U.S. Corporate Tax Reform: Groupthink or Rational Debate?

BY ROBERT D. ATKINSON | JULY 2011

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There is a growing consensus in Washington that the time has come for comprehensive corporate tax reform. Such reform could be the most important economic policy decision Washington makes. Its effects would likely have critical implications for the health of the U.S. economy for years to come.

While there are a range of issues any comprehensive tax reform package will have to address [including how foreign source income is taxed and the differential tax treatment of interest vs. dividends] this report addresses just two central issues:

1. the extent to which reform should be focused on broadening the base and reducing so-called tax "distortions" on strengthening tax incentives to drive certain types of corporate investments; and

2. the extent to which reform should be revenue neutral or cost revenue (at least in the short term) in order to lower the effective U.S. corporate rate.

If Washington is to get this right, the debate over corporate tax reform needs to be vigorous and informed by analysis and reason. Unfortunately, much of what passes for corporate tax reform policy analysis is nothing more than ideological assertions and Washington groupthink. Even among groups with differing ideologies, there is near universal belief in tax code simplicity. For example, the notion that the best tax code is one that is neutral and "doesn't pick winners" is so widely touted that it has become conventional wisdom, is no longer even questioned and crosses party lines. Case in point, the Obama Administration's Economic Recovery Board report on tax reform which stated: "The combination of a high statutory rate and numerous deductions and exclusions results in an inefficient tax system that distorts corporate behavior in multiple ways."[1] The issue of revenue neutrality is also confined by groupthink and ignores a significant body of academic research about the effects of taxes on corporate behavior. Anyone with the temerity to argue that simplicity should not be the main goal of corporate tax reform (and that the effective corporate rate needs to be lower) runs the risk of being treated with derision and disdain.

This report argues that this conventional wisdom is wrong and that if corporate tax reform follows the path laid down by the holders of the Washington economic consensus the result will be less growth, fewer jobs and reduced U.S. economic competiveness. In a world of intense international economic competition and a U.S. economy increasingly powered by innovation, a tax code that does not proactively "distort" the investment decisions of enterprises in the United States is one that is doomed to leave the United States behind in international competition. In fact, we are virtually the only nation in the world where the consensus is for eliminating, rather than expanding, incentives for business investment in innovation, capital equipment and machinery.

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Rather, than a tax code that is based on the belief that Washington does not need to actively shape the structure and performance of the U.S. economy, the United States needs a corporate tax code that achieves three key things:

1. Provides direct incentives for U.S.-based enterprises to invest in the building blocks of innovation, productivity and competitiveness: research and development and innovation commercialization, workforce training, and machinery and equipment (including computers and software);[2]

2. Taxes firms in internationally traded industries at a lower rate than firms in non-traded industries; and

3. Lowers the average effective corporate tax rate from its current levels.

Unfortunately, the conventional wisdom on tax reform, if followed, would lead to none of this. It would likely cut, not expand, key incentives that spur enterprises to invest more in the building blocks of growth and competitiveness, including the three most "costly" incentives, the deduction for domestic production, the R&D tax credit and accelerated depreciation. However, these are among the most pro-growth in the tax code. Reform would also likely raise taxes on traded sectors (sectors that compete globally such as vehicle production as opposed to those that do not such as barbershops) relative to their current rates (while lowering taxes on non-traded sectors), making them even less competitive than their competitors in other nations. And finally, if it is revenue neutral it would do nothing to lower the overall level of corporate taxation, thereby failing to address a key U.S. economic competitiveness challenge. American workers deserve better. At the very least, they should know that policymakers have heard and fairly considered all relevant arguments before deciding on a new tax policy.

CORPORATE TAX REFORM GROUPINGS

For anyone following the debate over corporate tax reform, it does not seem like much of a debate. When President Obama, in his 2011 State of the Union address, called on Congress to join with him to, "Get rid of the loopholes. Level the playing field. And use the savings to lower the corporate tax rate for the first time in 25 years—without adding to our deficit," he was saying what many Republican leaders have also been saying, with the one difference being that some Republican leaders might interpret the last phrase ("without adding to our deficit"), to mean a lower effective rate that would be budget neutral because it would spur compensating growth, whereas the President actually meant that he did not want to lower the effective rate.

