OUTLOOK

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ECONOMIC DATA AND COMMENTARY

The Case for Corporate Tax Reform

With the highest nominal rates in the industrial world, the U.S. explores a fairer, more productive tax system

In late September, after months of promising big changes, the Trump administration and congressional Republicans released a framework for tax reform, including highly anticipated plans to cut corporate taxes. Among the most significant proposals were cutting the baseline corporate tax rate to 20 percent from its current 35 percent, and limiting the maximum tax rate for many small and family-owned businesses—including sole proprietorships, partnerships and S corporations—to 25 percent.

The plan was welcomed by many business leaders, who have long argued that the U.S. statutory rate—the highest tax rate of all industrialized countries—leaves companies at a competitive disadvantage in an increasingly global marketplace. The high U.S. rate discourages new investment and retards growth, the argument goes, and has led U.S. multinationals to park trillions of dollars beyond our borders.

But this battle is far from over. Tax reform won't happen easily, in part because the current system is so complicated, says John W. Diamond, the Edward A. and Hermena Hancock Kelly Fellow in Public Finance at Rice University's Baker Institute and a longtime advocate of reforming the U.S. system. Diamond notes that one big stumbling block is that many companies are able to game the current system, using deductions and other preferences to pay much less than 35 percent—and in some prominent cases, no tax at all. Diamond spoke with OUTLOOK about the inefficiencies of the current system, the changes he would like to see and the prospects that a tax overhaul could pass this year.

OUTLOOK: What are some of the economic problems that are a consequence of a high corporate tax rate?

John Diamond: There are several. First, high taxes discourage investment and capital accumulation, which means that in the long run they reduce productivity and economic growth. Second, speaking about the situation in the United States, our higher tax rate discourages direct foreign investment while also encouraging U.S. multinational companies to invest more abroad. Third, higher rates encourage companies to seek to reduce taxes through "income-shifting."

This Month's Expert

John W. Diamond is the Edward A. and Hermena Hancock Kelly Fellow in Public Finance at Rice University's Baker Institute, and CEO of Tax Policy Advisers, LLC. His current research focuses on the economic effects of corporate tax reform, the economic and distributional effects of fundamental tax reform, taxation and housing values, public sector pensions, and other tax and expenditure policy issues.

Diamond has co-edited books including *Pathways to Fiscal Reform in the United States* (2015) and *Fundamental Tax Reform: Issues, Choices and Implications* (2008), both from The MIT Press. He has testified before U.S. House and Senate committees, the Joint Economic Committee and other federal and state committees on issues related to tax policy and the U.S. economy. Diamond served as a consultant for the World Bank on the efficacy of structural adjustment programs. He received his Ph.D. in economics from Rice University in 2000.

OUTLOOK: How does income-shifting work?

JD: Companies move income to low-tax countries and deductions to high-tax countries. They do that through mechanisms such as transfer pricing—the prices that large companies charge internally to move things from one part of the company to another.

As a result of the disparity in tax rates, companies such as Apple, which holds about $250 billion outside the United States, won't bring that money home even when it's needed, because then they'd have to pay the 35 percent tax rate. Altogether, U.S. companies hold more than $2 trillion outside of the U.S. So when Apple paid a dividend to shareholders a few years ago, instead of tapping its overseas stash, the company borrowed money in the U.S., where it can also deduct the interest on that loan.

There's a huge amount of U.S. corporate income locked out of the country simply because of tax rates and tax decisions. And that's just one way that corporate taxes cause inefficiencies.

OUTLOOK: What are some others?

JD: With all of its built-in preferences and the high statutory tax rate, our corporate tax system distorts how investment dollars are allocated across asset types and industries—and that reduces productivity of the nation's assets.

That's because it's the tax system, rather than questions of potential profitability or growth, that influences all kinds of choices that companies make. Do they finance new investments with debt or equity? Do they choose a corporate or non-corporate form for the organization? What proportion of earnings should they retain, pay out as dividends or use to repurchase shares?

Those decisions can make huge differences in terms of the actual tax rate companies pay. According to a 2017 Treasury Department paper, the marginal effective tax rate for corporations is 28.9 percent vs. 24.4 percent for pass-through businesses—and a negative 2.3 percent for owner-occupied housing.

> "The U.S. corporate tax rate used to be higher than it is now. The biggest change isn't that U.S. rates have escalated but that other countries' rates have gone lower."

