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Options for Corporate Tax Reform, 2017

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The coming year offers the opportunity to do reforms to fix problems of the corporate tax system that have accumulated over many decades. The Tax Reform Act of 1986 provided a major reform of the personal income tax, reducing the top rate from 50 percent to 28 percent and lowering other rates in a revenue neutral and distributionally neutral way. But it did not improve the corporate tax system.

Indeed, TRA86 actually raised corporate revenue in order to pay for reductions in personal rates. Moreover, the specific changes in depreciation rules in TRA86 reduced investment incentives, biasing the tax system in favor of owner-occupied housing in comparison to productivity-enhancing investment in business structures and equipment.

The current legislative environment may offer the opportunity to do five important things: (1) to reduce the overall corporate tax rate; (2) to correct the tax treatment of the profits earned by the foreign subsidiaries of U.S. corporations;(3) to replace the traditional corporate tax with some form of cash flow corporate tax; (4) to deal with pass-through corporations in an efficient and equitable way; and (5) to avoid increasing the fiscal deficit while doing these things.

I. Reducing the Corporate Tax Rate

The federal corporate tax rate is now 35 percent, the highest among all the major industrial countries. In addition, individual states levy corporate taxes with an average rate of 9 percent. Since those state taxes are deductible when calculating the federal taxable income, the effective federal tax rate is about 40 percent. The average rate among OECD countries is only about 25 percent.

The effective corporate tax rate is reduced by accelerated depreciation of investment in plant and equipment and by the deduction of nominal interest payments rather than lower real interest payments. These are similar to the practices in other industrial countries.

The House Republican tax plan developed when Paul Ryan was chairman of the Ways and Means Committee called for reducing the statutory rate from 35% to 20%. The Trump presidential campaign called for reducing it to 15%.

Reducing the corporate tax rate would attract funds to the corporate sector from other uses like owner occupied housing and agriculture. It would also attract foreign capital to the US corporate sector. These shifts would increase the efficiency with which capital is allocated across sectors and international markets. The increased capital in the U.S. business sector would raise the productivity and real wages of American workers. It would also increase real GDP growth as the corporate capital stock grows.

So lowering the corporate tax rate would have substantial economic benefits. It would however have a significant budget cost. Since the corporate income tax now collects about 1.6 percent of GDP, cutting the rate from 35 percent to about half that level would reduce revenue directly by about 0.8 percent of GDP. Although this would be partly offset by the faster economic growth and by the rise in real wages and profits, there would still be an increase in the budget deficit. In order to limit the revenue loss and achieve a long-run budget balance, the statutory rate would probably have to be reduced to be reduced to no less than 25 percent. I shall return to this a bit later.

II. Correcting the Tax Treatment of the Profits Earned by the Subsidiaries of U.S. Corporations

The United States is virtually alone in the way that it taxes the profits earned by the foreign subsidiaries of U.S. corporations.

Consider a U.S. owned subsidiary that earns profits in Ireland. It pays the Irish government a 12 percent tax and is then free to do what it wants with the after-tax profits. It can invest them in Ireland, or hold them in financial assets, or investment them in any country of the world except the United States. But if it brings those after-tax profits back to the United States, it must pay the U.S. tax of 35 % minus the 12 % paid in Ireland before it can either invest them in the United States or distribute them to shareholders. Not surprisingly, American corporations decide not to repatriate those after tax profits. The Treasury estimates that American corporations have decided to leave about $2.5 trillion of after tax profits outside the United States.

Other countries follow what is called the Territorial method of taxing the profits of foreign subsidiaries. Profits can be repatriated and invested in the home country after paying either no tax or a very small corporate tax (like 5% or 10%).

A shift by the United States to such a territorial system of taxation would have very substantial favorable effects. Most obviously, much of the $2.5 trillion of funds that have been accumulated abroad would be repatriated and invested in the United States. In addition, the future profits of the foreign subsidiaries of U.S. corporations would also be more likely to be repatriated. These repatriated profits would be invested in the United States by the repatriating parent company. If paid out as dividends or used to buy back shares, those funds would find there way into new investments.

In this way, the shift to a territorial system would have favorable effects similar to a reduction of the corporate rate cut: raising capital per worker, increasing productivity and real wages, stimulating higher growth and higher taxable incomes.

A U.S. shift to a territorial system would also increase the incentive for foreign companies to invest in the United States and to establish the United States as their headquarters, knowing that they could repatriate foreign profits to the U.S. for further investment in the U.S. or elsewhere.

A territorial system would raise corporate tax revenue for the United States by shifting more profits to be invested in the United States.

But there are potential adverse effects of the shift to a territorial system. It could encourage U.S. firms to establish subsidiaries in "tax shelter" countries with extremely low tax rates in order to earn profits there and then return them to the U.S. with little or no further tax. It could encourage firms to shift profits to such tax shelter jurisdictions by transfer pricing or debt transactions. These would require careful monitoring or special rules for tax shelter countries.

