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Tax Reform Should Avoid the Global Minimum Tax

In a town where consensus is rare, an agreement has emerged among Republicans that the main goals of corporate tax reform are economic growth and increased competitiveness. The good news is that given that we have a terribly anti-growth and anti-competition tax system, a few changes would go a long way to achieving the objectives. But they would work only if the Trump administration and Republicans in Congress abandoned their counterproductive proposition of a global minimum tax.

First, let's do a little recap about our current system. The United States has a 35 percent corporate income tax rate. It's the highest of all industrialized countries. That means U.S. companies doing business at home or abroad always incur a much higher tax burden than foreign competitors.

We also have, unlike most other countries, a worldwide tax system — subjecting companies to taxation on all income, regardless of where it's earned. For example, the profits of U.S.-owned plants based in Germany are subject to U.S. taxes even though these profits have already been taxed by the German authorities. They do receive a credit for foreign income taxes paid, yet that still puts them at a competitive disadvantage.

The silver lining is that as long as companies keep their foreign earnings abroad, they don't have to pay the additional U.S. tax. This explains much of the $2.6 trillion in foreign-earned income stored abroad by American companies. While this protects companies from our punishing system, it also creates a disincentive to invest any of that money back into the United States.

The high tax rate and the worldwide tax system are big impediments to U.S. competitiveness in foreign markets and account for why, in the past two decades, a growing number of companies have decided to engage in corporate inversion, the practice of acquiring a foreign company and then relocating one's legal headquarters outside the United States for tax purposes.

I'm glad the Republican tax reform framework proposes lowering the corporate income tax rate to 20 percent and moving to a territorial tax system — one that doesn't tax foreign-earned income and doesn't penalize companies that want to bring that money back to the United States for investment. But as it happens, the framework also includes this sentence: "To prevent companies from shifting profits to tax havens, the framework includes rules to protect the U.S. tax base by taxing at a reduced rate and on a global basis the foreign profits of U.S. multinational corporations." That's bad news because it means the writers of the framework are ignoring research on the positive impact of lowering the corporate income tax rate on tax avoidance and instead are opting to smack an additional tax rate on foreign profit. If the rate is 15 percent, it means that any profit earned in a country with a lower rate would be taxed at a rate up to the 15 percent level.

One thing is clear: Territoriality with a global minimum tax would equal a full worldwide system because the current deferral protection would be effectively gone. Yet we're told not to worry because the rate would be so low that it wouldn't really matter. Not true. First, this bad fiscal policy would simply encourage companies to find ways to escape the system. Second, the minute Democrats are back in power, they could raise that rate, and companies could end up in a worse situation than the one they're already in. Besides, given that no one is serious about cutting spending, the pressure of future deficits almost guarantees that rate would go up.

They will also point to the word "global" in the framework, which means total worldwide income, as opposed to a country-by-country approach. That would arguably create slightly less disincentive to do business in low-tax places, such as Hong Kong and Bermuda. But why do we have to choose between a bad measure and a terrible one?

Good tax reform should be about enhancing competitiveness, which requires a low-rate and real territorial system. This sort of modified territoriality could quickly turn into a worldwide tax system without the protection of a deferral provision. That wouldn't be good, and it shouldn't be part of any reform agenda.

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