A Taxing Problem
How to Fix the U.S. Corporate Tax Code

American policymakers have adopted a host of measures to combat the economic malaise of the past few years, from fiscal stimulus and extremely loose monetary policy to tighter regulation of banks and other companies in the financial services sector. The results have been mixed at best: GDP growth totaled only about 2 percent in 2012, and unemployment remains stubbornly high. Economic pessimists now question whether the U.S. will ever return to the level of growth and global competitiveness it enjoyed for most of the 20th century.

One fix that hasn’t been tried is an overhaul of the U.S. corporate tax code. Despite huge changes in the global economy over the past few decades, American businesses operate under a tax regime that is essentially the same as it was in 1993.

Harvard University professor Mihir Desai argues that reforming the corporate tax system is “perhaps the most obvious and least painful” way to restore America’s competitive position and improve the living standards of ordinary people. A combination of lower corporate rates and a broader base of corporate taxpayers, Desai maintains, will benefit the public and private sectors alike.

OUTLOOK recently interviewed Desai about his ideas and the negative impact the current tax system is having on American industry and the broader U.S. economy.

OUTLOOK: Describe the basic elements of U.S. corporate tax structure.

Mihir Desai: One of the most notable things about the corporate tax structure is that it applies only to what are known as “C” corporations – businesses whose profits are taxed separately from their owners. As a result, over the past two decades we’ve seen the rise of pass-through entities that effectively pay no corporate tax, such as limited liability corporations and “S” corporations. Today, the corporate tax is primarily being paid by large, publicly owned, multinational companies.
“In the early 1990s, the U.S. would have been solidly in the lower end of the middle of the pack in terms of global corporate tax rates. Today we stand out as having one of the higher statutory rates in the world.

Most large U.S. companies pay a 35-percent marginal tax rate. That rate has changed very little over the past two decades. Meanwhile, in the rest of the world, corporate rates have fallen quite dramatically. In the early 1990s, the U.S. would have been solidly in the lower end of the middle of the pack in terms of global corporate tax rates. Today we stand out as having one of the higher statutory rates in the world.

**OUTLOOK: How else does our structure differ from those in competing nations?**

**MD:** We tax corporate income no matter where it is earned. So if you are a company earning money abroad, you have to pay taxes there and then you have to pay taxes in the United States when you repatriate that income back to this country, with credits earned for taxes paid overseas. If you keep the money abroad, you are basically able to defer the U.S. tax obligation.

The rest of our trading partners have moved away from a “worldwide system” of taxation of foreign income to what is called a “territorial system,” where you only tax income earned in your own territory. We really have not kept up with global developments.

**OUTLOOK: What problems does our current system create?**

**MD:** Our current system is the worst of all worlds. We have a high statutory marginal rate but a relatively narrow base of corporate taxpayers. High rates divert investment out of the U.S. corporate sector into foreign countries and into non-corporate sectors that don’t pay taxes. Incentives for investment are really distorted.

Despite political rhetoric to the contrary, the American worker is the one most hurt by this dynamic. American workers need capital to become more productive. When capital is invested elsewhere, real wages decline,

In addition, we’re not getting as much revenue from corporate taxes as we’d like in the public sector.

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**About this article**

Mihir A. Desai is the Mizuho Financial Group Professor of Finance and Senior Associate Dean for Planning and University Affairs at Harvard Business School. He is also a professor of Law at Harvard Law School. He received his doctorate in political economy from Harvard; his MBA as a Baker Scholar from Harvard Business School; and a bachelor’s degree in history and economics from Brown University.

Mr. Desai’s areas of expertise include tax policy, international finance, and corporate finance. His academic publications have appeared in leading economics, finance, and law journals. His research has been cited in *The Economist, BusinessWeek, The New York Times*, and several other publications.
OUTLOOK: What should a well-designed corporate tax code seek to accomplish?

