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Of all the policy changes that could improve the competitive position of the United States and the living standards of Americans, revamping the corporate tax code is perhaps the most obvious and least painful. High corporate taxes divert capital away from the U.S. corporate sector and toward noncorporate uses and other countries. They therefore limit investments that would raise the productivity of American workers and would increase real wages. This is the cruel logic of a corporate tax in a global economy—that its burden falls most heavily on workers.

What principles should guide a reform of the corporate tax that would advance American interests? First, the structure of the tax must reflect developments in the world economy—notably, declining tax rates in other nations, the mobility of innovative and headquarters activities, and the rising importance of non-U.S. markets. Second, corporate tax reform will probably need to be instituted separately from fundamental tax reform and must be roughly revenue-neutral, given fiscal and political realities. Third, any reform must relegitimize corporations as responsible citizens and the corporate tax as a meaningful policy instrument.

The proposal elaborated on in this article follows those three principles. It calls for a significant reduction in the corporate tax rate, a new tax policy toward innovation, and an end to taxes on active foreign income—changes that would give global corporations better incentives to locate and invest in the United States. It proposes a tax on the growing noncorporate business sector, to reduce distortions in firms' business structures and bring in revenues that offset corporate rate reductions. It also recommends aligning the definition of taxable income with what corporations report to capital markets, which could help broaden the corporate tax base, further fund rate reductions, and restore the public's trust in business.

These changes won't be truly effective, however, unless managers change their behavior. The complexity of the current system and the proliferation of tax avoidance techniques have made the corporate tax optional for many global corporations. Tax has been transformed from a compliance function into a profit center that provides the pennies needed to reach earnings per share targets. More broadly, globalization has led countless corporations to view countries' infrastructures as interchangeable, and national identities and responsibilities as passé. Rather than shirking their tax obligations, business leaders should treat them as seriously as their other social responsibilities.

The Imperatives for Change

Four developments in the U.S. economy make significant corporate tax reform an urgent priority. Any blueprint for change needs to address them.

The worst of all worlds—high rates and a narrow base. In 1986, the year of the last significant tax reform, the U.S. corporate tax rate was lower than that of most developed countries. Today the top U.S. corporate rate of 35% is one of the world's highest. During the intervening years, America's global economic importance decreased—a sometimes unsettling artifact of welcome growth in the developing world. As the importance of doing business in the United States has shrunk, the relative cost has risen rapidly.

Because capital is mobile, high tax rates divert investment away from the U.S. corporate sector and toward housing, noncorporate business sectors, and foreign countries. American workers need that capital to become more productive. When it's invested elsewhere, real wages decline, and if product prices are set globally, there is no place for the corporate tax to land but straight on the back of the least-mobile factor in this setting: the American worker. The flow of capital out of the United States only accelerates as opportunities in the rest of the world increase. This is the key to understanding why, despite political rhetoric to the contrary, reforming the corporate tax is central to improving the position of the American worker.

High corporate tax rates have further adverse consequences in a global setting. As corporations seize innumerable opportunities to shift income to lower-tax jurisdictions, tax revenue falls and top talent is diverted to tax-avoidance endeavors that create no economic value. Corporations spend more on lobbying and political donations, because managers place a premium on shaping legislation. In short, high rates increase the returns corporations get on questionable activities, corrupt the political process, and ultimately reduce the tax base. There are consequences within the corporate sector, too: Firms with less-mobile income—domestic retailers, for example—and fewer political connections suffer disproportionately from high rates.

The rise of noncorporate business income. Noncorporate income has gone from less than 20% of business income in 1986 to more than 50% today. This is a by-product of modest legislative efforts to allow entities with small numbers of shareholders to avoid double taxation. In response, the number of pass-through entities—such as limited liability companies, S corporations, investment trust structures, and limited partnerships—has rapidly multiplied, and a significant amount of business activity has migrated into those structures. The high tax rate has effectively driven capital away from the corporate sector and toward activities that can be shoehorned into the noncorporate business sector. Sectors that can use these structures—primarily the financial management of domestic

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Idea in Brief

With its high statutory rates, low revenues, and perverse incentives, the U.S. corporate tax code is broken.

Because multinational corporations are able to largely escape it, its burden falls most heavily on domestic-focused industries and on workers. It also drives capital out of the corporate sector and into noncorporate business. By skewing investments in these ways, the corporate tax reduces economic efficiency and productivity.

Fixing the system will require rate reductions and the elimination of attempts to tax overseas income. But it will also require heavier taxation of noncorporate businesses, an end to the disconnect between taxable income and the earnings reported to investors, and a commitment by business leaders to treat tax obligations as responsibilities to be embraced rather than costs to be minimized.

real estate, natural resources, and health care assets—have grown disproportionately. The remarkable "financialization" of the American economy over the past 25 years is in part an outcome of these incentives.

Because only private companies are allowed to set up such structures, corporations effectively pay a toll to be public. It's not clear why U.S. public capital markets should be hampered by such a toll.

The globalization of firm activity. As the world economy has become more integrated, nondomestic income at U.S.-based multinational firms has jumped. On average, foreign operations are growing more quickly and are more profitable than operations at home.

