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Right Idea, Wrong Direction: Obama's Corporate Tax Reform Proposals

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INTRODUCTION

The need for US corporate tax reform is blindingly obvious. Conservatives contend that the top corporate tax rate—whether measured in statutory or effective terms—is the second highest in the Organization for Economic Cooperation and Development (OECD). Liberals argue that the US corporate tax system is riddled with complex "loopholes," enabling many firms—whether incorporated or not—to pay less than their fair share.[1]

Responding to these criticisms, Obama's White House and Treasury Department released a joint report entitled, *The President's Framework for Business Tax Reform* (we refer to this report as "the framework"). Unfortunately, the framework omits the detail needed to fully assess its proposals. After all, this is an election year. But if the devil ever lives in the details, it is in the details of the tax code. Instead of details, the framework focuses on five elements of reform: the nominal and effective corporate tax rate, incentives for domestic manufacturing, taxation of international income, the tax code for small business, and the fiscal impact of proposed reforms.

This policy brief discusses the major elements of the proposed framework and important missing ingredients. Overall, the framework unduly concentrates on manufacturing activity, while neglecting America's strength in services, the most prominent future driver of jobs, investment, and growth. Projected revenue gains are not large enough to help curb the rising debt-to-GDP ratio.

LOWERING STATUTORY AND EFFECTIVE TAX RATES

A common feature of recent tax proposals—from the administration, the Congress, independent commissions, and think tanks—is to lower the extraordinarily high US corporate tax rates. On this issue, there is genuine bipartisan support.

Top Statutory Rate

Taken together, the US federal and state governments impose the highest statutory corporate tax rate in the world (table 1).[2] Recent proposals, without exception, would cut the top

1. One illustration of corporate tax complexity is that, in the Thomson Reuters tax handbooks (2012), Internal Revenue Code sections 161 through 383 occupy about 300 pages of fine print, and the accompanying regulations require another 1500 pages. These IRC sections are predominantly devoted to corporate taxation though some also apply to individuals. Elsewhere in the Internal Revenue Code, many other sections are addressed to corporations.

2. Until recently, Japan maintained a higher corporate tax rate. On April 1, 2012, Japan cut its top statutory rate from 39.8 percent to 36.8 percent, giving the United States a distinction no country should want: the world's highest corporate tax rate.

Table 1 Statutory, average, and marginal effective corporate tax rates for systemically important countries
(in percent)

	Statutory corporate tax rates, 2010[a]	Average effective corporate tax rates[q]		Marginal effective corporate tax rates, 2010[b]	
Countries	OECD Tax Database (2011)	World Bank (2009)	Hassett and Mathur (2011, 2010)	Chen and Mintz (2011)	Hassett and Mathur (2011)
Australia[c]	30.0	25.9	22.2	26.0	17.0
Brazil[d]	34.0	21.4	n.a.	35.1	n.a.
Canada	29.5	9.8	25.5	20.5	23.4
China, P.R.[e]	25.0	6.0	n.a.	16.6	n.a.
France[f]	34.4	8.2	27.5	34.0	23.8
Germany[g]	30.2	22.9	24.2	23.8	20.7
India[h]	34.0	24.0	n.a.	33.6	n.a.
Italy[i]	27.5	22.8	24.3	26.9	22.6
Japan	39.5	27.9	33.0	29.5	30.5
Korea, Republic of	24.2	15.3	18.1	29.5	13.6
Mexico	30.0	23.1	28.4	17.5	27.7
Netherlands[j]	25.5	20.9	19.4	16.8	15.1
Poland[k]	19.0	17.7	16.2	14.3	14.1
Russian Federation[l]	20.0	9.0	n.a.	31.9	n.a.
South Africa[m]	34.6	24.3	n.a.	14.5	n.a.
Spain	30.0	20.9	27.5	25.4	26.3
Sweden	26.3	16.4	18.5	18.9	12.6
Switzerland[n]	21.2	8.9	15.4	17.6	10.9
Turkey	20.0	17.0	13.1	5.6	7.3
United Kingdom[o]	28.0	23.2	22.3	27.9	18.8
United States[p]	39.2	27.6	29.0	34.6	23.6
Unweighted average, excluding United States[r]	28.1	18.3	21.0	23.3	20.8

(continued on next page)

federal rate in an effort to boost US jobs and investment.[3] Obama's framework would reduce the top federal rate from its current 35 percent to 28 percent. Senator Rick Santorum would reduce the top rate to 17.5 percent, and Governor Mitt Romney would bring the top rate down to 25 percent.[4] While these goals vary, they all point in the right direction. Nevertheless, they fall short of the competition: In recent days, the United Kingdom, for example, announced a cut in the corporate tax rate from 26 percent today to 22 percent in 2014.[5]

Effective Tax Rate

The framework outlines its own calculations of the effective tax rate, estimating that the United States has the second highest average effective tax rate among G-7 countries at nearly 36

3. Most tax experts believe that excessively high state taxation of corporations is limited by the ability of firms to "vote with their feet" and move to tax-friendly states. When this happens, the jobs and investment still remain in the United States, though not in the high-tax state. However, when the same response mechanism is triggered by excessively high federal taxation, firms move abroad, taking jobs and investment out of the country.

4. Romney's proposal would cut all other tax rates by one-fifth of their current levels. Neither Obama's nor Santorum's proposals mention any rate change besides the top rate, which typically applies to firms with annual revenue above $18 million.

5. According the Chancellor of the Exchequer George Osborne, the cut is an "advertisement for investment and jobs in Britain." *Financial Times*, March 22, 2012, page 4.

Table 1 Statutory, average, and marginal effective corporate tax rates for systemically important countries (in percent) *(continued)*

OECD = Organization for Economic Cooperation and Development; n.a. = data is not available

