



US Tax Discrimination Against Large Corporations Should Be Discarded

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The United States holds contradictory views about large corporations. When Americans speak of breakthroughs in research and engineering, they are justly proud of large firms that pioneered railroads and steam engines in the 19th century, automobiles, electric power, and oil exploration in the 20th century, and computers, software, and biotechnology in the 21st century. Yet when talk turns to paying taxes, public opinion holds that large corporations should pay a higher statutory tax rate than other business firms, and enjoy fewer deductions in computing their taxable income. Despite common sense and the teachings of economics, tax discrimination is alive and well.

A BAD IDEA

Why is tax discrimination a bad idea? Foremost because it penalizes the firm that can build a better turbine, a faster internet search engine, or drill for oil at an ocean depth of two miles. Discriminatory tax burdens on one group of firms drive scarce capital and entrepreneurial energy to less productive firms, penalizing the entire economy. If the targets of discrimination are the nation's largest firms (the norm in the United States) the country will find it harder to compete on a global scale in industries that require dedicated research for decades, industries that exhibit huge scale economies, and industries that network across national borders.

US-based multinational corporations (MNCs)—firms that account for the bulk of US exports, research and development (R&D), and almost all outward direct investment—pay high taxes directly and indirectly on their equity earnings. The “commanding heights” of the US economy—MNCs with far-flung business ties—pay the corporate rates depicted in table 1, and their American shareholders pay additional tax. The US statutory corporate rate (federal and state combined) in 2010 was the second highest among Organization for Economic Cooperation and Development (OECD) countries, at 39 percent—11 percentage points higher than the unweighted average of competing countries (table 1).¹ In addition, American shareholders paid another 15 percent tax on qualifying dividends received in their personal tax returns.

The plants of US MNCs are the most productive plants in the United States, both in terms of labor productivity and total factor productivity (output generated for a given quantity of land, labor, and other inputs). These MNCs capture the technological and social benefits from economies of scale. Large companies are the most technology-intensive, and spend the most on research and development. In 2008, the largest companies—defined as companies that employ 5000 or more persons—accounted for 69 percent of all US

1. Before he resigned, Prime Minister Kan in Japan was seeking a five percentage point reduction in Japan's corporate tax rate; if his successor, Prime Minister Noda carries out this reform, the United States will be left with the most burdensome corporate tax regime amongst the OECD countries.

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

Countries	Statutory corporate tax rates, 2010 ^a	Average effective corporate tax rates ^a		Marginal effective corporate tax rates, 2010 ^b	
	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

n.a. = data not available

a. The statutory corporate tax rates for Organization for Economic Cooperation and Development (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 excess BRL240,000 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.

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

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 INR10 million. 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 INR3 million. 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*; IRAP).

j. The Dutch statutory corporate tax rate applies to taxable income over EUR200,000.

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.

private sector R&D expenditures (table 2). R&D has created numerous new technologies in sectors ranging from energy, to computers and software, to bio-tech and health care. In addition to the social payoff from these technologies, R&D has consistently been associated with faster economic growth. Large companies pass on the benefits of scale economies to consumers in the form of lower prices. Despite the frequent vilification of Walmart, econometricians have shown that the arrival of a Walmart Supercenter leads to a 25 percent decrease in the average grocery bill for local consumers (Hausmen and Leibtag 2005). Efficient production also makes US goods and services more competitive internationally. Accordingly, large companies typically account for over 70 percent of US exports (table 3).

In addition to the overall benefits that they deliver to the American economy, large companies create good jobs at high wages for American workers. In 2009, the largest companies provided jobs to 32 percent of the American workforce (table 4.1). Likewise in 2009, large companies—here defined as companies with 500 or more workers—paid 50 percent higher hourly wages, provided 10 percent more working hours per week, and overall spent 36 percent more on annual payroll per employee than small companies—defined as companies that employ fewer than 100 persons (table 4.2). In addition to direct compensation, large companies consistently provide

better fringe benefits. A report by the Federal Reserve Bank of Kansas City concluded that “workers at large firms are much more likely to receive retirement benefits; life insurance; and health, dental, and vision insurance,” and that “eligibility for both short-term and long-term disability benefits are about twice as likely at large firms than at small firms.” Job stability is often considered the most important feature of the workplace. The report cites numerous studies which consistently find a positive correlation between firm size and job stability, as well as job satisfaction. Moreover, retirement plans are available to 78 percent of large-firm workers, compared to only 44 percent of small-firm workers (Edmiston 2007).

Conventional wisdom holds that small companies account for the lion's share of job growth, but this fails to distinguish between gross job creation and net job creation, nor does it take into account firm age. Recent research finds that, once company age is taken into account, company size no longer has a statistically significant effect on job growth. Most of the hype about small companies and net job growth reflects the job experience of start-up firms. The reality for the average worker is that large companies account for the biggest share of gross job growth. Thus, “if a worker is looking for the places where the most jobs are being created they should go where the jobs are—large and mature firms” (Haltiwanger, Jarmin, and Miranda 2010).

