REMAPPING DEBATE
Asking "Why" and "Why Not"

How fiscally prudent is “lower the rate and broaden the base”?

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Mar. 8, 2012 — The corporate tax reform mantra these days — at least on the Democratic side of the aisle — is “lower the rates and broaden the base.” Supporters frequently say that the goal is a corporate tax system that makes the United States more competitive in relation to other industrialized democracies, reduces inequities and inefficiencies, and is ultimately “revenue neutral.” But serious questions have been raised about the premises underlying the vision of lowering rates and closing unwarranted corporate tax loopholes concurrently, and about the fiscal prudence and ultimate revenue neutrality of proceeding in that manner.

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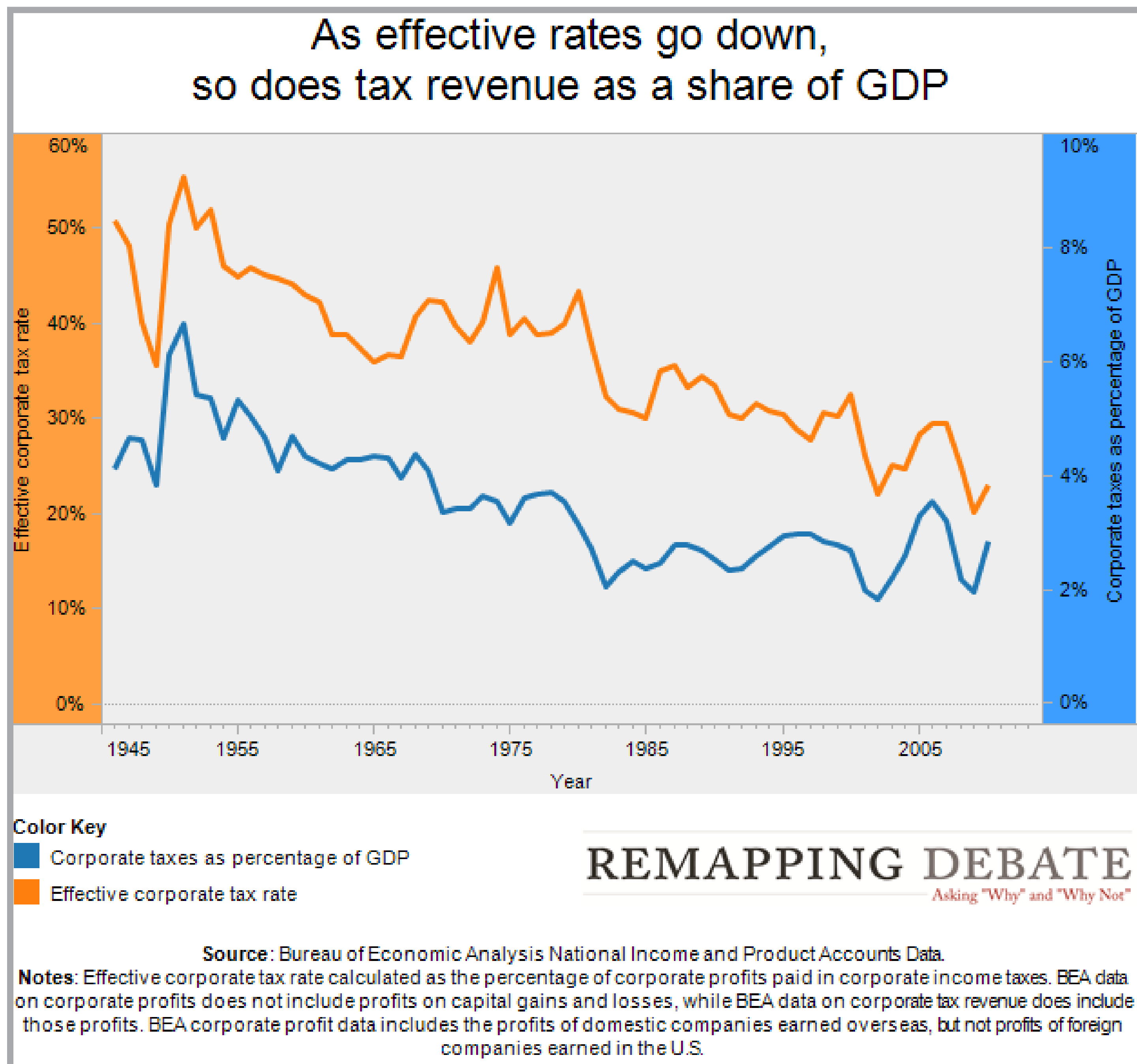
An alternative way to proceed would be to close unwarranted loopholes first, allow the dust to settle, and then make an independent determination about what is the fiscally and economically prudent course on corporate tax rates. After all, in addition to reductions in statutory rate, both the effective corporate tax rate and corporate tax revenues as a percentage of GDP have trended downward over the decades (see bottom box on next pafe).