a. The statutory corporate tax rates for OECD countries (all countries except Brazil, China, India, Russia, and South Africa) show the combined central and subcentral corporate income tax rates. The subcentral coverage of statutory corporate tax rates for non-OECD countries is not necessarily consistent.
b. The marginal effective corporate tax rate measures the tax liability incurred on an additional dollar of investment and informs scaling choices, conditional on the location. The Chen and Mintz (2011) marginal effective rates do not include the effects of the 100 percent temporary capital expensing or "bonus depreciation" rules recently passed by Congress in December 2010 in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. This rule increased the current 50 percent bonus depreciation in the tax code's section 168(k) to 100 percent for qualified property placed in service before December 2011. Chen and Mintz calculated that this provision reduces the US effective tax rate to as low as 17.5 percent, but only for a single year; it does not provide certainty for firms in their capital planning decisions, and it may simply accelerate investment outlays. For these reasons, Chen and Mintz (2011) excluded bonus depreciation effects in their marginal effective tax rate calculation. Hassett and Mathur (2011) calculated their marginal effective tax rates based on the approach outlined by Devereux and Griffith (1999).
c. Australia has a non-calendar tax year. Its statutory rates are in effect as of July 1.
d. The Brazilian statutory corporate income tax rate is 25 percent. In addition, social contribution on net profits at a rate of 9 percent are levied, leading to an overall rate of 34 percent. The 25 percent corporate income tax rate includes a 15 percent basic rate on net profits with tax adjustments and an additional income tax of 10 percent on the net profit which exceeds 240,000 Brazilian real per year.
e. For statutory rates, from January 2008, foreign and domestic entities are subject to a single enterprise corporate income tax at a rate of 25 percent. However, the rate for a low profit enterprise is 20 percent, and for a hi-tech enterprises the rate is 15 percent if certain conditions are met.
f. The French statutory rate includes a surcharge, but does not include the local business tax (*Taxe professionnelle*) or the turnover based solidarity tax (*Contribution de Solidarite*).
g. The German statutory rate includes the regional trade tax (*Gewerbesteuer*) and the surcharge.
h. For statutory rates, domestic companies are generally taxed at the rate of 30 percent; however profits from life insurance business in India are taxed at a rate of 12.5 percent. Foreign companies are taxed at a rate of 40 percent. A Minimum Alternate Tax (MAT) is levied at 15 percent of the adjusted profits of companies where the tax payable is less than 15 percent of their book profits. Dividend distribution tax (DDT) is levied at 15 percent on dividends distributed by a domestic company. Surcharge and education cess is applicable on the above taxes. A 10 percent surcharge in case of domestic companies and a 2.5 percent surcharge in case of foreign companies is applicable if total income is in excess of 10 million Indian rupees. Education cess of 3 percent is applicable on income tax plus surcharge, if any. Wealth tax is imposed at a rate of 1 percent on the value of specified assets held by the taxpayer in excess of the basic exemption of 3 million Indian rupees. Securities transaction tax (STT) is levied on the value of taxable securities transactions in equity shares and units of equity oriented funds.
i. The Italian statutory rates do not include the regional business tax (*Imposta Regionale sulle Attività Produttive*, or IRAP).
j. The Dutch statutory corporate tax rate applies to taxable income over 200,000 euros.
k. There is no Polish subcentral government statutory tax. However, local authorities (at each level) participate in tax revenue at a specified percentage for each level of local authority.
l. The statutory corporate income tax is split into the federal tax (2 percent) and the regional tax (18 percent that can be reduced to 13.5 percent for some categories of taxpayers). Dividends distributed can be subject to a 9 percent or 0 percent withholding tax. Interest income on state securities can be subject to a 15 percent or 0 percent withholding tax percent.
m. The statutory corporate income tax rate is 28 percent. However, South Africa imposes an additional secondary tax on companies (STC) at 10 percent on any net dividends declared by them. Therefore, if a company distributes 100 percent of its after-tax earnings as a dividend, an effective tax rate of 34.55 percent will apply. This does not apply to gold mining companies (which are taxed on a formula basis) or to South African branches of foreign entities which are taxed at a rate of 33 percent. The STC may be replaced by a withholding tax in the future.
n. In Switzerland, church taxes cannot be avoided by enterprises. They are included in the statutory rates.
o. The United Kingdom has a non-calendar tax year. Its statutory rates are in effect as of April 1.
p. The US subcentral statutory corporate rate is a weighted average of state corporate marginal income tax rates. The US effective corporate rate excludes bonus depreciation.
q. The average effective corporate income rate measures the average rate a firm might expect to face on an investment project over the possible range of profitability outcomes. Hassett and Mathur (2011) calculated their average effective tax rates based on the approach outlined by Devereux and Griffith (1999).
r. Hassett and Mathur (2011) do not have the data for some countries in the table. Hence, the unweighted average calculated from their numbers supplements the missing cells with data from either Chen and Mintz (2011) or the World Bank (2011) to enable a guesstimate.

Sources: Corporate tax rates for OECD countries are from OECD Tax Database (2011); Corporate tax rates for non-OECD countries are from KPMG's Corporate and Indirect Tax Rate Survey (2010); Marginal effective corporate tax rates are from Chen and Mintz (2011); Average effective corporate income taxes are from *Paying Taxes 2011: The Global Picture*, World Bank and PricewaterhouseCoopers (2011); Marginal and Average effective corporate income taxes are from Hassett and Mathur (2011); and authors' calculations.

percent. [6] Only Japan has a higher rate at 41 percent.[7] These estimates fly in the face of public perceptions, animated by claims that the largest US corporations pay little or no corporate tax. For example, Citizens for Tax Justice and the Institute on Taxation and Economic Policy (McIntyre et al. 2011) released a report in late 2011 claiming that:

> …[while] the federal corporate tax code ostensibly requires big corporations to pay a 35 percent corporate income tax rate, on average, the 280 corporations in our study paid only about half that amount. And many paid far less, including a number that paid nothing at all… But today corporate tax loopholes are so out of control that most Americans can rightfully complain, 'I pay more federal income taxes than General Electric, Boeing, DuPont, Wells Fargo, Verizon, etc., etc., all put together.'

These claims confuse the debate by zeroing in on specific corporations that incurred huge losses in the 2008–09 financial crisis. Such claims also muddy the picture by perpetuating the idea that corporations are cheating when they use subsidies or loopholes to reduce their tax bill. In reality, many practices

6. See table A1 of the framework and appendix I for the framework's methodology.

7. As noted, Japan is in process of reducing its statutory and effective corporate tax rates.

so labeled by Citizens for Tax Justice are regarded as proper tax incentives by other observers—including the House and Senate tax committees—which are designed to encourage investment in people, plant, and equipment.

BUT RAISING CORPORATE TAX REVENUE

To pay for lower corporate tax rates, the framework proposes a number of revenue raising measures. We question the arithmetic behind the pay for calculations; in our view, the loss of revenue from lower corporate tax rates is greatly exaggerated. Lower corporate rates will broaden the corporate tax base by stimulating new investment, which in turn will boost tax revenue. But before going more deeply into that discussion, it is worth reviewing the revenue raisers in the framework. They come under two major headings: first, close loopholes and end subsidies, and second, eliminate accelerated depreciation.

Close Loopholes and End Subsidies

The terms "loophole" and "subsidies" carry a deliberately negative connotation. Yet very few observers advocate the elimination of all deductions and credits, leading to a totally flat corporate tax, akin to a retail sales tax or a single rate value added tax (VAT). The Obama framework goes nowhere near these extremes.[8] Thus, when the framework claims it will "eliminate dozens of business tax loopholes and tax expenditures," the details are critical.[9] The first step in closing a loophole or ending a subsidy is identifying it, but the framework only identifies five specific examples.

The five loopholes or subsidies identified in the framework are: the last-in, first-out (LIFO) method of accounting for inventory costs; oil and gas taxation; interest deductions for life insurance policies on employees; capital gains taxation of carried interest; and the depreciation schedule for noncommercial aircraft.

LIFO and FIFO

Last-in, first-out (LIFO) and first-in, first-out (FIFO) are accounting methods for attributing the cost of inputs to the overall cost of goods sold. Under LIFO the latest or more recent costs of inputs held in inventory are attributed to goods sold. Alternatively, under FIFO the oldest costs of inputs held in inventory are attributed to goods sold.

LIFO hardly deserves the loophole label since it has existed in the tax law for decades and is well understood. The term loophole generally conveys the idea that a tax incentive is being used in a matter not originally designed, or that its original design pulled the wool over Congressional eyes. Neither feature applies to the LIFO method.

