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In Brief

INSTITUTE FOR INTERNATIONAL ECONOMICS

Reforming the US Corporate Tax

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September 2005 • 144 pp. • ISBN Paper 0-88132-384-5 • $19.95

The US corporate income tax badly serves the United States. It hobbles the country in global competition, does little or nothing to promote equality, is riddled with distortions that erode efficiency, and promises to get much worse. As a means of taxing the richest Americans—a popular goal—it is a hopeless failure. Many companies pay no corporate tax, and among those that do, the burden is highly uneven. The resulting economic distortion reduces US GDP by 24 cents for each dollar of corporate income tax the Internal Revenue Service collects.

The tax owes its survival to three political realities:

- Lawmakers can satisfy powerful constituents by contorting the Internal Revenue Code. Under pressure from business lobbies, Congress legislates deductions and exemptions that twist the corporate tax base far from any plausible financial definition, then Congress enacts "targeted" tax credits to carry out unrealistic industrial policies.
- Faced with a tax terrain of mountains and ravines, corporations employ armies of lawyers and accountants to devise avoidance strategies. These lobbyists and attorneys can collect handsome fees for creating and exploiting exotic loopholes.
- The general public confuses a tax on corporations with a tax on the rich, a popular goal for many Americans.

Two new forces may upset the traditional political equilibrium: the need for federal revenue and international competition. The fiscal bill is fast coming due on Social Security, Medicare, and other entitlements. In the battle between taxpayers and retirees, business firms will not escape. Without an alternative source of business revenue, Congress will focus on the corporate income tax, and higher rates will almost certainly be accompanied by deeper preferences. In that scenario, the economic costs of corporate income tax distortions will escalate, perhaps sharply.

Moreover, in today's era of global capital mobility, business firms are highly responsive to differences between corporate tax jurisdictions. Lower tax rates elsewhere encourage business firms to locate new facilities outside the United States. US marginal corporate rates have remained about the

same since the 1980s; meanwhile other industrial and emerging countries have cut their rates and added new incentives (e.g., tax holidays) to attract investment dollars.

The time has come to scrap the ancient corporate tax and replace it with more efficient means of raising revenue from the corporate sector. The authors propose two alternatives: a **national retail sales tax** (NRST) and a **corporate activity tax** (CAT) modeled after the value added tax (VAT). Either would assess tax at a low uniform rate across a broad base. Consequently, each could relieve the economic drag of tax distortion and allow Congress to increase revenues while inflicting far less damage on US business.

In macroeconomic terms, the NRST and CAT are similar in their efficiency and distributional impacts. Both systems would improve the efficiency of the US economy enormously compared with the corporate income tax. Either proposal would also sharply improve the competitive position of the United States as a place to base headquarters, research, and production of goods and services. Neither tax overtly penalizes success by relying on taxation of profits at a high rate, the *modus operandi* of the corporate income tax. Also, both can be tailored to eliminate the regressive impact on poor households.

With respect to border adjustment, the two systems are likely to achieve similar results, albeit through different paths. Both would put the US traded goods sector on the same tax footing as its global competition: Business taxes would be imposed on imports and exempted on exports—in full accordance with World Trade Organization (WTO) rules. Hence they would finally resolve the debate over offshore outsourcing for tax reasons.

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