Why America Still Needs Tax Reform (And Why There Are Faint Glimmers of Hope)

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Comprehensive tax reform is one of the most important things Congress can do to improve the nation's economy. Sensible reform will improve the nation's fiscal balance, increase competitiveness, and spur investment. Each of these will lead to increased productivity and living standards. Yet, despite clear economic evidence, progress has been hard to achieve. Although legislators on both sides of the aisle agree on its importance, the issue has lacked the political support needed to force legislation forward. The current presidential campaign may have even set events back. Without a determined push by the next president, tax reform is unlikely to happen for many years.

INTRODUCTION

The Information Technology and Innovation Foundation (ITIF) has previously argued that the United States suffers from three significant public debts: a fiscal debt that may exceed 86 percent of GDP within 10 years; a trade debt that is accumulating at between 2 percent and 3 percent of GDP per year; and an investment debt that takes a variety of forms, including inadequate investment in research, education, and infrastructure.[1]

Comprehensive tax reform done the right way is one of the few initiatives that can significantly improve all three deficits. ITIF has long argued that any such reform should include several key elements:

- A much lower statutory rate on corporate taxes, paid for in part by a higher statutory rate on the wealthiest individuals and on capital gains and dividends;
- A low rate on foreign income—to be paid when earned, not to be deferred.

- Elimination of tax exemptions that are not clearly linked to growth and investment; and
- Expansion of the research and development tax credit and accelerated depreciation, and creation of an "innovation box."[2]

Even if the reform does not raise additional revenues, it is likely to increase GDP. This will lower the debt-to-GDP ratio, reducing the burden of the debt. By boosting the competitiveness of goods and services produced in the United States, tax reform should increase exports and decrease imports, thereby improving the trade deficit.[3] Finally, intelligent reform would increase incentives to invest in America. A significantly reduced corporate tax rate would lower the hurdle companies must clear in order to make an investment, whether in machinery and equipment, research and development, or workforce training. This, in turn, would increase demand for the public sector complements needed to make corporate investment successful, including modern infrastructure and trained workers.

Academic studies clearly show that the economic costs imposed by corporate taxes exceed those imposed by individual income taxes or consumption taxes, particularly at our current statutory rate.[4] There is also sound evidence that the high U.S. rate is causing a growing number of companies to move abroad and for others to lose market share in globally contested industries. Finally, few people dispute that some of the tax exemptions and deductions currently in tax law do little to benefit the economy or the broader social welfare. Eliminating these and using the additional revenue to reduce the statutory rate and boost effective incentives (like the R&D tax credit) would boost the economy.

Despite this evidence, an impartial observer could argue that there has been little progress since ITIF's last report on the need for tax reform in 2014.[5] Congress has held many hearings on the issue, and a notable bipartisan consensus has emerged, especially on the need to reform taxation of foreign profits. But large gaps still remain in the way both parties approach the reform of individual and corporate taxes. Despite areas of agreement, the Obama administration has never devoted the time and effort needed either to strike a deal with the Republican majorities in Congress or develop a version of reform that gathers strong public support. As a result, momentum has stalled.

The need for reform still exists, however. This report will review some of the academic evidence supporting tax reform. It will also summarize some of the main political issues that still need resolution. These include the scope of reform, integration of the corporate and individual tax systems, and creation of an innovation box. As in other areas, such as immigration and regulatory reform, disagreement on a few key issues is preventing policymakers from acting on areas where they do agree. Finally, the report will look at prospects for reform in the next administration.

WHY REFORM IS NECESSARY

There is widespread agreement that the U.S. tax code is a mess: It is far too complicated; it imposes large administrative costs on individuals and businesses; and it contains many provisions that benefit narrow political interests at the expense of the overall economy. Perhaps most important, however, the statutory and effective rates on corporate income are way too high for today's global economy.

The top statutory rate on corporate income is currently 35 percent. On average, state and local taxes add another 4 percentage points. The combined rate of 39 percent is the highest among members of the Organisation for Economic Cooperation and Development (OECD). The United States has not lowered its rate since 1986. In the meantime, other developed countries have steadily lowered theirs. The weighted average of OECD countries is now under 32 percent, and the unweighted average is less than 25 percent.[6] These countries represent the United States' primary competition in world markets. The reduction in global corporate rates by our economic competitors reflects a shift from taxing productive activity to taxing consumption, often through a value-added tax (VAT), partly due to a realization that corporate taxes impose an especially large burden on economic activity.

Lower corporate rates boost growth.

Some minimize the statutory rate's importance to a company's competitiveness by pointing out that some U.S. companies often pay a much lower effective rate once deductions and other tax provisions are thrown in.[7] Effective rates dipped very low following the latest recession, as business profits fell and companies accumulated large deductions for losses. But in normal times, American companies suffer from relatively high effective rates. After looking at effective rates over several years, tax policy expert Martin Sullivan concluded that "it seems reasonable not to revise the consensus view that average world-wide effective corporate tax rates are somewhere in the mid- or upper-20s when we are not in the throes of a recession."[8] A 2015 study by PricewaterhouseCoopers calculated a three-year average effective rate of 28.6 percent for the United States, compared with 25.9 percent for other countries.[9] And an NBER (National Bureau of Economic Research) study of manufacturers' effective tax rates in 15 nations found that those in the United States paid the second-highest rates.[10] Moreover, many of our competitors continue to lower rates, by either reducing statutory rates or expanding tax incentives, such as the innovation box or R&D tax credit, which benefit industries that compete in global markets.