But in spite of this seeming unanimity of positions, there are in fact four distinct intellectual camps when it comes to corporate tax reform. The first two reflect the dominant Washington economic consensus and have as a core component the notion of "broadening the base, lowering the rate" (BBLR). This deeply held Washington consensus holds that the key to any effective reform is to purge the federal corporate tax code of its myriad credits, deductions and exemptions and use the resulting savings to lower the statutory rate from 35 percent to somewhere in the 20s.

There are two distinct groups within the BBLR camp. The first, *Hard Core Base Broadeners*, would take an axe to virtually all the loopholes, deductions, and incentives. For them, a flat rate on corporate income is preferable, and even better is a national value-added tax that allows for complete replacement of the corporate income tax system.[3] If the corporate system cannot be abolished, the savings from every deduction that is excised should be used to pay for driving the statutory rate as low as possible. The idea that the tax code should influence corporate decisions is anathema to these Hard Core Base Broadeners. "How could government possibly outguess market actors?" they ask. And the resulting flat rate should be as low as possible, because the higher the rate the higher the "deadweight" economic welfare loss.

This was the basis for the thinking behind the 1986 Tax Reform Act, which is held by the BBLRs as the high water mark of U.S. tax policy. It was also the basis of the U.S. Treasury's 2007 report on improving the competitiveness of the business income tax system, as it proposed eliminating incentives like accelerated depreciation allowances, the special deduction for U.S. manufacturing activities, and the research and experimentation credit, as well as many other tax preferences.[4] William Gale, director of the economic studies programs at the Brookings Institution, sums up this view when he states: "The sine qua non of meaningful tax reform is to clean out and rationalize the exclusions, exemptions, deductions, and credits in the tax system."[5] Translation: Get rid of incentives for innovation and investment and just give everyone the same low tax rate.

The *Pragmatic Base Broadeners* are not as hard core. While they agree with their hard core brethren that the tax code shouldn't be picking winners, they are willing to make a few exceptions for some particular incentives. For example, John Diamond and George Zodrow of the Baker Research Institute agree with the overall philosophy of the Hard Core Base Broadeners, but they are willing to have the tax code target a few select items where the economic evidence (and presumably Washington support for) is strong. They write, "An essential element of any successful tax reform proposal is the elimination of tax-induced distortions of economic decision-making (other than in a few very narrowly defined activities with widespread economic effects, such as investment in research and development and the emission of pollutants)."[6] But the difference between the two groups is only one of degree; either way, ideal tax reform gets rid of virtually all the incentives, perhaps leaving a few select ones like the R&D credit, and then uses the revenue to lower the statutory rate.

There is a third group that also favors a simpler tax code, but for quite different reasons. These *Progressive Tax Increasers* are unconcerned with theoretical issues like base broadening to reduce distortions; their main goal is making sure corporations pay their "fair share." And a key way to do that is to get rid of the myriad deductions such as the deferral of foreign source income and use the savings, not to cut the statutory rate, but to support government spending on social programs. For them, in a time when budgets for social spending are being cut, it is simply unconscionable that some people advocate for lower U.S. corporate taxes. The liberal Center for Budget and Policy Priorities exemplifies this group when it argues that, "The corporate tax code taxes different kinds of corporate investments at very different rates. This 'unlevel playing field' encourages businesses to choose among investments in substantial part based on their tax benefits, instead of making those decisions based entirely on investments' real economic value. Policymakers should level the playing field through corporate tax reform."[7] While this sounds like they are ideological Base Broadeners, in fact they see elimination of incentives as a way to raise the overall effective corporate tax rate, since for them corporate tax reform should "contribute to long-term deficit reduction."[8]

