

Remove a Major Incentive to Cheat

IN RECENT months, two corporate stories have dominated the news: Enron and the blow-ups in its wake, and the revelation that a slew of U.S. corporations like Stanley Works are either fleeing our soil to set up abroad or hiding in tax shelters.

In both cases, myriad and complex regulations have been suggested as solutions. But there's a simple answer to soothing all these woes in one fell swoop: Abolish the corporate income tax, lock, stock, and barrel.

The idea isn't as far-fetched as it sounds. Treasury Secretary Paul O'Neill has suggested it before on the grounds that it's simply a bad tax. But Mr. O'Neill's more timid compatriots inside the White House—cringing from anything that might offer fodder for class warfare—quickly disavowed themselves of the suggestion. They shouldn't have: Mr. O'Neill was right.

A brief review: Corporations are not people. Only people ultimately pay taxes. Therefore corporations do not pay the corporate tax. Ralph Nader notwithstanding, the campaign to get big business to pay its "fair share" in taxes has been a fraud perpetrated on the American public. Corporations must pass the costs of a tax onto flesh and blood just like they do with all their costs.

The question of the ultimate incidence of the corporate tax has been a holy grail for public-finance economists, who are not sure who really pays it anyway. But one thing is for sure: It's not just the shareholders. Investors care about after-tax returns, too. If a business has a cost, whether it's in taxes or anything else, investors demand a competitive return on their capital, over and above that cost. The corporate tax either is borne by all capital or it's passed onto labor and consumers, in the forms of higher prices and lower wages, as a kind of wage tax in drag.

It's not completely bad news,



then, that the corporate tax is easily avoided or minimized, especially by large multinational corporations. Corporate income-taxes account for about \$200 billion per year, a large enough number to be sure, but still less than 10% of federal revenues, and there is good evidence that the effective tax rate of major corporations has been dropping.

But bad news persists. Aside from the way this behavior shifts the burden to smaller businesses, it still manages to punish across the board. To the extent that the tax *cannot* be fully avoided, it puts U.S. corporations at a competitive disadvantage: The U.S. has one of the highest nominal corporate-tax rates in the world. And to the extent that the tax is avoided or minimized, there are still market failures and transaction costs brought on by the ways that corporations escape the tax.

The Big Five (soon to be Big Four) accounting firms have long made a killing by peddling complex tax-shelter de-

vices. In a typical arrangement, the accountants get a cut of the tax savings—up to 30%—in exchange both for their ideas and their willingness to assume some of the downside risk, as by indemnifying their clients if the deals don't work out. The huge fees—in the tens of millions of dollars per client per year—that the accountants collect become a principal reason for their conflict of interest on the accounting side.

Auditors are hard pressed to not approve transactions designed by their partners and bringing in big bucks to their own pockets. Rather than regulating the accountants, we should be asking *why there's so much money in them thar hills* in the first place. Killing the corporate tax will take a good deal of the excess profits off the table.

It would do more than that, too, especially in the context of overdue tax reform. The worst sins—complexity, inefficiency, and unfairness—come from Washington's foolish attempt to tax savings,

over and over and over. The personal income tax is designed to double tax savings: first when money is earned, and second when saved money yields interest or dividends. To the extent that the corporate tax falls on capital it adds a third tier of tax.

Imagine if we fixed the income tax to exempt savings—think of unlimited IRAs or pension plans—and repealed the corporate tax. We would in a single motion remove today's incentive for corporations to retain earnings. At the moment they do it because their shareholders want to avoid the double tax that falls on dividends. The incentive leads to such absurdities as Microsoft's current hoarding of \$40 billion in cash.

If we repealed the corporate income tax along with moving the basic tax system to one with unlimited deductions for savings, things would change. Corporations would no longer have an excuse for growing large, or an incentive for hiding their gains from everyone to avoid taxation. They could instead pay dividends. We'd have smaller, more focused, more competitive businesses, which could be more rationally valued by the markets.

Put this all together. Killing the corporate income tax would improve the efficiency and competitiveness of U.S. business; eliminate incentives to relocate overseas or to engage in mind-boggling shelter transactions; cut down a major source of accountants' compensation and a temptation to look the other way; eliminate disincentives to pay dividends and foster more efficient corporations, sensibly valued. Who can argue with that?

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