# Public Finance Field Exam
## August 2021

**Directions:** Answer both questions, in whatever order you prefer. The exam is open-book, but you may not consult anyone in composing your answers.

## 1. Tax Reform

Since the passage of the Tax Cuts and Jobs Act (TCJA) in the United States in 2017, there has been considerable discussion regarding the effects of provisions in the TCJA and potential changes in those provisions.

a. The TCJA imposed a cap on the federal individual income tax deductions permitted for state and local income and property taxes, replacing a full deduction with a deduction of up to $10,000 per tax filing unit per year. (State and local taxes remained deductible from the federal income tax for business taxpayers.) Discuss the effects of this change on economic efficiency, as well as its incidence across income groups, age cohorts, and states of residence, taking account of the potential impacts on

   i. Housing markets;

   ii. Behavior of state and local governments; and

   iii. Household location decisions.

b. The TCJA included a provision creating Opportunity Zones (OZs), census tracts chosen by states from among those satisfying federal specifications aimed at promoting economic activity in low-income areas. The main benefit provided to OZs is that qualifying investments in them receive tax benefits in the form of deferral and reduction of federal capital gains taxes.

   i. Discuss the possible rationale for using a place-based policy such as Opportunity Zones to address income and employment challenges, rather than policies targeted directly at individuals.

   ii. Evaluate the design of Opportunity Zones as a mechanism for achieving the potential objectives of a place-based policy you just discussed.

c. The TCJA included several provisions affecting the domestic decisions of corporations, including (1) a reduction in the corporate tax rate; (2) immediate expensing of equipment investment; (3) limits on deductible interest as a share of earnings before interest and taxes; (4) elimination of the ability of companies to deduct net operating losses against prior years' income.

   i. Discuss the potential impacts of each of these provisions on the level and composition of business investment.

   ii. How would you assess, theoretically, the overall combined impact on investment of these different provisions?

## 2. International Corporate Taxation

The Biden administration has proposed to strengthen the taxation of multinational corporations and has helped broker an international agreement about a minimum tax on the profits of multinational corporations. To simplify matters, let's assume that all countries currently use a territorial system whereby multinationals' profits are taxed based on where such profits are made. I.e., Google is a US company operating in many countries. Each Google subsidiary reports how much profits it makes in the country where it operates and pays corporate taxes there.

a. Explain the main weakness of the current territorial tax system in terms of tax avoidance for multinational corporations.

b. We assume that the minimum tax international agreement works as follows. If a subsidiary pays a corporate tax of less than 15% on the profits in the country where it operates, then the country where the multinational is headquartered will charge an extra tax to bring the tax rate to 15%. I.e., If Google Bermuda pays only 2% of its profits in taxes in Bermuda, then the US charges 13% extra tax on these profits to bring the total tax to 15%. Explain why such an agreement would resolve the issue you pointed out in a.

c. Suppose now that the international agreement fails to happen but that the US decides to go alone and impose such a 15% minimum tax on all its multinationals (companies headquartered in the US). Would this work to curtail tax avoidance by US multinationals? What is the weakest point of such a unilateral policy?

d. Countries like Ireland currently oppose the international agreement from b. because they claim that the agreement would prevent "fair tax competition" whereby countries compete to attract genuine business activity (as opposed to just paper profits) by having an attractive tax system. Is it true that the international agreement from b. would also curtail such "fair tax competition"?

e. To alleviate the issue raised by Ireland, countries agree to impose the minimum tax only on super profits defined as profits minus 5% of the value of tangible capital (land, buildings, and equipment) and 5% of the payroll (labor compensation) used in the foreign country. Explain why this exemption would indeed still allow countries to "compete fairly" while preventing tax avoidance.

f. The actual OECD agreement is c.+e. Discuss whether c. or c.+e. is preferable.