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WHY THE UNITED STATES NEEDS TO RESTRUCTURE THE CORPORATE INCOME TAX

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Why the United States Needs to Restructure the Corporate Income Tax

"If you had two companies in Pittsburgh that both were going to expand capacity and create 100 jobs, our tax code puts the company who chooses to put the plant in Pittsburgh at a competitive disadvantage over the company that chooses to move to a tax haven."[1] Gene Sperling, Director of President Obama's National Economic Council

Introduction

To increase employment and expand their economies, most developed countries are both reducing their corporate tax rates and restructuring their corporate tax systems. The United States appears to be taking the opposite approach. Consequently, the increasingly costly U.S. corporate tax structure is driving competitive, profit-seeking corporations to minimize their tax exposure and defer income overseas to lower-tax countries. Unless the United States reforms its corporate tax system, the country will fall further behind in global competitiveness.

U.S. political leaders are well aware of this problem. In this year's State of the Union address, President Obama said,

> Over the years, a parade of lobbyists has rigged the tax code to benefit particular companies and industries. Those with accountants or lawyers to work the system can end up paying no taxes at all. But all the rest are hit with one of the highest corporate tax rates in the world. It makes no sense, and it has to change. . . . So tonight, I'm asking Democrats and Republicans to simplify the system. Get rid of the loopholes. Level the playing field. And use the savings to lower the corporate tax rate for the first time in 25 years—without adding to our deficit.[2]

House Budget Committee Chairman Paul Ryan (R-WI) agrees that the corporate tax system is stifling America's long-term fiscal goals. "We are beginning to get a consensus that this corporate tax system we have is very uncompetitive. It pushes jobs overseas. It locks capital up overseas,"[3] he told NPR in April.

The President and Chairman Ryan are correct. If Congress does not overhaul the corporate tax structure, the United States will continue to lose jobs to countries with lower taxes, domestic firms will be uncompetitive internationally, and investment in the United States will continue to decline. This paper

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[1] David J. Lynch, "Does Tax Code Send U.S. Jobs Offshore?" *USA Today*, March 21, 2008, http://www.usatoday.com/money/perfi/taxes/2008-03-20-corporate-tax-offshoring_N.htm.
[2] Barack Obama, *Remarks by the President in State of Union Address* (Washington, DC: GPO, January 25, 2011), http://www.whitehouse.gov/the-press-office/2011/01/25/remarks-president-state-union-address.
[3] Scott Horsley, "Obama, Ryan Agree: Business Tax Codes Need Reform," *NPR*, April 16, 2011, http://www.npr.org/2011/04/16/135464262/left-right-agree-business-tax-codes-just-too-hard.

begins by looking at the U.S. corporate income tax rate and system and compares the U.S. with other countries. The paper also examines the problems with the current system and shows how these problems are hindering the long-term economic growth of the United States.

How Corporate Tax Rates Work

National Statutory Rate, Statutory Combined Rate, and Effective Tax Rate

What is a corporate tax rate? Political pundits and the media use the term frequently, but they rarely explain what it means. Furthermore, there are multiple ways to define the corporate tax rate. To compare countries and empirical information, it is essential to use the appropriate definition. The corporate tax rate consists of three different rates that must be looked at together:

1. *National statutory rate*: The central government's tax rate imposed by law and assessed on corporate profits. Like individual income tax rates, corporate income tax rates are progressive, increasing with higher levels of income. Discussions of statutory rates typically refer to the top marginal rate. In the United States, corporations that earn profits of more than $18,333,333 are taxed at the top marginal rate of 35 percent.
2. *Statutory combined rate*: The statutory combined rate is the central government statutory rate plus state and local tax rates. The United States has a federal statutory corporate tax rate of 35 percent and an average state and local rate of 4.2 percent, giving the country's corporations a 39.2 percent statutory combined rate.

