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US tax reform is vital but Donald Trump's plan is flawed

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Corporate tax reform has rightly been identified by both the President-elect and Congress as an immediate priority. There is no doubt that the status quo - where America has the highest statutory rate among major countries and companies hoard cash overseas - can be improved on. Unfortunately, the reforms identified by Paul Ryan, speaker of the House of Representatives, and Donald Trump appear set to damage the tax base and the US and global economies.

The central concept put forward by Mr Ryan, which appears to have the support of Mr Trump, is to turn corporate income tax from a tax on the return to capital into a tax only on extraordinary profits. This would be done by taxing corporate cash flows. In addition to the major reduction of the overall rate, the system would change in three fundamental ways. First, all investment outlays can be written off in the year they occur rather than over time. Second, interest payments to bondholders, banks and other creditors will no longer be deductible. Third, companies will be able to exclude receipts from exports in calculating their taxable income and will not be permitted to deduct payments to foreign suppliers or affiliates from income.

Unlike some of Mr Trump's other economic ideas, the corporate cash flow tax is supported by some experts in both political parties. However, it has four major - probably fatal - flaws.

First, the tax change will exacerbate inequality, with more than half the benefits going to the top 1 per cent of Americans. Eliminating the corporate tax on the returns to capital and substantially scaling back the rate on extraordinary profits is a radical step that might be defensible on grounds of eliminating double taxation in a world where capital returns are effectively taxed at the individual level. But it is very hard to justify in the current world, where exclusions and preferences mean that most corporate income is not taxed at the individual level and where the estate tax, which could be a backstop, is easily avoided and may well be eliminated.

Second, the tax change will capriciously redistribute income, increase uncertainty and place punitive burdens on some sectors. Think of a retailer who imports goods from abroad for 60 cents, incurs 30 cents in labour and interest costs, and then earns a 5 cent margin. With a 20 per cent tax, and no ability to deduct import or interest costs, the taxes will substantially exceed 100 per cent of profits even if there is some offset from a stronger dollar. Businesses that invest heavily, hire extensively and export a large part of their product will have negative taxable income on a chronic basis. It is hard to imagine that the political process will allow annual multibillion-dollar refunds, so they too may be victimised. Then there are the still unresolved questions of what the rules will be on interest deductibility for banks and of the treatment of businesses organised as partnerships that do not pay corporate taxes.

Third, the tax change will harm the global economy in ways that reverberate back to America. It will be seen by other countries and the World Trade Organisation as a protectionist act that violates US treaty obligations. Proponents may argue that it should be legal because it is like a value added tax, but the WTO is very clear that income taxes cannot discriminate to favour exports. While the WTO process would grind on, protectionist acts by other nations would be licensed immediately.

Proponents of the plan anticipate a rise in the dollar by an amount equal to the 15 to 20 per cent tax rate. This would do huge damage to dollar debtors all over the world and provoke financial crises in some emerging markets. Since US foreign assets are mostly held in foreign currencies, whereas debts are largely in dollars, American losses with even a partial appreciation would be in the trillions. Ironically, China, with its huge reserve hoard, would be a winner.

Fourth, the combination of a sharply lower rate, new opportunities for tax arbitrage and the fact that any revenue gains from bringing overseas cash home are one-shot means the Federal revenue base would erode. The result would be cuts in entitlement payments to consumers who spend heavily, tax hikes on individuals and reductions in government spending. Over time, this will slow growth and burden the middle class.

There is no need to reinvent the corporate tax wheel. Let's fix the tax we have by cutting rates, closing shelters, broadening the base and cracking down on tax havens. That would be an important step to making our economy grow faster. It would also be fairer.

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