Table 2 Research & development expenditure by firm size, 2008

Number of employees	Billions of dollars				Percent			
	Sales		R&D		R&D as a percentage of sales		Share of total R&D	
	US	Worldwide	US	Worldwide	US	Worldwide	US	Worldwide
5–99	522.3	603.1	28.5	36.2	5.5	6.0	7.0	5.5
100–249	284.3	350.3	12.9	16.4	4.6	4.7	3.8	3.2
250–499	211.1	257.0	8.8	11.2	4.2	4.4	2.8	2.3
500–999	261.4	392.4	10.1	13.4	3.9	3.4	3.5	3.6
1,000–4,999	1,032.2	1,471.0	39.3	56.1	3.8	3.8	13.8	13.4
5,000–24,999	2,271.9	3,234.7	59.3	86.4	2.6	2.7	30.4	29.6
25,000 or more	2,892.2	4,634.0	74.6	109.6	2.6	2.4	38.7	42.3
Total	7,475.4	10,942.5	233.5	329.3	3.1	3.0	100.0	100.0

R&D = Research and development

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

Table 3 Export value by firm size, 2008

Number of employees	1–19	20–99	100–499	500 or more	Total
Total export value (in billions)	\$93.1	\$81.7	\$102.9	\$788.0	\$1,065.7
Number of Firms	112,220	49,739	17,944	7,079	186,982
Share of total export value	8.7%	7.7%	9.7%	73.9%	100.0%
Average export value (in millions)	\$0.8	\$1.6	\$5.7	\$111.3	\$5.6

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

Sources: International Trade Administration, Exporters Database.

Table 4.1 Employment and payroll by firm size, 2008

Number of employees	Number of firms	Total employment	Total annual payroll (billions of dollars)	Average payroll per employee	Share of total annual payroll (percent)
0–99	11,116,000	63,608,000	2,300.0	\$36,000	38.6
100–499	90,000	17,547,000	700.0	\$40,000	12.0
500–999	9,000	6,299,000	300.0	\$43,000	4.6
1,000–2,499	5,000	8,358,000	400.0	\$46,000	6.5
2,500–4,999	2,000	6,726,000	300.0	\$49,000	5.6
5,000–9,999	1,000	6,773,000	300.0	\$50,000	5.7
10,000+	1,000	33,025,000	200.0	\$48,000	26.9
Total	11,224,000	142,338,000	4,500.0	\$41,000	100.0

Sources: US Census Bureau, Statistics of US Businesses.

Whatever the relative contribution of large and small companies to gross or net job growth, the bottom line for American workers—and the American economy as a whole—is to ensure that the United States remains a favorable location for US-based MNCs to do business.

Other countries, with a stronger egalitarian streak than the United States, ranging from Sweden to France to Canada, love

their largest corporations, bestowing upon them the accolades of “national champions.” Support for these companies takes many forms. In the more extreme cases, companies are awarded monopoly rights as well as government financing (e.g., China’s support for its state-owned enterprises). In less extreme cases, companies receive support via subsidized loans and significant tax breaks (e.g., Korea’s chaebols). A more modest type of affec-

Table 4.2 Hourly wages by firm size, private industry, 2009

Number of employees	1-49	50-99	100-499	500 or more
Mean hourly earnings	\$17.80	\$19.10	\$20.42	\$26.65
Mean weekly hours	33.60	34.20	35.80	37.00

Sources: Bureau of Labor Statistics, National Compensation Survey.

tion—simply abandoning discriminatory tax practices and proposals that significantly disadvantage US companies globally—would make a great deal of sense for the United States.

YET AN OLD IDEA

Ignoring the economic record and tax practice elsewhere, the US Congress has a long history of penalizing corporate size through higher tax rates. As early as 1909, Congress taxed corporate income in excess of \$5,000 at a rate of 1 percent, but exempted the first \$5,000. When the Internal Revenue Code of 1936 was enacted, discrimination became serious: That law taxed the first \$2,000 of corporate income at 8 percent, escalating to 15 percent for income in excess of \$40,000. Today, the federal rates escalate from 15 percent on the first \$50,000 of corporate income, to 35 percent for income in excess of \$10 million. Average effective tax rates—the rate which companies actually paid—discriminate even more against large corporations. In 2009, the largest corporations—those with over \$2.5 billion in assets—paid an average of 32.9 percent in income taxes as share of total taxable income, compared with an average 1.1 percent for the smallest firms—those with \$500,000 or less in assets. When global operations are taken into account, the largest corporations accounted for more than three-fourths of corporate tax revenue (table 5).

Escalating rates are only one worrisome feature of tax discrimination against large corporations. After the 16th Amendment was ratified in 1913, Congress exempted sole proprietorships and partnerships from the corporate tax. Income earned by these enterprises was simply merged with the income earned by the proprietor or partner and taxed on his individual return. In technical terms, these enterprises are treated as “pass-through” entities: Their income is passed through to the individual return and taxed only at that level. That was fine in an era when proprietorships and partnerships were truly small ventures: the famed family farm, the five-man legal or medical practice, and the local hardware store. Over the last forty years, however, the small partnership has been extended beyond recognition to cover an array of enterprises, some quite large, yet taxed as pass-through entities. This new generation of enterprises travels under comparatively recent legal forms: the Subchapter S corporation (Sub S), the limited

liability company (LLC), the limited liability partnership (LLP), the master limited partnership (MLP), the real estate investment trust (REIT), the real estate mortgage investment conduit (REMIC), and cooperatives (co-ops). We do not highlight this feature to suggest “rolling back the clock” and taxing pass-through firms as corporations. What we do emphasize is that corporations are subject to two layers of income taxation (business and personal) while competing pass-through firms are only subject to one (personal). Hence a significant tax bias exists against all corporations to begin with, and when large corporations are treated more harshly than other corporations, the discrimination becomes more severe.

