

Fool Me Once

Why Another Corporate Tax Cut
Won't Boost the Economy

Report by
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Executive Summary

The Trump administration and House Republicans are proposing a massive tax cut for corporations and the 1 percent. They falsely claim the plan will increase investment, reverse outsourcing, and create jobs, but this is just more of their failed “trickle-down” ideology. The evidence shows that another corporate tax cut will only increase the power and wealth of rich shareholders at the expense of average Americans.

The Republicans’ underlying assumption—that corporations invest more and create more jobs only when they are relieved of burdensome tax rates—is false. American businesses already enjoy a historically low cost of capital, and they have more than enough cash on hand to invest, raise wages, and create jobs. Corporations are choosing to make dividend payments and stock buybacks instead of investing because they face a lack of competitive pressure—itsself the result of power and wealth shifting toward rich shareholders. Another tax cut for the rich will only make the problem worse.

The Republican plan would also enact a “border adjustment”—a tariff on imported goods, which would hit low-income Americans the hardest. Like other aspects of the plan, Republicans have proposed this feature on the grounds that it will incentivize production in the United States. On this count, too, Brady-Ryan will fail to deliver; the tax will only succeed in punishing consumers with higher prices on imported goods.

An effective job creation strategy would push in the opposite direction and reduce shareholders’ power. To do that, we need competitive pressure on firms to invest, and a stronger bargaining position for other corporate stakeholders: workers and consumers.

We explain in detail the following major features of the plan and why they do not serve our country’s economic interests:

1. The Brady-Ryan plan proposes to reduce the corporate tax rate from 35 percent to 20 percent, supposedly to increase the incentive for corporations to expand U.S. operations. However, corporate tax cuts will only increase payouts to wealthy shareholders and will not increase investment or create jobs. We know this because:
 - The cost of capital for corporations is already at historic lows, but the return on capital is high. This is evidence for a basic market failure: There is no reason for corporations to invest because they face no pressure from would-be competitors.
 - While the statutory U.S. tax rate is higher than in many OECD countries, the effective rate is lower than most.
 - Despite the recovery from the Great Recession, recent research shows that corporations are investing marginal earnings and borrowed funds at 25 percent of the rate they invested during the 1960s.
 - Recent studies show that low investment relative to what theory would predict is driven by lack of competition and increased pressure to enrich shareholders.
 - Lower effective tax rates on shareholders only lead to more buybacks and dividends. Studies show that the 2003 dividend tax cut led to no discernible increase in investment, but caused payouts to spike by 21.5 percent. The results of the 2004 repatriation holiday, in which corporations were allowed to bring home funds held abroad at the low tax rate of 5.25 percent, delivered similar results; there was no detectable increase in investment, but payouts to shareholders increased on a one-for-one basis.



- Analysts predict Brady-Ryan would result in the same behavior: increased payouts to shareholders and no increase in investment. A 2016 report by Goldman Sachs forecasted a \$780 billion surge in buybacks as a result of the Republican tax plan.
2. The Brady-Ryan plan proposes a tax on imports and an exemption for exports under the assumption that this will boost U.S. production and create jobs. While it may be a good idea to promote U.S. competitiveness and job creation through targeted industrial policy, this plan will not return America to the golden age of manufacturing. Instead, it will drastically raise input prices for many businesses and place a significant burden on lower-income Americans.
 - The proposed border adjustment will fall largely on American consumers. The effect will be to raise prices of imported goods, which will hurt lower-income Americans the most. Estimates suggest a 10 percent tariff would cost households in the bottom quintile \$300 per year, twice the burden on households in the top 10 percent.
 - Raising prices while demand is still weak will likely reduce spending and hurt the economy.
 3. Supporters of the Brady-Ryan plan argue that it will curb tax avoidance, the practice of U.S. firms transferring their valuable intangible assets to subsidiaries overseas to avoid paying U.S. taxes. But Brady-Ryan only solves the problem of multinational tax avoidance by ending the tax on foreign profits entirely. That is akin to solving a debt collection problem by forgiving the debt.
 - Corporations will still be able to shift IP licenses, income from royalties, and profits generated from the sale of intangible services between foreign affiliates in order to reduce their tax bills.
 - In some respects, Brady-Ryan could worsen the tax avoidance of large multinational firms, which could claim large deductions on research and development carried out in the United States and then sell the resulting IP to a foreign affiliate tax-free.
 - By shifting the burden of taxation to consumers, corporations would be less sensitive to the tax rate because they no longer have to pay the tax.
 4. An actual job creation strategy would focus on creating incentives for meaningful investment instead of returning cash to corporations already sitting on more than \$2 trillion.
 - The corporate tax system should be reformed by closing the repatriation loophole and increasing, not reducing, effective tax rates. The best way to do this for the long run is to enact a formulary apportionment system, so profits are calculated globally and corporations have no reason to pretend to move their assets around.
 - In order to prevent CEOs from using profits to pay off shareholders and themselves instead of increasing worker salaries or investing to expand operations, Congress should raise effective top marginal tax rates on high-income individuals.
 - Since lax competition is to blame for the corporate sector's low investment, the Justice Department and FTC should return to a competition policy that would diffuse power throughout the economy.
 - Congress should fund public investment in transformational projects that create long-term growth and jobs: making mass transportation, broadband, quality child care, and health care available to all.



Introduction

With a unified government under their control, Republicans are once again preparing to do what they always do when they hold power: slash taxes for corporations and the rich while falsely claiming that doing so will boost economic growth. The Brady-Ryan Plan, outlined in a document released in April 2016, will cut rates on personal income taxes, with the vast majority of savings going to the highest-earning taxpayers. An estimate by the Tax Policy Center shows that the top 1 percent of income earners will receive 76 percent of the planned cuts, representing a tax break of \$212,660 per person, while the bottom 80 percent will keep just 11 percent of the total cuts, for an average savings of just \$210.¹ Startling as these figures are, they understate the plan's top-heavy nature. Proposed changes to the corporate tax code may prove even more damaging to average Americans in the long run:

- Reduce the corporate tax rate from 35 percent to 20 percent.
- Exempt exports from taxation, while including imports in the tax base.
- Upfront “expensing” of all capital investment, making new investment 100 percent deductible from a corporation’s tax bill in the year it is made.
- Tax holiday for repatriation of retained earnings held in overseas subsidiaries.
- Purely territorial tax system going forward.
- A maximum tax rate of 25 percent on income from pass-through entities.

Altogether, this set of changes to the corporate tax code would alter it from a tax on the worldwide profits of U.S. corporations (at least notionally) to a (lower) tax on the profits of U.S. corporations from domestic activities, plus a tax on imports. This paper concludes that, far from improving the economy, these sweeping changes would probably slow growth and result in less employment and lower wages than we would expect under our existing corporate tax structure.

Conservatives have marketed their tax plan on the false promise that lowering the corporate tax rate will help U.S. companies compete internationally, induce them to move offshored jobs and profits back to the United States, and spur investment and growth that would increase opportunity and raise wages for all Americans. This strategy has been tried before; 70 years of data shows that tax cuts for businesses do not lead to a stronger economy. The trickle-down policies of the Reagan administration ushered in an era of middle-class wage stagnation, rising corporate power, and massive returns at the top. Past “tax holidays” for multinational firms have only resulted in more payouts to wealthy shareholders, while the 2003 dividend tax cut resulted in no increase in firm-level investment or in employment; instead, the windfall was enjoyed entirely by shareholders.

While over 50 percent of U.S. multinational foreign income is currently booked in just seven important tax havens, these countries account for less than 5 percent of employment among foreign affiliates of U.S. multinationals, and an even lower percentage of sales. Notably, none of the top 10 employment locations for U.S. multinational firms are tax havens. These figures are further evidence that the reasons for offshoring profits found in the existing corporate tax regime are not the reasons why corporations outsource jobs. The jobs are going to the places where labor is cheap, and the profits

¹ For a thorough score of the Republican Party tax plan by the non-partisan Tax Policy Center, see Nunns et al. (2016).



are going to the places where taxes are low.

Claims that further cuts to corporate tax rates would improve the economy and create jobs are underpinned by two assertions: that the return on capital for American corporations is too low because they face an inordinately high tax rate, and that the cost of capital is too high, so corporations are size-constrained by their financial circumstances. Both of these contentions are provably false. First, the assertion that American corporations face high tax rates is incorrect; despite the statutory rate of 35 percent, studies show the effective U.S. corporate tax rate is on par with or even lower than other OECD countries, with many of the largest and wealthiest corporations paying single-digit rates or no taxes at all (Avi-Yonah and Lahav 2011 & Krantz 2016). More broadly, we highlight empirical evidence that financial constraints are not to blame for the fact that investment is below what economic theory would predict, and we provide a qualitative and quantitative explanation for why tax cuts have failed to boost growth in the past and will fail again.

