Corporate Tax Reform: If the Path is So Clear, What's the Problem?

Daniel Shaviro

NYU Law School

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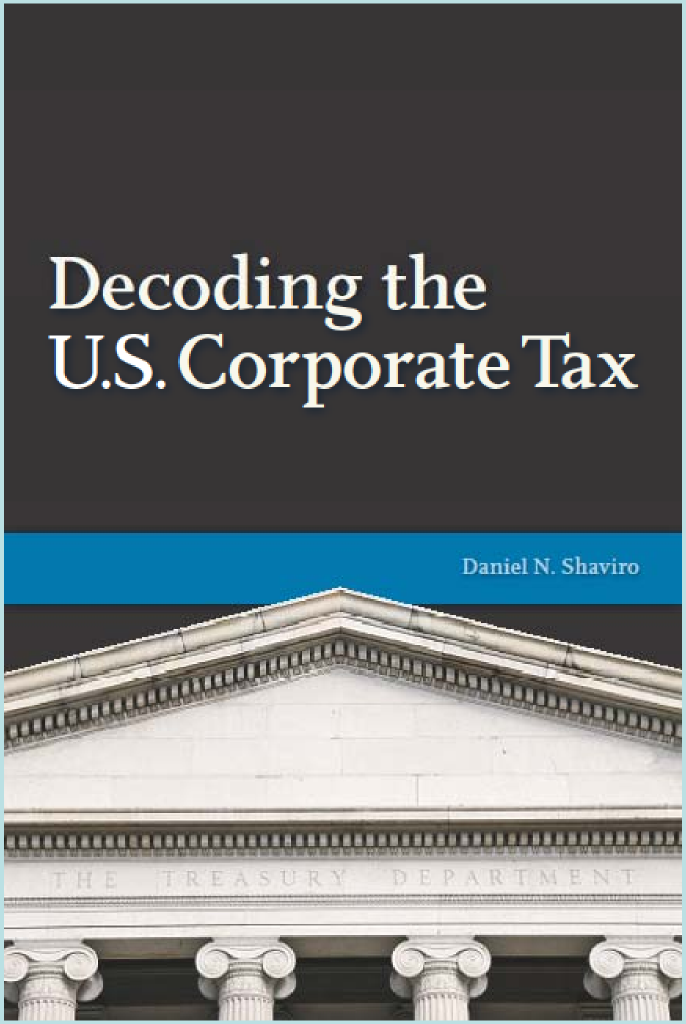
What's wrong with the existing U.S. corporate tax?



"Sometimes we hear of a solution in search of a problem, which someone offers to a baffled world despite the lack of any discernible need for it. Examples include … endless … tax cuts, interminable concert tours by the Rolling Stones when they are past age 60, and the live-action theatrical movie version of *Scooby-Doo*.

"Corporate [tax reform is the opposite], involv[ing] too many solutions in pursuit of too many problems…"

The seemingly simple case for lowering the corporate rate

With global capital mobility, countries face pressures of tax competition.

By lowering one's tax rate for mobile capital, one may increase one's share of both (a) real domestic investment and (b) reported domestic tax revenues from cross-border activity.

Assuming appropriate overall policy adjustments, this may be unambiguously good for the country adopting the lower rates.

The corporate rate is an (imperfect) proxy for the tax rate faced by mobile capital.

So why not just lower the corporate rate and have done with it?

If only it were that simple …

Unfortunately, a number of concerns either must or should be addressed before the corporate rate is lowered.

In particular, need to consider:

(1) federal budgetary concerns,
(2) what are the pay-fors,
(3) structural tax base design issues,
(4) implications for shareholder-level taxation.

My plan in the rest of this talk: describe each of these concerns, then briefly discuss U.S. international taxation (e.g., temporary tax holiday or permanent shift to a territorial system).

(1) Federal budgetary concerns

We are on a fiscal path to disaster – and this is *NOT* about short-term budget deficits but the long-term picture.

The U.S. public debt to GDP ratio is currently on a path to turn vertical as soon as the mid-2030s.

A disastrous credit market event (e.g., collapse of U.S. government debt market) could happen sooner, & is inherently unpredictable.

(And lunatics in Washington appear eager to risk deliberately making it happen within the next 3 months.)

Against this background, lowering the corporate rate without pay-fors would not only be reckless, but undermine the long-term credibility of the rate cut.

(2) The pay-for problem

There's at least a political logic to 1986-style tax reform (pay for the rate cuts via base-broadening).

But political economy issues make this inherently a steep & politically unnatural uphill climb. In particular:

--Interest group theory (concentrated interests are generally more powerful than diffuse ones).

--Endowment effect or status quo bias (losers scream a lot more loudly than winners say thank you).

By definition, revenue-neutral tax reform has both winners and losers.

If revenue-neutral, would this be as to (a) the federal budget?, (b) the existing corporate sector?, (c) the broader business sector?

Possible business/corporate sector pay-fors

JCT corporate tax expenditure list includes, inter alia:

ITEM	**2010-2014 Average Annual Amount**
Deferral for CFCs' active income	$14.1 B
Domestic production activities deduction	$8.6 B
Accelerated depreciation	$7.4 B
R & E expensing	$5.1B
LIFO for inventories	$4.0B

--I would agree that listing deferral as a tax expenditure isn't very illuminating (whatever one's view on international tax issues).

--But should defects in source rules be considered a pay-for?

--Some items promote new investment; transition gain to old investment from lower corporate rate.

(3) Structural tax base design issues

Tax Policy 101: first get the base right, then decide on the rate.

E.g., it wouldn't make sense to wipe out business deductions & then tax gross income at a nominally low rate.

Apart from replacing the income tax with a consumption tax, the big issue here is debt versus equity.

Arguably better than, or at least prior to, reducing the corporate rate would be adopting an allowance for corporate equity (ACE).

Or better still, an allowance for corporate capital (ACC), whether debt or equity.

Either would invite revisiting SH-level taxation – but this may equally hold for cutting the corporate rate.

(4) Shareholder-level taxation after corporate tax reform

Under ACE or ACC, accrue income at the SH level?

With a lower corporate rate, revisit the 15% dividend rate?

Note rising recent consensus that double taxation should mainly be addressed at the *entity* level.

Another big issue: use of C corporations as a tax shelter to avoid application of the top individual rate to owner-employees.

“Reasonable compensation” as a minimum, as well as a maximum? Could be very hard to implement.

Another approach: “dual income taxation” – Scandinavian precedents; assume “normal” entity-level return.

(5) International tax reform: territoriality?

Dividend holidays are a terrible idea, but exempting foreign source active income has increasing support (& note international trends).

Today's proponents of continued WW taxation are more concerned about protecting the U.S. source-based tax than about taxing U.S. companies' "true" FSI.

Territoriality plus changing the source rules could *raise* revenue.

Is it time to consider unitary WW approaches to source? (Parent-sub entity lines are economically close to meaningless.)

Transition issue: why should companies that accumulated billions abroad under the current regime escape altogether the tax that they expected to pay (or at least to incur costs avoiding)?