The Hidden Cost of
Federal Tax Policy

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CHAPTER 3

Why Should Congress Restructure the Corporate Income Tax?

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

US political leaders are well aware of this problem. In his 2011 State of the Union Address, President Barack Obama said the following:

> 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

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> 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.[1]

Speaking to National Public Radio in 2011, then–House Budget Committee Chairman Paul Ryan (R-WI), who is now chairman of the House Ways and Means Committee, agreed that the existing 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."[2]

President Obama and Chairman Ryan are correct. If Congress does not overhaul the corporate income tax structure, the United States will continue to lose jobs to countries with lower taxes, domestic firms will become increasingly less competitive internationally, and investment in the United States will continue to decline. This chapter begins by looking at the US corporate income tax rate and the corporate tax system and compares those of the United States with those of other countries. The chapter then examines problems with the current US system and shows how these problems hinder the long-term economic growth of the country.

HOW CORPORATE INCOME TAX RATES WORK

What does *corporate income tax rate* mean? Political pundits and the news media use the term frequently but rarely explain it. Furthermore, the corporate income tax rate can be defined in many ways. To compare countries and empirical information, one must use the appropriate definition. The corporate income tax rate in fact consists of three different rates that must be examined together:

- *National statutory rate.* This rate is the central government's tax rate, imposed by law, that is 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 $18.3 million are taxed at the top marginal rate of 35 percent.
- *Statutory combined rate.* The statutory combined rate is the central government's statutory rate plus state and local tax rates. The United States has a top corporate tax rate of 35 percent; along with the average combined state and local rate of 4.1 percent, the total statutory rate for corporations is 39.1 percent. However, corporations rarely pay the highest rate because of tax preferences, so focusing solely on statutory rates can be misleading.

Table 3.1. US and OECD Corporate Income Tax Rates, 2013

TYPE OF RATE	UNITED STATES (%)	OECD AVERAGE (%)	US RANK
National statutory rate	35.0	23.3	34th out of 34
Statutory combined rate	39.1	25.5	33rd out of 34

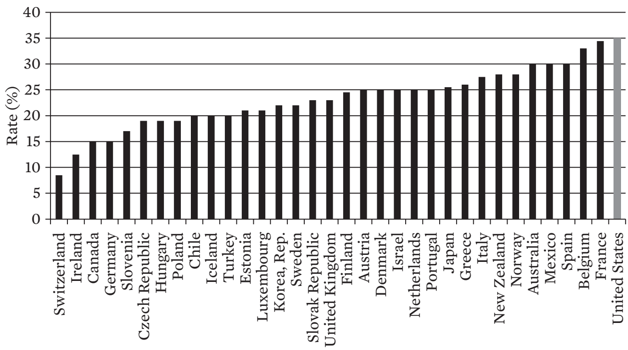
Source: PricewaterhouseCoopers, "Assessing Tax: 2013 Tax Rate Benchmarking Study for Industrial Products and Automotive Products," May 2013; OECD, "Taxation of Corporate and Capital Income," table II.I, Paris, May 2013; KPMG, "Corporate Tax Rates Table," http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx.

- *Effective tax rate*. The effective tax rate is the amount of income tax divided by total corporate income. The rate accounts for all deductions, credits, depreciation, and preferences in the tax code and yields the percentage of income that a corporation actually pays in taxes.

Table 3.1 shows where the United States ranks among developed countries in terms of the national statutory and statutory combined tax rates. Because of preferences in the tax code, effective tax rates vary widely from industry to industry. See the appendix for trends in the effective tax rates applying to different industries.