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The fourth group, the *Pragmatic Tax Incentivists* (which includes ITIF), views the corporate tax code as a key policy tool (like support for STEM education or direct funding for technology policy) that can support U.S. productivity, innovation and competitiveness. For them, corporate tax reform, if done right, can help reverse the decline over the last decade in capital investment in U.S. manufacturing, growth in corporate R&D (relative to other nations) and in U.S. international economic competitiveness. But doing it right means reshaping the tax code to provide stronger, not weaker, incentives for enterprises in the United States to invest in the building blocks of growth and innovation, particularly R&D, new machinery and equipment and workforce training. They see these tax-induced "distortions" not as harmful to growth, but as downright beneficial to productivity, innovation and U.S. competitiveness. At the same time they recognize the need to decrease the average effective corporate tax to better compete with other nations and see these expanded incentives as the best way to reduce the average effective rate.

Unfortunately, the debate over reform to date has largely been shaped by the BBLR camp, with supporters in places like the Treasury Department and the Congressional Budget Office, and at think tanks like Brookings and the American Enterprise Institute. As such, key questions such as, "What kind of tax-induced 'distortions' enhance growth?" have simply not been considered part of the debate.

THE IDEOLOGICAL BASIS OF THE "BROADEN THE BASE, LOWER THE RATE" POSITION

In their call for corporate tax reform, Base Broadeners, both the hard core and the pragmatic, look back fondly on the 1986 Tax Reform Act which cleaned out the Augean stables of tax interference. They tell a story of how over the years lobbyists and the elected officials who listen to them have mucked the stable back up, and so, it's time for another Herculean stable cleaning. But just as many of the arguments for tax reform today have not been based on empirical evidence or careful logic, the same was true in the 1980s as well.

A seminal article that laid the intellectual groundwork for the 1986 Act was authored by economists Larry Summers, former head of President Obama's National Economic Council, and Alan Auerbach. Both are neoclassical economists who by training and ideology do not believe the government should intervene to sway market-based allocation of the factors of production. In their 1979 National Bureau of Economic Research article on the investment tax credit (which at the time was a long-standing part of the corporate tax code designed to spur more capital investment), they argued for eliminating the credit in order to broaden the base and lower the statutory rate.[9] Yet, what's striking is not only their conclusion but how they came to it. Summers and Auerbach actually found that the investment tax credit was highly effective. In fact, in their economic modeling they found that an investment tax credit resulted in more equipment investment compared to a more simple tax code without the credit. Moreover, the credit boosted GDP compared to no credit. So, to be clear, Summers and Auerbach found that a less simple code—one that picked winners (in this case capital equipment)—would boost investment in capital equipment (which Summers and Brad DeLong showed in 1990 to be a key determinant in boosting growth and GDP compared to a simpler one.[10]

But notwithstanding their findings, Summers and Auerbach remained true to their neoclassical ideology and argued that Congress should eliminate the growth-inducing investment tax credit. Their reason? Because it resulted in non-market-based allocation of capital and crowded out "non-favored investment." In this case, the non-favored investment was structures (e.g., residential housing and commercial and industrial buildings). As they wrote, "The credit will bid up interest rates, discouraging the purchase of non-favored capital goods, principally structures."[11] This violates the First Commandment of the dominant neoclassical economics doctrine: "Thou Shalt Not Distort Allocative Efficiency." For Summers and Auerbach, and most of their Broaden the Base brethren, the view is, "potato chips, computer chips, what's the difference?"[12] For them, a dollar of one is equal to a dollar of the other, since that is what the market says. Thus, they see a dollar spent on housing as no different from a dollar invested in a new machine. And a tax code that "distorts" decisions in favor of the latter is to be avoided at all costs.

Today, this "first commandment" is behind much of the thinking on corporate tax reform. As the President's Recovery Advisory Board stated, "Because certain assets and investments are tax favored, tax considerations drive overinvestment in those assets at the expense of more economically productive investments."[13] But as is normally the case, they cited no evidence that just because an investment in one area is favored by the tax code that it is less productive than investments that are not. As we saw with the Summers and Auerbach study, the opposite is often true.

