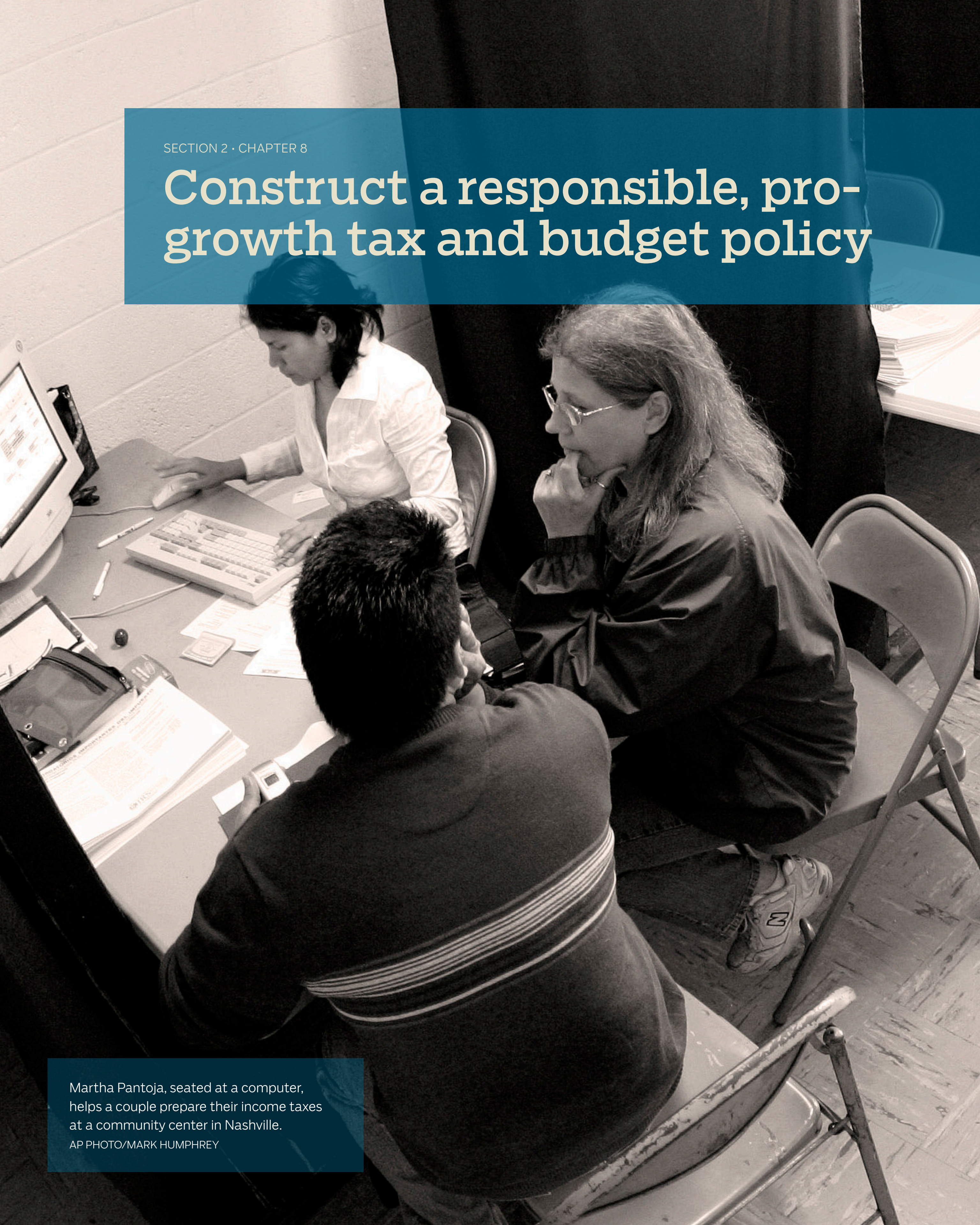
SECTION 2 • CHAPTER 8

Construct a responsible, pro-growth tax and budget policy



Martha Pantoja, seated at a computer, helps a couple prepare their income taxes at a community center in Nashville.
AP PHOTO/MARK HUMPHREY

The federal budget has a huge impact on the nation's economic health. The federal government's consumption and investment is a direct component of the country's overall economic output. It delivers billions of dollars in subsidies and grants to state governments, which themselves contribute directly to total gross domestic product.[1] A substantial portion of federal spending is simply payments to individuals, who then use that income to consume and invest, further contributing to the economy.