As a baseline for comparison, table 3.1 shows the average corporate tax rate for member countries of the Organisation for Economic Co-operation and Development (OECD). The average national statu-

Figure 3.1. National Statutory Corporate Income Tax Rates in OECD Countries, 2013

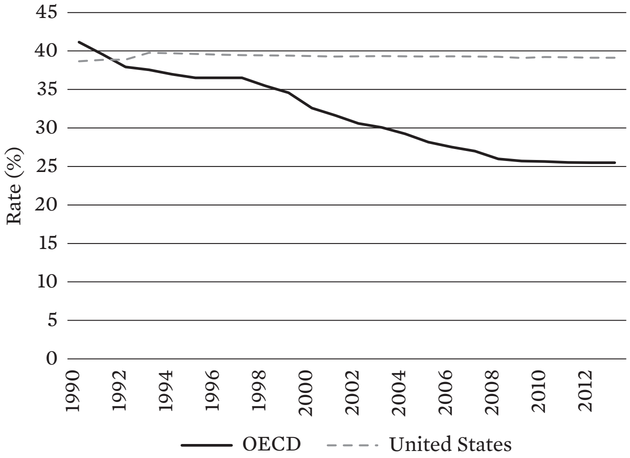


Source: OECD, "Taxation of Corporate and Capital Income," table II.I, Paris, May 2013.

tory rate for the OECD countries is 23 percent, and the average statutory combined rate is 25 percent. As of 2013, the United States had the highest statutory rate in the developed world and was second worldwide to the United Arab Emirates.[3] Uncompetitive US corporate tax rates, combined with the advantages of today's advanced communication technologies, lead certain US corporations to invest in other developed countries that have lower tax rates.[4] This situation threatens the health of the US economy. Figure 3.1 shows how the United States ranks compared to other OECD countries.

The gap between the US corporate tax rate and the rates of other developed countries was not always so large. In 1990, the OECD member countries' average statutory combined rate was 41.1 percent and the US rate was 38.7 percent. But less than a decade later,

Figure 3.2. Average Statutory Combined Corporate Income Tax Rates, 1990–2012

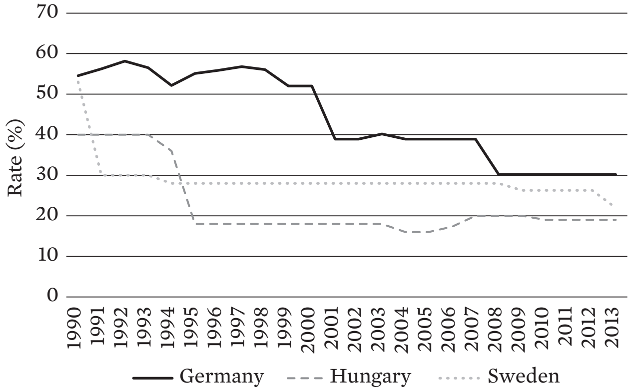


Source: OECD, "Taxation of Corporate and Capital Income," table II.I, Paris, May 2013.

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 inflow. The US statutory combined rate, however, had risen to 39.4 percent by then. Overall, the OECD rates have continued to fall, but US rates have remained high. Figure 3.2 illustrates the widening gap from 1990 through 2012.

Over a 20-year period, developed countries such as Germany, Sweden, and Hungary cut their corporate tax rates by 20 percentage points (see figure 3.3).[5] These countries have different economic and political institutions, yet they have all broken

Figure 3.3. Statutory Combined Corporate Tax Rate Cuts in Selected Countries, 1990–2013



Source: OECD, "Taxation of Corporate and Capital Income," table II.l, Paris, May 2013; Jason J. Fichtner and Nick Tuszynski, "Why the United States Needs to Restructure the Corporate Income Tax," Mercatus Working Paper 11-42, Mercatus Center at George Mason University, Arlington, VA, November 2011.

through barriers to decrease their corporate income tax rates.

A focus on only the US statutory corporate income 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 income taxes. Between 1994 and 2010, the effective tax rate for US corporations ranged between 21.8 and 27.8 percent. This range is higher than the OECD average and places the United States as having one of the highest rates in the world.