Mistaking such ideological thinking for reasoned analysis, Congress passed the 1986 Tax Reform Act, which not only raised taxes on corporations while lowering them on individuals (exactly the opposite of what should have been done given increasing global competition), it also eliminated the investment tax credit while expanding housing tax incentives. This contributed to the subsequent housing bubble and the decline in investment by manufacturers in equipment (down 8 percent over the last decade), which is one reason why the United States lost over 30 percent of its manufacturing jobs in the last decade.[14] So a reform based on the idea of simplifying the tax code contributed to reduced investment in equipment, U.S. industrial decline, lost jobs, and the housing bubble and resultant financial crisis. But at least it didn't pick winners.

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This gets to the fundamental intellectual difference between Base Broadeners and Tax Incentivists. For the former, any tax code that alters the "natural" allocation of factors—that is, capital, labor, and goods and services—dictated by market price signals makes the economy worse, not better. With their focus on allocative efficiency, neoclassical economists assume that markets get prices right most of the time; and that even when markets get prices wrong, government intervention in response will almost always be worse. But as innovation economists Phillipe Aghion, Paul David, and Dominique Foray note, "The empirical foundations for such sweeping statements remain remarkably fragile."[15]

In contrast, Tax Incentivists argue that the lion's share of growth comes not from *allocating* goods and services in the most efficient way. For them the primary drivers of growth are *productive efficiency*—the ability of organizations to reorganize production in ways that lead to the most output with the fewest inputs, including labor inputs—and *adaptive efficiency*—the ability of economies and institutions to change over time in order to respond to successive new situations, in part by developing and adopting technological innovations.[16] As such they argue that the gains in innovation and productivity spurred by the increased R&D that an R&D tax credit generates or by the increase in machinery and equipment that an investment tax credit produces vastly exceed any minor losses from "misallocation" of economic resources. From this perspective, if corporate tax policies to encourage R&D, capital equipment investment, or other key investments "distort" price signals, it is worth whatever minor "deadweight" loss to the economy that might result.

In short, the Base Broadeners assume that distortions of allocative efficiency impose large costs and that any benefits from more R&D or capital equipment or other key inputs that tax incentives might generate are marginal or in fact negative.[17] In contrast, Tax Incentivists argue the opposite; that losses from allocation inefficiency are small and gains from productive and dynamic efficiency are large. As Canadian government economist Aled ab Iorwerth wrote, "There is no presumption that distortions are necessarily welfare-reducing. Distortions that favor the contributors to long-run growth will be welfare-enhancing."[18] This explains why the Canadian government recently "distorted" their tax code to spur more capital expenditures by companies. And it's why other nations have put in place an array of tax incentives to spur investment in machinery and equipment (including software) and research and development.

Even when the empirical evidence is overwhelming in favor of tax "distortions," as it was in the Summers and Auerbach article, the almost religious faith in markets and the accompanying distrust of "industrial policy" leads Base Broadeners to ignore evidence and push relentlessly ahead. We see this most clearly these days with efforts to sacrifice the

R&D tax credit on the altar of base broadening. In their failed effort at tax stable cleaning, the Bush administration proposed eliminating the R&D credit and using the savings to lower the rate, even though virtually every academic study on the matter has shown that the R&D credit spurs growth and investment.[19] In fact, raising the Alternative Simplified R&D Credit from 14 percent to 20 percent would create over 162,000 jobs, increase GDP by $66 billion, and pay for itself after a period of years through increased tax revenues.[20] But for the hard core Base Broadeners this evidence is simply beside the point. For them, the R&D credit is just one more example of politicians using the tax code to pick winners. Never mind that the winners are not particular firms or particular technologies, but rather the tens of thousands of big, medium and small firms in the United States that conduct research and develop new products and processes. But even this is seen as government picking winners. This is nothing more than ideology masquerading as objective analysis.

WHY "BROADEN THE BASE, LOWER THE RATE" COULD MAKE THINGS WORSE, NOT BETTER

Revenue-neutral base broadening is touted by its supporters as helping U.S. economic growth and competitiveness. In fact, it is likely to lead to the exact opposite result. There are three key reasons for this.

