Fundamental Tax REform:

Fixing The Corporate Tax Code

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To expand their economies and increase employment, most developed countries are restructuring their corporate tax systems and reducing their corporate tax rates. To date, the United States has taken an opposite approach that has yielded one of the most complex and uncompetitive corporate tax structures in the industrialized world. Its effects are troublesome: outsourced economic activity; lost domestic investment, growth, and jobs; and an eroded corporate tax base.

There appears to be a growing bipartisan consensus for near-term reform of the United States’ corporate income tax system. But another round of ad-hoc, temporary changes—as has been the course over the past few decades—is unlikely to advance the aim of sustained economic growth and job creation.

A new working paper, “[Why the United States Needs to Restructure the Corporate Income Tax](http://mercatus.org/publication/why-united-states-needs-restructure-corporate-income-tax),”by [Mercatus Center at George Mason University](http://www.mercatus.org) senior scholar [Jason Fichtner](http://mercatus.org/jason-j-fichtner) suggests successful reform of the U.S. corporate tax code must address its fundamental problems: 1) the uncompetitive corporate income tax rate; and 2) the outdated “worldwide” system for corporate tax collection.

This paper compares the U.S. corporate tax code with that of other industrialized countries, reviews key differences and outcomes, and discusses the changes necessary to resolve the code’s underlying problems. Below is a brief summary; to read the paper in its entirety and view its full sources, please click [here](http://mercatus.org/publication/why-united-states-needs-restructure-corporate-income-tax) or on the title link above.

**THE FUNDAMENTAL PROBLEMS**

**The 35-Percent Rate**. In 1990, the [Organization for Economic Co-operation and Development](http://www.oecd.org/dataoecd/26/56/33717459.xls) [OECD] average statutory combined corporate tax rate was 41.1 percent, higher than the United States’ rate of 38.7 percent. But while other nations have been racing over the past few decades to slash corporate tax rates to welcome multinational corporations, the United States has stagnated. Today, the United States has one of the highest corporate tax rates in the industrialized world—a national statutory rate of 35 percent and a statutory combined rate of 39.2 percent, compared with the average OECD rates of 23.4 percent and 25.1 percent, respectively.

This tax-rate gap puts American companies at a tremendous competitive disadvantage that is likely to worsen as other OECD nations reduce rates further to encourage their own economic growth:

* ***Japan.*** Japan is the only country with a higher combined corporate tax rate than the United States, but it [plans](http://www.nytimes.com/2010/12/14/business/global/14yen.html?amp;adxnnl=1&amp;pagewanted=all&amp;adxnnlx=1292447099-JgGK6XeGuChHDpOcXuiHjg) to reduce its statutory combined rate by roughly 5 percent in the near future.
* ***Canada***. Canada is attempting to lower its combined statutory rate [from 18 percent to 16.5 percent by 2012](http://www.taxfoundation.org/news/show/27100.html).
  + A recent Canadian [study](http://policyschool.ucalgary.ca/files/publicpolicy/fed%20prov%20tax%20reform%201a.pdf) estimated a 3-percent reduction in Canada’s national statutory rate would create 100,000 jobs and draw $30 billion in additional business investment over seven years.
  + Another Canadian [study](http://www.financialpost.com/Corporate+cuts+create+jobs+study/4163689/story.html) found a similar rate cut would create 98,000 jobs in two years.
* ***The United Kingdom.*** The United Kingdom intends to lower its corporate tax rate from [28 percent to 23 percent by 2014](http://www.taxfoundation.org/news/show/27100.html).

**The “Worldwide” Tax System**. There are two basic types of international tax systems: worldwide and territorial. The United States is one of the few developed countries still using a worldwide-type system. The U.S. government taxes all income earned by firms registered as U.S. domestic companies, regardless of whether the companies earned that income here or abroad. In a territorial system, the government taxes only income earned domestically. In essence, the worldwide system creates a tax on exports, “double-taxing” the overseas profits of American companies when the companies bring the profits back to the United States.

The U.S. Treasury Department [summarizes](http://faculty.law.wayne.edu/tad/Documents/Country/Treasury%20inversion%20report%205%2017%2002.pdf) the system’s disadvantages for domestic firms:

*No country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity. For example, the U.S. tax system imposes current tax on the income earned by a U.S.-owned foreign subsidiary from its shipping operations, while that company’s foreign owned competitors are not subject to tax on their shipping income. Consequently, the U.S.-based company’s margin on such operations is reduced by the amount of the tax, putting it at a disadvantage relative to the foreign competitor that does not bear such a tax. The U.S.-based company has less income to reinvest in its business, which can mean less growth and reduced future opportunities for that company.*

**THE RESULTS**

**Lost Investment, Jobs, and Growth**. A country’s corporate income tax rate [plays a major role](http://www.heritage.org/Research/Reports/2011/02/Corporate-Tax-Reform-Should-Focus-on-Rate-Reduction) in determining whether companies will invest capital in that country. Unfortunately, the United States’ corporate tax structure is hurting opportunities in these areas.

