ACHIEVABLE CORPORATE TAX REFORM 2013

PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

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Realistic Goals for 2013

- Reduce top corporate rate to 25%.
- Phase out select corporate deductions over 10 years **BUT ONLY IF** historic corporate revenue collections fall as a percent of GDP.
- Enact “territoriality” through the dividend exemption method.

Realistic Objectives

- Restore US competitiveness in global markets
- Boost US investment from the current slump
- Create jobs in services as well as manufacturing

US Corporate Tax Rate

- Taken together, the US federal and state governments impose the highest statutory corporate tax rate in the world

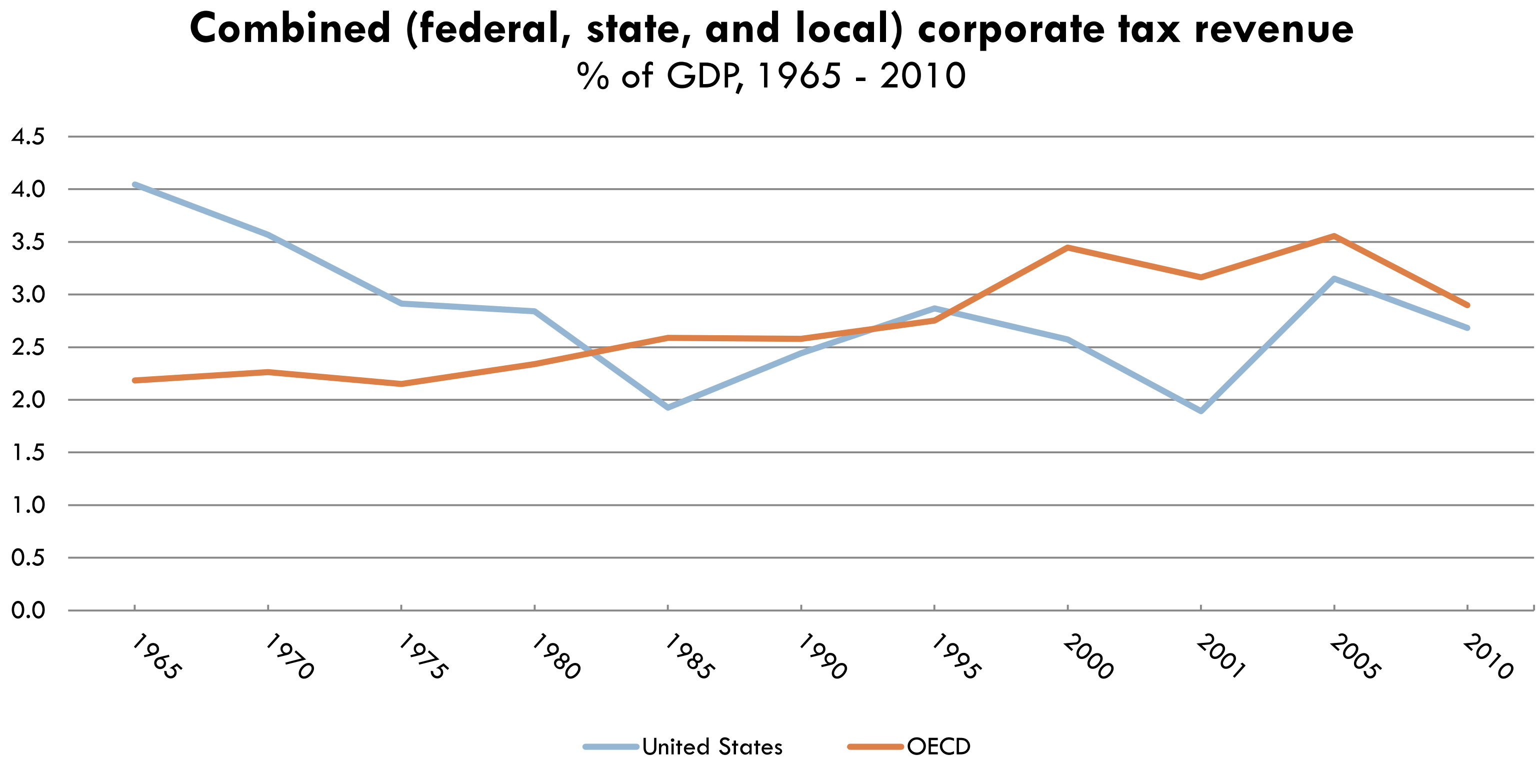
Statutory, Average, and Marginal Effective Corporate Tax Rates for Systemically Important Countries (in percent)