First, reform would reduce taxes on industries that face little or no international competition (e.g., electric utilities) and raise them on industries that are fighting for global market share (e.g., technology-based industries). Base Broadeners look at the fact that different industries pay different effective tax rates as evidence that the tax code is distorting economic activity and hurting competitiveness. In fact, if tax reform imposes higher effective rates on firms in industries that are exposed to international competition and lower rates on firms that are not in internationally traded industries, then U.S. competitiveness would suffer, not improve.

Regional economists distinguish between two kinds of economic sectors: traded and non-traded. The output of the former is largely sold to people (or firms) who live outside the region (or nation) where it is produced, while the latter is sold largely to people who live in the region (or nation). Few people travel outside their community to get a haircut. In contrast, few people buy a car that is produced in their community, unless they live in a place like Detroit. In this sense, from the perspective of the nation, barber services are not traded while automobile production is.

In other words, industries like grocery stores, electric utilities and car dealers do not compete globally, while industries like steel, pharmaceuticals and electronics do. While the former provide needed services, if their taxes increase they are not going to build fewer grocery stores, electric wires, or car dealerships since those investments are largely based on levels of consumer demand. But if the taxes on steel companies, drug companies and electronics companies are raised, they will act as any rational company would by moving some production to nations that tax them less.

This is why most U.S. states have tax codes that explicitly favor manufacturing and high-tech firms (and some other tradable industries). They know that if they have a tax code that doesn't "pick winners" and that taxes barber shops at the same rate as automobile factories that they will have the same number of barber shops but fewer automobile factories and hence fewer jobs. It's why most other countries' tax codes provide tax deductions and incentives that favor firms in globally traded industries. For example, in the last decade a number of nations have put in place "patent box" policies that tax income generated from patents at a much lower rate than other income.[21] These nations realize that jobs and their nation's competitiveness depend on the health of their traded sectors.

Even some Pragmatic Base Broadeners recognize the importance of taxing mobile (e.g., traded) activities less. For example, the London-based Institute for Fiscal Studies noted that, in principle, it would be efficient to tax mobile activities at a lower rate than those which are relatively immobile— this would allow a higher rate of corporation tax to be supported on less mobile (location-specific) economic profits, while using a lower rate to reduce the deterrence to mobile income.[22]

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Yet, some countries, including the United States, largely ignore this consideration. As Desai and Hines note, "in many countries, particularly high-income countries such as the United States, corporate tax provisions are designed on the basis of domestic considerations. Subsequently, modifications intended to address problems and opportunities that arise due to global capital and goods markets are incorporated often as afterthoughts."[23]

Under the current corporate tax code, industries pay different rates. And while there is not a one-to-one correlation between tax rates and extent to which an industry is non-traded, there appears to be relationship. For example, restaurants (which are non-traded) pay an average effective rate of 20 percent, while software firms (which are largely traded) pay 10 percent. Likewise, trucking (non-traded) firms pay around 31 percent, while metals and mining (traded) pay 7.4 percent. Electric utilities pay around 32 percent, while precision instrument firms pay 10 percent.[24]

Yet Base Broadeners pay almost no attention to this issue. For example, the President's Recovery Advisory Board report on tax reform proposed eliminating the Domestic Production Deduction, which was put in place to replace the Foreign Sales Corporation (FSC) law that was ruled illegal by the WTO in 2000 and was intended to help U.S. manufacturers competing in global marketplaces. Among the advantages of elimination they listed was that it would allow the overall corporate rate to be lowered by one percentage point, even though it would lead to manufacturers (that are traded) to pay an effective tax rate that would be three percentage points higher. Yet in the discussion of disadvantages there was no discussion of the impact on the competitive position of a key traded sector.[25] In fact, they "ridiculed" the deduction for applying to production of hamburgers in restaurants. But this tax deduction, while not perfect, is in fact, largely targeted at traded sectors. About 85 percent of the value of the deductions claimed under this provision is claimed by traded sectors such as manufacturing, information technology, or mining. "Hamburgers" (e.g., food service and accommodations) take just 0.2 percent of the total amount of the deduction.[26]

