TWO URGENT TAX REFORMS

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The U.S. corporate tax rate, 35%, is the highest in the industrialized world, and the gap between American and foreign rates is widening, as foreign countries are lowering their rates. This high corporate tax discourages investment and economic growth.

Most nations employ a territorial system, which taxes only their corporations' domestic earnings. The U.S., however, taxes its corporations on their worldwide earnings. This puts U.S. companies at a competitive disadvantage and introduces far-reaching economic distortions.

In order to increase international competitiveness and economic growth, the new Congress and the incoming administration need to:

1. **Lower the Corporate Tax Rate**
2. **Move to a Territorial Tax System**

1.

The Current Corporate Tax Impasse

The 35% corporate tax rate in this country is unusually steep, especially compared with an average 23% for other member nations of the Organization for Economic Co-operation and Development. On top of its high rate, U.S. corporations are taxed on their worldwide income—a path taken by only six other OECD members.

A worldwide tax system combined with high tax rates puts U.S. companies in a disadvantageous position compared with foreign companies. Thus, if an American company operates in the U.S. and Switzerland, its domestic affiliate pays U.S. taxes of 35% and its foreign affiliate pays U.S. taxes at 35% and Swiss taxes at 21%. U.S.-based companies can deduct the taxes paid to foreign governments from U.S. taxes owed to the Internal Revenue Service, but they are ultimately liable to pay the full 35% U.S. tax. This international tax regime puts American companies at a disadvantage compared with foreign companies.

By contrast, countries that have a territorial system tax companies only on the income earned within their borders. The American company operating in Switzerland and America would pay U.S. taxes on its domestic income and Swiss taxes on its Swiss income. In this way, companies can take full advantage of low-tax jurisdictions.

The combination of high corporate tax rates and a worldwide tax system encourages American companies to become owned by foreign companies. A recent example is Burger King, the U.S. fast-food chain, which merged with Canada's Tim Horton's, a doughnut chain, in order to access Canada's lower taxes. Burger King's profits earned in the U.S. are taxed at the U.S. rate, but its profits elsewhere—in North and South America, in Europe and Asia—are taxed at lower rates.

The U.S. corporate tax regime has another remarkable downside. While American companies are ultimately liable to pay a 35% tax on their earnings abroad, they can avoid paying it until they bring the money home. The result? American companies hold offshore about $2.6 trillion of earnings from foreign operations. No one knows how much would be repatriated with a lower U.S. tax, but it would be higher than it is now. The funds that companies bring back the U.S. would be available for domestic capital projects. They might also be returned to shareholders through dividends or share repurchases, where they could be spent or invested elsewhere—all of which would boost our weak economy.

It is difficult to overstate the importance of a sensible tax system to economic growth. Real GDP grew at an annualized rate of 1.1% in the first half of 2016. Indeed, failure to take into account the deleterious effects of higher taxes is one of the major reasons actual GDP growth has consistently underperformed the Obama administration's expectations.

2.

How to Fix the System

The incoming administration and the Republican Congress is well aware of the need for a reform of the corporate tax system and a cut in the statutory rate. Donald Trump has called for a corporate tax rate of 15%—which would reduce the U.S. rate below the OECD average, making American firms more competitive. Lower rates would attract jobs back to America. Trump would also allow a one-time repatriation of corporate profits held offshore, at a rate of 10%.

House Speaker Ryan would reduce the corporate tax rate to 20% and allow full expensing for investments in both tangible and intangible assets, which would result in a zero tax rate on new investment. Foreign subsidiaries would receive a 100% exemption from taxes on dividends. Ryan also proposes moving toward a territorial tax system. Upon repatriation, the U.S. corporations would face an 8.75% tax on cash or cash equivalents and a 3.5% tax on other forms of accumulated foreign earnings.

The combination of tax incentives created by dramatically lower rates and territoriality would attract some of the $2.6 trillion in offshore earnings back into the United States, which would create a stimulus to the U.S. economy.

The U.S. corporate tax system disadvantages domestic manufacturing in favor of foreign manufacturing. The system could be made far more supportive of U.S. domestic growth than it is at present. And with a 1% growth rate, it is time for reform.