The basic idea of the Brady-Ryan plan—to move the corporate tax toward taxing consumption rather than corporate profits—has been favored by some economists. That policy prescription is based on a theory that implies the existing tax on corporate profits is inefficient, because it penalizes the return on corporate investment, causing corporations to invest less than they otherwise would and thus reduce long-run growth. According to that theory, shifting the tax base from corporate profits toward sales, and thus the burden of taxation toward consumers, would cause households to substitute toward saving more and spending less. That would lower the cost of capital and, alongside the reduction in the tax rate itself, increase the net return to corporate investment, spurring corporations to do more of it. Since corporate shareholders tend to be rich, while consumption is relatively equitably distributed, that policy would sacrifice progressivity but increase efficiency, in which case its merit would come down to a political value judgment, balancing growth with distribution.

The problem is that this is a false tradeoff. The logic behind this theory does not reflect the economy's current situation and thus does not provide guidance on how best to reform the tax system.

The economic circumstances under which this tax shift would make sense—a scenario in which scarce capital impedes firms' investment and growth—are not the ones we currently face. After more than eight years of near-zero interest rates, there is no empirical case to be made that businesses lack access to funds. Studies by Philippon and Gutierrez (2016) and Mason (2015a) present evidence that corporations are generating historically large profits and have both their own substantial cash holdings and access to the capital market on favorable terms, yet despite these advantages, firms are still choosing not to invest. We argue this is the result of a lack of competition, which has reduced pressure to invest, allowing firms to focus overwhelmingly on shareholder payouts without fear of losing market share. Put differently, there is too much saving, not too little—one explanation for deficient aggregate demand. Trying to get individuals to save more by shifting the burden of taxes to consumption would do more harm than good. It would simply be a windfall for those who are already saving the most: the rich.

Under the Brady-Ryan plan, corporations would still pay taxes, but the economic burden would shift toward on consumers. The question of tax incidence—meaning who truly ends up paying a tax—is more complicated than it sounds: The entity cutting a check to the IRS may be different than the one



who actually pays in economic terms, through higher prices or lower wages. Empirical results show that businesses pass the cost of most consumption taxes on to their customers, whereas Clausing (2013) shows that, under the current system, corporate taxes are paid overwhelmingly by business owners, who skew toward the top of the income and wealth distribution. The Brady-Ryan plan contemplates taxing imports in particular, which are disproportionately consumed by the poor. That means the plan wouldn't just shift the incidence from corporations to consumers, but would specifically raise the prices of goods that are more commonly consumed by low-income households, like food and mass consumer items, relative to the high-end services that characterize the consumption of the rich.

Moreover, tax models constructed by the U.S. Treasury, the Congressional Budget Office, and the Joint Tax Committee, as well as the Tax Policy Center, assume that workers bear part of the burden of the existing corporate tax because corporations don't invest as much as they otherwise would if they were not taxed. If our analysis of the effect of changes in the corporate tax rate on investment is correct—i.e., reducing tax rates will have little to no effect on corporate investment—then that assumption is faulty and the existing corporate tax is even more progressive than those organizations estimate. Thus, eliminating international corporate income taxation and moving toward a consumption tax would be still more regressive.

The Brady-Ryan plan would achieve this shift by replacing the existing “source-based” tax on corporate profits—under which corporations are taxed based on where they choose to locate—with a “destination-based” tax on corporate sales—under which corporations would be taxed based on where their customers are. Under the existing U.S. corporate tax system, multinational corporations can avoid paying taxes they owe on foreign earnings by refusing to “repatriate” profits to their U.S. parent companies, instead piling up cash on the balance sheets of foreign subsidiaries. The “repatriation” loophole that enables this tax avoidance would be made a permanent feature of the corporate tax system under Brady-Ryan, which makes only sales to U.S. consumers taxable and hence exempts all future foreign profits from U.S. taxation, including profits earned from exports. This “solves” the problem of collecting taxes on offshored profits by ceasing to attempt to do so, which is not a solution but a giveaway.

Altogether, this set of changes to the corporate tax system goes a long way to dismantling it entirely: Incidence would shift to consumers, overseas profits and exports would be exempt, and all investment would be tax-exempt. This is a gigantic stride in the wrong direction. Ultimately, the best tax plan for economic growth, job creation, and higher wages would be a dramatic increase in the effective marginal tax rate on the rich, very much including a robust entity-level corporate profits tax. One promising approach is known as “Sales Factor Apportionment,” which accomplishes the Brady-Ryan plan's stated aim of reducing corporate incentives to relocate profits in low-tax overseas jurisdictions while preserving and even enhancing the progressivity of the corporate income tax. In this paper, we explain how Sales Factor Apportionment works and why it is a far better option than the one proposed by Brady-Ryan.

This paper proceeds in the following sections. First, we explain in detail what the Brady-Ryan proposal is. We conclude that it is best understood as a tax on the profits of corporations from their domestic activities, plus a tax on imports. This is in contrast with the existing corporate tax, which is a



tax on all corporate profits. In the next section, we offer both a theoretical background and empirical evidence as to why the plan will not have its intended effect of increasing investment in the United States and creating jobs. Instead, the proposal will slow, rather than stimulate, economic growth while shifting the burden of taxes down the income distribution and channeling more profits into the hands of shareholders. We then explain why Sales Factor Apportionment is a better corporate tax reform. Finally, we offer a defense of the concept of entity-level taxation, which we view as especially important given the alterations to the individual tax code also proposed in the Brady-Ryan plan. We conclude that, far from a step toward an ideal, efficient global corporate tax regime, this plan represents a step back, moving us toward a world of no corporate taxes and little progressive taxation of any kind, where the rich make the money because they can and the poor pay the taxes because they must.

What is the Brady-Ryan “Destination-Based Cashflow Tax” and How Does it Differ from the Existing Corporate Income Tax?

The existing corporate income tax is a tax on corporate profits—the money corporations have “left over” after deducting inputs, worker compensation, and other eligible expenses like interest on debt and a depreciation allowance for capital they have already purchased. This tax is “source-based,” which means that corporations are taxed based on where they earn their profits—a variable that multinational corporations can manipulate through creative accounting. Unlike most (if not all) other countries, the United States purportedly has a non-territorial corporate tax regime. That means that all profits earned by U.S. corporations—overseas or otherwise—are in theory taxable in the United States. But there’s a major loophole: Corporations can avoid actually paying the taxes they owe on overseas profits by refusing to “repatriate” them, leaving them instead on the balance sheets of the overseas subsidiaries who first book those profits. Thanks to that loophole, corporations have become increasingly adept at transferring the ownership of valuable assets to foreign subsidiaries at a low price, then having the rest of the corporation pay high rent to the subsidiaries to use those assets. This ensures the profits are disproportionately earned by the parts of the corporation that are taxed the least. At the extreme, in order to avoid U.S. corporate taxes, companies have “inverted” themselves to make their subsidiaries the parent companies, thereby transforming into foreign-based corporations and avoiding a substantial amount of their U.S. corporate income tax liability.

One crucial aspect of the status quo is that corporations with large assets on the balance sheets of overseas subsidiaries can still “use” the money to finance investment in the United States—for example, by issuing debt. Thus, the offshoring of profits to tax havens is not by itself the cause of low corporate investment, and a corporate tax reform aimed at repatriating profits will not cause higher investment or create jobs in the United States. The problem of offshored profits is, in fact, easily solved by eliminating the repatriation loophole, the first step toward a worldwide profits tax like Sales Factor Apportionment (discussed in further detail below). But rather than treat the problem directly, the Brady-Ryan plan uses it as an excuse to gut corporate taxes altogether, one further step in the decades-long effort to eliminate all taxes on capital and progressive taxation in general.



With this in mind, it is worth restating why we tax corporations at all. A pure profits tax is non-distortionary; that is, maximizing profits and maximizing 50 percent of profits yields the same behavior, so insofar as the existing corporate tax hits corporate profits, it is an optimal (and progressive) policy. In the presence of imperfect risk markets, with risk-averse firms, it has long been recognized that a pure profits tax with appropriate loss offset provisions actually leads to more, not less, investment; the government is in effect a silent partner. While current provisions do not fully offset losses, they provide sufficient offsets that there is some presumption that the existing tax actually encourages investment.

So what does the Brady-Ryan plan do? In addition to reducing the statutory tax rate from 35 percent to 20 percent, the most significant component of the plan is to shift from a corporate income tax to what is known as a Destination-Based Cashflow Tax (“DBCFT”). This will change both the tax base and the basis of the U.S. corporate tax system. Instead of taxing profits, the tax base of the DBCFT is corporate net sales: gross revenue from sales, minus the cost of inputs (provided those inputs are also in the U.S.), capital expenditure, and payroll. Instead of being source-based, the tax is assessed based on the “destination” of sales—the location of the buyer, not the seller. DBCFT would thus make the U.S. tax system territorial: U.S. corporations (and foreign corporations) would only be taxed on sales to U.S. customers. Sales to foreign customers, whether made by overseas subsidiaries or by stateside parents, would be tax-exempt in the U.S. The combination of a destination basis and net sales as the tax base amounts to a major change to the U.S. corporate tax system: Instead of taxing the worldwide profits of U.S. corporations, the system would be a tax on the profits of U.S. corporations from domestic activities, plus a tax on imports.

