Business Tax Reform

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Chairman Hatch, Ranking Member Wyden, and Members of the Committee, thank you for inviting me to appear today to discuss the opportunities and challenges in business tax reform. The views I express are my own and should not be attributed to the Tax Policy Center, the Urban Institute, the Brookings Institution, their boards, or their funders.

America's business tax system is needlessly complex and economically harmful. Thoughtful tax reform can make our tax code simpler, boost American competitiveness, create better jobs, and promote shared prosperity.

Business tax reform will boost long-run economic growth if it inspires more investment in the United States and if firms make investments with higher social returns. With high statutory rates, numerous tax breaks, and deferral of overseas profits, our current system creates many perverse incentives. Corporations sometimes see a more favorable investment climate abroad, multinationals hoard money in overseas affiliates, different types of investment face widely varying tax rates, debt financing is favored over equity, new and small businesses struggle under disproportionate compliance costs, and businesses big and small invest too much in tax planning. Thoughtful tax reform can reduce these distortions, encourage businesses to invest more domestically, and reorient investment to opportunities that yield higher returns for society.

But as you know, tax reform is hard. Meaningful reforms create winners and losers—and you may hear more complaints from the latter than praise from the former. In hopes of making your job a little easier, my testimony addresses seven main points about business tax reform:

1. **Policymakers should be realistic about near-term growth from business tax reform**. The growth effects of more and better investment accrue gradually, with their largest effects beyond the 10-year budget window. If reform is revenue neutral, revenue raisers may temper future growth. If reform loses revenue—tax cuts mixed with reform—deficits may crowd out private investment. Either way, the boost to near-term growth may be modest, at least in the budget window. Dynamic scoring by the Joint Committee on Taxation, which reflects the mainstream economic view, will thus play only a small role in paying for tax reform.

2. **The corporate income tax makes our tax system more progressive; corporate tax cuts would thus particularly help people with high incomes.** Much of the burden from corporate income taxes falls on corporate shareholders and investors more broadly, people who tend to have high incomes. The rest of the burden falls on workers including executives, professionals, and managers as well as rank-and-file employees. Economists debate how much of the burden falls on workers, but overall it is clear that corporate tax reductions would particularly benefit those with high incomes. Workers will benefit most from reforms that encourage more and better investment in the United States.

3. **Taxing pass-through business income at a preferential rate would create new opportunities for tax avoidance.** When taxpayers see an opportunity to switch from a high tax rate to a lower one, they often take it. This is especially true when they can make the shift with a mere paper transaction, not a real change in economic behavior. Prominent examples include Kansas's experiment with eliminating taxes on pass-through income, S corporations' profits exemption from Medicare payroll taxes, and preferential rates for long-term capital gains. Taxpayers will react the same way if pass-through business income gets preferential treatment. Legislative and regulatory measures to limit tax avoidance will introduce new complexities, create arbitrary distinctions, and impose new administrative burdens.

4. **Limiting the top tax rate on pass-through business income would benefit only people with high incomes.** In the Better Way plan, House Republicans propose that pass-through business income be taxed at no more than 25 percent, well below the 33 percent rate they propose for wages, salaries, and other ordinary income. The only taxpayers who would benefit are those who have qualifying business income and have enough income to otherwise be in a higher tax bracket. Almost all tax savings would go to people in the top of the income distribution. Creating a complete schedule of pass-through rates could reduce this inequity, but it would also expand the pool of taxpayers tempted by tax avoidance.

5. **Taxing pass-through business income at the corporate rate would not achieve tax parity.** Owners of pass-through businesses face one layer of tax: individual income taxes on their share of business profits. Corporate shareholders face two layers. The company pays corporate income taxes on its profits, and taxable shareholders pay individual income taxes on their dividends and capital gains. Taxing pass-through business income at the corporate rate would thus favor pass-throughs over corporations. Tax parity requires either a higher tax rate on pass-through business income, a new tax on pass-through distributions, or elimination of shareholder taxes.

6. **It is extremely difficult to pay for large cuts in business tax rates by limiting existing business tax breaks and deductions.** A new Tax Policy Center analysis finds that eliminating all corporate tax expenditures except for deferral could pay for lowering the corporate tax rate to 26 percent. To go any lower would require cutting other business deductions, such as for interest payments. But deductions lose value as tax rates fall. The more you cut rates, the harder it becomes to raise offsetting revenue by limiting tax breaks and other deductions. To pay for large rate reductions, lawmakers will therefore need to raise other taxes or introduce new ones. Options include raising taxes on shareholders, a value-added tax, and a carbon tax.

