Washington Center for Equitable Growth

In defense of the statutory U.S. corporate tax rate

Greg Leiserson   August 2017

It is increasingly apparent that many policymakers and commentators believe that business tax reform means reducing the statutory corporate tax rate. This fixation on the corporate tax rate is unfortunate and misguided. Business tax reform should be primarily about the tax base, not the tax rate. Treating the statutory rate as the key element of reform will inevitably result in a more expensive, more regressive, and less economically beneficial (if not actively harmful) reform than one that focuses on the tax base. By focusing on the base, it is possible to design reforms that achieve a given set of economic objectives at a far more modest cost. Focusing on the base therefore also makes it much easier to meet the minimum standard that tax reform should not decrease government revenues.

The focus on the rate is apparent in the evolution of public statements about tax reform from congressional Republicans and Trump administration officials. Modifications of the tax base were an important part of the blueprint for tax reform put out by Republicans in the House of Representatives in 2016. The blueprint contained three major proposed changes to the corporate tax: a reduction in the statutory rate; full expensing of capital investment combined with repeal of interest deductibility; and the imposition of a border adjustment that would tax imports and rebate tax on exports. But the joint statement on tax reform from six leading Republicans representing both Congress and the administration at the end of July expressed less enthusiasm for expensing and rejected outright the border adjustment, leaving the reduction in the statutory corporate rate the only element unscathed. More recently, National Economic Council Director Gary Cohn reiterated the administration's focus on the statutory corporate rate, saying that the administration will seek the lowest statutory rate possible.

Recent research indicates that the overwhelming majority of the corporate tax base consists of excess returns, meaning returns above the risk-free rate such as those due to monopoly pricing power, and income attributable to labor that was not paid out as wages. Cutting the corporate tax rate is inefficient and regressive because these types of income are relatively efficient to tax and accrue to business owners, who are disproportionately high-income and high-wealth.

Consistent with these findings, the corporate-level tax rate on the marginal investment—the tax rate paid on a hypothetical investment in tangible or intangible capital that yields the minimum return necessary to attract financing in capital markets—is far lower than the statutory tax rate: only 6 percent, according to recent estimates from the Congressional Research Service. This rate is lower than the statutory tax rate due to provisions of the corporate tax system such as accelerated depreciation and interest deductibility that allow a substantial portion of the return on corporate investment to avoid corporate tax. Proposals for business tax reform that focus on the base rather than the rate can achieve a much more attractive combination of benefits and costs than reforms that focus on cutting the statutory tax rate because they aim to keep as large a share of excess returns and disguised labor income in the tax base as possible.

The advantages of focusing on the tax base rather than the corporate tax rate are usefully illustrated by two proposals recently put forward by the tax policy community, both of which achieve the economic objectives of their proponents at far lower cost than reducing the statutory rate in isolation.

First, consider the destination-based cash flow tax. Adopting this proposed tax would effectively repeal the corporate income tax without reducing the statutory tax rate at all. The proposal would change the tax base—allowing full expensing of capital investment, repealing interest deductibility, taxing imports, and rebating tax on exports—in such a way that it would convert the corporate income tax into another type of tax entirely: an approximation to the business cash flow tax that is part of a consumption tax system. In other words, even if one adopts the view that corporate income taxes are uniquely distortionary and should be eliminated, it is possible to do so without reducing the rate. (The policies listed above do not yield a pure destination-based cash flow tax, as they would still tax certain corporate financial income, including interest, dividends, and capital gains.)

Next, consider the proposal for corporate tax reform put forward by Eric Toder at the Tax Policy Center and Alan Viard at the American Enterprise Institute. This proposal would reduce the corporate tax rate to 15 percent while taxing investors on the change in the value of their shares in publicly traded companies on an annual basis (and providing credit for corporate taxes paid to taxable investors). The proposal also would impose tax on interest income received by nonprofit organizations and by individuals in their retirement accounts, such as 401(k)s and individual retirement accounts.

