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DÉJÀ VU ALL OVER AGAIN?
REFLECTIONS ON AUERBACH'S "MODERN CORPORATE TAX"

Reuven S. Avi-Yonah[1]

Alan Auerbach's "A Modern Corporate Tax"[2] deserves attention for three reasons. First, its author is one of the foremost public finance economists of our time. Second, it was published under the joint auspices of the Hamilton Project of the Brookings Institution and the Center for American Progress, two center-left leaning institutions that would not normally support a proposal for reducing corporate taxes. Third, the Obama Administration has announced that it will proceed with a major tax reform study in 2011-12, leading to proposals that will be offered for implementation after the 2012 election. This is the best chance for major tax reform in a generation, and given its distinguished provenance, it is likely that Auerbach's proposal will play a significant role in shaping the corporate tax reform effort.

I believe, however, that Auerbach's proposal is the wrong way to go about corporate tax reform, for two main reasons. First, it is basically a repackaging of a series of consumption tax reform efforts that have been advanced by conservatives since the Hall-Rabushka Flat Tax of the 1990s. Auerbach's proposal is in fact very close to the Growth and Investment (GIT) plan proposed by the Bush Advisory Panel on Federal Tax Reform in 2005. All these proposals suffer from similar flaws and the Auerbach proposal is no exception. Second, there is one major innovation in Auerbach's proposal, which is his suggestion that the US simply ignore all non-US source transactions in its corporate tax. This is new compared to previous proposals that were generally destination based and border adjustable, but it is not an improvement.

In what follows, I will first explain how Auerbach's proposal is similar to the GIT and its predecessors, and then examine the international aspects of the proposal in more detail. I conclude by arguing that there are better ways to achieve corporate tax reform.

1. The Modern Corporate Tax and its antecedents.

   Auerbach's proposal is for a cash flow corporate tax: Corporations include all domestic receipts and deduct all domestic expenditures. The major change

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[2] Alan J. Auerbach, A Modern Corporate Tax, Hamilton Project/CAP (December 2010).

from the current corporate tax is to allow corporations to currently deduct all capital expenditures (like they will temporarily be allowed to in 2011 under the tax deal that was recently struck between the President and the Republicans).

This feature of Auerbach's proposal is not new. As Auerbach acknowledges, it has been a recurrent feature of corporate tax reform proposals since the UK Meade Committee in the 1970s. The Hall-Rabushka Flat Tax, the Bradford X Tax, and the GIT were all cash flow taxes.[3]

As Auerbach also recognizes, this feature of the proposal converts the corporate tax into a tax on consumption because it exempts the normal return to new investment from tax under the Cary Brown theorem, familiar to every US basic tax student.[4] In that sense, it converts the corporate tax into a VAT, except that it allows a deduction for wages.[5]

On the face of it, this feature of the Auerbach proposal should make it a revenue loser, because it gives corporations a deduction that they did not have previously. However, Auerbach argues that the deduction for capital expenditures will be offset by another feature of his proposal, which he believes would make it overall revenue neutral: The effective denial of a deduction for interest expense.

This feature is also not new. The Meade Committee proposed two variants of a corporate cash flow tax, which it called R and R+F. Under the R ("real") model, all financial transactions (borrowing, repayment of debt, and interest income and expense) are ignored. Under the R+F ("real and financial") model, interest income is includible and interest expense is deductible, but so

[3] Auerbach, 18.

[4] E. Cary Brown, "Business Income Taxation and Investment Incentives," in L.A. Metzler et al., eds., Income, Employment, and Public Policy: Essays in Honor of Alvin H. Hansen (New York: Norton, 1948).

[5] The wage deduction is intended to maintain progressivity, as compared to a VAT. However, the key issue for progressivity is the treatment of dividends, interest and capital gains, which were all excluded from income in Hall-Rabushka and the X tax and subject to a low flat rate under GIT. Auerbach does not commit to a proposal on this issue but the logic of non-deductibility of dividends and interest and the wish to equate the treatment of the corporate and non-corporate sector and to not discourage corporate distributions would suggest exempting dividends, interest and capital gains. This, however, would make the proposal much less progressive than current law even though wages will be taxed at progressive rates. I would support adopting a VAT and dealing with the progressivity issue through the personal income tax and through the expenditure side of the budget. A corporate tax is not a good vehicle for achieving progressivity because of the uncertainty about its incidence. See Avi-Yonah, Taxation as Regulation (ssrn, 2010).

are borrowing and repayment of debt. The result in both models is the same, because the deduction for repayment of debt is precisely offset by the inclusion of borrowing in income, and the time difference between the earlier inclusion and later deduction is taken into account by deducting the interest. Thus, in both R and R+F interest is effectively nondeductible.[6] This, Auerbach argues, will offset the deductibility of capital expenditures and make the proposal revenue neutral. Previous proposals like the GIT and its predecessors achieved the same revenue neutrality by adopting the R model, explicitly disallowing the interest deduction.

Auerbach argues that disallowing the deduction for interest is an improvement over current law's bias in favor of debt over equity. Since dividends are also nondeductible, this will create a more neutral corporate tax. Corporations that are growing and invest in new equipment will benefit from the new deduction for capital expenditures, but are also more likely to borrow more, which will increase their taxable income (if they borrow overseas, they lose the deduction for repayment of the loan and the interest).

Thus, Auerbach argues that overall his proposal is revenue neutral, although this is just on average: His Table 2 shows that in many recent years, because of high corporate debt, his plan would actually have broadened the corporate base.[7] He does not support reducing the corporate tax rate, although most economists believe we should reduce it since it is now the second highest in the OECD.

However, it seems to me that this proposal will hit two types of business hard. The first are start-ups that invest primarily in intangibles (intellectual property). Those types of businesses, which are some of America's most innovative, would not benefit from the new deduction for capital expenditures since they already deduct R&D expenditures and wages, and some human capital investment (e.g., founders' stock, which is not treated as wages) would still be capitalized. On the other hand, these businesses (even when they are publicly traded and thus subject to the corporate tax) frequently have to borrow, and the new tax on borrowing will affect them. A new Google or Facebook may thus find it expedient to incorporate overseas.

The second type of businesses penalized by the proposal is financial companies, because they rely on the deductibility of interest expense. If you

[6] Auerbach, 3 ("This paper takes an alternative approach that effectively achieves the same outcome but retains deductibility of interest expense: by including non-equity financial transactions in the calculation of taxable income, the new tax treatment of debt—taxable when borrowed but deductible when repaid—would mirror the symmetric tax treatment of equity—non-taxable when issued and not deductible when dividends are paid.")

[7] Auerbach, 8.

are a business that borrows and lends funds and makes a profit on the difference between the interest rates, then the fact that interest income continues to be taxable while interest costs are not deductible could induce you to relocate offshore as well.

Because of these behavioral effects, I am not sure that the reform will in fact be revenue neutral. It may raise additional revenue in the early years because of the non-deductibility of interest, but over time one would expect businesses affected by this rule to migrate overseas, while remaining US businesses would still enjoy the current deductibility of capital expenditures.

Auerbach states that "[s]hifting from depreciation deductions to immediate expensing typically will reduce the tax base; this will be true whenever investment exceeds depreciation, which is typical for a growing economy and true in each of [the last] five years. On the other hand, net financial investment for this sector is typically negative, because the nonfinancial sector is a net debtor to the rest of the economy, and growing companies typically increase their liabilities over time. Thus, these changes in the tax base typically offset each other".[8] This may be true for the past years studied by Auerbach, but will it still be true if behavioral responses to his proposal are taken into account?

In general, it seems to me that excluding the normal return to investment from income is bound over time to reduce the corporate tax base, because it converts the corporate tax from an income to a consumption tax. In that way, the Auerbach proposal is no different from its predecessors the Flat Tax, the X Tax, and the GIT. They all make the US into the world's biggest tax haven by enacting a zero rate for normal returns on corporate investment. Whether this is an improvement depends on the international aspects of the proposal, and we turn to those next.

2. Pure Territoriality: Back to the 1970s?

Auerbach's proposal is purely territorial: He simply ignores all "foreign source" activities and all cross-border transactions. In this way the proposal is different from VATs around the word as well as the GIT and its predecessors, which were generally destination-based border adjustable taxes, i.e., they excluded exports but were applied to imports. Auerbach, on the other hand, advocates a pure version of territoriality, like the French system before the adoption of CFC rules: All non-US source income and expenses are ignored, including easily shiftable passive income. This leads to a huge simplification because both Subpart F and the Foreign Tax Credit can be repealed.

[8] Auerbach, 9.

In principle this proposal is appealing because corporate taxes should be primarily source based.[9] But the problem, of course, is that the source of income is not easily defined, and so the obvious question is, would this proposal not lead to a massive shifting of income out of the US?

Auerbach answers this question in the negative. He argues that because the effective US tax rate on normal returns would be zero, the proposal would instead lead to a shifting of corporate income into the US:

"Thus, like the territorial approach, [the proposal] allows U.S. companies to compete abroad on an equal footing with companies from other countries. But the tax does not encourage U.S. companies to move their operations abroad. With investments facing a zero rate of corporate tax in the United States, they will be taxed less heavily than in countries that impose positive tax rates, even low ones, on corporate income. Thus, as in the case of profit-shifting activities, the pressure of international tax competition will no longer be a relevant consideration in setting the U.S. corporate tax rate."[10]

But will this in fact be the case? I believe the answer is no, for three reasons. First, as argued above, to the extent the proposal depends on increasing corporate tax rates by disallowing the interest deduction, there would still be an incentive for US corporations (especially financial ones) to move their operations to tax havens where there is no income tax at all.

