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The Challenges of Corporate-Only Revenue-Neutral Tax Reform

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Submission to the Finance Committee Working Group
On Corporate Income Tax

Introduction

There is universal recognition in Washington that the 35 percent federal corporate tax rate is out of step with our global competitors and should be lowered to at least 25 percent in order to improve U.S. competitiveness and economic growth. And while there is a need for comprehensive tax reform, many have suggested that lawmakers move forward with corporate-only reform, provided that it be accomplished in a revenue-neutral manner by broadening the corporate tax base.

While corporate-only tax reform may appear to be less complicated and more expeditious than comprehensive reform, there are reasons to believe that the goal of revenue-neutrality and economic growth are at odds with each other. For example:

1. People overestimate the amount of "loopholes" in the corporate tax code. The average static cost of cutting the corporate tax rate to 25 percent is about $120 billion per year over ten years. However, the total amount of corporate tax expenditures averages about $180 billion per year, $80 billion of which is the cost of deferral—which ought to be reserved for international tax reform, not used for reforming the domestic corporate code. Thus, the numbers suggest that to cut the corporate rate to 25 percent in a statically measured, revenue-neutral manner would require eliminating every other corporate tax expenditure—good and bad.
2. Many corporate tax expenditures are also available to pass-through businesses such as S-corporations and partnerships. Eliminating these provisions to finance corporate-only reform would effectively raise taxes on pass-through firms without any corresponding reduction in their tax rates. Even if lawmakers were to attempt to hold pass-throughs harmless, it would require complicating the code by creating one set of rules for C-corporations and another for pass-throughs.
3. Cutting the corporate tax rate to 25 percent would certainly boost economic growth—by at least 2 percent over the next decade or so according to the Tax Foundation's TAG model. However, our model also shows that the negative

economic effects of eliminating many of these corporate tax preferences would negate all of the growth generated by the rate cut.

Considering these issues, lawmakers would do well to rethink the self-imposed restriction of revenue neutrality, and focus on creating the maximum amount of economic growth, even if that comes at the expense of federal revenues. While there are certainly some base broadeners within the corporate code that won't dampen the growth effects of the rate cut, there are not nearly enough of these to fund a rate cut on a static basis.

On the other hand, lawmakers could take into account the long-run effects on tax revenues from the additional growth generated by the corporate rate cut. Simply cutting the corporate tax rate would generate enough economic growth to eliminate most, if not all, of the long-run revenue loss. Any short-term deficits could be covered by eliminating the least harmful tax expenditures or spending cuts.

So, lawmakers have a choice: they can eliminate most corporate tax expenditures and risk eliminating the growth effects of the rate cut; they can find offsets outside of the corporate code to maintain overall budget neutrality; or, they can relax the constraint of revenue neutrality and either accept a transitory deficit or look to spending restraint to cover the revenue gap. Given these choices, growth should always win out.

Corporate Tax Expenditures in Context

The corporate tax code is not riddled with as many "loopholes" as conventional wisdom would have it. According to the latest federal budget, there are roughly 80 corporate tax expenditures that have a total budgetary value in 2015 of $118 billion. By contrast, there are roughly 100 tax expenditures in the individual income tax code with a total budgetary value of $1.1 trillion.

Furthermore, the majority of these corporate provisions perform important functions, such as ameliorating double taxation, correcting what would otherwise be an overstatement of income, or moving the code toward a less distorting consumption base. Examples include: the deferral of income from controlled foreign corporations; accelerated depreciation (MACRS); expensing of research and experimentation (R&E) expenditures; and excess of percentage over cost depletion.

Provisions such as these promote economic growth by reducing the cost of capital and, thus, encouraging more investment and the efficient use of business resources. As we will see below, the economic effects of eliminating these provisions can cancel out the positive effects of reducing the corporate tax rate.