But beyond that, the federal government makes the investments and directs the resources that lay the foundations for the broader economy.

Furthermore, the tax code, which raises the revenue required to pay for government spending, constantly influences economic decision making, encouraging some activities while discouraging others. When the federal government doesn't raise enough in tax revenue to cover all of its spending, it must borrow and accumulate debt, which affects national savings, interest rates, and the federal government's current and future capacity to consume and invest.

Precisely because of the enormous influence of the federal budget on the broader economy, it is critical that these elements all be properly calibrated. Many of the policy proposals within this report address the direct investment and consumption elements of the federal budget, while some others

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address features of the federal tax code. What remains to be addressed is how to combine the budget commitments we must make to ensure prosperity for all with a tax system that generates adequate revenues to produce a responsible long-term federal budget that reduces the gap between revenues and spending to a manageable level.

The federal budget has dominated the policy and political debate in Washington over the past three years, but the debate has been entirely centered around deficit reduction. It is time to hit the reset button and move beyond a single-minded focus on the deficit to ask bigger questions about what investments we should be making in the future and how we should pay for these investments. The fiscal outlook for both the medium term and the long term has improved substantially compared to what it was just a few years ago, as Congress has enacted more than $2.5 trillion in deficit reduction, health care cost growth has slowed dramatically, and we have gained a better understanding of what drives long-term debt projections.[2]

We have also seen what happens when policymakers allow concerns about the deficit to trump all other economic needs. European experiments with austerity have deepened the global economic crisis and increased human suffering across the continent. In the United States we have managed to avoid the scale of austerity implemented by Greece or even the United Kingdom, but we have also suffered from ill-timed and ill-targeted cutbacks and fiscal contraction.

Putting the federal budget onto a permanently sustainable path is still an important goal—inadequate revenues and ever-increasing debt will make it difficult for the federal government to meet the challenges of the 21st century. But our fiscal debate should not be dominated by discussions of debt and deficit. It should be about ensuring that the federal government is able to marshal its resources effectively to promote future economic growth and shared prosperity.

It is not always the case that a gap between spending and revenue produces negative economic outcomes. In fact, a budget deficit can, in some instances, be a good thing for the economy. A deficit can help smooth out unforeseen fluctuations in the private economy, prop up demand when it is lacking, and

AT A GLANCE

Tax and budget policy

Problem: The federal budget is not serving our nation's needs. We are not raising enough revenue to pay the bills we're incurring, let alone to make the investments we need for the long-term economic well-being of the nation. The tax code has too many breaks that have outlived whatever usefulness they once had, and it has become, in some ways, ill-suited to a 21st century economy. On the spending side, we maintain programs that are not a good use of taxpayer dollars and neglect efficiencies that could save money.

Solution: Reform the individual income tax code to raise more revenue, while simultaneously simplifying and improving the fairness of the code. Focus on reducing the cost of health care by stripping out inefficiencies in federal health care spending. Cut costs by improving government efficiency and modernizing government operations. Reform the corporate income tax. Implement the growth-enhancing recommendations contained in this report.

Key policy ideas:

- Implement comprehensive individual income tax reform.
- Reduce federal health care costs by introducing reforms that will enhance competition, increase transparency, improve health care delivery, and cut administrative expenses.
- Create a framework for the key components of corporate income tax reform.

Other policies include improving the government's use of information technology to reduce fraud and improper payments and to close the "tax gap," updating federal excise taxes, and reducing spending in selected other categories.

Outcomes: The federal government will be able to fund necessary investments and operations without taking on an ever-increasing debt load, measured as a share of total economic activity. ■

finance critical public investments even when revenues run short. But a federal budget deficit can also be a drag on the economy, driving up interest rates, piling on debt that must eventually be paid back, crowding out private investments, and forcing painful cuts to public services. In order for the federal budget to lay the foundations for broad economic growth, deficits must be used when they are appropriate and reduced or even eliminated when they are not. In other words, the trick is to reserve the red ink for economic downturns and national emergencies.

Few would dispute that the past several years since the start of the Great Recession qualify as both an economic downturn and a national emergency. That is why the historically large federal budget deficits that we have experienced in recent years were inevitable, necessary, and appropriate. As the economy has improved, the budget deficit has declined substantially.[3] In fact, this year's budget deficit is expected to be just less than half the size of the budget deficit only four years ago, and the deficit is projected to decline further over the next few years.[4]

The trouble is that in later years, the budget deficit is projected to creep back up. Under ordinary economic conditions, large sustained deficits carry with them several specific economic hazards.[5] They can, under some circumstances, adversely affect domestic investment, result in higher interest rates, and even spark higher inflation.