In 2007, the US corporate tax base—in other words, taxable corporate profit—was just 13 percent of GDP, compared with the OECD unweighted average (excluding the United States) of 22 percent. However, in the early 2000s, some 82 percent of US business firms were not incorporated enterprises; instead they were pass-through entities (table 6). By comparison, in a sampling of other advanced countries, only around a third of business firms are not incorporated. Moreover, the fraction of US business activity subject to corporate taxation has progressively declined. In 1980, Subchapter S corporations (a promi-

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nent type of pass-through firm) accounted for just 3 percent of business receipts; in 2007 they accounted for 20 percent (table 7). By Peter Merrill’s (2007) reckoning, in 1987, business entities that were subject only to pass-through taxation accounted for 29 percent of total business income; however, by 2007, they claimed around 52 percent of total business income.² Thus, when critics argue that corporate income taxes today account for a lower share of US tax revenue than in prior years, and a lower share of GDP than in some foreign countries, they are comparing apples and oranges—such comparisons ignore the growing role of pass-through firms which are not taxed as corporations; they also ignore the greater prominence of pass-through firms in the United States than abroad. Comparisons of this nature simply cannot be used to support the contention that corporate America is undertaxed.

2. See Merrill (2007), page 3 for data though 2004. Merrill provided updated data to the authors.

Table 5 Corporate tax revenue by firm size, 2008 (billion dollars)

Firm size by total assets	Net income ^a	Income subject to tax ^b	United States income tax paid	Foreign income tax paid ^c	Worldwide income tax paid	Percent			
						Share of total net income	Share of total United States income tax revenue	Average effective tax rate ^d	Share of total worldwide income tax revenue
Under \$500K	122.1	7.4	1.4	0.0	1.4	6.8	0.4	1.1	0.3
\$500K–\$1M	32.4	3.7	0.9	0.0	0.9	1.8	0.3	2.8	0.2
\$1M–\$5M	80.2	12.7	3.8	0.0	3.8	4.4	1.1	4.8	0.9
\$5M–\$10M	36.4	7.7	2.6	0.0	2.6	2.0	0.8	7.2	0.6
\$10M–\$25M	48.5	11.8	3.9	0.1	4.0	2.7	1.2	8.2	0.9
\$25M–\$50M	35.8	10.3	3.5	0.1	3.6	2.0	1.0	10.1	0.8
\$50M–\$100M	35.4	12.6	4.3	0.2	4.5	2.0	1.3	12.8	1.0
\$100M–\$250M	56.9	23.5	8.2	0.6	8.8	3.1	2.4	15.4	2.0
\$250M–\$500M	61.4	31.6	11.0	1.4	12.4	3.4	3.3	20.2	2.8
\$500M–\$2.5B	229.3	118.5	41.3	5.6	46.9	12.7	12.3	20.5	10.8
Over \$2.5B	1,035.8	717.7	251.0	90.0	341.0	57.3	74.6	32.9	78.3
Total	1,806.8	971.1	336.7	98.8	435.5	100.0	100.0	24.1	100.0

a. Net income is the net profit or loss from taxable sources of income reduced by allowable deductions.

b. Differs from net income primarily by "Statutory Special Deductions."

c. Foreign tax paid is based on the foreign tax credit claimed by firms in their US corporate tax returns.

d. Amount of worldwide income tax paid as a percentage of net income.

Source: IRS Corporate Tax Statistics.

Table 6 Incorporated firms as a share of total firms in selected OECD countries (percent of total business firms)

	Incorporated firms (percent of total)
Australia	36.4
Germany	30.2
Italy	20.5
Japan	49.8
Spain	42.3
Sweden	30.9
United Kingdom	23.9
United States	18.0
Unweighted average of sample countries, excluding the United States	33.4

OECD = Organization for Economic Cooperation and Development

Note: Year of data for each country ranges from 2003 to 2006. For details please refer to table 3 in the OECD study.

Source: Survey on the Taxation of Small and Medium-sized Enterprises, OECD (2007).

REASONS FOR TAX DISCRIMINATION

At least four enduring but ill-informed reasons explain why encrusted lumps of tax discrimination find their way into the tax code and persist for decades, despite the harm they visit on the US economy.

