CORPORATE TAXES

Winning the Race 2012 **is a series of ten policy briefs that lay out broad principles and actionable ideas for the next administration to embrace to help the United States win the race for global innovation advantage.**

Context and Policy Divide

If the U.S. economy is to once again become globally competitive and driven by productive investment we need a tax code that provides generous incentives to invest in innovation and productivity while at the same time putting U.S. establishments that compete in global markets on a more level playing field with foreign competitors.

Yet today's partisan clash over taxes is the same one we have seen in every election for decades. Most Republicans insist that all taxes need to be reduced. Many Democrats insist on maintaining revenues needed for government programs they regard as critical and making sure "the wealthy pay their share." However, this clash misses the point. Yes, we need lower taxes, but on businesses, not individuals. And we also need to expand investment incentives if businesses are to create good jobs in America. If even some of the most liberal states in the nation have figured out that a competitive corporate tax code designed in the context of fiscal discipline is not a choice but a requirement if workers are to prosper, surely Washington can do the same.

Innovation Race Principles

- **Forget revenue neutrality.** The United States has not only the highest statutory corporate tax rate but also a very high effective rate. Corporate tax reform that does not reduce the effective rate will do little to restore U.S. global tax competitiveness. As such, the next administration shouldn't just shift the business tax burden, it should reduce it.

- **Simpler is not always better.** Well-designed tax incentives are neither corporate welfare nor government micromanagement. They can address serious market failures and facilitate investment to drive innovation and competitiveness. As such, it would be counterproductive to jettison all tax incentives in exchange for a lower statutory rate that applies to all businesses and activities the same way. A cutting-edge biotech firm competing globally is not the same as a hardware store. Other countries are gaining on or overtaking the United States in many globally traded sectors in part because they have fashioned tax codes to maximize innovation and competitiveness. As such, the next administration should push for expanding incentives for investments by business in skills, R&D and equipment and software in America.

- **Business taxes matter more than individual taxes**. Businesses drive economic growth. And businesses in globally traded industries are more likely to move offshore in response to high taxes than individuals are. As such, tax cuts and incentives should be focused, not on the suppliers of capital, but on the users of capital – that is business.

Policy Recommendations

✓ **Reduce the corporate tax rate to 20 percent:** This would move the United States from the highest corporate tax rate in the OECD to 21st and make investing in the United States more attractive while at the same time increasing the competitive position of U.S. establishments vis-à-vis their foreign competitors. This would also result in multinational companies deferring fewer taxes offshore since their profits in more nations would be taxed a higher rate than in the United States. On a static basis this reduction would cost the Treasury an estimated $100 billion per year, but on a dynamic basis after adjusting for the additional growth, it would likely cost significantly less.

✓ **Institute an Innovation and Investment Tax Credit (IITC):** In the last decade, the United States has fallen behind other nations in investment in the key building blocks of innovation and competitiveness: R&D, equipment and software, and worker training. In part this is because relative to other nations, U.S. capital markets reward short-term investments, not long-term ones. But it is also because U.S. tax incentives have become relatively less generous. The U.S. R&D tax credit is now 27th most generous, behind even Brazil, China, and India. To correct for this and to restore a climate of productive investment we need an IITC which would provide a tax credit of 45 percent of business investments on R&D and skills training and 25 percent on expenditures on new equipment and software. Both credits would be on expenditures in excess 75 percent of base-period expenditures (the average of the last three years). This would cost approximately $50 billion per year, but on a dynamic basis the cost would be considerably less because of induced growth. For example, ITIF has calculated that expanding the R&D tax credit would pay for itself in added revenues from growth after 15 years.

✓ **Pay for the tax reductions with other tax increases:** While cutting the corporate rate to 20 percent and instituting an IITC would power growth and spur some offsetting tax revenues, they would not likely be revenue neutral. As such, other taxes would need to be raised (with spending cuts used to reduce the budget deficit). The first place to start is to repeal the 2003 law that lowered the individual tax rate on dividends to 20 percent, which resulted in companies increasing dividend payments at the expense of investment. Taxing dividends as ordinary income would raise approximately $20 billion a year. In addition raising the capital gains tax rate from 15 to at 25 percent would raise an additional $10 billion each year. To recover the remaining funds from the new business tax expenditures, the next administration should propose instituting a border-adjustable corporate activity tax (like a value-added tax), such that imports would be taxed, not exports. More than 150 countries apply such a border-adjustable consumption tax on their imports, which imposes a tax burden on U.S. exports.

Related ITIF Resources

Innovation Economics: The Race for Global Advantage (Yale University Press, 2012)

We're #27: The United States Lags Far Behind in R&D Tax Incentive Generosity

Senate Hearing on Tax Reform Options: Incentives for Capital Investment and Manufacturing

Create Jobs by Expanding the R&D Tax Credit

Effective Corporate Tax Reform for the Global Innovation Economy

The United States is losing the race for global innovation advantage and the jobs and income that come with that. Many other nations are putting in place better tax, talent, technology and trade policies and reaping the rewards of higher growth, more robust job creation, and faster income growth. It's not too late for the United States to regain its lead but the federal government will need to act boldly and with resolve to design and implement strategies that include cutting business taxes and boosting public investment. *Winning the Race 2012* is a series of ten policy briefs that lay out broad principles and actionable ideas for the next administration to embrace to help the United States win the race for global innovation advantage. For more actionable policy ideas, visit ITIF's *Policymakers Toolbox* at www.itif.org/policymakers-toolbox.

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