Even if deficits do not directly harm the macroeconomy, they will incontrovertibly result in an ever-growing share of national income being used to pay off old debt, rather than going toward more productive investments. Deficits higher than a certain level will make the accumulated publicly held debt grow faster than overall economic growth. In other words, the national debt, measured as share of total economic output, will rise every year. Consequently, the costs of paying interest on that debt will rise as well. There is an opportunity cost that goes with paying interest on existing debt. Instead of using scarce resources to improve infrastructure or upgrade our stock of human capital, we will be forced to use more and more of them to simply pay back lenders. Since an increasing share of those lenders are foreign, more and more of future income will be sent overseas, further depriving the nation of critical opportunities.

For these reasons, it's important that the government brings in adequate revenue to make necessary investments and to meet its obligations and the demand for public services. At minimum, a "sustainable" federal budget is one that does not result in an increasing debt-to-GDP ratio. Note that this does not require a fully balanced budget. So long as deficits are small enough to prevent a rise in debt measured as a share of the total economy, we will avoid the risks of growing debt and dramatically improve the fiscal climate.

To that end, we present a plan to:

- Reform the individual income tax

- Reform federal health care programs

- Improve government efficiency to reduce overhead costs
- Implement other policies to reduce the federal budget deficit
- Reform the corporate income tax

Policies to reform the individual income tax[6]

The federal tax code is failing at its most important and basic task: raising adequate revenues to fund the services and operations of government. Over the past four years, the effects of repeated tax cuts and a weak economy combined to produce the lowest levels of federal revenue, measured as a share of the national economy, in nearly six decades. If we keep the tax code the way it is today, federal revenues will stay far below federal spending levels for the next decade and beyond, even with recent modest tax increases and even assuming significant spending cuts. The result will be unsustainable levels of debt and increasing pressure on crucial government investments in future growth.

The tax code needs to be reformed so that it generates higher revenues. According to Congressional Budget Office projections, maintaining today's tax code will result in revenues averaging about 18.5 percent of gross domestic product over the next decade.[7] From 1998 to 2001—the most recent years in which we had balanced budgets—revenues averaged about 20 percent of GDP. In the intervening years, our population has aged, Baby Boomers have started to retire, health care costs have risen, and our national security needs have changed dramatically. Clearly, generating additional revenue is a necessary component of any practical plan to address our budget challenges.

In "Reforming Our Tax System, Reducing Our Deficit,"[8] the Center for American Progress proposed a plan to overhaul the federal income tax code in a way that will raise increased revenues progressively while making the tax system more efficient, simple, fair, and comprehensible. Under our plan, federal revenues will match those revenue levels recommended by the bipartisan Simpson-Bowles plan by the middle to the end of this decade.

The key features of our plan are:

- Maintaining the current top marginal income tax rate
- Increasing the top marginal tax rate on capital gains to 28 percent
- Converting tax deductions to tax credits
- Closing tax loopholes
- Simplifying the tax system by reducing the number of filers who itemize, rendering the alternative minimum tax unnecessary, and implementing other reforms

Our plan keeps the top individual income tax rate at 39.6 percent, the same as it was under President Bill Clinton from 1993 through 2000, but we also address the top tax rates

Boston Police Superintendent William Evans, foreground right, laughs with Boston Police Special Operations Lt. Paul O'Connor, left.
AP PHOTO/ELISE AMENDOLA

for dividends and capital-gains income, which both have been cut substantially in recent years and were only partially addressed in recent tax legislation. Lower tax rates on capital gains and dividend income have not produced their promised economic benefits and have enabled many of the highest-income Americans to pay extremely low overall tax rates—lower than people far below them on the income ladder. Furthermore, these tax breaks for capital income have contributed to the rapid rise in income and wealth inequality the United States has seen over the past several decades. Our plan treats dividends as ordinary income, as they were for the 90 years preceding 2003, and restores the top capital-gains rate to 28 percent—the same rate that was in effect after President Ronald Reagan signed the 1986 Tax Reform Act and throughout much of the 1990s.