MD: A corporate tax is a hard thing to love because it is borne ultimately by somebody else – by shareholders, workers or consumers. It would almost always be better to tax those people directly rather than through a corporate tax.

That said, there is a case to be made for a well-designed corporate tax that serves as a backstop to a personal income tax. A relatively small corporate tax rate can help to alleviate concerns that people will use the corporate tax system to evade personal taxes.

It also should be in line to some degree with those of our competitor nations or other nations around the world. If our rate is well out of line with the rest of the world then the incentive for companies to move profits around and to make decisions based on the corporate tax becomes larger and larger.

Evolving Global Corporate Tax Rates

*Overall government corporate tax rate, including average state and local taxes

Source: Organization for Economic Co-operations and Development (OECD)
OUTLOOK: So what changes should be made to the tax code?

MD: The first thing we should do is bring our corporate rate down so it is more in line with where the rest of the world is in order to rid ourselves of these perverse incentives. A corporate tax of about 18 percent would bring us much closer to the international average.

Then, we have to reform the international side of the puzzle. That means no longer taxing overseas income and moving to a territorial regime, where we only tax the income earned in our own territory.

Finally, you have to think seriously about a small tax on the pass-through sector – something like 4 or 5 percent – to reduce the effective penalty on C corporations.

Those reforms would advance the integrity of the tax system and ensure that the world’s best global companies want to be headquartered in the United States, rather than flee it.

OUTLOOK: We often hear accusations that our tax code provides “subsidies” for corporations to move jobs overseas. Is that true?

MD: It is a very popular political accusation. And it’s a potent one, too, because in times of economic insecurity and globalization people are happy to create bogeymen regarding the overseas activities of multinational corporations. Because corporations don’t actually have to pay a U.S. tax until they bring the money home, there’s this notion we’ve provided a “subsidy” for them to invest abroad.

But that’s a problematic idea. We shouldn’t really care about equalizing the tax burdens of our corporations around the world. Instead, what we really want is to increase employment at home. And a big piece of that is enabling corporations to invest and grow around the world in the same way they would in the absence of taxes. That’s the underlying idea of an efficient tax policy: Firms and people should behave the same as they would in the absence of taxes. From a corporate tax standpoint, the recipe for that is going to be a territorial tax system.
Our tax system actually makes it less likely for certain corporations to make foreign investments or operate abroad. We should be happy when our companies succeed abroad because they also succeed at home.

**OUTLOOK: Can you give us an example?**

**MD:** Consider the problem for a U.S. corporation competing with, say, a German company that’s operating in Brazil. The German firm will pay the Brazilian tax rate, not the German tax rate. And the U.S. company will have to pay both the Brazilian rate and the U.S. rate if it repatriates money home. So if we say U.S. companies should pay the U.S. tax no matter what, U.S. companies won’t be doing terribly well compared with other companies that are not faced with double taxation.

Our tax system is actually making it less likely for certain corporations to make foreign investments or operate abroad. But we should be happy when our companies succeed abroad because evidence suggests they also succeed at home.

Imagine an extreme case in which we penalized foreign investment or even prohibited foreign investment. What would you see? You would see our corporations not enjoying the growth opportunities available abroad. You would see our corporations not keeping up technologically with what’s going on around the world. And you would see our corporations not accessing customers all around the world. And ultimately you would see those companies shrinking relative to what they would have been otherwise and ultimately shrinking at home, too.
Economic activity is not a zero-sum game. Every activity that you choose to do abroad is not activity that you’ve displaced from home.

**OUTLOOK:** In your academic articles, you cite studies showing that corporations that are successful abroad are more efficient than their purely domestic competitors.

**MD:** Corporations investing abroad tend to be more efficient and more profitable than companies that are purely domestic. And companies that are growing and flourishing abroad are also growing and flourishing domestically. The answer is quite clear: Economic activity is not a zero-sum game. Every activity that you choose to do abroad is not activity that you’ve displaced from home. In fact, the more you do abroad can even lead to more activity at home.