To be sure, eliminating LIFO would align the United States with the International Financial Reporting Standards of the International Accounting Board, since Japan is the only other country which allows LIFO accounting. That said, LIFO does not skew a tax advantage to any particular company or industry. Instead it is designed to avoid imposing taxes on the nominal appreciation of inventory held during an inflationary period. In other words, the original logic of LIFO was to enable American firms to escape taxation on phony profits during periods of high inflation. But LIFO can also distort investment decisions during inflationary episodes by prompting firms to acquire more inventory than necessary rather than acquire new plant and equipment. This particular distortion may be offset by accounting flexibility that allows accelerated depreciation for plant and equipment.[10] It is difficult to assess the impact of eliminating LIFO without knowing the difference in adjusted gross income between FIFO and LIFO accounting for LIFO companies. Treasury probably knows this figure, but it was not revealed in the framework.[11]

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8. In *Reforming the US Corporate Tax* (2005), Hufbauer and Grieco advocated this sort of radical approach, but the idea finds no traction in the current tax debate.

9. The term tax expenditures is technical language for measures often called subsidies.

10. A policy goal often advocated is tax neutrality between different forms of business capital. Some commentators argue that LIFO accomplishes this goal (Viard 2006), but other commentators contend that LIFO encourages earnings management (Kleinbard, Plesko, and Goodman 2006).

11. In its analysis of the FY2013 budget, Treasury claims that this change would increase revenue by $73 billion between 2013 and 2022. See table 15–3 of *Analytical Perspectives—Budget of the US Government*. Available at: http://www.whitehouse.gov/omb/budget/Analytical_Perspectives.

In any event, LIFO will be missed, particularly by manufacturing firms, if inflation creeps back to levels above 5 percent.

Renewed Attack on the Majors

The second set of proposals recall past Obama administration attacks on "big oil," (also called the majors), a favorite target of tax discrimination (see Hufbauer and Vieiro 2011 for a summary of past attacks). If enacted, Obama's proposals would place US oil and gas firms at a greater competitive disadvantage in a global industry which is already dominated by state-owned enterprises. The framework proposes to disallow the expensing of intangible drilling costs (IDC). Intangible drilling costs for oil companies are the functional equivalent of research and development costs for manufacturing and information technology firms. Both may be tax expenditures (or subsidies), but the arguments for immediate deduction (expensing) are similar: to encourage research and development (R&D) and IDC, because these outlays generate substantial spillover benefits for other firms, and because the useful lives of research findings, or oil exploration, are hard to determine. Further, in the oil and gas industry, no tangible asset is created by drilling a dry hole—nothing with any salvage value.

The framework also seeks to repeal percentage depletion for oil and gas wells. Percentage depletion was effectively eliminated in 1975 for the majors, so formal elimination largely scores political points.[12] But another possible feature, eliminating the immediate deduction (expensing) of substances used in tertiary recovery, would be a serious matter. Tertiary recovery is one component of energy independence. Moreover, some tertiary methods inject carbon dioxide under high pressure into old fields, prolonging their useful life. These have the side benefit of curtailing the release of carbon dioxide into the atmosphere.

Genuine Loopholes

The third proposal in the Obama framework qualifies as a genuine loophole closer. This deals with the tax treatment of insurance policies. The practice at issue, inside build up, refers to policies bought by corporations to insure the lives of employees for the benefit of the corporation. The gains from these policies are not taxed until a life insurance policy is paid out (if the person dies while still an employee). Corporations often finance the premium payments with debt, and then deduct the interest payments on that debt. The proposal would eliminate this interest payment deduction "unless the [policy] is on an officer, director, or employee who is at least a 20 percent owner of the business." The idea is to prevent inside build up via insurance policies on employees who cannot be characterized as key employees—the original target of "key man" life insurance.

The last two loopholes may also justify the name, but they are symbolic. No estimates were revealed as to the revenue that would be collected, but since the new taxes would fall on relatively few individuals, it seems unlikely they are major revenue raisers. The framework proposes taxing carried (profit) interests as ordinary income. This provision targets hedge fund and private equity managers and has received considerable media attention.[13] The framework would also increase the depreciation life of non-commercial aircraft (often used for the convenience of corporate executives) from five years to seven years, in line with commercial aircraft.

End Accelerated Depreciation—Sections 168 and 179

Much more important than closing loopholes, the Obama framework hopes to squeeze out revenue by lengthening depreciation schedules across a range of industries. The framework states that:

> …although [accelerated depreciation] provides an incentive to invest, it comes at the cost of higher tax rates for a given amount of revenue. In an increasingly global economy, accelerated depreciation may be a less effective way to increase investment and job creation than reinvesting the savings from moving towards economic depreciation into reducing tax rates.

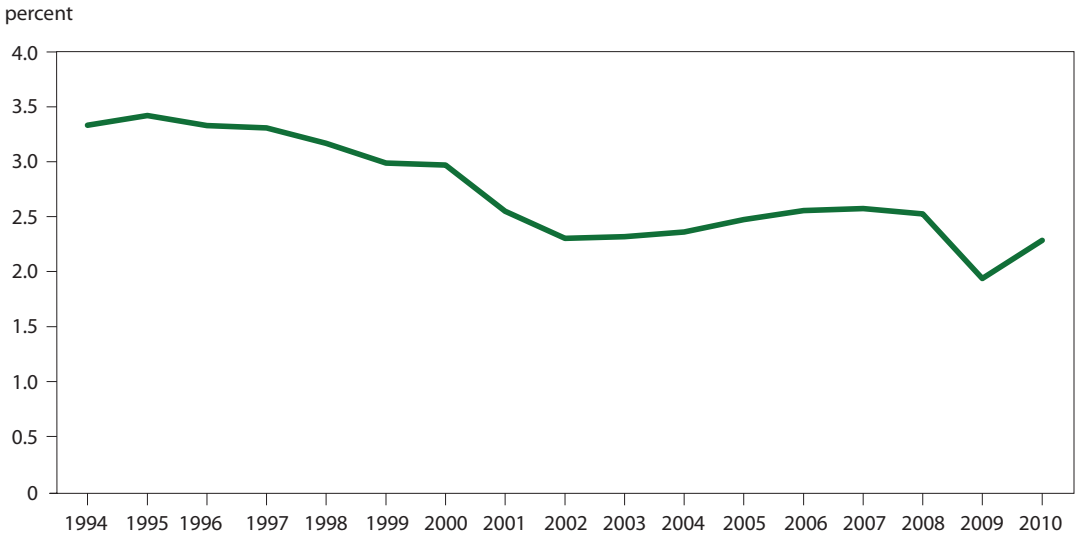
In plain language, the framework proposes to end accelerated depreciation—a tax expenditure—in order to pay for lower corporate tax rates.

Under current law (title 26 USC § 168 (k)), accelerated depreciation—also known as the accelerated cost recovery system (ACRS) and a feature of the tax code for the past five years under the label "bonus depreciation"—will expire in 2013. Expiration will return the tax treatment of plant and equipment investment to its pre-recession form. Bonus depreciation allows

12. Elimination of percentage depletion will, however, raise the tax bill for smaller oil and gas companies, the so-called independents.

13. Mitt Romney faced considerable criticism when he revealed his effective tax rate was only 13.9 percent in 2010. The returns show that Romney earned more than $13 million in carried interest over the previous two years. See "Mitt Romney's tax returns shed some light on his investment wealth" from the *Washington Post*, January 24, 2012. Available at: http://www.washingtonpost.com/politics/mitt-romney-releases-tax-returns/2012/01/23/gIQAj5bUMQ_story.html.