7. **Making business tax cuts retroactive to the start of 2017 would not promote growth and would benefit only shareholders.** Retroactive tax cuts would give a windfall to profitable businesses. That does little or nothing to encourage productive investment. Indeed, it could weaken growth by leaving less budget room for more pro-growth reforms. Retroactive tax cuts do not help workers; the benefits would go solely to shareholders.

I elaborate these points in the remainder of my testimony.

1. POLICYMAKERS SHOULD BE REALISTIC ABOUT NEAR-TERM GROWTH FROM BUSINESS TAX REFORM

Thoughtful business tax reform will encourage more and better investment in the United States. But the benefits of that investment will not show up immediately. They build gradually over time as businesses accumulate their stock of productive capital. The largest benefits may occur beyond the usual 10-year budget window.

Moreover, the potential growth from business tax reform will be offset, at least in part, by other aspects of reform. If reform is revenue neutral, revenue raisers may temper future growth. If reform reduces the corporate tax rate while slowing investment write-offs, for example, the net effects on investment and growth will reflect the growth penalty from slower write-offs along with any growth benefits from lower rates. Depending on the changes, the net effect could even slow growth. If reform loses revenue—tax cuts mixed with reform—deficits may crowd out private investment. Either way, the net boost to economic growth will be less than might be suggested by a narrow focus on the growth-increasing aspects of reform.

Policymakers should therefore be realistic about how much additional growth they can expect from business tax reform and how much dynamic scoring can help pay for its costs. Former Ways and Means Chairman Dave Camp's tax reform in 2014 provides a good example. His proposal reduced the corporate tax rate to 25 percent, but among the offsetting revenue raisers were limits on interest deductibility and slower depreciation. As a result, the Joint Committee on Taxation (2014) concluded that the plan would likely reduce future investment. The plan boosted economic activity modestly, because JCT believed other features would encourage people to work more. On net JCT expected Camp's plan to lift gross domestic product by a total of 0.1 to 1.6 percent over 10 years, yielding additional federal revenues of $50 to $700 billion. Welcome amounts, to be sure, but modest relative to the revenue changes of large-scale business tax reform.

2. THE CORPORATE INCOME TAX MAKES OUR TAX SYSTEM MORE PROGRESSIVE

The burden of the corporate income tax falls on three types of people. Corporate shareholders bear some of the tax because it reduces the dividends and capital gains they receive. Owners of capital bear some of the tax because it reduces the return to capital in the economy more broadly. And workers bear some of the tax because it reduces the size and quality of the US capital stock, which in turn reduces their wages, salaries, and benefits.

Debate continues about how much each group bears. Some individual studies suggest workers may bear as much as 60 to 70 percent of the corporate income tax. But many other studies find lower shares. Federal agencies estimate that workers bear 19 to 25 percent of the corporate income tax (Huang and Debot 2017).

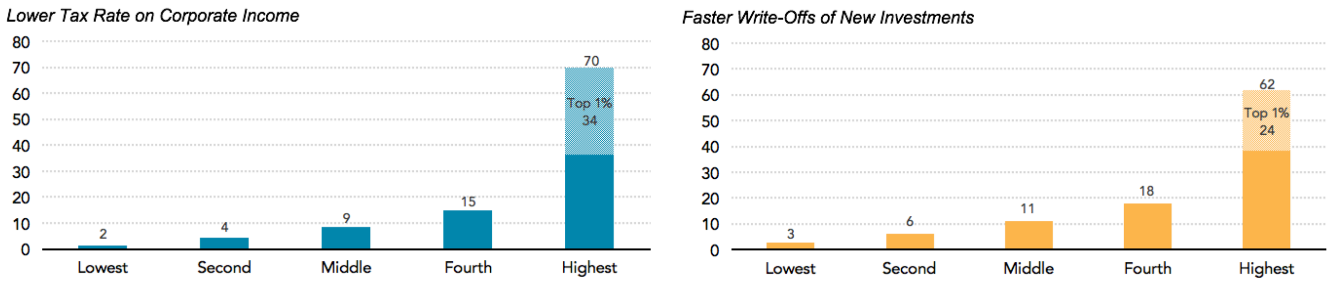
My colleagues at the Tax Policy Center estimate that in the long run, 20 percent of changes in the corporate tax rate are ultimately borne by workers (Nunns 2012). The remainder is borne by corporate shareholders (60 percent) and capital owners generally (20 percent). Changes in investment write-off rules, however, can have a bigger effect on workers. Depreciation and expensing rules have a more direct effect on investment—and thus the productivity that drives wages, salaries, and benefits—than do changes in the corporate tax rate. TPC estimates that, in the long run, 50 percent of changes in depreciation rules and expensing are borne by workers and 50 percent by all capital.