Countries	Statutory Corporate Tax Rates, 2010	Average Effective Corporate Tax Rates		Marginal Effective Corporate Tax Rates, 2010	
	OECD Tax Database (2011)	World Bank, 2009	Hassett and Mathur (2011), 2010	Chen and Mintz (2011)	Hassett and Mathur (2011)
Australia	30.0	25.9	22.2	26.0	17.0
Brazil	34.0	21.4	n.a.	35.1	n.a.
Canada	29.5	9.8	25.5	20.5	23.4
China, P.R.	25.0	6.0	n.a.	16.6	n.a.
France	34.4	8.2	27.5	34.0	23.8
Germany	30.2	22.9	24.2	23.8	20.7
India	34.0	24.0	n.a.	33.6	n.a.
Japan	39.5	27.9	33.0	29.5	30.5
Mexico	30.0	23.1	28.4	17.5	27.7
Russian Federation	20.0	9.0	n.a.	31.9	n.a.
Sweden	26.3	16.4	18.5	18.9	12.6
Turkey	20.0	17.0	13.1	5.6	7.3
United Kingdom	28.0	23.2	22.3	27.9	18.8
United States	39.2	27.6	29.0	34.6	23.6
Unweighted average, excluding US	28.1	18.3	21.0	23.3	20.8

Source: Hufbauer and Vieiro (2012). See source for notes.

