Obama's Corporate Tax Plan Illustrates Lunacy of U.S. Code: View
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By The Editors

(Bloomberg View) -- In his latest attempt to find the money to repair the U.S.'s decrepit roads and bridges, President Barack Obama is proposing to raid the overseas bank accounts of corporate America. Inevitably, because it involves the U.S. tax code, the plan is not without its absurd aspects. But it could point the way toward making tax policy more sensible.

Obama's budget proposes to tax the roughly $2 trillion in earnings that U.S. businesses are holding overseas at a one-time rate of 14 percent, and to direct the resulting revenue toward public-works projects. The tax rate for new overseas earnings would then be set at 19 percent, 16 percentage points below the current top rate for domestic earnings, regardless of whether companies bring the money back to the U.S.

This isn't the worst such plan. It would discourage companies from continuing to stash their cash abroad in the hope that Congress will eventually give them another "tax holiday."

And infrastructure investment is a prudent way to spend the one- time revenue boon. Plus, it would shore up bridges and rail lines that, in some cases, are in dangerously poor shape.

The plan's second component, meanwhile, acknowledges the deeper problem that leads businesses to this strange situation in the first place. Unlike most industrialized countries, which tax only domestic earnings, the U.S. compels companies to pay taxes on their worldwide earnings. They receive credits for taxes paid to foreign governments and can defer what they owe on overseas income until the money is brought back into the U.S.

This has a number of distortive effects. Most obviously, it discourages companies from bringing money home to pay dividends or make new investments. It also encourages them to take on debt, leads to burdensome compliance costs and outlandish legal trickery, and makes U.S. businesses less competitive in foreign markets.

Obama's plan to tax new foreign earnings at a reduced rate implicitly recognizes the foolishness of this system. Yet it fails to follow this insight to its logical conclusion: Abolish most taxes on overseas earnings altogether.

Such a proposal wouldn't have the same political appeal, which is to say it wouldn't force Republicans into the awkward position of defending the right of U.S. corporations to keep their profits overseas. But, if combined with a lower corporate tax rate, it has the virtue of being a better policy.

Eliminating the tax on overseas profits would allow companies to allocate more capital according to its best uses instead of its tax consequences. It would put U.S. businesses on a level playing field with foreign competitors. And although it could drive corporations to expand their operations overseas instead of at home, the evidence shows that when U.S.-based companies boost investment in their foreign subsidiaries, the number of Americans they employ actually rises. Their domestic employee compensation and R&D spending also increase.

A more obvious problem is foregone revenue. But the amount the IRS takes in from overseas corporate profits relative to the effort it expends chasing them down is small. A better way to collect revenue would be to eliminate most of the dozens of special breaks in the tax code that allow many companies to pay taxes at an effective rate far below the official one. More preferable still would be to eliminate the corporate-income tax altogether and make up the revenue by taxing investment income at the same rate as labor income.

No, of course, that's not going to happen anytime soon. In the meantime, Obama's proposal offers a decent start to negotiations with Congress -- and maybe toward a larger debate over reforming the corporate tax code.

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