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CORPORATE TAX POLICY FOR THE 21ST CENTURY

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This paper discusses three issues relating to corporate tax policy in the United States for the 21st century. First, the paper compares U.S. corporate tax policy with that of other Organisation for Economic Co-operation and Development (OECD) economies, concluding that there is a large and growing gap between U.S. policy and international norms. Second, the paper notes a few aspects of the 21st century global economy that have profound implications for tax policy. Finally, the paper concludes with some observations about new directions for corporate tax policy in view of American tax exceptionalism and global economic trends.

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I. INTRODUCTION

In its 101st year, the U.S. corporate income tax system is showing its age. The system, of course, was not designed to function in a highly integrated global economy or in an economy where much of the nation's value added is attributable to services and intangible property. While taxing corporate income causes many well-known distortions in a closed economy, these distortions are magnified in an open economy setting.

This paper discusses three issues relating to corporate tax policy in the United States for the 21st century. First, the paper compares U.S. corporate tax policy with that of other OECD economies, concluding that there is a large and growing gap between U.S. policy and international norms. Second, the paper notes a few aspects of the 21st century global economy that have profound implications for tax policy. Finally, the paper concludes with some observations about new directions for corporate tax policy in view of American tax exceptionalism and global economic trends.

II. AMERICAN CORPORATE TAX EXCEPTIONALISM

The U.S. corporate tax departs from general international practice in several ways: (1) the high statutory tax rate, (2) the high effective tax rate, (3) the shrinking share of business activity conducted in corporate form, (4) the repatriation tax on foreign source

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income, (5) the less favorable taxation of technology, and (6) the relatively high reliance on income relative to consumption taxes.

A. Corporate Tax Rate

Following the Tax Reform Act of 1986, the top corporate tax rate, including state income taxes, was 38.6 percent. That rate, in 1988, was almost 6 percentage points *less* than the average for other OECD countries. As of 2010, by contrast, the top U.S. corporate tax rate was 39.2 percent, 13.7 percentage points *higher* than the average for other OECD countries (25.5 percent), and second only to Japan (as shown in Figure 1).[1] Since 1988, the other OECD countries have on average lowered their top corporate tax rates by 0.9 percentage points a year, while the top U.S. corporate rate has slightly increased.

Countries with smaller economies, as measured by GDP in 2008, have reduced statutory corporate tax rates fastest. The average OECD tax rate, excluding the United States, fell by 19 percentage points over the 1988–2010 period, while on a GDP-weighted basis, the OECD average fell by 14.7 percentage points.