Figure 1 Did accelerated depreciation make a difference? Machinery orders as share of GDP, 1994–2010



Sources: US Census Bureau's *Manufacturers' Shipments, Inventories, and Orders Survey*.

a company to deduct the full cost of plant and equipment investment the same year assets are put into service. Under normal circumstances, asset costs are capitalized and then deducted over the next 5 to 15 years, according to depreciation schedules published by the Internal Revenue Service (IRS) which roughly measure the service lives of physical assets. Accelerated depreciation permits much larger deduction and lowers taxable income in the initial years, but these features are reversed in later years. Bonus depreciation essentially allows the corporation to keep the full time value of money over the entire life of the asset; it does this by reducing tax payments immediately rather than over a period of years. When interest rates on corporate debt are high, this is a significant advantage; however, when corporate interest rates are low—the situation since the financial crisis—the advantage is less.

Here's a short history of the bonus depreciation provision. In 2008, President George W. Bush signed into law a bill that allowed 50 percent bonus depreciation. In his famous stimulus bill (the American Recovery and Reinvestment Act of 2009), President Obama extended this provision to cover 2009 and 2010. In December 2010, Obama and the Congress agreed to increase the bonus depreciation allowance to 100 percent for 2011, but scheduled the allowance to revert to 50 percent in 2012, and expire in 2013. The framework endorses this outcome: expiration of bonus depreciation in 2013.

A companion accelerated depreciation measure is the IRC Section 179 deduction: This was increased from $100,000 in 2007 to $275,000 in 2008, and then to $500,000 in 2010. This deduction, though of no importance for large corporations, is significant for small business firms. Section 179 can be claimed on virtually all purchases of business equipment and, like bonus depreciation, allows a company to immediately deduct the cost of new equipment rather than capitalize the cost and deduct it over the service life. The framework's goal of slashing accelerated depreciation will be accomplished if current law takes effect. For tax years beginning after 2011, the Section 179 deduction is limited to $25,000.

Since both bonus depreciation and the Section 179 deduction essentially expire by 2013, the framework's proposal amounts to an endorsement of current law. Two points should be made about elimination of accelerated depreciation (ACRS). The first point is that ACRS is highly important to capital-intensive firms (e.g., utilities, transportation, heavy manufacturing) while a lower corporate tax rate is for more important to non-capital-intensive forms (e.g., information and communications technology, biotech). The trade-off between lower corporate rates, benefitting "new economy" firms, and ending ACRS, harming "old economy" firms, is sure to set up combat between the two camps when Congress debates the extension of Sections 168 and 179.

The second point has to do with the effect of ACRS on capital outlays. New machinery is a critical part of innovation in most sectors of the economy, and accelerated depreciation makes investment in new machinery a more attractive proposition. Even though ACRS incentives have become more favorable, figure 1 shows that machinery orders have

been on a downward trend, as a share of GDP, since the mid-1990s. ACRS may have slowed the decline, but it is evident that stronger forces are working to reduce machinery orders. More generally, capital spending in the American economy, outside the real estate sector, has not fared well over the past two decades. In our view, extraordinarily high corporate tax rates are a contributing cause.[14]

INCENTIVES FOR DOMESTIC MANUFACTURING

According to the framework, "the manufacturing sector plays an outsized role in the US economy with significant spillovers to other sectors that make it particularly important to the future of job creation, innovation, and economic growth."[15] Evidently President Obama did not listen to the late Steve Jobs when, in reference to manufacturing employment, Jobs told the President "those jobs aren't coming back!"[16] Even Christina Romer, former Chairperson of the President's Council of Economic Advisors, understood that services are the future of US employment: "American consumers value health care and haircuts as much as washing machines and hair dryers. And our earnings from exporting architectural plans for a building in Shanghai are as real as those from exporting cars to Canada."[17]

Manufacturing plays a vital part in the US economy and is indeed a source of innovation, but it can't become the jobs machine of political folklore. Manufacturing accounted for 13 percent of US GDP in 2010 and 8 percent of employment. By comparison, services accounted for 77 percent of US GDP in the same year and 79 percent of employment (see figures 2 and 3).[18] Over the last few decades, these shares have been trending slowly but consistently towards more services. In the 1980s, manufacturing accounted for roughly 20 percent of GDP, while services accounted for roughly 60 percent. Fundamental changes in the pattern of demand drive the trend towards services. Moreover, while US firms compete very well in high-tech manufactures in the global economy, the nation's comparative advantage is inexorably shifting towards high-tech services (Jensen 2011).

These facts should inform tax policy: Services are the driver of future job growth. The overwhelming majority of employment is already in services. In 2010, over 110 million people were employed in the services sector. That figure is estimated to rise to over 130 million by 2020 (see figure 3).

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However, when it comes to corporate tax rates, the Obama framework focuses on manufacturing firms. Specifically, it would cut the top corporate tax rate on manufacturing to 25 percent, 3 percentage points lower than the 28 percent for non-manufacturing corporations. In doing so, the framework contradicts one of its own precepts: "tax expenditures in the tax code vary dramatically by industry. These differences manifest themselves in disparate average rates across industries… the result is a tax system that distorts investment decisions."[19] It is difficult to reconcile the framework's goal of removing old distortions with its advocacy of a new distortion directed against the service industries. Perhaps, in a backhanded way, offering a preferential tax rate for manufacturing firms is the administration's compensation for ending bonus depreciation. If that's the political logic, leaving ACRS in place and adopting a single corporate tax rate would be a cleaner solution.

14. Another cause is that hard infrastructure of all kinds (highways, bridges, airports, transmission lines, pipelines) are effectively walled off from private investment either because the facilities reside in the public domain (and state coffers are empty) or because regulatory permits take an extraordinarily long time (which is the case for transmission lines and pipelines).

15. See page 11 of the framework.

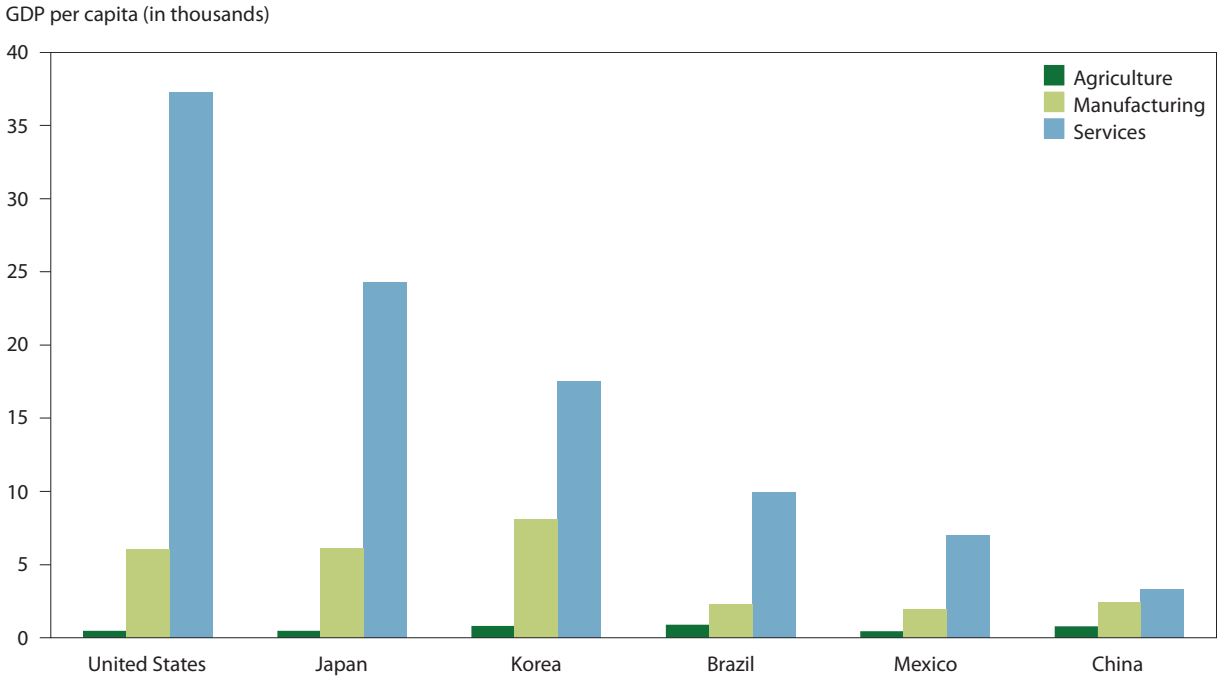
16. See "How the US Lost Out on iPhone Work," by Charles Duhigg and Keith Bradsher, the *New York Times*, January 24, 2012. Available at: http://www.nytimes.com/2012/01/22/business/apple-america-and-a-squeezed-middle-class.html?pagewanted=all

