Comprehensive Reform for US Business Taxation[1]

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Introduction: Globalization and Tax Competition

Political leaders have long accepted the proposition that investment location and business activity are, to some degree, motivated by tax considerations. As globalization has enhanced international competition, the United States has gotten more concerned about the contest for business investment – not because more investment abroad is bad for employment at home, but rather because more investment at home is good for raising productivity. While corporate taxes are certainly not the only consideration driving investment and location decisions, they are important.

In the 1980s, after the 1981 Reagan tax cuts, the US corporate rate was lower than most of its industrial competitors -- primarily Canada, Europe and Japan. Since then, many OECD countries have slashed their corporate tax rates and introduced new incentives, such as rapid depreciation. Moreover new industrial competitors have emerged -- China, Korea, India, Mexico, Brazil, and others. While some of the new competitors have high statutory tax rates, their effective tax rates are often much lower--through tax holidays, special credits and deductions, and lenient enforcement.

By the late 1990s, the average effective foreign corporate tax rates actually paid by foreign affiliates of US-based MNEs were considerably lower in a number of countries than the average effective (federal plus state) corporate tax rate paid in the United States. This was true not only of traditional low-tax countries, such as Singapore, Hong Kong and Ireland, and tax-haven countries, such as Bermuda, Netherlands Antilles, and the Cayman Islands, but also of major industrial competitors, such as France, the United Kingdom, China, Taiwan, Mexico and Brazil.

The upshot, two decades after the Reagan revolution, is that the United States has become relatively less attractive from a tax standpoint. In his analysis of 59 countries, John Mutti found that, in the period 1984-92, some 20 countries had lower effective corporate rates than the United States, and 39 had higher rates. However, by the period 1992-96, 43 of the countries had lower effective rates than the United States, and only 16 had higher rates.[2] The trend continues to this day.

To meet the challenges of a more competitive international business environment, federal business taxation within the United States should be fundamentally reconsidered. The mainstay of federal business taxation, the US corporate income tax, is riddled with distortions and inequities.[3] As a means of taxing the richest Americans – a popular goal – the corporate income tax is a hopeless failure. Many companies pay no corporate tax, and among those that do the burden is highly uneven.[4] Under pressure from business lobbies, Congress legislates deductions, exemptions and credits that twist the corporate tax base far from any plausible financial definition and distort the structure of effective rates. Faced with a tax terrain of mountains and ravines, corporations employ armies of lawyers and accountants to devise avoidance strategies.

Reviving the spirit of tax reform debates in the 1990s,[5] we propose to *replace* the corporate income tax with a tax that has a much broader base at a much lower rate: the Corporate Activity Tax (CAT), a variant of the subtraction-method value-added tax (VAT). The CAT will immediately broaden the corporate tax base, and reduce distortions between firms and industries. As a variant form of the VAT, the CAT would be adjustable at the border, and for this reason as well would improve US competitiveness in the global marketplace. To maintain the progressive character of the tax code, we include a companion measure to preserve the spending power of households at the lowest income levels.

Proposal: the Corporate Activity Tax (CAT)

The tension between fiscal demands and the competitive burden of corporate taxation requires a new workhorse for federal business taxation. In fact, our recommendation goes further than simply adding a new tax. Instead, we suggest *replacing* the current corporate income tax – with its multiple loopholes and jagged profile – with a relatively flat business tax.[6]

Following the footsteps of Senator William Roth (R-DE) and Representative Richard Schulze (D-PA) in 1985, Representative Sam Gibbons (D-FL) in 1993, and Senators John Danforth (R-MO) and David Boren (D-OK) in 1994, we recommend a subtraction-method value-added tax (VAT) as an alternative template for US business taxation.[7] Our proposal is a corporate activity tax (CAT) broadly structured to include labor, capital and technology income in the tax base.