   However, corporations rarely pay the highest rate because of tax preferences, so focusing on solely on statutory rates can be misleading and out of context.
3. *Effective tax rate*: The effective tax rate is the amount of tax a divided by its total income. The effective tax rate accounts for all deductions, credits, depreciation, and preferences in the tax code and shows what percentage of its income a corporation actually pays in taxes.

Figure 1 shows where the United States ranks among developed countries in terms of these three corporate tax rates.

Figure 1: 2010 Corporate Tax Rates, United States vs. OECD Countries[4]

	United States	**Average of OECD Countries**	**U.S. Rank**
National Statutory Rate	35.0%	23.4%	34th out of 34
Statutory Combined Rate	39.2%	25.1%	33rd out of 34
Effective Rate	29.0%	20.5%	33rd out of 34

Source: Kevin A. Hassett and Aparna Mathur, *Report Card on Effective Corporate Tax Rates: United States Gets an F*, Tax Policy Outlook No. 1 (Washington, DC: American Enterprise Institute, February 2011), http://www.aei.org/docLib/TPO-2011-01-g.pdf.

The average tax rate for OECD countries provides an appropriate baseline for comparison. As Figure 1 shows, the average national statutory rate for OECD countries is 23.4 percent, the average statutory combined rate is 25.1 percent, and the average effective rate is 20.5 percent; the United States has a national statutory rate of 35 percent, a combined rate of 39.2 percent, and an effective rate of 29.0 percent. No matter which tax rate we examine, the United States has one of the highest corporate tax rates in the industrialized world. The only country with higher rates is Japan, and it plans to reduce its statutory combined rate by roughly 5 percent in the near future.[5] Uncompetitive U.S. corporate tax rates combined with today's advanced communications technology means certain corporations will invest in other developed countries with lower rates.[6] This situation poses an economic threat to the United States. Figure 2 shows where the United States ranks compared to other OECD countries.

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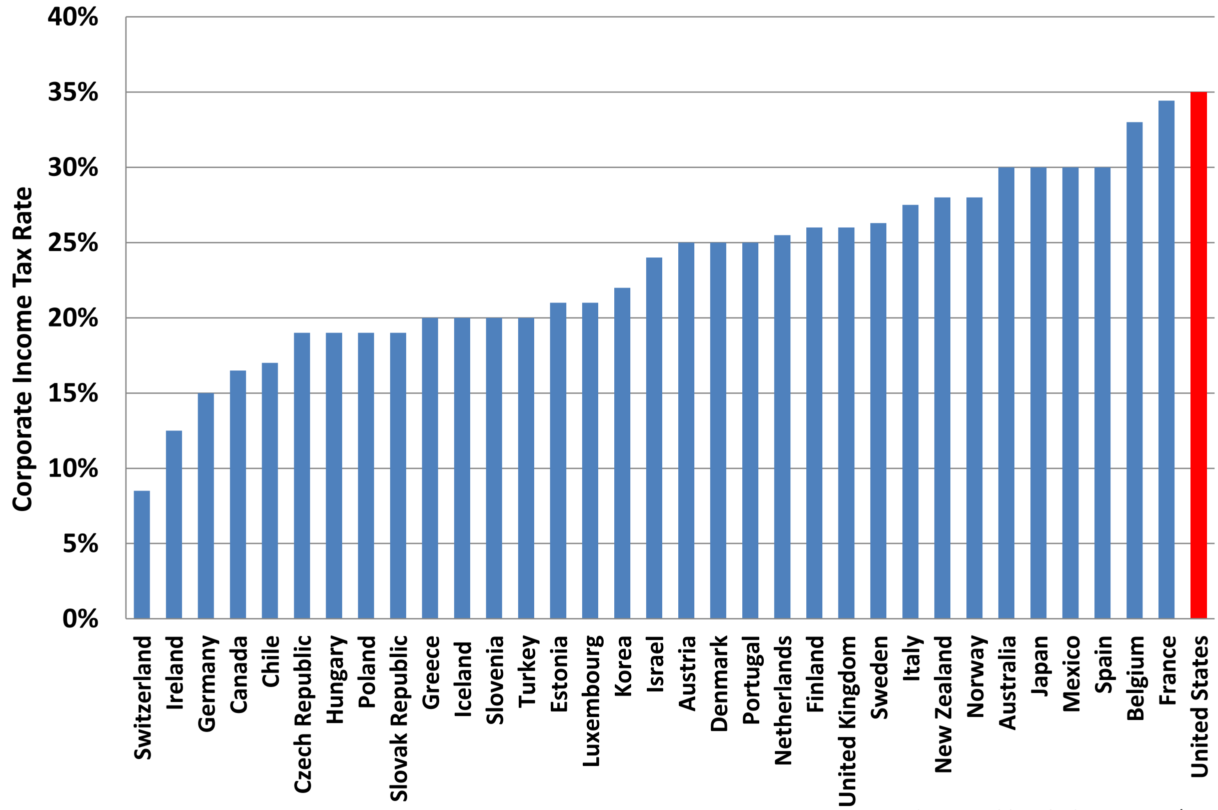
[4] OECD stands for Organisation for Economic Co-operation and Development. The 34-member-country organization promotes policies to improve economic and social well-being.