17. See "Do Manufacturers Need Special Treatment?" by Cristina Romer, the *New York Times*. Available at: http://www.nytimes.com/2012/02/05/business/do-manufacturers-need-special-treatment-economic-view.html?_r=1

18. Table 3 figures were calculated by breaking down GDP per capita by percentage of value-added to GDP by sector (agriculture, manufacturing, or services). It shows that richer countries have much higher services-to-manufacturing ratios.

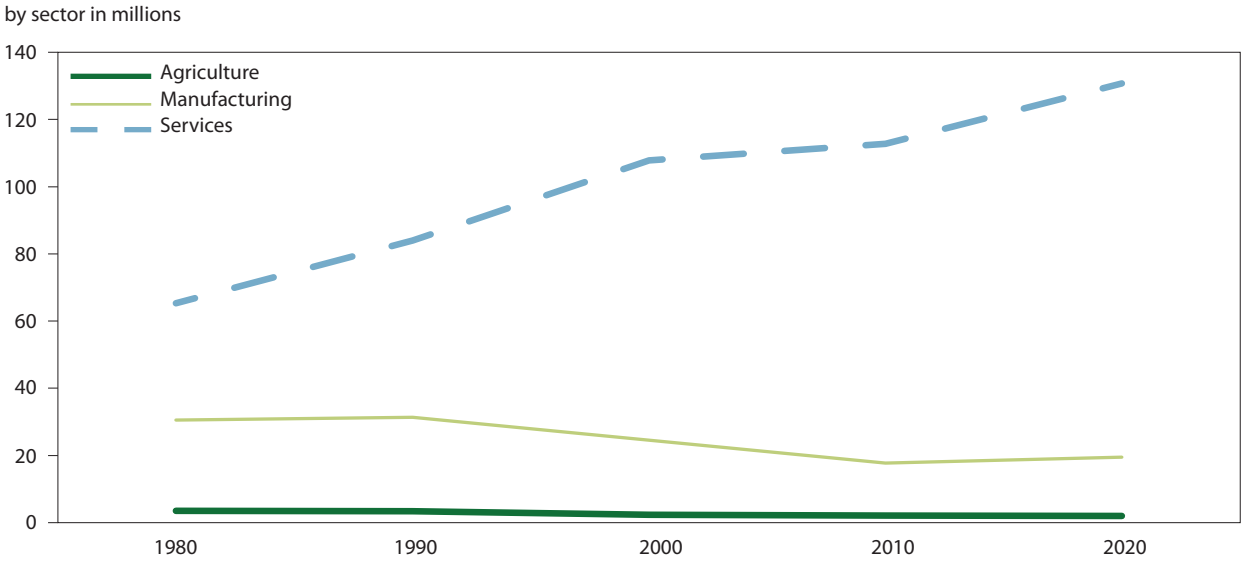
19. See page 4 of the framework.

Figure 2 Composition of GDP (GDP per capita by sector for 2009)



Sources: Author's own calculations and World Bank's *World Development Indicators*.

Figure 3 Projected US employment



Sources: World Bank's *World Development Indicators*, US Bureau of Labor Statistics, US Census Bureau, and author's own calculations.

Advanced Manufacturing—Section 199

The administration has campaigned in industrial states with the claim that it will double the tax breaks available to advanced manufacturing—a term the framework does not define—using Section 199 of the Internal Revenue Code. This section is not discussed in the framework, but Obama's FY2013 budget proposal seeks to tighten up the qualification requirements to focus the deduction to a greater extent on hard core manufacturing. According to the Congressional Research Service (CRS) in 2008, only 60 percent of Section 199 deductions were claimed by manufacturing firms; the other 40 percent

Table 2 Use of research and development (R&D) tax credit by industry (in millions of US dollars)

Industry	2000	2002	2004	2006	2008
Manufacturing	4,766	4,623	4,686	5,106	5,420
Professional, scientific, and technical services	2,887	3,446	3,304	2,961	3,932
Information	1,502	1,149	977	1,025	1,132
Wholesale and retail trade	693	594	812	832	865
Administrative/support and waste management services	47	82	23	183	288
Finance and insurance	106	196	142	174	237
Management of companies	52	50	70	137	276
Total	**10,389**	**10,369**	**10,244**	**10,788**	**12,736**

Source: IRS *Corporate Tax Statistics*.

were claimed by a mix of industries, including the information, finance, and management sectors (Sherlock 2012). Like the administration's proposal for a preferential manufacturing tax rate, the advance manufacturing deduction brings more distortion and complexity to the tax code.[20] Instead the administration should settle on a low corporate tax rate for all firms.

Another proposal to strengthen American manufacturing and innovation would increase and make permanent the R&D tax credit. Here the basic justification is the spillover effect of R&D. While R&D credits are used by manufacturing more intensively than other sectors their use by services firms is increasing at a faster rate (see table 2). For example, information and professional, scientific, and technical services (PSTS) claimed about 30 percent of R&D credits in 2008, and these firms will all benefit from making R&D credits permanent. This proposal has the virtue of neutrality between industries: It encourages R&D and innovation in all sectors of the economy.

TAXATION OF INTERNATIONAL INCOME

Yet President Obama is not taking advice from one of the greatest innovators of our time. Perhaps the president will eventually read the label on the back of the iPad Steve Jobs presented him, which he now proudly totes around. The iPad's country of origin label suggests a better way of thinking about tax reform: "designed in America, assembled in China." Contrasted with this suggestion, the administration's framework resolutely opposes production abroad by US firms.

The international section of the Obama framework, while vague, is the most alarming. The framework points out that "deferral can make [the US tax system] effectively much closer to a territorial system…for many companies."[21] But the administration views a territorial tax system as a vice, not a virtue. This is so, despite the fact that the overwhelming majority of OECD countries apply a territorial system to tax the foreign subsidiaries of their multinational corporations (see table 3).

