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Introduction

The US corporate income tax, the mainstay of federal business taxation, is riddled with distortions and inequities.[1] As a means of taxing the richest Americans—a popular goal—it is a hopeless failure. Many companies pay no corporate tax, and among those that do, the burden is highly uneven (GAO 2004). Meanwhile, the richest Americans command income from numerous sources besides corporate dividends.

The distortions and inequities are amazing. Under pressure from business lobbies, Congress legislates deductions and exemptions that twist the corporate tax base far from any plausible financial definition; then Congress enacts "targeted" tax credits to carry out ersatz industrial policies. Faced with a tax terrain of mountains and ravines, corporations employ armies of lawyers and accountants to devise avoidance strategies.

Reviving the spirit of tax reform debates in the 1990s,[2] we propose to replace the corporate income tax with a tax that has a much broader base at a much lower rate. We explore two alternatives: a national retail sales tax (NRST) and a corporate activity tax (CAT). To address regressivity, both alternatives are coupled with measures to preserve the real spending power of households at the lowest income levels.

Replacing the corporate income tax would immediately reduce the variation of tax rates across industries and contribute to economic efficiency.

1. Among the many critics, see Ballentine (1980), Pechman (1987), and Steuerle (2004). Graetz (2002a) recounts a few of the recent abuses, for example, "lease-a-deduction" schemes.

2. These debates are summarized in Hufbauer and Gabyzon (1996).

In compliance with World Trade Organization (WTO) rules, but in different ways, the NRST and CAT would be fully adjusted at the US border, taxing imports of goods and services while imposing no tax on exports. By eliminating any tax advantage from producing goods or services overseas and then selling them in the US market, these alternatives would end the debate over offshore outsourcing of blue-collar and white-collar jobs for tax reasons.

At this point, a reader might justifiably ask: "Haven't we been down this road before, only to reach a dead end? Every sensible person has known for decades that corporate taxation is a mess. What makes fundamental business tax reform more plausible today than in the 1990s?"

The big change is the looming specter of fiscal crisis, driven by entitlement programs, that lies just over the horizon. Even if the future entitlements already promised under current law are dramatically curtailed, rising federal spending practically guarantees higher business taxation. Raising corporate tax rates, however, will multiply inefficiencies within the United States and severely damage US competitiveness in the global economy. Faced with the choice of paying more taxes through the current corporate income tax system or paying an equal amount through a new system with a much broader base and far lower rates, we think that—with White House leadership—the business community will stop counting beans and finally endorse serious tax reform.[3]

In this monograph, we take stock of the US fiscal outlook and guess what the compromise between cutting entitlement spending and raising taxes might look like. Based on the experience of OECD countries, we forecast how much of the tax increase will be collected from businesses. After reviewing the taxation of US-based multinationals, we conclude that taxing production abroad will not become a major source of new revenue. We then summarize the worldwide use of value-added taxes (VATs), conspicuously excluding the United States. Next, we sketch the elements and revenue potential of an NRST and a CAT, modeled after the subtraction-method VAT. A special section is devoted to aspects of border tax adjustment of both the NRST and CAT, with rough calculations of their impact on the US current account deficit (colloquially, the trade deficit). Finally, we assess the pros and cons of the NRST and CAT as replacements for the corporate income tax.

None of the tax relief measures enacted in the past four years meaningfully reformed business taxation. Small changes were only a question

3. Bruce Bartlett, a prominent member of the Ronald Reagan and George H. W. Bush administrations, is at the vanguard of conservatives who have come to support a value-added tax for raising revenue, saying that "the value-added tax is by far the best option available to deal with an unpalatable situation. Absent any evidence that the White House and Congress are prepared to restrain out-of-control spending, I see no alternative" (Bruce Bartlett, "Feed the Beast," *New York Times,* April 6, 2005, 23). See also Bartlett (2004).

of which firms could most effectively lobby Congress. As a fiscal crisis approaches, however, higher taxes will become necessary; this in turn will jeopardize the competitiveness of US firms doing business at home and abroad. This dilemma may open the door to reforms that could not be achieved when lower taxes were the legislative order of the day. Congress may have to do the right thing not just in political terms but in economic terms as well.[4]

4. Eugene Steuerle of the Urban Institute made this point in conversation with the authors in October 2004. Lindert (2003) likewise posits that taxes are more efficient when their revenues rise as a share of GDP because "people should be much more sensitive to possible extra deadweight costs when budgets are already bigger. In a democracy, *the extra economic costs become political costs* [italics in original]."