In addition to addressing the capital-income rates, an important part of the new revenue in our plan comes from reducing the value of various tax expenditures. Under the existing tax system, many of these tax expenditures, such as those for mortgage interest, charitable giving, and retirement savings, are upside-down—that is, they provide a bigger benefit to those in higher tax brackets. That is both unfair and inefficient.

Our proposal addresses the upside-down problem, while achieving significant, progressive revenue increases, by transforming itemized deductions into credits. Most expenses that are currently claimed as itemized deductions would be transformed into nonrefundable tax credits equal to 18 percent of their value. This would provide the same tax benefit to taxpayers in all tax brackets—with middle-income taxpayers benefiting from the change.

The exception in our plan to transform itemized deductions into an 18 percent credit is for charitable contributions. Those contributions will generally be eligible for up to a 28 percent credit. The subsidy for charitable giving will thus be decreased for those in higher tax brackets but not decreased by as much as the other forms of deductions. It should also be noted that a credit higher than 18 percent will be available initially for mortgage-interest expenses for those taxpayers for whom an 18 percent credit represents a reduction in benefit relative to the current mortgage interest deduction. The mortgage interest credit will be gradually phased down to the 18 percent that is available for other itemized expenses.

Our plan also replaces the standard deduction with a large standard credit of $5,000 for couples and $2,500 for singles. The standard credit largely serves the same purpose as the existing standard deduction—relieving most taxpayers of the need to track and itemize their expenses for tax purposes. Currently, only about one-third of taxpayers itemize their expenses. Under our plan, about 80 percent would claim the standard credit and only about one-fifth would itemize.

Other tax expenditures are also streamlined under our plan, including those for retirement savings used by high-income taxpayers. Our plan closes several difficult-to-justify loopholes, including the carried-interest loophole that allows investment-fund managers to convert their income into low-taxed capital gains, and the so-called S corporation loophole through which high-income professionals can avoid Medicare taxes.

Our plan also simplifies the process of tax filing by eliminating several complicating features of today's tax code. For one thing, by cutting back on the tax advantages that the alternative minimum tax is meant to address, that complex part of the tax code is rendered unnecessary. Our plan therefore entirely eliminates the alternative minimum tax.

We also eliminate personal and dependent exemptions and the standard deduction and replace them with the larger standard credit and an expanded child credit. This reduces the number of steps required for tax filing and consolidates several different calculations into one simpler mechanism. Our plan also renders unnecessary the phase-out of personal exemptions and the Pease limit on itemized deductions.

Policies to reform federal health care programs[9]

We also favor spending cuts where possible in addition to revenue reform. But these must be carefully targeted, as parts of the federal budget are either already at record low levels or soon will be. These are levels that will undermine our ability to make critical economic investments such as education funding, transportation infrastructure, and basic scientific research.

In fact, most spending in the federal budget is projected to decline over the next 10 years. There is one major exception to this rule: health care spending. Total federal health care spending amounted to 4.7 percent of GDP in 2012, and the Congressional Budget Office projects that total will rise to 6.1 percent by 2022.[10] By comparison, the CBO expects all other programmatic spending to decline from 16.6 percent of GDP in 2012 to 13.8 percent in 2022.

In "A Systemic Approach to Containing Health Care Spending," we proposed a range of policies to reform federal health care spending that would generate hundreds of billions of dollars in savings without slashing benefits or merely shifting costs among senior citizens, families, or states.[11] Our approach is to lower the overall cost of health care by improving efficiency, eliminating wasteful subsidies, and heightening the incentives for improving the quality of care without increasing costs. Taken together, our reforms will not only reduce federal spending over the medium term but will also bend the cost curve over the long term.

- **Reform the way prices are determined for health care products and some services:** Right now, the government sets these prices for the most part. Instead, Medicare and Medicaid should adopt market-based prices, allowing manufacturers and suppliers to compete to offer the best prices.

- **Reform the way health care is paid for and delivered:** Right now, Medicare and Medicaid pay a fee for each service for the most part. This creates incentives for doctors to order more and more profitable tests and procedures. Instead, these programs should pay a fixed amount for a bundle of services or for all of a patient's care.

- **Encourage states to become accountable for controlling health care costs:** Accountable-care states that keep overall health care spending below a global target would be rewarded with bonus payments.

- **Reduce drug costs:** When Medicaid covered drugs for seniors, drug companies provided large discounts, but Medicare does not get the same deal. Medicaid rebates should be extended to brand-name drugs purchased by low-income Medicare beneficiaries.