Put simply, a territorial system taxes corporate income earned at home; it does not attempt to tax corporate income earned aboard. If the administration truly wanted to make US firms more competitive, it would likewise move towards a true territorial tax system, one that only taxes profits earned domestically. That way, US firms operating in global markets would not be disadvantaged relative to their peers based in Canada, Germany, Japan, and most other countries. Moreover, a territorial tax system would clear away the complexities required to manage a worldwide tax system, the current US model. The worldwide system requires an intricate system of foreign tax credits to avoid double taxation. Indirectly, worldwide taxation also creates an incentive for managers to defer repatriation of their profits earned abroad as long as possible. None of this is good for US-based multinational firms or for US investment.

Yet the framework moves in the direction of reinforcing the worldwide taxation system. Without specifics, the framework proposes a minimum rate of tax on income earned by US-controlled corporate subsidiaries operating abroad. The minimum rate is not specified, but the framework would clearly eliminate some, or all, of the benefits of deferral since foreign profits would face immediate US taxation. If enacted, this proposal would instantly place US-based multinationals at a competitive disadvantage relative to their foreign rivals—firms that compete in the same overseas markets but are taxed by their home countries on the basis of territorial systems.

20. The CRS states that "section 199 production activities deductions increases the after-tax return to particular investments by lowering the effective tax rate in certain industries, thus may distort the allocation of capital. The effect reduces economic efficiency and total economic output by directing capital away from its most productive use… [and] increased complexity in the tax code."

21. See page 13 of the framework.

Table 3 International tax systems and the *Fortune* Global 50 companies, 2009

Headquarter country	Number of companies	Percent of companies	Percentage of revenues	2009 statutory corporate tax rate	Taxation of foreign-source income
United States	17	34	37	39.5	Worldwide with credit
France	6	12	11	34.4	Territorial
Germany	5	10	9	33.0	Territorial
Britain	4	8	9	28.0	Territorial*
Netherlands	2	4	7	25.5	Territorial
Japan	4	8	7	41.3	Territorial*
China	3	6	6	25.0	Worldwide with credit
Belgium	2	4	4	34.0	Territorial
Italy	2	4	3	30.3	Territorial
Switzerland	1	2	2	24.7	Territorial
South Korea	1	2	1	25.0	Worldwide with credit
Luxemburg	1	2	1	28.6	Territorial
Mexico	1	2	1	28.0	Worldwide with credit
Russia	1	2	1	22.0	Worldwide with credit
Total/average	**50**	**100**	**100**	**31 for non-US**	

* Enacted to a territorial system in 2009

Source: "Japan's move to territorial taxation contrasts with US international tax policy," *International Tax Notes*, Ernst & Young, April 10, 2009.

It is unclear exactly how much revenue the new minimum tax would raise. That would depend both on the rate and how it is implemented. However, the Committee for a Responsible Federal Budget Project (CRFB) estimates that, if the next president reverses the Obama administration's direction and instead signs a territorial tax bill in his first day in office, the total reduction in tax revenue in the decade from enactment to 2022 would be "up to $80 billion, depending on the details." While the CRFB is a bipartisan, non-profit organization comprised of notable tax and budget experts, a loss of $80 billion over a decade is at the high end, as the committee acknowledges. Even if the revenue loss reaches $8 billion annually, it should be viewed as a down payment on greater gains to US competitive strength in world markets.

TAXATION OF SMALL BUSINESS

The framework outlines proposals which "make tax filing simpler for small businesses and entrepreneurs." The proposals are generally mild and would have little impact. For example, small businesses with up to $10 million in gross receipts would be eligible to use cash accounting opposed to accrual accounting (the current limit for cash accounting is $5 million). Tax breaks for small business are good politics, but in designing national business tax policy, the administration needs to remember that the majority of net job creation, R&D, and exports comes from large corporations (see Hufbauer and Vieiro 2011, and tables 4 and 5 of this report).

Possibly to head off controversy, the framework skirts the problem created when large firms migrate out of the corporate tax system by using such legal forms as master limited partnerships. Over the past three decades this migration has severely eroded the corporate tax base. Nothing in the framework would put a halt to future erosion. Yet, as the least harmful means of paying for a lower corporate tax rate, halting and even selectively rolling back the migration makes the most sense. Huge misallocations of human and physical capital are bound to occur when half the business sector pays a federal tax rate of 35 percent on profits and the other half pays nothing.[22]

FISCAL IMPACT OF THE FRAMEWORK

The framework asserts that reforms "should be fully paid for and be more fiscally responsible than our current system."[23] It's hard to disagree with that. Fiscal balance is a worthy goal and should factor into any reform. But forecasts of revenue, spending, and economic growth are notoriously complex and often wildly inaccurate. Usually they start from a benchmark trajectory of revenue and spending from which the impacts of

22. See Hufbauer and Vieiro (2011).

23. See page 18 of the framework.

Table 4 US research and development (R&D) expenditure by firm size, 2008 (billions of US dollars)

Number of employees	Sales		R&D		R&D, as a percentage of sales		Share of total R&D	
	United States	Worldwide	United States	Worldwide	United States	Worldwide	United States	Worldwide
5–99	522	603	29	36	5.5	6.0	7.0	5.5
100–249	284	350	13	16	4.6	4.7	3.8	3.2
250–499	211	257	9	11	4.2	4.4	2.8	2.3
500–999	261	392	10	13	3.9	3.4	3.5	3.6
1,000–4,999	1,032	1,471	39	56	3.8	3.8	13.8	13.4
5,000–24,999	2,272	3,235	59	86	2.6	2.7	30.4	29.6
25,000 or more	2,892	4,634	75	110	2.6	2.4	38.7	42.3
Total	**7,475**	**10,943**	**234**	**329**	**3.1**	**3.0**	**100.0**	**100.0**

Source: National Science Foundation/Division of Science Resources Statistics, Business R&D and Innovation Survey: 2008.

Table 5 Export value by firm size, 2008

Number of employees	1–19	20–99	100–499	500 or more	Total
Total export value, in billions of US dollars	93	82	103	788	1,066
Number of firms	112,220	49,739	17,944	7,079	186,982
Share of total export value in percent	8.7	7.7	9.7	73.9	100.0
Average export value in millions of US dollars	1	2	6	111	6

Notes: Figures only include direct exporters. Does not include non-exporting firms or firms which support export production.

Source: International Trade Administration, Exporters Database.

tax changes are measured. Every year, the Congressional Budget Office (CBO) releases two such benchmarks, often referred to as its baseline current law projection and its baseline current policy projections. Current law projections are calculated assuming that laws as written will not be modified. Current policy projections attempt to reflect highly probable changes in the law (such as extending unemployment insurance, the R&D tax credit, or exemptions from the alternative minimum tax).

In the current political landscape, it is especially difficult to predict which tax or spending law features, now scheduled either to expire or to come into force on automatic pilot, will be altered. Among the uncertainties are these: the extension or expiration of Bush-era tax cuts, massive sequestration of defense and entitlement spending mandated by the December 2011 debt-limit deal, and extension of the payroll tax cut. Decisions on these blockbuster questions will shape the long-term fiscal picture. Given these uncertainties, it is especially difficult to construct a sensible baseline forecast.

While the framework seeks fiscal neutrality, it does not provide a serious analysis of its own baseline forecasts on the estimated impact of proposed reforms. The framework makes the claim that, under current law, there are "about $250 billion in [revenue] costs over the next decade" that "would no longer add to the deficit under the president's framework." This figure is not broken down between framework features that raise revenue and features that lose revenue.