WORLDWIDE VS. TERRITORIAL TAX SYSTEMS

Another important aspect of the corporate income tax system is the way in which taxes are allocated and collected. There are two basic types of international tax systems: worldwide and territorial.[6] The US system is basically a worldwide system whereby businesses registered as US domestic companies are subject to taxation on all income regardless of whether the income is earned domestically or internationally. The US government taxes profits generated by certain types of overseas activities in the year the profits are earned, but it does not tax profits from other activities until the corporation 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 US tax rate, so that the business is not taxed by both a foreign tax authority and the United States on the same income. However, complex rules limit US corporations from taking full credit for foreign taxes. If a foreign tax rate is less than 35 percent, as it is in all other OECD countries, US corporations 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 income tax system. Many foreign corporations that trade with the United States are incorporated in countries that operate under a territorial tax system. As of 2012, 28 OECD member countries had implemented a territorial tax system, whereas only 6 continued to use a worldwide tax system.[7] The other five OECD countries operating under a worldwide system had a 2013 average statutory corporate income tax rate of 22.3 percent, which is much lower than the 35 percent rate the United States imposes. In essence, the current US corporate tax system is a tax on exports and can be viewed as imposing double taxation on overseas profits, which hinders this country's ability to compete economically with other nations.

The tax treatment of corporate income from foreign-owned corporations creates a tax disadvantage for domestically owned corporations. Consider just one illustrative example. Until TRA86, foreign shipping income earned by US controlled foreign corporations was eligible for deferral treatment. It was reinstated with the American Jobs Creation Act of 2004. But as the Department of Treasury points out in a 2002 paper,

> 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.[8]

The complicated US corporate income 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.[9] Such reforms would significantly reduce the inefficiencies, inequities, and complexities of the current US corporate tax system and would produce substantial economic benefits. Furthermore, adopting a territorial tax system would remove a major incentive that exists now for US multinational corporations to move their headquarters operations overseas. Both Japan and the United Kingdom adopted territorial tax systems in 2009 to compete with other markets and expand their economies.[10]

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

THE PERILS OF A HIGH CORPORATE TAX RATE

Corporations respond to high tax rates by relocating their economic activity to lower-tax countries. The current US corporate tax structure puts

US-headquartered corporations at a tremendous disadvantage in the global marketplace because other countries have lowered their corporate income tax rates to welcome multinational corporations. In December 2010, then–Prime Minister Naoto Kan said he hoped to stimulate Japan's slow economy with a corporate tax rate cut of 5 percentage points.[11] The United Kingdom underwent a multiyear process to lower its combined corporate tax rate to 20 percent by 2015.[12]

Canada lowered its national corporate tax rate from 18 percent to 16.5 percent in 2011 and further to 15 percent in 2012, giving it a combined rate of roughly 26 percent once the provincial tax rate is included.[13] Canada had good reason to lower its rate. A 2011 study by Duanjie Chen and Jack Mintz, of the University of Calgary, estimates 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.[14] An independent study by Canadian Manufacturers & Exporters finds that a similar rate cut would create 98,000 jobs in a two-year period.[15]

The corporate income tax rate plays a major role in determining where a corporation will invest capital.[16] Thanks to today's communication technologies, corporations that do 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 than the other, it would be financially irresponsible for an entrepreneur or an expanding corporation to invest in the country with the higher rate.

US corporations have been and are continuing to move outside the United States to initiate and expand business opportunities. Their share of worldwide profits attributable to foreign revenue increased from 6.7 percent in 1965 to 38.2 percent in 2009.[17] Not only do such investment shifts create losses and impede growth for corporations; they also create losses for American workers because corporations choose not to use profits to create more jobs in this country.

DISTORTED INCENTIVES

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

Many corporations spend more time and resources using tax rules as profit centers than they do focusing on potential business investment. This system is inefficient because the resources used to combat the corporate income tax could be invested in intellectual or physical capital. Investment could help a corporation grow, which would lead to more jobs and output and would expand the domestic economy. Instead, the high US corporate income tax rate distorts the incentive structures and investment behaviors of corporations. It is sometimes more "profitable" for corporations to invest in lobbyists who can work to expand tax preferences than to use their financial resources to expand business output.[18] Federal tax policy should instead provide the proper structure to encourage business growth. The current US corporate tax structure forces American businesses to misallocate resources, causing a ripple effect throughout the financial structure of corporations. The high US corporate tax rate means that corporations must cut costs or raise prices elsewhere to compete with businesses based in countries with lower corporate income tax rates.