**OUTLOOK:** So companies that invest abroad are not less likely to invest in their operations at home than purely domestic companies?

**MD:** That’s right. But let me be clear, that’s an average statement, and of course there will be exceptions. If a company moves a plant from North Carolina to Mexico, you could say we’ve just lost jobs because of that foreign investment. And in a sense you would be right. That particular decision looks like substitution of jobs abroad for jobs at home. But what we really should be focused on is average effects across all companies. And you at least have to ask yourself what would have happened if they’d all kept production at home. What would have happened to their ability to produce products at globally competitive rates against competitors from all around the world? If the answer is they would have been less competitive, you have to consider how that would have affected their domestic activities, such as research, marketing and other activities that produce great jobs here in the U.S.

Another important misconception is that all foreign activity is purely labor arbitrage – the pursuit of lower wages and thus lower overall costs. A lot of foreign investment is actually motivated by the need for market access and market opportunities. There is just tons of growth around the world and a company has got to be there in some form to access that growth and to allow that growth to filter back and benefit domestic activities. The caricature of labor arbitrage doesn’t bear a lot of resemblance to reality.
The corporate tax as currently structured is a disincentive to investing in the United States.

**OUTLOOK:** Americans have experienced a lackluster manufacturing sector and jobs creation at a time when U.S. corporations have invested heavily abroad and their foreign operations have grown more quickly than their domestic operations. What effect would your corporate tax proposal have on this pattern?

**MD:** The decline of U.S. manufacturing has many causes, including economic growth around the rest of the world. But it's worth remembering that the manufacturing share of GDP around the world has also been shrinking. It's shrinking because of technology and because manufacturing's value added is lower relative to services all around the world. And of course manufacturing's decline is also related to other macro variables such as exchange rates, productivity levels, education levels, all kinds of things.

But having said that, the corporate tax as currently structured is indeed a disincentive to investing in the United States. It is borne largely by workers. Shareholders' capital is mobile; customers are mobile; so the people who end up bearing the corporate tax are the workers. It's going to reduce their real wages, and that's because you have less capital in your country to work with, to be productive with.

The real irony here is that people view the crisis of the American economy today and they say the corporate tax should be higher. If you care about the American worker and you care about rising wages then you want to let the American worker become more productive. You let the American worker become more productive by letting him have more capital to work with and you do that by cutting corporate taxes.

It may be fun politically to bash corporations but that doesn’t align with fundamental reality.
RATES VS. REVENUE
Despite having one of the highest corporate tax rates, the U.S. now collects less in corporate tax revenue, as percentage of GDP, than most of the other OECD nations.

Source: Harvard Business Review

OUTLOOK: In addition to an overhaul of the corporate tax structure, you’ve also argued that business managers must change their attitude and behavior when it comes to corporate taxes. Can you elaborate on that idea?

MD: More than half of American corporations no longer have significant domestic tax obligations, according to the U.S. Government Accountability Office. Yet, ironically, managers have come to embrace corporate social responsibility. Companies tout their constructive role in society and pour resources into social programs while pursuing aggressive strategies. Instead, they should show their commitment to their communities by treating their tax obligations as responsibilities commensurate with, say, abiding by environmental regulations.

Boards of directors and managers could then promote that attitude by ensuring that the performance of tax directors was evaluated on compliance rather than profit maximization. Codes of ethics could prohibit transactions that serve only to reduce tax obligations. In short, any statement of corporate values that declares a company will honor commitments to outside stakeholders – communities, the environment, customers – should also include a commitment to fulfill tax obligations.
**Interest Rates and Economic Indicators**

The interest rate and economic data on this page were updated as of 1/31/13. They are intended to provide rate or cost indications only and are for notional amounts in excess of $5 million except for forward fixed rates.