Our characterization of the plan in this way contrasts with the way the plan has been described by other researchers and tax experts, as a Value-Added Tax with a payroll deduction. Below, we explain why we characterize it the way we do.

First, in order to enact the destination basis, the cost of goods imported into the U.S. would be part of the tax base, while exports from the U.S. would be excluded from it. This aspect of the plan, called a “border adjustment,” would severely penalize companies that do a lot of importing and benefit companies that do a lot of exporting.² That is likely to be inconsistent with existing trade agreements that guarantee foreign goods access to U.S. consumers on the same terms enjoyed by U.S. goods. Accordingly, trade partners will likely challenge the plans through the World Trade Organization’s dispute resolution mechanism. If the U.S. is in breach of existing rules, the WTO can permit our trading partners to take retaliatory action.

Second, a company’s (U.S.-based) payroll would be exempted from the tax base. This is in contrast with the standard structure of a VAT, in which the cost of labor is part of the tax base—meaning it is not deducted from sales. (For the purpose of the existing corporate income tax both in the US and in other countries, payroll is deducted—hence why it is a tax on profits rather than sales.) VATs are permissible under WTO rules because the design of the border adjustment means that foreign-

² Some economists claim that the increased buying power of the dollar would largely offset this penalty. Clausung and Avi-Yonah (2016) cast doubt on this claim. In this paper, we assume no foreign exchange adjustment offset. To the extent that there is one, that would mitigate the plan’s protectionist impact (and thus its improvement in the balance of trade), but it would not mitigate the erosion of the corporate tax base, the rate reduction, or the implication that entity-level taxation would be severely weakened if not eliminated outright.



produced goods are not discriminated against in the country that levies a VAT (in fact, all of our major trading partners in the developed world have national VATs). But the payroll exemption in the DBCFT proposal would advantage U.S. corporations relative to foreign ones that pay VAT on employee compensation in their own countries in addition to their own corporate tax. In other words, the tax overhaul would create an incentive for goods to be produced in the U.S., relative to overseas, and that is what makes it incorrect to describe the plan as a VAT. Protectionism is in fact a core part of the argument that has been put forward in favor of the proposal, but it is the provision most likely to invite a contrary ruling by the WTO, as well as a policy response from our trading partners.

Third, instead of exempting interest paid on outstanding debt and an allowance for incremental depreciation of past investment, as the current system does, Brady-Ryan would exempt all capital expenditure by corporations in the year it is made. This is the so-called “expensing” provision designed to induce corporations to invest more by making the tax treatment of their investment even more favorable than it has been to date. The tax system already allows depreciation to be used to reduce tax bills on a more accelerated schedule than full economic depreciation, and that depreciation has been further accelerated as a policy explicitly aimed at inducing corporations to invest by making those future tax deductions more valuable (since they are allowed to be exercised more quickly). Full expensing is essentially super-accelerated depreciation: a 100 percent depreciation allowance in the year the investment is made. It is analogous to tax exemptions for savings in the individual tax system, for things like contributions to retirement accounts and savings plans for higher education and health care, except that the tax shelter corporations enjoy would cover investment for any purpose.

Fourth, Brady-Ryan would remove the tax exemption for interest on outstanding debt, in order to reduce the strong tax bias in favor of financing companies with debt rather than equity.

Will the Brady-Ryan Plan Work?

In order to assess whether the DBCFT proposal will succeed in boosting investment and bringing jobs back to the United States, it’s necessary to take a step back and ask under what conditions one would expect it to succeed, and then assess whether those conditions actually exist. Our view is that recent empirical evidence casts substantial doubt on the relevance of the theoretical case for replacing a corporate income tax with a modified VAT. Thus, the proposed tax reform will not increase firm-level investment or create jobs because the conditions it is designed to address do not, in fact, exist. Instead, the proposal would simply shift a greater share of corporate resources into the hands of shareholders and top executives.

The idea of replacing taxes on corporate income with taxes on consumption has a long history in the economic theory of “optimal taxation.” The theory generally favors exempting investment income from taxation on efficiency grounds, because taxing the returns to capital—the money corporations earn and pay out to their shareholders and lenders—induces those stakeholders to invest less, and hence the economy grows less over the long term. Scholars of the optimal taxation of capital—for example, Stiglitz (2015)—typically don’t stop there; they distinguish between the economic return to investment, market compensation for the risk investors take, and “rents,” meaning the investment returns that arise from anti-competitive behavior that channel resources from some other



stakeholder (like workers and consumers) to investors. The ideal tax system would exempt the first category in order to maximize investment, productivity, and wages in the economy, levy a moderate tax (with loss offsets) on the second in order to mitigate risk and hedge bets, and tax away the third entirely. However, in practice it is difficult to distinguish these three theoretically distinct concepts, and hence the relevant policy debate concerns whether and how much to tax corporate profits at all (and also whether and how to tax other forms of capital income).

The argument in favor of taxing consumption is that in the short run, it is relatively inelastic, so the tax has little impact on behavior and hence is non-distortionary. In the long run, shifting resources from consumption to savings automatically channels those resources toward increased investment, which grows the economy. On the other hand, taxing the economy return to investment distorts the economy so output is lower than it otherwise would be. Thus, the type of reform embodied in the DBCFT is compatible with orthodox economic theory.

The usual counterpoint is that shifting from taxing corporate income to taxing consumption is regressive: The owners of a corporation who pay the tax on its income are rich,³ while consumption is far more equitably distributed among households than capital income. In economic theory, shifting the burden of taxation from corporate income to consumption is a classic efficiency–equity tradeoff, in which the overall growth that comes from making the tax system more efficient compensates, at least in part, for the regressive shift in the tax burden. In the most orthodox treatment, that compensation would come about from “naturally” higher wages to be had when increased investment and output by firms leads to economic growth. And if wages do not increase enough to counteract the loss in real welfare from higher taxes on consumption, then some kind of redistributive fiscal policy could make up the difference.

That is how it’s supposed to work. But let’s consider some of the empirically crucial components of this policy conclusion.

One underlying assumption of optimal taxation theory is that increased saving by consumers makes more capital available, which results in increased investment and expanded output by corporations. The savings–investment relationship has been sorely tested in recent decades, and in particular since the financial crisis of 2008. While it is true, as a matter of national accounting, that savings equals investment, that is not a behavioral relationship. At a given interest rate, it is possible for desired savings to exceed desired investment, pushing down the cost of capital. As evidence of the abundance of investable funds, we point out that since 2008 the cost of capital has been as low as it can go—the so-called “Zero Lower Bound” that constrains the return on savings to drop no lower than 0 percent. In other words, money that “wants” to be invested is abundant, but the uses for those funds are scarce—a phenomenon referred to as “secular stagnation.” This term implies that the economy is operating below capacity thanks to slack demand, and that as a result, further increases in available funds will have no impact on investment.⁴

³ The idea that some portion of the corporate tax is incident on labor (and hence that it is not as progressive a tax as the income and wealth profile of those who own corporations might suggest) relies on exactly the theory that the tax deters investment. As discussed in this paper, we view that theory as empirically problematic, and we further appeal to direct evidence about the incidence of corporate taxes contained in Clousing (2013).

⁴ Summers (2016a & 2016b).



The fact that the cost of capital is low generates another empirical puzzle relevant to the debate over corporate tax policy: Why is the return on capital so high? In a traditional model, a low cost of capital and high returns on invested capital would induce corporations to expand their output to the point where the two were equal. If existing companies attempted to protect high profit margins by maintaining prices instead of expanding, then new entrants, financed by abundant savings looking for investment opportunities, would compete down those high returns. Recent research, however, shows that corporations, especially large ones in economically important sectors, are more profitable than ever, and that they generate those profits through anti-competitive behavior like collusion, mergers, and monopolization. Furthermore, the evidence shows that, rather than investing in expanded capacity, corporations return those profits to their owners in the form of dividends and stock buybacks that push the money out the door.⁵ The rise in corporate profits and payouts is further evidence that financial constraints are not the operative impediment in the way of more robust investment and that, therefore, corporate tax cuts will fail to stimulate stronger growth.