OUTLOOK: When did the United States become such a high-tax country for corporations?

JD: Actually, the U.S. corporate tax rate used to be higher than it is now. The biggest change isn't that U.S. rates have escalated but that other countries' rates have gone lower. The Tax Reform Act of 1986 (which also reduced individual taxes) cut the federal corporate rate from 49 percent to 34 percent. In 1989, the rate inched back up to 35 percent, where it has stayed for nearly 30 years.

Over that period, many other countries have reformed their tax structures and reduced corporate rates. In 1988, the combined U.S. federal and state tax rate on companies averaged 38.4 percent, which was five percentage points lower than the sample average of 19 other member nations of the Organization for Economic Cooperation and Development [OECD]. Today, the combined U.S. rate is 40.5 percent, which is 12.6 percentage points higher than in those 19 countries. That's a swing of nearly 18 percentage points. The U.S. went from being a relatively low-tax country to where now we have the highest statutory corporate tax rate of any developed country. That disparity makes a difference in an economy that is now much more globalized, and in which capital is so mobile. Other countries have competed for capital by lowering their corporate tax rate, and we've fallen behind.

OUTLOOK: When did the United States start taxing corporate income, and what percentage of federal revenue do these taxes provide?

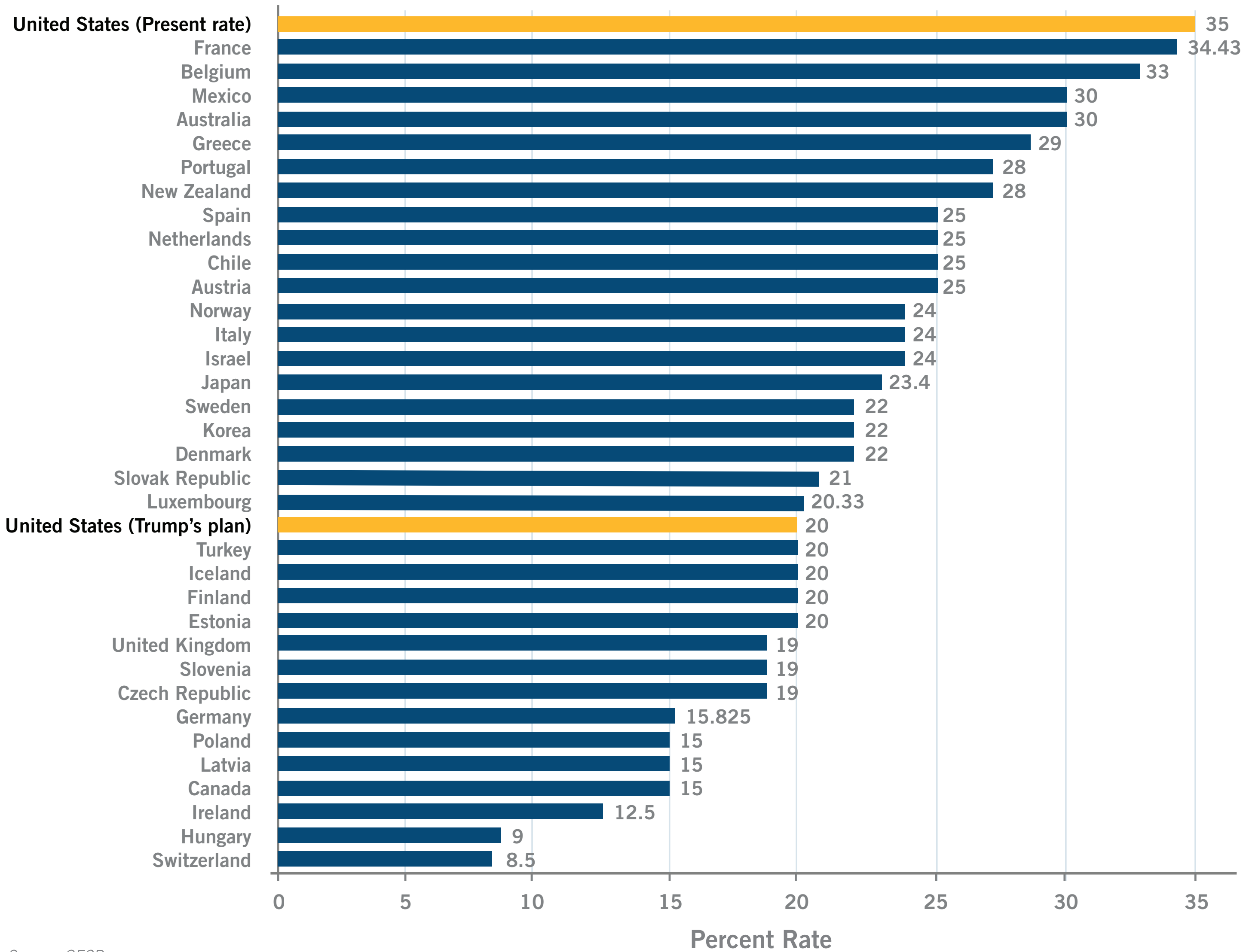
JD: The federal government began collecting income tax on companies in 1909, four years before the 16th Amendment launched individual income taxes. And until 1943, corporate and individual income provided roughly equal shares of federal revenue. With the rise of personal incomes after World War II and the onset of payroll taxes, the share paid by corporations began dropping steadily.

