NATIONAL CENTER FOR POLICY ANALYSIS

Is the Corporate Income Tax Regressive?

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In a recent Iowa speech a heckler yelled at former Massachusetts Governor Mitt Romney to raise corporate taxes. Romney replied, "Corporations are people, my friend." He quickly clarified that statement to indicate that corporations are people because they are owned by people and that when you tax corporations you are taxing people — people who own corporations.

Dallas Headquarters:
12770 Coit Road, Suite 800
Dallas, TX 75251
972.386.6272
Fax: 972.386.0924

www.ncpa.org

Washington Office:
601 Pennsylvania Avenue NW,
Suite 900, South Building
Washington, DC 20004
202.220.3082
Fax: 202.220.3096

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Executive Summary

There is good reason to believe that it is workers, not the owners of corporations, who ultimately pay much, if not all, of the corporate income tax. And not just workers employed by corporations — all workers throughout the country.

The U.S. corporate tax income is relatively high compared to many other countries. Our statutory tax rate is 35 percent, but our effective rate is lower — 28 percent — due to subsidies and tax credits and other tax breaks that corporations receive on their investments. Japan has a much higher effective rate — 39 percent. But some countries have much lower effective rates; for example, Portugal's effective corporate tax rate is about 19 percent. High corporate taxes encourages U.S. corporations to invest overseas, and discourage foreigners from investing in the United States. This reduces demand for U.S. workers, compared to what it would be if U.S. tax rates were lower. As a result, American workers' wages are lower than they otherwise would be. Conversely, increased overseas investment raises the wages of workers abroad.

If we consider, then, what happens to relatively poor American workers and relatively rich American investors, we find that the poor workers are hurt significantly, while the rich investors are hurt a bit. If we do not factor in the wellbeing of workers in other countries and just focus on U.S. workers and investors, we have to conclude that a high U.S. corporate income tax is regressive.

If the United States cut its corporate income tax rate dramatically, the country would likely experience a huge rise in net domestic investment, which is now running at a postwar low of 4 percent. This would, potentially, raise U.S. workers' wages dramatically — by as much as 10 percent.

If cutting the U.S. corporate income tax would help workers and the economy, why not do it yesterday? For two reasons. First, the United States needs tax revenue. Second cutting the corporate tax on its own

can impact revenues from the personal income tax. There is a reason the top U.S. corporate tax rate is 35 percent — the same as the top personal income tax rate. If corporate tax rates are lower than personal income tax rates, people have an incentive to shelter their self-employment income (lower their personal tax bill) by incorporating. Thus, reforming the corporate tax has to be part of a comprehensive tax reform.

The Purple Tax Plan. That is where the Purple Tax Plan comes in. The Purple Tax Plan replaces the federal, personal and corporate income taxes, as well as the estate and gift taxes with a broad-based, low-rate, progressive retail sales tax and a low-rate, progressive inheritance tax. It also makes the highly regressive Federal Insurance Contributions Act (FICA) payroll tax — the combined Social Security and Medicare payroll tax — highly progressive. The plan eliminates the need for households to file tax returns and enormously simplifies business tax compliance. It also eliminates all taxation of saving.

Moving to the Purple Tax can help the economy in many ways. But one of the most important is eliminating the corporate income tax, which is costing U.S. workers dearly.

About the Author

Laurence J. Kotlikoff is Professor of Economics at Boston University, Senior Fellow at the National Center for Policy Analysis, Research Associate of the National Bureau of Economic Research, Fellow of the Econometric Society, a former member of the Executive Committee of the American Economic Association, and President of Economic Security Planning, Inc., a company specializing in financial planning software. He is also a columnist for Bloomberg.

Kotlikoff received his B.A. in Economics from the University of Pennsylvania in 1973 and his Ph.D. in Economics from Harvard University in 1977. From 1977 through 1983 he served on the faculties of economics of the University of California, Los Angeles and Yale University. In 1981-82, Kotlikoff was a Senior Economist with the President's Council of Economic Advisers.

Kotlikoff has served as a consultant to many national and international government groups including the International Monetary Fund, the World Bank, the Organization for Economic Cooperation and Development, the Office of Management and Budget, the U.S. Department of Education, the U.S. Department of Labor and many others. He has also served as a consultant to many business concerns including The American Council of Life Insurance, Merrill Lynch, Fidelity Investments, AT&T, and other major U.S. corporations. Kotlikoff has provided expert testimony on numerous occasions to committees of Congress including the Senate Finance Committee, the House Ways and Means Committee, and the Joint Economic Committee.