Estimates of low effective rates often suffer from a logical flaw. Part of the reason why U.S. companies pay low effective rates is because they do not repatriate foreign profits and therefore escape the high domestic rate. If you believe that these profits will eventually be brought back to the United States, then these revenues should be included in the effective rate calculation, even though companies may not pay for several years. On the other hand, if these profits are never going to be repatriated, then lowering the tax on foreign income should not cost very much.

Lower corporate rates boost growth. A 2008 literature review found that increasing the corporate rate by one percent led to a 1.05 percent decline in the corporate tax base.[11] Another study found that falling corporate rates in other countries had already hurt U.S. economic performance and warned that the effect would get worse over time.[12] A third study concluded that a 10 percent increase in the U.S. corporate rate lowered real GDP by 1.5 percent and hourly wages by 4 percent.[13] Finally, in a study commissioned by the Business Roundtable, Ernst & Young concluded that if the U.S. had lowered its corporate tax rate over the last decade to 25 percent, U.S. firms would have acquired a net $590 billion of assets in cross-border mergers instead of losing $179 billion.[14]

Opponents of reducing the effective corporate tax rate assume that the fiscal benefit will accrue only to firms. But this assumes that corporate profits are not subject to competitive pressures. If all companies in an industry face lower costs due to lower taxes, competitive forces will mean that a significant share of the savings are passed on in the form of lower prices and higher wages.

In fact, a large part of the ultimate burden for corporate taxation is borne by workers and consumers. Consumers suffer when companies respond to higher taxes by raising prices. Workers suffer when companies move jobs overseas. But they also suffer when companies lower their corporate investment, since wages are still driven by labor productivity, which in turn is driven by the amount of capital labor has to work with. The Joint Committee on Taxation assumes that labor bears around 25 percent of the corporate tax.[15] One study, however, found that under some assumptions the burden could be as high as 70 percent.[16]

A few people still argue that corporate taxes are too low. The European Commission's recent decision in August 2016 to increase Apple's tax bill in Ireland by roughly $14.5 billion has boosted their spirits, even though most of the money would be paid by U.S. taxpayers rather than Apple itself, because Apple would be allowed to deduct foreign taxes from whatever it owes the U.S. Treasury, and even though the Commission's logic does not depend on how high or low U.S. tax rates are.

A recent example of this argument comes from Sen. Elizabeth Warren (D-MA).[17] Senator Warren makes three points, all of them misleading: First, she laments that corporate taxes have fallen significantly, both as a share of GDP and as a share of total tax revenues. But it is not principally because companies like Apple have gotten lower tax rates. It is largely due to the fact that, unlike many countries, the United States lets many businesses file as pass-through entities—in which case income is not taxed at the business level but instead shows up on individual business owners' tax returns as their personal earnings. After the most recent federal tax reform in 1986, an increasing share of businesses adopted these forms.

Second, despite the fact that Warren's home state of Massachusetts, where both chambers of the legislature are controlled by Democrats, recently cut the state corporate tax rate precisely to be more globally competitive, she discounts the threat of companies moving operations abroad in search of lower taxes or to avoid losing global market share because of very high U.S. taxes. But the fact that virtually all OECD countries except the United

States have cut their corporate taxes over the last two decades surely has something to do with the recent increase in corporate inversions and foreign acquisitions of U.S. companies. Because of these differences in tax rates, U.S. companies feel the need to move operations abroad in order to remain competitive with their foreign counterparts. Likewise, the high U.S. corporate tax rate makes the U.S. economy less attractive as location for inward foreign direct investment. But the threat of high taxes is not just that productive activity goes abroad or doesn't come to the United States; it is that the activity doesn't take place at all. Nowhere does Senator Warren acknowledge the large deadweight burden that today's high tax rate imposes on investment.

Ideally, tax reform would look at the entire revenue code, including both individual and corporate taxes.

Finally, Senator Warren advocates that the tax code should favor smaller businesses over larger ones. But in fact, as Eric Toder of the Urban-Brookings Tax Policy Center and others have shown, "The federal income tax generally favors smaller over larger businesses."[18] Moreover, as discussed below, smaller businesses are not the primary source of new job creation or product innovation in today's economy. Most of them do not face international competition. And as a group they are less productive, pay lower wages, and provide fewer employee benefits than large firms. Although many romanticize their role in the economy, a focus on small business distracts us from adopting policies that will actually boost growth and raise living standards. Large multi-national companies are not villains; in fact, they are the key drivers of U.S. economic growth and innovation. Even if they paid no corporate taxes, these companies would still be delivering huge benefits to the country. They create and support millions of high-paying jobs, deliver innovative products that decrease in price and increase in quality (and which other companies quickly emulate), deliver financial gains to hundreds of institutional pension plans that otherwise worry about whether they will have sufficient funds to pay retirees, and generate exports that enable consumers to pay for their imports.

HOW MUCH REFORM IS ENOUGH?

