POLICY FOCUS

How Corporate-Tax Reform Could Help American Workers

RECIPES FOR RATIONAL GOVERNMENT FROM THE INDEPENDENT WOMEN'S FORUM

By Rachel DiCarlo Currie, Senior Fellow, Independent Women's Forum

MARCH 2017
VOLUME 7, NUMBER 3

IN THIS ISSUE

independent™ women's forum

WHAT YOU NEED TO KNOW

Republicans and Democrats don't agree on much these days, but they do agree that America's antiquated corporate-income-tax system deserves an overhaul.

The current system is a textbook case of bad public policy. America has the highest combined statutory rate among Organization for Economic Cooperation and Development (OECD) members, yet it also has a labyrinthine maze of tax breaks that distort economic incentives and favor certain industries and companies over others. In addition, the worldwide scope of U.S. corporate taxation encourages firms to keep their foreign profits overseas. The net effect is to discourage investment, suppress wage and job growth, and promote excessive leveraging — all without raising that much revenue.

Recognizing these problems, House Republicans have put forward a plan that would transform the federal corporate-income tax, which has a top rate of 35 percent, into a "destination-based cash-flow tax" with a flat rate of 20 percent. In other words, the House GOP plan would exempt exports and profits earned in foreign countries; it would eliminate the deductibility of import purchases and interest payments; and it would allow for immediate expensing of capital investments.

While the plan has its merits, it might well violate U.S. trade agreements and could also spark global financial turmoil. A better solution would be to adopt a broad-based consumption tax that could help finance large income-tax reforms — both for businesses and for individuals — without losing revenue or making the tax code less progressive.

WHY YOU SHOULD CARE

All Americans have an interest in reforming our corporate-income tax and creating a revenue system that's more conducive to investment, job creation, and broad-based prosperity.

- **Compared with other taxes, the corporate-income tax is particularly damaging to economic growth.** Indeed, a 2008 OECD **study** found that, of all the different kinds of taxes, corporate taxes are "most harmful for growth, followed by personal income taxes, and then consumption taxes."
- **America's corporate-tax regime is among the most onerous and inefficient in the Western world.** Besides having the highest **combined statutory rate** among OECD members, we also have some of the highest **effective rates**. Yet as a share of GDP, the amount of revenue America generates from taxes on corporate income is well below the **OECD average**.
- **Workers bear a significant portion of the corporate-tax burden.** While it's difficult to calculate precisely what share of the tax burden falls on workers (as opposed to shareholders and other investors), both the **Congressional Budget Office** and the **Joint Committee on Taxation** now assume that they indirectly pay 25 percent of it. Other economists put the number much higher.

Corporate-tax reform should thus be a top priority for U.S. policymakers.

MORE INFORMATION

Who Pays the Corporate-Income Tax?

Many Americans seem to believe that the corporate-income tax does not really affect them. After all, it's paid by *corporations*, not individuals — right? Wrong. "Corporations are just shells or buckets of money," **notes** Hoover Institution economist John Cochrane. "People pouring money in or taking it out bear the entire burden."

But how much of the burden falls on capital (i.e., shareholders and other investors), and how much of it falls on labor (i.e., workers)? Economists traditionally assumed that all — or virtually all — of the burden fell on capital. In recent years, however, many have concluded that a substantial share falls on labor. Indeed, a wide range of economists — including **Alison Felix** of the Kansas City Fed; **Mihir Desai, Fritz Foley, and James Hines** of Harvard and the University of Michigan; and **Kevin Hassett and Aparna Mathur** of the American Enterprise Institute — have found that high corporate-tax rates suppress wages.

A big reason for that is international capital mobility. As economist Jim Nunns of the Urban-Brookings Tax Policy Center has **explained**, "International capital mobility shifts some of the corporate income tax burden on the normal return from corporate capital to labor, which is relatively immobile internationally." In plain English: Multinational corporations can move their investments to lower-tax countries far more easily than workers can move their labor — which means a considerable chunk of the corporate-tax burden eventually gets paid by workers. Think of it this way: A reduced capital stock leads to reduced labor productivity, which leads to reduced wages.

To be sure, the precise distribution of the corporate-tax burden remains a matter of intense debate. Yet it should be clear that the tax is not nearly as progressive as many liberals think.

