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CORPORATE INCOME TAX: MORE TROUBLE THAN IT'S WORTH

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INTRODUCTION

Politics often yields suboptimal policy. In some cases, visible benefits flow to a select group at the expense of the largely invisible broader public. In others, visible costs are imposed on a select group, despite the largely invisible expenses borne by the broader public. Russell Long – the late U.S. senator from Louisiana and longtime chairman of the Senate Finance Committee – summed up this paradigm with the mantra: "Don't tax you, don't tax me, tax that man behind the tree."[1]

The corporate income tax is one of the best examples we have of attempting to tax the man behind the tree. It enjoys strong populist appeal. The general public's perception is that it collects revenues from wealthy businesses that can afford to shoulder significant burdens. Survey data show strong support for the notion that corporations should pay their "fair share" of taxes, a sentiment with which 70 percent of Americans agree.[2] At the same time, a majority also believe corporations fail to fulfill that obligation.[3]

It's easy to see why. Because it is assessed at an institutional level, the corporate income tax indulges the fiction that revenue is extracted from a nameless, faceless entity, rather than from individuals, many of whom are not wealthy. Its structure obscures the fact that the corporate income tax is just an attenuated form of individual taxation.

Every dollar of government revenue raised by the corporate income tax ultimately is paid by one of three groups of individuals: employees, customers or shareholders. The tax also poses huge compliance costs and distortions, all to raise a relatively paltry amount of revenue. These factors should call into question the wisdom of taxing corporate profits at all.

BURDENS FALL ON INDIVIDUALS

Because corporations pass on all of their costs, corporate income taxes inevitably lead to some combination of lower wages for workers, higher prices for consumers and lower returns for investors. The precise extent to which each bears the tax's burden is a matter of much debate and research.

Though literature on this matter is complex, some studies suggest that as much as three-fourths of direct corporate-income-tax costs are borne by a firm's workers.[4] One analysis of the tax's impact finds that each one percentage point increase in the corporate income tax is correlated with a 1.23 percent decrease in annual gross wages.[5] Applied to a hypothetical household with earnings at the median level, this would amount to a reduction in annual income of about $660.[6] For some context, that is (very roughly speaking) equivalent to about one-third of what the average household spends on gasoline in a year.[7]

It's especially troubling that labor – particularly low-skilled labor – bears the brunt of the corporate income tax, since it's arguably the group least able to adapt to those higher costs. Customers can respond to a price increase by switching to competing products or services. Shareholders of publicly traded companies can switch to other investments, given America's highly liquid and accessible stock markets. While skilled workers may be able to find employment elsewhere, lower-skill workers often do not have that luxury, as the economic dislocations from innovation and trade have made readily apparent in recent years.

DISTORTIONS

Applying taxation at the enterprise level makes little economic sense and generates significant distortions. The National Taxpayers Union Foundation estimates the cost for firms to comply with the corporate income tax to be roughly $140 billion per year.[8] To place that figure into context, annual compliance costs from the corporate income tax drains from the economy an amount roughly equivalent to the net earnings of five of the most profitable companies in the world: Apple Inc., JPMorgan Chase & Co., Berkshire Hathaway Inc., Wells Fargo & Co. and Exxon Mobil Corp.[9] That number doesn't even include the impact of current or planned Internal Revenue Service rulemakings, which can impose additional burdens on businesses.

Perhaps even more destructive than compliance costs are the costs companies bear to avoid the corporate income tax in the first place. Many large businesses have entire departments dedicated to exploring and implementing various legal tax-avoidance strategies. From deferring income to setting up subsidiaries in lower-tax countries, where firms often will domicile intellectual and intangible property, companies devote enormous amounts of time and money to activities that are not especially useful in creating long-term economic prosperity.