B. Effective Tax Rate

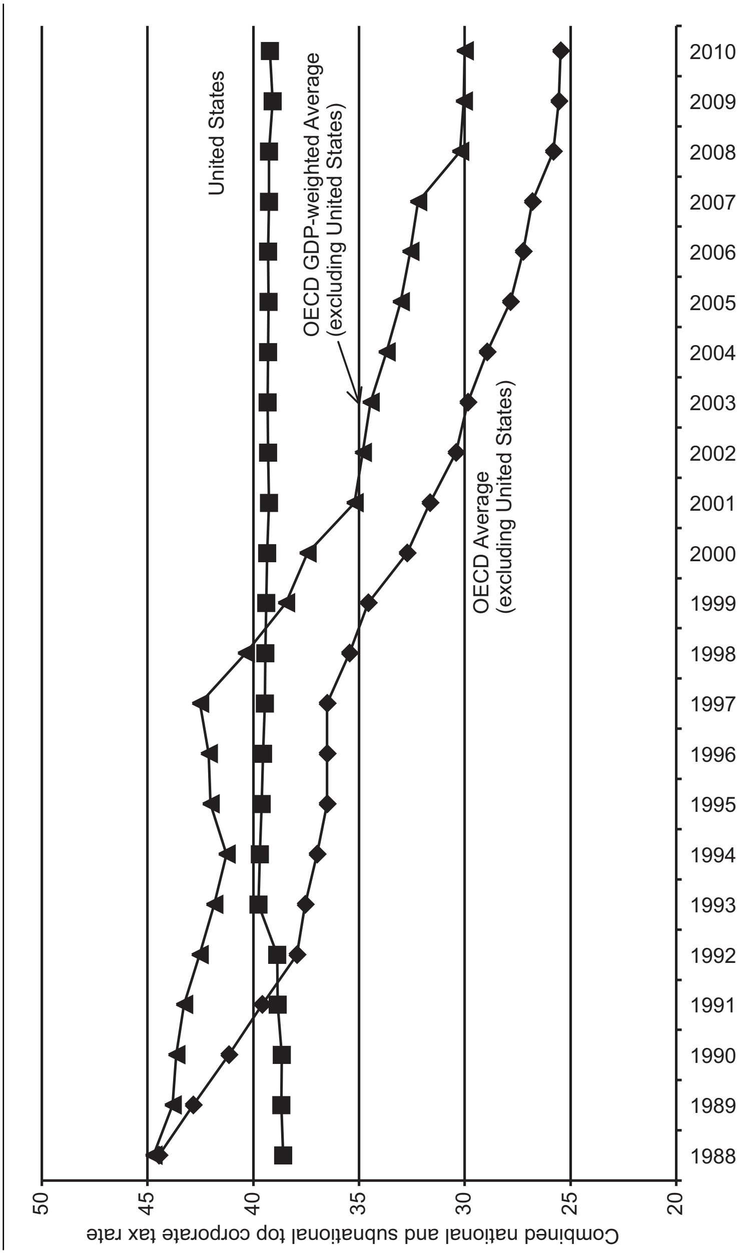
A variety of effective tax rate studies provide persuasive evidence that the effective tax rate on U.S. corporations, like the statutory tax rate, is high by international standards. The World Bank's Doing Business project calculated the current tax rates for a standardized company operating in the largest city of 183 countries, and concluded that the U.S. effective corporate tax rate was 27.9 percent in 2009, third highest among the 31 OECD countries (World Bank, 2010). Similarly, according to PricewaterhouseCoopers calculations, the weighted average book effective tax rate for public U.S. companies over the 2006–2008 period was 28.4 percent, second highest, after Japan, among the 31 OECD countries.

The Institute for Fiscal Studies (IFS) has calculated marginal and average effective corporate tax rates for equity-financed investments in plant and machinery in 19 OECD countries. For 2005 (the most recent year available), IFS reported that the United States had the fifth highest marginal effective tax rate and the third highest average effective tax rate (Klemm, 2003). In a study prepared for the World Bank, Chen and Mintz (2010) calculated marginal effective tax rates on corporate capital for 80 countries, including subnational taxes and non-income taxes on capital such as irrecoverable sales tax on capital purchases and property taxes. For 2009, they found the United States had the highest effective corporate tax rate among OECD countries, followed by France and Japan.

[1] Corporate tax rate data for Chile, which joined the OECD in May 2010, is published by the OECD from 2000 forward. Data for Slovenia and Israel, which joined the OECD in July and September 2010, respectively, have not yet been published.

Figure 1

U.S. and Average OECD Corporate Tax Rates, 1988–2010



Source: Organisation for Economic Co-operation and Development, Centre for Tax Policy and Administration, *OECD Tax Database*, www.oecd.org/ctp/taxdatabase.

C. Share of Business Conducted in Corporate Form

Surprisingly, despite the high U.S. statutory rate, corporate tax revenues relative to GDP are lower than the OECD average — 3.3 percent versus an average of 3.9 percent in the other OECD countries in 2006 (OECD, 2008a). Some have suggested this indicates the *effective* tax rate paid by U.S. corporations is low by international standards; however, the studies cited above show a relatively high U.S. corporate effective tax rate.

The most likely explanation for this conundrum of high U.S. statutory rates and low revenue yield relative to GDP is the shrinking U.S. corporate sector. According to Internal Revenue Service (IRS) data, in 1987 regular corporations reported about 71 percent of business taxable income; however, 20 years later, this had fallen to 48 percent of business income.[2]

Part of this dramatic decline in business income attributable to regular corporations is due to the 1986 Tax Reform Act, which for the first time in modern history reduced the top individual rate below the top corporate rate. Also contributing to the shift of business activity away from the corporate sector was the adoption of limited liability partnership (LLP) and limited liability company (LLC) statutes by the states, providing the benefits of limited liability to entities taxed as partnerships. The share of businesses with taxable profits in excess of $1 million that are unincorporated is higher in the United States than in any other country for which the OECD has data (U.S. Department of Treasury, 2007).

