Reforming Corporate Taxes

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On Dec. 22, 2017, President Donald Trump signed into law the Tax Cuts and Jobs Act, one of the most sweeping changes to the nation's tax code in over 30 years. In addition to reducing income tax rates for most individuals through 2025, the law makes a number of changes to the U.S. corporate tax system in an effort to encourage American firms to invest more domestically instead of shifting profits and production to lower-tax jurisdictions overseas.

The United States has long had one of the highest corporate tax rates among developed countries at 35 percent (effectively around 39 percent once average state taxes are included). The 2017 act reduces the federal rate to 21 percent. The law also lowers tax rates that apply to S corporations and limited liability companies, or so-called "pass-through" entities. These companies do not pay corporate taxes; instead, owners are taxed on the firms' income at the individual level. Under the new law, these individuals can deduct 20 percent of eligible business income that is received via a pass-through entity from their total taxable income.

For firms with global operations, the law substantially changes how income from their foreign subsidiaries is treated. Previously, income earned by foreign subsidiaries of American companies was subject to the U.S. corporate tax, an arrangement known as a worldwide tax. Firms could defer paying the U.S. tax by keeping those earnings outside the United States and investing them in their foreign subsidiaries. Under the new law, the United States will not tax foreign-source income stemming from certain tangible investments, such as plants and equipment. This approach, known as a territorial tax, is used by many other developed countries.

The new law still maintains some elements of the worldwide tax, however. Foreign-source income from intangible assets, such as patents, is subject to a minimum U.S. tax. The law also establishes a minimum tax on deductible payments made by U.S. firms to foreign subsidiaries in an effort to discourage income shifting to low-tax countries. Finally, the law requires U.S. multinational firms to pay taxes on foreign income currently held overseas over a period of up to eight years. That income is subject to a reduced tax rate of 15.5 percent for liquid assets (such as cash) and 8 percent for other assets.

With these changes, policymakers sought to encourage firms to shift more money back into the United States as well as spur them to make more domestic capital investments. Firms' channeling of profits and investments overseas to avoid U.S. taxes has been a long-standing concern of policymakers in both political parties. It is estimated that nonfinancial U.S. companies hold around $1 trillion in cash reserves overseas. (See "Taxing the Behemoths," *Econ Focus*, Third Quarter 2013.) To further encourage investment, the law also allows businesses to deduct 100 percent of expenses for certain fixed assets over the next five years.

In theory, reducing firms' corporate tax burden may encourage them to invest in new projects because owners of the firms retain more of the profits from those investments. Reducing the overall corporate rate and changing how foreign earnings are taxed make the United States more competitive with the rest of the developed world and may therefore encourage U.S.-based firms to invest more at home. Those investments may drive up demand for workers and therefore push up wages.

While several economic studies have found that higher corporate taxes have a negative effect on investment, evidence on the effect of corporate tax cuts is less clear. One study found that a 2005 tax cut for domestic manufacturers led to increased investment, while another study of a 2003 dividend tax cut found no evidence of increased investment. A 2015 paper by Alexander Ljungqvist of New York University and Michael Smolyansky of the Fed Board of Governors used variations in state corporate tax rates to compare the effects of tax hikes and cuts in bordering counties. They found that while tax increases reduced employment and income, tax cuts generally had no stimulative effect unless implemented during a recession.

Still, economists acknowledge that it is difficult to study federal corporate tax cuts empirically because they have been rare — the 2017 Act marks only the third time federal corporate tax rates have fallen in nearly four decades. And while state corporate tax changes have been more numerous, Ljungqvist and Smolyansky noted that they are also on a much smaller scale, which could explain why tax cuts did not appear to have much effect on employment or wages in their study.

Ultimately, it will take some time before all of the changes in the Tax Cuts and Jobs Act are implemented and the full impact of the law is known. One unknown is how much the tax cuts will cost. The Joint Committee on Taxation estimated that the corporate changes alone may add roughly $1 trillion to the federal debt over the next 10 years before accounting for any economic growth generated by the reform. Another outstanding question is how other countries will respond to the changes. The new headline U.S. corporate tax rate is more competitive with the rest of the developed world, but that advantage may prove temporary if other countries respond by also lowering rates. **EF**