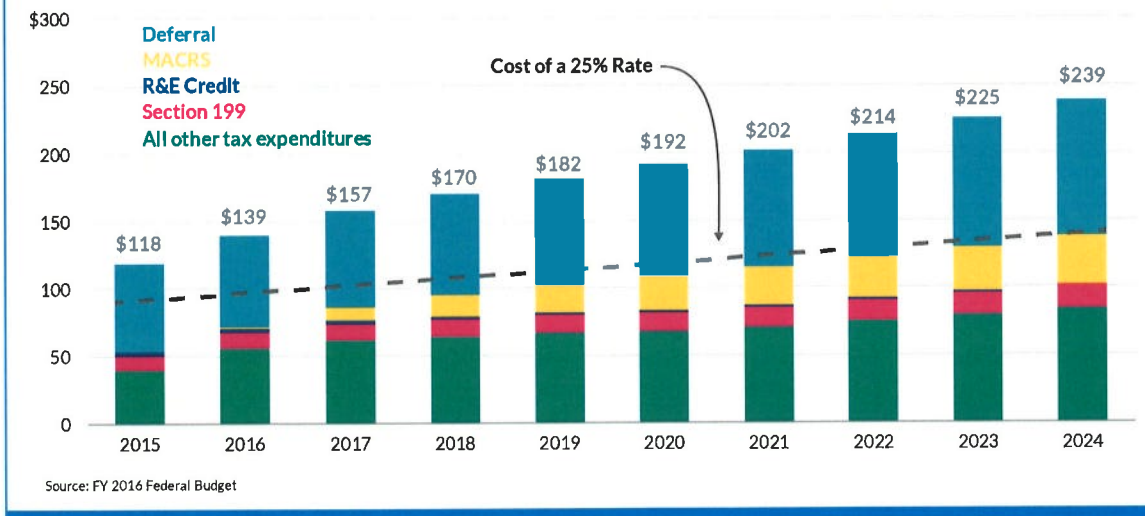
Chart 1 shows the mathematical challenge of eliminating corporate tax preferences in order to offset the static cost of cutting the corporate tax rate. The bars illustrate the value and composition of tax expenditures in each of the next ten years, as is projected

in the 2016 Federal Budget, while the line illustrates the approximate cost of cutting the corporate tax rate to 25 percent.

In 2015, corporate tax expenditures purportedly "cost" the Treasury $118 billion, a cost which is projected to grow to $239 billion by 2024. Over the next ten years, the total budgetary cost of all corporation tax expenditures is $1.8 trillion, an average of roughly $180 billion per year.

As the chart illustrates, the two biggest factors in the growth of corporate tax expenditures are the projected cost of deferral and the cost of accelerated depreciation. Deferral is the largest single corporate tax expenditure, with a total ten-year cost of $800 billion. Accelerated depreciate is the next largest, with a ten-year cost of $194 billion, followed by the Section 199 manufacturing deduction at $140 billion. The R&E tax credit has a ten-year budgetary cost of $18 billion (compared to the $70 billion cost of the R&E expensing provision). That leaves the cost of all other provisions at $674 billion.

Chart 1: Cutting the Corporate Tax Rate to 25% on a Static Basis Requires Eliminating Nearly Every Tax Expenditure



Source: FY 2016 Federal Budget

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In contrast to this menu of available base broadeners, the ten-year cost of cutting the corporate tax rate to 25 percent is roughly $1.2 trillion ($1.3 trillion including the elimination of the corporate AMT), or $120 billion per year. As is illustrated here, the cost of an immediate rate cut would start at $94 billion in the first year and gradually grow to $140 billion annually by the end of the decade.