Second, corporate tax reform risks cutting rather than expanding tax incentives which are critical to growth and innovation, such as the R&D tax credit and expensing of capital *equipment.* Base Broadeners would cut many key incentives for investment (and oppose the addition of others), including favorable tax treatment for investment in machinery and equipment and the R&D credit. For example, the President's Recovery Advisory Board examined the benefits (and costs) of eliminating the domestic production deduction and accelerated depreciation. But these "distortions" enhance growth. For example, virtually every academic study on the issue finds that giving companies a tax credit for research and development performed in the United States is an effective growth policy.[27] So even if BBLR could be accomplished in a way that does not change the sectoral allocation of taxes (e.g., not increasing taxes on traded sectors) it is likely to cut or even eliminate key incentives that lead to more investments in productivity and innovation which in turn spur U.S. competitiveness. Getting rid of the R&D credit would lead to less R&D investment while eliminating accelerated depreciation would lead to less equipment investment.

Third, revenue neutrality will not make the U.S. economy more competitive. As long as corporate tax reform has to be revenue neutral, it will mean that establishments in the United States overall will still pay higher taxes than most of our international competitors, most of which have lowered effective corporate tax rates over the last two decades. When President Obama spoke in favor of corporate tax reform, he stated, "Get rid of the loopholes. Level the playing field. And use the savings to lower the corporate tax rate for the first time in 25 years—without adding to our deficit." By not "adding to our deficit" he meant that his proposed reform would be revenue neutral in static terms. That is, establishments in the United States would still pay the same amount of taxes.

To be sure, the tax burden of U.S. companies is a concern only if one believes that it is nations that compete and not merely countries and that nations design tax systems accordingly. But for some Base Broadeners, the very concept "national economic competitiveness" has no intellectual meaning, and so for them it doesn't matter what the effective tax rate is in terms of U.S. competitiveness.[28] For them, while a company like Boeing might compete against Airbus, the United States doesn't compete against Europe. As such, there is no need to lower our effective corporate rate to better compete with European nations that have lowered their effective rates over the last two decades. This position ignores the reality that nearly all countries act as countries and not merely as the domiciles of private companies.

Other Base Broadeners do recognize that nations compete and acknowledge that tax reform is needed to enhance U.S. competitiveness, even if the effective rate is not lowered. Still, for them, getting rid of "distortions" remains the Holy Grail. They would use the "savings" to lower the statutory rate and assume this will somehow make the United States more competitive. But there are really only two ways that such reform could make the U.S. economy more competitive.

The first is if firms make decisions as to where to locate investment on the basis of the statutory rate and not the effective rate. But there is little evidence that this is the case, especially when there are so many studies and so much data publicizing the effective rates of various nations. If the amount of tax that the average corporation has to pay is the same under a simplified tax system with a lower statutory rate as under one with more deductions and credits but a higher statutory rate, there should be no difference in the effect on U.S. competitiveness from a first order analysis.

The second reason would be if the majority of the tax exemptions that are eliminated were hurting firm competitiveness or were accruing primarily to non-traded firms—that is, grocery stores, hair salons, etc. In fact, as discussed above, the opposite actually appears to be true. Certainly the three largest "distortions", the R&D tax credit, the domestic production deduction and accelerated depreciation help, not hurt, competitiveness and help traded firms more than they help non-traded firms.

Reducing the statutory rate without reducing the effective rate will do little or nothing to make the United States more competitive internationally.