Introduction

In a recent Iowa speech a heckler yelled at former Massachusetts Governor Mitt Romney to raise corporate taxes. Romney replied, "Corporations are people, my friend." He quickly clarified that statement to indicate that corporations are people because they are owned by people and that when you tax corporations you are taxing people — people who own corporations.

This comment prompted considerable reaction from bloggers, many of whom said Romney was coddling corporations. Interestingly, no one pointed out that Romney was right about corporations being owned by people, but arguably very wrong about who really pays the corporate tax.

There is good reason to believe that it is workers, not capitalists (the owners of corporations) who ultimately pay much, if not all, of the corporate income tax. And not just workers employed by corporations — all workers throughout the country.

What Is Taxed: Capital or Labor?

The argument that workers bear the brunt of the corporate income tax goes like this. Corporations use two inputs — capital and labor — to produce output. Capital refers to plant, equipment, inventories and intellectual property. Labor refers to the hours worked by the corporation's employees.

Corporations do not start with either of these inputs in place. They start with investors registering a company as a corporation and handing the corporation money. In exchange, the corporation hands back shares of stock and bonds. The corporation then uses this money to buy physical capital, hire labor, produce goods or services, and sell them. After the workers are paid and the government receives its corporate taxes, the investors get what is left.

If the corporation pays more taxes, simple accounting suggests that less money will be left over for investors; that is, that rich investors, not poor workers, will get hit with the tax. That is not necessarily so.

> *"Capital can flee high taxes; workers are stuck."*

Capital Takes Flight. If the investors do not like receiving less income, they have an option: They can take their money and invest abroad where the corporate tax rate is lower. When this happens, the capital they buy or will buy goes with them (with their investment dollars), but they leave the workers they would otherwise be hiring back home. Economists refer to this as capital mobility and labor immobility.

The fact that capital can and does move anywhere in the world to chase higher post-tax returns and workers are, in general, stuck in the country in which they were born, can change entirely who really bears the corporate income tax. When corporations leave a country or a region within a country, they reduce the total demand for labor in the country and this puts downward pressure on *all* workers' wages.

Case Study: Boeing Heads East. A contemporaneous example is Boeing's decision to build its new passenger jet — the Dreamliner — in a huge aircraft factory in South Carolina rather than in Washington state. Boeing, which is hiring non-unionized labor in South Carolina, says it is doing this to lower its costs. But back in Washington state, the machinist union, with the help of the National Labor Relations Board, is crying foul and taking Boeing to court.

The union claims that Boeing is retaliating against it for periodic strikes. But regardless of Boeing's motives, the point the union gets very well is that Boeing's decision will hurt their members, in their wallets, over time.

To be sure, not all corporations will follow Boeing's lead and move to South Carolina or other states that have lower costs to operate. The reason is that as some companies start to leave places where costs are high, wages in those places start to fall and continue to fall until the remaining companies are indifferent between staying and leaving.

A Thought Experiment: State versus State. As a thought experiment, suppose Washington state were to set its corporate tax rate, which actually is now zero, to 27 percent — the effective U.S. federal corporate rate. This is miles higher than the highest corporate tax rate of any state; it is even higher than Washington, D.C.'s 9.975 percent rate.

In jacking up its tax rate, Washington state would produce a massive exodus of corporations from the state, but not workers, because we are going to assume that workers are stuck living in Washington state. Notwithstanding the loss of many corporations, a decade from now,

there would still be some corporations located in Washington state paying the 27 percent rate. They would be operating there because labor costs had fallen enough for them to do so.

A Washington state accountant looking at his corporate clients' state corporate income tax returns would immediately say Washington state corporations pay Washington state corporate income taxes. He would be dead wrong. Yes, his clients transfer money to the state government, but that money is really coming from having to pay their workers less in salary and fringe benefits. It is Washington state's relatively poor workers who really pay the corporate income tax, not the corporation's relatively rich investors. This is the sense in which the corporate income tax is regressive.

Now for the Rest of the Story. There are still some twists to the economic story of who really bears the corporate income tax. Those corporations who left Washington for other states or countries raise the demand for labor in the places they choose to operate. This raises the wages of workers in those locations. So what really happens is that workers in Washington state (assuming they are stuck there) are hurt and workers elsewhere are helped. Under some conditions, the losses to workers in Washington state are exactly offset by gains to workers outside of Washington state.

OK, so if workers over here are hurt, but over there are helped, this means workers collectively are not hurt. So who pays the corporate income tax?

Good question. The answer is rich investors, but not just rich investors who were originally investing in Washington state. All investors around the globe are hurt a little bit by not being able to operate as cheaply in Washington state. If you add up all these little hurts, you end up with a collective loss to investors that, under simplifying assumptions, is precisely equal to the tax revenues collected by Washington state.