Recently, both job creation and economic growth have been key topics among economic policy advisors. Restructuring the US corporate tax system would address both issues. Policymakers 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, corporations may choose overseas destinations for business. Estimates of how many domestic jobs the current corporate income tax has quashed range from 200,000 to 3 million,[19] but the consensus is that many employees are laid off specifically because of the high costs imposed by the current US corporate tax structure. During the 2000s, major multinational corporations have reduced US jobs by

2.9 million while increasing overseas employment by 2.4 million.[20] Not all of these jobs were cut and outsourced specifically because of the US corporate tax system. But was the system a contributing factor? Absolutely. Although outsourcing is no longer popular, 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 on a corporation is an additional tax on individuals. Many people view corporations as faceless entities whose tax burden is unimportant. But corporations are made up of individual investors and workers attempting to earn money by maximizing profits. Corporations are not the only ones affected by corporate income tax rates. In addition to investors and workers, individual consumers are affected when high tax rates force corporations to charge more for their products and services. The highly flawed US corporate tax system is, thus, a form of double taxation on workers, consumers, and investors alike. Economist Steven Horwitz notes that the corporate income 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

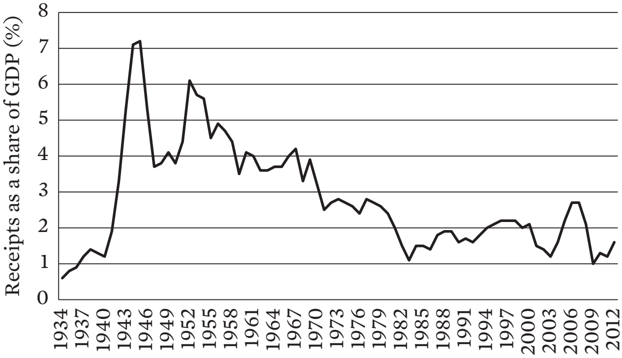
> value lowers the value of various investment funds on which millions of Americans depend for retirement and other income. [21]

As a report of the Joint Economic Committee explains, “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.”[22] A working paper published by the Congressional Budget Office suggests that workers bear “slightly more than 70 percent of the burden of the corporate income tax.”[23] Moreover, economists Kevin Hassett and Aparna Mathur find an interesting unseen consequence of raising tax rates. For every 1 percent increase in corporate tax rates, they find a 1 percent decrease in wages.[24] This finding illustrates that corporations respond to incentives and allocate resources within given constraints. Moreover, it indicates another way by which individuals ultimately bear the burden of any corporate tax.

DECREASED ECONOMIC GROWTH AND TAX REVENUE

The existing US corporate income tax also impedes the country’s economic growth. A 2008 working paper published by the National Bureau of Economic Research on effective corporate tax rates concludes that a “10 percent increase in an effective tax rate reduces the aggregate investment to GDP ratio by 2 percentage points.”[25] The paper also shows that high

Figure 3.4. US Statutory Corporate Income Tax Receipts as a Share of GDP



Source: Office of Management and Budget, "Receipts by Source as Percentages of GDP: 1934–2018," table 2.3, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/hist02z3.xls.

corporate tax rates are negatively correlated with economic growth.

A higher corporate tax rate may actually lead to less government revenue than a lower rate would. The high corporate tax rates give US corporations an incentive to keep their profits overseas so that they can defer paying taxes in the United States. Business news articles widely report that US corporations have $2.1 trillion in profits held overseas, which is estimated to reduce corporate tax revenue to the US Treasury by almost $50 billion in 2014.[26] Indeed, US corporate tax revenue is lower than that of many OECD countries, even as a percentage of GDP.[27] As figure 3.4 shows, even as the US economy has grown, corporate tax receipts as a percentage of GDP have decreased and have remained between 1 percent and 3 percent since 1990. A study by economists Alex Brill and Kevin Hassett shows significant evidence that lowering the US corporate tax rate would enhance tax revenue.[28]

CONCLUSION

The uncompetitive US 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, federal corporate tax restructuring must occur. While other nations have been racing to slash corporate tax rates over the past 20 years, the United States has stagnated. At times the federal government has enacted temporary changes to corporate tax policy, but the fundamental problems that need permanent reform have been ignored.