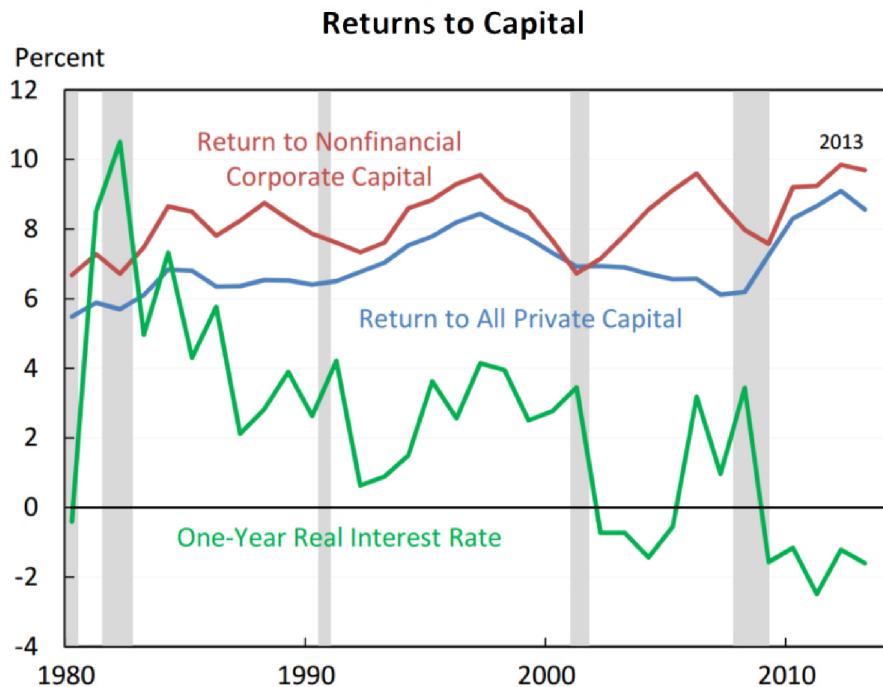


Figure 1: Furman and Orszag (2015) report the rate of return on corporate capital, as measured in Compustat, against the one-year real interest rate, a measure of the cost of capital to credit-worthy borrowers. The latter has been declining over decades and reached the Zero Lower Bound during and after the financial crisis, while the rate of return has held remarkably constant. The combination poses a challenge to traditional theories that predict the (after-tax) return on capital should equal its cost over the long run.

In his 2015 paper “Disgorge the Cash,” Roosevelt Institute Fellow J.W. Mason shows how the shareholder revolution, beginning in the 1980s and continuing up through the present, has resulted in the re-ordering of corporate priorities, privileging payouts over investment. Mason finds that in the

⁵ Furman and Orszag (2015) address this empirical puzzle, and posit that it’s caused by anticompetitive behavior and interfirm inequality. Elhauge (2015) takes a similar view.



1960s (the earliest period in which the Compustat database is available), 40 cents of the marginal dollar of corporate earnings or borrowing was invested. Today that figure is around 10 cents. The difference, Mason explains, has nothing to do with access to funds; in addition to aforementioned low interest rates, corporations, he points out, are holding more than \$2 trillion in tax havens abroad and, by 2012, had recovered their pre-recession cash flow high. Instead, changes in corporate governance account for both the decline in investment and the rise in payouts.

Mason argues that shareholders—both the “activists” whose takeover campaigns generate publicity, and “passive” investors who are the activists’ willing partners—have led a revolution in corporate governance through which they have become the residual claimants on corporate resources—that is, the ones who reap the benefit of any windfall cashflow and profit. As equity became the dominant form of managerial compensation, managers increasingly weighed the benefit of any marginal investment on the firm’s equity value, against the alternative of a larger dividend. The value of marginal investment to a company enjoying a super-normal stream of rents is lower than its value to the economy as a whole. Even if investment did expand output, it would not increase the stock price of a company that was already enjoying high rents, and might even reduce the stock price if it lowered profit margins. These managerial incentives acted as a “carrot” to induce managerial compliance with shareholder interests, operating alongside the “stick” of a hostile takeover. As a result, payouts doubled as a share of GDP beginning in the 1980s.

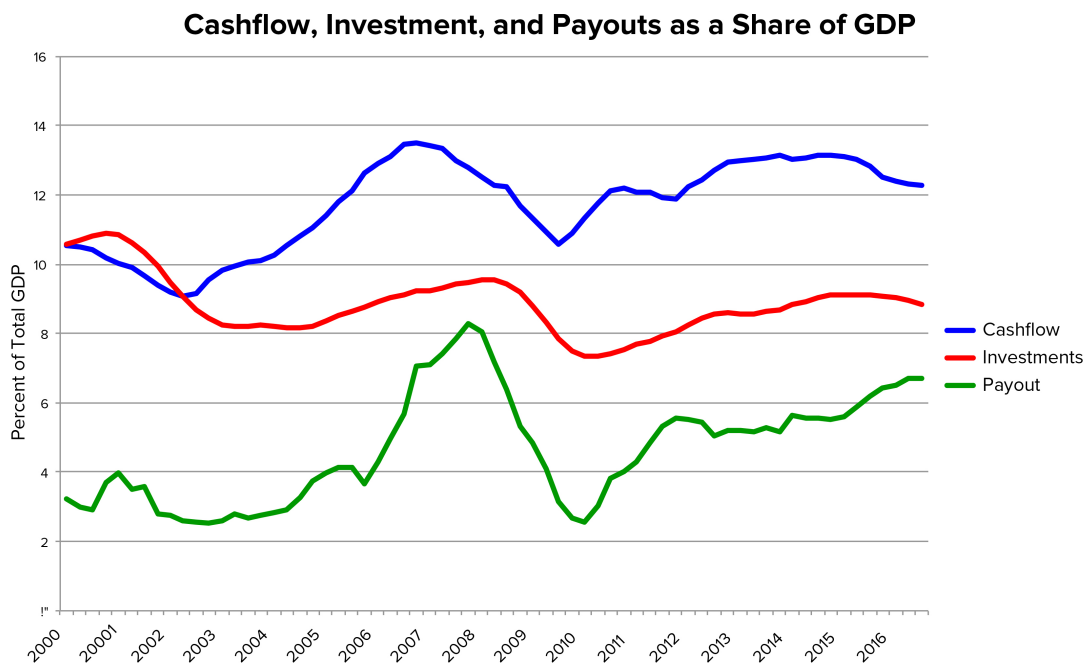


Figure 2: Mason (2015a) reports time series for corporate cashflow, investment, and payouts as a share of GDP in Compustat. All are pro-cyclical, meaning that they expand as a share of output when the economy is growing and contract during recessions. But what the longer series reveals is that increasingly, cashflow is being used to finance payouts, while investment is following a downward ratchet: it declines during recessions and never reaches its previous level. That is due to the revolution in corporate governance, favoring payouts to shareholders over investment for the long term in the absence of competition that would give corporations a reason to invest and grow.

Far from reversing this payout obsession, which is the true reason for low corporate investment and



slack labor demand, a corporate tax cut would only exacerbate it. Today, roughly 50 cents of every dollar borrowed is paid out to shareholders. This figure alone casts doubt on the classical model of corporate finance, since that model assumes firms access the capital market to finance their investment. Instead, today's capital market functions in reverse, as a mechanism to siphon money out of corporations and into the hands of their financial backers. Following the 2008 financial crisis, rather than investing in growth, recovering corporations responded by funneling more money back to shareholders: From the second half of 2009 to the end of 2013, growth in payouts was nearly double that of investment—\$740 billion compared to just \$400 billion. These figures help explain the weakness of the economic recovery and, more importantly, reveal the role payouts have played in replacing investment; they make it difficult to argue that financial constraints are to blame for low corporate investment and lackluster growth.

Philippon and Gutierrez (2016) confirm this point empirically: Investment is low despite high profit margins, and financial constraints are not to blame for that low investment. Those authors find a strong correlation between low investment and “common ownership,” which here refers to the phenomenon of payout-demanding asset managers taking positions in a broad cross-section of competing firms. Common ownership is gaining increased attention as a potential cause of collusion in the output market, as firms owned by the same shareholders will not undercut one another's prices. It is also seen as a cause of increasing pay for the executives who carry out the large asset-manager owners' preferred policies.⁶ These asset managers generally pursue a “passive investment” strategy and are not looking to trade on high-frequency movements of stock prices. But, as the authors of those studies maintain, “passive investment does not imply passive ownership.” In other words, by investing for the long term and exercising a large degree of control over corporate decision-making, common shareholders steer corporate resources to themselves while limiting competition, thus ensuring large profit margins for the firms in their portfolio without having to invest in growth opportunities.⁷

The study by Gutierrez and Philippon reveals that many corporations that—based on measures of expected return like Tobin's Q—would be expected to invest more are instead opting to use capital to issue payouts.⁸ The authors also find that payouts are higher and investment is lower in non-competitive industries with low firm entry and high market concentration. In other words, low corporate investment is premised on a lack of market incentive to compete and high shareholder demand for payouts, not on a lack of funds or low return on investment. Under these conditions, why would tax incentives cause corporate managers to favor investment over payouts? The predominant effect of tax cuts will simply provide a further windfall to shareholders.