- **Bring Medicare payments into line with actual costs:** The independent Medicare Payment Advisory Commission, which advises Congress on Medicare policy, has identified numerous ways that health care providers should be more efficient. Targeting inefficiency is much better than resorting to a series of blunt, across-the-board cuts in provider payment rates. Under our plan, for example, hospitals would fare much better, with smaller and better-targeted cuts.

- **Increase premiums for high-income Medicare beneficiaries:** High-income beneficiaries pay higher premiums under current law. But the share of beneficiaries who pay higher premiums should be expanded and the higher premium amounts should be increased by 15 percent.

Policies that improve government efficiency to reduce overhead costs[12]

With the pressing need for public investments, rising health care costs, and an inadequate tax system, the need to avoid compounding the budget challenges with waste or inefficient use of scarce public resources is obvious. Any dollar in savings that we derive from improving the way the government does business is a dollar we do not need to raise in taxes or cut from a productive program or investment. We believe that we can save billions by improving the way government performs routine tasks such as benefit payments and contracting and by making better use of information technologies.

Better use of information technology is a key part of streamlining the federal government and combating waste. The website Recovery.gov, which provides the ability to track funds disbursed under the American Recovery and Reinvestment Act of 2009, shows this potential. Fraud complaints have been filed on less than 2 percent of recovery contracts and grants; typically, complaints are filed on 5 percent to 7 percent of projects. Because of this, costs have also been lower than expected, allowing the administration to fund an additional 3,000 projects. The Recovery.gov model should be expanded for other purposes.

Information technology can also help close the roughly $300 billion tax gap, or the amount of federal taxes that go unpaid every year due to noncompliance. The Internal Revenue Service could incorporate nontax databases to identify noncompliant taxpayers, as recommended by the Government Accountability Office and the Treasury Department's inspector general.[13]

Cloud computing provides another way to break down barriers across federal agencies and achieve savings. There are about 1,100 data centers across the federal government, each comprising expensive server units that consume large amounts of electricity. Cloud computing allows separate servers such as these to be networked together to form a shared "cloud." This networking would allow government to reduce the total number of data centers, the amount of electricity, and the number of storage facilities it now requires. The British government predicts it could cut its information-technology, or IT, budget by 20 percent by adopting cloud computing and other related IT improvements. The U.S. government would save $16 billion a year if it could do the same.[14]

There are also opportunities to reduce overhead costs associated with information collection and service delivery. Online forms and other information-gathering tools, such as health care IT, environmental sensors, and satellite technologies, can replace paper reporting and reduce the need for data entry and person-to-person service.[15] "There are more than 10,000 government forms in 173 different agencies that could be automated to allow citizens and businesses to conduct their business with government online," according to the IBM Center for the Business of Government.[16]

One other area that is ripe for savings is federal procurement. Each year, the federal government spends about $500 billion buying everything from office supplies to weapons systems. The cost of procuring all those goods and services has skyrocketed since 2000: From 2001 to 2008 total federal procurement costs rose more than 142 percent. Fortunately, a comprehensive and coordinated approach to reducing those costs can yield enormous savings. The Center for American Progress has previously estimated that the government could save upward of $400 billion from reforms to the way it buys goods and services.[17]

Other policies to reduce the federal budget deficit

The policies described above will take us most of the way toward a sustainable federal budget. We also propose several other smaller changes that will help reduce the budget deficit, including:

- **Updating federal excise taxes:** We propose an increase in the cigarette tax in order to both raise revenues and reduce health care costs. We propose an increase in alcohol taxes, to reverse decades of erosion in revenue from that source. Finally, we propose regulating and imposing small fees on internet gambling.
- **Reducing defense spending:** Though defense spending has already been cut somewhat, we believe the Defense Department can certainly be asked to further streamline, reducing waste and inefficiency along the lines previously proposed by the Center for American Progress.[18]
- **Reforming other nondiscretionary programs:** Programs such as federal agriculture subsidies are long overdue for reform to bring them in line with current economic and budget realities.[19]

The federal budget is one of our most important tools for building an economic environment that allows all 300 million engines of growth to run at full capacity. We need to invest wisely and pay for those investments responsibly.

