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Business Taxes Are Bad Business

It is a fundamental principle of economics that when you subsidize something, you get more of it, and when you tax something, you get less of it. As a result, by taking a relatively large share of business income in taxes, the U.S. government tends to penalize productive activity. Before the 2012 presidential election, the top statutory corporate income tax rate, which includes both the federal and the average state corporate income tax rates, was more than 39 percent in 2011, the second highest in the industrialized word, behind only that of Japan.

Until the 1980s, corporate income tax rates in the "social democracies" exceeded America's corporate income tax rate. At that point, virtually all of the nations that the United States competes against, even the most socialist of the lot, such as Sweden, began to come to the conclusion that, if they wanted to prosper in a global marketplace, penalizing entrepreneurship in this way was not a good idea. To attract business, the corporate income tax rates in those countries began to decline. The United States lowered its top corporate income tax rate one time, in 1986, but then raised it again in 1993, even though by that time the industrialized world average had dropped below that of the United States.

The corporate income tax rate became a topic of discussion in the lead-up to the 2012 presidential election, as President Barack Obama and Republican candidate Mitt Romney put forth their preferred policies. According to the February 2012 "President's Framework for Business Tax Reform," released jointly by the White House and the U.S. Treasury Department, the United States should have "[reduced] the top corporate tax rate from 35 percent to 28 percent." Romney's budget plan called for reducing the top corporate income tax rate to 25 percent to "jumpstart the economy," since the economic recovery from what has been called "The Great Recession" of 2007-2009 had been the most anemic post-recession recovery in U.S. history.

In April of 2016, the Obama administration announced a move to discourage "corporate inversions," in which a U.S.-based company merges with a foreign company and then moves its corporate headquarters abroad in order to pay the lower corporate tax rate in that foreign country. In an update to the "President's Framework for Business Tax Reform," the White House and the U.S. Treasury Department proposed a 19-percent tax on foreign earnings in order to remove the incentive for American companies to relocate abroad. They also repeated their desire to reduce the corporate income tax rate from 35 percent to 28 percent and put "the United States in line with major competitor countries and encourage greater investment in America."

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In October of 2017, Republicans in the U.S. House of Representatives proposed a new tax plan supported by the Trump administration, the Tax Cuts and Jobs Act, which would cut the federal corporate tax rate from 35 percent to 20 percent. Senate Republicans unveiled their own tax-plan bill on November 9, 2017, which would delay implementation for one year and then phase in a corporate income tax rate reduction to 20 percent. On December 22, 2017, President Trump signed into law an amended version of the Tax Cuts and Jobs Act, introducing a flat corporate income tax rate of 21 percent, effective January 1, 2018.

Democrats called foul, saying the poor would have to pay more taxes so that the rich didn't have to.

Before deciding whether the corporate income tax is a good way for any government to raise revenue, we should first consider who bears the burden of the corporate income tax. This is a difficult question, the answer to which economists do not all agree, but one thing is certain: In the end, all taxes are paid by people. When the government levies a tax on a corporation, the corporation is more like a tax collector than a taxpayer. The burden of the tax ultimately falls on people, namely, the customers, the owners, and/or the workers of the corporation.

The reason that the company is not carrying the burden is simply because the company is not a person. (Yes, the company does have a kind of legal personality, but that is not the same thing.) Any type of tax means that the wallet of some live human being is going to be plundered.

There are three groups of people who could possibly be affected: the customers, the shareholders, and the workers. As it turns out, the customers don't usually pay the bulk of the corporate taxes because companies do not usually have the power to increase their prices with impunity in order to account for the money that they are forced to turn over to the government. Companies are already charging as much as they can for their products and services, given the forces of supply and demand operating in a competitive economic environment, so corporations cannot arbitrarily raise prices just because the government decides to levy a tax on profits. Therefore, the people really paying the corporate income tax are some mixture of the shareholders, in the form of lower dividends and/or share prices, and the workers, in the form of lower wages.

We can understand fairly easily how the shareholders might get hit: The government is taking a percentage of the profits, and the profits belong to the shareholders. How the workers are affected is more subtle. If there is a closed economy, where capital could not move in or out of the country, then it would be the shareholders who would largely pay the corporate income tax. However, if there is an open global economy, where Americans could invest abroad and foreigners could invest in the United States, then the workers would end up paying more of the corporate income tax in the form of lower wages.