[5] Hiroko Tabuchi, "Japan Will Cut Corporate Income Tax Rate," *New York Times*, December 13, 2010, http://www.nytimes.com/2010/12/14/business/global/14yen.html.

[6] OECD, "Taxation of Corporate and Capital Income: Table II.I, Corporate Income Tax Rate," https://www.oecd.org/dataoecd/26/56/33717459.xls; Hassett and Mathu, *Report Card*.

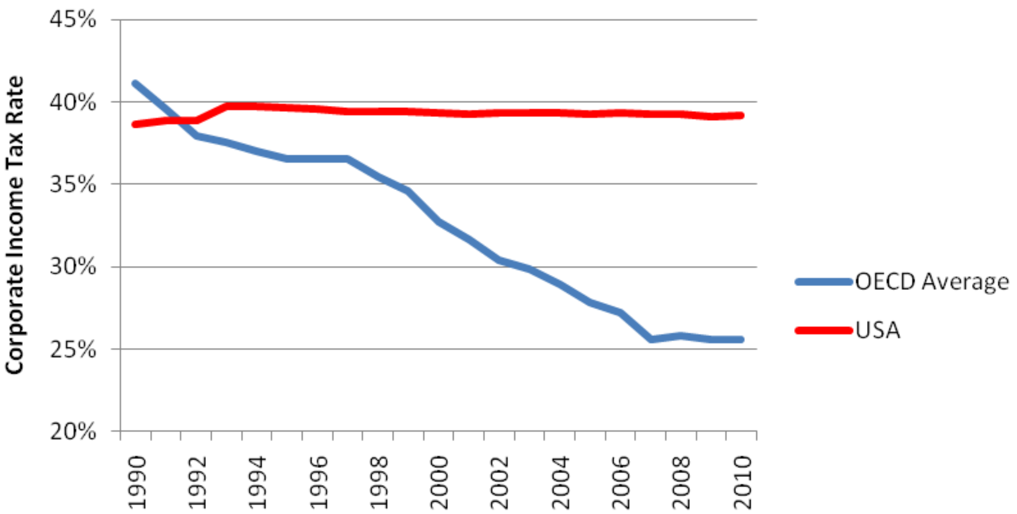
Figure 2: Corporate Income Tax Rates in OECD Countries



Source : 2011 OECD Tax Database
Produced by: Veronique de Rugy, Mercatus Center at George Mason University

The gap between the U.S. corporate tax rate and the rates in other developed countries was not always so large. In 1990, the OECD average statutory combined rate of 41.1 percent was higher than the 38.7 percent U.S. rate. However, less than a decade later, in 1999, the average statutory combined rate for the OECD countries had fallen to 34.8 percent as countries tried to either arrest capital flight or attract capital inflows. The United States' statutory combined rate, however, had risen to 39.4 percent by 1999. In the OECD rates have continued to fall, but U.S. rates have stagnated. Figure 3 illustrates the widening gap.

