NATIONAL CENTER FOR POLICY ANALYSIS

Abolishing the Corporate Income Tax Could Be Good for Everyone

Brief Analysis No. 799 by Laurence J. Kotlikoff August 5, 2014

The U.S. corporate income tax produces little revenue — only 1.8 percent of gross domestic product (GDP), or about $288 billion in 2013. Yet the compliance, collection and avoidance costs of collecting this tax are huge.

Dallas Headquarters:
14180 Dallas Parkway, Suite 350
Dallas, TX 75254
972.386.6272

www.ncpa.org

Washington Office:
601 Pennsylvania Avenue NW,
Suite 900, South Building
Washington, DC 20004
202.220.3082

Worse yet, America's relatively high marginal tax rate encourages both U.S. and foreign corporations to operate outside the United States. It also prevents firms from returning overseas profits and reinvesting them domestically.

Burden of the Corporate Income Tax. As with many elements of the tax system, there is disagreement over who ultimately bears the burden. The general public thinks the tax is paid by rich owners of large corporations and that it does not affect workers. However, the tax appears to fall largely on U.S. workers. Workers rarely seek employment abroad, whereas corporate investment can readily be shifted overseas, reducing the demand for American workers.

If the United States accounted for most of the world's gross domestic product (GDP), the corporate income tax would not have much effect on where the world invested its capital, because the world's capital stock would have nowhere else to go. The extra revenue generated from the corporate tax would, in this case, make little difference to U.S. real wages. However, the United States accounts for only about one-fourth of the world's capital stock. Hence, the potential for capital investment to avoid the corporate tax by shifting or staying abroad is real.

In fact, the average U.S. tax on corporate capital appears to be, according to some independent analysts, among the highest of developed countries. It has also remained high over time, as other countries have lowered their rate to attract capital investment from abroad.

My colleagues and I developed a dynamic economic model of the United States, Europe, Japan (with Hong Kong, Taiwan and Korea), China and India. It accounts for each country or region's changing demographics and each country's fiscal policies over many generations. The model allows us to analyze the immediate and long-term economic effects from various tax changes, including corporate tax reform. [See the technical paper here: http://www.ncpa.org/pub/simulating-the-elimination-of-the-us-corporate-income-tax.]

Our analysis shows that eliminating the U.S. corporate tax — holding constant the corporate tax rates of other countries — would produce a rapid and dramatic increase in domestic investment, GDP, real wages and national saving. We analyzed two alternatives to make up for the revenue: a 3.4 percent tax on wages or consumption. We also modeled a reduction in the corporate tax to 9 percent and broadening the tax base by eliminating loopholes.

Economic Effects of Replacing the Corporate Tax. Abolishing the corporate tax produces permanent economic benefits.

- The capital stock would increase by one-fourth to about one-third (23 percent to 37 percent) — with most of the added investment reflecting capital flowing into the United States.
- Real wages would rise 12 percent to 13 percent.
- Gross domestic product would rise 8 percent to 10 percent.

Further, the tax base would expand over time, producing additional revenues that would make up for about one-third of the revenue loss from repealing the corporate tax. Over time, due to economic growth, the tax rate required to replace corporate tax revenues would fall.

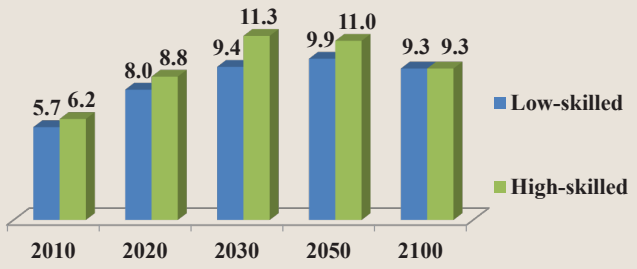
The beneficial economic effects of a consumption tax are somewhat greater than a wage tax, as are the long-run welfare gains for individuals. But, a consumption tax comes at some modest losses to current older generations. Using progressive wage taxes to make up the loss in tax revenues produces a quite remarkable finding: All generations, including those yet to be born, are better off.

Economic Effects of Reducing and Broadening the Corporate Income Tax. Replacing the current 35 percent corporate tax with a more broadly based rate of just 9 percent, and eliminating loopholes, would increase wages for all workers, increase GDP and still produce just as much revenue. In the first scenario, the corporate tax reduction would be supplemented with a revenue-neutral wage tax of 1.1 percent in 2010, which would gradually fall to –0.8 percent (a modest tax break for earned income) by 2100 [see Figure I]:

- Wages would increase about 6 percent in the short run for both low- and high-skilled workers, eventually increasing 9 percent over the long run.
- GDP would immediately and permanently increase 6 percent.
- In addition, capital stock would increase 17 percent in the short run and 30 percent by 2040.

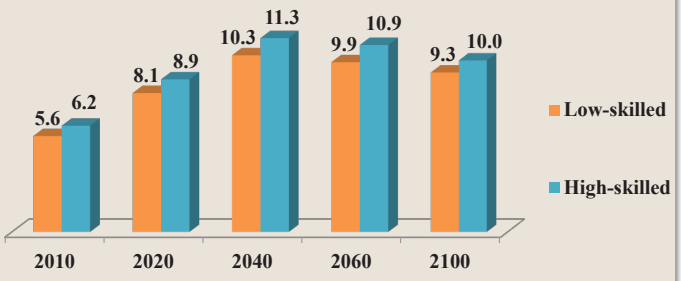
A revenue-neutral consumption tax would produce similar results [see Figure II]:

Figure I
Income Growth Effects (Percent) of Reducing U.S. Corporate Tax (with Transitional Wage Tax)



Source: Hans Fehr et al., "Simulating the Elimination of the U.S. Corporate Income Tax," Table 14.

Figure II
Income Growth Effects (Percent) of Reducing U.S. Corporate Tax (with Transitional Consumption Tax)



Source: Hans Fehr et al., "Simulating the Elimination of the U.S. Corporate Income Tax," Table 14.

- Wages would increase about 6 percent in the short run for both low- and high-skilled workers, eventually increasing 9 percent over the long run for low-skilled workers and 10 percent for high-skilled workers.
- GDP would immediately and permanently increase 6 percent.
- Capital stock would increase by 17 percent in the short run and 30 percent by 2040.

The substantial, but still limited, roughly revenue-neutral reduction in the U.S. corporate tax rate produces growth effects that are pretty close to those arising under the complete elimination of the U.S. corporate income tax.

Conclusion. Eliminating the U.S. corporate income tax has great potential to make all Americans better off because the corporate tax drives investment out of our country with surprisingly small benefit in terms of government revenues.

Laurence J. Kotlikoff is director of the Tax Analysis Center and Professor of Economics at Boston University.