COMMENT: A fairer tax deal for all America's companies

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While economists and pundits debate the economic effects of the tax cut President George W. Bush signed into law in May, new corporate tax cut bills have begun to surface in the US Congress. The likelihood of a further cut in corporate tax is high but what form would it - or should it - take? The bills in Congress are answers; but what is the question?

At 35 per cent, the US corporate tax rate is surpassed only by that of Japan's among leading industrialized nations. For US multinationals, the story is particularly bleak. Double taxation of US companies' overseas operations raises the cost of capital, damping investment in economic activity at home and reducing the competitiveness of US companies' exports.

This is where the new tax cut bills come in. Discussion centers on international tax policy because the US needs to replace US export subsidies judged illegal by the World Trade Organization. But this necessary change offers an opportunity to tackle wider problems in corporate taxation.

In the US Congress, we are at a fork in the road. On the one hand, a recent bill sponsored by Phil Crane and Charles Rangel would try to replicate the status quo with special-interest tax laws. The bill proposes a reduction in corporate tax for domestic manufacturing operations but seeks to recover the cut from foreign manufacturing activities. Such a proposal pits manu-facturing companies against non-manufacturing companies and suggests US companies producing overseas are damaging American growth and jobs.

On the other hand, Bill Thomas, (and, separately, Senator Orrin Hatch) have put forward a tax change that would improve the competitiveness of American companies by reducing double taxation and expanding incentives for business investment - the weak spot in the economy's recovery.

The Crane-Rangel bill's approach to tax policy is flawed because it does not deal with the problem of increased cost of capital and ignores the contribution of US multinationals to the US economy. Each business decision taken by a multinational - including how much to invest and where - is influenced by tax policy, particularly how income from foreign investment is taxed.

The starting-point for multinationals' investment in foreign countries is the same as for investment at home: profitability. Indeed, each dollar of foreign direct investment by US companies, in present value, generates 70 per cent more interest and dividend receipts and US tax revenues than the equivalent dollar of domestic investment.

But the US approach to international taxation dates from the 1960s, when US companies provided half of all foreign direct investment, produced about 40 per cent of the world's output and made the US the largest capital exporter in the world. The US is now the largest *im*porter of capital and no longer dominates foreign markets.

If US businesses are to succeed in the global economy, the US tax system must not hamper their ability to compete against foreign-based companies - especially in foreign markets.

At the moment, however, the tax system contains a bias against US-based multinationals because it differs in several important respects from the system operated by most of America's trading partners. While about half the leading industrial countries do not tax the active income earned by a foreign subsidiary, the US taxes all income earned through a foreign company. The US also places greater restrictions on the use of foreign tax credits, leading to double taxation of international income. The Thomas bill tackles these problems directly. It also avoids the prospect of European Union retaliation - which could provoke a trade war at a time when prospects for a global economic recovery are cloudy.

As for the question of how to help individuals losing jobs in US manufacturing, that could be dealt with by incorporating into the tax cut bills the personal re-employment accounts - proposed by Mr Bush earlier this year - that would provide substantial support for new training and benefits.

The Crane-Rangel approach is the sort of special interest tax policy that breeds cynicism about the tax code and promotes the interests of lobbyists over economic growth. The Thomas bill, on the other hand, represents sound international tax policy and increases the chance of a broad tax reform that could make all of us better off.

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