Figure 3: Average Statutory Combined Corporate Tax Rates: OECD Countries vs. the United States

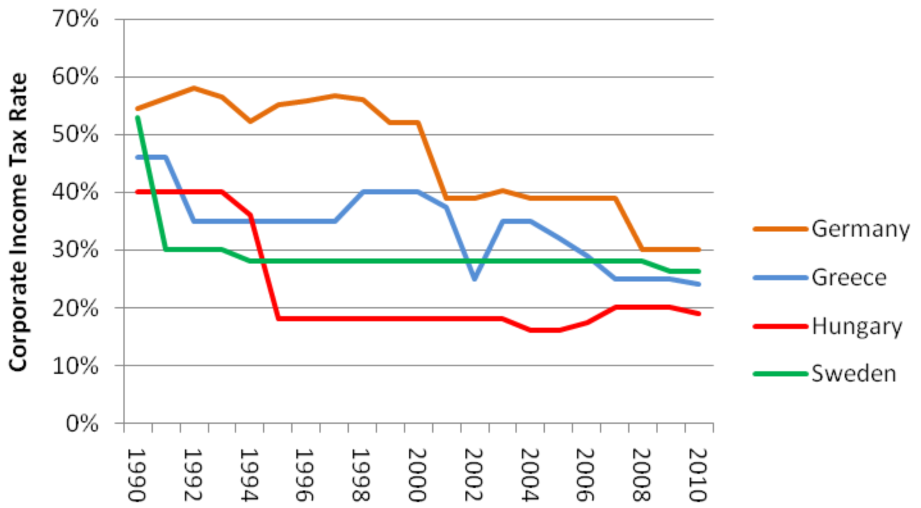


Source: Author's calculations based on OECD, "Taxation of Corporate and Capital Income, Table II.I, Corporate Income Tax Rate."

It is difficult to argue that lowering the combined tax rate is impractical or difficult. For example, over a 20-year period, developed countries like Germany, Sweden, Hungary, and Greece cut their corporate tax rates by 20 percent (see Figure 4).[7] These countries face different economic and political institutions, yet they all have broken through barriers to decrease their corporate tax rates.

[7] Chris Dubay, *Corporate Tax Reform Should Focus on Rate Reduction*," WebMemo No. 3146 (Washington, DC: Heritage Foundation, February 11, 2011), http://www.heritage.org/Research/Reports/2011/02/Corporate-Tax-Reform-Should-Focus-on-Rate-Reduction.

Figure 4: Statutory Combined Corporate Tax Cuts by Germany, Sweden, Hungary, and Greece



Source: Author's calculations based on OECD, "Taxation of Corporate and Capital Income, Table II.I, Corporate Income Tax Rate."

A focus on the statutory corporate tax rate could misrepresent the rate that corporations actually pay. The statutory rate is a ceiling. As explained previously, the effective tax rate, which accounts for all deductions, credits, depreciation, and tax code preferences, reflects what corporations actually pay in taxes. The effective tax rate for U.S. corporations ranges from 27.7 percent to 34.6 percent depending on the measures used. The range of effective tax rates remains higher than the OECD average and is still one of the highest rates in the world. Hence, whether we focus on statutory combined rates or the effective tax rate, the results are the same.

Worldwide Versus Territorial Tax Systems

Another important aspect of the corporate tax system is the way taxes are allocated and collected. There are two basic types of international tax systems: worldwide and territorial.[8] Though a hybrid of the two, the U.S. tax system is basically a worldwide system whereby firms registered as U.S. domestic companies are subject to taxation on all income regardless of whether they earn that income domestically or internationally. The U.S. government taxes profits generated by certain types of overseas activities in the year earned, but it does not tax profits from other activities until the company repatriates that income to the United States. Domestic corporations may take a credit for taxes paid on foreign income to foreign tax authorities, up to the U.S. tax rate, so that two national governments (a foreign tax authority and the

[8] Fichtner, *Reforming the U.S. Corporate Tax System*.