### Key Economic Indicators

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market’s view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

### Economic and Interest Rate Projections

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<th>Source: Insight Economics, LLC and Blue Chip Economic Indicators</th>
<th>US Treasury Securities</th>
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<tr>
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### Implied Forward Swap Rates

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<th>1-year Swap</th>
<th>3-year Swap</th>
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<td>1.03%</td>
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<td>3.24%</td>
<td>3.42%</td>
<td>3.57%</td>
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### HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

### 3-Month LIBOR

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

### Relation of Interest Rate to Maturity

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

### Treasury Yield Curve

The graph shows the yield curve for various maturities, including 3 months, 6 months, and 1 year. The data is updated as of January 2013.
CoBank Reports 2012 Financial Results

CoBank this month announced fourth-quarter and full-year financial results for 2012. The bank reported net income of $853.9 million for the year, up 21 percent from $706.6 million in 2011. CoBank also reported net income of $153.4 million for the fourth quarter of 2012, an increase of 7 percent as compared to the fourth quarter of 2011.

Net interest income rose 16 percent to $1,238 million for 2012, which reflected a 40 percent increase in average loan volume to $70.3 billion. For the fourth quarter of 2012, net interest income rose 30 percent to $312.9 million. Total loans outstanding at December 31, 2012, were $72.0 billion.

The large increase in average loan volume was driven primarily by CoBank’s merger with U.S. AgBank, which closed on January 1, 2012. Through the merger, the bank acquired U.S. AgBank’s assets and liabilities, including approximately $20 billion in lower-spread, lower-risk wholesale loans to 25 Farm Credit associations. CoBank also experienced higher average loan volume during the year in its Rural Infrastructure operating segment, primarily due to growth in lending to rural electric customers throughout the country, as well as an increase in agricultural export financing due to the growing role of U.S. agriculture in feeding the world. Those increases offset declines in seasonal agribusiness lending that occurred as a result of lower commodity prices in the first half of the year, shifting farmer delivery patterns at grain and farm supply cooperatives, and the strong financial position of agricultural cooperatives and businesses.

“We’re extremely pleased with CoBank’s performance in 2012,” said Robert B. Engel, president and chief executive officer. “Our merger with U.S. AgBank more than lived up to expectations, delivering meaningful and enduring benefits for our business. Despite difficult conditions in the financial markets and the broader U.S. economy, the bank continued to meet the needs of its customers in rural America while building financial strength and flexibility for the long term.”

As previously announced, the bank’s full-year results also included a one-time benefit of $44.6 million for a Farm Credit Insurance Fund refund received in the second quarter of the year, partially offset by losses of $28.5 million in the fourth quarter related to the extinguishment of a portion of the bank’s subordinated debt. The bank also incurred losses on early extinguishments of other debt securities, net of prepayment fees, totaling $37.3 million in 2012, as compared to $25.7 million in 2011.
In March, the bank will distribute $425.0 million in total patronage, including $344.5 million in cash and $80.5 million in common stock. For most customers, that will represent 100 basis points of average qualifying loan volume during the past year, effectively lowering their overall net cost of debt capital from CoBank.

“This year’s record patronage payout includes the 75 percent cash component approved by our board of directors in December,” Engel said. “As a cooperative lender, we’re delighted to be providing our customer-owners with such a significant return, which they can use to invest in the future growth of their own businesses.”

Credit quality in the bank’s loan portfolio improved modestly during 2012 as a result of the merger and the addition of AgBank’s high-quality loans to Farm Credit associations. At year-end, 1.01 percent of the bank’s loans were classified as adverse assets, compared to 1.03 percent at the end of the third quarter of 2012 and 1.25 percent at December 31, 2011. The provision for loan losses totaled $70.0 million in 2012, including $50.0 million in the fourth quarter, largely due to specific credit challenges involving a small number of customers, further assessment of risk associated with individual loan and industry concentrations, as well as continued weakness in the economy. The 2011 provision was $58.0 million. Nonaccrual loans were $170.2 million at December 31, 2012, or 0.24 percent of total loans, compared to $134.9 million, or 0.29 percent of total loans, at year-end 2011.