Accordingly, for guidance we must turn to other sources. Estimates published by the Joint Committee on Taxation and used by the Congressional Budget Office customarily project that cutting the corporate tax rate would reduce corporate tax receipts if nothing else changed.[24] In real life, other magnitudes do change when tax rates are lowered or raised. Static "no other change" estimates ignore the logic behind cutting the corporate tax rate in the first place: a positive boost to US business activity.

In light of the static bias in official estimates, it is worth reporting research that supports a dynamic view: namely, that cutting the corporate tax rate would reduce revenue much less than supposed by static estimates. For example, the Institute for Research on the Economics of Taxation (IRET) has constructed a model of the US economy to examine a variety of tax policy reforms. Using this model, IRET ran simulations to estimate the potential economic impact of a 10 percentage

24. In the same static spirit, the CRFB estimates that cutting the corporate tax rate to 25 percent would add $1 trillion to the federal debt through 2021.

Table 6 IRET model: 10 percentage point cut in corporate tax rate

	2008 level (billions of dollars)		Change between baseline and simulation	
Items	Baseline	Simulations	Billions of US dollars	Percent
Gross domestic product	14,441	14,767	326	2.3
Private business output	10,728	10,979	251	2.3
Private business capital stock	27,608	29,357	1,749	6.3
Wage rate (dollars per hour)	33	34	1	1.9
Private business hours of work (billion hours)	192	193	1	0.4
Federal tax receipts, of which:	2,503	2,522	19	0.8
Federal personal income taxes	1,102	1,146	43	3.9
Federal corporate profits tax (accruals)	181	129	–52	–28.7
Federal Social Security and Medicare receipts	974	997	22	2.3
State and local tax receipts, of which:	2,036	2,085	48	2.4
State and local personal income taxes	302	314	11	3.8
State and local corporate profits tax (accruals)	51	51	0	–0.1

IRET = Institute for Research on the Economics of Taxation

Note: The baseline and simulation scenarios both assume continuation of the expensing rule in place since 2008 (50 percent bonus expensing).

Source: Institute for Research on the Economics of Taxation (IRET), 2010.

Table 7 Corporate tax revenues in OECD countries regressed on the consolidated tax rate, 1981–2007

	Explanatory variables				
Dependent variable	Constant	Combined corporate tax rate	R-squared	Observations	Clusters
All OECD countries					
Corporate tax revenues/GDP	4.42 ***	–0.04 ***	0.04	640	29
	(0.178)	(0.005)			

OECD = Organization for Economic Cooperation and Development

Notes: Standard errors of the coefficient estimates are reported in parentheses. Estimation using the underlying panel data set includes country fixed effects (not reported). *,**,*** denote statistical significance at the 10, 5, and 1 percent levels. Clusters are the number of countries covered by the panel dataset.

Source: Hufbauer and DeRosa (2010).

point corporate tax rate cut.[25] Cutting the corporate tax rate would prompt a jump of 6.3 percent in the private business capital stock, raise the average wage rate by 1.9 percent, and boost GDP by over 2 percent. Federal receipts from corporate taxation would drop by $52 billion. On net, however, federal receipts would rise by $19 billion, or 0.8 percent, due to offsetting rises in personal income, Social Security, and Medicare taxes (see table 6 for results from the model).

Similarly, table 7 reports a panel regression of corporate tax revenue expressed as a percent of GDP in OECD countries. In this exercise, tax revenues are regressed against the corporate statutory tax rate (federal, state, and local combined), controlling for country fixed-effects. The very small, though statistically significant, coefficient—a negative value of 0.04—indicates that a 1 percentage point increase in the corporate tax rate may slightly decrease corporate tax revenue expressed as a percentage of GDP. In other words, there is a very small but negative connection between tax revenue and statutory tax rates within the range of rates implemented by OECD countries over the past quarter century—a range that covers statutory rates between roughly 20 and 40 percent.

Another empirical study (Mertens and O'Ravn 2011) supports the claim that cutting the corporate tax rate would not reduce revenues, indicating that the current corporate tax

25. These estimates are pegged off the CBO's 2008 baseline projections and assume a continuation of 100 percent bonus depreciation.

rate is positioned on the right-hand side of the Laffer curve.[26] Using US data from 1950 to 2006, Mertens and O'Ravn find the "increase in the tax base is sufficiently large that the corporate income tax cut leads to a small decline in corporate tax revenues only after the first quarter and a surplus thereafter." They conclude that "cuts in corporate income taxes are approximately self-financing." They further find that "a one percentage point cut in the [average effective corporate tax rate] raises real GDP per capita on impact by 0.5 percent and by 0.7 percent after five quarters."

Judging from their revenue estimates, neither the CBO nor the OMB subscribes to the research just cited. But many Congressmen and independent economists do. So here's a suggestion: Enact a corporate rate cut, 10 percentage points, phased in at 2 percentage points a year, starting in 2013. If the revenue yield predicted by dynamic scoring (adjusted for the business cycle) fails to materialize, then postpone the next phase in the rate cut. To complement the rate cut, close a few genuine loopholes, and take measures to arrest and even rollback the migration of large firms from the corporate tax system.

THE REPUBLICAN RESPONSE

Congressman Paul Ryan, chairman of the House Budget committee, released a budget plan—entitled *Path to Prosperity*—which contrasts sharply with the Obama framework. The plan covers a host of controversial issues not related to corporate taxation, ranging from Medicare reform to personal income taxes. While the Ryan plan avoids many of the specifics needed to assess its impact, it succinctly outlines a position on pro-growth tax reform, claiming the plan would:

- reduce the corporate rate to 25 percent;
- repeal the Alternative Minimum Tax (which applies to both individuals and corporations);
- broaden the tax base to maintain revenue growth consistent with current tax policy and as a share of the economy consistent with historical norms of 18 to 19 percent in the following decades;
- shift from a worldwide system of taxation to a territorial system both to put American companies and their workers on a level playing field with foreign competitors and to end the lock-out effect that discourages companies from bringing back foreign earnings to invest in the United States.

The Ryan plan emphasizes the importance of increasing US competitiveness both by adopting a territorial tax system and reducing the corporate tax rate. If President Obama is reelected in November 2012, he should be able to find common ground with Congressmen Ryan at least on lowering the corporate tax rate.

THE MISSING ELEMENT—A NATIONAL CONSUMPTION TAX[27]

As everyone knows, the US debt trajectory is unsustainable. US Treasury bonds and bills held by the public now amount to approximately 75 percent of US GDP, and foreseeable deficits will push the figure to 94 percent by 2022.[28] In the wake of the European sovereign debt crisis, the American public seemingly agrees that the US debt-to-GDP ratio must stop rising before it breaks the 100 percent mark. Based on historic norms, the federal deficit can average 2 to 3 percent of GDP annually without raising the debt-to-GDP ratio, but not 6 percent for a prolonged period. While the Great Recession of 2008–09 entailed deficits well above 6 percent of GDP, and added several trillion dollars to the public debt, going forward the big surge will come from entitlement spending (especially Medicare, but also Medicaid and Social Security). Again, there is seemingly widespread agreement that entitlement spending, now 13.5 percent of GDP, must eventually be capped.