Second, like any cash flow tax, the Auerbach proposal still taxes rents. As is well known, allowing a current deduction for capital expenditures only exempts the normal or marginal return from tax. Rents or infra-marginal returns are still subject to corporate tax at 35%. Auerbach acknowledges this, but seems to assume that such rents are country-specific and therefore not shiftable out of the US:

"Because corporations generate additional earnings, called rents, through production, there would still be a corporate tax base. But the taxation of rents and break-even returns to capital have different effects on behavior and, as a consequence, on the incidence of the corporate tax burden. While taxing the normal returns required to meet the cost of capital discourages investment and, especially in an open economy, may cause a shift in some of the corporate tax burden from capital to labor because of the resulting decline in worker productivity, taxing rents is less likely to do so, particularly if these rents are not easily shifted from the United States."[11]

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[9] For the reasons why see Avi-Yonah, The Structure of International Taxation (1995).
[10] Auerbach, 11.
[11] Auerbach, 10.

The problem, however, is that the literature on multinationals shows that while they do typically earn rents, these rents typically are the result of ownership of intellectual property or other types of internal ownership advantages that are not specific to any given location.[12] In fact, it is precisely the profit from such rents that is the subject of shifting in transfer pricing practice. Since the US would still tax these rents at 35%, one would expect them to be shifted. But shifting in a purely territorial system with no Subpart F and presumably weak transfer pricing enforcement is much easier than it is under current law.

Finally, Auerbach ignores the likely reaction of other countries to the US adopting his proposal. But if the US becomes the world's biggest tax haven, other countries are likely to respond by putting it on their "black list" and applying CFC rules and transfer pricing to tax the income that would be shifted into the US. This might negate the anticipated beneficial effect on inbound FDI.

In addition, adopting the Auerbach proposal would create a significant risk of double taxation. The reason is that other countries may consider the US corporate tax not to be an income tax and therefore not eligible for credit or exemption under domestic law or tax treaties. They would argue that by allowing deductibility of capital expenditures, the tax effectively becomes a consumption tax. That was in fact the reason the US ruled that such a cash flow tax was not creditable when it was proposed for adoption elsewhere. This would not be an issue if the US corporate tax rate were zero, although it would mean that the US might lose the purported advantage of the zero rate because the same income would be taxed by another country. But to the extent the US still taxes rents, the same rents could be subject to double taxation, which would create further incentive to shift them out of the US.

None of these observations are new: They were all made about the Hall-Rabushka, X Tax, and GIT cash flow tax proposals.[13] At the time, the US did not adopt these proposals, in part because of these objections. Why should we now continue down the same route, especially if there are better alternatives?

3. Conclusion: Better Alternatives for Corporate Tax Reform.

There are three objectives that drive the Auerbach proposal. The first is simplification, and it is true that a cash flow corporate tax would probably be simpler than the current version because it does not need to account for basis. But so would a VAT, and therefore the question is, why not just abolish the corporate tax and adopt a VAT instead?

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[12] See, e.g., Pitelis and Sugden, The Nature of the Multinational Firm.

[13] See, e.g., Avi-Yonah, From Income to Consumption Tax: Some International Implications (1996).

A VAT would also address another possible problem with the Auerbach proposal, which is WTO compatibility. The GIT and its predecessors were border adjustable destination based taxes, but because they allowed a deduction for wages, they did not qualify as a VAT and were therefore probably in violation of WTO rules that prohibit border adjustability for "direct" taxes. The Auerbach proposal is not formally border adjustable, but its pure territoriality approach when combined with the US source rules (e.g., title passage for purchased inventory) would (as Auerbach argues) create the same effect as a destination based tax. Since Auerbach also has a subtraction method and a deduction for wages his proposal is a "direct tax" and it may well be challenged in the WTO as effectively border adjustable. If we adopted a normal invoice-credit destination based VAT, we would not have this problem.

The second element driving the Auerbach proposal is competitiveness. The current corporate tax rate in the US is the second highest in the OECD, and we are the last worldwide taxing jurisdiction, which results in income being trapped overseas. But these problems can be addressed by reducing the corporate tax rate while expanding the base and by exempting dividends from active income, which is the approach taken by all of our trading partners. Auerbach, instead, would keep the high corporate rate but narrow the base, which seems to fly in the face of everything we learned from the 1986 tax reform effort.

The third element is debt/equity and corporate/shareholder integration. Auerbach, like most integration proposals since CBIT, would deal with the debt/equity problem by eliminating the interest deduction. But unlike CBIT and its progeny Auerbach does not deal with the corporate/noncorporate bias or with the retention/distribution bias, and does not deal with debt/equity outside the corporate context. If we want integration, then I would prefer dividend deduction, but CBIT or BEIT would also achieve better results than Auerbach.[14]

In sum, the Auerbach "modern corporate tax" proposal combines old proposals (a cash flow corporate tax) with very old practices (pure territoriality, which was the norm in continental Europe and its former colonies before 1980). The result is not particularly modern, and it suffers from the same flaws as its predecessors. I would prefer to keep the corporate tax with a lower rate, to exempt active dividends while narrowing opportunities for deferral of passive income, to allow a deduction for dividends as a way of addressing debt/equity, and to adopt a normal invoice/credit, destination based VAT.

[14] See Avi-Yonah and Chenchinski, The Case for Dividend Deduction (2010, ssrn).