

# Treasury conference on business taxation and global competitiveness

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The corporate income tax system is showing its age in the 21st century. It was not designed for an open economy nor one in which much of the nation's value added is attributable to services and intellectual property. While, corporate income taxation causes many well-known distortions in a closed economy, these distortions are magnified in an open economy for several reasons.

First, differences between U.S. and foreign income tax systems can affect where capital is invested. No doubt, this is why corporate tax rates in the European Union member states have declined dramatically as the European economy has become more economically integrated. Indeed, the average top corporate tax rate in the European Union is now 15 percentage points less than that in the United States.

Second, attempts by high tax countries, like the United States, to level the investment playing field by taxing foreign income at the same rate as domestic income, inevitably put U.S. companies at a disadvantage relative to competitors in lower tax jurisdictions. In short, with free movement of direct and portfolio capital investment, it is impossible for a single country, such as the United States, to design its corporate income tax system to be neutral with respect to the location of investment and neutral with respect to the ownership (or nationality) of investment.

Third, in an open economy, proper income tax administration requires identification of the geographic source of income. With a larger share of economic value now attributable to services and intangible property, it is becoming increasingly difficult to establish arm's length prices. Moreover, the globalization of capital markets allows flexibility in the location of debt.

Finally, in an increasingly open economy, the burden of the corporate income tax falls heavily on wages, as has been confirmed in recent empirical research by Kevin Hassett, Michael Devereux, and others. This undermines the traditional progressivity argument for maintaining a high corporate income tax rate.

Reform of the corporate income tax system could reduce its drag on the economy, but in the modern global economy, using the corporate income tax to raise revenue is like writing a letter with a manual typewriter rather than sending an email—its out of date and inefficient.

Increased capital recovery deductions, while lowering the effective tax rate on new investment, do nothing to address the difficulties in determining the geographic source of income or the competitive disadvantage faced by US multinationals operating abroad due to the high US rate. By contrast, a lower corporate income tax rate, would lessen, but not eliminate, the distortions caused by the corporate income tax in a global economy.

In addition to lower corporate income tax rates, the competitive position of US multinationals could be improved through a variety of incremental reforms. In particular, two important temporary provisions in the U.S. anti-deferral regime should be made permanent—the active finance and the “look through” rules. Other aspects of the U.S. anti-deferral regime that are out of step with other countries also should be examined, including the foreign base company sales and services rules.

A European style dividend exemption system—referred to as a territorial tax system—would have both advantages and disadvantages. It would eliminate the tax disincentive to repatriating foreign income and would allow further simplification of the foreign tax credit; however, it does not address the difficulties in identifying the geographic source of income and for some taxpayers would greatly increase taxes on royalty and export income.

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The President's Advisory Panel on Federal Tax Reform developed a territorial tax option, but it differed in certain important respects from the European model in ways that would be harmful to U.S. competitiveness. In particular, the Advisory Panel proposal would have disallowed a deduction for certain domestic overhead and interest expenses unlike the territorial tax systems of other countries. The proposal also left in place the current anti-deferral regime which often sweeps in more active business income than the rules of other OECD countries.

As a last observation, I would note that consumption taxes, such as the value added tax, are far more compatible with a global economy than the income tax as they generally do not affect the location or ownership of investment and do not require transfer pricing rules. Consumption taxes comprised 15.6% of combined US revenues in 2004, the lowest among the OECD countries, and about half the OECD average of 30.5%.