Today, corporate taxes generally account for between 6 percent and 12 percent of federal revenue, compared with 40 percent to 60 percent from individual income taxes. The rest comes from payroll taxes and excise, estate and other taxes.

OUTLOOK: While the U.S. corporate rate is high relative to other countries, don't deductions and other incentives make up for some of that competitive difference?

JD: If you look at the marginal effective tax rate, which takes into account deductions, preferences and credits, the U.S. used to be about 8 percentage points below the average for other industrialized countries. Now, we're about even on that marginal basis. So we really have lost the competitive advantage we once had.

CORPORATE TAX RATES IN DEVELOPED ECONOMIES



Source: OECD

OUTLOOK: Are there other areas in which you see the United States falling behind in terms of tax structure?

JD: One major difference is that other countries have switched to a territorial system, which means they tax only the income that's earned within their boundaries. The U.S. follows a worldwide approach, trying to tax all of the income of U.S. companies, regardless of where it's earned. We're the only OECD country that has not moved to a territorial tax system.

> "Other countries have switched to a territorial system, which means they tax only the income that's earned within their boundaries. The U.S. follows a worldwide approach, trying to tax all of the income of U.S. companies, regardless of where it's earned."

OUTLOOK: If that's the case, how does keeping money overseas help U.S. companies avoid paying U.S. taxes?

JD: The code allows for deferral of U.S. taxes until the money's brought home—hence the Apple example I cited. Companies can simply park the money outside the U.S. indefinitely.

OUTLOOK: What are possible ways to reform the U.S. system?

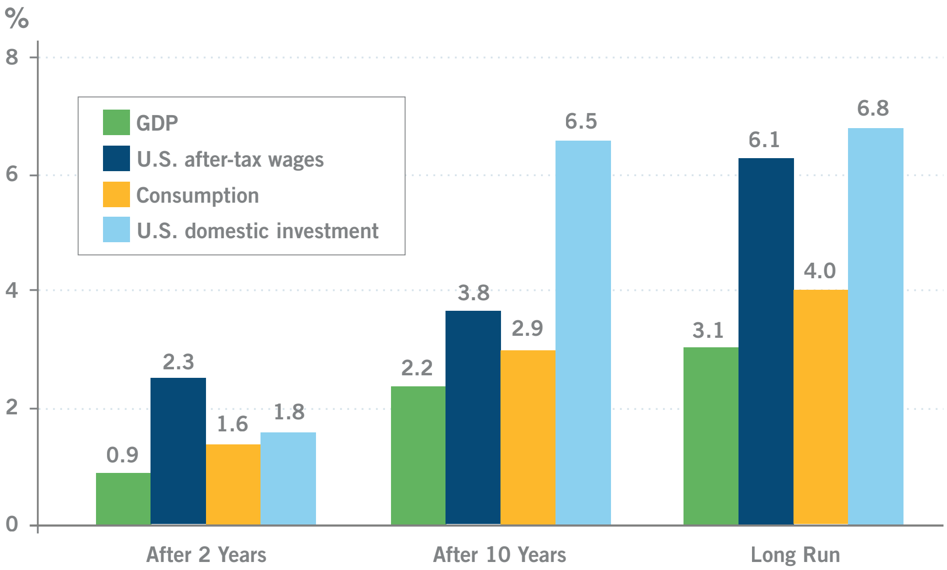
JD: There are a couple of general ways to go about it, with plenty of room for variations. In 2014 then-House Ways and Means Committee chair Dave Camp put forth a proposal that would reduce the corporate rate from 35 percent to 25 percent, while at the same time broaden the base of corporate taxpayers by eliminating a lot of deductions and preferences. Of course, you could bring the rate down by more than that, but in order to keep the reform revenue-neutral and not exacerbate federal debt, you'd have to eliminate more deductions. If you were willing to have a higher rate, you could leave in the research and development credit and accelerated depreciation, for example, because they're targeted toward investment.