US Corporate Tax Revenue

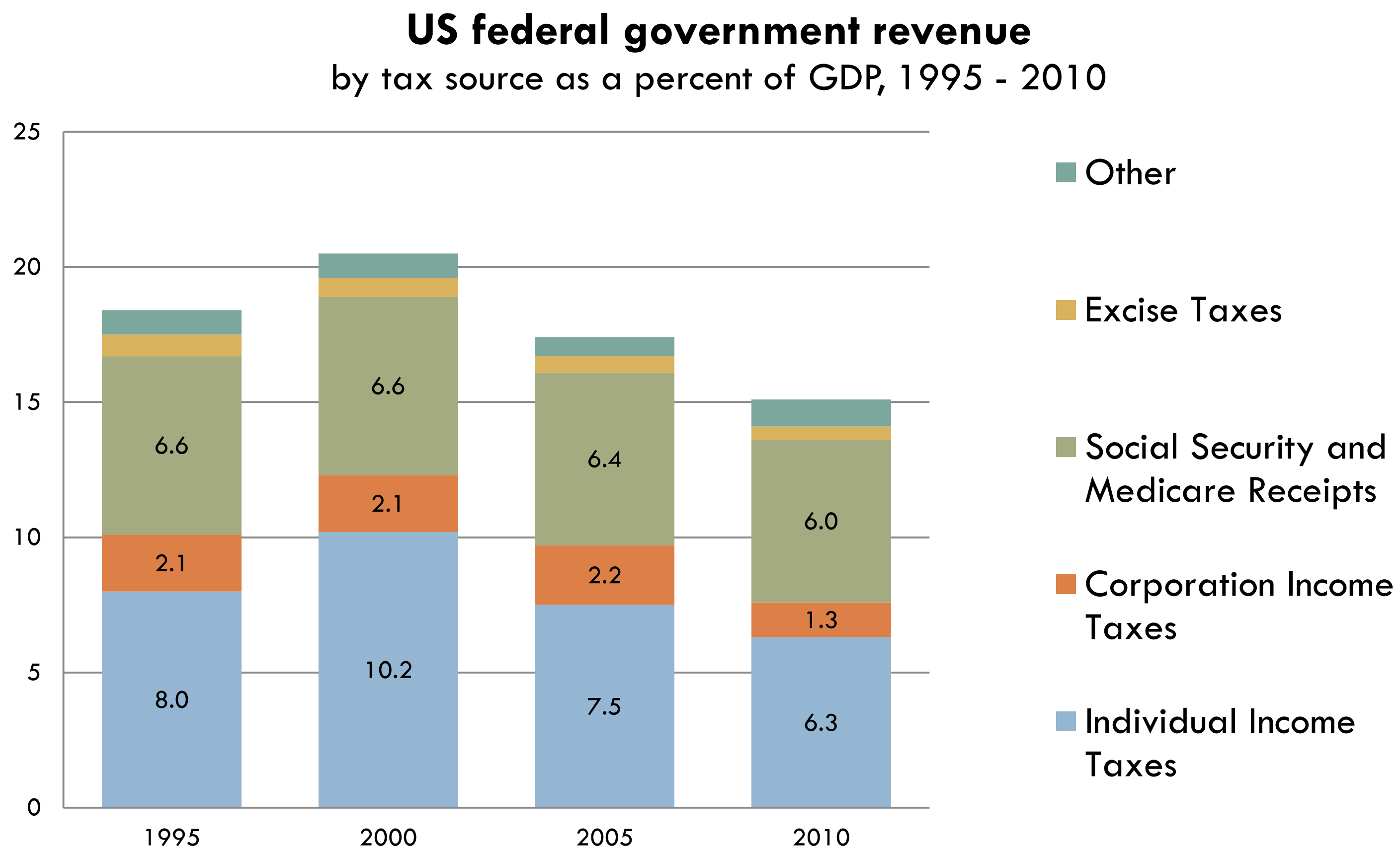
- US corporate tax revenue, since the major tax overhaul in 1985, has hovered between 2-3 percent of GDP, slightly below the OECD average.



Source: OECD Revenue Statistics (November 2012)

US federal tax revenue by source

- Corporate tax revenue only makes up a small piece of the total federal revenue pie. Individual income taxes as well as entitlement taxes account for the lion's share of revenue.