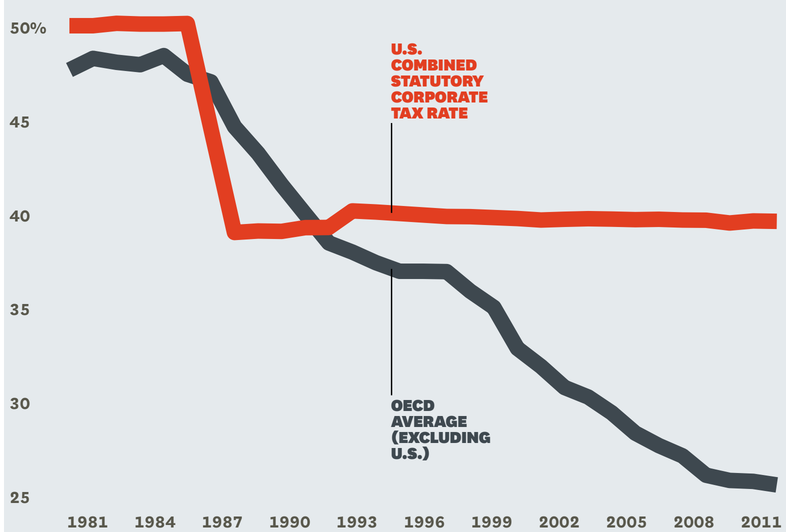
Under its current system the United States taxes the worldwide income of its citizens, including corporations. Foreign income is taxed by the source country and then taxed again by the U.S. upon repatriation, with credits provided for taxes already paid to the source country. This approach aims to ensure that investments face the same tax rate regardless of where they're made, which sounds logical enough. But that logic is flawed for two reasons: First, imposing a tax upon repatriation encourages American firms to keep capital offshore. Second, and even more important, the approach assumes that whenever firms invest abroad, the United States loses a corresponding amount of investment. In fact, the evidence suggests that as firms enter new markets and become more efficient, they expand at home. Indeed, it is naive to think that penalizing the global activities of firms in today's world will help them become better employers at home.

The appropriate policy is not to tax active foreign income, because doing so creates different tax treatments for investments made by U.S.-based and foreign-based corporations. Such discrimination reduces aggregate productivity because it can reward less-productive owners with higher after-tax returns. Other governments around the world have recognized this; among the large developed economies, the United States is now alone in taxing the worldwide income of its corporations. A particular irony of the tax on foreign income is that it raises little revenue. So eliminating it could end significant distortions in the allocation of capital and increase the supply of domestic corporate capital, all while resulting in a minimal loss of revenue.

With globalization, corporations have also entered a new era of mobility, in which they can change their national identities with ease. Several UK companies left their home for Ireland in response to the old UK regime of taxing foreign income. Mergers

The U.S. Tax Rate Has Become Increasingly Uncompetitive

Until the early 1990s the combined (state and federal) statutory corporate tax rate in the U.S. kept pace with the rate in most developed countries. But during the past 20 years, rates in other OECD nations have fallen sharply, making the U.S. an outlier.



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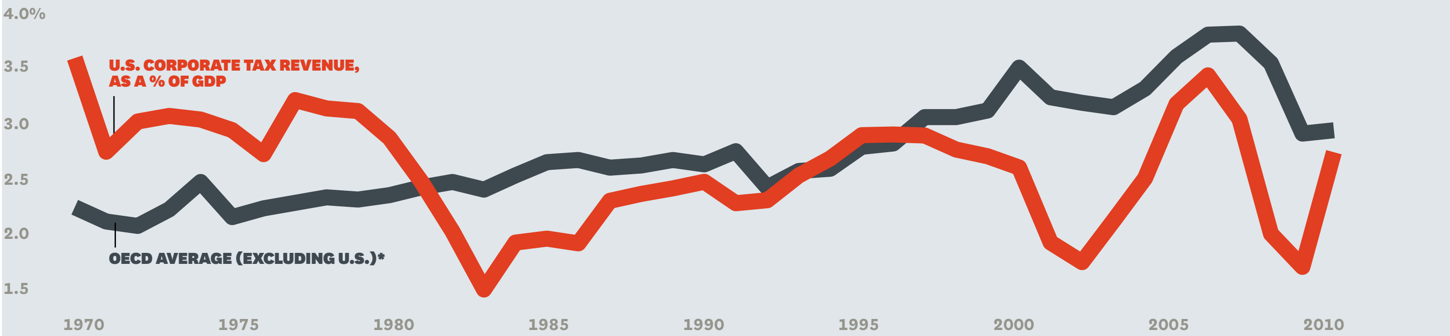
Higher Rates Don’t Translate into Higher Revenue

Despite having one of the highest corporate tax rates, the U.S. now collects less in corporate tax revenue, as a percentage of GDP, than most of the other OECD nations.



*EXCLUDES MEXICO AND CHILE BECAUSE OF A LACK OF DATA.

and acquisitions provide another way for firms to effectively redomicile themselves, and entrepreneurs are choosing their homes on the basis of tax regimes. The exceptional treatment of foreign income for American firms is all the more problematic because headquarters can easily migrate out of the United States, taking associated jobs with them.

The decoupling of financial and taxable income. It is now fairly common for American firms to announce large profits to the capital markets while reporting no taxable income to the government. The disconnect has multiple causes, including tax policies such as those related to the depreciation of new equipment. Income reported to tax authorities no longer has any meaningful connection to income reported to Wall Street.

This has several adverse consequences. For starters, shareholders are deprived of a true understanding of the economics of firm performance. How can one get a clear grasp of profits when they’re being characterized opportunistically for the audience in question? Managers also devote resources that could otherwise be invested in growth to capitalizing on the differences in reporting requirements. (Imagine how creative individuals would be in reporting personal income if they could obtain mortgages without submitting their tax returns.) Finally, the public loses faith in corporations when leading companies repeatedly boast of profits while not paying taxes.

Tying the corporate tax more closely to reported earnings could broaden the corporate tax base and restore credibility to corporations and the tax as a whole. But rather than making the two kinds of profit reports conform completely (which might reduce the information conveyed to capital markets), one could loosely align them by requiring firms to pay a minimum percentage of their reported financial income over a period of years.

A Code That Strengthens U.S. Businesses and Workers

A reform that combined a significant rate reduction, an end to the foreign-income tax, a new tax on noncorporate business income, and a closer link between tax payments and reported earnings would pay for itself. The revenue lost by cutting the rate and exempting overseas income would be offset by the revenue gained from implementing the other two measures. Estimates using recent data suggest that a corporate rate cut from 35% to 18% could be funded by a 5% tax on noncorporate business income and by aligning taxable income with income figures on financial reports. What’s more, such a reform would advance the integrity of the tax system and ensure that the world’s best global companies want to be headquartered in the United States, rather than flee it.

Over the years the corporate tax code has often been amended to spur innovative activity—for example, through the research-and-development tax credit—and to favor particular industries, such as manufacturing. These diffuse efforts complicate the tax code and, because they’re usually structured as temporary provisions, often prove ineffective. Legislators would do better to concentrate on an overall rate reduction and on luring innovative activity through a strengthened version of the “patent boxes” that have become popular around the world. A patent box would tax the returns to intellectual property at a preferential rate as long as that intellectual property was developed and employed within the United States, thus promoting higher-quality domestic jobs.

Such a change and the move away from a worldwide tax regime also require changes to the transfer-pricing regime employed by the United States. Currently, the fiction of using prices that would have been obtained between unrelated parties for trans-

The complexity of the system and the proliferation of avoidance techniques have made taxes optional for many corporations.

actions within multinational firms creates too much leeway for reallocating profits out of the United States, especially with the growing importance of intangible property. Transfer-pricing standards need to be reoriented so that how multinational firms distribute resources, talent, and profits around the world determines the amount of profits that can be rightfully allocated to different jurisdictions. The illusion that profits are accruing to post-office boxes in sunny locations undercuts confidence in the tax system overall and needs to be countered by considering the actual location of resources and managers within firms.

Corporate Taxes as a Social Responsibility

American corporations have become more aggressive about minimizing their tax obligations. The rise in intangible assets, the mobility of income, the availability of intermediaries who peddle avoidance strategies, and the increasing attention paid to reported earnings have all made tax planning an important piece of financial management. As a result, more than half of American corporations no longer have significant domestic tax obligations, according to the U.S. Government Accountability Office.

At the same time, ironically, managers have come to embrace corporate social responsibility. Companies routinely tout their constructive role in society and pour resources into social programs even as they pursue aggressive tax strategies. Instead they should show their commitment to their communities by treating their tax obligations as a responsibility commensurate with, say, abiding by environmental regulations.

Boards of directors and managers could promote that attitude by ensuring that the performance of tax directors was evaluated on compliance rather than profit maximization. Codes of ethics could prohibit transactions that serve only to reduce tax obligations. In short, any statement of corporate values that declares a company will honor commitments to outside stakeholders—communities, the environment, customers—should also include a commitment to fulfill tax obligations. These efforts should occur hand in hand with the policy changes described earlier. Insisting on tax responsibility when the U.S. tax system is out of step with global norms is unfeasible and, perhaps, unfair.

Finally, firms should commit to reporting in greater detail precisely what their tax payments have been. Continued obfuscation over such a significant set of payments should not be tolerated by shareholders. Clarity over tax payments will help shareholders understand the underlying economics of businesses and ensure that efforts to reach earnings targets will not be abetted by transitory manipulations of tax payments.

THE CORPORATE TAX HAS BECOME a major obstacle to investment in the corporate sector of the United States and, consequently, a drag on the productivity and real wages of the American worker. Its impact worsens every day as the noncorporate business sector expands, opportunities for savings become more global, and attractive foreign investment opportunities multiply.

A handful of changes would transform the corporate tax system from an obstacle to an asset. But these must be matched by a shift in the managerial approach to corporate taxes: from an opportunistic perspective to one that treats tax obligations as a commitment to important stakeholders. Renewing the contract between managers, shareholders, and citizens along these lines can lay the foundation for what the U.S. needs—faster growth in the productivity and real wages of American workers.

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