It is also very clear from the chart that offsetting the cost of the rate cut would require eliminating every corporate tax expenditure except for deferral. Indeed, the value of all tax expenditures aside from deferral is roughly $1 trillion over ten year—some $200

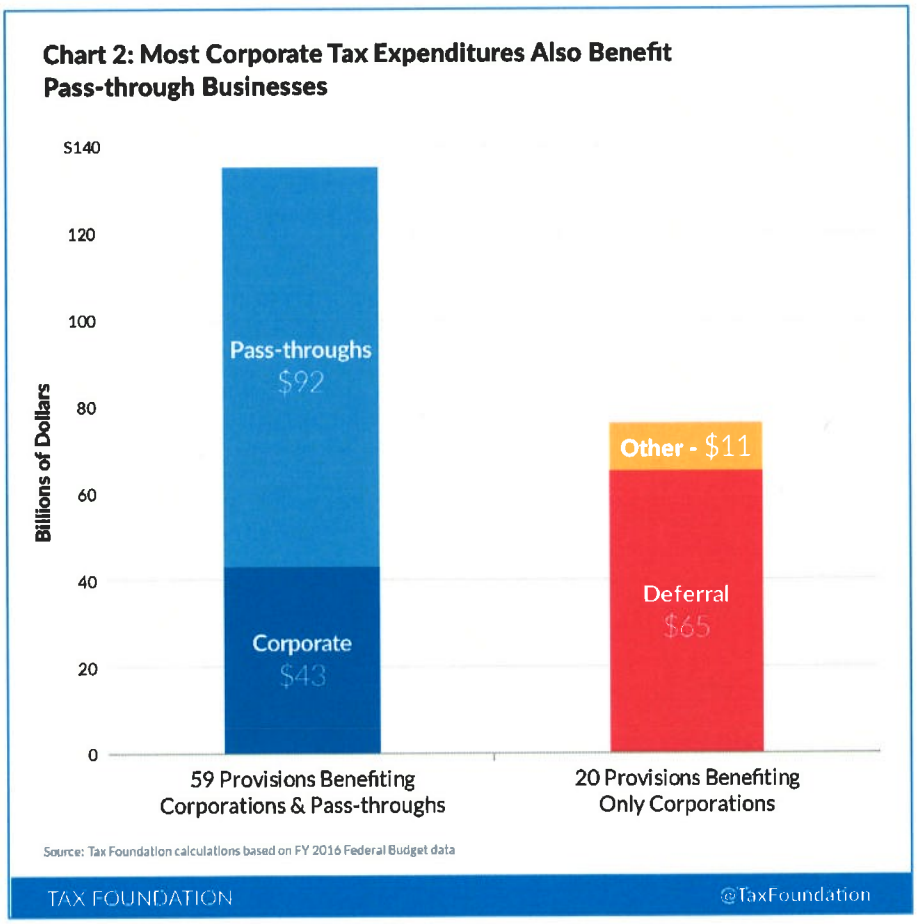
billion or more short of offsetting the $1.2 trillion cost of cutting the corporate tax rate to 25 percent.

Since there is a very strong case to be made that any changes to deferral should be reserved for international tax reform, the math would seem to indicate that lawmakers will have to reach out beyond the corporate tax system if they intend to enact revenue-neutral, or even budget-neutral, corporate-only tax reform.

Corporate Tax Expenditures Are Shared with Pass-Throughs

Another complicating factor in attempting to broaden the corporate tax base to finance corporate-only tax reform is the fact that non-corporate businesses, such as S-corporations and partnerships, can also take advantage of many of the same tax expenditures as traditional C-corporations.

Chart 2 shows that 59 of the 79 corporate tax expenditures also benefit pass-through businesses. These provisions include a wide variety of items such as the R&E tax credit, the Section 199 manufacturing deduction, accelerated depreciation, the tax credit for low-income housing, and the charitable deduction. The value to C-corporations of these widely available provisions is $43 billion, whereas the value to pass-throughs of those same provisions is $92 billion, more than twice as much.



Considering the disparity in how much each sector benefits from these provisions, it seems impossible for lawmakers to broaden the corporate tax base and not have pass-throughs suffer some collateral damage. Indeed, doing so would create two vastly different tax codes for corporations and non-corporations, resulting in an even more complicated tax code.