CAT Collection

The CAT is designed to apply to medium and large corporations, those with annual receipts of about $10 million and more. The number of such firms in 2000 was around 131,000. To be conservative, we estimate that the number of firms subject to CAT liability—in other words, the number of tax collection points—would be around 200,000. This number is a small fraction of total taxpaying business entities (about 24 million). We propose to retain the distinction under current law between taxable firms (normal Subchapter C corporations) and pass-through firms (Subchapter S corporations, partnerships and proprietorships). Under current law, business entities that are organized as Subchapter S corporations, partnerships or proprietorships are not taxed on their business income. Instead their income (or loss) is attributed to their owners and taxed as individual income.[8]

CAT Tax Base

The CAT is a broad-based consumption tax assessed at the business level. The CAT tax base would be domestic sales of goods and services (with exceptions for capital and technology income noted below) minus purchases from other US firms, *but only if the vendors are subject to the CAT tax.* Purchases of raw materials, utilities, components and inventory from US firms subject to the CAT would all be eligible deductions. So would purchases of equipment and software—the functional equivalent (under the present corporate tax law) of immediate expensing.[9] However—and this is important—purchases from US firms not subject to the CAT could *not* be deducted by firms subject to the CAT. In this way, the CAT would be indirectly collected on business-to-business sales from pass-through firms (mainly small firms) to large firms, because large firms would include such purchases in their CAT base.

Since the CAT is a value-added tax, it would be adjustable at the border: exports of goods and services would be exempt, while the tax would be collected on imports of goods and services. The employer's portion of Social Security taxes (currently 6.2 percent) and Medicare taxes (1.45 percent) – essentially business taxes on the use of labor inputs – would be credited against the CAT.[10] However, no refund would be permitted for excess credits. The rationale for the credit mechanism has three parts: first, not to disturb time-tested arrangements for financing Social Security and Medicare; second, not to discourage employment; third, to ensure that payroll taxes are collected on US exports, even when no CAT is collected.

Table 1 illustrates the base to which the CAT would apply. By taxing only medium and large corporations—and therefore reducing the number of collection points—the CAT avoids many of the evasion and enforcement problems of other consumption taxes. Elements of the estimating process, spelled out in table 1, track the basic features laid out above.

CAT Tax Rate

The CAT would be assessed at a single rate. In table 2, we use the base summarized above to calculate rates required to meet two revenue goals (based on 2000 data): replacement of the federal corporate income tax with the CAT, and raising business tax revenue by about $200 billion, to reach a total of $400 billion. According to these calculations, a revenue neutral rate would be 7.8 percent; the rate required to raise an additional $200 billion would be 11.6 percent. Our calculated rates make provision for the amounts required to alleviate the tax burden for all households up to the poverty line for household income (as described below). Corporations subject to the CAT would be allowed a tax credit to cover the employer share of Social Security and Medicare payroll taxes.

Impact of Proposal Relative to Current System

Domestic Efficiency

The more jagged the tax profile as between firms and industries, the greater the extent of economic distortion. One reason is that too few resources are committed to heavily taxed sectors (or firms), and too many resources are committed to lightly taxed sectors (or firms). Another reason is that executive and professional talent gets spent lobbying for and seeking out tax shelters. These forces ensure that the corporate tax burden differs greatly between firms and industries. Replacing the corporate income tax would immediately compress the variation of tax rates across industries and contribute to economic efficiency.

Jorgenson and Yun (JY, 2001, table 7.10) estimate that the *average* efficiency cost for the corporate income tax is 24.2 cents per dollar raised when compared to a "hypothetical, non-distorting" tax.[11] According to the estimates presented by JY, the average efficiency cost of a consumption tax with a rate of 15 percent is about 5.5 cents per dollar.[12] Based on these coefficients, replacing the corporate income tax with a consumption tax would save about 18.7 cents per average dollar of revenue collected (24.2 cents minus 5.5 cents). In 2000, the federal corporate income tax collected $208 billion, so the efficiency gain of switching from corporate income tax to a less distorting consumption tax would be on the order of $39 billion annually. Capitalizing this annual efficiency savings over an infinite time horizon at a 4.45 percent discount rate (the rate used by JY) indicates that the present value of the switch is roughly $876 billion.