D. Taxation of Foreign Source Income

Of the 31 OECD countries, 25 have "territorial" tax systems under which active income of foreign subsidiaries is wholly or at least 95 percent exempt from home country tax. Notably, Japan and the United Kingdom adopted territorial tax systems last year. By contrast, the United States, Chile, Ireland, Korea, Mexico and Poland tax domestic parent companies on dividends received from foreign subsidiaries, with a credit for foreign taxes paid.

Because the U.S. corporate tax rate is far higher than international norms, a U.S. multinational typically would pay a substantial repatriation tax if it remitted earnings from most foreign jurisdictions. As a result, investment of foreign earnings in U.S. property is discouraged. Elimination of the similar "lock-out" effect caused by the high Japanese corporate tax rate is the main reason why Japan's Ministry of Economy, Trade and Industry pushed for adoption of a territorial tax system last year.

E. Taxation of Technology

Many countries, including the United States, have tax systems designed to encourage research and experimentation (R&E). Based on 2008 information, OECD (2009) ranked U.S. tax incentives for R&E as 24th lowest out of 38 countries analyzed (as

[2] Internal Revenue Service, Statistics of Income Division, *Integrated Tax Database*, http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html.

shown in Figure 2). Moreover, the OECD calculations do not take into account the temporary nature of the U.S. R&E credit, which currently has expired, nor the "patent box" regimes available in eight of the other countries, which provide a reduced tax rate for certain patent-related income.

F. The Tax Mix

In 2007, federal, state, and local governments combined relied on goods and services taxes for about one-sixth of U.S. tax revenues as compared to more than 31 percent in the other OECD member countries — a 15 percentage point difference (as shown in Figure 3).[3] Greater reliance on income and profits taxes in the United States as compared to other OECD countries represents about 13 percentage points of this difference (OECD, 2008a).

III. IMPLICATIONS OF THE 21ST CENTURY ECONOMY FOR U.S. TAX POLICY

Three aspects of the 21st century economy can be expected to have an important influence on tax policy choices: (1) increasing global integration, (2) declining U.S.-centeredness, and (3) the growing economic importance of intangible property.

A. Increasing Global Integration

The increase in cross-border trade in goods, services, and investment is a striking feature of the latter half of the 20th century. Global integration is likely to continue in the 21st century, barring government policy reversals.

Increasing global integration is illustrated by the sum of imports and exports of goods and services, which has tripled in economic importance over 50 years, from less than 10 percent of GDP in the 1960s to over 30 percent in 2008 (International Tax and Policy Forum, 2010). About one-third of trade in goods occurs between affiliates of multinational companies.[4] Also, the stock of U.S. *direct* investment abroad has nearly doubled in economic importance over 30 years, growing from 14 percent to 25 percent of GDP, while the stock of U.S. *portfolio* investment abroad has grown by a factor of 13, from 2.3 percent to 29 percent of GDP (Nguyen, 2009). The stock of inbound investment and the stock of outbound investment are now both over half of GDP and cross-border portfolio investment is now substantially larger than direct investment (Nguyen, 2009).

B. Declining U.S.-Centeredness

Since World War II, the economies of the rest of the world have on average grown faster than that of the United States, with the result that U.S. companies are far less