By contrast, only 20 provisions apply solely to C-corporations and they have a total budgetary value of $76 billion in 2015. As Chart 2 indicates, deferral comprises 85 percent of the total budgetary cost of these 20 provisions. The rest, including inventory sales source rules, the exemption of credit unions from tax, and the lower graduated income tax rates for corporations, total just 11 billion. Therefore, even if lawmakers were to repeal all of these items in an attempt to broaden the corporate tax base in a way that didn't effect pass-throughs, there is still not enough savings here to offset the full cost of a 10 percentage point reduction in the corporate tax rate.

The Economic Effects of Corporate Base Broadening

Setting aside the challenging static mathematics of broadening the corporate tax base in order to finance a rate cut, it is even more important for lawmakers to understand the different economic effects of eliminating various corporate tax expenditures as offsets. As we'll see, exchanging some tax expenditures for rate cuts can have a positive effect on economic growth while trading other provisions for rate cuts can negate any of the economic growth generated by the lower rates.

In order to establish a benchmark, we used the Tax Foundation's TAG model to first simulate the economic effects of cutting the corporate tax rate to 25 percent with no offsets to see how much growth a "pure" policy would generate. As Chart 3 indicates, cutting the corporate rate to 25 percent with no offsets can boost the level of GDP by 2 percent over roughly a decade. The challenge to those who insist that corporate tax reform be revenue-neutral is to find offsets that don't diminish the growth potential of a pure rate cut.

Rather than model the economic effects of all 79 different corporate tax expenditures, we instead separated them into four groups based on their characteristics, then used the model to estimate what the economic effects would be if these provisions were eliminated and the static savings was used to lower the corporate rate by an equivalent amount.

There are certainly many different ways to group these very different provisions, but we've chosen to split them along these main characteristics (the full list is included in the appendix):

Group 1: Provisions that move toward a consumption base or prevent double taxation. This group includes deferral—which is intended to prevent the double taxation of foreign profits—and 15 provisions that offer firms full a fuller, more accurate measure of their costs of production, including expensing, accelerated depreciation, or the proper treatment of inventories (such as LIFO). Eliminating them would raise the cost of capital by more than the corresponding tax rate reduction would reduce it.

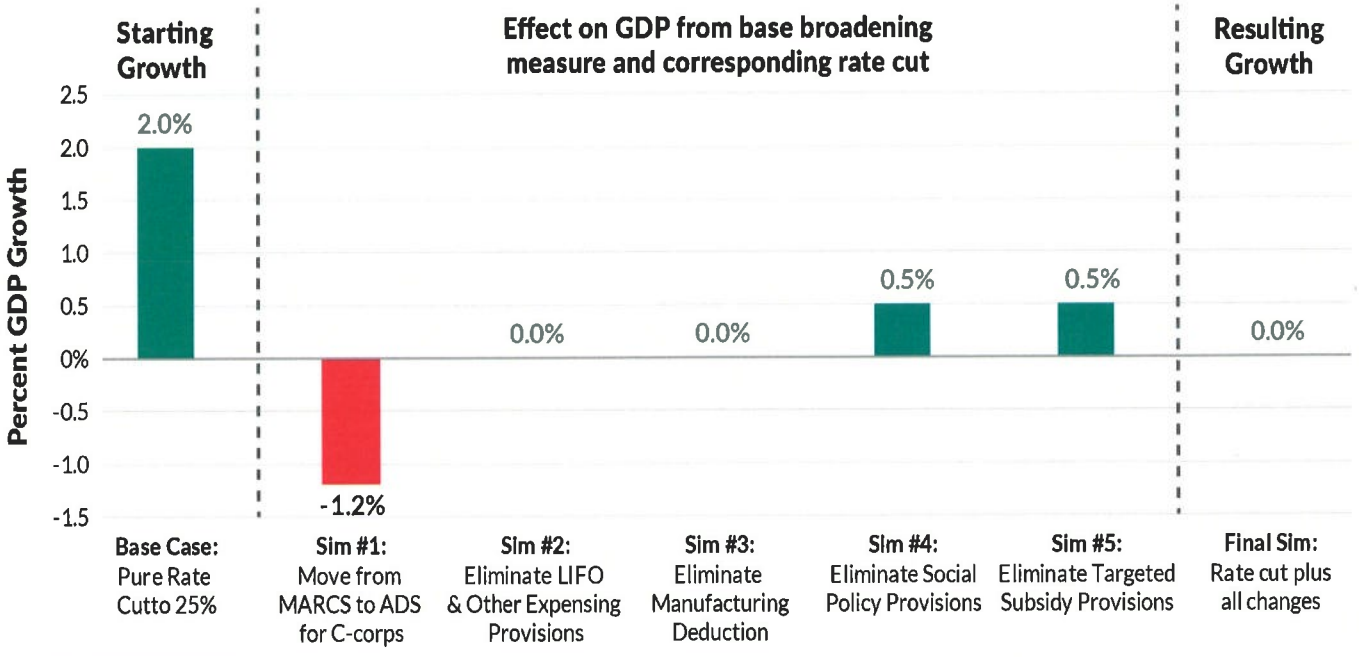
Group 2: Provisions that effect business activity at the margin but don't move toward a consumption base. The main component of this group is the Section 199 manufacturing

