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If Not A VAT, Then What Should Business Taxes Look Like?

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Recent weeks have seen a lot of conversations in presidential politics and the tax policy world about a value-added tax, or VAT.

Both Senators Rand Paul (R-Ky.) and Ted Cruz (R-Tex.)have included VATs as a replacement business tax (and payroll tax).

For doing so, the plans have come under pretty sharp criticism from Dan Mitchell of the Cato Institute and Ramesh Ponnuru of AEI. For his part, Steve Moore of The Heritage Foundation has come to the VAT's defense.

The basic criticisms have come in several forms:

1. A VAT double taxes wages, making their rates artificially low
2. VATs have grown in places they've been tried, notably in Europe
3. The border adjustable advantage is overblown
4. VATs are opaque when taxes should be painful and visible
5. The VAT collects too much of federal taxes under these plans, obscuring the true tax burden with skinny personal taxes

All of these criticisms have merit, some stronger than others. Grover Norquist's Americans for Tax Reform, while not pig piling on this latest VAT attack, remains anti-VAT and has made all these points in the past.

So, it seems clear that the VAT is not a harmonious choice on the right, to say the least.

If not a VAT, then, what type of business tax reform should conservatives be pushing? The answer is a reformed corporate income tax with equivalent treatment for unincorporated firms.

There are three principal problems with the way America taxes business income. Note that there are also problems elsewhere in the tax system, but this analysis is confined to the business level tax.

The rate is too high
The United States has the highest statutory marginal tax rate on business profits in the developed world.

Corporations face a tax rate of 40 percent, and unincorporated "flow through" or "pass through" firms (Subchapter-S corporations, partnerships, sole proprietorships, LLCs, etc.) can face a rate approaching 50 percent. These numbers include state business profit taxes, which you must do in comparing countries on an apples-to-apples comparison.

Not only are these rates very high in any context, they are also high by international standards. According to the OECD, the average developed nation rate is under 25 percent and falling. Our rates are higher than every single one of our major trading partners–Canada, Mexico, Japan, the United Kingdom, France, and Germany. They are higher than the BRIC countries of Brazil, Russia, India, and China, according to Deloitte.

We double tax international income

Most developed nations seek to tax only that income earned inside their borders. In contrast to this common sense "territorial" system, the United States taxes the "worldwide" income of our employers.

Imagine you are a U.S. company that makes a profit in China. You pay the 25 percent Chinese income tax on that business profit. If you want to bring the remaining money back to the United States, you have to pay the IRS and state revenue offices the difference between the Chinese income tax you already paid and either the U.S. corporate tax (40 percent) or flow-through tax (50 percent).

As Donald Trump would say, how dumb is that?

Our tax code is biased against business fixed investment

Most business expenses are deductible against business revenues in the calculation of taxable business profit. Pencils, wages, rent, etc. are simply deducted in the year they are paid.

But business fixed investment–when companies invest in buildings, fiber optic cables, work desks, laptops and tablets, etc.–is not generally treated this way. The tax code forces companies to slowly deduct the cost over several to many years, in an arbitrary process known as "depreciation."

Tablets and laptops are depreciated over five years. Desks take seven years. Buildings take 39 years, unless of course you pay the alternative minimum tax (40 years) or the building is a residential rental (27.5 years). That's nuts, and it's arbitrary. In fact, the depreciable life of these investments are set by Congress with revenue scores, not accounting, in mind.

This means the tax code advantages some use of business expenditure (e.g., buying a pencil or paying a wage) over others (e.g., buying a laptop). A tax system should be neutral.

Even worse, business fixed investment is one of the cornerstones of productivity growth. Without productivity growth, you don't get economic growth. Without economic growth, our living standards remain stagnant or fall.

All of these have very simple but powerful fixes:

- **To fix the rate problem**, bring the U.S. corporate rate to 25 percent or less (don't forget about the states). Extend the same rate to flow-through firms, which can be done in a number of ways.

- **To fix the international double tax problem**, transition from worldwide to territorial taxation. If that means a one time tax on existing overseas profits, so be it.
- **To fix the bias against business fixed investment**, move from depreciation to full expensing. If this needs to be limited to exclude real estate reform for scoring reasons, that's ok.

We can do all these things by simply reforming our existing business tax system. We don't need a VAT to fix our lousy tax code.