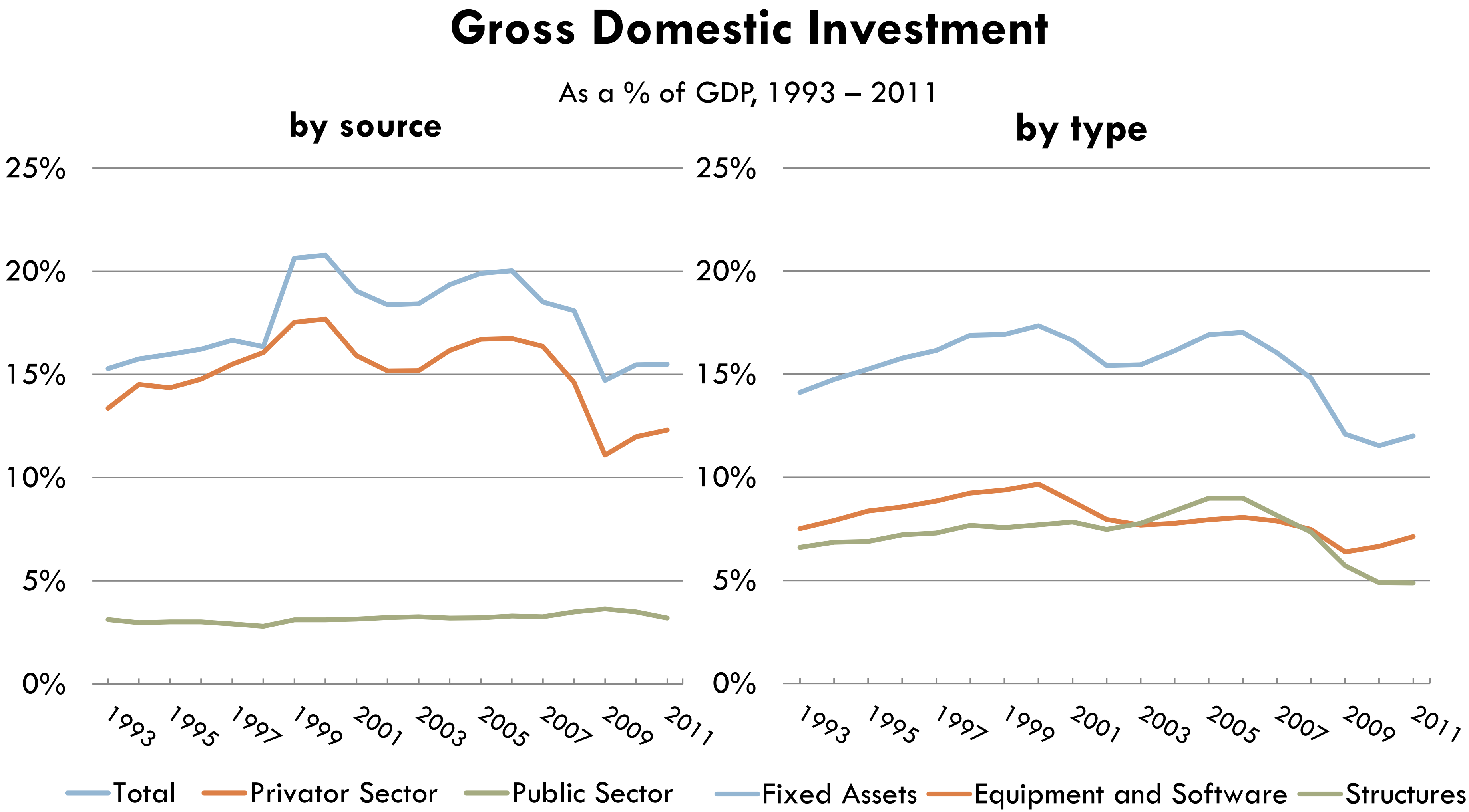


Source: IRS Data Book

Why US Corporate Tax Revenue is 2% to 3% of GDP in a normal year

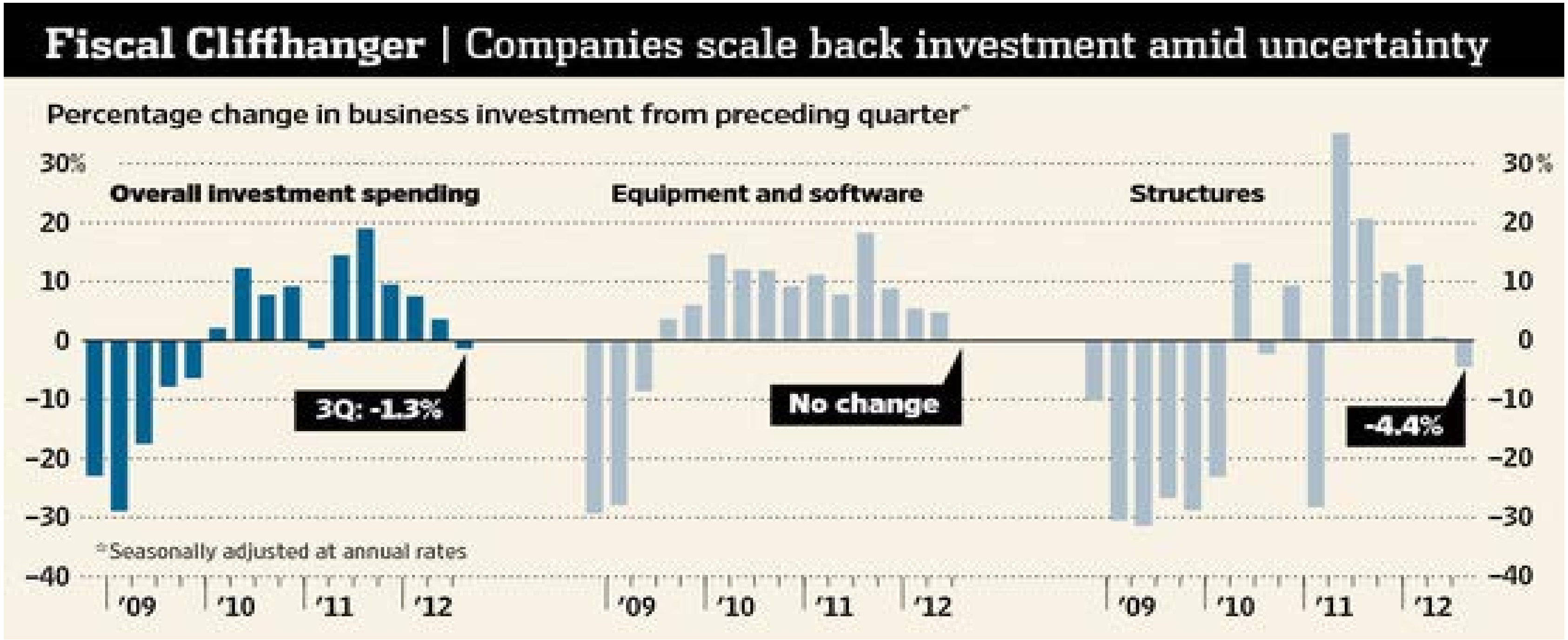
- Not because MNCs escape their fair share: their average effective rate is about 27%.
- Rather because "passthrough" entities conduct a large portion of US business (Subchapter S, MLPs, cooperatives, LLCs, etc.).
- The US "passthrough" share is much larger than in other OECD countries, and has grown substantially from 3% of business receipts in 1980 to 20% in 2007.

US Investment Record



Source: US Federal Reserve's Flow of Funds Report

“Business Investment Falls Off a Cliff”



- According to the Wall Street Journal, “ half of the nation’s 40 biggest publicly trade corporate spenders have announced plans to curtail capital expenditures this year or next.”
- Preliminary estimates from the Commerce Department project 1.3 percent decline in business investment in 3Q12. The drop for 4Q12 could exceed 4 percent.

The President's Framework for Business Tax Reform

- Nominal and effective corporate tax rate
- Taxation of international income
- Taxation of small business
- Close loopholes and end subsidies
- Incentives for domestic manufacturing

Nominal and effective corporate tax rate

- *Both major political parties agree, the corporate tax rate should be cut significantly.*