Internal Revenue Service) do not tax corporations on the same income. However, complex rules limit U.S. corporations from taking full credit for foreign taxes. If the foreign tax rate is less than 35 percent, as it is in most OECD countries, U.S. firms have a tax incentive to keep their profits overseas.

The United States is one of the few countries in the developed world that still uses a worldwide-based corporate tax system. Many foreign corporations that trade with the United States are incorporated in countries that operate under a territorial tax system. Twenty-six OECD member countries have implemented a territorial tax system, while only eight continue to use a worldwide tax system.[9] The other seven countries operating under a worldwide system have an average statutory corporate income tax rate of 22.36 percent, much lower than the 35 percent tax the United States imposes. In essence, the current U.S. tax system is a tax on exports and can be viewed as imposing double taxation on overseas profits, which further hinders the country's ability to compete economically with other nations.

The tax treatment of corporate income from foreign-owned firms creates a tax disadvantage for domestically owned firms. As the U.S. Treasury Department points out,

> 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.[10]

The complicated U.S. corporate tax system could be greatly simplified and the playing field with trading partners leveled if the United States moved toward a territorial system. Potential reforms include exempting all foreign-source income, exempting only active foreign-source income, or exempting only certain kinds of foreign-source income.[11] Such reforms would significantly reduce the inefficiencies, inequities, and complexities of the current U.S. corporate tax system and produce substantial economic benefits. Furthermore, adoption of a territorial tax system would remove a major incentive for U.S.

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[9] The countries are Chile, Greece, Ireland, Israel, Korea, Mexico, Poland, and the United States.

[10] Office of Tax Policy, United States Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications* (Washington, DC: Office of Tax Policy, May 2002), http://faculty.law.wayne.edu/tad/Documents/Country/Treasury%20inversion%20report%205%2017%2002.pdf.

[11] Foreign source income refers to income earned outside the company's home country. Active income is a category of income introduced with the Tax Reform Act of 1986 and generally refers to salaries, wages, commissions, and income from sources in which the company actively and materially participates. Passive income refers to revenue derived from sources such as rental real estate and income from other sources in which the company does not actively or materially participate. The distinction is important for tax purposes because passive losses are generally not allowed to offset active income.

multinational corporations to move their headquarters operations overseas. In 2009, both Japan and the United Kingdom adopted territorial tax systems to compete with other markets and expand their economies.[12]

A territorial system has numerous advantages over the more complicated worldwide tax system. It allows firms to focus less on complex accounting strategies and concentrate more on growth, investment, and production. A less complicated system would also mean less red tape within the tax code, allowing for less bureaucracy to administer and enforce tax laws.

The Perils of a High Corporate Rate

U.S. Firms at a Disadvantage

Firms respond to high tax rates and relocate economic activity to lower-tax countries. Thus, the current U.S. corporate tax structure places U.S.-headquartered corporations at a tremendous disadvantage in the global marketplace because other countries have lowered their corporate income tax rates to welcome multinational corporations. As mentioned earlier, in December 2010, Japanese Prime Minister Naoto Kan said he hoped to stimulate Japan's slow economy with a 5 percent corporate tax rate cut.[13] The United Kingdom is undergoing a multiyear process to lower its combined corporate tax rate to 24 percent by 2014.[14]

Canada is attempting to lower its national corporate tax rate from 18 percent to 16.5 percent, giving it a combined rate of roughly 28 percent. Canada has good reason to do this. A recent study by Jack Mintz, head of the Public Policy School at the University of Calgary, estimated that a 3 percent reduction in Canada's national statutory rate, from 18 percent to 15 percent, would create 100,000 jobs and draw $30 billion in additional business investment over a seven-year period.[15] An independent study by the Canadian Manufacturers and Exporters found that a similar rate cut would create 98,000 jobs in a two-year period.[16]