Taking this a step further, Mason (2015b) refutes the notion that low investment could be due to the absence of high-return investment options. Even in ostensibly investment-intensive and expanding high-tech industries like pharmaceuticals, computers and electronic goods, communications equipment, medical equipment, scientific equipment, and software and data processing, investment

⁶ Azar, Schmalz, and Tecu (2017) on airlines; Azar, Raina, and Schmalz (2016) on banking; and Anton, Ederer, Gine, and Schmalz (2016)

⁷ Azar (2016) offers a theoretical treatment of the common ownership phenomenon, including a mechanism of board-level decision-making that leads to much more anti-competitive behavior as large shareholders with holdings across an industry become the pivotal voters.

⁸ Tobin's Q refers to the ratio of a firm's total market value (in terms of its stock price) to the “book value” of its capital. The theory of that ratio holds that a high Q implies the firm will be very profitable relative to the cost of its productive capital, and hence that such a firm would want to invest in more capital in order to take advantage of those high profit margins by expanding output.



has declined steadily since 2000 as payouts have risen. Of the 15 firms making the largest payouts in 2014, eight were tech companies including IBM, Intel, and Cisco. Even notoriously long-run-oriented Apple, which for decades abstained from significant payouts, paid out \$56 billion in dividends and buybacks in 2014, thanks to a campaign of shareholder activism. It would be hard to argue that Apple does not have investment opportunities—its margins are high, its market penetration, even now, lags its competitors, and it is a pioneer of multiple services in its own “app ecosystem.” Clearly, the decline in investment has little to do with access to capital, productive investment opportunities, or—considering Apple’s 2014 tax rate of 7.3 percent⁹—a punitive tax code, and thus we should not expect a broad corporate tax cut to spur investment.

Distribution of Annual Returns on Equity Across S&P 500

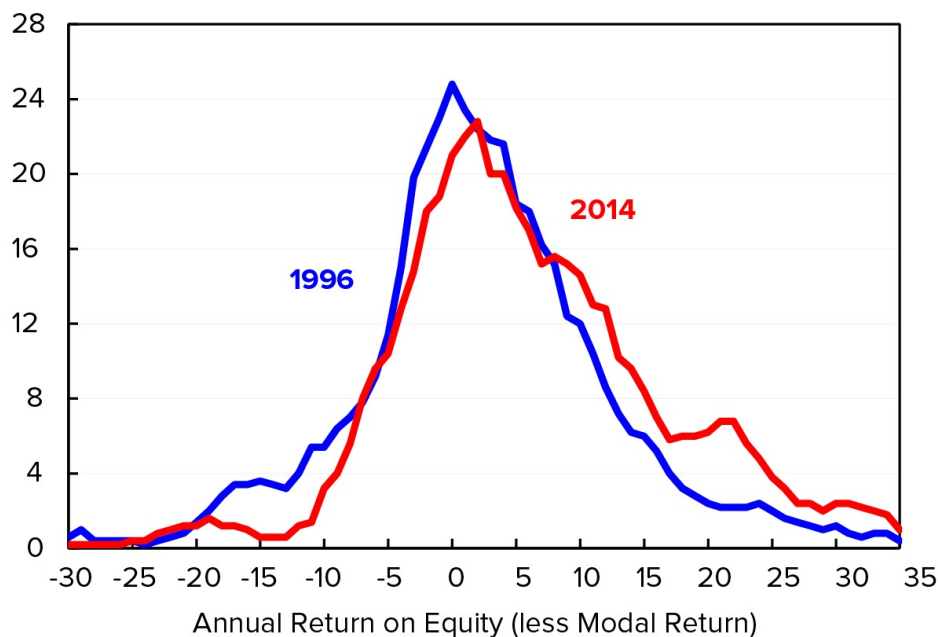


Figure 3: Furman and Orszag (2015) also report firm-level returns on equity for firms in the S&P 500. That distribution shifted to the right between 1996 and 2014, meaning that a larger share of firms was earning higher profits.

Combining the findings of Philippon and Gutierrez (2016) and Mason (2015a and 2015b), as well as evidence from the effects of the recent history of low interest rates, which did not stimulate investment, there is little reason to believe that raising the return to capital by lowering corporate tax rates would lead to increased investment. In fact, with shareholders standing to pocket an even larger percentage of corporate revenue thanks to the windfall of a corporate tax rate cut, we should expect investment to remain flat or decline as managers shift funds to increased payouts.

Real world examples show that this is exactly what has happened in the past. In 2003, Congress enacted one of the largest one-time capital income tax cuts in U.S. history, reducing the tax rate shareholders pay on the money returned to them as dividends from 38.6 percent to 15 percent for high

⁹ Apple reported that it paid \$3.3 billion in taxes around the world on \$34.2 billion of profit in 2011, of which \$2.5 billion was paid in the United States, for a total U.S. corporate income tax bill of 7.3 percent. Furthermore, unusual reporting methods outlined by Sullivan (2012) have allowed Apple to misrepresent its true effective tax rate to its shareholders, as shown in Permanent Subcommittee on Investigations (2013).



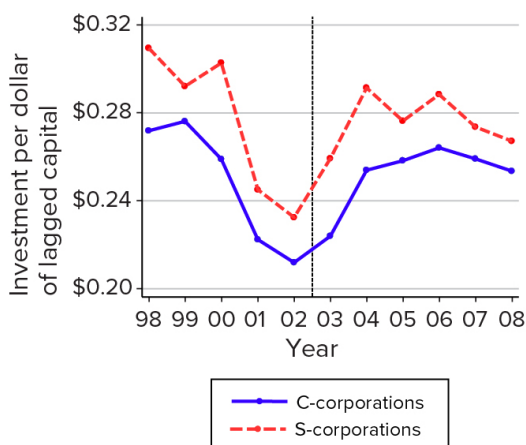
earners (who account for most dividend payments). In theory, if investors expected the tax change to be permanent, this policy change should have had more or less the same effect as a cut in the corporate tax rate: As after-tax payouts to shareholders increased, shareholders should have pushed corporations to invest more and grow in order to obtain more of those payouts in the future. This was not the case.

Examining a representative sample of nearly 75,000 corporations, Yagan (2015) finds that, despite its size, the dividend tax cut failed to stimulate growth in either corporate investment or employee pay. Instead, it caused corporations to spend an even larger share of revenues on payouts, which spiked by 21.5 percent following its passage. The paper's estimation strategy is to examine differences in behavior by traditional C-Corporations and "pass-through" S-Corporations, since the latter were unaffected by the tax change, and it is thus possible to compare affected and unaffected companies that otherwise behave similarly. The finding that the tax cut did not increase corporate investment holds true across the sample, regardless of firm size, age, profitability, cash, and debt.

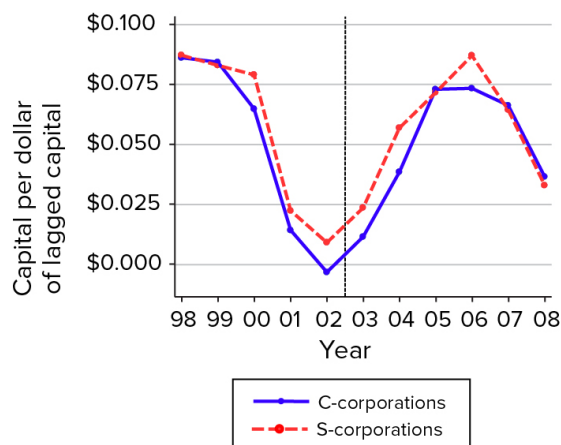


Effects of the 2003 Dividend Tax Cut

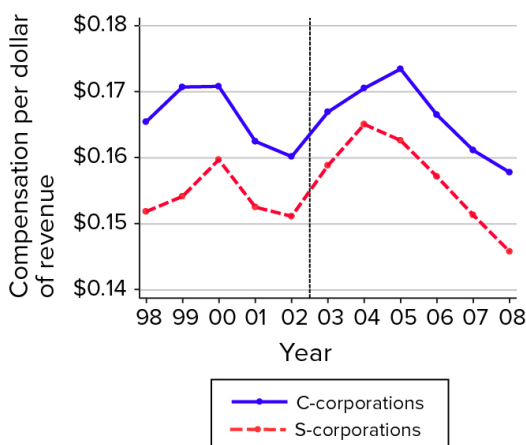
Panel A. Investment



Panel B. Net Investment



Panel C. Employee Compensation



Panel D. Total Payouts to Shareholders

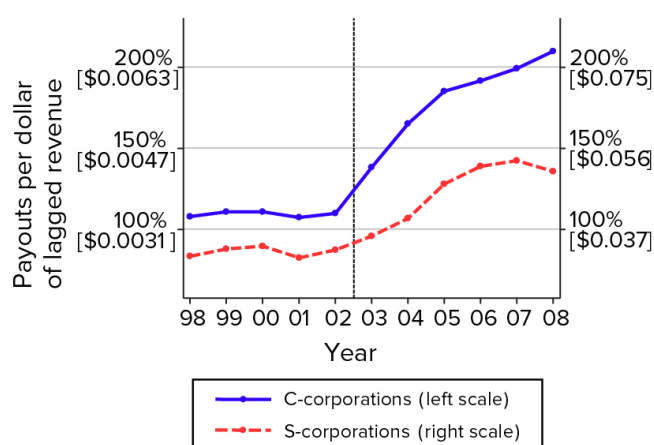


Figure 4: Yagan (2015) compared C-corporations, whose dividend taxes were cut in 2003, to S-Corporations, whose dividends were unaffected. The former are the treatment group for this study, and the latter are the control group. Each panel of this chart presents a different corporate use of funds: gross and net investment, payroll, and payouts to shareholders. Contrary to neoclassical theory, corporate investment did not respond to an increase in the after-tax return to investment, represented by the dividend tax cut. Payouts to shareholders, on the other hand, did—shareholders realized the entire windfall from the tax cut.

