens and Cyrille Schwellnus: "Do corporate taxes reduce productivity and investment at the firm level? Cross-Country evidence from the Amadeus dataset." OECD Economics Department Working Paper No. 641, September 30, 2008, cited in: "Corporate Taxes and Economic Growth." PwC, 1 February 2010.
56 See Gentry, W. and R.G. Hubbard: "Success Taxes, Entrepreneurial Entry, and Innovation." National Bureau of Economic Research, *NBER Working Paper* No. 10551, June 2004.
57 Johansson, Asa, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia: "Tax and Economic Growth." *OECD Economics Department* Working Paper No. 620, 11 July 2008.

The Joint Committee on Taxation determined in a recent study that while reductions in individual income tax rates may provide the largest short-term economic stimulus by temporarily increasing income, and with it the consumption of goods and services, reductions in corporate taxes have the greatest effect on long-term growth by increasing the stock of productive capital, which leads to higher labor productivity.[58] Given that the Joint Committee generally professes skepticism with regards to the dynamic response to tax changes, this is a not-insignificant stance and one that is framed not by ideology but by copious empirical evidence.

## How to Fix Our Corporate Tax Code

### 1. Reduce the Tax Rate

Having a corporate tax rate more competitive with the rest of the world would go a long ways toward stimulating more investment, productivity growth, employment, and output in the United States. Having a lower rate would both help encourage more investment by domestic companies as well as reduce the incentives in place to shift investment abroad.

Most tax economists on both side of the aisle are in agreement on this much. The stickier question is by how much we should reduce corporate tax rates and whether we should account for some of the revenues that would be lost by such a tax by eliminating any number of tax expenditures on the corporate side.

We concur with Alex Brill and Kevin Hassett's suggestion—referenced earlier—that the revenue loss from a slight reduction of the corporate tax rate would be relatively modest and less than the official estimates from the Joint Committee on Taxation and the U.S. Treasury because of the dynamic response of businesses to such a change. Of course, in today's environment of trillion dollar deficits even a small loss of revenue is a political non-starter, so proposing such a change begets another question: What revenue offsets should be included to make up for the revenue lost from reducing the tax rate?

Reforming our corporate tax code is well overdue and there are provisions that would make sense to eliminate to raise revenue. However, to impose a strict accounting that would make corporate tax reform revenue neutral may not result in a tax code—and rate—that are optimum for our economy. The fact that our effective corporate tax rate—what businesses pay after accounting for the various exclusions and deductions—remains near the top for developed nations suggests that the answer may be that we need to take less income from our households (who pay the corporate tax, after all) via the corporate tax rate.

While no one would characterize the corporate tax code as being "pristine" or as resembling in any way what an ideal corporate tax code might look like, many of the exclusions, credits, and deductions that make the tax code so complicated are in place to encourage investment—such as bonus depreciation and the research and experimentation tax credit.[59] Eliminating either of these to compensate for revenue lost from a tax rate reduction would not improve economic growth.[60]

Decreasing the corporate tax while retaining certain tax expenditures tends to be characterized simply as a gift to corporations. However, we need to remind people--over and over again, if necessary--that corporations *do not pay taxes*—workers, consumers, and investors do, and probably in that order. Reforming the tax code should be done with the goal of minimizing its impact on economic growth; distributional issues may be better dealt with outside of the confines of the tax code.

### 2. Transition to a Territorial Tax System

Any government that has power to tax needs to decide how to tax businesses located within its jurisdiction that also operate outside its jurisdiction. While expanding a tax base to include all of the income of a business would ostensibly allow the government to impose a lower tax rate (or else simply collect more revenue), such a tax code creates an incentive for another government to set up a system that does not tax income accrued

[58] "Macroeconomic Analysis of Various Proposals to Provide $500 Billion in Tax Relief." *Joint Committee on Taxation,* JCX-4-05, 1 March 2005.

[59] Hodge, Scott: "Who Benefits from Corporate Loopholes?" *Tax Foundation Fiscal Fact*, March 2011.

[60] We would like to go on the record as stating that the Research and Experimentation Tax Credit could (and should) certainly be made more efficacious.

outside its area to attract businesses and their accompanying tax revenue.

Alone among the thirty members of the Organization of Economic Cooperation and Development, or OECD, the United States uses a worldwide tax system that requires companies based in the U.S. to pay taxes on all of its earned income, regardless of where it was generated. Our isolation on this matter is relatively recent: Japan and the UK adopted a territorial system only in the last couple of years, following a steady exodus of the other developed countries from a worldwide system.