Right now, the current tax code does not generate the revenue needed to support the investments, protections, and other activities in the budget. Though reducing the federal budget deficit should not be an immediate concern for economic policymakers, after we return to a more normal economic footing, persistent large deficits do present a challenge for sustained and shared growth. Decades of tax cuts have left us with an inadequate and inefficient tax system, even after accounting for recent tax increases, and rising health care costs have been pushing spending up. Our proposals would address these two twin underlying

Illinois Department of Revenue Store Keeper Danny Morres moves Illinois 1040 tax forms toward the Document and Control Center for processing in Springfield.
AP PHOTO/SETH PERLMAN

causes of projected structural deficits. If implemented in full, these policies would combine to reduce the federal debt and put the budget on a sustainable path.

Policies that reform the corporate income tax

Corporate tax reform is an important issue for the federal budget and the economy. We do not offer a comprehensive proposal here, but we do offer some guidance on elements that should be included in tax reform – ideas that are refined further in a Center for American Progress white paper on corporate tax reform.

First, we start with revenue. In our view, corporations should not be exempt from contributing to meet the budget challenges we face. That is, corporate tax reform should produce additional revenue.

Second is the question of the tax rate. Effective U.S. corporate tax rates are about the same as those of other major economies.[20] While the nominal U.S. corporate income tax rate is among the highest in the world, American corporations, on average, pay a much lower effective rate than nominal rate because many provisions in the tax code reduce liability. A significant part of what we outline here is designed to scale back those liability-reducing provisions. If significant base-broadening is achieved, then some rate reduction could be appropriate once the need for additional revenue has been met. In addition, while U.S. corporate taxes are not out of line with our global competitors, some companies that are less well positioned to take advantage of the tax preferences in the code do pay relatively higher taxes, and this raises concerns regarding their competitive posture. The combination of relatively high rates and numerous tax preferences means that the tax code is creating distortions, often unintended and harmful, in the economy.

With these two conditions as a base, we move on to address three areas of the corporate tax system that are in particular need of attention: reducing the tax code's bias toward debt financing over equity financing, leveling the playing field among competing businesses and industries by eliminating inefficient tax breaks, and reforming the taxation of international income.

Reducing the tax bias toward corporate debt

Under the U.S. corporate income tax interest on debt is deductible but dividend payments to shareholders are not. This creates a bias toward debt that can cause a number of problems.

Two polices that could address the problem of the tax system favoring debt over equity are:

- The President's Economic Recovery Advisory Board's August 2010 report on tax-reform options offered a modest illustrative proposal to limit the deductibility of net interest expense to 90 percent of expense in excess of $5 million per year. So, for example, if a corporation has $15 million of net interest expense, it could deduct all of the first $5 million and then $9 million of the next $10 million, for a total deduction of $14 million.[21]

- An innovative approach was recently enacted in Germany.[22] Under Germany's rule, interest is deductible only up to 30 percent of annual earnings before interest, taxes, depreciation, and amortization.[23] The rule applies only when net interest (interest expense minus interest income) is higher than €3 million (about $4 million), thereby exempting smaller businesses.

Either a stronger form of the advisory board proposal, a provision along the lines of the German approach, or their equivalent, should be adopted.

Leveling the playing field and eliminating tax breaks

There is a wide range of tax provisions that serve little or no continuing purpose and should be eliminated. The Center for American Progress has outlined these in detail in a number of publications, including "Good News on Deficit Reduction."[24] Among the provisions that deserve particular scrutiny are:

- Oil and gas tax expenditures

- Timber and agriculture tax subsidies

- Last in, first out, or LIFO, and lower of cost or market rule, or LCM, inventory and accounting rules
- Offshore reinsurance loopholes
- Deferral of capital gains taxes via like-kind exchanges
- Write-offs of "business" meals and entertainment[25]

Moreover, there is a clear need to re-examine the line between corporate C-corp businesses subject to the corporate income tax and S-corps, partnerships, and other businesses that are not despite many of them being on the same scale as C-corps (Bechtel, for example). Certainly businesses larger than a certain size that are mostly competing against publicly traded corporations that are subject to the corporate income tax should also be subject to the same tax regime as their direct competitors.