Finally, evidence suggests that making the tax treatment of current corporate investment more favorable through expensing would indeed have an impact on corporate investment, but only on relatively small companies that are financially constrained. Zwick and Mahon (2016) looked at the effect of accelerated depreciation allowance—provisions whereby corporations are permitted to deduct a larger portion of an asset’s total value from their taxes earlier in the asset’s life—on investment among a large number of firms. In their sample of over 120,000 companies, accelerated write-offs raised investment by 10–17 percent. This, however, was largely due to the response by smaller and financially constrained firms, which make up only a small percentage of overall

investment. Sixty-two percent of all investments in the study were carried out by the largest 5 percent of firms, which were 27 percent less likely to respond to the increased incentive by investing more. A similar dynamic held when the sample was split between cash-rich firms paying dividends and cash-poor firms abstaining from such payouts; the latter group was 1.5–2.6 times more responsive to increasingly generous depreciation allowances.

In some respects, this is a favorable result, since enabling the growth of struggling firms may well be a worthwhile policy goal. Unfortunately, as the 62 percent figure implies, these small, cash-strapped firms make up only a tiny fraction of business investment. Thus a large portion of the cost of enacting an immediate expensing provision will go not to incentivizing new investment, as it is intended, but simply to lowering the net cost to large corporations for the investments they were already likely to make. The policy therefore seems relatively unlikely to affect investment or aggregate demand.

Tying this back to earlier discussion, it is important to remember that, while financial constraints might be an operative issue preventing stepped-up investment by some small firms, this is not true of the economy at large. As Philippon and Gutierrez (2016) showed, access to funds for investment does not explain recent declines in investment. They appeal instead to a lack of market competition, which would normally push corporations to innovate, expand capacity, and grow. Moreira (2016) opens up another possible explanation, not mutually exclusive with that of Philippon and Gutierrez: that a cumulative lack of demand explains diminished growth and investment for start-ups and young firms. She also finds that financial constraints do not explain the sluggish growth observed since 2000.

The empirical finding that corporations are not investing as much as we would expect them to is exactly what underlies the political push to reduce the tax burden on returns to corporate investment—under the presumption that high effective taxes are what is holding back firm-level investment. But the studies and analysis presented here show that that is not the case: Investment is low despite the fact that after-tax returns to investment are already high; making them higher by reducing taxes on capital has not worked to increase investment in the past, and there is no reason to believe the circumstances are right for it to work now.

What Will Happen Instead?

A core tenet of tax analysis is that accounting and financial variables change in response to changes in the tax code far more readily than do “real” economic variables, like corporate investment or consumer prices, which take longer to respond to new policies.¹⁰ Thus, it’s sensible to divide our forecast of the impact of corporate tax reform into short- and long-run components.

The key point in estimating the short-run impact of a destination-based tax system is that the existing corporate tax system has not been the key driver of the outsourcing of production from the United States. The fault for that lies with trade agreements and other international macroeconomic policies that encourage capital mobility and labor outsourcing. Insofar as labor outsourcing could be solved by

¹⁰ Saez, Slemrod and Giertz (2012), Slemrod and Bakija (2008) and Auerbach and Slemrod (1997) summarize a vast body of research on taxation that suggests a hierarchy of behavioral response: Real economic decisions concerning employment or investment are far less responsive to taxation than are financial or accounting decisions.



tax policy, that's because taxing imports under a border adjustment amounts to a protective tariff that would reverse our trade policy. What the existing corporate tax system is at fault for is the offshoring of profits to tax havens. And while adopting the DBCFT would address that problem by (1) foregoing any claim on profits earned abroad and (2) making it more difficult to devise ways to offshore profits whose "real" location is the United States, it would not actually result in any increase in domestic investment or jobs. The same profits would pile up in the hands of the same corporations (and/or their shareholders) without taxation, and there is no reason to expect that to reverse the decline in long-term investment described in the previous section. If anything, the DBCFT would probably exacerbate it. The "location elasticity" of profits would be reduced, but the location elasticity of profits isn't the real economic problem. The major effect of offshoring profits is the reduced tax revenue—and Brady-Ryan would just reduce it more by exempting exports and profits from foreign activities from taxation entirely.

The immediate impact of reducing the tax rate from 35 percent to 20 percent is to increase after-tax profits at the expense of the Treasury and of individual taxpayers. If this corporate tax proposal is enacted alongside a cut in the individual capital gains tax, then the incentive to leave the earnings retained and undistributed would be reduced (depending on how the tax rate on ordinary income changes). On the other hand, at least for S-Corporations and other pass-through entities, if the legislation includes a statutory maximum rate on earnings derived therefrom, regardless of the tax bracket into which the individual who pays taxes on corporate profits falls, that type of pass-through structure would become even more of a tax shelter than it already is,¹¹ and traditional C-Corporations would reorganize to take advantage of that favored tax status, as we have already seen to date in Kansas.¹²

The Brady-Ryan proposal would formally make the corporate tax system territorial—U.S. corporations would no longer owe U.S. tax on revenue from abroad—but this policy has already been de facto implemented in the form of past corporate tax repatriation holidays for overseas profits. As discussed above, tax is only owed on these profits when they are "repatriated," and in the past corporations have accrued them in overseas subsidiaries in expectation of possible future tax holidays that will afford the opportunity to bring the profits "home" at a low tax cost.

This was done in 2004, and we know what happened: There was no increase in investment, and all the money accumulated overseas was paid out to shareholders in the form of dividends and stock buybacks, despite provisions in the repatriation holiday designed to prevent the proceeds from being used for that purpose.¹³ Those provisions were ineffective because corporate uses of funds are fungible. Since that holiday, accumulated overseas profits have risen back to where they were, and higher. Should the repatriation holiday component of the current proposal be enacted, we can expect the same result.¹⁴ Moreover, the new system that would permanently exempt future overseas profits from taxation would simply formalize what has been U.S. tax policy for decades. So in the future, the profits won't be accumulated over time and then repatriated en masse during a holiday; they will

¹¹ Cooper et al. (2015) attempt to track the taxes paid by S-Corporations and pass-throughs.

¹² Mazerov (2016) collects the evidence of the failure of Kansas' corporate tax policies, in particular the total exemption for business income earned from pass-through entities.

¹³ Dharmapala, Foley, and Forbes (2011), Marr and Highsmith (2011)

¹⁴ In fact, corporations are already telling their shareholders and market research analysts as much: an article in *The Intercept* on January 5, 2017, reported that on corporate earnings calls, CEOs and CFOs of Cisco, Hewlett Packard, and other companies reported to shareholders their plans to raise payouts and embark on mergers and acquisitions following the expected repatriation holiday.



simply be repatriated and paid out to shareholders continuously, at a fantastic gain for the owners of U.S. corporations that earn large profits overseas.

Nor will adopting a territorial system by itself induce relocation of real economic activity—including production and all the employment that comes with it—that might currently be taking place overseas back to the U.S. U.S. companies that make and sell goods overseas to take advantage of cheaper labor costs will continue to do so, and the profits from that activity will no longer be subject to any U.S. taxes. In that sense, moving to a territorial system to counter the offshoring of profits amounts to “solving” the problem of collecting a debt by simply declaring that the debt is no longer owed.