The New Global Tax Competition

America has failed to enact serious corporate-tax reforms since the 1980s. Meanwhile, countries across the industrialized world have been slashing their own rates to lure investment, create jobs, and boost wages. A new **report** from the Congressional Budget Office shows that, between 2003 and 2012, the top combined statutory rate — which includes corporate-income taxes at all levels of government — declined significantly in nations such as the United Kingdom, Canada, Germany, Italy, and Japan. In the United States, it barely budged. Today, America's top combined statutory rate — nearly 39 percent — is the **highest in the OECD**.

The international comparisons get murkier when we look at *effective* corporate-tax rates. Because of all the exemptions, deductions, credits, and other preferences baked into our tax code, America's effective corporate rate varies dramatically from industry to industry and company to company. (It also varies based on methodology.)

In fact, as the *New York Times* **reports**, some hugely profitable American companies have managed to shrink their U.S. corporate-tax bill to zero — or even less than zero. Still, a number of recent studies have **confirmed** that America's effective average and marginal tax rates on corporate income are among the highest in the developed world.

Why U.S. Corporate Taxes Need an Overhaul

Our corporate-tax regime also encourages U.S. multinationals to keep their foreign income parked abroad by forcing them to pay the 35 percent federal rate on all overseas profits they wish to repatriate. As Harvard economist Martin Feldstein has **noted**, most other countries require their multinationals to pay "only a small token tax if they bring their after-tax profits back to their home country."

In short: America's current system features a toxic combination of a high statutory rate that discourages investment, myriad tax preferences and loopholes that reduce revenue, and a worldwide scope that has prompted U.S. companies to keep **trillions of dollars** stashed outside the country and, in some cases, to relocate their headquarters abroad via corporate "**inversions**."

To offer some perspective on the system's inefficiency (using **OECD data**): In 2015, the revenue generated by corporate-income taxes amounted to 4.4 percent of GDP in New Zealand, 3 percent of GDP in Sweden, and 2.7 percent of GDP in Ireland, compared with only 2.2 percent of GDP in America — even though America's top combined statutory rate was 11 percentage points higher than New Zealand's, 17 percentage points higher than Sweden's, and nearly 27 percentage points higher than Ireland's.

Is a 'Border-Adjustment Tax' the Answer?

House Republicans now have a chance to help fix the corporate-tax code. The centerpiece of their **reform plan** is a "destination-based cash-flow tax" (DBCFT) that would replace the federal corporate-income tax while lowering the top rate from 35 percent to 20 percent. Unlike the present system, the DBCFT would not apply to exports or profits earned overseas, but it would eliminate the deductibility of imports — in that sense, it would be "border adjusted," and would effectively provide all exports with a 20 percent subsidy. Meanwhile, the DBCFT would also eliminate the deductibility of interest payments, while allowing for immediate expensing of capital investments.

Supporters of the tax, such as economists Alan Auerbach of UC-Berkeley and Michael Devereux of Oxford, **argue** that it would "encourage companies to locate their productive activities and profits in the United States." But wouldn't it be a major tax increase on American importers? No, say Auerbach and Devereux, because the DBCFT would trigger a large rise in the value of the dollar, and "a stronger dollar would make imports cheaper, offsetting the increase in taxes paid."

That's the theory, anyway. Yet plenty of other economists view the DBCFT as a potential disaster. For example, former U.S. Treasury secretary Larry Summers has **warned** that, by causing a sharp spike in the dollar, the DBCFT "would do huge damage to dollar debtors all over the world and provoke financial crises in some emerging markets. Since U.S. foreign assets are mostly held in foreign currencies, whereas debts are largely in dollars, American losses with even a partial appreciation would be in the trillions. Ironically, China, with its huge reserve hoard, would be a winner."

Summers also fears that the tax would violate U.S. trade obligations, earning us a rebuke from the World Trade Organization and possibly provoking retaliatory actions from other countries.

The Case for Comprehensive Tax Reform

There are good arguments on both sides of the border-adjustment debate, and the American people deserve to hear all of them. Replacing the corporate-income tax with the type of DBCFT that Republicans have proposed would be a truly radical reform. Back in December, Tax Analysts chief economist Martin Sullivan **told** the *New York Times* that "it would be the biggest change in business tax law ever in the United States."

