

BROOKINGS

FRIDAY JUNE 20, 2008

WELCOME | REGISTER | LOG IN

Corporate Taxes, in Need of Reform

Taxes, Competitiveness, Corporate Taxes, Business

Jason Furman, Senior Fellow, Economic Studies

Washingtonpost.com



OCTOBER 27, 2007 — America's system of taxing business and capital income is broken. It is complicated, economically inefficient and is proving increasingly incapable of raising the revenues it should.

Case in point: The United States has the second highest corporate tax rate of the 30 countries in the Organization of Economic Cooperation and Development (OECD). But because the United States has so many generous special tax preferences for businesses, it collects the fourth lowest corporate tax revenues as a share of GDP among all OECD countries.

Over the last decade, Congress has responded to these problems by cutting tax rates on capital income. Capital gains and dividend taxes have been reduced in the last ten years and the *Wall Street Journal* editorial page has started gunning for the corporate tax rate as a next step. The problem is that rate cuts, by themselves, do nothing to simplify the tax system and increase the already daunting long-run deficit. Moreover, recent rate reductions may even have increased economic inefficiencies by raising the national debt and providing unnecessary windfall gains to people and businesses that have already made their investment decisions.

Just as not every tax cut will improve the tax code, not every improvement to the tax code requires a tax cut. We should consider tax reform in the classic 1986 mode: lower tax rates and broaden the tax base by limiting special exemptions. Both halves of this classic equation have the potential for helping the economy by eliminating the perverse incentives to invest in tax-favored activities rather than in more economically productive activities.

Treasury Secretary Henry Paulson opened the door for change this summer by stating that now is the time "to consider ways our business tax system can be improved." His staff provided a hypothetical analysis of how much rates could be lowered if special preferences were eliminated. A group of corporate executives agreed. "I'd

RELATED CONTENT

RESEARCH AND COMMENTARY

[The Concept of Neutrality in Tax Policy](#)

Jason Furman, U.S. Senate Committee on Finance, April 15, 2008

RESEARCH AND COMMENTARY

[Three Keys to Effective Fiscal Stimulus](#)

Douglas W. Elmendorf, Washingtonpost.com, January 26, 2008

PAST EVENT

[Facilitating and Rewarding Work](#)

Wednesday, December 12, 2007
9:00 AM to 12:00 PM
Washington, DC

[More Related Content »](#)

happily trade all credits for simplification and lowering the rates," declared Jim Owens, the CEO of Caterpillar.

Now, House Ways and Means Chairman Charles Rangel (D-N.Y.) has taken the next major step, moving from considerations and hypotheticals to proposing the most ambitious corporate tax overhaul in at least two decades. The proposal is part of a larger tax bill that would also include a repeal of the Alternative Minimum Tax (AMT), an expansion of tax breaks for moderate-income families, and a return of tax rates for the most affluent households towards their Clinton-era levels.

The centerpiece of the corporate tax reform is a reduction of the corporate tax rate from 35 percent to 30.5 percent, hardly living up to columnist Robert Novak's warning that Rangel would be unveiling "the most radical left-wing tax revision in half a century." Without adding to the deficit burden, this rate reduction would be fully paid for by a series of measures to broaden the corporate tax base to ensure that different forms of investments are taxed at similar rates. The biggest of these steps is a repeal of a special deduction for manufacturing businesses that was enacted in 2004 over the nearly universal objection of tax experts who warned that the government should not be tilting the playing field in favor of certain types of businesses. (Note that at the new 30.5 percent corporate rate manufacturing companies would still be paying lower tax rates than they are today.)

Rangel also proposes a fix for the completely broken rules used to tax international investments. Currently, businesses that invest overseas can immediately deduct all the cost from their taxable income, just as they can with domestic investments. But unlike domestic investments, companies do not need to pay taxes on their overseas profits until they bring them back to the United States. And if these firms continually reinvest their profits overseas, they never have to pay any U.S. taxes. The result is, in effect, a tax subsidy for investing abroad – one that distorts investment decisions and costs at least \$6 billion annually, according to Congress' Joint Committee on Taxation. The Rangel plan proposes one way to end this subsidy, though others could be considered as well.

It is notable that both the Republican President and the Democratic Chairman of the House Ways and Means Committee now agree in principle that corporate rates should be reduced, that the AMT should be fixed and that both steps should be paid for through other tax offsets. Rangel has shown us one sound way to accomplish this. If the administration has other ideas, they should join the discussion with specific proposals of their own.