Project Syndicate

Cutting US Corporate Tax Is Worth the Cost

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CAMBRIDGE – The United States Congress is close to enacting a major tax reform. The plan's most important provision reduces the corporate tax rate from 35% to 20% – from the highest among all OECD countries to one of the lowest – and allows US companies to repatriate the profits of their foreign subsidiaries without paying additional US taxes. Opponents of the legislation point to the resulting increase in the federal budget deficit, which will add $1.5 trillion to the government debt over the next ten years.
I dislike budget deficits, and I have long warned about their dangerous effects. Nonetheless, I believe that the economic benefits resulting from the corporate tax changes will outweigh the adverse effects of the increased debt.

The lower rate will attract capital to the US corporate sector. American corporations will invest more in the US, because foreign countries will no longer offer lower tax rates, and will repatriate profits earned by their foreign subsidiaries rather than leaving them abroad. They will also bring back some of the previously earned foreign profits that have been left outside the US, estimated by the Treasury to be worth $2.5 trillion. Foreign companies will expand their investments in the US – or even shift their operations there – to take advantage of the lower tax rate. And within the US, capital will flow from agriculture and housing to higher productivity uses in the corporate sector.

Although it is difficult to estimate the total increase in capital in the corporate sector, I think it is reasonable to assume that over the next ten years it will reach at least $5 trillion. The increased flow of capital to the corporate sector will raise productivity and real wages. If that happens, it will raise annual real GDP in 2027 by about $500 billion, equivalent to 1.7% of total 2027 GDP, implying a gain of $4,000 per household in today's dollars.

These favorable effects are directly relevant to balancing the primary adverse effects usually associated with a fiscal deficit: that government borrowing crowds out private capital formation; that higher interest payments generally require higher taxes or reductions in spending on defense and nondefense programs; that a budget deficit implies an unwanted increase in aggregate demand when the economy is at full employment; and that a higher debt ratio leaves less capacity for increased emergency government spending.

I believe that none of these problems will materialize during the coming decade. Let's consider them in turn.
Although the $1.5 trillion of government borrowing caused by the tax bill during the next decade could crowd out an equal amount of private borrowing, the capital stock will grow by an even larger amount. The $1.5 trillion corporate tax cut will go directly to US companies, and the stock of corporate capital will grow further because of the inflow of funds from the rest of the world. Even with increased government borrowing, the proposed tax reform can therefore still raise the corporate capital stock by some $5 trillion over the next decade.

Moreover, the $500 billion increase in total annual income by 2027 would increase tax revenue by $100-150 billion a year. That is enough to cover the $60 billion in interest payments on the $1.5 trillion of extra debt, with money left over to increase government spending or reduce personal taxes.

Likewise, concern that an increase in the fiscal deficit would undesirably stimulate aggregate demand is misplaced. In fact, the stimulative effects of the fiscal deficit and increased corporate investment should be welcomed, for two reasons. First, they will offset the contractionary effects of the expected increase in the federal funds rate and the shrinking size of the Federal Reserve's balance sheet. And, second, after nine years of economic expansion, most experts expect the US to enter recession sometime in the next five years.

Similarly, concern about the ratio of government debt to GDP, which has doubled in the past decade and is now 77%, is exaggerated. The Congressional Budget Office projects that even with no further legislation, the debt ratio will rise to 91.2% by 2027. The direct effect of the $1.5 trillion deficit implied by the tax reform would be to raise that to 97%. A military emergency or an economic downturn would call for additional debt-financed spending or tax reductions. But even a massive spending program like the $900 billion American Recovery and Reinvestment Act of 2009 would add only an additional three percentage points to the debt ratio. It is hard to believe that a debt ratio of 97% would make that more difficult to achieve than a debt ratio of 92%.

So, for all four of these reasons, I believe that the benefits of cutting the corporate tax rate more than offset the adverse effects normally attributed to budget deficits. But, looking ahead, I believe that reducing the fiscal deficit should be a high priority after the 2018 congressional election. A tax on carbon dioxide emissions or a slowdown of spending growth for federal entitlement programs can start to bring the debt ratio back down toward the 50% level that prevailed before the 2008-2009 downturn. But first it is important to enact the proposed tax reform.

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Martin Feldstein, Professor of Economics at Harvard University and President Emeritus of the National Bureau of Economic Research, chaired President Ronald Reagan's Council of Economic Advisers from 1982 to 1984. In 2006, he was appointed to President Bush's Foreign Intelligence Advisory Board, and, in 2009, was appointed to President Obama's Economic Recovery Advisory Board. Currently, he is on the board of directors of the Council on Foreign Relations, the Trilateral Commission, and the Group of 30, a non-profit, international body that seeks greater understanding of global economic issues.

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