The first battle, which may have already been lost, is over the proper scope of tax reform. Every reform effort must strike a compromise between what is desirable and what is feasible. Putting aside the question of whether total revenues should be raised or lowered, there are a number of goals for tax reform. A principal one should be to shift toward taxes that impose a smaller deadweight burden on the economy. This means lowering the effective rate on businesses and in particular on firms competing in globally traded markets. Economists generally agree that business taxes deter more productive activity than do individual taxes. Moreover, in an increasingly globally competitive economy, lowering taxes on internationally mobile activities can increase welfare by improving national economic competitiveness. A secondary goal should be to reduce tax expenditures that do not benefit society as a whole by compensating for externalities. Since the tax burden rises sharply as the statutory rate increases, this type of reform can have a positive effect on economic growth by reducing the misallocation of investments and allowing lower rates on productive activity.

Should We Include Individual Reform?

Ideally, tax reform would look at the entire revenue code, including both individual and corporate taxes. ITIF has argued elsewhere in favor of raising the marginal tax rate on individuals in return for a lower corporate tax rate.[19] Studies have shown that, largely because capital is more mobile than labor, corporate income taxes place a higher burden on the economy than do individual income taxes, which in turn impose a larger burden than taxes on consumption.[20] Such a change also makes sense because the United States has a relatively low top individual rate but the highest statutory corporate rate among members of the OECD.

Another reason for combining individual and corporate tax reform is that most of the tax expenditures that might pay for lower corporate statutory rates are on the individual side. Provisions such as the exclusion of employer-paid health-care costs ($2.7 trillion over 10 years), capital gains taxes ($1.1 trillion), the deductibility of mortgage interest ($948 billion), and the deduction for state and local taxes ($1.5 trillion) mainly benefit those with more income.[21] For example, the Joint Committee on Taxation estimated that, in 2014, tax returns showing over $100,000 in total income accounted for over 81 percent of the cost of the mortgage interest deduction.[22] The figure for the deduction for state and local taxes was 92 percent.[23] The behavior induced by most of these provisions, such as purchasing larger homes and spending relatively more of one's income on health care, often imposes large costs on society by diverting resources away from more productive uses.

Nevertheless, a consensus seems to have developed to limit tax reform to just the corporate side. Many of the largest tax expenditures are extremely popular with the middle class, even if they have perverse economic results. Although better tax policy would help moderate inflation in housing, education, and health-care costs, in the short term, individuals who take advantage of current law would suffer a loss, unless the provisions were phased in. For example, the home mortgage deduction could be phased out for existing mortgages over 15 years. Nevertheless, the feeling is that reforming both would be too contentious, while successful corporate reform might generate positive momentum, making it easier to reform individual taxes later.

Progress on this consensus has been halted by the determined opposition of small businesses, many of whom operate as pass-through entities.[24] Because they are structured as S corporations, partnerships, or limited liability corporations rather than C corporations, these entities do not pay corporate taxes. Instead, income flows through to the individuals who own the entity and is included on their individual tax returns. These entities would not benefit directly from a lower rate on corporate taxes. Indeed, to the extent that they compete with C corporations, a lower corporate rate would reduce their competitiveness. This would be especially true if reform used the elimination of business tax expenditures to pay for the lower corporate rate. However, since most small businesses are either suppliers of companies that compete in international markets, or sellers to domestic consumers, to the extent that corporate tax reform makes the United States more globally competitive and grows the economy, most small businesses would benefit from the growth effect.

Although small business tends to be a powerful political lobby, its importance is often exaggerated and should not be used to delay tax reform.[25] As ITIF has noted, as a group compared with large businesses, small businesses are less productive, pay their workers less, export less, invest less in research and development, and injure and lay off their workers at higher rates.[26] In addition, pass-through entities already enjoy a competitive advantage against C corporations because they pay only one layer of tax, not two. This advantage exists even if the top marginal rate on individual taxes exceeds the corporate rate. For instance, if the relevant individual rate is 50 percent when the corporate rate is 15 percent, a pass-through entity only has to pay the 50 percent rate. Corporate shareholders must pay 15 percent when the corporation earns a profit and then another 50 percent when the profits are paid to them in the form of dividends. Although shareholders can always defer the payment of individual taxes until they realize income, pass-through firms always have the option of restructuring if they think this really confers an advantage. Lower taxes on dividends and capital gains can reduce or even reverse this penalty, which is another reason for combining individual and corporate reform.

The main problem with limiting reform to the corporate side, however, is that there is less scope to lower the corporate rate by eliminating tax expenditures if the goal is revenue neutrality, especially if policymakers do not take into account tax reform's positive impact on economic growth. First, the total revenue lost to corporate tax expenditures is much smaller than for individual expenditures. Second, most of the largest corporate provisions, such as accelerated depreciation (i.e., MACRS), play an important role in lowering the effective cost of investment. Since the ultimate goal of tax reform is to spur economic growth, this may be counterproductive.