- President's Framework proposes cutting the corporate tax rate to 28 percent for non-manufacturing firms, 25 percent for manufacturing firms.
- Institute for Research on the Economics of Taxation (IRET) simulations suggest that a 10 percentage point corporate tax rate cut would:
  - Increase the private business capital stock by 6.3 percent;
  - Raise the average wage rate by 1.9 percent;
  - Raise GDP by over 2 percent; and
  - Reduce federal receipts from corporate taxation by $52 billion, but increase federal revenue overall by $19 billion due to higher personal income, Social Security, and Medicare taxes.

Nominal and effective corporate tax rate

Corporate Tax Revenues in OECD Countries Regressed on the Consolidated Tax Rate, 1981-2007

Dependent Variable	Explanatory Variables: Constant	Explanatory Variables: Combined Corporate Tax Rate	R-Squared	Observations	Clusters
<u>All OECD Countries</u>					
Corporate Tax Revenues/GDP	4.42***	-0.04***	0.04	640	29
	(0.178)	(0.005)			

Notes: Standard errors of the coefficient estimates are reported in parentheses. Estimation using the underlying panel data set includes country fixed effects (not reported). *,**,*** denote statistical significance at the 10, 5, and 1 percent levels. Clusters are the number of countries covered by the panel dataset.

Source: Hufbauer and DeRosa (2010).