The proposal by Toder and Viard includes a reduction in the statutory rate, but it is more usefully understood as a redefinition and reallocation of the tax base across entities. By taxing investors on the change in the value of their shares, a substantial fraction of the corporate tax base is effectively shifted from the corporate level to the investor level. The new taxes applied to certain interest payments offset the exclusion of interest payments from the corporate tax base, thus achieving a more consistent treatment of investments financed in different ways. The major changes in the tax base in this proposal are the implicit partial exclusion of corporate income attributable to foreign investors and the use of market valuations rather than measuring income directly.

The common theme of these two proposals is a reform that modifies the tax base to achieve clear economic objectives at a more modest cost than simply cutting the corporate tax rate. The destination-based cash flow tax proposal shows that it is possible to completely repeal the corporate income tax in an economic sense without reducing the statutory corporate tax rate to zero. The Toder-Viard proposal highlights that full or partial integration proposals can achieve similar economic aims by shifting the tax base between firm-level taxes and investor-level taxes, provided that the investor-level taxes are appropriately reformed.

Estimates from the Tax Policy Center suggest that both the Toder-Viard proposal and the not-quite-pure destination-based cash flow tax could be implemented on a roughly revenue-neutral basis in the first decade, including the cost of providing expensing for noncorporate businesses in the cost of the latter proposal. Although both proposals have important weaknesses, either one would offer a far more attractive combination of costs and benefits than a simple reduction in the statutory corporate tax rate.

A key implication of the existence of these proposals is that simple arguments against corporate income taxation or capital taxation, even if true, are inadequate to make the case for statutory corporate rate cuts as the centerpiece of reform. Arguing for statutory rate cuts requires first rejecting superior and far cheaper policy alternatives.

Indeed, the variants of these two plans that have achieved political traction highlight the problems of focusing on the statutory tax rate. The House Republican blueprint draws heavily from the destination-based cash flow tax but adds a large cut in the statutory corporate tax rate. This rate cut would come at great cost, would be a key contributor to the higher federal budget deficits that would cause the blueprint to harm economic growth, would provide little or no economic benefit even if financed by other tax increases or spending cuts, and would be severely regressive. In effect, the blueprint shifts the United States toward a consumption tax but then adds a partial exemption for consumption by business owners (via the rate cut) with no justification.

Similarly, there has been some congressional interest in increasing tax rates on capital gains and dividends as a potential offset for statutory corporate rate cuts, but little apparent interest in the more fundamental reforms to taxation at the investor level that are core to the Toder-Viard proposal. The focus on offsets for a statutory rate cut rather than a focus on the appropriate base for taxation ultimately undermines any economic merits the proposal might otherwise have.

Regardless of one's views on the relative merits of consumption taxation and income taxation, on the economic and fiscal costs of the erosion of the corporate tax base, or on the harm resulting from corporate inversions, business tax reform should be about reforming the tax base, not cutting the rate. Cutting the rate is an expensive and regressive substitute for other superior reforms.

Many arguments for reducing the corporate tax rate are in large part arguments for increased reliance on consumption taxes. Plausible tax legislation, however, looks quite different from reforms that would move the United States toward a consumption tax. (In the interest of disclosure, this author is not an advocate of converting the income tax into a consumption tax.) The idealized consumption tax would tax labor and excess returns while exempting from tax the risk-free return to capital. Thus, relative to current law, legislation would focus on exempting the risk-free return and leave the taxation of excess returns unaffected to the extent possible. But with the apparent focus in Congress and within the Trump administration on reducing the statutory corporate tax rate, plausible tax legislation is more likely to reverse those outcomes, reducing taxes on excess returns to the maximum extent possible and leaving the taxation of risk-free returns relatively unaffected. This approach is not the path to equitable growth.

Our Mission

Accelerate cutting-edge analysis into whether and how structural changes in the U.S. economy, particularly related to economic inequality, affect economic growth.

Washington Center for Equitable Growth

1500 K Street, NW, Suite 850, Washington, DC 20005 • Tel: 202-545-6002 • www.equitablegrowth.org • @equitablegrowth