deduction. This measure does impact a targeted sector of businesses at the margin, effectively lowering their corporate tax rate, but does not move the system toward a consumption base. Eliminating these provisions is the equivalent of a rate increase.

Group 3: Provisions that have social policy objectives and those that have minimal economic effects. There are more than 20 provisions that can generally be considered social policy in nature, but which don't distort the market. These include the special Blue Cross/Blue Shield deduction, the deductibility of charitable contributions, the work opportunity tax credit, and the credit for low-income housing investments. Repealing these provisions would have little impact on economic activity.

Group 4: Provisions that involve subsidies or those which distort the market in some fashion. There are more than 30 provisions that are generally intended to benefit a specific sector, industry, or policy objective. What makes these different from Group 3 is that these can be considered more of a direct subsidy to an industry or tend to distort the market in some way. These items include the exclusion of interest on public purpose State and local bonds, the exemption of credit union income from tax, the energy production credit, the new markets credit, and the credit for energy efficient appliances. Repealing these provisions would eliminate the distortions caused by them and would add to economic efficiency and growth.

Chart 3: The Economics of Cutting the Corporate Tax Rate to 25% & Broadening the Tax Base



Source: Taxes & Growth Model

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Simulation Results

Group 1 Simulations:

The tax expenditures in Group 1 have a ten-year budgetary value of roughly $1.2 trillion, or an average of about $120 billion per year. However, deferral is the largest component of this group with a ten-year value of $812 billion and, for the purposes of this simulation, we are assuming deferral is reserved for any reform of the international tax system. MACRS has the second-highest value at roughly $195 billion over ten years and the remaining provisions have a value of $161 billion over ten years.

For illustrative purposes, we simulated MACRS and the remaining expensing provisions separately:

Simulation 1: Change from MACRS to the Alternative Depreciation System (ADS).

The static value of eliminating MACRS allows for a rate cut of 1.6 percent[1]. We modeled this rate cut and changed the depreciation regime within the model from MACRS to ADS. As Chart 3 shows, this trade-off lowered the level of GDP by 1.2 percent by the end of the adjustment period. The main cause of the decline in GDP is the fact that the policy increases the cost of capital (the "service price") by 3.1 percent. Moreover, the policy reduces business stocks by 3.3 percent and the wage rate by 1.0 percent.

Simulation 2: Eliminate LIFO and the remaining expensing provisions.

The static value of eliminating these expensing provisions allows for a rate cut of 1.5 percent. However, eliminating these provisions also increases the cost of capital and affects businesses at the margin. Therefore, we modeled their elimination as a rate increase of equal value. As a result, the net effect of these changes has zero impact on GDP.