- The very small, though statistically significant, coefficient—a negative value of 0.04— indicates that a 1 percentage point increase in the corporate tax rate may slightly decrease corporate tax revenue expressed as a percentage of GDP.
- In other words, there is a slight negative connection between tax revenue and statutory tax rates within the range of OECD tax rates since 1981—a range that covers statutory rates between roughly 20 and 40 percent.

Nominal and effective corporate tax rate

- Mertens and O'Ravn (2011) supports the claim that cutting the corporate tax rate would not reduce revenues, indicating that the current corporate tax rate is positioned on the right-hand side of the Laffer curve.

- Using US data from 1950 to 2006, they find the "increase in the tax base is sufficiently large that the corporate income tax cut leads to a small decline in corporate tax revenues only after the first quarter and a surplus thereafter."

- Concluding that "cuts in corporate income taxes are approximately self-financing." They further find that "a one percentage point cut in the [average effective corporate tax rate] raises real GDP per capita on impact by 0.5 percent and by 0.7 percent after five quarters."

Taxation of international income

- *President's Framework* – Without specifics, the framework proposes a minimum rate of tax on income earned by US-controlled corporate subsidiaries operating abroad. Without deferral, foreign profits would face immediate US taxation.
- By the Treasury's estimates, these measures would increase tax revenues by $16 billion annually.
- If enacted, this proposal would instantly place US-based multinationals at a competitive disadvantage relative to their foreign rivals.

Taxation of international income

International tax systems and the Fortune Global 50 companies, 2009

Headquarter Country	Number of companies	Percent of companies	Percentage of revenues	2009 statutory corporate tax rate	Taxation of foreign-source income
United States	17	34	37	39.5	Worldwide w/ credit
France	6	12	11	34.4	Territorial
Germany	5	10	9	33.0	Territorial
Britain	4	8	9	28.0	Territorial*
Netherlands	2	4	7	25.5	Territorial
Japan	4	8	7	41.3	Territorial*
China	3	6	6	25.0	Worldwide w/ credit
Belgium	2	4	4	34.0	Territorial
Italy	2	4	3	30.3	Territorial
Switzerland	1	2	2	24.7	Territorial
South Korea	1	2	1	25.0	Worldwide w/ credit
Luxemburg	1	2	1	28.6	Territorial
Mexico	1	2	1	28.0	Worldwide w/ credit
Russia	1	2	1	22.0	Worldwide w/ credit
Total/average	50	100	100	31 for non-US	

* Enacted to a territorial system in 2009

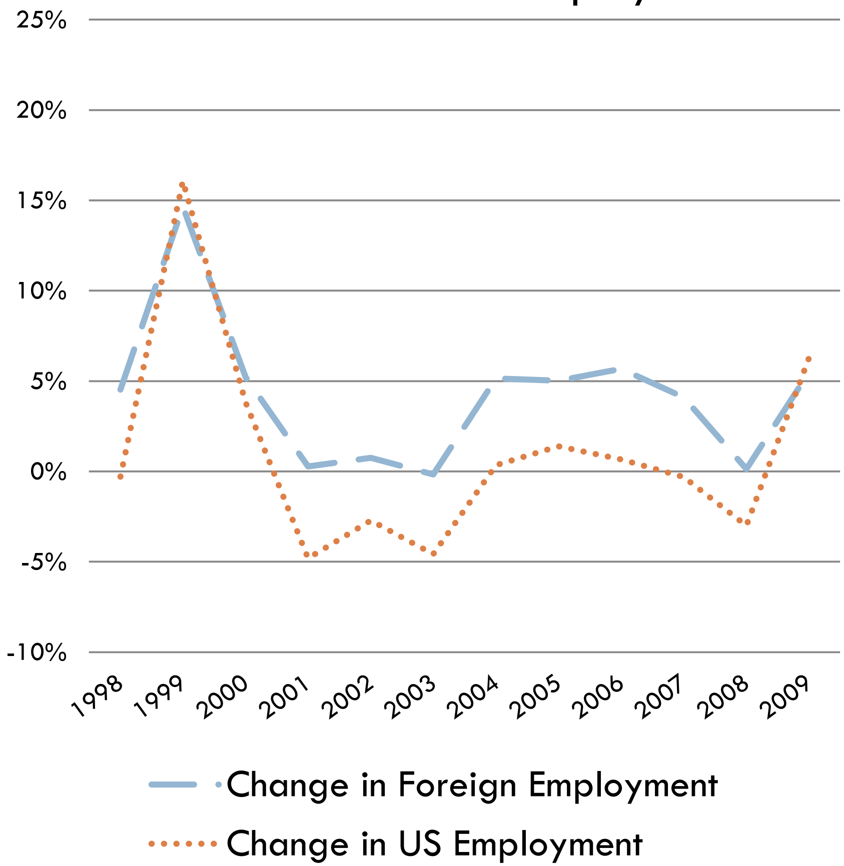
Source: "Japan's move to territorial taxation contrasts with US international tax policy," International Tax Notes, Ernst & Young. April 10, 2009.