Who Pays the U.S. Corporate Income Tax? Substitute the United States for Washington state and consider what happens if the United States sets its corporate tax rate well above the rates being set by other countries. Investors start to flee America. This reduces demand for U.S. workers and lowers American workers' wages a lot. Conversely, it raises the wages of workers abroad. Investors, regardless of their nationality, are all hurt a little bit.

If we consider, then, what happens to relatively poor American workers and relatively rich American investors, we find that the poor workers are hurt significantly, while the rich investors are hurt a bit. If we do not factor in the wellbeing of workers in other countries and just focus on U.S. workers and investors, we have to conclude that establishing a higher U.S. corporate income tax rate than prevails abroad would be a regressive move.

How High Is the U.S. Corporate Income Tax Rate Compared to Other Countries? The figure shows the United States has a relatively high effective corporate income tax rate. The effective tax rate differs from the statutory or nominal tax rate due to subsidies and tax credits and other tax breaks that corporations receive on their additional dollars of investment. The United States' statutory tax rate is 35 percent, but its effective rate is lower — 28 percent. Japan has a much higher effective rate — 39 percent. But some countries have much lower effective rates; for example, Portugal's effective corporate tax rate is about 19 percent.

Helping American Workers by Cutting the U.S. Corporate Income Tax Rate. As the above discussion indicates, if the United States were to cut its corporate income tax rate dramatically, the country would likely experience a huge rise in net domestic investment, which is now running at a postwar low of 4 percent. In the 1950s and 1960s it averaged over 13 percent. The higher investment would come from U.S. corporations expanding their operations in the United States and foreign companies moving more of their operations here.

All of this would, potentially, raise U.S. workers' wages dramatically. Indeed, based on a number of simulation studies over the years, eliminating the corporate income tax would, over time, raise U.S. real wages by as much as 10 percent.[1] That is a pretty big increase. Apart from increases in fringe benefits (much of which has come in the form of higher health care premiums paid by employers), most U.S. workers have not received a real wage increase in decades.

Of course, if other countries were to follow the U.S. lead and also cut their corporate income tax rates, there would be less of a gain to workers. But even if all countries set their corporate tax rates to zero, U.S. workers would benefit because our rate is higher than that of many other countries.

The most recent example of a country booming following a reduction in its corporate income tax rate to 10 percent, ultimately to 12.5 percent in the late 1990s, is Ireland.[2]

Between 1995 and 2007, Ireland had a remarkable record of growth, with annual growth rates averaging more than 5 percent. Today, Ireland is in very tough shape due to its banking crisis. But it is in a better position to weather its current economic malaise thanks to that growth.[3]