But how it treats corporate investment is one big drawback of this approach. While having a lower rate does help encourage new investment, it's just as generous to the income that comes from existing capital. A plant that doesn't expand gets the same tax break as one that spends a lot on new equipment, so there's really no incentive for growth. The tax reduction is just a transfer of funds from the U.S. Treasury to owners of old capital.

A second approach, put forward most recently by House Republicans, is known as a destination-based cash flow tax. As proposed by the House, this approach would do five things:

- First, it would lower the statutory rate to 20 percent.
- Second, it would allow businesses to write off capital investments immediately as opposed to depreciating them over time.
- Third, it would move us to a territorial system, so companies would no longer have to pay U.S. taxes on overseas profits.
- Fourth, businesses would no longer be able to deduct interest as a business expense.
- And, finally, to keep the plan revenue-neutral, there would be a border adjustment tax, which imposes a sort of value-added tax on imported goods.

POTENTIAL EFFECTS OF CORPORATE REFORM
Diamond's analysis of the growth of various indicators as a result of the Camp tax plan



Source: Business Roundtable

While no system is perfect, the beauty of this approach is that you largely eliminate the incentive to keep money overseas, and you move to a consumption-based tax that encourages investment. The ability to write off new investments immediately means the effective tax rate on those investments would be zero, rather than 20 percent.

OUTLOOK: Is there an approach that companies particularly favor?

JD: In general, most seem to agree on the first type—the base-broadening, rate-reducing reform. But with any variation you're going to have winners and losers. For example, the House plan's original border adjustment tax, which I like, would deny businesses deductions for the cost of goods they import from their overseas plants. The tax would apply to all direct consumer purchases of imported goods. By contrast, export sales would be excluded—if you manufacture something that will be exported, you don't have to include revenue for that product as taxable income. So companies are going to line up on one side or the other, depending on their business.

And now the House seems to have moved away from the border adjustment tax. That's a major problem that may put the destination-based cash flow approach off the table.

OUTLOOK: Cooperatives have generally been treated as non-taxable entities under our current system. Do any of the reform plans being discussed change that?

JD: I haven't seen any proposed changes involving subchapter T, which is the part of the tax code that lays out the tax treatment of cooperatives and their patrons. So this isn't likely to change.

> I think reform is more likely now than it has been in the past 15 years, but that doesn't mean it will happen."

OUTLOOK: Reducing the U.S. trade deficit has long been a goal for economists and politicians alike. Are there other ways that reducing the tax rate encourages exports?

JD: Any corporate reform, whatever the approach, is going to encourage exports to the extent that it increases GDP. The destination-based cash flow tax may be the most encouraging to exports, but that wouldn't be because of the border adjustment tax. It would be because your effective tax rate for new investment in the U.S. would be zero. More companies would want to locate in the U.S. and then ship their products abroad.

OUTLOOK: What do you think are the chances that we'll see corporate tax reform by the end of the year?

JD: That's anybody's guess. I've been on a couple of panels before Congress in the past four years, one for the Senate Finance Committee during the Obama administration and another just recently under the Trump administration. The amazing thing is that both times there was very little disagreement among panelists chosen by both Republicans and Democrats. There seems to be a very large area of common ground on this issue. So much so that I think coming up with reforms acceptable to both parties is actually very easy from a theoretical economics view.

Yet there's a political problem we just don't seem able to get past. We couldn't under the Obama administration, and it doesn't seem as though we're really making any headway now, although it looks like Congress may take its first real shot at it this fall.

I think reform is more likely now than it has been in the past 15 years, but that doesn't mean it will happen. Permanent reform would require 60 votes in the Senate. Unfortunately, there are so many outside factors affecting this that I just don't know how that's going to play out. It's pure politics, and that's not really my area of specialization.

