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INSTITUTE PROPOSES MAJOR US CORPORATE TAX REFORM

Washington, DC—A new study by the Institute for International Economics concludes that the United States should abolish the present corporate income tax in favor of a cash flow tax paid only by the largest firms. This reform would reduce the economic distortions and curtail the inequities caused by the current system, eliminate the international competitive disadvantages that the system foists on US business, and enhance public revenues. It should be an integral part of any tax reform program that emanates from the recent report of the President's Advisory Panel on Federal Tax Reform.

In *Reforming the US Corporate Tax*, authors Gary Clyde Hufbauer and Paul L. E. Grieco offer two alternatives for replacing the federal corporate income tax. One is a corporate activity tax (CAT), a cash-flow tax paid only by large corporations. The second is a national retail sales tax (NRST), collected at the checkout counter.

Both of these alternatives have key advantages over the proposals recently put forward by the president's advisory panel. Both would be assessed on a large revenue base at low taxation rates. By comparison with the current federal corporate tax, which has a marginal rate of 35 percent, either the CAT or NRST could raise the same revenue at rates between 10 and 12 percent—with much simpler laws and far less paperwork than firms now face.

In its "Growth and Investment Plan," the president's advisory panel suggests replacing the corporate income tax with a cash flow tax. This plan has similarities with the CAT advocated by Hufbauer and Grieco. Their common goals—shared by the NRST—are to adjust business taxes at the border, allow full expensing of new

investment, and level the jagged and inefficient tax profile.

However, the CAT and the NRST have a decisive advantage over the panel's plan—much lower rates. Because the panel's plan allows a deduction for wages and salaries, the tax rate must be 30 percent in order to replace the revenue generated by the current corporate tax. When combined with the individual income tax on dividends and capital gains, the overall marginal tax rate on capital income would be around 40 percent, compared with about 25 percent for a CAT or NRST. Further, the panel's cash flow tax would be collected on over 7 million corporations and partnerships while the CAT would be assessed only on about 200,000 of the largest firms.

The administration and Congress should, however, view the panel's plan as a starting point for far-reaching reform of the ancient corporate income tax. Since 1909, the federal government has relied on this tax as its primary method of business taxation. But the accumulated vices of the corporate income tax are well known:

- Uneven effective rates, between and within industries, distort the US economy.
- Numerous credits and deductions encourage firms to engage in lobbying and tax-avoidance schemes.
- Debt financing is encouraged over equity financing.
- Dividends and capital gains are double-taxed, discouraging investment.
- Because the corporate tax is not adjusted at the border, US production for the home and export markets is discouraged while abusive transfer pricing is encouraged.

Before the advent of intense worldwide competition for business investment, these vices were outweighed by the political advantages of the corporate income tax. Today, there are new and persuasive reasons for scrapping the corporate tax.

First, the growth of mandatory entitlement spending after 2010 threatens to create a fiscal crisis in the United States. The authors conclude that the federal government must *both* cut entitlements *and* increase taxation in order to maintain fiscal balance. Some of the increased tax revenue will inevitably be collected from business firms. The rickety corporate tax system, which already costs the US economy roughly 24 cents for every

dollar collected, will inflict tremendous damage on the US economy if it becomes the vehicle for collecting additional revenue on a large scale.

Second, the corporate income tax drives new plant and equipment investment to other countries and prompts firms to establish their corporate headquarters in tax-friendly jurisdictions like London, Zurich, or Singapore rather than in leading US metropolitan areas. The United States now applies a higher combined federal-state tax on corporate profits than most of its competitors. Moreover, under its current rules, the United States seeks to tax the worldwide profits of US-based firms, contrary to the practice of many other countries. As a result, when taxes play a role in a firm's decision on whether to locate in the United States or elsewhere—in Europe or Asia—the United States often comes off second or third best.

Third, most nations adjust a substantial portion of business taxes at the border so that imports are taxed while exports are not. Under World Trade Organization rules, the United States cannot adjust the corporate income tax at the border. Thus in tax terms it is often more advantageous for firms to serve US and foreign markets with production abroad rather than production in the United States. And it pays them to use abusive transfer prices to book profits in low-tax jurisdictions abroad rather than in the high-tax United States.

The federal corporate tax is slowly but surely eroding the US industrial and intellectual base, not only in manufactured goods but also in a wide range of service activities. A broad-based low-rate business tax, modeled after an NRST or CAT, would reverse this destructive process.

About the Authors

Gary Clyde Hufbauer, Reginald Jones Senior Fellow since 1992, was formerly the Marcus Wallenberg Professor of International Finance Diplomacy at Georgetown University (1985-92); Senior Fellow at the Institute (1981-85), deputy director of the International Law Institute at Georgetown University (1979-81); deputy assistant secretary for international trade and investment policy of the US Treasury (1977-79); and director of the international tax staff at the Treasury (1974-76). Among the books he has authored

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Paul L. E. Grieco, doctoral student at Northwestern University's Department of Economics, was a research assistant at the Institute for International Economics. He coauthored "The Payoff to America from Global Integration" in *The United States and the World Economy: Foreign Economic Policy for the Next Decade* (2005) and assisted with *NAFTA Revisited: Achievements and Challenges* (2005).

About the Institute

The Institute for International Economics, whose director is C. Fred Bergsten, is the only major research center in the United States that is primarily devoted to global economic policy issues. Its staff of about 50 focus on macroeconomic topics, international money and finance, trade and related social issues, and international investment, and cover all key regions—especially Europe, Asia, and Latin America. The Institute averages one or more publications per month; holds one or more meetings, seminars, or conferences almost every week; and is widely tapped over its popular Web site.

Reforming the US Corporate Tax

Gary Clyde Hufbauer and Paul L. E. Grieco

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