For some, the step-by-step approach is a political non-starter: “That’s not going to happen,” said Dean Baker, co-director of the Center for Economic Policy and Research, a progressive think-tank in Washington. “I think it makes more sense to try and close some of the loopholes and lower the rates rather than doing nothing.”

To Robert S. McIntyre, though, the idea of packaging loophole-closing and rate reduction together is a “terrible strategy for the Democrats.” McIntyre is director of Citizens for Tax Justice, another progressive advocacy organization in Washington. First of all, he said, “Republicans will want to compromise off [a revenue neutral proposal], which means that it will lose money.” Second, McIntyre adheres to the view that corporate tax reform is supposed to “raise some money” in the course of closing tax breaks, characterizing the abandonment of such a goal — the “revenue-positive” approach — as a “complete surrender” of the principle that is supposed to animate reform.

Rates and distributional fairness

Among the arguments often deployed in support of combining rate reduction with elimination of various corporate tax breaks is that it is important to create a more even playing field in terms of the taxes paid by corporations in different sectors. It is not disputed that, currently, a corporation's effective tax rate can vary wildly depending on whether the corporation is in a high-tax-break or lower-tax-break industry, and on the finesse with which a corporation's accountants and attorneys work the system.



Source: Bureau of Economic Analysis National Income and Product Accounts Data.
Notes: Effective corporate tax rate calculated as the percentage of corporate profits paid in corporate income taxes. BEA data on corporate profits does not include profits on capital gains and losses, while BEA data on corporate tax revenue does include those profits. BEA corporate profit data includes the profits of domestic companies earned overseas, but not profits of foreign companies earned in the U.S.

But do concerns about enhancing inter-corporate equity and generating greater predictability on taxes mean that rates need to be reduced? Actually not, according to a range of tax policy analysts. Jim Kessler, for example, the senior policy vice president for policy and a co-founder of Third Way, a Washington advocacy organization that bills itself as centrist, agreed that his stated goals of simplification, equity, and predictability do not require a particular nominal tax rate — the goals could be achieved by reducing loopholes and treating corporations in different sectors alike *regardless of rate*. (A separate goal of Third Way — remedying what it sees as a rate that puts the U.S. at a competitive disadvantage when it comes to corporate decisions as to where to locate their operations, of course, would require rate reduction).

Eugene Steuerle, a tax policy expert who is now a fellow at the Urban Institute and who is described on the Institute's website as the "Economic Coordinator and original organizer of the 1984 Treasury study that led to the Tax Reform Act of 1986," concurs with Kessler, agreeing that a decision to reduce variation in *effective* rates could be done as easily at a nominal rate of 35 percent as it could be done at a nominal rate of 28 percent.

And Baker agrees that, "at least as a logical matter" there is "no reason you have to lower the rates to equalize" the system.

Race to the bottom

There are several tricky aspects to the argument that rates should be lowered to eliminate any competitive disadvantage the U.S. faces in relation to other advanced economies. For one, as a 2011 Citizens for Tax Justice report points out, "U.S. corporations pay a smaller percentage of their profits in taxes than do corporations based in other developed nations." For another, a second 2011 CTJ report noted, the U.S. in 2009 collected less in corporate taxes as a share of GDP "than all but one of the 26 OECD countries for which data are available." More fundamentally, the U.S. does not operate in a static international environment; countries do respond to one another. In fact, as depicted in a table in a 2008 Tax Foundation report, it was the U.S. that led the path in the mid-1980s to lower statutory corporate tax rates; it was the other member nations of the OECD (including the subset of larger nations that make up the G-7) that followed.