Group 2 Simulation:

The static value of eliminating the Section 199 manufacturing deduction allows for a rate cut of 1.16 percent. However, like the simulation above, these provisions are also at the margin and we model their elimination as a rate increase of equal value. As a result, the net economic effect of these changes is zero.

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[1] For simplicity, we assumed a revenue loss of $12 billion for every 1 point reduction in the corporate rate. This is based on the roughly $1.2 trillion ten-year cost of cutting the corporate rate to 25 percent, or $120 billion per year.

Group 3 Simulation:

The static value of eliminating these social policy provisions allows for a rate cut of 2.46 percent. As is shown in Chart 3, when we enter this rate cut into the model we find that it boosts the long-term level of GDP by 0.5 percent. What drives this increased GDP growth is that the policy lowers the service price of capital by 1.3 percent which, in turn, boosts business stocks by 1.5 percent, and the wage rate by 0.4 percent.

Group 4 Simulation:

The static value of eliminating these targeted economically distorting tax subsidy provisions allows for a rate cut of 2.39 percent. As is shown in Chart 3, when we enter this rate cut into the model we find that it boosts the long-term level of GDP by 0.5 percent. The same factors that contribute to the boost in GDP in the Group 3 Simulation have comparable effects in this simulation.

Final Simulation:

For the final simulation, we entered into the model all of the rate changes afforded by the elimination of these provisions, as well as the change in depreciation schedules. As Chart 3 illustrates, the result of this summary simulation shows that the effect of broadening the corporate tax base fully negates the economic growth generated by the pure rate cut. The net effect of cutting the corporate tax rate to 25 percent while eliminating every corporate tax expenditure (except for deferral) is zero economic growth.

Indeed, no growth means no added investment or jobs, and no long-term recovery of federal revenue. It means that all the political pain of broadening the corporate tax base is for naught.

Conclusion

Lowering the 35 percent federal corporate tax rate to at least 25 percent is essential to making the U.S. more competitive and boosting long-term economic growth. Indeed, the Tax Foundation's TAG model finds that such a rate cut with no offsets would increase the level of GDP by 2 percent over the next decade and, over the long-term, would also recover all of the estimated static revenue loss.

However, while there is a strong desire among many lawmakers to offset a rate cut with a broadening of the corporate tax base, there are both practical and economic challenges with such a tradeoff.

First, if we set aside deferral, there simply are not enough "loopholes" in the corporate tax code to fully offset the ten year cost of cutting the corporate tax rate to 25 percent. Moreover, the majority of corporate tax provisions are shared with pass-through businesses such as S-corporations and LLCs. Eliminating these tax breaks indiscriminately would inadvertently increase the effective tax rates born by these non-corporation businesses with no corresponding reduction in their marginal tax rates. This should clearly be avoided.

Finally, our TAG model shows that the economic effects of broadening the corporate tax base fully negates the positive growth resulting from the rate cut itself. These results are consistent with similar exercises performed by the Joint Committee on Taxation and academics such as John Diamond at Rice University.

The lesson from this is that lawmakers would do well to put a priority on generating economic growth and improving U.S. competitiveness rather than maintaining static revenue-neutrality.

CORPORATE INCOME TAX EXPENDITURES FOR FISCAL YEARS 2014-2024		
In millions of dollars, based on assumptions from the Mid-Session Review of the 2015 Budget.		
		2015-24
Group 1: Provisions that move toward a consumption base or prevent double taxation		
	Deferral of income from controlled foreign corporations (normal tax method)	$811,980
	Accelerated depreciation of machinery and equipment (normal tax method)	$194,820
	Expensing of research and experimentation expenditures (normal tax method)	$70,250
	Inventory property sales source rules exception	$58,480
	Excess of percentage over cost depletion, fuels	$10,900
	Last In, First Out	$18,700
	Excess of percentage over cost depletion, nonfuel minerals	$6,170
	Accelerated depreciation on rental housing (normal tax method)	$5,690
	Expensing of exploration and development costs, fuels	$4,990
	Expensing of multiperiod timber growing costs	$2,590
	Natural gas distribution pipelines treated as 15-year property	$980
	Amortize all geological and geophysical expenditures over 2 years	$930
	Expensing of certain small investments (normal tax method)	$640
	Expensing of certain multiperiod production costs	$330
	Expensing of reforestation expenditures	$320
	Expensing of certain capital outlays	$190