Tax That Fellow Behind the Tree

One explanation tracks Senator Russell B. Long's famous aphorism about the political forces which drive tax legislation: "Don't tax you, don't tax me, tax that fellow behind the tree." In the eyes of many Congressmen, large corporations that do business on a global scale are well hidden behind the tree. Americans and their representatives in Congress have long entertained the notion that a corporate check paid to the US Treasury means "somebody else" pays the tax, conveniently forgetting that the money has to come from someplace—higher prices (from consumer pockets), lower wages (fewer jobs, reduced salaries), less investment (both R&D and physical equipment), or smaller dividends (hurting pensions and universities, not just John Q. Moneybags). This last source is not the largest target. On average, the ten S&P 500 companies that paid the highest dividends in 2010 distributed

Table 7 US business activity by corporate form (percent of business receipts)

Form of business	1980	1990	2000	2007
Subchapter C Corporations	86.2	74.7	68.0	62.1
Subchapter S Corporations (pass-through)	3.2	14.3	17.2	20.3

Sources: SOI Tax Statistics, Integrated Business Data, International Revenue Services, 2010.

less than 5 percent of total corporate revenues to shareholders.³ Moreover, pension plans typically have significant holdings in large corporations. For example, the Missouri and Ohio state-employee public pension plans held 4.8 percent and 4.4 percent of their assets in oil and natural gas firms, respectively. In both states, these holdings accounted for over a tenth of their annual returns between 2005 and 2009 (Shapiro and Pham 2011).

Tax the Rich

Another explanation springs from the fallacy that imposing an extra tax burden on large corporations is a fine way of extracting money from the pocket of John Q. Moneybags, namely the richest one percent of Americans. This fallacy ignores three facts: First, as mentioned, dividends paid by large corporations typically account for less than 5 percent of their annual revenue stream; second, more than half of dividends paid by these corporations go to shareholders with adjusted annual incomes of less than \$250,000;⁴ and third, the ownership of small firms (whether partnerships or corporations) is typically far more concentrated than the ownership of large corporations (John Q. Moneybags looms largest in the ownership profile of small firms).

Populism

A third explanation draws upon the populist strand in American history. Populism dates back to President Andrew Jackson if not earlier, but a more recent expression was the “Cross of Gold” speech delivered by William Jennings Bryan at the Democratic convention of 1896, where he denounced the moneyed interests of New York and London. That strand was spun into a whole length of yarn by Franklin Delano Roosevelt during the Great Depression. Among many memorable statements, Roosevelt declared, “Organized money hates me—and I welcome their hatred!” Populist spirits spring to life in hard times, but their expression differs from one era to the next. Today, when the United States faces high unem-

ployment, these spirits are erupting in anti-globalization, anti-outsourcing, and anti-MNC sentiments.⁵

Ability to Pay

Possibly the most enduring rationale for imposing higher tax rates on large corporations is the argument that they have a greater “ability to pay.” As the law is now written, the largest corporations (those with assets of \$2.5 billion or more) pay about three-fourths of US corporate income taxes, even though they account for just 57 percent of corporate net income (see table 5). The ability to pay rationale contains three misleading ingredients. First, it confuses corporations with individuals. Someone who earns \$500,000 has a greater ability to pay than someone who earns \$50,000, and it seems fair for the richer person to pay a larger *share* of his income in taxes. The same argument does not apply to firms. The size of the firm says nothing about the size of individual ownership shares, nor does it correlate with the annual income of the individual owners. Second, when ability to pay is translated into tax laws that penalize size, a sure result is that capital and brains will migrate to alternative ownership structures, exacting an efficiency cost on the economy. Third, even in an age of globalization, rather few rich individuals surrender their citizenship to escape higher individual income taxes; but in this age, many goods and services can be produced in friendlier tax jurisdictions when the IRS claims a bigger share of income from larger US firms.⁶

3. Based on calculations by the authors from Annual 10K SEC filings.

4. Internal Revenue Service, SOI Tax Stats—Individual Income Tax Return (Form 1040) Statistics, Table 4.1, www.irs.gov (accessed on August 17, 2011).

5. In a speech promoting *The American Jobs Act*, President Obama recently declared, “Do we keep tax loopholes for oil companies—or do we put teachers back to work?” This rhetoric implies that the administration’s plan will raise \$35 billion for “teachers and first responders” by taxing oil and gas companies. See *The American Jobs Act*, page 6, available at www.americanjobsact.com.

6. Arthur Laffer and Stephen Moore (2009) find substantial evidence that rich Americans move within the United States to states with lower income and estate taxes. See an op-ed in the *Wall Street Journal*, available at <http://online.wsj.com/>, which discusses their book, available at www.alec.org. However, only a tiny number of Americans shed their citizenship each year to escape the IRS.

CONTEMPORARY THREATS OF TAX DISCRIMINATION

Tax discrimination *in favor of* “small business” (recognizing that some pass-through firms are giant enterprises) has been a gradually expanding feature of the Internal Revenue Code. More recent, and more troubling, are proposals that translate into tax discrimination *against* large corporations.

Higher Taxes on MNCs

Conspicuous are the Obama Administration’s repeated calls to tax the income earned abroad by US-based MNCs more heavily, despite the fact that corporate tax systems elsewhere follow the norm of territorial taxation—meaning rules that tax corporate profits earned at home but not corporate profits earned abroad. Japan and the United Kingdom were the latest countries to join the “territorial tax club” (table 8). The United States remains the major exception, to its disadvantage as a global competitor. Mexico, Ireland, Israel, and Korea are the only other OECD countries not in the territorial club (Hufbauer and Wong 2011).