As a result, reducing the statutory rate without reducing the effective rate will do little or nothing to make the United States more competitive internationally. And given that the U.S. statutory and effective corporate tax rates are high compared to those of other nations, cutting the effective rate is important. There is a broad consensus that the United States has the highest or close to the highest statutory corporate tax rate (35 percent). There is less consensus on the issue of where the U.S. ranks relative to other nations on the effective corporate rate. In part this is because the effective rate can be calculated in a number of different ways. As Peter Merrill of PricewaterhouseCoopers points out, a number of studies have found that the United States has very high effective rates.[29] The Institute for Fiscal Studies (IFS) calculated marginal and average effective corporate tax rates for equity-financed investments in plant and machinery in 19 OECD countries. For 2005, the United States had the fifth highest marginal effective tax rate and the third highest average effective tax rate.[30] Chen and Mintz, in a study for the World Bank, calculated marginal effective tax rates on corporate capital for 80 countries, including sub-national taxes and non-income taxes on capital such as sales tax and property taxes. For 2009, they found the United States had the highest effective corporate tax rate among OECD countries. PricewaterhouseCoopers found that the weighted average book effective tax rate for public U.S. companies over the 2006–2008 period was 28.4 percent, second highest, after Japan, among the 31 OECD countries.[31]

One reason the effective U.S. tax rate is so high relative to other nations is that these other nations have recognized that they are in intense competition for economic activity. This is a key reason why average corporate tax rates among the 30 OECD nations have declined by at least 15 percentage points over the last 30 years, to a level well under 35 percent. Economists Michael Deveraux, Ben Lockwood, and Michela Redoano found that the desire for nations to be internationally competitive has been the principle driver of these declines.[32]

Finally, many Base Broadeners will argue that even if the U.S. corporate tax rate is making establishments in the United States less competitive internationally, massive budget deficits demand that corporate tax reform must be revenue neutral. Likewise, many of the Progressive Tax Increasers will also argue that now is not the time to cut corporate taxes, especially when cuts of entitlements and other social programs are on the table. But this ignores two key factors. First, reducing corporate taxes does not necessarily lead to reduced government revenues. In fact, studies find no relationship between declines in corporate tax rates and public spending.[33] One reason is that lower corporate taxes generate more growth, making up at least some of the lost tax revenues and spending. Clausing finds that the combined revenue-maximizing corporate income tax rate is 33 percent, significantly lower than the combined U.S.-state rate.[34] One reason is that higher effective tax rates lead to less investment (and thereby lower future tax revenues) and also more income shifting overseas. But also, unless the U.S. economy becomes more competitive internationally and starts creating more high-wage jobs as a result, federal budget problems will get worse, not better, and it will be hard to create the kinds of good jobs that American workers need.

WHAT SHOULD CORPORATE TAX REFORM DO?

All this is not to say that tax reform should not work to reduce special deductions, exemptions and credits that cannot be justified on a competitiveness, productivity or innovation basis. Indeed, a reconstituted corporate tax code which closes parochial loopholes might have some positive impacts on growth, however modest they might be. But if the dogged faith in simplicity ends up trumping efforts to reshape the code as a driver of innovation and U.S. competitiveness, it will result in less, not more, growth and jobs. So the choice should not be between a corporate tax code riddled with particular exemptions and a completely neutral code. Rather, the code should focus on expanding exemptions and incentives focused on spurring innovation and growth-enhancing activities while eliminating ineffective ones. In other words, complexity is good so long as it is right kind of complexity.

Unless the U.S. economy becomes more competitive internationally and starts creating more high-wage jobs as a result, federal budget problems will get worse, not better, and it will be hard to create the kinds of good jobs that American workers need.

One way to do this would be to create a simple and easy-to-administer U.S. growth and innovation tax credit. This credit would be modeled on the current Alternative Simplified Credit for R&D (ASC). Under the ASC, firms can receive a credit of 14 percent for expenditures on research performed in the United States in excess of 50 percent of base period expenditures. As noted above, the R&D credit is highly effective at spurring R&D. But the U.S. credit is relatively anemic relative to our international competitors, with the U.S. ranking 17th of 30 OECD nations in R&D tax generosity.[35] In fact, Brazil, China, and India all offer more generous R&D tax credits to firms than the United States does. So one key component of corporate tax reform should be strengthening the credit.

But R&D, while important, is not enough. A second way to reform the corporate tax code to be more pro-growth is to create incentives for establishments not just to conduct research in the United States but also to commercialize and produce the innovations here. As such, any competitiveness-based tax incentive should also provide a credit that encourages establishments' investments in capital equipment and workforce training, and also support innovation through steps like a "patent box" which taxes income from patented products at a lower rate than other income.