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Why then, might not European or other competitor nations respond to another U.S. rate reduction by lowering their own rates again, in the manner of states here in the U.S. that compete with one another to offer corporations the largest tax breaks and incentives?

This was among the questions I put to a Treasury Department spokesperson who, nominally, was prepared to speak on background. But, even on background, the spokesperson refused to be responsive, declining to speak to potential future developments.

I also sought to get Senator Ron Wyden (D-Ore.) to answer the question of whether the "lower the rate" element might set off a rate-lowering arms race. Wyden has sponsored a broad tax reform bill that, on the corporate side, would lower the statutory rate from 35 percent to 24 percent and broaden the base by eliminating many loopholes and what Wyden describes as "corporate welfare." Wyden's office did not respond.

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Kessler of Third Way, who supports the rate-lowering, base-broadening approach, agreed that the question of race to the bottom raises a "very legitimate" issue, and said, "I can't guarantee you that that won't happen." McIntyre went much further. "If we cut our corporate rate," he said, the other countries will reluctantly — but they'll feel pressure to do it — lower theirs as well. That's what happened after [the 1986 Tax Reform Act]."

Some of those I spoke with cited factors that might militate against reactive rate cuts by others. Kessler said that European countries would be hard-pressed to lower rates when they so desperately needed revenue, and Baker pointed out that a reform that was revenue-neutral (that is, one that did not reduce the effective rate) would be understood as one that retained in many ways the relative positions between and among countries, and thus was not a change that would logically cause other nations to respond.

Baker did say that, as a political or rhetorical matter, businesses in those countries would be likely to try to use a U.S. rate cut to argue for rate reductions that they would like to see in any event. And he cautioned against over-reliance on the idea that business location decisions are motivated solely or principally by tax rate: rate is "far from the only factor and can easily be outweighed by [other factors like] the quality of the work force, the quality of the infrastructure, and being close to other businesses." he said.

The idea that tax rate is determinative in causing companies not to locate or expand in the U.S. is a myth, Baker added. That debunking, he asserted, is readily available from "business people who are being honest."

Multiple questions as to "neutrality"

One question about the combined approach is whether it would, in fact, be enacted as revenue-neutral. Eugene Steuerle of the Urban Institute observed that "a deficit-neutral reform of the corporate code is very difficult, because — if it's really deficit-neutral — you're going to create a lot of losers out there, and they're going to scream bloody murder, which is why that debate hasn't even proceeded very far."

But another issue is what happens down the road.

Things could work out as proponents hope, but what if they did not? "It wouldn't be the first time that the Congress passes changes to the tax code that [turned out] not beneficial to the U.S. economy," Kessler acknowledged. "I would say that the Bush tax cuts were a horrible mistake for the economy. It didn't get the revenue that the supporters said it was going to get and arguably it helped create a bubble."

> The abandonment of a "revenue-positive" approach is a "complete surrender" of the principle that is supposed to animate corporate tax reform. — Robert S. McIntyre, director of Citizens for Tax Justice

I presented two scenarios in my questioning. In the first, there is loophole closing prior to any rate reduction. In the second, rate reduction occurs simultaneously with loophole closing. I suggested that Congress would be much more readily amenable to remedying any ill effects of "too much" loophole closing (responding, for example, if a business sector were able to produce evidence that it was being unfairly hurt by the absence of a credit or preference) than it would be if a problem arose because rate reduction turned out to be a mistake (for example, if the revenue lost came to be missed, if the lower rates did initiate a renewed race to the bottom with other countries, or otherwise).

Kessler agreed that, from a political point of view, the lowered rate is locked in more securely than are the elimination of tax breaks, although he argued that the need, in general, to get 60 votes in the Senate would operate to make restoration of tax breaks more difficult. (Getting to 60 may not always be as difficult as it may seem. Sometimes a tax break, even if it is one that a particular Senator does not affirmatively support and isn't afraid to oppose, comes packaged in a bill for which the Senator believes he must vote.)

McIntyre said that it would be distinctly more difficult to remedy an ill-conceived rate reduction given the level of corporate influence: "It's very hard to raise their rate. Absent a World War, I don't know how we could do it."

So why go ahead?