Yet, if he has his way, President Obama would put even more distance between the US tax system and the territorial club, and impose sharply higher taxes on the largest US corporations. In his first budget blueprint,⁷ released in February 2009 for fiscal year 2010, President Obama proposed to deliver on a campaign promise: “When I am President, I will end the tax giveaways to companies that ship our jobs overseas, and I will put the money in the pockets of working Americans, and seniors, and homeowners who deserve a break.”⁸ The FY2010 budget laid down a marker that sharply divided the Obama administration from nearly all CEOs of US-based MNCs. Obama’s “reforms,” estimated to raise \$210 billion in tax revenues over 10 years (from 2010 to 2019), include curbs on the foreign tax credit, repeal of other tax credits (e.g., the enhanced oil recovery credit), and higher taxes (e.g., an excise tax on Gulf of Mexico oil and gas).

Although this agenda gained no traction in Congress, in his next budget blueprint, released in February 2010 for FY2011, Obama pursued similar themes, though on a smaller scale. And again, in his budget message, for FY2012, the

7. A New Era of Responsibility, Renewing America’s Promise, Budget of the United States Government, Fiscal Year 2010, www.gpoaccess.gov (accessed on December 8, 2010).

8. Remarks of Senator Barack Obama, “A Change We Can Believe In,” Spartanburg, SC, November 3, 2007, www.barackobama.com (accessed on February 15, 2011).

president called for around \$129 billion (over 10 years) from higher taxes on profits earned abroad.⁹

More recently, President Obama’s “Plan for Economic Growth and Deficit Reduction”, released in September 2011, would repeal the Last-In-First-Out (LIFO) method of accounting for inventory cost, thereby raising \$52 billion over 10 years on the back of anticipated inflation. The Plan would also reinstate the Superfund tax, even though that tax bears little connection to the true sources of environmental damage, raising another \$19 billion over 10 years. Both measures are squarely targeted at large corporations.¹⁰

Higher Taxes on “Big Oil”

“Big oil” is often a favorite target of tax discrimination. In the most recent saga, Senators Robert Menendez (D-NJ) and Charles Schumer (D-NY), along with several co-sponsors, introduced a revised version of their Close Big Oil Tax Loopholes Act in May 2011 (first introduced in February 2011 as S. 258). The title and text of the bill make certain that higher taxes will be visited on just five firms (the “majors”): BP, Conoco-Phillips, Chevron, Royal Dutch Shell, and Exxon-Mobil.¹¹ How will higher taxes be achieved? In four ways:¹²

- By disadvantaging US “majors” compared to their foreign-based competitors through higher US taxes when the majors extract petroleum abroad (the Middle East, Africa, etc.). Nearly all foreign-based competitors are either headquartered in countries that practice territorial taxation, meaning they do not tax income earned abroad, or are state-owned

9. For details, see Hufbauer and Wong (2011). Almost since its inception, the US Internal Revenue Code has taxed US corporations on their worldwide income but allows a credit for foreign corporate taxes and defers US taxation until profits are repatriated to the United States as dividends. If, as the Obama team has proposed, US taxes were collected in the year profits are earned abroad rather than the year when they are repatriated, the result would be a sharp increase in the effective tax rate paid by US-based MNCs on their worldwide income. Also, see Hufbauer and Assa (2007).

10. See President Obama’s recent budget proposals, *Living Within Our Means and Investing in the Future: The President’s Plan for Economic Growth and Deficit Reduction* (September 2011), available at www.whitehouse.gov.

11. These are “major integrated oil companies,” as defined in IRC Section 167(h)(5)(b), namely firms that produce worldwide over 500,000 barrels of oil a day and, in 2005, had gross receipts exceeding \$1 billion. The provisions attacked in the Menendez bill are often called tax preferences or loopholes. However these provisions are available to other industries and generally on better terms, so that the oil and gas industry, and particularly the major oil and gas taxpayers, already receive less favorable tax treatment than the tax treatment generally available to others.

12. Many of these provisions were outlined in the Obama Administration’s 2012 budget, but for all oil and gas firms, not just the majors. In an effort to secure more Congressional support, Senators Menendez and Schumer would limit their application to the majors.

Table 8 OECD home country method of taxing foreign-source dividends

Taxation method	Countries	Dividend exemption percentage	Statutory tax rate ^d
Countries with territorial tax systems (exempting foreign-source dividends from domestic taxation)^a	Australia	100	
	Austria	100	
	Belgium	95	
	Canada	100	
	Czech Republic	100	
	Denmark	100	
	Finland	100	
	France ^c	95	
	Germany	95	
	Greece	100	
	Hungary	100	
	Iceland	100	
	Italy	95	
	Japan	95	
	Luxembourg	100	
	Netherlands	100	
	New Zealand	100	
	Norway	97	
	Portugal	100	
	Slovak Republic	100	
Slovenia	95		
Spain	100		
Sweden	100		
Switzerland ^b	100		
Turkey	100		
United Kingdom	100		
Countries with worldwide tax systems, and foreign tax credits	Chile	0	17.0
	Ireland	0	12.5
	Israel	0	25.0
	Korea	0	21.2
	Mexico	0	30.0
	Poland	0	19.0
	United States	0	39.2

OECD = Organization for Economic Cooperation and Development

a. In general, territorial tax treatment dividends depends on qualifying criteria (e.g., minimum ownership level, minimum holding period in the source country, and/or the source country tax rate).

b. The effective exemption may be reduced by up to 5 percent as a proxy for general and administrative expenses.

c. The exemption percentage is at least 95 percent, but can be higher.

d. Refers to general applicable tax rate, including surcharges, of combined central and subcentral government taxes.