Source: US Federal Reserve's Flow of Funds Report

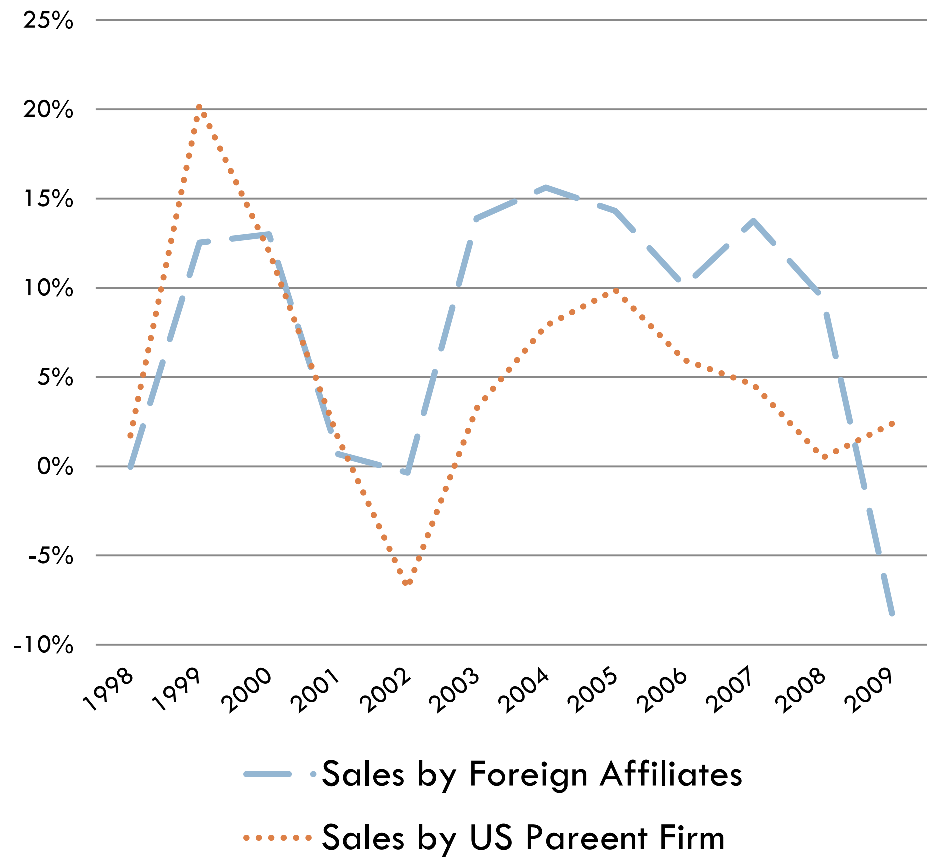
Taxation of international income

US MNC's domestic and foreign activities
Year-over-year change

in the number of employees



in sales



Source: BEA

Obama's corporate tax proposals

- *Treasury's estimated revenue gains over 5 years*
  - Reform U.S. international tax system ($77 billion)
    - Defer deduction of interest expense on deferred income of foreign subsidiaries ($28 billion)
    - Determine the foreign tax credit on a pooling basis ($26 billion)
    - Tax currently excess returns associated with transfers of intangibles offshore ($12 billion)
    - Modify tax rules for dual capacity taxpayers ($5 billion)
  - Reform treatment of financial and insurance industry institutions and products ($29 billion)
    - Impose a financial crisis responsibility fee ($23 billion)
  - Eliminate fossil fuel preferences ($17 billion)
    - Repeal expensing of intangible drilling costs ($11 billion)
    - Repeal percentage depletion for oil and natural gas wells ($5 billion)
  - Other revenue changes ($89 billion)
    - Repeal LIFO method of accounting for inventories ($31 billion)
    - Repeal lower-of-cost-or-market inventory accounting method ($10 billion)
    - Tax carried interests as ordinary income ($8 billion)

Top corporate tax expenditures

- US Treasury Analytical Perspectives estimates for 5 years (2013 – 2017)
  1. Deferral of income from controlled foreign corporations – $216 billion
  2. Accelerated depreciation of machinery and equipment – $209 billion
  3. Exclusion of interest on public purpose State and local bonds – $65 billion
  4. Deduction for US production activities – $61 billion
  5. Credit for low-income housing investments – $37 billion
  6. Expensing R&E expenditures for General Science, Space, and Technology – $32 billion
  7. Exclusion of interest on life insurance savings – $14 billion
  8. Credit for increasing research activities – $14 billion
  9. Energy investment credit – $10 billion
- The top two on the Treasury "hit list" (deferral and accelerated depreciation) should not be characterized as tax expenditures.