A permanent shift to a territorial system would be quite different from the one-time repatriation holiday that was tried in 2004. Companies were then allowed to repatriate foreign subsidiary profits with the understanding that those funds would be invested in the United States. Much of the repatriated funds were nevertheless used for share buybacks and dividends. It is not possible however to know how much of the funds that were paid out as dividends or share buybacks were then used to finance investments in other firms. Moreover, a permanent shift to a territorial system would have different incentives than the one-off repatriation holiday.

III. Adopting a Cash-Flow Corporate Tax

Several years ago at an annual AEA meeting I proposed replacing our corporate income tax with a cash-flow tax. The company's tax base would be increased by any inflow of cash – whether from product sales, borrowing or the issuance of equity – and would be decreased by any outflow of cash – whether from the cost of inputs, from repaying debt or buying back shares. Like many good ideas, it was not pursued at the time so I will not comment on its potential virtues.

There is now discussion of a so-called "cash flow border adjustment tax" that has a different structure. There are three components to this CFBT: first companies would get an immediate write-off for all investments in plant, equipment and inventories; second, companies would not be allowed to deduct interest on new loans; and third there would be a deduction for export sales and an extra tax on imports. I think that in some long-run steady state this would be equivalent to the simpler cash flow tax that I proposed earlier.

Allowing an immediate write-off of all expenditures for plant and equipment would provide a strong incentive for productivity-increasing investments. It would also cause a very large loss of revenue.

Eliminating interest deductions on new loans would raise significant revenue but would be difficult to implement. When is a loan "new" rather than a rollover of an existing loan? How should leasing be distinguished from borrowing? How should loans of foreign subsidiaries be treated?

The firms that gain from expensing would be different from those that lose from eliminating interest deductions, making it politically difficult to enact such a pair of proposals.

To complete the similarity to a true cash flow tax, the CFBT plan adds a border adjustment piece: all imports would be subject to an additional tax at the corporate tax rate while all exports would be granted an additional deduction at that rate in calculating table profits. Although this might look like a plan to increase exports and decrease imports, it would not be. As economists understand, an improvement in the trade balance requires a change in the difference between national saving and national investment. The fundamental economic relation is that "exports minus imports equals national saving minus investment." Since there is no change in saving or investment, there will be no change in imports and exports despite the tax on imports and subsidy to exports. The textbook resolution of this apparent paradox is that the exchange rate of the dollar would rise enough to make the value of foreign goods when they reach the U.S. lower by enough to just balance the effect of the tax on imports. The same would apply to the subsidy on exports.

In principle, therefore, the border adjustment tax would have no net effect on the prices paid by U.S. consumers or the prices received by U.S. exporters. There are of course reasons why the full textbook adjustment of the exchange rate might not happen in practice. Importers and retailers therefore fear that they might lose from the tax on imports. Since there is no gain for them in the border adjustment and a risk of a serious loss, they have been opposing it politically, arguing that it would raise prices to American consumers.

The opponents of the border adjustment tax system appear to have won the political battle. A statement by the Republican leadership dealing with taxes has explicitly withdrawn support and my judgment is that Congress will not be able to enact the CFBT plan.

IV. Dealing with Pass-Through Businesses

It is said that about half of business activity in the United States is conducted by organizations that are not traditional Subchapter C corporations. These include subchapter S corporations (the income of which is added to other personal income for personal income tax purposes), partnerships, and sole proprietorships.

If the top rate of personal income tax is reduced from today's roughly 40 percent to (say) 30 percent, some high income individuals would still have a strong incentive to see if their income can be taxed as corporate income at a rate of 20 percent or 25 percent. To do this they would incorporate their activity as a Subchapter C corporation. The advantage of doing this would be limited by the tax on dividends and the potential future tax on the principal when the corporation is dissolved.

It is not clear how this transformation could be limited. Would it be by the size of the pass-through entity? Or by the nature of the business activity?

Back in the 1980s many small subchapter C corporations were induced by a change in the tax rules to convert to subchapter S corporations that were taxed as part of personal income. Perhaps something similar might be done again.

V. Avoiding an Increase in the Fiscal Deficit

The reduction of the corporate rate and some of the other potential changes could significantly increase the fiscal deficit. The House Republican plan originally proposed to solve this by the border adjustment tax.

The BAT raises substantial revenue because the tax on imports raises more revenue than the subsidy on exports. The U.S. imports about 15 percent of GDP and exports about 12 percent. With a 20 percent corporate rate applied to both, the net revenue effect would be to raise revenue by 20 percent of 3 percent of GDP or about 0.6 percent of GDP.

At today's level of GDP, that is about $120 billion, probably enough to offset the revenue loss due to the corporate rate reduction.

A challenge to corporate tax reform is therefore how to replace the revenue that will not be raised if the border adjustment tax is not enacted.

More generally, the combination of corporate and personal tax reforms can only be enacted without support from Democratic Senators by using the budget process known as reconciliation. Reconciliation requires that there is no significant budget deficit beyond the first ten years.

Even with dynamic scoring that recognizes the extra revenue from faster economic growth, achieving the necessary long-term budget balance would require limiting the size of the corporate rate reduction and offsetting the reductions in the personal tax rates by eliminating or limiting a variety of personal deductions and exclusions.