In these discussions, terms like "workers" and "labor" refer to all types of workers, including highly paid executives, professionals, and managers. Economists expect increased investment to boost productivity and incomes across all types of jobs and decreased investment to do the reverse.

FIGURE 1

Reducing Corporate Taxes Primarily Benefits People with High Incomes

Share of corporate tax reduction by expanded cash income quintile (%)



Source: Long-run change in tax burden from the Urban-Brookings Tax Policy Center Microsimulation Model (Version 0217-1), Table T17-0180.

The benefits of cutting corporate income taxes thus go predominantly to people with high incomes. Under TPC's estimates, about 70 percent of the benefit from cutting corporate tax rates would go to people in the top fifth of the income distribution, with 34 percent going to people in the top 1 percent (figure 1). The benefits of accelerating investment write-offs would be somewhat less concentrated at the top, with 62 percent going to the top fifth by income and 24 percent to the top 1 percent.

3. TAXING PASS-THROUGH BUSINESSES AT PREFERENTIAL RATES WILL INSPIRE TAX AVOIDANCE

American businesses take many forms, from sole proprietors working from home to publicly traded multinationals that span the globe. The largest businesses are usually organized as C corporations, which pay the corporate income tax. Millions of sole proprietorships, partnerships, limited liability corporations, and S corporations, however, do not pay the corporate income tax. Instead, their owners pay ordinary income taxes on their share of profits. These entities are often called pass-throughs because for tax purposes their income passes through to their individual or owners.

Pass-throughs are an important economic force. They account for about 95 percent of all businesses and more than half of all business revenue (Looney and Krupkin 2017, Prisinzano et al. 2016).

Both President Trump and the Better Way plan have proposed that business income from pass-throughs be taxed at a lower maximum rate than wages, salaries, and other types of ordinary income. The Trump administration proposed that all business income be taxed at 15 percent, with a top individual tax rate of 35 percent. In their Better Way proposal, House Republicans proposed a 25 percent tax rate on pass-through business income, below their top 33 percent rate on ordinary income.

These rate differentials—20 percentage points under President Trump's proposal and 8 percentage points under the Better Way's—would create new avenues for tax avoidance. Taxpayers facing higher tax rates on their nonbusiness income would now get a big tax saving if they can recharacterize some of that income as business income. Highly paid professionals, for example, might provide services through LLCs and claim some portion of their compensation as business income.

Taxpayers clearly respond to such rate differentials. When Kansas exempted all pass-through income from its state income tax, with rates up to about 5 percent, Kansans responded by creating new LLCS, partnerships, and so on. State revenue plummeted without any apparent economic boost (DeBacker et al. 2016). At the federal level, profits from S corporations are not subject to Medicare payroll taxes. The resulting rate differentials—2.9 percentage points through 2012, up to 3.8 percentage points since 2013—have inspired some professionals to route income through S corporations and treat it as profit rather than compensation (Burman and Rosenberg 2017). Preferential tax rates similarly encourage people to convert ordinary income into capital gains and dividends.

President Trump and the Better Way architects have both indicated they will introduce measures to curb avoidance. Legislative and regulatory measures can limit avoidance but will introduce new problems. Eligibility rules will create new complexity, create arbitrary distinctions (e.g., between qualifying and nonqualifying businesses), and increase administrative costs. Enforcement will require Internal Revenue Service resources and impose new taxpayer burdens. And despite such efforts, some avoidance will still occur. Payroll tax avoidance through S corporations, for example, continues to be an issue today (Burman and Rosenberg 2017).