Moreover, the United States has the highest general corporate income tax rate among the 34 member-nations of the Organisation for Economic Co-operation and Development (OECD).[10] Our high corporate tax rates encourage businesses and trade associations to engage politically in order to advocate for credits, deductions and exemptions that are helpful to them. Because many such changes are justifiable individually, Congress begins poking holes even in a recently reformed tax system almost immediately. Thus continues the cycle of the corporate tax code moving from relatively clean, as it was following the 1986 tax reform, to totally cluttered in just a few decades.

The incredible proliferation of tax-avoidance tactics in recent years is a damning statement about the complexity and cost associated with America's corporate income tax code and the lengths to which businesses feel they must go to protect their bottom lines from its predation. As but one of hundreds of examples, the technology giant Apple was hit recently with a European Union ruling that Ireland must collect from it a staggering $14.5 billion as punishment, effectively, for utilizing what was a legal tax structure that reduced its burdens.[11] This is part and parcel of Ireland's yearslong strategy to outcompete its EU counterparts and the United States with a low corporate tax rate and a welcoming legal environment.

If the United States had a rational corporate income tax code, Apple and other multinationals like it might never have found it necessary to seek refuge in lower-tax countries like Ireland (a refuge that might disappear if the EU's crackdown stands). The current U.S. code leads businesses to make the perfectly rational decision to shift some operations overseas and not repatriate income associated with them, keeping out of the country trillions of dollars that might be invested in growth opportunities, in order to avoid the cost and complexity imposed by Uncle Sam.

Corporate income taxes also encourage the use of debt over equity financing, which might contribute to greater risk and systemic instability. As Megan McArdle wrote in *The Atlantic*:

> Debt finance makes companies riskier. But because payments on debt are tax deductible, and dividends are not, companies have a strong incentive to use debt rather than equity finance. The deductibility of debt payments also lowers the required rate of return for new projects, possibly encouraging companies to invest in marginal ideas that aren't really worth it. Without the corporate income tax giving them a 35 percent reduction on their interest payments, they might think twice.[12]

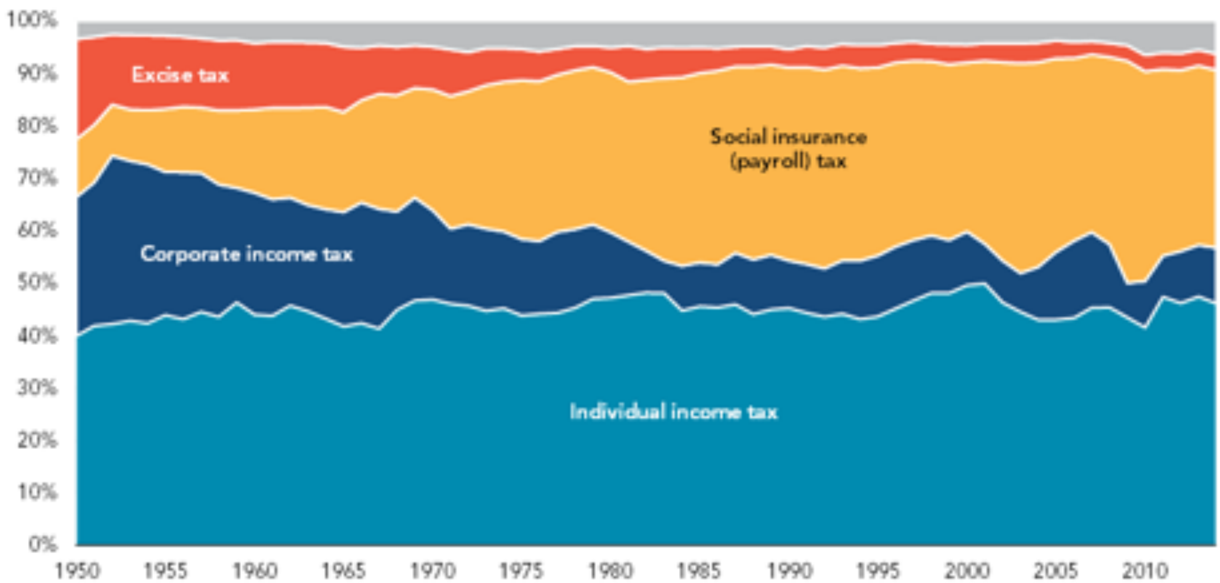
In addition to its economic distortions, the corporate income tax creates other policy and political distortions. Some analysts posit that an ideal tax code is one that taxes each dollar once, when it reaches an individual. But having already been taxed once when the company recorded its income, corporate profits that reach investors in the form of dividends and long-term capital gains are taxed again through the individual income tax code. Because this double taxation punishes investment, Congress has enacted preferential marginal rates for capital gains and dividends in order to mitigate the impact, at least partially. But those preferences have been subject to controversies of their own, particularly in the battles over how to tax the "carried interest" earned by investment fund managers, who typically are compensated in part with a share of investment profits that are subject to lower rates than ordinary income not at risk in the market.[13]