Incentives for domestic manufacturing

- *President's Framework* – Reduce corporate tax rate to 25 percent for manufacturing as well increase section 199 deductions for advanced manufacturing.
- Manufacturing accounted for 13 percent of US GDP in 2010 and 8 percent of employment. By comparison, services accounted for 77 percent of US GDP in the same year and 79 percent of employment.
- Services are the driver of future job growth. The overwhelming majority of employment is already in services. In 2010, over 110 million people were employed in the services sector. That figure is estimated to rise to over 130 million by 2020.
- The framework contradicts one of its own precepts: "tax expenditures in the tax code vary dramatically by industry. These differences manifest themselves in disparate average rates across industries…the result is a tax system that distorts investment decisions."

Fiscal Impact of Proposals

Comparison of Fiscal Proposals

	Fiscal Commission Proposal	Bowles-Simpson Plan	Schakowsky Deficit Reduction Plan	Debt Reduction Task Force	The Ryan Plan
Corporate tax rate	23-29%	26%	N/A	27%	Replaced with a consumption tax of 8.5%
Spending target in 2020 (percent of GDP)	21.8%	22.0%	23.5%	23.0%	22.3%
Revenue target in 2020 (percent of GDP)	20.6%	20.5%	20.2%	21.4%	18.5%
Deficit/Surplus in 2020 (percent of GDP)	-1.2%	-1.4%	-3.3%	-1.5%	-3.8%
Debt held by the public in 2020 (percent of GDP)	66%	65%	N/A	60%	69%
Adoption of a broad-based consumption tax (VAT)[i]	N/A	N/A	N/A	Debt Reduction Sales Tax of 6.5%	Business Consumption tax of 8.5%
Adoption of Territorial Tax System	Yes	Yes	N/A	N/A	N/A

Source: Hufbauer and Foong Wong (2011)

Missing elements in the current debate

- Recognition that demographic aging, crumbling infrastructure, and global military obligations compel a permanent increase in federal spending from the historic norm of 21%-22% of GDP to 24%-25%.

- National consumption tax: In 2008, the average OECD country collected 6.5% of GDP from federal VAT/GST to finance social spending. VAT/GST are the leading means of taxing consumption in 29 out of the 30 OECD countries– US being the exception.