In 2015 the top 10 corporate provisions were expected to cost $132 billion or 88.3 percent of total corporate tax expenditures.[27] By far the largest was the deferral of income from controlled foreign corporations, at $75.5 billion. But eliminating this would subject U.S. companies to extremely high corporate rates on all of their foreign earnings. More important, it would place them at a further disadvantage when they compete with foreign firms in overseas markets whose home nations have a territorial system with a lower corporate rate. The top six expenditures also include the deduction for U.S. production activities ($11.0 billion), accelerated depreciation of machinery and equipment ($8.1 billion), and the expensing of research and experimentation expenditures ($4.1 billion). All of these lower the cost of investing and manufacturing in the United States and, relative to many other competitors, are modest in size.[28]

Finally, some participants question the value of devoting the enormous amount of political and economic capital needed to enact reform if it only results in lowering the statutory rate a few percentage points. For Democrats this is especially true. In general, Democrats are more skeptical of the claim that lower taxes will automatically produce higher levels of investment and jobs or that the benefits will accrue to most Americans. They also tend to advocate higher marginal rates on individuals. Limiting reform to the corporate side focuses on tax cuts to business rather than higher tax rates on the wealthy and makes reform harder. Many Republicans are wedded to lower individual rates, including on the wealthy, making them highly unlikely to support any kind of corporate rate reduction paid for by increasing taxes on the top brackets. At the same time, budget hawks from both parties will scold reformers unless any changes are budget neutral. And finally, the political optics are not good, especially for Republicans, of cutting taxes on "big fat corporations" while failing to cut taxes on the little guy and mom and pop main street businesses.

A final problem raised by corporate reform is the concern that lowering rates far below the marginal rates on the individual side would cause businesses to incorporate and to shelter income in the corporation, thereby avoiding the individual tax.[29] At first this might seem odd, since incorporation would subject income to taxation at both the individual and corporate levels rather than just the former. But given the ability to defer realization and the current step-up in basis at death, this strategy could ensure that many profits are never subject to individual taxes. The estate tax partially compensates for this possibility. Current law also contains rules limiting the accumulation of capital in a firm. However, these rules are subjective and hard to enforce. A simpler solution would be to eliminate the step-up in basis at death and to treat the transfer of stock at death as a sale. This is a key component of the Grubert-Altshuler proposal discussed below.

The spate of inversions has spurred concern on both sides of the aisle that the current treatment of foreign profits threatens to erode the corporate tax base and also deters companies from using foreign income to either invest in the United States or return money to shareholders.

Then How About Just International Reform?

Two main proposals try to get around this impasse on the proper scope of reform. The first would limit reform to the treatment of how companies are taxed on their international profits. Unlike most countries, the United States taxes U.S. companies on both their domestic and foreign earnings. But it does not tax foreign earnings until they are "repatriated" back to the United States. This unique practice, established at a time when U.S. companies faced little global competition, creates several problems.

Although the taxation of foreign income removes a possible incentive for companies to move production abroad, it also places them at a disadvantage when competing against foreign firms in international markets because they are subject to higher taxes on that income. And the ability to defer tax on foreign earnings only to pay the 35 percent tax when money is repatriated gives companies a large incentive not to bring profits back into the country.

Until recently, many people did not worry about the threat of U.S. companies moving abroad. Tax law subjects U.S. companies to immediate taxation of past profits if they move their headquarters overseas. Although some companies maneuvered around this by arranging to be acquired by a smaller overseas firm, reforms have limited this practice. Discussing inversions in 2012, Jane Gravelle noted, "Legislation enacted in 2004, which treats inverted firms as U.S. firms either indefinitely or for a period of time (depending on continuity of ownership) appears to have ended this practice."[30] Yet, over the last two years, a number of large inversions have taken place, often in the pharmaceuticals sector. A primary motivation has been tax savings. Although the administration has promulgated a series of new rules to discourage future deals, it is unlikely to succeed in the long-term. In any case, its rules will not affect the outright acquisition of U.S. companies by foreign firms. Indeed, these types of mergers appear to be increasing.[31] This is worrisome because, if global competition forces a move overseas, the United States is much better off if it occurs through either an outright move or an inversion than if it occurs through an acquisition. In the former two instances, U.S. management retains control of the company. U.S. managers are likely to feel a stronger attraction to the United States, are less likely to move manufacturing and research abroad, and will face internal resistance to such moves. Foreign managers are likely to have fewer qualms about replacing existing managers who do not wish to relocate abroad.

In addition to prompting the administration to erect its own version of the Berlin Wall, the spate of inversions has spurred concern on both sides of the aisle that the current treatment of foreign profits threatens to erode the corporate tax base and also deters companies from using foreign income to either invest in the United States or return money to shareholders.

The result is that an encouraging bipartisan consensus has emerged around the need to reform the taxation of foreign profits. For instance, a bipartisan report of the Senate Finance Committee opened with the statement: "By standing still, the United States has fallen behind other countries that have adopted modern international tax rules to help their companies and workers compete in the global marketplace."[32] This reform has centered around a few key components:

- Creating a new, lower statutory rate for foreign income somewhere between 15 percent and 20 percent;
- Eliminating deferral of the tax on foreign income;
- Taxing immediately all past unrepatriated foreign profits at a lower rate (usually between 10 percent and 15 percent); and
- Creating (in some cases) an innovation or patent box.