In short, the American public wants to see a return to the historic norm of federal deficits not exceeding 2 to 3 percent annually. But the big question is the level of spending and taxation at which the budget will be roughly balanced, with annual deficits not exceeding the historic norm. Will federal revenues be capped at their historic average, around 18 to 19 percent of GDP? This range would limit federal expenditures to around 21 percent of GDP (assuming annual deficits at the historic norm of 2 to 3 percent of GDP). This scenario requires a rollback in current entitlement spending by around 3 percentage points of GDP (a cut of some $450 billion annually). In broad strokes, this is the Republican answer to the looming sovereign debt crisis.

26. Arthur Laffer makes much of the claim that after a certain level, high tax rates diminish tax revenue owning to evasion, avoidance, and a decrease in economic activity. See, for example, Laffer (2004).

27. For a longer description of the impact of adopting a national consumption tax, see Hufbauer and Wong 2011.

28. The phrase "held by the public" excludes Treasury bonds and bills held by the Federal Reserve, the Social Security Trust Fund, and other federal agencies, but it includes debt held by foreign central banks and other foreign entities.

Table 8 Tax revenue for select OECD countries, 2008 (as a percent of GDP)

	Total tax revenue		Corporate tax revenue		VAT/GST revenue	
Country	**Federal**	**State and local**	**Federal**	**State and local**	**Federal**	**State and local**
Canada	14.0	15.4	2.2	1.2	1.9	0.8
Denmark	35.0	11.9	3.0	0.3	10.1	0.0
Finland	21.3	9.4	2.7	0.8	8.4	0.8
France	15.3	5.3	2.9	1.2	6.7	0.0
Germany	11.5	11.4	0.5	1.4	3.9	3.2
Italy	22.7	7.0	3.4	0.3	5.6	0.4
Japan	9.3	8.0	2.0	1.8	2.0	0.5
Korea	16.3	4.4	3.9	1.2	4.3	0.0
New Zealand	31.5	2.1	4.4	0.0	8.5	0.0
Norway	37.8	5.1	12.4	1.2	7.4	0.0
Spain	10.8	10.4	2.5	0.3	2.4	2.7
Sweden	24.6	16.1	3.0	1.2	9.3	0.0
Switzerland	10.8	11.6	1.6	1.7	3.7	0.0
Turkey	16.1	2.1	1.6	0.2	4.4	0.6
United Kingdom	27.0	1.7	3.6	0.0	6.4	0.0
United States	10.4	9.4	1.6	0.3	..	0.0
OECD total	**21.0**	**8.4**	**3.2**	**0.0**	**6.5**	**1.0**

VAT = value added tax; GST = goods and services tax; OECD = Organization for Economic Cooperation and Development

Source: OECD Revenue Statistics—Comparative tables.

An alternative scenario would enact new taxes to bring federal revenues to around 24 to 25 percent of GDP, permitting annual expenditures of around 27 percent of GDP. Again, in broad strokes, this is the Democratic answer to the looming sovereign debt crisis. While this scenario still requires capping the future growth of entitlement spending, it does not envision a sharp rollback of present levels.

The November 2012 election might decisively choose between the two scenarios just sketched. More likely, the choice will turn on the prolonged tug and haul of political forces as the debt ratio rises and a financial crisis becomes more imminent.

Returning to our subject of corporate taxes, we fear that, if the Democratic scenario prevails in the American political debate, populist forces may seek to raise taxes on big companies. In our view that's almost the worst place to raise taxes. Higher corporate taxes will almost certainly presage an erosion of American competitiveness and diminished growth.

That said, what's better than an increase in corporate taxes? Though now quite unpopular, the better approach is a national consumption tax, which could comfortably raise revenue of 6 percent of GDP with far less damage to growth and competitiveness.

Consumption taxes form an important source of public revenue elsewhere. Prominent globally, but not in the United States, is the value-added tax (VAT) and its functional equivalent, the goods and services tax (GST). Both are broad-based consumption taxes imposed at each stage of the supply chain from primary producer to retail merchant. If done right, these taxes avoid much of the complications of corporate and personal income taxation, such as defining myriad deductions and exemptions and applying multiple tax rates and tax credits to different categories of income and expense. Moreover, since VAT and GST payments are remitted by business firms, they avoid the hassle of collecting the same amount of tax from millions of households. In 2008, the average OECD country collected 6.5 of GDP from VAT/GST revenue at the federal level (see table 8).[29] In fact, the VAT and GST are the leading means of taxing consumption in 29 out of the 30 OECD countries—with the United States being the exception.

Another major advantage of any broad-based tax in the VAT/GST family is the favorable impact on trade and US

29. While the OECD has published more recent data for 2009 and 2010, the global financial crisis and subsequent global slowdown temporarily decreased tax receipts for those years. We use 2008 figures, which more accurately reflect anticipated tax revenues in the next few years.

competitiveness. The tax can be rebated on exports of goods and services and imposed on imports. If the United States adopted a rate of 10 percent, and adjusted the tax at the border (exempted on exports of goods and services, imposed on imports), the net export-boosting effect would be roughly similar to a 10 percent devaluation of dollar. According to estimates by William Cline, a 10 percent devaluation of the dollar would reduce the US current account deficit by about 1.5 percent of GDP after four years, or around $220 billion. [30]

What's better than an increase in corporate taxes? Though now quite unpopular, the better approach is a national consumption tax, which could comfortably raise revenue of 6 percent of GDP with far less damage to growth and competitiveness....Republicans [should] allow the Democrats to implement a fairly designed national consumption tax in exchange for a sharply lower corporate tax rate and a territorial tax system.

Set against these features is the stark reality that anything resembling a VAT or GST is deeply unpopular on Capitol Hill. Most Senators and Representatives are convinced that voting for a national consumption tax will destroy their Congressional careers. However, if the choice comes down to a deep rollback in Medicare and Social Security benefits, or a steep rise in personal income taxes, the US political calculus could change—as it has in other advanced countries. But our immediate worry is that, in dire circumstances, Congress might turn to higher business taxation (especially higher corporate tax rates) before giving serious consideration to a national consumption tax.

CONCLUSION

Overall, the framework comes up short in two big respects. First, it fails to promote future drivers of growth. It does not seize the moment to sharply reduce corporate taxation across the board, both the statutory rate and the effective rate. Instead, it discriminates against service firms and multinationals and generally reinforces a negative view of "big business." Second, the framework fails to address the structural budget problem. It ignores the migration of large firms from the corporate tax system and it ducks the debate over a national consumption tax.

Both sides of the political aisle agree that corporate tax reform is needed. The administration, realizing the vanishingly small prospect of serious reform in an election year, scored political points but did not offer a serious proposal. A better alternative, perhaps awaiting new political leaders in 2013, would envisage a grand bargain on tax reform: Republicans allow the Democrats to implement a fairly designed national consumption tax in exchange for a sharply lower corporate tax rate and a territorial tax system. In the same bargain, both parties hammer out an agreement on capping the future rise of entitlement spending, without attempting to rollback present benefits in significant ways. Taken as a package, these measures would spur the economy by encouraging investment, increasing competitiveness, and boosting exports. Equally important, the package would exorcise the specter of ever-widening budget deficits and a perilous escalation in the debt-to-GDP ratio.

30. Cline's calculations indicate that about 80 percent of the improvement comes from a reduction in the deficit on goods and services trade, with the remaining 20 percent from reduced net payments on international assets and liabilities (inward and outward foreign direct investment, private portfolio investment, and central bank holdings of dollars).

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