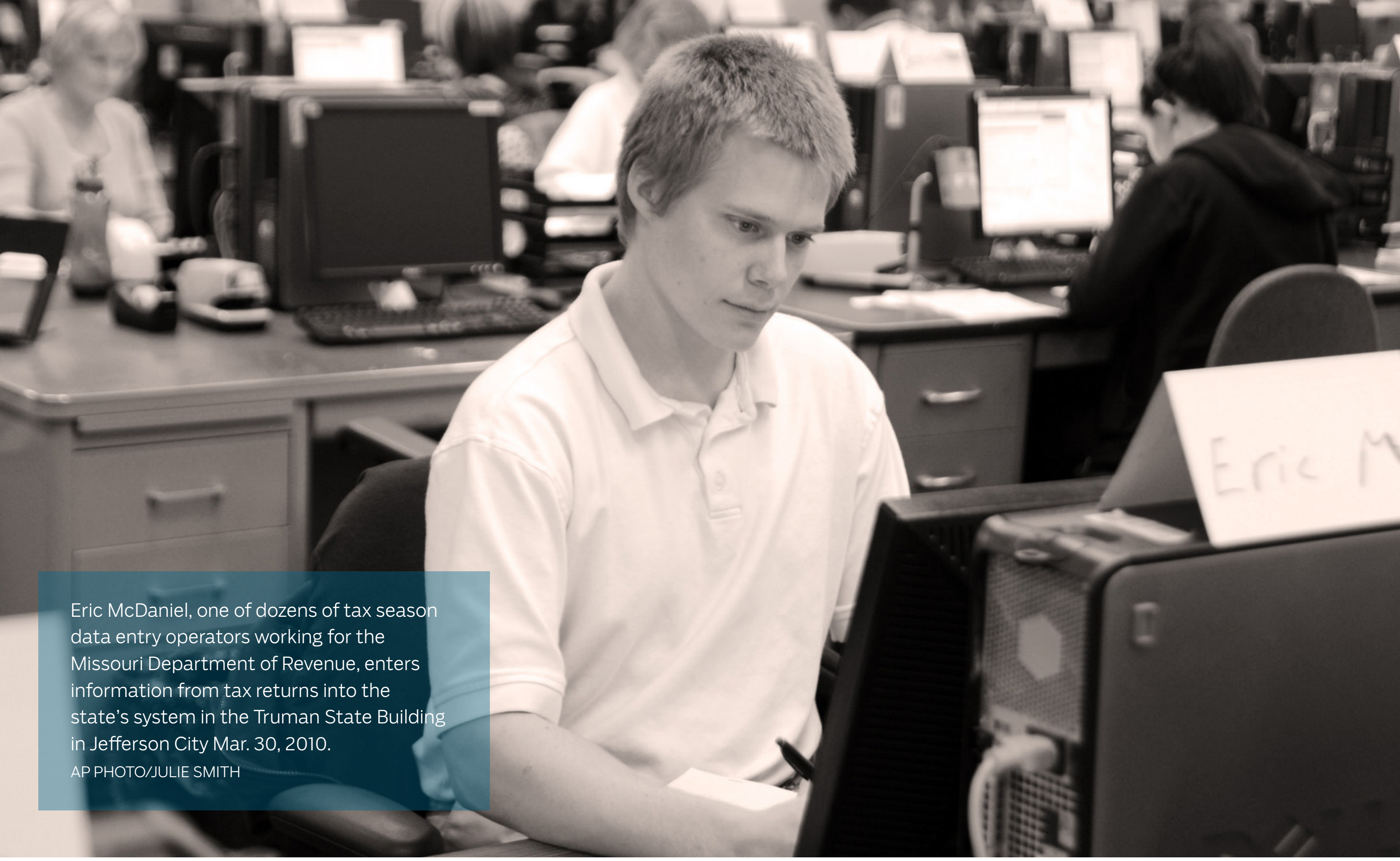
Reforming the taxation of international income

The big issues in international taxation are how to encourage job creation in the United States and how to stem the rampant tax avoidance that our current system permits.

The current system creates huge opportunities for tax avoidance by multinational corporations. Moving to a "territorial" system, as many multinationals advocate, would make it worse.