Earlier this year the White House put out a report calling for a 19 percent tax on foreign earnings with no deferral.[33] Actual tax payments would be further reduced by allowing for a normal return on equity before assessing taxes. Past unrepatriated earnings would be subject to a 14 percent tax. However, progress on legislation has been slow, possibly because some legislators feel that the threat of companies moving abroad has fallen. Although the spate of inversions has died down for now, future deals are inevitable and will likely cause renewed pressure on Congress to do something.

In response to the slow progress on reducing the statutory rate, a growing number of people and organizations, including ITIF, have begun calling for the creation of a patent or innovation box.[34] An innovation box would respond to lower foreign tax rates by creating a new statutory rate for all profits that derive from innovation activity, which is either highly mobile or brings broad social benefits or both. Traditionally this includes income derived from patents or copyrights. More recently, some nations have enacted provisions that also include income derived from domestic research. Innovation boxes recognize that the corporate tax rate has less of an economic impact on companies in industries that operate only domestically and do not face international competition. Although the scope of these bills can be very broad, the depth of the tax benefit can be limited to the amount of research needed to develop the product or service. Representatives Charles Boustany (R-LA) and Richard Neal (D-MA) in July 2015 circulated a discussion draft of legislation that would allow all profits from a wide range of sources to potentially qualify for a rate of almost 10 percent. But this benefit would be limited by the fraction of domestic research and development to total costs as defined in the bill. Thus companies that spent very little on research would get little benefit from the lower rate.

This concept has generated a good deal of bipartisan support in Congress. The report by the Senate Finance Committee stated, "The co-chairs agree that we must take legislative action soon to combat the efforts of other countries to attract highly mobile U.S. corporate income through the implementation of our own innovation box regime that encourages the development and ownership of IP in the United States, along with associated domestic manufacturing."[35]

Three proposals show that there are a variety of ways to get to very low corporate rates while simplifying tax law and boosting investment.

A growing number of countries have implemented some form of an innovation box, and these boxes are therefore becoming part of the global competition for taxable profits.[36] By persuading companies to locate globally mobile intellectual property in their jurisdiction, countries both hope to boost the taxable profits of foreign companies, and to encourage increased innovation from domestic firms. Although research on innovation boxes is still preliminary, in a survey of 200 bio-pharma companies, 40 percent said that they would relocate foreign research to the United States under a patent box regime, and an equal number indicated they would move manufacturing processes and jobs.[37] Another paper estimates that a 1 percentage point decrease in the tax rate for IP produces a 3 percent increase in new patent applications, mainly from domestic investors.[38] The authors found no effect on cross-border attribution of patent income, at least in the short term.

The Obama administration opposes an innovation box, however.[39] Its main arguments are that an innovation box is very expensive and reduces potential funding for the research and development credit, that it adds complexity to the tax code, and that most of the benefit, at least in the near term, goes to rewarding past activity rather than encouraging future investment. As ITIF has noted, many of these objections are not valid, and others could be dealt with through careful drafting, but the administration's opposition, and its general lack of interest in corporate reform in general, has held up progress on any bill.[40]

INTEGRATION

Another option that some hope can break the impasse between individual and corporate reform is corporate integration. These proposals attempt to eliminate or reduce the double taxation of income at both the individual and corporate level. In particular, three proposals show that there are a variety of ways to get to very low corporate rates while simplifying tax law and boosting investment.

The Grubert-Altshuler Proposal

Earlier this year, economists Harry Grubert and Rosanne Altshuler released a paper proposing a corporate tax rate of 15 percent.[41] Because companies would continue to get a deduction for any foreign taxes paid, this rate is low enough that it effectively acts as a territorial system, since many nations have effective rates near or higher than this rate. Since the low rate would apply to both domestic and foreign income, it would also not serve as an incentive for firms to move overseas.

Grubert and Altshuler pay for the low rate by making three major changes to tax law. The most important would tax all capital gains and dividends as normal income. Although corporate shareholders may come out more or less even because the higher individual rates would be offset by a lower rate at the corporate level, the owners of other capital assets and those operating as pass-through entities would experience a significant tax increase. However, these taxpayers would still pay fewer taxes than if they were incorporated.

The second change is to eliminate the step-up in basis at death. This allows individuals to inherit assets without ever paying taxes on gains that occurred prior to the original owner's death. The only justifiable rationale for maintaining the step-up in basis is that otherwise the estate tax would subject at least part of the gain to double taxation. Under the proposal, when someone dies, the estate would pay income tax on all assets as if they had been sold at market value. Finally, Grubert and Altshuler would charge interest on deferred capital gains. Individuals normally do not pay tax on capital gains until they sell an asset. The proposal would maintain this practice, but would then charge interest on the resulting tax on the assumption that the gains had been realized uniformly during the holding period. This eliminates the incentive for individuals to delay selling stock solely to avoid paying tax on the gain: Any delay is likely to result in a larger bill later. The purpose is to reduce tax law's influence on the timing of investment decisions.