This does not mean that the company will deliberately reduce the wages of its workers in order to pay the corporate income tax. To understand how the process works, imagine a world in which there is no corporate income tax. Investment capital would move around seeking the best return it could get. Then imagine that one country introduces a tax on business profits. This would mean that any investment in that country would now get a lower return, namely, the return that an investor would have gotten before the tax, minus the tax itself. This would obviously lead to some domestic capital flowing out, to be invested elsewhere for a better return, and to some foreign capital not coming in to be invested domestically, because the return on investment would no longer be as good.

This movement of capital matters, because it is capital investment that makes labor more productive. It is pretty hard digging a ditch with your bare hands, but add $50 of capital for a shovel and it gets a lot easier. Add $50,000 of capital for a backhoe, and it gets easier still. It is also a fundamental economic principle that the average wages in a country are determined by the average productivity of labor in that country. So more capital being employed will tend to increase productivity and push wages up, while less capital will tend to decrease productivity and push wages down. That is how the workers would end up paying some part of the corporate income tax. Essentially, all workers in the country would get lower wages as a result of the tax on corporate profits.

It is worth noting that there is no disagreement among economists on this point. This is not an economic theory. It is not some conservative or progressive hypothetical argument. It is not even a political talking point. This is simply an accurate description of the world we live in and how economic forces actually operate.

Where the argument does come in to play is over the split: How much of the tax are the shareholders paying and how much are the workers paying? In general, it is understood what influences the split. The more mobile capital is, then the more it is the workers who pay. Again, this is not disputed. What is argued about is the proportion that each group pays. Various studies say that it is perhaps 30 percent the workers and 70 percent the shareholders. But other studies yield opposite results, so that does not really get us very far.

Well then, if it is the shareholders and the workers who actually pay the corporate income tax, then why does the government collect it from the companies? The answer is, "because the corporation has always been a convenient entity to hit on for money."

However, businesses have been becoming less convenient as places for the government to get cash because corporations have figured out ways to reduce their tax liabilities, resulting in the corporate income tax becoming a relatively smaller source of government revenue. We therefore need to consider changing the corporate income tax system. The ideal solution would be to abolish the corporate income tax altogether and just tax shareholders at the normal income tax rate on the dividends and capital gains that they would make from their stocks. (That is assuming that there should be any kind of income tax at all, but that is a topic for another article.) That solution may sound like a shocking change to the way that the world works today, but since it is not true that businesses pay the corporate income tax, then why continue with the fiction that they do?

The corporate income tax is popular, at least in part, because it appears to be paid by rich corporations. This may explain why a September 2017 Pew Research Center survey revealed that 24 percent of U.S. adults favored lowering corporate income tax rates, while 52 percent favored raising them. (Another 21 percent favored no change, and the remainder apparently had no opinion on the matter.) And yet, those who bear the ultimate burden of the tax, namely the shareholders and the workers of corporations, are often not rich. If the true nature of the corporate income tax were more widely known, the tax might very well be less popular among American voters.

In thinking about how to reform the tax system, there are five principles worth keeping in mind.

First, taxes should never be used for unconstitutional purposes because that leads to fraud, graft, economic inefficiency, and government tyranny.

Second, taxes should never be used to fund social-engineering schemes. The point of taxes is to raise the revenues necessary to operate the government that America needs, not to reward the politically well-connected or to address income inequality, as the first item is fraud and the second is beyond the ability of government to achieve.

Third, taxes should not distort productive activity. This means that tax rates should be lowered and tax loopholes for special interests should be eliminated, because high corporate taxes give investment advantages to other countries, and loopholes reflect the choosing by government of winners and losers.

Fourth, the tax system should not harm some citizens by making government virtually free for a large part of the population. In addition to closing loopholes, the tax base should be broadened. All citizens should pay something so that they are reminded that government is not free.

Fifth, a major factor in the current economic crisis is that Americans tend to consume too much and save too little. The tax system should not penalize savings and investment because, as was noted earlier, investing in capital increases the productivity of labor.

With that as background, here are the arguments that support not only reducing the corporate income tax (as was recently done by the Trump administration) but eliminating it altogether:

Argument No. 1: Lowering the corporate income tax rate leads to economic growth and job creation because companies have more money to invest. The President's Economic Recovery Advisory Board, which operated during the Obama regime, in a paper entitled "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," called for lowering the corporate income tax rate to "increase the stock of available capital — new businesses, factories, equipment, or research — improving productivity in the economy," and said that it would reduce the incentives of U.S. companies to shift operations and employees abroad.