In my view, the potential costs of the DBCFT outweigh the potential benefits. A better alternative would be to embrace some version of the **Competitive Tax Plan** that was first devised by Columbia law professor Michael Graetz and subsequently became the model for Senator Ben Cardin's **Progressive Consumption Tax Act**.

Both the Graetz plan and the Cardin bill would implement a broad-based value-added tax (VAT) on goods and services, and then use the VAT revenue to finance massive income-tax reductions. All married couples earning less than $100,000 a year would be exempt from paying federal income taxes altogether, as would all single tax filers earning less than $50,000 and all head-of-household filers earning less than $75,000. Both Graetz and Cardin would establish three marginal tax brackets for personal income, and both would significantly reduce the top rate from its current level of 39.6 percent. In addition, both would offset the VAT with new tax credits or rebates for lower- and middle-income households, and both would provide a VAT exemption for small businesses with annual receipts below a certain threshold.

Under the Graetz plan, the federal corporate-tax rate would drop from 35 percent to 15 percent. Under the Cardin bill, it would fall to 17 percent. However, both proposals would also tax *personal* investment income at the same rates as regular income.

When the Urban-Brookings Tax Policy Center analyzed the Graetz plan a few years ago, it concluded that, with a single VAT rate of 12.9 percent, the plan was **both revenue neutral and distributionally neutral**, meaning it would not increase the deficit or make the tax code any less progressive.

Ultimately, the best way to do corporate-tax reform is through *comprehensive* tax reform that shifts the burden from income to consumption while maintaining our current levels of progressivity. With that goal in mind, both the Graetz plan and the Cardin bill offer a great starting point.

How Corporate Taxes Encourage Debt

America's corporate-tax system gives companies a huge incentive to finance their investments with debt rather than equity, because interest payments are tax deductible. Yet as a 2016 International Monetary Fund (IMF) **study** observed, this debt bias does not make economic sense: "The original rationale for allowing a deduction only for interest was that this is seen as a cost of doing business whereas equity payments are business income, a view also reflected in international accounting principles. In economic terms, however, both are a return to capital and there is no a priori reason to tax them differently."

Taxing them as differently as America does has encouraged excessive corporate "leveraging" — in other words, it has encouraged companies to accumulate more debt relative to their assets than they otherwise would have. This has important implications for financial and economic stability. "There is a fundamental tension," the IMF study noted, "between regulatory efforts that require financial institutions to hold more capital and tax incentives that induce them to hold less."

Republicans are therefore correct that corporate-tax reform should seek to reverse the system's current debt bias.

WHAT YOU CAN DO

You can help improve America's corporate-tax system and make it more globally competitive.

- **Get Informed:** Learn more about U.S. corporate-income taxes and the need for reform. Visit:
  - **Independent Women's Forum**
  - **The Organization for Economic Cooperation and Development**
  - **The Congressional Budget Office**
- **Talk to Your Friends:** Help your friends and family understand these important issues. Tell them about what's going on and encourage them to join you in getting involved.
- **Become a Leader in the Community:** Get a group together each month to talk about a political/policy issue (it will be fun!). Write a letter to the editor. Show up at local government meetings and make your opinions known. Go to rallies. Better yet, organize rallies! A few motivated people can change the world.
- **Remain Engaged Politically:** Too many good citizens see election time as the only time they need to pay attention to politics. We need everyone to pay attention and hold elected officials accountable. Let your Representatives know your opinions. After all, they are supposed to work for you!

ABOUT THE INDEPENDENT WOMEN'S FORUM

The Independent Women's Forum (IWF) is dedicated to building support for free markets, limited government, and individual responsibility.

IWF, a non-partisan, 501(c)(3) research and educational institution, seeks to combat the too-common presumption that women want and benefit from big government, and build awareness of the ways that women are better served by greater economic freedom. By aggressively seeking earned media, providing easy-to-read, timely publications and commentary, and reaching out to the public, we seek to cultivate support for these important principles and encourage women to join us in working to return the country to limited, Constitutional government.

We rely on the support of people like you! Please visit us on our website **www.iwf.org** to get more information and consider making a donation to IWF.

Our Partners

Contact us if you would like to become a partner!

Connect with IWF! Follow us on: