



THE INCONSISTENCIES OF THE OBAMA CORPORATE TAX PLAN

Josh Barro, *Senior Fellow*

President Obama's corporate tax reform plan starts with a few, broad principles—the corporate tax should have a lower rate and a broader base, and should cause fewer distortions between different kinds of economic activities. These are good principles; for the most part, the plan sticks to them.

In some components, though, the plan goes astray, creating or expanding tax preferences and introducing new distortions. Particularly, it prefers manufacturing over other sectors, renewable energy over other energy sources, and certain multinational structures over others. These are all deviations from the goal of tax neutrality, and they are all negative features of the plan.

The plan has good ideas at its core and its problems can and should be fixed. Some of the ill-advised proposals, like expanded manufacturing deductions and tax credits for in-sourcing jobs, would cost revenue. Others, like new efforts to tax the foreign operations of U.S. firms, would raise it. As such, it may even be possible to eliminate the undesirable features of this corporate tax reform plan without significantly affecting the amount of revenue to be collected.

What needs to be fixed:

- **Eliminate tax preferences for energy—uniformly.** Energy production activities tend to be heavily tax-favored. As the President notes, income from investments in oil and gas structures is taxed at just 9 percent, a far lower rate than for most categories of business investment. Tax reform should raise the effective tax rate on such investments. But as Deputy Assistant Secretary of the Treasury for Environment and Energy Gilbert Metcalf reported in 2009, while oil and gas production gets tax subsidies at a rate of \$63 per billion BTUs, renewable energy is subsidized to the tune of \$584 per billion BTUs. Instead of also eliminating tax subsidies for renewable energy, President Obama

proposes to expand them in his tax reform. This is a missed opportunity—tax reform should eliminate subsidies for energy from all sources.

- **Don't go for failed industrial policy.** President Obama's reform plan includes a host of tax preferences designed to prefer domestic manufacturing over other industries. Instead of abolishing the domestic production tax credit—an easy way to raise revenue and cut the overall corporate rate—Obama proposes to expand it, increasing the tax favoritism shown to the manufacturing sector. The truth is that American manufacturing is not in decline—manufacturing employment has declined because of strongly improving manufacturing productivity in the last several decades. Instead of trying to use the tax code to reproduce the economy of the 1950s, we should tax different types of economic activity equally and let capital be allocated where it can most efficiently be used.
- **Don't put US-based multinationals at a disadvantage.** Finally, the tax reform plan contains some ill-advised attempts to collect more tax related to the foreign activity of U.S.-based multinational firms. The United States is already unusual in trying to tax the foreign income of companies based here—most advanced countries use a “territorial” tax system that applies only to economic activity within the taxing country. Today, U.S. firms are liable for tax on foreign income, but can defer that tax until they actually return foreign profits to the United States. Obama proposes to impose a non-deferrable minimum tax on profits earned in low-tax countries. So long as this tax is set low enough that it only applies to tax havens like Bermuda, this proposal won't be a problem. But attempts to tax the real foreign activities of U.S. firms in lower-tax jurisdictions like Ireland and Hong Kong would place U.S.-based firms at a major disadvantage compared to their foreign competitors.

What works:

- **Cut the corporate tax rate from 35 percent to 28 percent.** As the White House notes, the United

States has one of the highest corporate income tax rates among advanced countries, even though our tax receipts are not especially high. Cutting the rate by 20 percent would make us more competitive; lost revenue can be offset by broadening the corporate tax base.

- **Reduce distortions between debt and equity.** Most corporate tax systems create incentives for firms to finance themselves with debt, but the American tax code is more distorting than most. Lowering the corporate tax rate reduces the tax penalty associated with equity financing. The president also proposes—without specifics—to limit the deductibility of interest expenses, further reducing the debt-equity distortion. This would be a good way of expanding the tax base to offset the rate reduction.
- **Realign C-corporations and S-corporations to their intended purposes.** The S-corporation is a pass-through entity that is designed to help small business owners avoid the burden of complying with a separate corporate income tax. S-corporations also enjoy the advantage of being taxed only once, which reduces the marginal effective tax rate on investments in S-corporations by about six percentage points. As a result of this tax preference, business activity has shifted toward S-corporations and other pass-through forms, leading to revenue loss. President Obama's plan would simplify tax rules for small businesses, while restricting the ability of large firms to reduce their tax burdens by using pass-through forms.

The good news is that the negative features of this corporate tax plan can be fixed. Proposals adding new tax preferences or introducing protectionism to the tax code could be stripped while those achieving the broad principles of base expansion and rate reduction are retained. When considering the President's proposal, Congress should keep an eye toward eliminating distortions and preferences in the tax code—including the ones the President is now proposing to add.