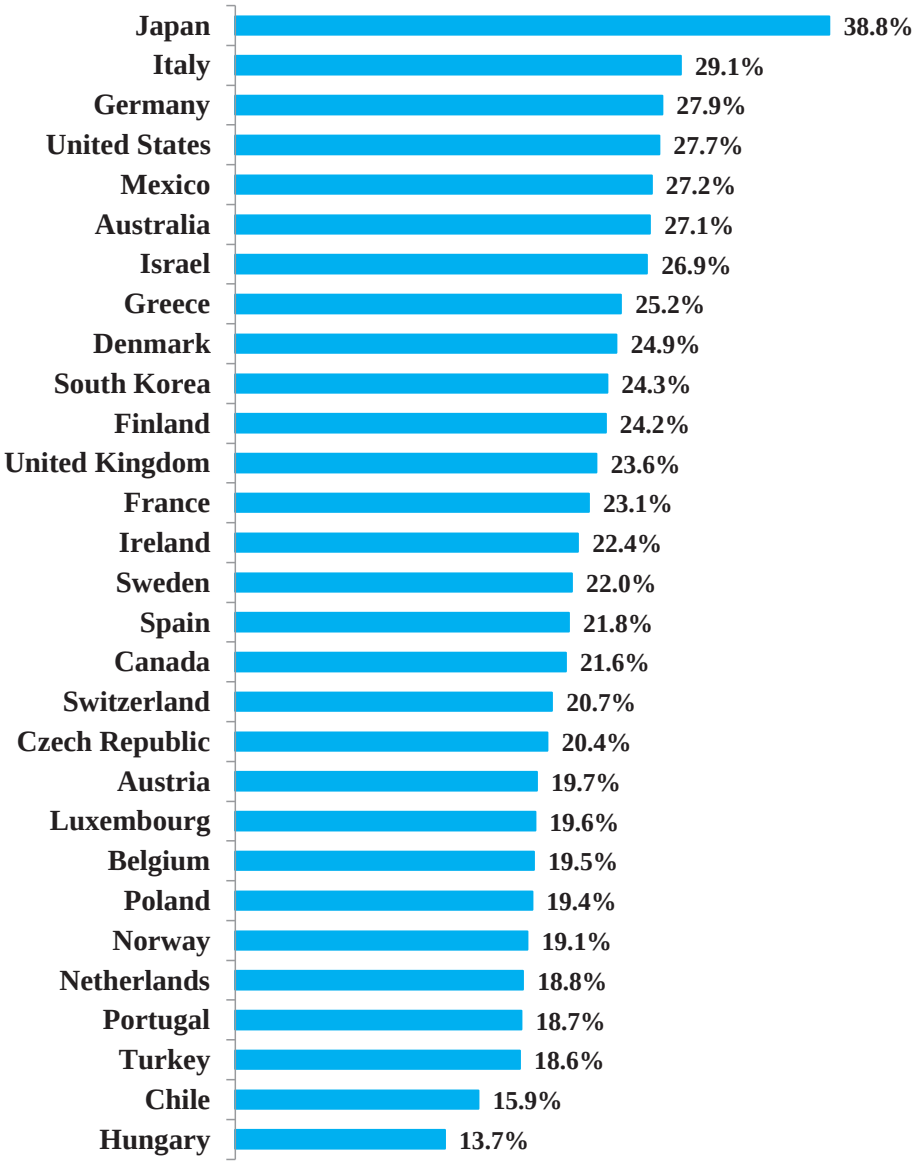
If cutting the U.S. corporate income tax would help workers and the economy, why not do it yesterday? For two reasons. First, the United States needs tax revenue. Second cutting the corporate tax on its own can impact revenues from the personal income tax. There is a reason the top U.S. corporate tax rate is 35 percent — the same as the top personal income tax rate. If corporate tax rates are lower than personal income tax rates, people have an incentive to shelter their self-employment income (lower their personal tax bill) by incorporating. Thus, reforming the corporate tax has to be part of a comprehensive tax reform.

The Purple Tax Plan

The website www.thepurpletaxplan.org lays out a simple, radical tax reform that includes eliminating the corporate income tax. The Purple Tax Plan is a transparent, efficient and progressive tax system that should appeal to both parties. It is also simple enough to fit on a postcard [see the sidebar]. It will help our economy save, grow, produce jobs and deliver higher wages. And it should produce about 2 percent more revenue measured as a share of gross domestic product.

Progressive FICA, Sales and Inheritance Taxes. As the sidebar indicates, the Purple Tax Plan replaces the federal personal and corporate income taxes as well as the estate and

Average Effective Corporate Tax Rate for Developed Countries* (2006-2009)



*Developed countries include 29 of the 34 Organization for Economic Cooperation and Development members. Estonia, Iceland, New Zealand, Slovakia and Slovenia are not included because there is not enough information available to calculate their effective rates. The effective rate takes into account tax offsets, the present value of depreciations and other deductions.

Source: PricewaterhouseCoopers, "Global Effective Tax Rates," Table 1, April 14, 2011. Available at http://businessroundtable.org/uploads/studies-reports/downloads/Effective_Tax_Rate_Study.pdf. And Kevin A. Hassett and Aparna Mathur, "Report Card on Effective Corporate Tax Rates: United States Gets an F," American Enterprise Institute, February 2011. Available at http://www.aei.org/docLib/TPO-2011-01-g.pdf.

gift tax with a broad-based, low-rate, progressive retail sales tax and a low-rate, progressive inheritance tax. It also makes the highly regressive Federal Insurance Contributions Act (FICA) payroll tax — the combined Social Security and Medicare payroll tax — highly progressive. The plan eliminates the need for households to file tax returns and enormously simplifies business tax compliance. It also eliminates all taxation of saving.

The Purple Tax's sales tax taxes all consumption purchase. But it includes, in the tax base, the consumption services enjoyed from homes, boats, planes, cars and other major durables, which households own. These are consumption services we, in effect, buy from ourselves. Households in economic distress are permitted to defer their tax payments on the services from their homes. Also, the Purple Tax provides a monthly payment (demogrant) based on household size. The demogrant is large enough to fully cover the sales taxes of the poor. Since the poor pay no sales tax, on net, and the rich do, the demogrant makes the sales tax progressive.