International Competitiveness

Unlike the corporate tax, which discourages inward foreign investment, the CAT would not penalize corporate activity within the United States both because the incidence of the CAT is expected to fall primarily on consumption, and because the CAT is adjustable at the border.[13]

Econometric estimates suggest that 5-percentage points of corporate taxation depress the inward foreign investment stock by about 15 percent. Estimates of this tax response (here three-to-one) have increased over past decades and are likely to increase further as global economic integration proceeds. Even at a three-to-one coefficient, the United States would attract a substantial amount of inward foreign direct investment by replacing the corporate income tax with a CAT. This should be seen as a very welcome development.

Repeal of the US corporate tax would certainly be a bold step. However, it represents the end stage of the trend of tumbling corporate tax rates among OECD countries, a process that has now put US firms at a competitive disadvantage vis-à-vis their foreign competitors. After the 1986 Tax Reform Act, the US statutory rate remained approximately constant at 35 percent (40 percent including state corporate taxes), until the passage of the American Jobs Creation Act of 2004 (AJCA). The AJCA will eventually cut the federal US corporate tax rate, for qualified activities, to 32 percent. Meanwhile industrial countries abroad have cut their statutory rates, and emerging nations (such as China and India) often have special exemptions and lax enforcement.

By contrast with the corporate income tax, the CAT would be fully adjusted at the US border, in compliance with WTO rules: the tax would be imposed on imports of goods and services and exempted on exports. By eliminating any tax advantage from producing overseas and then selling the goods and services in the US market, the CAT would put an end to the debate over offshore outsourcing for tax reasons, whether blue-collar or white-collar. An important sub-theme of US economic competition with China is the difference in corporate taxation. The best way to address this difference is not by expanding Subpart F to reach deferred profits lodged in Chinese subsidiaries, but by wholesale reform of US taxation of business done in the United States. That way, whether goods and services are made in China or India or anyplace else, when sold to US residents they will pay the same tax rates as US-made goods and services.

Fairness

Progressivity is a political requirement of the US tax system. While it is possible to create a progressive system of consumption-only taxation, it is easier to ensure that a hybrid system of consumption and income taxes will be progressive. Introduction of a broad-based federal consumption tax as a substitute for *both* the corporate and individual income taxes would be widely characterized as regressive, since the share of income spent on consumption tends to fall as income rises. To the extent that shifting the tax burden from the rich to the poor is seen as unfair, so instituting a full replacement VAT or national sales tax will be politically difficult.[14] Under our hybrid proposal, we address the regressivity problem of consumption taxes by collecting sufficient revenue so as to rebate the tax on the initial dollars of household outlays; the rebates could be administered through the individual income tax system.[15] In table 2, we set aside enough annual CAT revenues to rebate CAT payments to all households for purchases up to the poverty line, thereby ensuring a progressive structure overall.

Simplicity

US taxation of corporate earnings currently entails a complex two-tier system. Earnings are first taxed at the corporate level, and subsequently at the shareholder level, as shareholders receive income in the form of dividends and capital gains (on the sale of shares). In 2003, the Bush administration reduced the tax rate on qualified dividend received prior to 2009—and extended the new lower rate of 15 percent to capital gains. These measures temporarily alleviated, but did not eliminate, the economic distortions associated with a two-tier system. By contrast, the CAT attacks the distortions at their root.

The CAT is designed as a response to deficiencies of the federal corporate income tax, while focusing the collection burden on business firms rather than individual taxpayers. First, the CAT is designed to be broad-based, applying across-the-board to all sectors of the economy. For these reasons, it encourages more efficient allocation of resources than the corporate income tax.[16] Second, the CAT will eliminate the distortions associated with the two-tier income tax system, in which only corporate earnings are singled out for double taxation. Under the CAT, to the extent income is taxed at the individual level, no distinction would be made between wages, salaries, interest, rents and dividends.