Sources: Country tax rates are from OECD, OECD Tax Database, "Roadmap for Growth", Business Roundtable, 2010.

enterprises which are highly protected and supported. By contrast, the United States taxes foreign income, but allows a credit for foreign taxes paid. Under the Menendez-Schumer proposal, the method of calculation would reduce the credit and thereby increase the US tax bill. Over a period of years, the higher tax burden would diminish the role of US majors in the world energy picture, giving a distinct advantage to competitors such as PetroChina (China), Lukoil (Russia), Petronas (Malaysia), Total (France), and a flock of national oil companies based in the Middle East. Ironically, this provision would do little harm to BP and Shell, which are based outside the United States, and would actually provide them with a competitive advantage over the other three (Chevron, ConocoPhillips, and ExxonMobil) which are headquartered in the United States. Whatever one thinks about energy independence and global warming, weakening the US-based majors makes no sense.

- By raising the statutory tax rate by 2 percentage points on the domestic manufacturing income earned by the majors. This would be accomplished by denying majors the benefit of a deduction available to all companies that earn income from "domestic production activities"¹³ The majors are heavily engaged in both oil and gas production and in "manufacturing," principally the refining of crude petroleum. When the "manufacturing deduction" was first enacted in the American Jobs Creation Act of 2004, all qualifying activities got the benefit of a deduction roughly equal to a 3 percentage point cut in the statutory tax rate (from 35 percent to 32 percent), phased in over several years, but in 2008, the oil and gas industry was limited to a 2 percentage point cut.¹⁴ The Menendez-Schumer bill would compound this history of tax discrimination by denying the deduction altogether, but just for the "Big Five."¹⁵
- By repealing the provision that allows majors to claim partial expensing of intangible drilling costs (IDC). The Code currently allows 100 percent expensing of IDC by "independent" oil firms, but only 70 percent by "inte-

grated" firms—in other words, firms engaged in production plus refining and/or marketing (this limit was enacted in stages between 1982 and 1986; it applies both to integrated oil and gas firms and to other integrated mining firms). Intangible drilling costs for oil companies are the functional equivalent of research and development costs for manufacturing firms. In both cases the arguments for immediate deduction (expensing) are similar: to encourage R&D and IDC both because of spillover benefits to other firms,¹⁶ and because the useful life of research findings, or oil exploration, is hard to determine. Further, in the oil and gas industry, there is no "tangible" asset created by the drilling of the well—nothing with any "salvage value." Ignoring these arguments and clear parallels to other natural resource industries, the Menendez-Schumer bill would require the Big Five to capitalize all IDC, and deduct the costs over the life of the oil field, though independents could still expense 100 percent of IDC and all other integrated firms could continue to expense 70 percent of such costs.

- By eliminating percentage depletion for oil and gas production by the Big Five and by eliminating the immediate deduction (expensing) of substances used in tertiary injection by the majors. Percentage depletion was effectively eliminated in 1975 for the majors, so formal elimination in the Menendez-Schumer bill amounts to symbolic discrimination. Eliminating the immediate deduction (expensing) of substances used in tertiary recovery, however, is another matter. Some 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. Under the Menendez-Schumer bill, expensing of the carbon dioxide (and other injectants) would no longer be permitted.¹⁷

The Menendez bill focuses these tax law changes on the Big Five, and is calculated to raise about \$21 billion over 10 years. The Obama budget proposal does not single out the Big Five, but it would discriminate against all US oil and gas companies by comparison with other industries, raising about \$36 billion over 10 years.¹⁸ According to estimates of the American Petroleum Institute—a trade association repre-

13. Section 199 of the Internal Revenue Code, often called the "manufacturing deduction," is actually applicable to all production, extraction, manufacturing, and farming activities, and further includes software and film production, architectural and engineering services, and construction activities. See IRC Section 199 (c)(4).

14. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343).

15. Just to illustrate the nature of this last example of tax discrimination, three of the top five natural gas producers in the United States would continue to receive this deduction, while the other two would not. Two of the top five refiners would receive the benefit, while the other three would not. Foreign-based companies operating in the Gulf other than Shell and BP, such as companies based in Brazil, Italy, Norway, Australia, and China, would receive the benefit on their US income, but US-based companies would not.

16. The most recent advances in shale gas exploration and development are clear examples of such spillover effects.

17. The Obama Administration's 2012 budget would also lengthen the amortization period for geological and geophysical studies (G&G). This provision was not embraced in the Menendez-Schumer bill since major integrated oil companies are already required to capitalize and amortize their G&G costs over seven years under IRC Section 167 (h).

