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Tax Reform for Manufacturers

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Overview

Corporate tax reform has been actively percolating in the U.S. in recent years. Despite an emerging consensus regarding the well-known problems facing our tax system as well as possible solutions, forward progress has been elusive. The gridlock on tax reform is costly to all American businesses, but it is especially costly to manufacturers. Too many of our tax policies are temporary and ever-changing. The end result is a climate of uncertainty in which businesses are unable to confidently make long-term investment and hiring plans, and in which tax rules dictate or heavily influence business decisions.

The problems with the current system of business taxation are well-known. It is no secret that the maximum federal tax rate on corporate income in the U.S. is very high, at 35 percent, while corporate tax rates in most other developed countries have fallen significantly in recent years. The tax system is also a complex amalgam of deductions, credits, and other features, many of which are temporary in nature and make planning very difficult. A classic example is the U.S. capital cost recovery system, which provides important benefits in the form of accelerated depreciation allowances but is costly to administer and can result in the non-uniform treatment of business investments. An ideal tax system would create the fewest distortions to business decisions about capital and labor, except to promote the types of activities that generate positive spillovers. Yet another problem is that the U.S. is one of a very small number of countries that still uses a worldwide tax system, in which businesses are taxed on all of their income regardless of where it is earned. Since foreign source income is not taxed until it is repatriated to the U.S., a large amount of foreign-source income is effectively sitting in foreign accounts with little chance of ever being repatriated back to the U.S. Most of our major trading partners have adopted territorial systems in which taxes are levied only on the income that is earned within a country's borders and foreign source income is either completely or largely exempted.

Advances in technology, transportation, and tax accounting have made business capital much more mobile, to the point that the decision to pay U.S. corporate income taxes has become almost voluntary. Indeed, economic activity can be relocated for tax purposes via accounting or legal actions even if production activities do not actually move physically. It is perfectly legal (and in the profit-maximizing interests of shareholders) to minimize total tax payments by moving activity to lower-tax jurisdictions. This carries important costs for manufacturers who, partly in response to the changing global business tax environment, employer fewer and fewer American workers. A decision to move production off-shore is a decision to reduce or end the employment of Americans. Most developed countries have recognized the unparalleled mobility of business capital and the shrinking revenue importance of corporate income taxes, and have begun to think of their business tax systems as more of an economic development tool than a revenue source. Our business tax system drives a wedge between the owners of mobile capital, who can more-easily escape U.S. tax burdens, and the owners of immobile capital, which remains within our borders either due to economic constraints or sheer patriotism. Owners of both types of business capital deserve a more pro-business tax system that is based on efficiency, fairness, and simplicity.

Solutions

We encourage the full and careful consideration of the following set of business tax reforms, based on the National Association of Manufacturers' tax reform platform and resembling the sweeping reforms recently enacted in the United Kingdom:

1. Reduce the maximum tax rates on business income for both corporate and non-corporate pass-through entities. The NAM platform calls for a maximum tax rate of 25 percent. This would increase efficiency by reducing distortions to business activity that are created by the current high rates, and enhance the competitiveness of U.S. firms in the increasingly multinational business environment.

2. A robust capital cost recovery system, perhaps going as far as full expensing, would lower the cost of capital and improve cash flow, thus enabling businesses to pursue a larger number of profitable projects, and increase both investment and employment. It would also enhance fairness across sectors and types of capital, both domestically and internationally.

3. An enhanced research and development tax credit, perhaps as high as a 20% alternative simplified credit, would further encourage investments that support productivity gains and higher earnings for workers. A strong commitment to public support for business R&D activities would also promote international competitiveness and fairness. The R&D credit was introduced in 1981, and until it was permanently extended in late 2015, it had been allowed to expire and be renewed on 16 occasions, sometimes on a retroactive basis.

4. Move to a territorial system for taxing multinational businesses. In 2000, only 13 of the 34 OECD countries had territorial systems. That number has more than doubled as of 2014, with an additional 15 countries adopting territorial structures. Only six of the 34 OECD countries (and none of the other G7 countries) have a worldwide system as of 2015: Chile, Ireland, Israel, Korea, Mexico, and the U.S.

Taken together, these proposals would greatly enhance the competitive position of U.S. firms—especially manufacturing firms—while also dramatically simplifying the tax code and providing much-needed stability to the system. They would also bring a substantial economic impact. In our recent analysis for the National Association of Manufacturers, we estimated that this plan would add almost one percentage point (about 0.9) to GDP growth on an annual basis, amounting to over $12 trillion over ten years. Additionally, the plan would add nearly 1.5 percentage points to investment growth on an annual basis (just over $3.3 trillion over ten years), and between 492,000 and 522,000 jobs per year (over 6.5 million jobs over ten years).

Notable barriers to progress include concerns about the overall revenue impact as well as the distribution of that revenue across income groups. The prevailing tax policy climate in the U.S. is such that anything resembling a tax increase is effectively dead on arrival. The practical outgrowth of this is the notion that any tax reform proposal must be revenue-neutral if is to have any chance of passage. This constraint on the policy discussion is unfortunate. Concerns over short-term and longer-term revenue adequacy are indeed quite important, but we must not lose sight of the other prominent goals of tax reform such as efficiency, fairness, and simplicity. To be sure, the revenue impact of a pro-business tax reform package would not necessarily be negative in the long term. A pro-business tax reform package could potentially increase total tax revenues in the long term if we consider impacts on other tax revenue streams in a full-budget analysis. On that note, it is important to consider business tax reform within the context of a broader tax reform effort. Even if we desire revenue neutrality for the broader reform package, it is not necessary to impose revenue neutrality on every individual component.

A similar barrier to business tax reform involves the incorrect public perception of business taxes as a tax on the relatively-wealthy owners of capital. Any effort to reduce business taxes—and especially corporate income taxes—is viewed as an injustice that further tips the income distribution in favor of the wealthy. Estimated distributional impacts have become prominent components of any tax reform debate in recent years, and have meant the death knell for more than one reasonable proposal. It is important to emphasize that business taxes are ultimately borne by people at all points on the income distribution. They are born by workers through lower wages or employment opportunities, by consumers through higher prices on final goods and services, and by the owners of capital in the form of lower returns to investment. And the owners of capital are not necessarily high-wealth or even high-income individuals; they include the large number of individuals with corporate stocks in their retirement accounts. In essence, we all pay business income taxes in one way or another.

Despite a large volume of theoretical and empirical literature on the incidence of the corporate tax, consensus has proven elusive. Recent studies have indicated that workers bear more than half, and perhaps as much as 70 percent, of the corporate tax burden. If workers bear any of the burden, pro-business tax reform that potentially reduces revenue can and should be viewed as pro-worker tax reform because it could increase employment and wages. Alternatively, even if the owners of capital bear most of the burden of the corporate income tax, it is important to recognize that many workers are owners of capital to the extent that they hold corporate stock directly or as part of their retirement savings. As such, workers could enjoy a separate longer-term benefit from a reduction in the tax rate due to the resulting increases in the values of their retirement accounts.

These impacts will have important effects on the distribution of the overall tax burden that should not be ignored in the policy discussion. As with the revenue neutrality issues discussed above, we should also avoid placing excessive importance on the distributional consequences of individual elements of a broader tax reform package. The potential distribution of the costs and benefits of business tax reform should be examined in light of the total distribution of costs and benefits of the broader tax reform package.

Endorsed by:

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