Notes:

[1] This proposal draws on the authors' forthcoming monograph *US Taxation of Business in a Global Economy*, as well as a chapter of the forthcoming volume *US Taxation of International Income*, by Gary Clyde Hufbauer and Arial Assa, both to be published by the Institute for International Economics.

[2] Mutti, John, *Foreign Direct Investment and Tax Competition* (Washington: Institute for International Economics, 2003), table 2.4.

[3] Among the many critics, see Pechman, A. Joesph, *Federal Tax Policy,* 4th ed. (Washington DC: Brookings Institution, 1987).

[4] See Government Accountability Office (GAO), Comparison of the Reported Tax Liabilities of Foreign- and US-Controlled Corporations, 1996-2000, Report GAO-04-358, 2004.

[5] These debates are summarized in Hufbauer, Gary Clyde and Carol Gabyzon, Fundamental Tax Reform and Border Tax Adjustments, POLICY ANALYSES IN INTERNATIONAL ECONOMICS 43 (Washington: Institute for International Economics, 1996).

[6] Our proposal does not include changes to the individual income tax. It could be implemented either as a stand-alone plan or coupled with personal income tax simplification. In table 2 below we estimate a revenue neutral rate, as well as a revenue positive rate that could offset losses from reform of the individual income tax, such as reform of the alternative minimum tax (AMT).

[7] Charls E. Walker, a Deputy Secretary of the Treasury during the Nixon Administration, was the intellectual father of the business transfer tax (a version of the subtraction VAT), and largely responsible for sparking reform in the 1980s and early 1990s.

[8] Pass-through firms would calculate their profits and losses as under current law, but reformed (if possible) so that taxable income matched financial income under generally accepted accounting principles (GAAP). In 2000, there were 4.9 million corporations with receipts less than $10 million; in addition, there were 2.1 million partnerships and 17.9 million nonfarm proprietorships.

[9] Consequently, firms would not be able to deduct depreciation of equipment from the CAT base.

[10] The Social Security tax is assessed on each employee's compensation up to $90,000, while the Medicare tax is uncapped.

[11] Jorgenson and Yun estimate that the *marginal* efficiency cost of the corporate income tax is 0.279. In other words, the final dollar of revenue collected via the corporate income tax places a burden of 27.9 cents on the economy above and beyond the dollar of collected revenue. As the amount of revenue rises, the marginal efficiency cost of the tax increases. Jorgenson, Dale W. and Kun-Young Yun, *Lifting the Burden: Tax Reform, the Cost of Capital and U.S. Economic Growth* (Cambridge, MA: MIT Press, 2001).

[12] One reason for using the 15 percent consumption tax figure is to incorporate state and local sales tax rates, which JY estimates to be 5.5 percent on average. Our rough estimate of efficiency cost is based on marginal rates of efficiency cost for a consumption tax simulation presented in JY (2001, table 8.12a).

[13] As the eminent scholar Arnold Harberger notes, in contrast to the corporate income tax, the tax wedge caused by a VAT works its way through the economic structure via prices paid by consumers. Harberger adds that this does not mean that a VAT has no effect on factor prices, but concludes that "the rise of the [factor] price is basically sufficient to cover the value added tax and what happens between wages and net returns to capital [as a result of imposition of a VAT] is a sort of a secondary story, not the primary story" (Harberger, Arnold, Corporate and Consumption Tax Incidence in an Open Economy. American Council for Capital Formation, 1994, http://www.accf.org/publications/reports/sr-corpconstax1994.html, accessed March 12, 2005).