The United States has an infamously dense and complicated tax code that is in dire need of simplification. Systemic problems exist not only with tax loopholes and havens but also with the uncompetitive high corporate income tax rate and the worldwide-based tax system, which together encourage American businesses to move jobs and investment overseas and to lobby for more loopholes. High corporate income taxes lead to lower wages and less investment and also hinder long-term economic growth at home. To protect American jobs and secure future fiscal stability for the country, the United States must slash its corporate tax rate to at least the OECD average, preferably below, and must move toward a territorial tax system. Absent sweeping corporate income tax reform, US competitiveness will continue to decline. Continued inaction by Congress will create troublesome results: the foreign outsourcing of economic activity, a further loss of American jobs, the sale of US businesses to foreign multinational corporations, 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.

CHAPTER 3: WHY SHOULD CONGRESS RESTRUCTURE THE CORPORATE INCOME TAX?

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6. Jason J. Fichtner, *Reforming the U.S. Corporate Tax System to Increase Corporate Tax Competitiveness*, report prepared for the Joint Economic Committee, 109th Cong., 1st sess., May 2005.
7. The countries were Chile, Ireland, Israel, the Republic of Korea, Mexico, and the United States. See PricewaterhouseCoopers, "Evolution of Territorial Tax Systems in the OECD," prepared for the Technology CEO Council, April 2, 2013.
8. Office of Tax Policy, "Corporate Inversion Transactions: Tax Policy Implications," US Department of the Treasury, Washington, DC, May 2002.
9. *Foreign-source income* refers to income earned outside a corporation's home country. *Active income* is a category of income introduced with the Tax Reform Act of 1986. It generally refers to salaries, wages, commissions, and income from sources in which a 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 a company does not actively or materially participate. The distinction is important for tax purposes because passive losses are generally not allowed to be offset against active income.
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See also Joint Committee on Taxation, “Estimates of Federal Tax Expenditures for Fiscal Years 2012–2017,” JCS-1-13, Washington, DC, February 1, 2013, table 1.

27. OECD, “Revenue Statistics: Comparative Tables,” OECD StatExtracts database, http://stats.oecd.org/Index.aspx?DataSetCode=REV.
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CHAPTER 4: WHY DO WORKERS BEAR A SIGNIFICANT SHARE OF THE CORPORATE INCOME TAX?

1. Benjamin Harris, senior research associate at the Brookings Institution, states:

    > Determining who bears the burden of the corporate income tax is a complicated exercise. The corporate tax can influence the investment decisions of capital owners, how companies finance investment, and the international allocation of capital, and these effects can vary not only across countries but also across sectors. Changes in firm and investor decisions can then affect wages, output prices, and levels of investment, which in turn can influence the terms of trade. In sum, the complex set of economic interactions makes it difficult to isolate the impact of the corporate tax on the return to capital and land, wage rates, and consumer prices.

    See Benjamin H. Harris, “Corporate Tax Incidence and Its Implications for Progressivity,” Tax Policy Center, Urban Institute–Brookings Institution, Washington, DC, November 2009.
2. Jason J. Fichtner and Nick Tuszynski, “Why the United States Needs to Restructure the Corporate Income Tax,” Mercatus Working Paper 11-42, Mercatus Center at George Mason University, Arlington, VA, November 2, 2011.
3. In recent changes to the understanding of who ultimately bears the costs of taxation, the Joint Committee on Taxation assumes that 75 percent of the tax is paid by owners of capital and 25 percent by workers. Joint Committee on Taxation, “Modeling the Distribution of Taxes on Business Income,” JCX-14-13, Washington, DC, October 16, 2013. Slightly older methodology from the Treasury Department assumes that 82 percent of the corporate income tax is borne by capital