The Toder-Viard Proposal

Also this year, economists Eric Toder and Alan Viard issued a revised version of an earlier proposal.[42] Their paper also calls for a corporate tax rate of 15 percent, but it gives taxable corporate shareholders a credit for taxes paid at the corporate level, thereby effectively eliminating the double taxation of income. However, integration confers a net benefit to nonprofits (including tax-exempt savings programs) and foreign citizens, both of whom currently escape any individual income tax and are only taxed indirectly through their ownership of U.S. shares. Only a quarter of U.S. corporate stock is held by taxable individuals.[43] This severely limits our ability to shift taxes from the corporate to the individual side. Since all corporate shareholders pay tax indirectly through the corporate tax, any reduction in the tax or a credit for having paid it would confer a net benefit to them. In order to offset the gain to nonprofits and retirement plans, the proposal would subject them to a 15 percent tax on interest income. Although reducing the effective tax on foreign investors may seem unwise, doing so should encourage a greater flow of investment funds into the United States. Like the Grubert-Altshuler proposal, Toder and Viard would tax dividends and capital gains as ordinary income, except that rather than imposing interest on deferred gains, they would include the gain and loss in market value each year, whether or not the stock was sold.

The House Republican Task Force Proposal

Soon after becoming Speaker of the House, Paul Ryan (R-WI) formed a series of task forces to develop policy proposals on a number of major issues. The tax group, consisting largely of Republican members of the Ways and Means Committee, recently issued its blueprint.[44] It calls for lowering the corporate rate to 20 percent and permits companies to deduct the full cost of capital investments in the first year. Small businesses would benefit because all pass-through income would be taxed at 25 percent. To pay for this reduction, it eliminates interest deductibility on corporate debt. There is a widespread feeling that current law strongly encourages debt over equity by giving the former a much lower, possibly even negative marginal tax (which is different than the average effective rate).[45] Eliminating the deduction would reverse this advantage and encourage companies to rely more on equity. This in turn might increase their financial stability. Because companies have to make interest payments even if they are not making a profit, a greater reliance on equity could also reduce the pressure for short-term financial results.

The net effect of higher foreign taxes could be a reduction in U.S. tax revenues rather than an increase in corporate effective tax rates.

Besides lowering the statutory rate significantly, the proposal deals with foreign competitiveness in a novel way. It would exempt exporters from paying tax on foreign earnings. In addition, it would also subject imports to a new tax. This border adjustment is essentially equivalent to the treatment of value-added taxes (VAT) in operation in over 150 other countries. (Their border-adjustable taxes act as a rebate for their exporters and a tax for ours.) However, it may violate current rules of the World Trade Organization. This should not foreclose debate on the issue. The administration instead should negotiate new provisions that allow the United States to accomplish the same thing through the corporate tax that other nations do using a VAT.

THE FIGHT OVER THE U.S. TAX BASE

The slow recovery from the last recession and continued fiscal difficulties have encouraged other countries to seek more tax revenue, ideally in a way that does not discourage productive investment. One increasingly common practice has been to examine the taxes paid by foreign corporations, many of them American. Since U.S. companies usually get a credit for taxes paid to other nations, companies might be able to pass on higher international taxes by deducting them from what they otherwise would pay to the U.S. government. Therefore, the net effect of higher foreign taxes could be a reduction in U.S. tax revenues rather than an increase in corporate effective tax rates.

The foreign efforts come in two forms: investigations by both individual countries and the European Union (EU) against the accounting practices of U.S. companies and their arrangements with low-tax countries in Europe, and the BEPS (base erosion and profit shifting) project, a multinational effort to address perceived problems in the taxation of multinational companies.

Individual Actions Against U.S. Companies

The current multinational taxation regime is governed by a large number of bilateral and multilateral treaties that govern how each nation will tax foreign companies that operate in its jurisdiction. Until recently, these treaties have primarily focused on ensuring that companies are not taxed twice on the same income. However, the existence of low-tax jurisdictions such as Ireland and Luxemburg, together with vague accounting rules and discrepancies in the tax laws of different countries, has resulted in many companies paying very low or no tax on at least some of their income. Addressing this is not always in the U.S. interest, however. Because U.S. companies receive an immediate credit for the taxes they pay to other countries, an increase in foreign tax rates can result in a reduction of U.S. tax revenues rather than an increase in the effective corporate tax rate.

The basis of the current system is that income is taxed where profits are made. This in turn requires a careful accounting of the company's revenues and costs, including those from intangible assets. There is little question that companies have been aggressive about transferring intangible assets, such as patents, trademarks, and managing services, to subsidiaries in lightly taxed countries. Although transfer pricing is governed by detailed rules, the complexity of modern operations and the uncertainty about the value of intangible assets make it very difficult to arrive at any objective value.[46] In this environment, countries have a very difficult time contesting the valuations of private companies.

Yet there seems to be a clear determination that multinationals, and especially high-tech companies with a high share of revenue from intangibles, are not paying their fair share. Addressing this issue in the context of the current system will require broader agreement on the practice of transfer pricing, possibly combined with efforts to establish a global tax floor above which all income is taxed. Absent that, it seems that we may see a push to assess corporate income taxes based on a combination of sales, employment, and other activity within each country (three-factor apportionment). U.S. states currently use some combination of these factors to apportion the U.S. income of national companies. Any movement in this direction would almost certainly transfer parts of the tax base away from low-tax jurisdictions. Because the companies would be entitled to a credit on any higher taxes that result, it would also reduce U.S. tax revenue.