These distortions, among many others, combine to create what economists term "deadweight loss," or a loss in economic efficiency associated with a given tax or other government policy. Some conservative economists, like Boston University's Laurence Kotlikoff, assert that deadweight losses associated with the corporate income tax might even exceed the revenues collected by the tax.[14] While that claim is somewhat contentious, even more progressively minded researchers like former Obama administration adviser and University of Chicago economist Austan Goolsbee have found significant losses from the corporate income tax.[15] In a world in which policy disagreements run rampant, economists largely speak with one voice on this matter.

MODEST REVENUE

While the corporate income tax is politically popular, many economists and political analysts question whether it's really worth the trouble it causes.[16][17] Despite having the highest rate among developed countries and the third-highest rate

FIGURE I: SOURCES OF FEDERAL REVENUE, FY 1950-2014



SOURCE: Tax Policy Center, Office of Management and Budget

in the world, at nearly 39 percent, the federal government currently only generates about 10 to 12 percent of its revenue from the corporate income tax. That pales in comparison to other major sources, amounting to less than a third of individual income tax receipts and less than half of payroll tax receipts in most years.[18] The story is the same when expressed as a percentage of the economy, where corporate income tax receipts comprise less than 2 percent of gross domestic product.[19]

In fact, corporate income tax revenues having been declining as a proportion of federal tax receipts for decades. After peaking in the early 1950s, when the corporate income tax accounted for more than 30 percent of all federal tax revenues (equivalent to more than 6 percent of GDP), the tax has dwindled in importance, largely offset by growing payroll tax receipts.

CONCLUSION

For all of its compliance costs, incalculable lobbying expenses, the perverse incentives it creates, the harms it does to our economy and the ways it poisons our politics, the corporate income tax doesn't raise very much money. Taking the bold step to simply eliminate it, rather than nibbling around its edges with modest reductions in marginal rates, would at once free up $140 billion in annual capacity that could be devoted to productive pursuits. It also would encourage the repatriation of trillions of dollars of capital currently held offshore and turn the United States into the world's premier destination for highly mobile multinationals who seek favorable legal climates.

No matter how logical, a step so radical would, of course, never happen in today's political climate. Given persistent deficits and mounting debts, the odds that Congress would willingly reduce revenue by hundreds of billions per year are approximately zero. While R Street and its free-market allies have spent years identifying potential reductions in spending, from agribusiness subsidies to duplicative defense programs, the simple fact is that Congress would seek to replace some or all revenue lost by making such a change.

But if tasked with a clean slate and a mandate to raise as much as $400 billion or so in revenue each year, Congress would be wise to dispense with the corporate income tax entirely in favor of any number of other methods that impose fewer deadweight losses, are more easily administered and don't create such political challenges.

ABOUT THE AUTHOR

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Before joining R Street, Andrew was vice president of government affairs for the National Taxpayers Union, a grassroots taxpayer advocacy organization. He previously served with the Center for Educational Freedom at the Cato Institute and completed internships in the U.S. Senate and the House of Representatives with members from his home state of Michigan.

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