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[12] "Global Effective Tax Rates," Business Roundtable.
[13] Tabuchi, "Japan Will Cut Corporate Income Tax Rate."
[14] Scott Hodge, *Countdown to #1: 2011 Marks 20th Year That U.S. Corporate Tax Rate Is Higher than OECD Average* (Washington, DC: Tax Foundation, March 9, 2011), http://www.taxfoundation.org/news/show/27100.html.
[15] Duanjie Chen and Jack Mintz, *Federal-Provincial Business Tax Reforms*, University of Calgary, School of Public Policy Research Papers 4, No. 1 (Calgary, AB: University of Calgary, January 2011), http://policyschool.ucalgary.ca/files/publicpolicy/fed%20prov%20tax%20reform%201a.pdf.
[16] Paul Vieira, "Corporate Tax Cuts to Create 100,000 Jobs: Study," *National Post*, January 25, 2011, http://www.financialpost.com/Corporate+cuts+create+jobs+study/4163689/story.html.

The corporate income tax rate plays a major role in determining where a company will invest capital.[17] Thanks to communications technology, companies doing business together often do not require physical proximity. Thus, if two countries are similar in culture, infrastructure, and economic growth potential and one has a dramatically lower corporate income tax rate, an entrepreneur or an expanding firm would be financially reckless to invest in the country with the higher corporate tax rate.

U.S. firms are indeed 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.[18] A recent study in the journal *Tax Notes* showed that in 2004, multinational corporations shifted roughly $50 billion away from the United States to low-tax countries.[19] This investment shift not only creates losses and impedes growth for firms; it also creates losses for American workers. Companies could have utilized such profits to create more U.S. jobs.

Distorted Incentives

With a tax rate so much higher than that of other countries, U.S. corporations must turn their accounting departments into profit-maximizing centers. Companies need complex financial engineering tactics to minimize revenue losses using tax code preferences. Through various transfer pricing arrangements, accountants can allot income and capital to different countries to minimize tax liabilities and help companies to remain competitive.

Companies can spend more time and resources using tax rules as profit centers than focusing on potential business investment. This system is inefficient: the resources used to combat the tax could be invested in intellectual or physical capital. Investment could help the company to grow, which would lead to more jobs and output and would expand the domestic economy. Instead, the high corporate income tax rate distorts firms' incentive structures and investment behaviors. It sometimes becomes more "profitable" for companies to invest in lobbyists who can expand tax preferences than to use those resources to expand business output. Public policy should provide the proper structure to encourage growth. The current corporate tax structure forces firms to misallocate resources, causing a ripple effect throughout the

[17] Dubay, "Corporate Tax Reform Should Focus on Rate Reduction."
[18] "Taxing American Corporations in the Global Marketplace," Business Roundtable, March 30, 2011, http://businessroundtable.org/studies-and-reports/taxing-american-corporations-in-the-global-marketplace/.
[19] Peter Merrill, "The Corporate Tax Conundrum," *Tax Notes*, October 8, 2007.

organization's financial structure. The higher U.S. corporate tax rate means that firms have to cut costs or raise prices elsewhere to compete with firms based in lower-taxed countries.

Recently, both job creation and economic growth have been key topics among economic policy advisors. Restructuring the corporate tax system would address both issues. Policy makers debate the need for the federal government to continue investing in economic growth, yet such investment can do little good when current economic policies actually inhibit growth. When other countries have lower corporate income tax rates, firms may choose overseas destinations for business. Estimates of how many domestic jobs the current corporate income tax has killed range from 200,000 to 3 million,[20] but the consensus is that many employees are terminated specifically because of the high costs imposed by the current corporate tax structure. During the 2000s, major multinational corporations reduced U.S. jobs by 2.9 million while increasing overseas employment by 2.4 million.[21] Not all of these jobs were cut and outsourced specifically because of the corporate tax system. But was that system a contributing factor? Absolutely. Though outsourcing is no longer a popular trend, it remains an option for almost any multinational corporation seeking to reduce costs, including costs imposed by the corporate income tax.

Burden of Tax Falls on Individuals

A tax upon a corporation is an additional tax on individuals. Many people view the taxing of corporations as if some faceless entity were paying the tax. However, corporations are made up of individual investors and workers attempting to earn money by maximizing profits. Companies are not the only ones affected by corporate tax rates either. Individuals are also affected when high tax rates force corporations to charge more for their products and services. The poorly constructed U.S. corporate tax is, thus, a form of double taxation on productive workers, consumers, and investors. Economist Steve Horwitz notes that the corporate tax has "negative effects on real human beings" in several ways.

"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 values lowers the value of various investment funds on which millions of Americans depend for retirement and other income." [22]

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[20] Lynch, "Does Tax Code Send U.S. Jobs Offshore?"

[21] David Wessel, "Big U.S. Firms Shift Hiring Abroad," *Wall Street Journal*, April 19, 2011, http://online.wsj.com/article/SB10001424052748704821704576270783611823972.html.

[22] Steven G. Horwitz, "Corporations Are Indeed People," *Austin Statesman,* August 13, 2011, http://www.statesman.com/opinion/corporations-are-indeed-people-1740934.html.

As a report by Jason Fichtner of the Joint Economic Committee of the United States Congress explained, "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 shareholder, or a combination of all three."[23] A working paper by the Congressional Budget Office suggests workers bear "slightly more than 70 percent of the burden of the corporate income tax."[24] Moreover, economists Kevin Hassett and Aparna Mathur found an interesting unseen consequence of raising tax rates. For every 1 percent increase in corporate tax rates, they found a 1 percent decrease in wages.[25] This fact illustrates that corporations respond to incentives and allocate resources within given constraints and shows another way that individuals ultimately bear the burden of any corporate tax.

Decreased Economic Growth and Tax Revenue

The corporate income tax also impedes the country's economic growth. A 2008 National Bureau of Economic Research (NBER) working paper concluded that a "10 percent increase in an effective tax rate reduces the aggregate investment to GDP ratio by 2 percentage points."[26] The NBER paper also shows that corporate tax rates are negatively correlated with economic growth.

A higher tax rate may actually lead to less government revenue than a lower rate would. The $50 billion that U.S. corporations shifted to lower-tax countries in 2004 may have cost the U.S. government $17.4 billion in tax revenue.[27] Indeed, corporate tax revenue in the United States is lower than that in other OECD countries, even as a percentage of GDP. As Figure 5 shows, even as the economy has grown, corporate tax receipts as a percentage of GDP have decreased and have remained fairly constant since 1990. A study by economists Alex Brill and Kevin Hassett shows significant evidence that lowering the U.S. corporate tax rate would enhance tax revenue.[28]