U.S. tech firms have already been the target of numerous complaints.[47] Google has faced complaints about its tax practices from the United Kingdom, Spain, France, and Italy, among others. In 2015 the European Union (EU) alleged that a tax deal Amazon had reached with Luxembourg amounted to unfair state aid. Shortly after, the company altered its tax structure and began paying taxes in several European countries. As mentioned above, the problem dramatically escalated when the European Commission decided that Apple owed the Irish government $14.5 billion in back taxes and interest.[48] The United Kingdom recently changed its tax laws to make it more difficult for companies to avoid paying taxes on revenues earned in the country. As a result, Facebook announced that it would alter its tax practices there. The United States has protested these investigations. Secretary of the

Treasury, Jack Lew has stated that the Commission "appears to be adopting an entirely new legal theory and applying it retroactively in a broad and sweeping manner."[49] But given the difficulty of assigning profits and its own support for the BEPS project, it is not clear that U.S. protests will have any effect. Indeed, Secretary Lew himself has voiced concern about companies' ability to shift profits to low-tax jurisdictions.[50]

The BEPS Project

The BEPS project is a much broader initiative by the OECD and some non-OECD nations to deal with the allocation of profits within multinational companies. It consists of 15 separate goals or action plans. The United States participated heavily in the process of developing both the extensive reports on each area and the recommended policies. Some of the action plans are minor. Others would lead to improvements in the system of international taxation. However, a few raise serious concerns for U.S. multinationals and the U.S. government. Indeed, a recent analysis by Gary Hufbauer of the Peterson Institute for International Economics finds that "implementation of the BEPS Actions would drive many [multinational companies] to 'invert' (i.e., relocate their headquarters to tax-friendly countries) and others to offshore significant amounts of R&D activity."[51] It claimed that other countries had already taken over 30 unilateral measures in response to the BEPS initiative, most of which disadvantage U.S. firms.[52]

Action 5 requires that companies have a firmer nexus with a low-tax country before they can take advantage of its tax regime. If enforced, companies will no longer be able to lower their taxes simply by transferring intellectual property to a low-tax regime and then routing all of their profits through the country as a result of licensing agreements and management fees. Instead, companies will need a greater nexus, such as manufacturing, or research and development facilities, in the country. A first glance, this could help the U.S. government by weakening the pull of low-tax jurisdictions on U.S. companies. However, many have expressed the fear that, rather than being pushed out of these countries, U.S. companies will instead transfer more of their production and research overseas in order to preserve their link with the country. Foreign governments might even take more aggressive activity to pursue low-tax countries than they do currently. This would directly affect not only the U.S. tax base, but the level of productive activity in the country. The Finance Committee's bipartisan working group on international tax reported: "The co-chairs agree that the anticipated impact of the new nexus requirements on innovation box regimes will have a significant detrimental impact on the creation and maintenance of intellectual property in the United States, as well as on the associated domestic manufacturing sector, jobs, and revenue base."[53]

Ironically, the nexus requirement also gives the United States an advantage in the use of innovation boxes. Under the single market, EU countries cannot condition tax advantages on the location of activity within their country. European countries with innovation boxes would still have to adopt a nexus requirement but companies could meet that requirement by investing in any EU state. This significantly diminishes the advantage to the country with the innovation box. The United States is free from this constraint and can require that any manufacturing or research needed to qualify for an innovation box be done in the United States.[54]

Action 7 raises even more problems. Under current international tax rules, a company must have a permanent establishment in a country before the country can tax it. However, in the digital economy, companies can raise large revenues from within a country without ever having much of a physical presence in it. Amazon can let French shoppers order off its site and then direct foreign or local companies to ship to them. Starbucks can operate thousands of coffee shops in the United Kingdom, but if most of its costs consist of payments to foreign subsidiaries for trademark licensing, management fees, and advertising, its profits may be minimal. Action 7 would loosen the requirement for a physical presence. As the Peterson Institute's Hufbauer points out, this would amount to a reintroduction of tariffs on U.S. products because companies that only import goods or services into a country without having a physical presence there would now be subject to a tax at the corporate level that they presumably would try to pass on to their customers.[55]

Dramatically lowering the U.S. corporate tax rate may seem like a pipe dream. Yet, given the policies of other developed countries, it is vitally important if the United States is to maintain its global competitiveness.

Actions 8 through 10 try to reform the transfer pricing system. There is no question that that existing rules suffer from the worst of two worlds: They are very complex but deliver little objective certainty about how to treat specific transactions. There is also little question that multinational companies have been aggressive about using these rules to transfer profits to low-tax countries. But a better system, while easy to desire, is hard to accomplish.

As explained above, moving away from accounting profits and toward a formula based on sales, assets, or employees presents its own problems. Since different countries would probably use different formulas depending upon what benefitted them most, there is a real chance that the same income would be taxed in more than one jurisdiction. Instead, the BEPS reports hint at giving regulators the ability to second-guess the original valuations of a company's accountants. This discretion is likely to be used in only one direction: to increase revenues by ruling either that transfer prices were artificially low or that the payments generated by intellectual property (IP) are artificially high. Because the share of profits that multinational corporations declare abroad is much higher than their share of sales, this might seem to benefit the U.S. government. But if the Internal Revenue Service used these powers to bring back huge profits from overseas, it would likely press other nations to move toward a formula approach, reduce the competitiveness of U.S. firms abroad, and spark a new round of foreign acquisitions and inversions.[56] A better way of dealing with this problem might be to adopt a version of option B from former Ways and Means Committee chairman David Camp's proposal, which would disallow deferral for any profits earned in a country with an exceptionally low tax rate (say 10 percent). This could end up creating a de facto tax floor around the world, especially if other major nations and regions (e.g., Japan and the EU) adopted the proposal.