18. Estimated from the Obama Administration's 2012 budget.

senting the industry—these provisions applied to oil and gas companies could put nearly 60,000 jobs at risk in the year of implementation, and more later, as firms cut back exploration and production in the United States. Moreover, the provisions could discourage the majors from a deep dive into the high-tech extraction of natural gas from shale, since the discriminatory tax changes would equally apply to that activity.

Not only do these provisions discriminate against the majors by comparison with smaller US oil and gas firms, they also discriminate against US-based firms by comparison with many foreign-based firms doing business in the United States and competing in the same geologic basin. Many foreign-based firms are not defined as “major integrated oil companies” and therefore would escape the penalties of the Menendez-Schumer bill. To take a leading example, within the Gulf of Mexico, about 90 oil and gas companies operate, and of these more than a quarter are foreign-based. Yet the Menendez-Schumer provisions would discriminate only against the five large majors, three of which are headquartered in the United States.

Penalizing “Dual Capacity” Companies

US-based “majors” and hard mineral companies face an additional attack—this time from the Obama Administration, but very similar to the attack directed against the Big Five in the Menendez bill. As a general practice, private oil companies pay royalties for the right to extract oil and gas and they also pay corporate income taxes on their earnings.¹⁹ The same description applies to many hard mineral companies, for example, copper and gold mining firms. Oil and hard minerals are often located in formations owned by sovereign governments—either under the land (as in the Middle East and Russia) or offshore (as in the North Sea and off the coast of Africa). Consequently, these firms are known as “Dual Capacity” taxpayers because they make payments to the foreign host government in two capacities: They pay both royalties for the right to extract government-owned resources and they pay income taxes on their profits from extraction and sale.

The United States allows a foreign tax credit (FTC) to avoid double taxation when a US company does business abroad. Otherwise the firm would be taxed on the same income both by the foreign country and by the United States, under the US system of worldwide taxation. The FTC is designed to offset the US corporate tax liability by the amount of corporate taxes

paid to the foreign country. Without the FTC, it would be impossible for US companies to do business abroad, since the combination of US and foreign corporate taxes would often claim 70 percent or more of corporate earnings.

In short, the FTC is a foundation stone of globalization. Without the FTC, few if any US firms could expand to become multinational corporations unless the United States joined the great majority of countries and adopted a system of territorial taxation rather than worldwide taxation. However, like any provision in the tax code, the FTC is subject to abuse. Forty years ago, the Treasury became concerned that some foreign countries might “go easy” on royalty payments, but “jack up” corporate tax payments, so that US-based MNCs could claim a foreign tax credit for payments which really amount to a business expense, namely a deduction for royalties. After extensive deliberation, the Treasury issued the “Dual Capacity” regulations designed to distinguish between foreign income taxes (credited against US income tax) and foreign royalties (deducted as a business expense). Under the regulations, the taxpayer has a choice between two methods for calculating its foreign tax credit. If the foreign corporate tax on oil or mineral income exceeds the general corporate tax rate in that country, the Dual Capacity taxpayer can claim the FTC for an amount that equals the general corporate income tax rate times the relevant income. This is the safe harbor method. Alternatively, if the Dual Capacity taxpayer can affirmatively demonstrate—and prove in court when challenged by the IRS—that the individual facts and circumstances establish that the corporate income tax applied to oil or mineral income does not contain a disguised royalty, then the taxpayer can claim the actual tax paid as an FTC. This is the facts and circumstances method. If the Dual Capacity taxpayer elects the facts and circumstances route, but fails to establish its case, then the IRS would argue that none of the payment can be claimed as a foreign tax credit—instead the entire payment should be characterized as a royalty and deducted, along with other business expenses, in calculating corporate earnings subject to US taxation.

The Dual Capacity regulations have served the Treasury and US-based MNCs well since they were implemented in 1983. But to squeeze more revenue, the Administration has proposed a new approach. Whenever the foreign corporate tax rate on oil or mineral income exceeds the general corporate tax rate in the country, the entire difference would be automatically characterized as a royalty—thereby depriving the firm of a portion of its foreign tax credit—whatever the facts and circumstances. Under current law, in order to claim the extra credit, the taxpayer bears the full burden of proof. Under the proposed rule, the taxpayer is denied the credit, regardless of the circumstances. To be sure, the proposed rule would raise additional tax revenue (estimated

19. Current law is often mischaracterized by its proponents as “allowing” a tax credit for a payment that is not a tax, but instead a royalty. As the explanation in our text shows, the current IRS rules explicitly prohibit such a result, but that has not stopped the mischaracterization.

at \$4.5 billion between 2012 and 2016), but at the cost of new discrimination against US oil and hard mineral firms.²⁰

The proposed rule assumes that any excess in the oil or hard mineral tax rate over the general tax rate amounts to a disguised royalty (Aldonas, Jenn, and Olson 2010). This is a false assumption. There are good reasons why some countries, such as Norway and the United Kingdom, tax oil and hard mineral income at higher rates than other types of income. The firms are often big and profitable; just as the forces of US political economy impose discriminatory taxes on big and profitable corporations, so the forces of political economy abroad may demand a higher tax rate. Such discrimination is no more commendable abroad than in the United States, but it's a fact of political life. Second, some countries, such as the Gulf States and Chile, may use tax policy as a tool to diversify their economy. Hence a low general corporate tax rate on service and manufacturing firms, may be coupled with a high rate on resource firms. In fact, the state of Alaska follows just this policy.