What could conceivably result in the relocation of economic activity to the United States is the border adjustment that imposes the corporate tax on imports but not on inputs to production sourced domestically. This aspect of the plan makes the U.S. a tax haven, not only for U.S. companies “coming home,” but also for foreign companies shifting their real economic activity to the U.S., which would go untaxed so long as they did not sell to U.S. consumers. Since the U.S. would have no traditional corporate tax, and the DBCFT would exempt payroll, employment in corporations conducting operations in the United States would be double-tax-exempt relative to conducting operations in our major trading partners. That is the most likely basis for a complaint from our trading partners to the WTO, which might create pressure for the border adjustment to be rescinded. U.S. corporations whose business model rests on imports, like Walmart, will also have a keen interest in weakening or eliminating the border adjustment, which would significantly cut into their profit margins.

Shifting from the short term to the long-term view, the impact of the Brady-Ryan tax plan is likely to be even worse, for two reasons: First, the incidence of the corporate tax could be shifted to consumers, and second, the plan would increase the power of corporate shareholders and the managers who serve their interests, at the expense of other priorities—workers, consumers, long-run investment,, and the Treasury.

Tax incidence refers to the idea that the entity responsible for paying a tax administratively may not be the same that bears its economic cost. If corporations can raise prices and/or reduce wages to offset their tax owed, then the tax incidence is on consumers and/or workers, even if corporations that sell to or employ them are responsible for writing a check to the IRS. But empirical studies conclude that the incidence of the existing corporate income tax is either mostly or fully born by shareholders, who tend to be rich.¹⁵

So what will happen when the existing system is replaced—and in particular, when a new tax on imports is levied? Unfortunately, we know from a great deal of recent research that the output market is uncompetitive—and a lack of competition creates ideal conditions for corporations to shift the tax incidence to consumers in the form of higher prices.

The shifting of incidence might happen especially quickly in importing sectors like retail, since those

¹⁵ Clausing (2013) argues that the existing corporate tax is born exclusively by employers (and, by implication, their shareholders), casting doubt on the general consensus that some of the burden is born by workers. Clausing (2016) reviews studies by the U.S. Treasury, the non-partisan Tax Policy Center, and the Congressional Budget Office, which estimate that wealthy corporate owners pay 75–82 percent of corporate income taxes, with workers shouldering no more than a quarter of that burden. CBO (2016) estimates that the top 1 percent pays more than 40 percent of all corporate income tax, more than that group’s share of national income taxes.



firms' imported inputs will no longer be deductible from their tax bill. Importers like Walmart would go from declaring and paying tax on their existing high profit margins to having to declare nearly all revenue as taxable profits, since the cost of all their imported inputs would no longer be deductible. That would drive their real after-tax profits well into negative territory, even despite a reduction in the tax rate from 35 percent to 20 percent. The most powerful retailer in the country is not going to operate at a substantial loss, so instead they would need to raise prices. This is why it is fairly likely that political pressure will weaken or eliminate the border adjustment as the proposal goes forward. To the extent that the policy instead causes a dollar appreciation, that would mitigate the relative penalty on importers, since imported goods would become relatively cheaper as they were subjected to the DBCFT. We make no prediction about the exchange rate response to the policy, other than to say that to the extent it neutralizes the effect on the trade balance, it also neutralizes the effect on potential re-shoring of jobs.

Looking at various existing consumption taxes in other countries, we find strong support for our expectation that the tax in imports contained in the Brady-Ryan proposal would be passed on to consumers. Examining the incidence of VATs in 17 European countries from 1999 through 2013, Benedek et al. (2015) found that corporations actually pass more than the full cost of the VAT on to consumers by raising prices. That paper, conducted by the International Monetary Fund, estimated that European corporations respond to hikes in the VAT rate by raising prices by 138 percent of the tax increase. And since consumption is far more equitably distributed in the population than is ownership of corporations, that incidence is much more regressive than the current corporate income tax.

Studies of Australia's VAT, referred to as a goods and services tax or "GST," returned similar results. Estimating the impact of four potential GST hikes on a range of economic outcomes, Verikios, Patron, and Gharibnavaz (2016) found that the consumer price index would rise as a result of both hikes in the tax rate and expansions of the GST to include a wider range of goods. Additionally, in a study conducted for the Australian treasury, Cao et al. (2015) arrived at a similar conclusion, finding that an expansion of the GST would result in higher consumer prices and lower household welfare.

It should be noted that the theoretical argument in favor of replacing the corporate income tax with a consumption tax relies on the incidence falling on consumers. According to the theoretical literature that advocates for eliminating corporate taxation, the whole reason why a corporate income tax is inefficient is that it reduces the incentive to grow the economy over the long run by reducing the post-tax return to capital formation. Thus, an efficient planner would want to shift the burden to consumption, and hence down the distribution of income and wealth, because the result would be a larger, more capital-intensive economy that pays out higher wages and returns to everyone, even to workers who own no capital. From this point of view, consumption is an ideal tax base because (1) it is relatively inelastic, and (2) to the extent it is elastic, it shifts household budgets toward savings, increasing capital formation.

The aforementioned studies relate to the international experience with Value-Added Taxes, but the DBCFT isn't exactly that, and there is little experience to draw on in assessing pass-through associated with that particular policy. As discussed above, however, the DBCFT is a tax on the profits of corporations from domestic activities, combined with a tax on imports. And we do have substantial



empirical evidence relevant to tariff pass-through and the distributional impact of protectionist trade policies. The resulting price hike will fall hardest on consumers at the lower end of the income distribution, who spend a far higher share of their income on import-intensive products and “tradable” goods than wealthier consumers.

A body of economic research shows that the cost of tariffs is borne disproportionately by the poor. Using a model of international trade with a flexible demand system that allows for differential consumption patterns among the rich versus the poor, as well as data on aggregate expenditure across countries, Fajgelbaum and Khandelwal (2016) find that individuals at the 10th income percentile bear more than double the burden from enacting trade restrictions than those at the 90th percentile, because the poor spend a higher percentage of their income on imported goods. A January 2017 article by Jason Furman, Katheryn Russ, and Jay Shambaugh also showed that the incidence of tariffs is highly regressive. They estimate that those in the lowest decile lose over 1.5 percent of their income to inflated prices from tariffs, compared to less than 0.3 percent for Americans at the richest 10th percentile. Using 2014 as a sample year, Furman, Russ, and Shambaugh estimate that a 10 percent tax on imports—half the rate proposed by Brady-Ryan—would cost the bottom quintile of consumers more than \$300 per household.

To summarize the analysis in the previous sections, there is too much uninvested capital in the economy, not too little—in other words, we are in a Keynesian world, not a neo-classical one. The cost of capital is essentially as low as it can go and has been for nearly a decade, but that capital is still not being put to productive uses. The DBCFT would likely add to this glut and exacerbate the problem by further shifting corporate resources away from the components of aggregate demand and toward increased shareholder payouts. The result would be yet more stagnation and structural weakness, slack labor markets, lost job opportunities, wage stagnation, and output below potential.

The existing corporate income tax falls on shareholders, and hence reducing the rate and shifting the burden to consumers would reduce the effective marginal tax rate faced by shareholders, regardless of whether the money is paid out or remains on corporate balance sheets. That reduction in the effective marginal tax rate further increases shareholders’ bargaining power, because they would get to keep more of the money they win in a multilateral corporate bargaining context, where they play against other corporate stakeholders like workers and consumers.¹⁶ That strengthens the incentive to reduce investment and payroll and increase the prices paid by consumers, all to the benefit of payouts to shareholders and compensation for the senior executives who act in shareholders’ interests. Thus, in the long run, what we can expect from the Brady-Ryan corporate tax plan, especially if it’s passed in conjunction with tax cuts for wealthy individuals, is more of the same tax policy we’ve experienced for the last several decades: A reduction in the effective top marginal tax rate will lead to a decline in corporate investment and demand for labor. All of this will exacerbate the problem of secular stagnation and labor market dysfunction.

It’s worth noting that new research makes this argument with respect to national and international macroeconomic data. Not only are corporations not investing because they face no competitive pressure to do so and aggregate demand is slack, but that lack of investment is itself the cause of slack

¹⁶ See, for example, Piketty, Saez, and Stantcheva (2014) and Goldstein (2012).



macroeconomic demand. Chen, Karabarbounis, and Neiman (2017) document the increase of corporate “net saving,” the assets accumulated on the balance sheet of the corporate sector, as a global phenomenon. In contrast with the neoclassical theory, which assumes that households lend money to corporations through the financial sector, they write “The corporate sector... transitioned from being a net borrower to being a net lender of funds to the rest of the global economy.” They relate that phenomenon to rising corporate profits thanks to lower interest rates, higher markups, and lower corporate tax rates. Gruber and Kamin (2015) have a similar finding, and note that it challenges the orthodox theory particularly thanks to the rise in payouts to shareholders. Neoclassical models would rationalize the rise in retained earnings and net saving with corporations accumulating resources for an uncertain future, in which case they would not pay them out to shareholders. Finally, Barkai (2016) shows that both the labor and the capital share in US GDP have declined, while the share of GDP going to corporate profits has increased. The distinction between the capital share and the profit share crucially depends on the theoretical distinction between the economic return to productive capital (what Barkai calls the “required rate of return on capital”) and non-economic rents accruing to non-productive factors, like the owners of monopolistic corporations. Barkai locates the explanation for that re-allocation of national income in exactly the rise in markups that is the prize for anti-competitive behavior, while a falling real interest rate reduces the required return on capital and hence capital’s share of national income.