THE OUTLOOK FOR REFORM

A recent report on BEPS stated: "The proposition that [multinationals] need to pay more tax enjoys considerable political resonance as government budgets are strained, the world economy is struggling, income inequality is rising, and the news media have publicized instances of corporations legally lowering their global tax burdens by reporting income in low-tax jurisdictions and expenses in high-tax jurisdictions."[57] Given this sentiment, dramatically lowering the U.S. corporate tax rate may seem like a pipe dream. Yet, given the fact that most other emerging and developed nations spent the last two decades lowering their own corporate tax rates, it is vitally important if the United States is to maintain its global competitiveness.

Congress slightly brightened the political prospects for reform late last year by building a large number of semipermanent tax provisions into the budget baseline. Some provisions, such as the research and development tax credit, were made permanent. Others, such as accelerated depreciation, were extended for several years. The cost of these extensions is now part of current law. Under the budget rules, Congress no longer has to pay for them, and it can use the elimination of those that do not promote growth to pay for tax cuts, including reductions in the marginal rate. However, the Obama administration insists that any reform bill include the cost of these changes, thereby making reform even more difficult. Hopefully, the next administration will be willing to start fresh.

Properly done, [tax reform] can spur significant increases in investment, make the United States much more attractive as a place to locate, and speed us toward innovations.

The Republican Congress has also mandated that the Joint Committee on Taxation and the Congressional Budget Office use "dynamic" scoring when estimating the cost of major legislation related to tax and mandatory spending. Dynamic scoring takes into account not only the immediate impact of new legislation on economic activity, but also the indirect costs as a result of higher or lower economic growth. Since sensible tax reform is expected to boost economic growth, thereby producing higher tax revenues and lower spending, dynamic scoring should lower the estimated cost of tax reductions. In 2014 Chairman Camp issued a draft of both individual and corporate tax reform. The Joint Committee on Taxation's dynamic score for the bill was between $50 billion and $700 billion less than its static score over 10 years, depending on the assumptions used.[58] The bill was projected to increase GDP by between 0.1 percent and 1.6 percent annually for the next decade.

One big obstacle to reform involves the proceeds from deemed repatriation. President Obama and many Democrats insist that the revenues be devoted to infrastructure spending. Republicans wish to use the money to lower other taxes. Regardless of the merits of each approach, spending the revenues would clearly constitute a net tax increase if CBO's official score estimated a net increase in revenues over the 10-year period. Since the vast majority of congressional Republicans have signed a pledge not to raise taxes, it is difficult to see how it could be part of any tax reform, even one that was beneficial.

CONCLUSION

Corporate tax reform is not easy politically, but it becomes much easier when policymakers recognize that their nations are in a "race for global innovation advantage" and that losing that race would have a number of negative consequences.[59] Policymakers in a number of other countries have come to that realization and have successfully implemented major corporate tax reforms as a result. A case in point is the United Kingdom. In 2008, it had a statutory corporate rate of 28 percent, well below the current U.S. rate. Like the United States, it applied this rate to worldwide income and, also like the United States, many of its corporations were moving abroad in search of lower rates. Policymakers from the country's major political parties realized bold action was needed. As a result, they phased in a rate of 20 percent by 2015 and eliminated taxes on foreign income.[60] Later reforms included an expanded and reformed R&D tax credit and a patent box that by 2017 will impose a tax rate of just 10 percent on business income from patents and other IP.

The nation's financial future is characterized by both hope and serious difficulty. Likely breakthroughs in a number of technological fields could restore historic levels of productivity growth, especially if significant reforms of the current system, including expanding federal support for R&D, are put in place to encourage them. But we are not likely to enjoy these effects for a least another decade.[61] At the same time, government and the private sector suffer from large financial imbalances. Many promises will not be kept. It is imperative that instead of fighting about the distribution of losses, we focus on realizing the promise of the future and growing the pie. If we do that, we can all be much better off.

Tax reform is one of the structural reforms that needs to take place. Properly done, it can spur significant increases in investment, make the United States much more attractive as a place to locate, and speed us toward the innovations mentioned above. Unfortunately, like immigration reform, regulatory reform, education reform, and other efforts to increase economic welfare, the political process seems unable to move us forward. Those issues on which there is broad agreement, such as the need to fix the taxation of foreign income, are held hostage to the broader deal. And a refusal to compromise or even negotiate holds up an agreement that would improve the country.

Neither of the presidential candidates has proposed a reform plan that is remotely capable of passing a likely future House or Senate. Still, there is always hope. A great deal of progress has been made in educating members about the issues. A number of attractive proposals have been put forward. Bipartisan consensus is emerging on some issues. If the next president is pragmatic and willing to engage in the difficult negotiations needed to write and pass major tax legislation, then perhaps something will get done in 2017. If not, then the country will have missed one more opportunity to choose a better future.

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