[14] In that respect, it should be noted that VAT systems in Europe, Canada, and other countries generally either exclude sales of food, housing and medical care from the tax base, usually by applying a zero rate of tax or by imposing a much lower rate of tax on sellers or these and other "necessities". Conventional wisdom is that such exclusions and preferences are necessary to offset the perceived "regressivity" of a VAT, based on the traditional view that the VAT's burden will always be passed forward to consumers (rather than workers or shareholders) in the form of higher prices. We reject the idea of special preferences for "necessities." When preferential rates apply to sellers of food, medical care and housing, zero or low rates apply to all sales. Consequently, a significant portion of the anti-regressivity benefit is wasted on middle- and upper-income households.

[15] While, in reality, it is the regressive or progressive nature of the tax system as a whole that should matter to taxpayers, politicians and advocates tend to fixate on the nature of specific taxes (e.g., the income tax, the CAT, the payroll tax, etc.). For this reason it would be politically imperative that a rebate be in some way visibly tied to the CAT (thereby making the CAT "package" progressive). The obvious examples of political connection are Social Security and Medicare benefits: these are visibly tied to payroll taxes (i.e., Social Security and Medicare taxes).

[16] The Congressional Budget Office report "The Effects of Adopting a Value-Added Tax" (1992) simulated the effect of raising approximately $150 billion in annual revenue

under two alternatives: raising income taxes as opposed to introducing a broad-based federal level VAT. The conclusion of the study (p. 4) was that: “A broad-based VAT would allocate resources more efficiently than an income surtax, in part because it would not tax saving but for other reasons as well. First, the portion of the VAT’s burden that falls on the value of existing capital, or wealth, would not distort the allocation of resources at all. Second, although a broad-based VAT would have few, if any, tax preferences to distort allocation of resources, *the current tax is replete with tax preferences, and a surtax would magnify the distortions resulting from these preferences*” (emphasis added). While the Congressional Budget Office’s analysis relates to raising income tax in general, its conclusions are applicable to raising corporate income tax as well. In that regard, it should be noted that the Treasury Department estimated in a report entitled “Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once” (1992) that the increase in economic welfare from eliminating double taxation would range from 0.07 percent to 0.73 percent of annual national consumption.

Table 1. Illustrative Calculation of CAT Base, 2000
($ billions and percent)

Total private industry value added		8,607
Minus:	Value added by partnerships and nonfarm proprietorships	(1,253)
Minus:	Value added by corporations with receipts under $10 million	(1,178)
Plus:	Repeal of depreciation allowances for large corporations[a]	516
Minus:	Expenditures for equipment and software by large corporations	(659)
Plus:		
	Imports of goods and services	1,445
Minus:		
	Exports of goods and services	(1,070)
Equals: Tax base for CAT: Corporations with receipts of $10 million and over		6,408
Memorandum		
GDP in 2000		9,828
Corporate income tax revenue in 2000		208
	as percent of GDP	2.1

a. A capital consumption adjustment is a negative component of private industry value added. Instead of allowing a depreciation deduction, the CAT will expense equipment and software in the year they are purchased.

Source: *Statistical Abstract of the United States: 2003,* US Census Bureau; *National Income and Product Accounts*, Bureau of Economic Analysis; and authors' calculations.

Table 2. Possible CAT Rates
($ billions and percent)

	Replace Existing Corporate Income Tax	Raise $400 Billion through Business Taxes
Revenue goal	208	400
Plus payroll credit[a]	181	181
Total collected revenue	389	581
CAT rate (flat)	**6.1**	**9.1**
Plus revenue to finance progressivity[b]	108	161
Total revenue raised	497	745
CAT rate (progressive)	**7.8**	**11.6**
Memorandum		
CAT base	6,408	

a. Revenue amount required to meet revenue goal and allow $181 billion tax credit for payroll taxes to large corporations.

b. Amount of revenue required to rebate CAT rate to all households for purchases up to the poverty line. This effectively removes $1.4 trillion from the tax base.

Source: Authors' calculations.