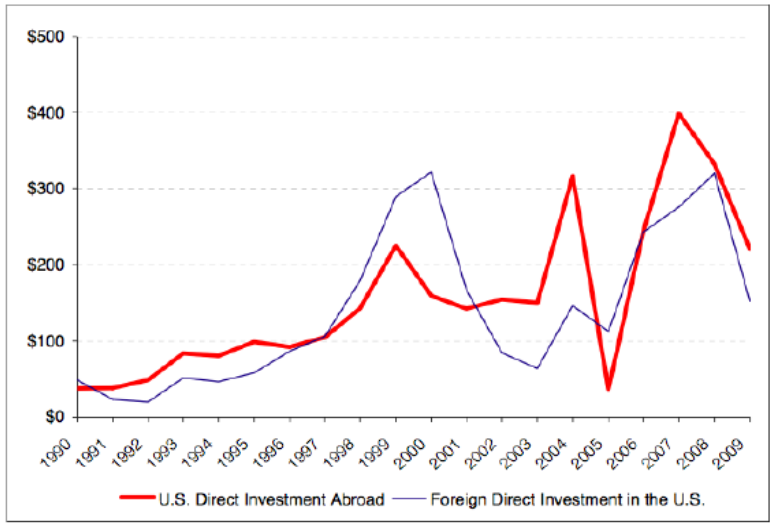
In a territorial tax system, the government only taxes the activities that occur within its jurisdiction, effectively ignoring a company's operations outside of its jurisdiction. For instance, a company headquartered in Denmark would pay corporate income taxes to Denmark only on the profits it actually earned in Denmark under such a system and be done with it.

In a worldwide tax system, a company remits taxes based on its global activities, with a credit to reflect the taxes it pays abroad. In the case of the United States, the company with a Danish subsidiary not only pays the Danish corporate tax of 25 percent but also must pay the U.S. government an additional tax so that the effective tax rate of the company's operations abroad face the same tax as businesses that operate solely in the U.S. In this case, it means that an additional tax of roughly 10 percent of profits would be due to the U.S. Government.

The intent of a worldwide tax system is to create a level playing field for U.S. companies producing only domestically, and U.S. companies operating abroad, so that there is no tax benefit to a U.S. company shifting operations overseas.

However, such a system also puts U.S. companies operating abroad at a competitive disadvantage *if* they are there in order to operate and sell in markets abroad. And that is precisely the reason that most companies move abroad, according to a preponderance of data. For instance, the Congressional Research Service observed the growth in foreign direct investment by U.S. firms in order to serve local markets abroad, noting that between 2000 and 2007 foreign affiliates increased their share of economic output within U.S. multinational companies from 22 percent to 30 percent.[61] The graph in **Figure Five** illustrates the trend toward increasing U.S. investment abroad, with temporary dips due to the repatriation holiday in 2004 and the recent recession.

**Figure 5:**
**Foreign Direct Investment in the United States and U.S. Direct Investment Abroad, Annual Flows, 1990-2009 (in billions of**




**Source:** U.S. Department of Commerce

**Note:** The drop in U.S. direct investment abroad in 2005 reflects actions by U.S. parent firms to reduce the amount of reinvested earnings going to their foreign affiliates for distribution to the U.S. parent firms in order to take advantage of one-time tax provisions in the American Jobs Creation Act of 2004 (P.L. 108-357).

Graph from: Jackson, James K.: "U.S. Direct Investment Abroad: Trends and Current Issues." Congressional Research Service, 1 February 2011.

## Conclusion: Dispelling Misperceptions and Prioritizing

The economist John Maynard Keynes is famous for writing that the ideas of dead economists are more powerful than is commonly understood; nowhere is this more evident than in people's perceptions of trade and the globalization of business.

One of the most durable economic ideas in the heads of non-economists is mercantilism, a notion that treats trade as a zero-sum game with winners (exporters) and losers (the importers) and encourages policies to create more "winners" in a country. Economists dismissed this notion with Adam Smith and David Ricardo but it remains a

[61] Jackson, James K.: "U.S. Direct Investment Abroad: Trends and Current Issues." Congressional Research Service, 1 February 2011.

durable worldview for many citizens the world over and not a few politicians.

Another durable yet largely disproved theory is the notion that efforts to reduce the cost of capital and investment inevitably displace workers and lead to an immiserizing growth that leaves workers and the economy worse off than before. The Luddites may have lost the battle in the realm of economic thought but many people still share those same concerns, uncomprehending that history shows that greater investment typically brings with it greater productivity, wages, and employment growth as well.

Along with these intuitively appealing but incorrect ideas goes the notion that domestic companies expand abroad primarily to substitute cheaper foreign labor for domestic labor. Our corporate tax code is largely predicated upon this notion, uniquely amongst the realm of the developed economies, and the Obama administration gives this worldview its full-throated support.

We beg to differ. In a world where transportation costs and borders matter, it behooves growing companies in almost every sphere of the economy to sell their products abroad, and for most that will inevitably mean setting up operations overseas as well. Expanding operations abroad inevitably leads to job creation domestically as well—the high-skilled, well-paid support jobs at a company's headquarters that are precisely the jobs we want more of. As Ed Glaeser discusses in his recent book *Triumph of the City*, there are good reasons that communities in the United States fight fiercely for such jobs and mourn when headquarters move away—witness the machinations in St. Louis and Milwaukee when their breweries were bought by foreign concerns.[62]

It is time that the United States had, in the words of former Treasury Secretary William Simon, a tax code that looked as if it were designed on purpose. Such a tax code would be focused on maximizing economic growth, reflecting the reality that growth is not only the best way to create jobs for all Americans but also the best and only way for us to afford to help those who are left out of the economy. To that end, such a tax code would have relatively low tax rates on capital to encourage investment, and it would not put U.S. operations abroad at a competitive disadvantage by applying higher taxes on them than on the non-American companies operating in the same market.

[62] Penguin Press, 2012.