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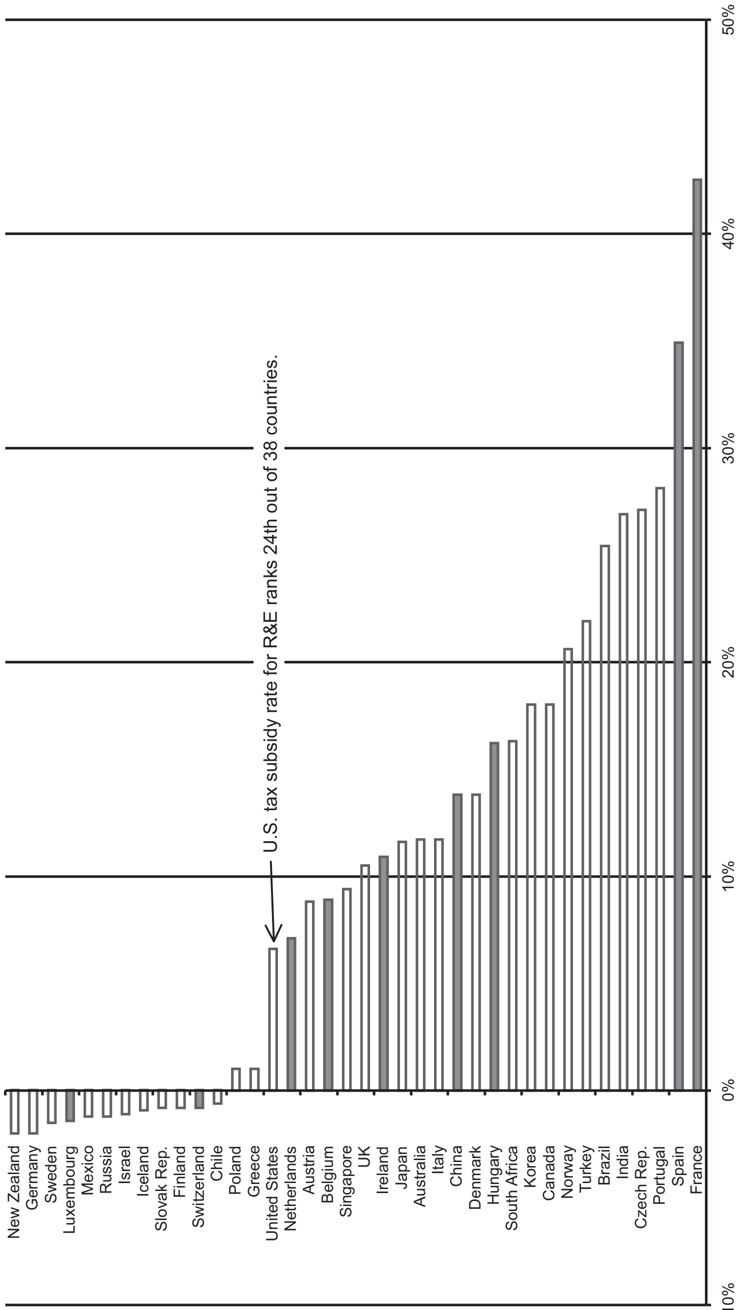
[3] These data do not include Chile.

[4] These calculations are based on data from Barefoot and Mataloni (2009) and Anderson and Zeile (2009).