4. LIMITING THE TOP TAX RATE ON PASS-THROUGH BUSINESS INCOME WOULD BENEFIT ONLY PEOPLE WITH HIGH INCOMES

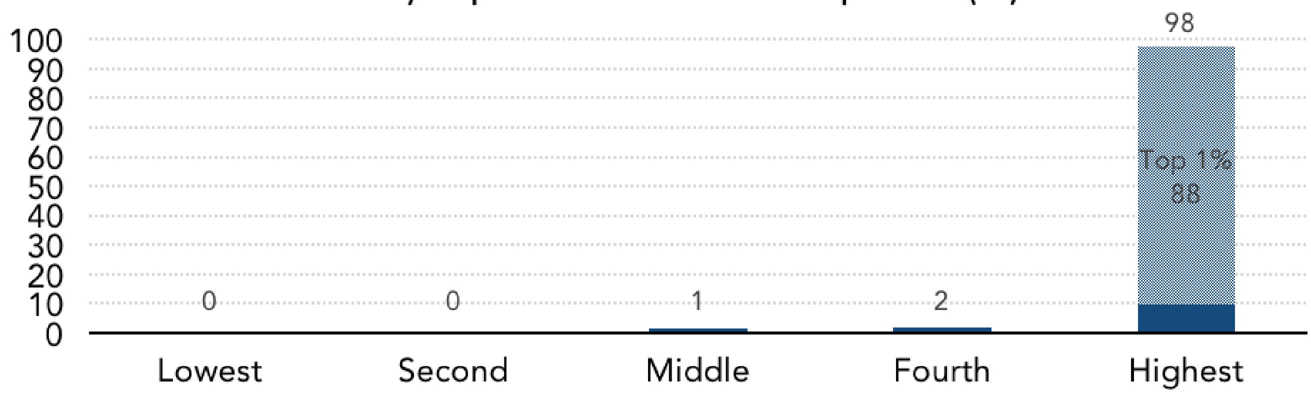
Proposals for a maximum tax rate on pass-through business income would overwhelmingly benefit people with high incomes for two reasons. First, people with high incomes are much more likely to have business income. The Tax Policy Center estimates, for example, that the top 1 percent receive more than half of pass-through business income. Second, maximum rates would help only taxpayers whose income is high enough that they would otherwise be in a higher tax bracket.

The benefits from a maximum tax rate on pass-through business income thus skew enormously to people with high incomes. Rohaly, Rosenberg, and Toder (2017) recently considered several scenarios in which business income from pass-throughs faces a maximum tax rate of 15 or 25 percent and with narrow and broad definitions of qualifying income. They estimated the effects of the maximum against a baseline of a 33 percent top individual tax rate and no alternative minimum tax, similar to leading Republican proposals. In all four cases, the benefits of a maximum tax tilt heavily to the high end. In the case with a 25 percent maximum rate and a broad definition of qualifying income, for example, they find that 88 percent of the tax savings go to people in the top 1 percent by income (figure 2).

FIGURE 2

Capping Pass-through Tax Rates Benefits People with High Incomes

Share of tax reduction by expanded cash income quintile (%)



Source: Rohaly, Rosenberg, and Toder (2017), Urban-Brookings Tax Policy Center Microsimulation Model (version 0217-1), Table T17-0166.

Note: 25-percent top rate on a broad definition of pass-through business income. Measured against a baseline with a 33 percent top individual rate and no AMT.

One way to reduce this inequity would be to introduce a complete schedule of preferential rates for taxpayers at all income levels. If a reformed code has individual rates of 35 percent, 25 percent, and 10 percent, for example, the preferential rate schedule for pass-through business income might be 30 percent, 20 percent, and 5 percent. Benefits would still skew to people with the highest incomes because they receive the most business income. But this rate structure would eliminate the extra skew that comes from a maximum rate. On the other hand, this approach would greatly amplify concerns about tax avoidance. A maximum rate invites avoidance by the relatively few taxpayers with income high enough to benefit. A schedule of preferred rates invites avoidance by taxpayers at all income levels.

5. TAXING PASS-THROUGH BUSINESS INCOME AT THE CORPORATE RATE WOULD NOT ACHIEVE TAX PARITY

In a perfect world, businesses would organize as corporations or pass-throughs based on business and personal considerations. In practice, taxes often drive those decisions.

Some observers have suggested that taxing pass-through and corporate income at the same rate would create a level playing field. The Main Street Tax Fairness Act (H.R. 5076 and S. 707), for example, would tax pass-through business income at the corporate tax rate. If the corporate rate fell, the pass-through rate would fall as well.

