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How Best to Tax Business

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The details of the tax code may not make your heart sing, but they are enormously important and, at long last, they may be changing. In fact, the next 12 months are shaping up to be a critically important time.

Despite an uneven start, tax reform is on the agenda in Congress. And the ideas being considered, especially regarding business taxation, are not mere tweaks to our ossified system. They would profoundly alter how the government raises money and upend the incentives for private decision makers. This is fascinating to tax policy nerds like me. But it is important for everyone to understand.

The motivating force behind business tax reform is that the statutory corporate tax rate in the United States is one of the highest in the world. The high rate encourages all kinds of perverse behavior, such as leaving money parked in overseas subsidiaries and inverting corporate structures to take advantage of lower rates abroad.

The current corporate tax finds no fan in Kevin A. Hassett, the economist recently nominated by President Trump to lead the Council of Economic Advisers. Some of Mr. Hassett's research suggests that our high corporate taxes may be so distortional that a cut in the rate might increase tax revenue.

In another paper, Mr. Hassett finds that corporate taxes depress wages for manufacturing workers. In a world where capital is mobile and labor is not, capital escapes from high-tax nations, leaving workers behind to bear the burden of lower productivity and reduced incomes.

The debate in Congress, however, has gone beyond a simple discussion of tax rates. The Better Way plan, championed by House Speaker Paul D. Ryan and Representative Kevin Brady, the Republican chairman of the Ways and Means Committee, promises fundamental changes in the nature of business taxation, most of which would, in my view, be steps in the right direction. There are four key issues.

WORLDWIDE VS. TERRITORIAL Most nations aim to impose taxes on economic activity that takes place within their borders. Such a system is called territorial. By contrast, the United States has a worldwide corporate tax. If a company based in the United States produces a product abroad and then sells it abroad, our Treasury takes a cut of the profits when they are brought back home.

The House tax bill would move our system toward international norms. American companies would be able to compete abroad on a level playing field with companies based in other nations. The tax incentive for corporate inversions would be eliminated.

INCOME VS. CONSUMPTION Many economists have argued that taxes should be levied based on consumption rather than income. Consumption taxes would do less to discourage saving and investment and would thus be more favorable to economic growth. In addition, consumption taxes are arguably fairer: They tax the standard of living people enjoy rather than the value of what they produce.

The House plan moves toward a consumption tax by allowing businesses to deduct their investment spending immediately, rather than depreciating it slowly over time. By exempting the income that businesses reinvest, the government would essentially be taxing consumed profits.

ORIGIN-BASED VS. DESTINATION-BASED TAXATION The corporate tax system is now origin-based. It levies taxes on the profit from goods produced in the United States, regardless of where they end up. An alternative, proposed in the House bill, would be to tax all goods consumed in the United States, regardless of where they are made. This destination-based approach would tax imports and exempt exports, which is sometimes called a border adjustment. In this way, the business tax would resemble many of the value-added taxes used in Europe.

Some advocates have argued that the switch to destination-based taxes would make American goods more competitive and reduce our trade deficits. Some critics have suggested that it would unduly hurt firms that rely on imports and their customers. Both arguments are probably wrong.

To be sure, the immediate impact of the change would be to discourage imports and encourage exports. But that in turn would mean Americans would supply fewer dollars in foreign-exchange markets, and foreigners would demand more dollars. As a result, the dollar would appreciate, making foreign goods cheaper for Americans, and American goods more expensive for foreigners. The movement in the exchange rate would offset the initial impact on imports and exports.

The main advantage of destination-based taxation is that it is easier to determine where a good is consumed than where it is produced. In a world where multinationals produce goods using parts from around the world, origin-based taxes invite firms to game the system with transfer pricing schemes. Destination-based taxation is less easily gamed.

DEBT VS. EQUITY Now, firms can deduct interest payments to bondholders, but they cannot deduct dividend payments to equity holders. This treatment encourages firms to rely on debt rather than equity, making them more financially fragile than they would otherwise be.

The House plan fixes this asymmetric treatment of debt and equity by no longer allowing firms to deduct interest payments. A business's taxes would be based on its cash flow: revenue minus wage payments and investment spending. How this cash flow is then paid out to equity and debt holders would be irrelevant.

While I like the policy choices proposed by the House bill, not all economists agree. Some view the bill as too radical, risking too many unintended consequences. Others worry that transitioning from the old system to a new one is not worth the cost, even if the new one is better.

Without a doubt, the coming debate will involve immense politicking. Any large tax change creates winners and losers, and the losers are sure to make their voices heard. But what matters most is whether the changes are better for the United States over all, not for special-interest groups. The more voters understand, the better off we all will be.