OUTLOOK: A temporary tax cut, passed in the Senate through budget reconciliation, would require just 51 votes. Is that a good option?

JD: Temporary reforms are generally bad. For one thing, they create uncertainty. I liked some of the ideas behind the temporary Bush tax cuts of the early 2000s, but it's very difficult to plan when you don't know how long temporary measures will last and what parts will be extended versus allowed to expire. For another thing, debt held by the public is 77 percent of GDP, so tax cuts need to be budget neutral, offset by clear plans to broaden the tax base and/or cut government spending. Simply adding to the deficit with a temporary measure that reduces tax revenue but doesn't address these other issues is not good fiscal policy.

"Corporate profits are a good thing, not a bad thing. They mean American workers are outcompeting foreign workers in the production and distribution of goods."

OUTLOOK: To what extent is corporate tax reform being held up by reform for individuals? Can you do one without the other?

JD: The individual side is clearly more of a stumbling block. On the corporate side there's very nearly a consensus on what direction we should go. I hear both sides saying we need to fix this. On individual taxes, the two parties come at it from very different angles.

So by sticking individual and corporate together, you make corporate reform harder and less certain. If you really just wanted to get something done, it may be best to do corporate reform alone. That's assuming the goal is to get a positive step, to get a win.

OUTLOOK: Others might argue that corporate profits have been rising in recent years, so we should increase their taxes, not cut them. How do you respond to that argument?

JD: Just because companies have profits doesn't mean the tax system is working. I think we're fortunate that corporate profits are increasing right now despite the drag our tax system puts on competitiveness. Whether profits at a given point are high or low, the tax rate is still causing the economic distortions and damages I've described.

Keep in mind that corporate profits are a good thing, not a bad thing. They mean American workers are outcompeting foreign workers in the production and distribution of goods. That's something we all should want more of, not less. So, my answer is: We're doing okay, but we could do better.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 8/31/17. They are intended to provide rate or cost indications only and are for notional amounts in excess of $5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Forecasts courtesy of Bloomberg and Blue Chip Economic Indicators

				US Treasury Securities	
2017	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q3	2.70%	1.60%	1.16%	1.48%	2.35%
Q4	2.50%	2.30%	1.21%	1.63%	2.52%
2018	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	2.30%	2.30%	1.26%	1.78%	2.64%
Q2	2.30%	2.10%	1.32%	1.95%	2.74%
Q3	2.20%	2.20%	1.33%	2.10%	2.84%

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD SWAP RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	1.33%	1.45%	1.64%	1.79%	1.94%	2.11%
0.25	1.41%	1.47%	1.69%	1.84%	1.96%	2.12%
0.50	1.50%	1.51%	1.73%	1.88%	1.99%	2.15%
0.75	1.55%	1.61%	1.77%	1.92%	2.05%	2.20%
1.00	1.56%	1.66%	1.81%	1.94%	2.06%	2.21%
1.50	1.69%	1.74%	1.89%	2.03%	2.15%	2.29%
2.00	1.72%	1.80%	1.94%	2.08%	2.19%	2.32%
2.50	1.81%	1.87%	2.02%	2.15%	2.25%	2.36%
3.00	1.90%	1.95%	2.09%	2.21%	2.31%	2.41%
4.00	2.03%	2.10%	2.23%	2.33%	2.41%	2.48%
5.00	2.17%	2.24%	2.35%	2.46%	2.50%	2.55%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

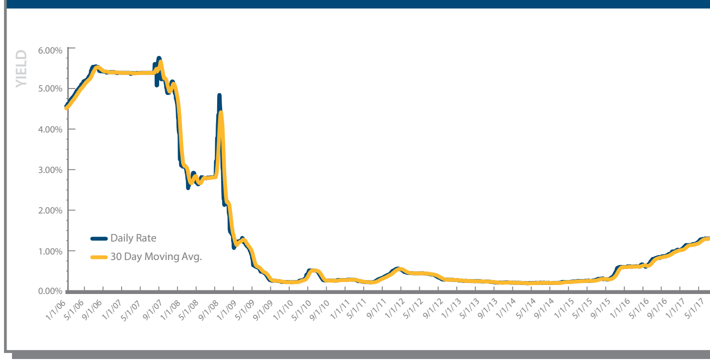
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	5	5	5
90	6	8	9	7
180	9	14	15	13
365	21	28	31	24

