Not So Fast? Evaluating the Case for 1986-Style Corporate Tax Reform

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1986-Style Tax Reform

- Since the early 1980s “tax reform” has almost always meant some variant of “broaden the base, lower the rates.”
- Before that it usually meant “broaden the base so the high rates are real, not fake.”
- Advantages are sometimes over-hyped – e.g., overall incentive to work (or save, if still an income tax) may not much change.
- And keeping “tax revenues” constant is optics, not substance. One could view the repeal of many tax expenditures as actually cutting “spending” (i.e., allocative policy).
- Repealing “bad” tax concessions is a no-brainer – but there could be multiple budgetary claimants for the fiscal benefit.

Individual vs. corporate 1986-Style tax reform

- Recent years have seen diminished support (especially on the left) for 1986-style individual income tax reform.
- But there still appears to be at least hypothetical bipartisan consensus in favor of doing this for the corporate income tax.
- This largely reflects concern about tax competition & the disparity between the statutory (as distinct from the effective) U.S. corporate rate & that in peer countries.
- Why hasn't it happened yet, if "everyone" agrees?
- Not just because our politics is such a horrendous mess – also because there is no obviously good way of doing it.
- Stand-alone corporate tax reform (where the rest of the tax system stays the same) faces the Redundant Conundrum: If all of the choices are bad, then none of the choices are good.

The "Original Sin": Taxing Corporate Income at the Entity Level

- With a realization-based income tax for individuals, taxing corporate income at the entity level may verge on being unavoidable. (Or at least, any possible alternatives aren't being much discussed.)
- But once we have this feature, *all* alternatives will be bad.
- This is not to deny that we should choose whichever alternative is least-bad.
- But "Everything else would be even worse" is not a very catchy sales pitch.
- Also, it's often hard to determine what exactly is least-bad.
- Cutting the statutory corporate rate can combine easing some problems with making others worse.

Problem #1 with taxing income at the entity level: Taxpayer information

- With an entity-level tax, attributes of the entity, not the owners, determine current tax liability.
- For example, entity-level taxes can't take account of the marginal rates that would apply to owners (and entity-level graduated rates make no sense).
- Loss nonrefundability also is affected. Not all bad if one wants to restrict individual-level tax shelter losses – or make it easier for business income to get effective refundability.
- But the latter comes at the price of encouraging inefficient, tax-driven multi-business consolidation.
- However, the biggest taxpayer-information problem that results from entity-level income taxation pertains to taxpayer residence.

An imagined "alternative history" of international taxation

- Suppose corporate income could be & was flowed-through to the "right" individuals.
- International income taxation would look radically different (& be far less problematic).
- There would be no serious dispute regarding the desirability of a WW tax on resident individuals' income. (There might also be no foreign tax credits other than on a pure reciprocity basis.)
- It would also be far easier to contemplate exempting inbound investment.
- But if resident individuals can invest through foreign entities, the case for both a WW tax on residents & a zero tax on "inbound" take a large hit.
- Entity-level corporate income taxation effectively requires applying the same tax rate to domestic & foreign SHs.

Problem #2: The temptation to tax at both entity & owner levels

- Once there's an entity-level tax, it may be hard to resist also imposing tax at the owner level (and distinguishing debt from equity).
- Not a forced move, but also not a surprise.
- This can lead, e.g., to discouraging the use of C corporations, encouraging excessive corporate leverage & lock-in of corporate earnings.
- There can also be opposite effects at each of these margins!
- E.g., say the corporate rate is lower, SH-level realization can be permanently avoided, the dividend rate may change in the future, etc. [Merton Miller effect: yesterday vs. tomorrow]
- One might like to lower the corporate rate in light of *expected* SH-level taxes – but hard to say how best to do this when the latter may be all over the map.

Corporate vs. non-corporate business

- The relationship between corporate & non-corporate business is another huge problem for stand-alone corporate tax reform.
- The U.S. has an unusually even mix between the two sectors.
- The owners of flow-throughs might not mind if we simply lowered the corporate rate.
- But revenue-neutral 1986-style corporate/business reform implies that their taxes will go up, from the base-broadening.
- This is not just a political problem – it's plausible that non-corporate business already is generally more highly-taxed (e.g., due to the unavailability of cross-border profit-shifting strategies).

Problem #3: The difficulty of distinguishing between capital income and labor income

- We sometimes think of the entity-level corporate tax as falling on “capital income” (though not, of course, all such income).
- That’s what’s left if all value created by workers is paid out in the form of arm’s length salaries.
- But less so when owner-employees under-compensate themselves & rely on stock appreciation to come out whole.
- The problem of corporations as a tax shelter for labor income is an old one but not well-addressed, & with today’s rates we may be more eager to get it right than, say, under 1960s rates.
- Dual income taxes (limiting the low corporate rate to normal returns on equity) could be used to address this – but have not been much discussed by policymakers.

Argument #1 for 1986-style corporate tax reform: we're "out of step"

- Two reasons this might matter: the wisdom of crowds, & competitive pressures.
- Paeans to "American exceptionalism" notwithstanding, I tend to agree that it's significant if everyone else does things differently.
- But (a) we have more market power than most countries, and (b) the real locus of exceptionalism is our broader reliance on income taxation.
- Competitive pressures do matter. But we're not similarly out of step re. effective tax rates, and 1986-style corporate tax reform leaves overall business taxation about the same.

Argument #2: general merits of revenue-neutral base-broadening

- "Lower the rates, broaden the base" is Tax Reform 101. BUT:
- (a) Why link the repeal of corporate tax expenditures to corporate tax rates? (Lots of other budgetary claimants.)
- (b) Given the various issues discussed above – e.g., corporate versus non-corporate business – how much more neutral does this make the overall tax system?
- (c) Transition issue posed by increasing tax burdens on new investment (via slower cost recovery) in exchange for lowering tax burdens that's partly for old investment (via rate reduction that applies to future income from past investments).

More arguments for 1986-style corporate tax reform

- (3) Desirability of lower tax rate for capital income than labor income: Maybe yes, but then we should also address labor income that's in the corporate base and non-corporate capital income.
- (4) Response to the second level of tax: But again, note the heterogeneity of expected SH-level taxes.
- (5) Addressing debt bias in the corporate sector: Maybe, but again consider rising Merton Miller effects.
- (6) First step towards improving our international tax rules: If our tax rate on FSI is too high, some argue that it's beneficial to lower the corporate rate so it will matter less.
- But surely, under current tax institutions, it makes sense to have a higher tax rate for domestic source income than FSI (& to move away from using deferral / FTCs to achieve this).

Summing up

- The case for 1986-style corporate tax reform is widely viewed as very strong.
- But in fact the net policy improvement is likely to be, at best, quite modest if all else stays the same.
- I myself would be more enthusiastic if the package included (a) dual income tax-style rules addressing undistributed labor income of owner-employees, and (b) appropriate international tax reform.
- Even so, there would be remaining normative uncertainties.
- Plus, the more issues we open up, the more it turns into a very different and more controversial process.