

OPINION | MAY 6, 2010

Time to Junk the Corporate Tax

By MICHAEL J. BOSKIN

President Obama has put tax reform on the agenda, but surprisingly little attention is being paid to fixing the most growth-inhibiting, anticompetitive tax of all: the corporate income tax. Reducing or eliminating the corporate tax would curtail numerous wasteful tax distortions, boost growth in both the short and long run, increase America's global competitiveness, and raise future wages.

The U.S. has the second-highest corporate income tax rate of any advanced economy (39% including state taxes, 50% higher than the OECD average). Many major competitors, Germany and Canada among them, have reduced their corporate tax rate, rendering American companies less competitive globally.

Of course, various credits and deductions—such as for depreciation and interest—reduce the effective corporate tax rate. But netting everything, our corporate tax severely retards and misaligns investment, problems that will only get worse as more and more capital becomes internationally mobile. Corporate income is taxed a second time at the personal level as dividends or those capital gains attributable to reinvestment of the retained earnings of the corporation. Between the new taxes in the health reform law and the expiration of the Bush tax cuts, these rates are soon set to explode.

This complex array of taxes on corporate income produces a series of biases and distortions. The most important is the bias against capital formation, decreasing the overall level of investment and therefore future labor productivity and wages. Also important are the biases among types of investments, depending on the speed of tax vs. true economic depreciation, against corporate (vs. noncorporate) investment, and in favor of highly leveraged assets and industries. These biases assure that overall capital formation runs steeply uphill, while some investments run more, some less uphill. It would be comical if the deleterious consequences weren't so severe.

Of course, the corporation is a legal entity; only people pay taxes. In a static economy with no international trade, the tax is likely borne by shareholders. The U.S. economy is neither static nor closed to trade, and taxes tend to be borne by the least mobile factor of production. Capital is much more mobile globally than labor, and the part of the corporate tax that is well above that of our lowest tax competitors will eventually be borne by workers. In a growing economy, the lower investment slows productivity growth and future wages.

There is considerable evidence that high corporate taxes are economically dangerous. In a 2008 working paper entitled "Taxation and Economic Growth," the Organization for Economic Cooperation and Development concluded that "Corporate taxes are found to be most harmful for growth, followed by personal income taxes and then consumption taxes." Virtually every major tax reform proposal in recent decades has centered on lowering taxes on capital income and moving toward a broad-based, low-rate tax on consumption. This could be accomplished by junking the separate corporate income tax, integrating it with the personal income tax (e.g., attributing corporate income and taxes to shareholders or eliminating personal taxes on corporate distributions), and/or allowing an immediate tax deduction (expensing) for investment (which cancels the tax at the margin on new investment and hence is the priority of most economists). The Hall-Rabushka Flat Tax, the Bradford progressive consumption tax, a value-added Tax (VAT), the FairTax retail sales tax, four decades of Treasury proposals and the 2005 President's Tax Commission proposals would all move in this direction.

Reducing or eliminating the negative effects of the corporate tax on investment would increase real GDP and future wages significantly. Junking both the corporate and personal income taxes and replacing them with a broad revenue-neutral consumption tax would produce even larger gains. Nobel Laureate Robert Lucas concluded that implementing such reforms would deliver great benefits at little cost, making it "the largest genuinely true free lunch I have seen."

Reducing taxes on new investment could help strengthen what is a historically slow recovery from such a deep recession. It would also strengthen the economy long-term. American workers would benefit from more jobs in the short run and higher wages in the long run.

However, if a new tax device is used to grow government substantially, it will seriously erode our long-run standard of living. The VAT has served that purpose in Europe and, while better than still-higher income taxes, the larger-size governments it has enabled there are the prime reason European living standards are 30% lower than ours. Trading a good tax reform for a much larger government is beyond foolish. No tax reform can offset losses that large. Hence, a VAT should only be on the table if it is not only revenue-neutral but accompanied by serious spending control.

Further, the fraction of Americans paying no income taxes is approaching 50%. That sets up a dangerous political dynamic of voting ever-rising taxes to pay for ever-rising spending. We need more people with a stake in controlling spending. Replacing corporate and personal income taxes with a broad-based consumption tax could increase the number of those with "skin in the game." But some reforms, for example a VAT, might be much less transparent and may not serve this purpose.

Congresses (and presidents) seem unable to avoid continually tinkering with the tax code. A tax reform that is quickly riddled with special features would lose much of its economic benefit. We need a stable tax system that changes much less frequently, so families and firms can more reliably plan their future. Current fiscal policy, loaded with immense deficits, ever-growing debt, and the prospect of higher future taxes, is the biggest threat to such stability. To balance proposed spending in Mr. Obama's budget in 2015, his Deficit Commission's target year, will require at least a 43% increase in everyone's income tax. Thus, spending control is vital to tax stability.

American companies and their workers compete in the global marketplace saddled with a costly, anachronistic corporate tax system. To compete successfully in the 21st century, we will need to reform corporate taxation. There are several paths to doing so, each with its advantages. Unfortunately, tax policy is headed in exactly the wrong direction, raising taxes on corporate source income. Business investment is growing again after the collapse in the recession, which is usual in a cyclical recovery with very low interest rates. But eventually structural drags, from our antiquated tax code to massive public debt, will impede investment and economic growth.

Mr. Boskin is a professor of economics at Stanford University and a senior fellow at the Hoover Institution. He chaired the Council of Economic Advisers under President George H.W. Bush.