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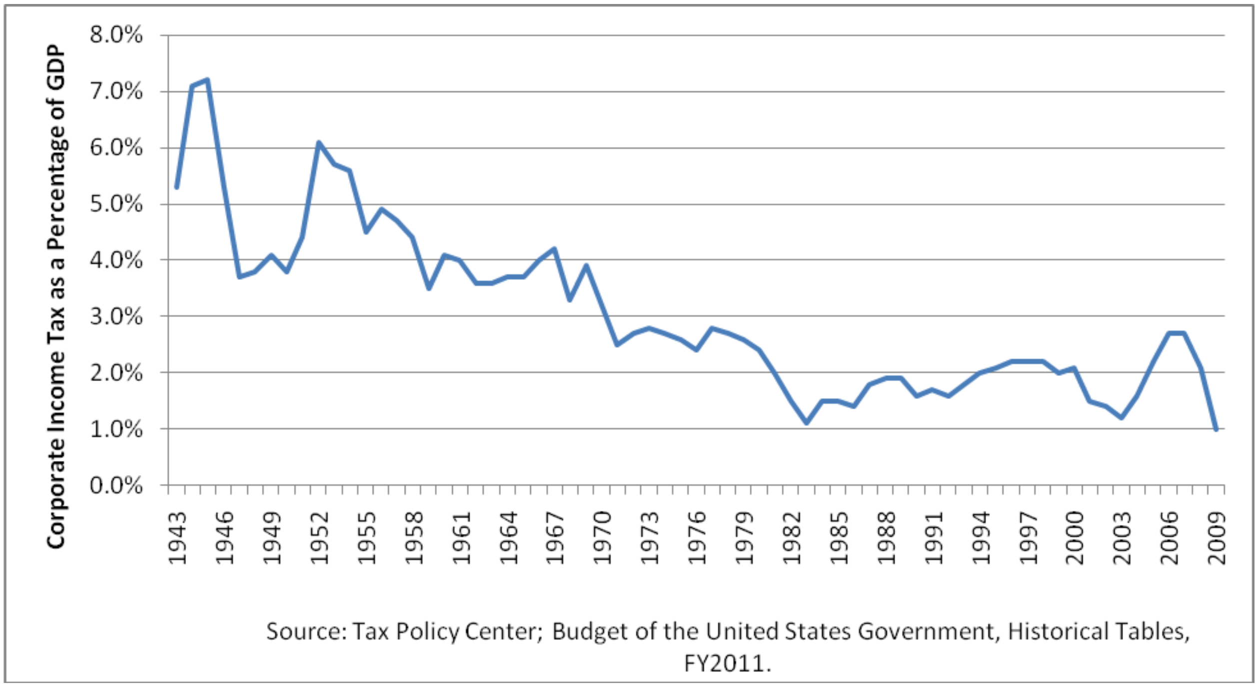
[23] Jason Fichtner, *Reforming the U.S. Corporate Tax System to Increase Competitiveness* (Washington, DC: Joint Economic Committee, United States Congress, May 2005).
[24] William Randolph, "International Burdens of the Corporate Income Tax" (working paper, Congressional Budget Office, Washington, DC, August 2006), http://www.cbo.gov/ftpdocs/75xx/doc7503/2006-09.pdf.
[25] Kevin A. Hassett and Aparna Mathur, "Taxes and Wages" (American Enterprise Institute Working Paper No. 128, Washington, DC, June 2006), http://www.aei.org/docLib/20060706_TaxesandWages.pdf.
[26] Simeon Djankov, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer, "The Effect of Corporate Taxes on Investment and Entrepreneurship" (National Bureau of Economic Research Working Paper No. 13756, Cambridge, MA, January 2008).
[27] Merrill, "Corporate Tax Conundrum"; "Global Effective Tax Rates," Business Roundtable.
[28] Alex Brill and Kevin Hassett, "Revenue-Maximizing Corporate Income Taxes" (American Enterprise Institute Working Paper No. 137, Washington, DC, July 31, 2007), http://www.aei.org/docLib/20080404_BrillandHassettPublication.pdf.

Figure 5: U.S. Statutory Corporate Income Tax as a Share of GDP



Conclusion

The uncompetitive U.S. corporate tax system impedes American corporations' ability to compete in the global marketplace. It also discourages potential domestic investment. If the United States is to be competitive in the future, some level of corporate tax restructuring has to occur. While other nations have been racing over the last 20 years to slash corporate tax rates, the United States has stagnated. At times the government has enacted temporary changes to tax policy, but it has ignored the underlying problems that need permanent reform.

The United States has an infamously dense and complicated tax code that is in dire need of simplification. Systemic problems exist not only in loopholes and tax havens, but also in the uncompetitive high corporate income tax rate and the worldwide-based tax system that encourages businesses to move jobs and investment overseas and to lobby for more loopholes. High corporate taxes lead to lower wages and investment and hinder long-term economic growth. To protect American jobs and secure future fiscal stability, the United States must slash its corporate tax rate. Absent sweeping corporate tax reforms, U.S. competitiveness will continue to languish. Inaction will create troublesome results: the foreign outsourcing of economic activity, a further loss of American jobs, the sale of U.S. companies to foreign multinational companies, a further erosion of the corporate tax base, and the continuation of harmful tax policies that are biased against saving, investment, job creation, and economic growth.