The bank’s allowance for credit losses totaled $595.1 million at year-end, or 1.87 percent of non-guaranteed loans when loans to Farm Credit associations are excluded. “Our allowance is strong and provides a solid level of protection against losses in our loan portfolio,” said David P. Burlage, CoBank’s chief financial officer.

Capital and liquidity levels at the bank remain well in excess of regulatory minimums. As of December 31, 2012, shareholders’ equity totaled $6.4 billion, and the bank’s permanent capital ratio was 16.1 percent, compared with the 7.0 percent minimum established by the Farm Credit Administration (FCA), the bank’s independent regulator. At year end, the bank held approximately $19.3 billion in cash and investments. The bank averaged 190 days of liquidity during 2012 and had 204 days at year end, compared with the 90-day FCA minimum.
Engel noted that 2012 represented the 13th consecutive year of earnings growth for the bank. “Very few other financial institutions in the world can point to a track record of continuous success as long as CoBank’s,” he said. “We have benefited immensely from the strength of our customer base and the fundamental soundness of the U.S. rural economy.”

At the same time, Engel said the bank faces a number of ongoing challenges, including slow overall economic growth, intensified competition for loans and low interest rates that have significantly decreased returns on invested capital.

“As always, we’re focused on the long-term position of the bank,” Engel said. “While the earnings environment is likely to be less favorable for CoBank in 2013, we are very confident in our ability to continue meeting the needs of our customers, fund our patronage program and fulfill our mission of service to rural America.”
CoBank Announces $5 Million Fund For U.S. Agricultural Research and Education

CoBank announced this month that it has committed $5 million to fund agricultural research and education at land grant universities and other institutions throughout the United States.

The CoBank contribution will support a broad range of programs at more than 30 schools, including academic research, scholarships for students, cooperative education and leadership development.

“We’re pleased to announce the establishment of this new fund,” said Everett Dobrinski, chairman of the CoBank board of directors. “For well over a century, land grant universities and other academic institutions have supported the development of the rural economy, helping U.S. agriculture to become the most productive and innovative in the world. This contribution, which was unanimously approved by our board, will enhance research and education programs at these schools and promote the continued advancement of American agriculture and rural America.”

Recipient institutions were selected based on a wide range of criteria, including the nature and extent of their agricultural programs as well as existing relationships with CoBank, its customers and Farm Credit association partners across the country. A full list of recipient universities is included below:

- Auburn University
- California Polytechnic State University
- Colorado State University
- Cornell University
- Fresno State University
- Illinois State University
- Iowa State University
- Kansas State University
- Montana State University
- New Mexico State University
- North Dakota State University
- Ohio State University
- Oklahoma State University
- Oregon State University
- Purdue University
- South Dakota State University
- Texas A&M University
- Texas Tech University
- University of Alaska
- University of Arizona
- University of California-Davis
- University of Idaho
- University of Illinois
- University of Maine
- University of Minnesota
- University of Missouri
- University of Nebraska
- University of Vermont
- University of Wisconsin
- Utah State University
- Washington State University
Details regarding the gifts to individual universities will be announced over the course of the year as the particulars of each grant are finalized. CoBank is designing each contribution in collaboration with the school as well as customers and Farm Credit associations from the surrounding area.

Bob Engel, CoBank’s president and chief executive officer, noted that support for research and education is an important part of the bank’s broader corporate social responsibility program. “One of the best ways for CoBank to return value to rural America is by giving to academic institutions that are engaged in agricultural research and training the next generation of rural business and civic leaders,” Engel said. “We’re deeply thankful for our board’s generosity and look forward to strengthening our long-term relationships with these great schools.”

The $5 million agricultural university fund follows a significant contribution by CoBank to the University of Colorado last year. In early 2012, the bank announced it would contribute $2.5 million to CU Denver Business School in support of a new center for commodities research and education at the school.