There are two basic features of the U.S. tax code enabling corporations to avoid taxes through international transactions. The first is the ability, on paper, to shift profits to other countries where taxes are lower. This is a big problem. Here's one example of how it can work: A U.S. company transfers a patent or trademark to a foreign subsidiary, and then the U.S. parent company pays that subsidiary high royalties, which are deductible for the U.S. parent on its U.S. income taxes. Those royalty payments are made out of U.S. income that would otherwise have been subject to U.S. corporate income taxes. Income has thus been shifted and paying U.S. tax on that income has been avoided. In practice, the foreign subsidiary is usually based in a tax-haven country, which applies little or no tax on the incoming royalty income—so total taxes are reduced. There are technically rules against this sort of behavior, but those rules can be successfully circumvented. Consider that American companies reported 43 percent of their overseas profits in the tax-haven countries of Bermuda, Ireland, Luxembourg, the Netherlands, and Switzerland in 2008, even though those countries employed only 4 percent of the companies' foreign workforces, and the companies made only 7 percent of their foreign investments in those jurisdictions.[26]

The second underlying feature of the tax code enabling international transactions to reduce tax liability is known as deferral. Deferral allows U.S. corporations to not pay U.S. tax on the income that is earned overseas until it is formally brought into the United States. A great deal of the income shifted to other countries is therefore either taxed



Eric McDaniel, one of dozens of tax season data entry operators working for the Missouri Department of Revenue, enters information from tax returns into the state's system in the Truman State Building in Jefferson City Mar. 30, 2010.
AP PHOTO/JULIE SMITH

later, which companies prefer, or never taxed because it isn't ever technically "repatriated."

There is a simple solution to this problem: End deferral and simply tax the income as soon as it's earned. Then there would be no incentive to shift income to other countries because doing so wouldn't reduce taxes. This solution, however, would result in the U.S. tax code being far out of line with other countries, with possible ramifications for competitiveness and long-term job creation, discussed below. Alternatives short of completely eliminating deferral are also possible such as rules to clamp down on income-shifting or render income ineligibile for deferral if it is in a tax-haven country, for example.

The other issue we address here is whether the corporate income tax encourages jobs to move overseas. The current system has that effect, and, again, the culprit is deferral. A company that moves jobs to a country with lower taxes than the United States can benefit from doing so. Technically the U.S. tax—minus a credit for the foreign tax a company has paid—applies, but it is deferred pending repatriation.

There is, however, another side to this story. U.S. multinational corporations argue that the U.S. system of taxing their income wherever it is earned, even with deferral allowing them to delay (sometimes indefinitely) the payment of taxes, puts them at a disadvantage compared to companies from countries with territorial tax systems that tax only income earned in the home country. They argue, for example, that if a U.S. company is bidding against a Dutch company to buy a South Korean company, the Dutch company will often end up winning because the South Korean company is worth more to the Dutch company: The Dutch company's after-tax rate of return will be higher because the Netherlands does not impose a tax on income earned by Dutch companies overseas. The Dutch company will pay only the South Korean tax on the subsidiaries earnings, whereas the U.S. company will have to pay the higher U.S. tax. The U.S. companies argue that this means fewer home office jobs in the United States and fewer profits being earned by shareholders in the U.S. company—to the nation's detriment.

So, while ending deferral would solve the problem of companies favoring investment in low-tax jurisdictions, U.S. multinational corporations would still be concerned about their competitiveness in foreign countries. Going to a territorial system for the United States would satisfy that concern, but it would exacerbate the incentive to site operations in other countries and make the tax-avoidance problem worse.

The bottom line for corporate income tax reform

Corporate tax reform is complicated and involves many interacting pieces. Clearly there are tax preferences that should be eliminated. Limiting deductions for interest payments on debt is also a needed reform. Doing those things could allow for some rate reduction once revenue targets have been met. With respect to the way international income is treated, the objectives are to deal with the rampant tax avoidance that the current system allows and encourage job creation in the United States, while addressing those concerns of multinational corporations that are legitimate.

Moving to a territorial system is unacceptable and would exacerbate many of the current problems with the tax system. Eliminating deferral is attractive but in the long run it could have adverse unintended consequences, and it is unrealistic. A more likely and helpful approach would be to put in place a hybrid system that includes a robust minimum tax that would be immediately applied to all income (i.e., no deferral), so that there would be less of an advantage to shifting income to low-tax countries to reduce U.S. tax or to moving jobs overseas. Most countries that ostensibly have territorial systems actually do something similar to this, unlike the United States—although any such measures in a revised U.S. tax system should be more aggressive than what most of these other countries do. The concerns expressed by multinational corporations could be addressed by adjusting the tax rate either overall or with a modestly differentiated rate for repatriated earnings—consistent with an overall increase in revenues.

Finally, the United States should work with our trading partners to address these issues cooperatively. In the end, international cooperation is necessary to truly address all the challenges described here in a fair way that benefits both U.S. and global economic growth. ■

Endnotes

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