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Obama noodles with loopholes, calls it 'reform'

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President Obama calls it "tax reform," and the headlines blared that he would lower rates and close loopholes. But behind the rhetoric and the headlines, Obama's new tax proposal is probably just a political document that replaces the "loopholes" he doesn't like with "incentives" he likes.

High rates, loopholes, complexity, and a hodgepodge system for foreign-earned income are all problems, the Obama plan notes. But the president responds with rates that are still too high, and he preserves his own loopholes, leaves complexity in place, and perpetuates our draconian and nearly unique system of worldwide taxation.

Obama's "Framework for Business Tax Reform," which was issued Wednesday, has plenty to praise, including lowering the corporate tax rate from 35 percent to 28 percent. Impressively, the 23-page document begins with a clear discussion about the evils of a high corporate tax rate riddled with loopholes, an arrangement that "is uncompetitive relative to other countries, distorts business decision making, and slows economic growth."

Figuring out the tax code and complying with it is hard work, especially for small businesses, Obama's framework notes. Time spent on compliance detracts from the productive work that small businesses could be doing, such as making, selling, moving, or servicing things.

Also, tax complexity "distorts investment," the framework notes. Rather than investing in whatever is most economically promising, businesses often invest where the tax treatment is most advantageous. So instead of profit flowing from productivity and value, it flows from tax cleverness. When profit and value are not linked, society is poorer.
But Obama has no interest in ending this complexity, and he has no problem with using the tax code to pick winners and losers. The oil and gas "tax preferences" he would end are mostly not actual "preferences" for oil and gas, but broader preferences that oil and gas also happen to get.

The loophole in question is the "domestic production tax deduction." This provision currently allows corporations to deduct 9 percent of their income from various activities dubbed "domestic production."
So Uncle Sam taxes the guy who fixes your car at a higher rate than the guy who made your car -- and Obama is just fine with that. His proposal actually increases the deduction to 10.7 percent of "production" revenues, but simply declares that oil and gas drilling and coal mining don't count as production.

The liberal justification: The domestic production deduction is supposed to keep manufacturers from going overseas, so oil companies shouldn't get it. As a staffer at the liberal Center for American Progress puts it, "What are they going to do, move the oil field to the North Sea."

But only oil, gas and coal are targeted. Forestry and construction, for instance, get to keep the deduction. So is Obama afraid that real estate developers in Fairfax County are going to build their developments in Guadalajara?

This isn't closing a loophole -- it's increasing a loophole but blocking one corner of it.

Obama's tax plan also would make permanent and expand "key tax incentives to encourage investment in clean energy." So tax deductions that happen to benefit Exxon and Peabody are destructive distortions, but tax credits written to benefit General Electric and First Solar are "key tax incentives."

The biggest failing of Obama's tax plan may be his treatment of income earned overseas. Almost every other country in the world taxes only income earned within its borders -- a "territorial tax system." But the United States taxes even foreign-earned income of U.S.-based companies.

Currently U.S. corporations can defer taxation on some of their foreign income until they bring that money home, either by paying dividends, or investing in the United States. Obama wants to limit companies' ability to do that by creating a new minimum tax that U.S. corporations must pay on their foreign profits. In other words, Obama's reform bolsters one of the worst aspects of our tax code -- worldwide taxation.

"Worldwide taxation is a penalty" for being based in the United States, Dan Mitchell of the libertarian Cato Institute explains. "Allowing deferral mitigates that penalty. In Obama-speak," this "counts as the government giving you something."

Tax reform is popular, and that's why Obama makes a big deal about it. But his pollsters probably tell him that oil companies are unpopular, and so he finds a way to punish them. And bashing "Benedict Arnold corporations" that "move profits and jobs overseas" is an old standard for Democratic politicians.

At first glance, Obama's tax package looks promising -- lower rates and fewer loopholes. A serious read, however, reveals a plan that is no simpler and no fairer than what we have today. The plan is more about politics than policy.

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