Argument No. 2: U.S. businesses have been moving overseas because the United States has had one of the highest statutory federal corporate income tax rates in the world, among countries with modern, free market economies. Such high corporate income tax rates have induced American companies to relocate their headquarters overseas. For example, Johnson Controls, a company with a market value of $23 billion, moved its headquarters from Wisconsin to Ireland in 2016 because the move would save the company about $150 million dollars in U.S. taxes annually, and would allow the company to enhance the "ability to invest in growth opportunities everywhere around the world."

Argument No. 3: High corporate income tax rates encourage U.S. companies to retain their foreign earnings abroad instead of investing in expansion and employment in the United States. The Congressional Joint Committee on Taxation estimated that untaxed foreign earnings of American companies totaled approximately $2.6 trillion in 2015. A study published by J.P. Morgan found that 60 percent of the cash held by 602 U.S. multinational companies was sitting in foreign accounts. If an income tax cut were offered to companies that returned this cash, the study estimated that $663 billion would be invested into business expansion and job growth in the United States. J.P. Morgan itself announced in January that it would be using the savings resulting from the newly enacted tax legislation to open 400 new bank branches and add 4,000 employees to the 167,000 already working in the United States. On top of that, J.P. Morgan announced that it would give a 10-percent wage increase to 22,000 employees, effective February 25. Those employees are now making between $15 and $18 an hour. The bank also said that it plans to increase small-business loans by four billion dollars, just part of the $20 billion it intends to invest in the United States over the next five years. But J.P. Morgan is not the only corporation that has announced plans to repatriate cash and invest it here in America. Tech titan Apple plans to build a new campus and create 20,000 new jobs, while entertainment giant Disney announced plans to give a one-thousand-dollar bonus to 125,000 employees.

Argument No. 4: Lowering corporate income taxes results in increased international investment in the United States, and thus more jobs. According to a working paper published by the Organization for Economic Cooperation and Development, countries with higher corporate income tax rates lose revenue in foreign direct investment, as compared to countries with lower corporate income tax rates. A peer-reviewed study published in *Applied Economics* looked at corporate income tax rates and foreign direct investment in 85 countries. The study found that a 10-percent reduction in the corporate income tax rate was associated with an increase in foreign direct investment equivalent to 2.2 percent of the country's gross domestic product.

A recent *Washington Post* article highlighted this point, reporting that "as Bank of America chief executive Brian Moynihan travels the world in 2018, he says he keeps hearing the same thing over and over: Foreign businesses want to pump money into the United States again after President Trump's tax cuts…. There's growing cohesion among executives, cutting across industry and even geography, that Trump's tax plan is going to deliver massive new investment in the United States, which should, in turn, boost growth and employment."

Argument No. 5: As explained earlier, raising corporate income taxes lowers worker wages. Lower wages for workers results in a decreased ability to buy goods, which leads to lower sales and income for businesses and a net increase in unemployment. Lowering the corporate income tax rate has the opposite effect.

Argument No. 6: The current federal income tax doesn't provide substantial money to government, and it vastly reduces investment by corporations to improve productivity because of the costs associated with complying with the tax. A simple tax principle is that if the income tax rate is zero, then income tax revenues will be zero, and if income tax rates are 100 percent, then income tax revenues will still be zero. And why is that? Because, with a 100-percent income tax rate, companies would have no incentive to provide goods and services and, of course, no one would invest in the company to begin with if he knew that 100 percent of his earnings would be confiscated. Somewhere between zero and 100 percent lies the corporate income tax rate that would bring in the most tax revenue. This idea is often referred to as the "Laffer Curve," named after Reagan administration economist Arthur Laffer. Laffer noted that it's possible to lower income tax rates and get more tax revenues because people would work more, invest more, and produce more. Studies have shown this to be the case, but ultimately, taxes should be lowered through less government, as opposed to revenues being increased to support big government. The time has come to consider killing the corporate income tax altogether. It used to bring in about 30 percent of federal revenue. Today, even with record corporate profits, it amounts to barely nine percent of total tax payments. That is because corporations pay hundreds of millions of dollars every year to tax accountants and tax attorneys who devise ways to reduce a corporation's income tax liability to the absolute legal minimum. If the corporate income tax were eliminated, then businesses could spend that money for capital investment and job creation.

The lower federal corporate income tax rate that went into effect this year will not completely stop corporations from shifting profits overseas because there are still countries that have corporate income tax rates lower than 21 percent. But that is an argument for reducing the corporate income tax further

— to *zero* percent. The resulting boom in economic activity would likely result in an increase in other revenue streams to the federal government (e.g., an increase in capital gains tax revenues), offsetting the "loss" in corporate income tax revenues. And even if this offsetting did not fully happen, the goal, as already indicated, should not be to replace the same revenue through different means, but to lower taxes through less government.

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