However, making these rates equal would not achieve parity. Business income from pass-throughs faces a single layer of tax: each owner pays individual income taxes on his or her share of business profits. Corporate income, however, faces two layers of tax: one when the company pays its taxes and the other when shareholders receive dividends or realize capital gains. Several factors limit the size of this second layer of tax. Most dividends and capital gains are taxed at preferential rates. Capital gains are not taxed until they are realized. And most corporate stock is held by tax-exempt and tax-deferred investors (Burman, Clausing, and Austin 2017). But accounting for all those factors, corporate income still faces higher taxes, on average, than does pass-through income.

Taxing pass-through business income at the corporate tax rate would thus not achieve parity. True parity requires that pass-through income face a higher tax rate than corporate income, that pass-through income face a second layer of tax, or that shareholder taxes be eliminated.

6. IT IS EXTREMELY DIFFILCULT TO PAY FOR LARGE CUTS IN BUSINESS TAX RATES BY LIMITING EXISTING BUSINESS TAX BREAKS AND DEDUCTIONS

Tax policy experts have spent much of this decade trying to find enough payfors to lower the corporate tax rate to 25 or 28 percent, the rates targeted by Governor Romney and President Obama in the 2012 presidential campaign. In his 2014 proposal, Dave Camp demonstrated that a 25 percent rate might be technically possible but would require substantial cuts in existing tax breaks and limits on interest deductibility. The Tax Policy Center (2017) recently estimated that the corporate rate could be reduced to 26 percent without losing revenue in the long run if all corporate tax expenditures were eliminated except deferral. This would require eliminating such tax benefits as accelerated depreciation for machinery and equipment, expensing of investments for small businesses under section 179 of the code, expensing of research costs, the research credit, and the low-income housing credit, among others.

Today, some Republican proposals go much further, lowering the corporate rate to 15 to 20 percent. It is extremely difficult to pay for such large cuts by limiting business tax breaks and deductions alone. As TPC and JCT analyses indicate, getting the corporate rate into the mid-20s may use up all business tax breaks. And there’s a second challenge: deductions lose value as tax rates fall. A deduction that costs $100 at today’s 35 percent rate is worth only $80 at a 28 percent rate and only $43 at a 15 percent rate. The more you cut rates, the less budget savings you get by rolling back each deduction.

The only way to pay for large rate reductions is to increase other taxes or introduce new ones. One option is to raise taxes on shareholders, who get significant benefits from corporate tax reductions. Eric Toder and Alan Viard (2016) offer one approach, which would tax shareholder gains at ordinary income tax rates as they accrue rather than at realization. Another option is to introduce a value-added tax or a close relative like the destination-based cash flow tax. A third option is to introduce a carbon tax, which would discourage emissions of greenhouse gases and accelerate our move to cleaner energy sources.

7. RETROACTIVE TAX CUTS WOULD NOT BOOST GROWTH, WOULD BENEFIT ONLY SHAREHOLDERS

Some tax policy optimists once hoped reform would happen quickly, with many changes taking effect on January 1, 2017. With three-quarters of the year now behind us, some voices still argue for that start date, especially for any business tax cuts.

Making tax cuts retroactive would do little or nothing to promote economic growth. Indeed, it could weaken growth since it would leave less budgetary room to enact other pro-growth reforms. The purpose of business tax reform is not to put additional cash into the coffers of profitable businesses. Some slack may remain in our economy, but giving windfalls to businesses would provide little or no stimulus. Instead, the goal of business tax reform should instead be to change the financial incentives businesses face so they invest more and invest better here at home. Retroactive tax cuts fail to do that.

The benefits of retroactive tax cuts would go solely to shareholders, not to workers. A retroactive tax cut would thus be more regressive than forward-looking cuts in corporate tax rates or more favorable investment write-offs. The Tax Policy Center estimates that 76 percent of the benefits of a retroactive cut in corporate taxes would go to people in the top fifth of the income distribution (compared with 70 percent for forward-looking rate reductions and 62 percent for faster write-offs) and 40 percent to the top 1 percent (compared with 34 percent and 24 percent, respectively).

As 2017 draws to a close, lawmakers should focus on business tax reforms in 2018 and beyond.[1]

Thank you again for inviting me to appear today. I look forward to your questions.

[1] One possible exception are the temporary tax provisions that expired at the end of last year but are widely expected to be extended. For my general views on these "tax extenders," see Marron (2012).

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