Base Broadeners will argue that this will simply distort economic decision making, leading to more equipment investment and workforce training than is economically rational. But there is compelling scholarly evidence that businesses do not capture all of the benefits of their investments in R&D, workforce training, and new machinery and equipment, particularly IT.[36] As a result, without specific encouragement, companies will invest less in these areas than is optimal from a societal perspective. This gap between the level of spending supported by the market alone and the social optimum justifies a role for government.

As such, Congress should enact an American Innovation and Competitiveness Tax credit that provides a credit of 30 percent on expenditures on R&D and workforce training and a credit of 15 percent on machinery and equipment (including software) in excess of 50 percent of base period expenditures. For business to get the full benefits from new equipment, they need higher-skilled workers. Allowing employee training expenditures to be counted as qualified expenditures for the credit would help correct the problem that workforce training in the United States has fallen by approximately half as a share of GDP over the last decade.[37]

Congress should enact an American Innovation and Competitiveness Tax credit that provides a credit of 30 percent on expenditures on R&D and workforce training and a credit of 15 percent on machinery and equipment (including software) in excess of 50 percent of base period expenditures.

Base Broadeners will argue that these incentives are distortionary because there are no differences between private and public rates of returns. But there is considerable evidence that there are significant spillovers from business investments in research, new equipment and workforce training and that market forces alone will lead to underinvestment in these drivers of growth.[38] Moreover, targeting incentives toward particular activities (e.g., R&D and new capital investment) can be much more efficient than hoping for the same result with an across-the-board rate cut. Even the President's Recovery Advisory Board acknowledged as much when they stated that, "Compared to other more targeted tax cuts to encourage investment, a reduction in the corporate tax rate would have a smaller incentive effect on new investment per dollar of tax revenue lost.[39]

Even if Base Broadeners accept this logic, they will argue that driving the statutory rate as low as possible by eliminating all deductions, even the growth-inducing ones, is the key. As one study conducted by supporters of base broadening argues, "a lower statutory rate under the [base broadening, rate reduction] approach reduces incentives for income shifting by U.S. multinationals (e.g., through the use of transfer pricing, debt reallocation, the relocation of patents and other intangible assets, and similar activities)."[40] To be sure, as long as the U.S. corporate tax system is not based on a territorial approach, there will be incentives for this income shifting unless U.S. rates are lower. But there is no reason to believe that such income shifting would be significantly higher if the effective rate, rather than the statutory rate were lowered.

Another argument is that a lower statutory "rate reduction will attract investments by U.S. and foreign multinationals that generate above-normal profits, which in turn will contribute to revenues."[41] But again, if U.S. and multinational firms can achieve a lower effective rate, they should be indifferent if the rate comes from a lower statutory rate or through taking advantage of powerful tax incentives for investment. In fact, the goal of tax policy is not to attract and retain high-profit activities to the United States, it's to attract, retain and grow high productivity, high wage jobs to the United States—something an American Innovation and Competitiveness tax credit is more likely to achieve than simple statutory rate reduction.

CONCLUSION

The debate over tax reform wasn't always dominated by the Base Broadeners. As University of Colorado political scientist Sven Steinmo argues, it is only in the last thirty years that the idea of tax reform has come to be defined as lowering rates and cutting loopholes. He notes that "a 'good tax system' has moved from being one that explicitly introduced distortions into the capitalist marketplace to one that minimizes these distortions. In short, it is widely believed by both the left and the right that a 'good tax system' keeps the government out of private economic decision making."[42] But the quest for simplicity should not override efforts to craft a corporate tax code that more effectively spurs productivity and innovation.

The United States is at risk of losing its global competitive advantage and with it faster per-capita income growth. To effectively respond, the nation must take concerted and strategic actions in a host of areas, including reform of the corporate tax code to transform it into a more effective tool to support private sector efforts to innovate and be more productive.

ENDNOTES

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