Figure 2

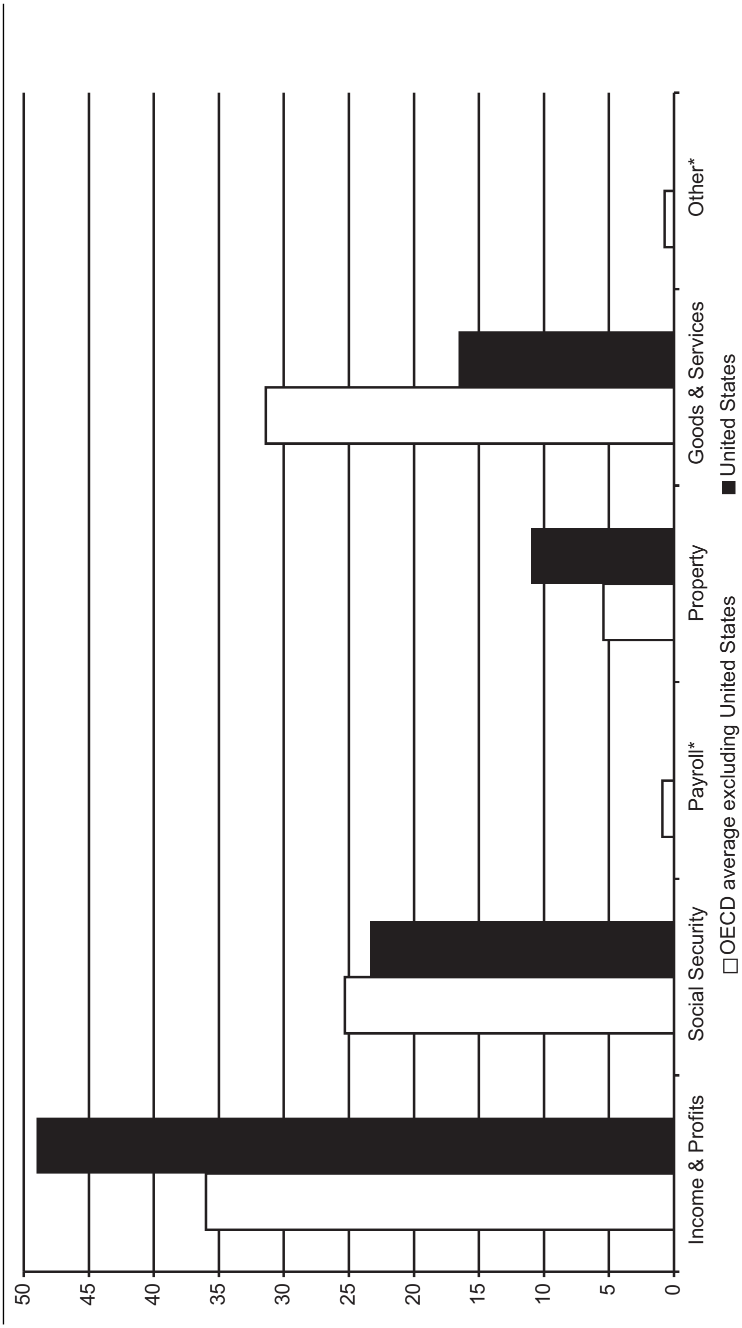
Tax Subsidy Rate for R&E in OECD and Seven Other Countries, 2008



Notes: Solid bar indicates presence of a patent box regime. R&E tax subsidy rate does not include effects of patent box regimes.
Source: OECD Science, Technology and Industry Scoreboard 2009.

Figure 3

OECD Tax Revenues by Type: Percent of Total Taxation, 2007



Source: Organisation for Economic Co-operation and Development, 2008.

*Negligible for the United States.

U.S.-centric than ever before. Sales through foreign affiliates accounted for 36 percent of U.S. multinational sales in 2006, up from 28 percent in 1982 (Mataloni, 2008, 1994). Many U.S. multinationals now rely on foreign markets for more than half their sales.

Dramatic reductions in the costs of computing and telecommunications have made possible global trade in services, such as shared services centers, as well as global collaboration in activities such as research and experimentation. Some headquarters functions of multinationals now can be distributed around the world, a phenomenon that Desai (2009) calls the "de-centering" of the firm.

C. The Rise of Intangibles

Another striking feature of the 21st century economy is the rising importance of intangible assets. One indicator is the increase in the market-to-tangible book value ratio of the S&P 500 companies, which increased from about 1.0 in 1978 to 3.5 as of year-end 2006 (Bernstein Research, 2007). Another indicator, highlighted by the volcano-related shutdown of the UK airspace, is that air freight accounts for 25 percent of UK trade by value, but less than one percent of trade by weight (Wright and Reed, 2010).

IV. U.S. TAX POLICY IMPLICATIONS OF A 21ST CENTURY ECONOMY

These global economic trends have profound implications for U.S. corporate tax policy — raising the economic cost of maintaining a system that increasingly departs from international norms and limiting the portion of the corporate tax burden that falls on capital income. Three tax policy changes may be advisable in view of 21st century economic trends: (1) reduce the corporate tax rate, (2) limit residence-based corporate taxation, and (3) increase reliance on consumption taxes.

A. Reduction in Corporate Tax Rate

Imposing one of the highest corporate tax rates in the world is unlikely to advance growth or fairness in the United States in the 21st century. As cultural, technological, and regulatory barriers to cross-border investment decline, differences between national tax rates have an increased effect on where capital is invested and research is conducted. Competition for mobile capital likely explains why corporate tax rates in the European Union member states have declined dramatically with the formation of a common market, and why seven member countries have adopted lower rates on income from certain intellectual property (with adoption in the UK scheduled for 2013).