	Expensing of exploration and development costs, nonfuel minerals	$100
	Total =	$1,188,060
	Total minus deferal & MACRS	$181,260
	Group 2: Provisions at the margin, but not toward a consumption base	
	Deduction for US production activities	$140,090
	Tonnage tax	$880
	Total=	**$140,970**
	Group 3: Provisions with nominal economic effects	
	Credit for low-income housing investments	$83,610
	Exclusion of interest on life insurance savings	$81,370
	Tax credit for orphan drug research	$38,870
	Graduated corporation income tax rate (normal tax method)	$38,300
	Deductibility of charitable contributions, other than education and health	$21,170
	Deductibility of charitable contributions (education)	$10,100
	Tax incentives for preservation of historic structures	$5,590
	Exclusion of interest on rental housing bonds	$4,910
	Special Blue Cross/Blue Shield deduction	$3,550
	Deductibility of charitable contributions (health)	$2,850
	Exclusion of interest on student-loan bonds	$2,450
	Credit to holders of Gulf Tax Credit Bonds	$1,100
	Credit for employee health insurance expenses of small business	$1,080
	Work opportunity tax credit	$960

	Small life insurance company deduction	$430
	Tribal Economic Development Bonds	$190
	Special alternative tax on small property and casualty insurance companies	$180
	Credit for disabled access expenditures	$170
	Deduction for endangered species recovery expenditures	$150
	Employer-provided child care credit	$100
	Empowerment zones	$70
	Indian employment credit	$30
	Total =	**$295,910**
	Group 4: Targeted provisions with distortionary economic effects	
	Exclusion of interest on public purpose State and local bonds	$139,170
	Exemption of credit union income	$25,390
	Special ESOP rules	$21,520
	Credit for increasing research activities	$18,300
	Exclusion of interest on hospital construction bonds	$16,730
	Energy production credit	$12,100
	Exclusion of interest on bonds for private nonprofit educational facilities	$10,980
	Tax exemption of certain insurance companies owned by tax-exempt organizations	$8,460
	Exclusion of interest on owner-occupied mortgage subsidy bonds	$6,030
	Advanced nuclear power production credit	$5,210
	New markets tax credit	$4,630
	Exclusion of interest for airport, dock, and similar bonds	$3,630
	Energy investment credit	$3,330

	Exclusion of interest on bonds for water, sewage, and hazardous waste facilities	$2,200
	Qualified school construction bonds	$1,440
	Exemption of certain mutuals' and cooperatives' income	$1,340
	Credit for holders of zone academy bonds	$1,060
	Tax credits for clean-fuel burning vehicles and refueling property	$880
	Exclusion of interest on small issue bonds	$810
	Credit for investment in clean coal facilities	$760
	Recovery Zone Bonds	$590
	Industrial CO2 capture and sequestration tax credit	$460
	Exclusion of interest on bonds for Highway Projects and rail-truck transfer facilities	$420
	Exclusion of utility conservation subsidies	$300
	Credit for energy efficient appliances	$270
	Deferral of gain on sale of farm refiners	$250
	Credit for holding clean renewable energy bonds	$200
	Special rules for certain film and TV production	$160
	Exclusion of interest on energy facility bonds	$100
	Qualified energy conservation bonds	$100
	Investment credit for rehabilitation of structures (other than historic)	$100
	Exclusion of interest on veterans housing bonds	$40
	Credit for construction of new energy efficient homes	$30
	Bio-Diesel and small agri-biodiesel producer tax credits	$20
	Total =	**$287,010**