Kessler said he thought “it’s worth rolling the dice.” The level of risk in doing so is, in his view, low: he did not believe that any error in estimating the scope of the fiscal impact of rate reduction would be significant. In contrast, he thought the potential benefit of making change would be significant, saying that he believed the current tax system is “not anywhere near the optimal place where it should be on

Plenty of candidates for stand-alone loophole closing

Robert S. McIntyre of Citizens for Tax Justice has a long list of what he considers unwarranted corporate tax breaks, but he identified as a giant one the current rule that allows U.S. companies to “defer” U.S. taxes on their offshore profits until those profits are brought back to the U.S., a process that may take years if it happens at all. The cost to taxpayers, according to a CTJ report: at least $50 billion per year.

McIntyre derides the argument in favor of maintaining or expanding the tax break as coming down to, “The other countries aren’t good at policing offhore abuses either, so we can’t be the ones who do,” or “We won’t be able to compete in China against a French company that wants ot build a factory there and won’t have to worry about any French taxes.”

Jim Kessler of Third Way also has candidates for loopholes that deserve to be closed independent of whether anything is done regarding corporate tax rates. Among these are the provision that allows oil and gas producers to take an immediate expense deduction for intangible drilling costs. In a submission to last year’s “Super Committee” that was charged with identifying the means by which to reduce the deficit by $1.2 trillion over 10 years, Third Way said that the provision “inappropriately insulated investors from the risks” of their projects, and estimated the 10-year cost of the tax break at $12.5 billion. Another tax break for that industry — a depletion allowance that allows independent oil and gas producers to shelter about 15 percent of their income — was described as “an unnecessary industry-specific subsidy” that costs taxpayers $11.2 billion over 10 years.

And Eugene Steuerle of the Urban Institute nominated for close scrutiny the current system of “tax arbitrage” by which a company can, for example, create highly negative tax rates by “borrowing and buying equipment for which you now get 100 percent expensing on a temporary basis.” The “classic game” being played by international companies “has been to put their interest deductions in the high-rate country — that’s the U.S.” at the same time that they disproptionately book income in a foreign country.

A Treasury Department spokesperson, speaking on background, confirmed that President Obama continues to believe that there are corporate tax loopholes that should be eliminated even in the absence of rate reduction, but would only specify the President’s call to end oil and gas subsidies.

the corporate side." Kessler also said it was essential to adapt the system to a world that is significantly more globalized than it was at the time of the last major overhaul 25 years ago.

Baker's rationales for proceeding with "lower the rate and broaden the base" was that simultaneity was the only politically feasible way to achieve two desirable results: greater distributional equity, and a reduction in the "total waste" of a big industry devoted to wangling tax breaks. "If we could instead of having General Electric pay however much they're paying their accountants…to the government, that's a big gain. And if that means some other companies are instead paying less in tax, that's to my mind still positive."

Alice Rivlin, the first director of the Congressional Budget Office and a member of 2010's Bowles-Simpson panel, also thought rate reduction should proceed simultanteously with loophole elimination. Wouldn't waiting to make a separate decision on rates be more fiscally prudent? Rivlin said "no." Her reasoning, ironically, is derived from the fact that corporate tax receipts have "shrunk as a source of revenue over many years" (she characterized corporate tax revenues as "tiny"). As such, even a rate reduction that turned out to be unwise, she argued, would not have significant fiscal consequences. Thus, she concluded, on the corporate taxation side "you can't make the argument that we should wait and see if we really need [more lowering of rates]."

And the Treasury? Again, even on background and in the face of multiple inquiries, Treasury wouldn't speak to the issue of the fiscal prudence of proceeding with rate cuts at the same time as loophole closing. The spokesperson with whom I was in contact likewise would not address the asymmetry between: (1) the difficulty, if a course correction came to be needed. in restoring rates that had been cut; and (2) the ease with which, subsequent to loophole closing, an independent decision to lower rates could always be made, if warranted. (These were among the questions to which Sen. Wyden's office did not respond.)

Or perhaps not?

CTJ's McIntyre is still sounding the call for revenue-positive corporate tax reform because "the alternatives are not very pretty." If the Congress "does not get some money out of the corporations and the wealthy people, then they have to get it somewhere else to deal with the deficit," and that, McIntyre said, means entitlement programs, infrastructure, and education funding — are things that he characterized as "much more important to most Americans and, in my view, all a lot more important to a successful business economy as well."