*Investment*

* U.S. firms are moving away from the United States to initiate and expand business opportunities. U.S. corporations’ share of worldwide profits attributable to foreign revenue has increased [from 6.7 percent in 1965 to 38.2 percent in 2009](http://businessroundtable.org/studies-and-reports/taxing-american-corporations-in-the-global-marketplace/). Companies often choose to keep this money abroad instead of bringing it home to reinvest in business expansion and job creation because the U.S. government would impose a second layer of taxes on the foreign-earned profits the companies brought back to the U.S.
* Steep corporate tax rates also have discouraged companies from investing in the United States. A recent [study](http://www.taxanalysts.com/www/features.nsf/Articles/FE9DCA58402875D7852573680064DA50?OpenDocument) in the journal *Tax Notes* showed that in 2004 multinational corporations shifted roughly $50 billion away from the United States to lower-tax countries.

*Jobs and Growth*

* [Estimates](http://www.usatoday.com/money/perfi/taxes/2008-03-20-corporate-tax-offshoring_N.htm) of U.S. jobs lost due to the current corporate income tax range from 200,000 to 3 million, but the consensus is that many companies terminate employees because the current corporate tax structure cuts so extensively into their profits that the companies move abroad.
* During the 2000s, major multinational corporations [reduced](http://online.wsj.com/article/SB10001424052748704821704576270783611823972.html) U.S. jobs by 2.9 million while increasing overseas employment by 2.4 million.
* A 2008 National Bureau of Economic Research [NBER] working paper [concluded](http://www.nber.org/papers/w13756) that a “10 percent increase in an effective tax rate reduces the aggregate investment to GDP ratio by 2 percentage points.” The NBER paper also shows that corporate tax rates are negatively correlated with economic growth.

**Higher Taxes on Individuals.** Asindividuals ultimately bear the burden of any corporate tax, the United States’ poorly constructed corporate code also increases the tax burden on workers, consumers, and investors. Economist Steve Horwitz explains:

*If corporations respond by reducing compensation or firing workers, the impact of the tax hits the employees. If they raise prices, the impact falls on the consumers who buy the product. And if they take a reduction in profits, the falling stock value lowers the value of various investment funds on which millions of Americans depend for retirement and other income*.

* A [paper](http://www.aei.org/docLib/20060706_TaxesandWages.pdf) by economists Kevin Hassett and Aparna Mathur showed that for every 1-percent increase in corporate tax rates, there was a 1-percent decrease in wages.
* A [working paper](http://www.cbo.gov/ftpdocs/75xx/doc7503/2006-09.pdf) by the Congressional Budget Office suggests workers bear “slightly more than 70 percent of the burden of the corporate income tax.”
* A [report](http://www.house.gov/jec/CorporateTaxReform.pdf) by the Joint Economic Committee summarizes the point, “*Any tax imposed on corporations results in either a reduction to employee wages, an increase in costs passed on to consumers, a reduction in the return to capital received by shareholders, or a combination of all three*.”

**Loopholes and Lobbyists**. By distorting U.S. companies’ incentive structures and investment behaviors, high corporate taxes also pose a significant unseen cost: inefficient use of resources. Companies often find it more “profitable” to invest in lobbyists who can expand tax preferences than to invest in intellectual or physical capital to expand business. Thus, companies that successfully exploit loopholes may end up paying little to no taxes, but at the expense of productive economic activity; companies that cannot afford to work the system must pay one of the highest tax rates in the industrialized world, making it highly difficult for them to compete. In either case, the U.S. loses some combination of economic activity and tax revenue.

**Higher Taxes, Lower Revenue**. Despite having one of the highest corporate tax rates, corporate tax revenue in the United States is lower than that in other OECD countries, even as a percentage of GDP. A [study](http://www.aei.org/docLib/20080404_BrillandHassettPublication.pdf) by economists Alex Brill and Kevin Hassett shows significant evidence that lowering the U.S. corporate tax rate would actually enhance tax revenue.

**THE NEEDED REFORMS**

The uncompetitive U.S. corporate tax system impedes U.S. companies’ ability to compete in the global marketplace and discourages potential domestic investment. If the United States is to be competitive in the future, some level of corporate tax restructuring has to occur. Successful reform must address the fundamental flaws in the system, specifically the uncompetitive corporate income tax rate and worldwide tax system.

**Lower the Corporate Income Tax Rate**. The U.S. corporate income tax rate should be reduced to at-or-below the OECD statutory average of 23.4 percent and ensure the statutory combined rate also falls below the OECD average of 25.1 percent.

**Move to a Territorial System.** Moving to a territorial system would significantly reduce the inefficiencies, inequities, and complexities of the current U.S. corporate tax system; help level the playing field for domestic firms; and remove a major incentive for U.S. multinational corporations to move their headquarters’ operations overseas. Potential reforms include exempting all foreign-source income, exempting only active foreign-source income, or exempting only certain kinds of foreign-source income.

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