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

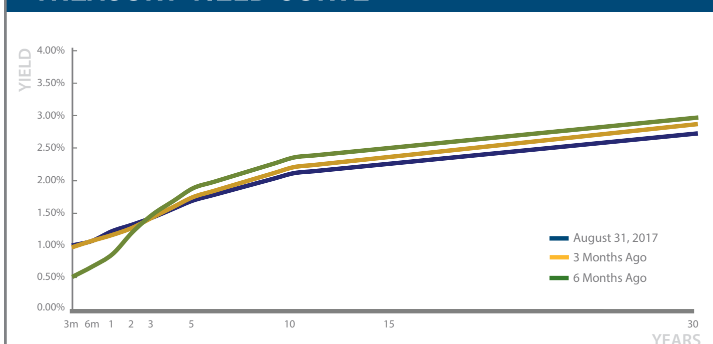
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE



COBANK UPDATE

CoBank Commits More Than $500,000 to Hurricane Relief Efforts

Photo by Daniel Cima for the American Red Cross

Tom Halverson

CoBank has committed more than $500,000 to support relief efforts following hurricanes Harvey, Irma and Maria. CoBank's contributions are being made in partnership with customers, CoBank employees and other Farm Credit institutions and will support a number of organizations involved in the humanitarian response to the hurricanes.

"It is difficult to grasp the full scope of damage caused by these devastating hurricanes," said Tom Halverson, CoBank's president and chief executive officer. "The impact of these disasters will be felt for a long time, but CoBank is committed to supporting our customers, our colleagues and our Farm Credit partners as they begin the process of recovery. CoBank stands with people in impacted communities and is proud to provide a helping hand at this difficult time."

CoBank's hurricane relief contributions include:

- **$335,000 to the American Red Cross**
  The bank made a corporate contribution of $200,000 to the American Red Cross to support the most urgent needs for food, water and shelter in hurricane-ravaged areas of Texas and Florida. In partnership with AgFirst, CoBank made an additional $100,000 contribution to support relief efforts in Puerto Rico. Finally, CoBank committed to match employee contributions to the Red Cross on a dollar-for-dollar basis, which generated an additional $35,000 in corporate support.

- **$25,000 to the Texas Farm Bureau Foundation**
  CoBank and the Farm Credit Bank of Texas jointly committed $50,000 to the Texas Farm Bureau Foundation's Hurricane Harvey relief fund. The fund will benefit farmers and ranchers whose homes and livelihoods have been impacted by the disaster.

- **$100,000 to Relief Funds Established by the Bank's Electric Distribution Customers in Texas and Florida**
  CoBank committed $50,000 to a fund established by the Texas Electric Cooperatives, the statewide association for rural electric cooperatives across the state. An additional $50,000 supported relief funds established by the Florida Electric Cooperative Association and the electric cooperatives of Lee County. The funds will benefit the employees of these cooperatives whose own homes have been damaged or destroyed due to the hurricane.

About CoBank

CoBank is a $125 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving more than 70,000 farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture, rural infrastructure and rural communities. Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

For more information about CoBank, visit the bank's web site at www.cobank.com.

Hurricane Relief Efforts *(continued)*

Photo by Daniel Cima for the American Red Cross

- **$50,000 to the Farm Credit System Employee Relief Fund**
  CoBank committed $50,000 to a relief fund established by the Farm Credit System to support its own employees in times of disaster. Hurricane Harvey damaged or destroyed the homes of a number of Farm Credit employees, and the bank's contribution to the Farm Credit System Employee Relief Fund will support our colleagues who have been impacted by Hurricanes Harvey, Irma and other natural disasters.
- **$10,000 to the TSTCI Foundation Relief Fund**
  CoBank committed $10,000 to a relief fund established by the Texas Statewide Telephone Cooperative, Inc., which represents rural telecommunications carriers throughout the state. Funds will support relief efforts for impacted communities within TSTCI members' service territories.

"CoBank remains in contact with our customers in impacted communities," Halverson said. "In addition to our relief contributions, CoBank is standing by to provide our customers in impacted areas with access to credit they may need in the months ahead. As a mission-based lender, we want to do everything we can to help our customers and the communities they serve to recover, rebuild and move forward."