Volume Title: Taxes and Capital Formation

Volume Author/Editor: Martin Feldstein, ed.

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-24079-7

Volume URL: http://www.nber.org/books/feld87-2

Publication Date: 1987

Chapter Title: The Cash Flow Corporate Income Tax

Chapter Author: Mervyn A. King

Chapter URL: http://www.nber.org/chapters/c7698

Chapter pages in book: (p. 109 - 110)

# 14 The Cash Flow Corporate Income Tax

Mervyn A. King

The current debate on tax reform has raised again the question of what to do about corporate taxation. The cumulative effect of piecemeal changes to the tax system has been to create major distortions to the pattern of savings and investment, and has led to falling revenue in real terms. As a result, the goal of "fiscal neutrality" has attracted a good deal of support from both economists and politicians. The practical expression of this perception of the need for change has been the elimination of many existing concessions to investment and savings. This can be seen most clearly in the major overhaul of the corporate tax system in the United Kingdom in 1984, and in the United States in 1986.

The debate in both countries has focused on moving toward fiscal neutrality by taxing "economic income." The concessions to investment are to be eliminated in return for a cut in the corporate tax rate. But this debate shows that the attempt to return to a comprehensive income tax raises at least as many questions as it answers. The calculation of economic depreciation of an asset is not straightforward, and proposals to index the tax system for inflation have foundered on practical objections. Is there, therefore, any alternative way to attain the objective of fiscal neutrality without a significant erosion of the tax base?

There is indeed such an alternative. It is the *cash flow corporate income tax*. The basic idea is to tax the company on its net cash flow received from real business activities and to avoid any distinction be-

Mervyn A. King is a professor of economics at the London School of Economics and a research associate of the National Bureau of Economic Research.

tween capital and income items. Fiscal neutrality is achieved by harmonizing investment incentives on a common basis of immediate expensing for all assets.

Why not simply abolish corporate income tax altogether? There are two objections. First, a corporate income tax exists already, and to abolish it would be to yield windfall capital gains to the current owners of corporate equity. Second, in the absence of a tax on corporate income, it is not easy for the authorities to tax the income received by either foreign investors in domestic companies or domestic subsidiaries of foreign corporations. The cash flow corporate income tax represents an attempt to construct a tax that is neutral with respect to both financial and investment decisions and at the same time continues to yield the government positive revenue. It requires no adjustment for inflation and hence avoids the complicated indexation provisions that are necessary under alternative tax bases.

The principle of the tax is to levy a charge on the net cash flow to the company resulting from its real economic activities. The tax base is the difference between the receipts from sales of goods and services on the one hand and the purchases of goods and services required in the production process (including purchases of capital goods) on the other hand. This means that no deduction would be allowed for payments to the suppliers of finance. More specifically, this would imply the phasing out of deductibility of interest payments or, alternatively, adding into the tax base new loan capital raised.

The effect of such a tax system would be to increase the incentive to invest in the U.S. economy relative to either the current position or that proposed in the various plans before Congress. At existing tax rates, there would seem to be no reason to suppose that revenue would be lower than current levels. The transitional and administrative problems raised by a switch to the cash flow corporate income tax are discussed in the paper (see Martin Feldstein, ed., *The Effects of Taxation on Capital Accumulation* [Chicago: University of Chicago Press, 1987]), and there appear to be solutions to all of these.

Successful tax reform requires an understanding not only of the effects of the current system but also of alternative systems that can be used as benchmarks to evaluate reform proposals. In this context, the cash flow corporate income tax merits further consideration.