Corporate Tax Reform Is the Key to Growth

It could increase the U.S. capital stock by $5 trillion and cause a $500 billion rise in annual income.

By Martin Feldstein
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The debate over tax reform is focusing on all the wrong things: the personal rates and the deduction for state and local taxes. What will truly matter for the economy is corporate tax reform, which will lead to a major increase in capital spending by companies. That in turn will raise productivity and real wages.

These gains start small but will grow year after year as capital flows to corporate investment in the U.S. from the rest of the world and from other parts of the U.S. economy. Although it is hard to judge how much the U.S. capital stock will grow, a reasonable estimate is that tax reform will raise the U.S. capital stock by $5 trillion within a decade, causing annual national income to rise by $500 billion—equal to $3,500 a household.

That boost in future gross domestic product outweighs the adverse effect of the $1.5 trillion increase in the national debt. The government's interest cost on the extra debt will be substantially less than $100 billion a year, and the potential rise in the annual trade deficit will be less than 0.5% of GDP.

The $500 billion gain in total income is the right measure for evaluating the tax reform. It's wrong to focus on the resulting change in the rate of economic growth, as some critics have done. Even though an annual gain of $500 billion by 2027 translates to a substantial $3,500 in income per household, the implied increase in the growth rate is surprisingly small. Since GDP is projected to be $30 trillion in 2027, a $500 billion increase represents a gain of 1.7%, or just 0.17% per year over the decade.

The most important reform is to cut the corporate tax rate from 35%—the highest among major industrial nations—to 20%. This will increase corporate capital directly by reducing the tax burden. Cutting the corporate rate to 20% would raise retained earnings by about $2 trillion over 10 years.

The lower tax rate will also induce foreign companies to shift some of their production to America. And capital within the U.S. will move from low-productivity uses in agriculture and housing to corporate investments that can create good jobs and raise real wages. This will be reinforced by reforms that induce American corporations to bring back profits earned by their foreign subsidiaries. Under the proposed reform the U.S. will follow the practice of nearly all other countries in adopting a "territorial" tax system. This will make American companies bring back cash from foreign subsidiaries as it is earned.

In addition, tax reform will help bring home some of the $2.6 trillion that U.S. companies already hold abroad because of today's unfavorable taxation of repatriated profits. The GOP plan includes a one-time moderate mandatory "deemed repatriation" tax on those profits accumulated overseas, after which the funds can be repatriated with no further tax.

What about tax reform's effect on the budget deficit and the national debt? I have long been a deficit hawk. It is troubling that America's ratio of debt to GDP has more than doubled in the past 10 years and is projected to increase from 77% today to 91% in a decade, even with no legislated changes in taxes or spending. An extra $1.5 trillion of debt will raise that ratio to 96%. But I believe the advantages of the corporate tax reform outweigh the adverse effects of the relatively small debt increase.

The challenge for the Congress after the next election will be to start reversing the rise in the debt. The debt-to-GDP ratio, which was 35% as recently as 2007, is heading to more than 100%. But cutting future annual deficits from the projected 5% of GDP to 3% would reverse that trend, causing the ratio to head back toward about 60%. That would be a useful next step toward a fiscally responsible condition for the U.S. economy. But the first step is to put tax reform into law.

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