Apart from ignoring the true reasons for high taxation of resource income—reasons which have nothing to do with disguised royalties—the proposed rule is oblivious to the realities of international competition. State-owned oil giants—such as PetroChina, Petrobras, Saudi Aramco, and Gazprom—enjoy preferential access to resources in their home countries. For these firms, corporate taxation is simply not an issue, and it is not surprising that they have crowded out private resource firms over the past thirty years. But even leaving aside state-owned competitors, with few if any exceptions, private competitors of US firms are simply not taxed by their home countries on oil or mineral income earned abroad. Looking at the fifty largest oil firms in the world, the only private companies subject to worldwide corporate income taxation are American.²¹ Non-American private firms—such as BP (United Kingdom), Shell (Netherlands), Total (France), ENI (Italy), and Repsol YPF (Spain)—are based in countries that follow the principle of territorial taxation. Foreign income is generally not taxed by the home country; hence there are few if any foreign tax credits, and Dual Capacity issues do not arise.

CONCLUSION

The United States is a high-tax country for large corporations trying to do business. Statutory and average effective US corporate rates remain among the highest in OECD countries and far

20. See the Obama Administration's 2012 budget, page 185.

21. Chinese and Russian state-owned oil enterprises do pay taxes on their income earned abroad, but at rates significantly lower than the US corporate tax rate. Moreover they enjoy other advantages from their close relations to the state.

exceed rates in China (table 1).²² But the fact of high rates will not prevent the United States from becoming a still higher tax country when fiscal deficits are finally addressed by the president and Congress. "Ability to pay" and similar populist arguments for raising corporate taxes will surely be rolled out in the context of deliberations in the new Super Committee negotiations and subsequent ratification debate in Congress, scheduled for December 2011.²³ The balance between spending cuts and tax hikes remains to be determined, but it seems unlikely that higher taxes will be completely off the table. And once taxes are on the table, it seems likely that some voices will urge higher taxes on large corporations. Higher taxes can take different forms. An outright increase in the statutory tax rate seems unlikely since there is talk on both sides of the political aisle of cutting the corporate rate from 35 percent to 25 percent. However there is also talk—especially in the US Treasury and the Democratic side of the aisle—of eliminating a wide range of corporate deductions without a dollar equivalent reduction in the corporate tax rate.²⁴

The Congress and President Obama should ignore the voices calling for higher taxation of large corporations. These companies already pay tax rates that are too high, both by national and international standards, and the result is to drive business activity and jobs to other countries. Other solutions can provide better results. The Administration has already shown that it can answer populist calls for higher taxes on rich Americans by espousing the Buffett Rule: No millionaire or billionaire should pay federal income taxes at a lower effective rate than middle class Americans.²⁵ But even if enacted, the Buffet Rule would make a very small dent in the America's fiscal deficit. To make serious progress towards fiscal balance, while at the same time encouraging private business to expand production, boost exports and create jobs, the United States should

22. Effective tax rates are defined as taxes paid (at the margin, or in total) divided by corporate income consistently defined (again, at the margin or in total).

23. The committee was created as part of the 2011 debt-limit negotiations which concluded with legislation specifying \$900 billion in spending cuts over the next decade and the creation of a select Congressional committee which will recommend another \$1.5 trillion of deficit reduction over the decade, subject to an up or down Congressional vote by December 2011. The following Senators and Representatives were named by Congressional leaders to the Joint Select Committee on Deficit Reduction: Sen. Patty Murray (D-WA), Sen. Max Baucus (D-MT), Sen. John Kerry (D-MA), Rep. Jim Clyburn (D-SC), Rep. Chris Van Hollen (D-MD), Rep. Xavier Becerra (D-CA), Sen. Jon Kyl (R-AZ), Sen. Pat Toomey (R-PA), Sen. Rob Portman (R-OH), Rep. Jeb Hensarling (R-TX), Rep. Dave Camp (R-MI), and Rep. Fred Upton (R-MI).

24. See, for example, the section starting on p. 49 in President Obama's recent budget proposals, *Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction*, available at www.whitehouse.gov.

25. Warren Buffett, "Stop Coddling the Super-Rich," *The New York Times*, August 14, 2011.

adopt a national consumption tax and, at the same time, slash corporate tax rates. The United States is one of the very few countries in the world which does not use this form of taxation, much to its disadvantage as a place to do business.²⁶

Whatever is done, the Congress should eliminate and reject the sorts of discriminatory provisions and proposals highlighted in this Policy Brief. Since the Great Recession erupted in 2008, considerable alarm has been voiced over the rise of China. Some authors even foresee the “eclipse” of US economic power within a decade (Subramanian 2011). Whatever the merits of these forecasts, it makes no sense for the United States to erode its leadership position in the world economy by discriminating against the largest US-based corporations, thereby encouraging them to seek more favorable business climates abroad.

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26. See, for example, Hufbauer and Grieco (2005) and Hufbauer and Wong (2011).

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