The upshot of this analysis of long-run tax incidence and shifting bargaining power within corporations is that the DBCFT might indeed accomplish its aim of reducing the location elasticity of corporate profits with respect to the tax rate. But the way it would do that is by shifting the burden of taxes from corporations to customers. That just lets corporations avoid U.S. taxes by other means: Instead of moving their profits overseas, they can just make their customers pay their taxes for them, reserving the substantial increase in after-tax profits for payouts and executive compensation. It’s a misguided solution that mistakes a symptom of previously flawed tax policy for the cause, and by applying a superficial treatment for the symptom, worsens the problem: Effective taxes on corporations and their rich shareholders would decline, exacerbating power dynamics that cause macroeconomic underperformance and lead to widening inequality.

A Better Corporate Tax Reform: Sales Factor Apportionment

In this analysis, then, the key to effective corporate tax reform is addressing the following questions: First, how close can we get to a pure profits tax, and what are the key trade-offs in the construction of such a tax? Secondly, do we want to tax the return to corporate capital—and if so, all corporate capital, or only equity?

The longstanding conservative ambition to reduce effective taxes on the rich has, in recent decades, taken the form of tacit permission for corporate tax avoidance through the stashing of profits in overseas tax havens and the subsequent instatement of a tax holiday to permit the accrued profits to be passed on to shareholders.



If strengthening the corporate tax system is the policy goal, as opposed to dismantling it for good, then there is a much better option on the table: “Sales Factor Apportionment,” or SFA. The idea behind SFA is to retain profits as the tax base of the corporate tax, but change the basis from source to destination. The basic mechanism is that corporations that operate in more than one tax jurisdiction would add up their profits globally. That would be the tax base. They would then “apportion” shares of those profits to each jurisdiction using a “sales factor,” the share of total global sales made in that jurisdiction. That would keep the corporate tax progressive, while taking away corporations’ ability to reduce their tax bill by locating their profits in low-tax jurisdictions. Corporations, after all, cannot relocate their customers as easily.

SFA (or variants thereof using factors in addition to sales, like employment) is already used to determine taxation of corporations among U.S. states. There is no evidence that firms operating in multiple states under formulary apportionment respond to tax differences between states by moving real economic activities from one state to another. This suggests that SFA could help curb the large problem of tax avoidance through profit-shifting.

In addition to providing a crisp solution to the problem of corporations shifting profits to low-tax jurisdictions, formulary apportionment would greatly reduce “competitiveness” concerns associated with corporate tax policy differences between nations. Any firm—U.S.- or foreign-based—operating in the United States would be taxed based on the economic activities occurring here. Thus, there would be no tax advantage associated with being a foreign-headquartered firm, and no incentive to undertake corporate inversions in order to change tax treatment. Arguably, adopting such a system would therefore act as a spur to foreign governments to follow suit. That is also true of the DBCFT, but in that case, the likely result would be a worldwide race to the bottom that would lead to the end of corporate taxation. On the other hand, if countries adopt SFA in sequence, we would end up with a solid basis on which to tax corporations in the age of the multinational.

SFA would reduce the elasticity of the location of profits to the local tax rate—the degree to which corporations shift profits overseas based on variation in the tax rate—by making taxes owed independent of the location of profits. The DBCFT, on the other hand, would reduce the location elasticity by shifting the tax burden to consumers, so corporations would no longer have to pay taxes on their profits at all. If the DBCFT were adopted and remained in place, over time the whole idea that corporations owe any taxes at all would gradually slip away.

Why Do We Need Entity-Level Taxation?

Many economists and tax experts have thought for a while that corporate taxation is obsolete and unnecessary, and the recent problem of international tax avoidance only illustrates its obsolescence in the age of international capital mobility. Since corporations operate in numerous countries and can move their profits out of reach of national governments and play those governments against one another to attract their business, the thinking goes, why not just tax individuals, who are generally far less mobile?¹⁷ After all, corporations have to be owned by someone.

¹⁷ Of course, as Zucman (2015) shows, individuals have also proven adept at using international capital mobility to hide their income and wealth from tax authorities, even to the point of expatriating for tax purposes. Just consider the Panama Papers.



Unfortunately, recent evidence shows that that this “someone” is often untaxed. According to an analysis by the Tax Policy Center, 76 percent of U.S. corporate stock is held in non-U.S.-taxable accounts, in tax-sheltered pension plans and other savings vehicles (heavily concentrated among the rich, who get the best advice about using social policy tax shelters to avoid taxes), by nonprofit institutions that don’t pay taxes, or by foreign accounts (which may themselves be owned beneficially by Americans seeking to avoid U.S. taxes).¹⁸ The authors of that analysis write:

Corporate earnings are generally subject to two levels of tax—first, the company pays a corporate income tax; second, the shareholders pay an individual income tax on dividends and capital gains... However, observers have overlooked the substantial erosion at the second level of taxation of corporate income... As a result, corporate earnings are largely exempt at this level.

What the debate over international tax avoidance shows is that, in addition to being exempt from the second level of tax, a large and increasing fraction of corporate profits is exempt from the first level as well. Consider also the replacement of traditional corporate-tax-paying C-corporations with S-Corporations, LLCs, LLPs, and sundry pass-through entities that do not pay taxes at all at the entity level. Supposedly, their owners are taxed on that income; however, in many cases, they are not. A 2015 study of that large and growing sector showed that a substantial fraction of its income is untraceable and isn’t taxed at all, and that the effective tax rate overall is 19 percent—lower than the effective tax rate on C-Corporation income, even with international tax avoidance.¹⁹ Starting in the 1990s, corporations fitting certain loose criteria could simply reclassify themselves as pass-throughs, and over time, more of them did, alongside the general privatization of the corporate sector and the demise of the traditional publicly-held corporation.²⁰

All of this shows that replacing the corporate tax with a DBCFT, reducing the tax rate, and enacting a maximum tax rate on pass-through income would just be the next, and perhaps final, step in the decades-long trend of exempting capital income from taxation. We need an entity tax because the individual tax system is inadequate and lets an enormous share of profits go untaxed. Without both systems, it is too easy for rich owners of capital to escape taxation.

Conclusion

In recent decades, policy-makers have relied heavily on flawed theoretical models as justification for reducing taxes on the economic return to capital. And they have gone well beyond even the theory, moving toward the elimination of all taxation of corporate profits. Replacing the corporate income tax with a DBCFT, reducing the tax rate, adopting a territorial system, and enacting a maximum tax rate on pass-through earnings could be the culmination of that effort. Because capital income is earned disproportionately by the rich, lifting its tax burden and shifting that burden to consumption is a regressive policy that will promote rising inequality, both in the distribution of capital income and by shifting the allocation of national income from labor to capital (and, more specifically, to profits,

¹⁸ Rosenthal and Austin (2016), Zucman (2015).

¹⁹ Cooper et al. (2015)

²⁰ Doidge, Karolyi, and Stulz (2015); Pomerleau (2017); Slemrod (1996)



assuming there is an empirical distinction between the return to capital and economic rents).²¹ But again, that is no surprise: The high-level policy debate is explicitly about the tradeoff between an inefficient-but-progressive tax system and an efficient-but-regressive one. The problem is that the economic theory on which that tradeoff is based is wrong.

It isn't true that the economy, and corporations in particular, are starved for capital or reason to invest: on the contrary, the cost of capital is low and the return on capital is high. Corporations are choosing not to invest in order to preserve high profit margins for their owners, and they face little competitive pressure to increase output and lower prices, since their would-be competitors either don't exist in the first place or are owned by the same shareholders. As a consequence, firms spend less on payroll and long-term investment as a share of their total revenues, and far more on payouts to shareholders. That is why secular stagnation has set in—and why we observe the market failure of high returns to invested capital alongside a low market cost of capital. All of these phenomena result from power shifting in favor of the richest corporate stakeholders, and that, in turn, is caused by a reduction in their effective tax rate and the consequent strengthening of their bargaining position. Reducing effective marginal tax rates on the rich by eliminating the corporate tax system and shifting its burden to consumers will only worsen that.

This plan will not create jobs or increase investment. It will make the rich richer and more powerful within the corporations they own and run, and in the economy as a whole. It is the opposite of the optimal policy in the current economic environment. If there is any upside, its likely failure to achieve its stated purpose may finally do what the last several tax policy failures failed to: overturn the consensus both within the economics field and among policy-makers that lower taxes on the rich are better for the economy.

²¹ Piketty, Saez, and Zucman (2016)



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