Differences between U.S. and foreign corporate tax rates also affect the location of income and expenses. The arm's-length standard for determining inter-company prices works well when there are exact comparables. However, the growing economic importance of marketing and manufacturing intangibles, which intrinsically are valuable due to their uniqueness, makes it far more difficult to determine appropriate transfer prices. In light of the high U.S. corporate tax rate, taxpayers have an incentive to shift income to lower-tax jurisdictions to the maximum extent permitted under transfer pricing rules. Further, the high U.S. corporate tax rate creates an incentive for all U.S. corporations to increase debt finance and for multinational companies to borrow in the United States rather than in lower-tax jurisdictions abroad.

The mobility of direct and portfolio capital investment not only increases the efficiency costs of corporate taxation but it also makes it less likely that the corporate tax is achieving fairness objectives. With fewer impediments to cross-border investment, shareholders and companies can seek higher returns abroad, leaving the corporate tax burden on less mobile factors, such as labor (Randolph, 2006).

B. Limitation of Residence-Based Taxation of Corporations

Under present law, the United States asserts jurisdiction to tax the worldwide income of a U.S.-parented multinational company, but is limited to taxing only the U.S. source income of a foreign-parented multinational company. Thus, for a multinational company with, say, 90 percent of its global income earned abroad by foreign affiliates, U.S. residence of the parent company increases the amount of income subject to U.S. income tax jurisdiction by nine times.

In the author's view, the fact that a company files its articles of incorporation in a U.S. state should not provide a sufficient nexus for the federal government to assert global tax jurisdiction. The current U.S. tax regime causes a variety of perverse effects. First, the fact that most other countries have a territorial system while the United States does not creates an incentive for new companies to incorporate outside the United States. Although existing U.S. corporations might wish to change their place of incorporation, U.S. tax legislation enacted in 2004 makes it difficult to "invert" corporate residency from the United States to a foreign jurisdiction. Second, the foreign operations of U.S. companies are more valuable, from a tax standpoint, to foreign-based than to U.S.-based multinationals. This makes it more difficult for U.S. companies to be successful bidders for foreign companies. Third, it is more likely that cross-border mergers will be arranged so that the U.S. company is the target and the foreign company is the acquirer (Huizinga-Voget, 2009).

Moreover, with the rapid growth in outbound foreign portfolio investment, U.S. shareholders need not, and increasingly do not, limit their portfolios to U.S.-resident companies. While the logic of the worldwide tax system is to make taxes a neutral factor in the location of investment, the result is to distort ownership.

It is commonly argued that residence-based taxation of corporate income is necessary to maintain progressivity. However, in the 21st century economy it is far from clear that the incidence of the corporate tax falls on shareholders. Moreover, residence-based taxation of U.S. companies creates horizontal inequity between U.S. shareholders in otherwise identical U.S. and foreign headquartered multinational companies.

C. Increase in Reliance on Consumption Taxes

In a global economy, consumption taxes, such as a value added tax, may be more advantageous than the corporate income tax. Consumption taxes do not affect the location or ownership of investment and generally do not require transfer pricing rules. The comparative advantage of consumption taxes is borne out by empirical evidence and by the policy choices of countries most exposed to international trade and investment.

A 2008 OECD study of 21 countries found that tax structure affects economic growth, with corporate taxes having the most negative effect on GDP per capita, and taxes on immovable property and consumption having the least adverse impact (OECD, 2008b). Hines and Summers (2009) find that countries with small populations, which tend to rely more heavily on cross-border trade and investment, have tax structures that raise a larger share of revenue from consumption-type taxes and a smaller share from income taxes. They note that the rapid pace of globalization implies that large countries are becoming more similar to small open economies.

V. CONCLUSION

In conclusion, 21st century global economic trends suggest the United States should make tax policy choices in a manner more similar to those that have been made by state and local governments. These jurisdictions rely far more heavily on consumption taxes than the federal government and have relatively low corporate tax rates that generally are not imposed on worldwide income. Intergovernmental fiscal conflicts can be expected to arise, though, if the federal government, confronted by the need to raise more revenues, or to raise revenues with less damage to the economy, encroaches upon traditional state and local tax bases.

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