The Purple Tax Plan

1. Replaces federal, personal and corporate income taxes with a 17.5 percent retail sales tax.
2. Taxes all consumption purchases plus services from homes, boats, planes, cars, etc.
3. Taxes annual consumption done abroad above $5,000.
4. Rebate based on family composition sized to ensure poor pay no sales tax on net.
5. Exempts first $40,000 of earnings from the employee portion of FICA payroll tax.
6. Eliminates ceiling on FICA payroll tax.
7. Subjects to FICA tax all income from ownership rights in business in which one works.
8. Taxes inheritances (accumulated gifts and bequests received) over $1 million at 15 percent.
9. In transition, taxes at 15 percent all tax-deferred assets, pensions and capital gains.

A 15 Percent Effective Tax Rate. The Purple Tax is a 15 percent solution. The effective consumption tax rate is 15 percent; if you spend $100 at the store, $15 of your expenditure goes toward taxes and you end up with $85 in goods. Hence, this represents a $15 tax on your $100 of income or wealth. Also note that $15 divided by $85 gets you back to the nominal 17.5 percent tax rate; that is, $15 is a 17.5 percent markup on $85.

The FICA tax is also levied at close to a 15 percent rate. The employee plus employer tax rates combined equal 15.3 percent. And the proposed inheritance tax is 15 percent. Having a single tax rate for everyone to focus on may be a great advantage in limiting federal spending over time. The reason is that everyone will know that if the government spending more on anyone or anything, the 15 percent rate will need to be raised.

Conclusion

Moving to the Purple Tax can help the economy in many ways. But one of the most important is eliminating the corporate income tax, which is costing U.S. workers dearly. The corporate income tax also entails very high compliance costs and has led to an entire industry of people — corporate tax lawyers and accountants — who are wasting their lives trying to comply with a tax that does much more harm than good.

Endnotes

1. See, for example, Alan J. Auerbach and Laurence J. Kotikoff, Dynamic Fiscal Policy (Cambridge, England: Cambridge University Press, 1987) and Hans Fehr, Sabine Jokisch and Laurence Kotlikoff, "Dynamic Globalization and Its Potentially Alarming Prospects for Low-Wage Workers," Kotlikoff.net, 2011. Available at http://www.kotlikoff.net/content/dynamic-globalization-and-its-potentially-alarming-prospects-low-wage-workers. This research doesn't directly focus on corporate tax changes, but it does show how changes in capital per worker can impact a country's real wage. If the United States were to eliminate its corporate income tax, the relative size of its tax would fall by roughly 28 percent. Taking the net return to capital abroad as given (which assumes that the United States is a small open economy), standard Cobb-Douglas production technology would imply a 13 percent increase in the real wage. The United States, of course, is not a small open economy, which is why an increase of around 10 percent is the best estimate.
2. A 10 percent rate was introduced in 1981 for manufacturing. In the early 2000s, a 12.5 percent rate was established for all corporations.
3. "Celtic Tiger," Wikipedia, August 1, 2011. Available at http://en.wikipedia.org/wiki/Celtic_Tiger.

The NCPA is a nonprofit, nonpartisan organization established in 1983. Its aim is to examine public policies in areas that have a significant impact on the lives of all Americans — retirement, health care, education, taxes, the economy, the environment — and to propose innovative, market-driven solutions. The NCPA seeks to unleash the power of ideas for positive change by identifying, encouraging and aggressively marketing the best scholarly research.

Health Care Policy.

The NCPA is probably best known for developing the concept of Health Savings Accounts (HSAs), previously known as Medical Savings Accounts (MSAs). NCPA President John C. Goodman is widely acknowledged (*Wall Street Journal*, WebMD and the *National Journal*) as the "Father of HSAs." NCPA research, public education and briefings for members of Congress and the White House staff helped lead Congress to approve a pilot MSA program for small businesses and the self-employed in 1996 and to vote in 1997 to allow Medicare beneficiaries to have MSAs. In 2003, as part of Medicare reform, Congress and the President made HSAs available to all nonseniors, potentially revolutionizing the entire health care industry. HSAs now are potentially available to 250 million nonelderly Americans.

The NCPA outlined the concept of using federal tax credits to encourage private health insurance and helped formulate bipartisan proposals in both the Senate and the House. The NCPA and BlueCross BlueShield of Texas developed a plan to use money that federal, state and local governments now spend on indigent health care to help the poor purchase health insurance. The SPN Medicaid Exchange, an initiative of the NCPA for the State Policy Network, is identifying and sharing the best ideas for health care reform with researchers and policymakers in every state.

NCPA President John C. Goodman is called the "Father of HSAs" by *The Wall Street Journal*, WebMD and the *National Journal*.

Taxes & Economic Growth.

The NCPA helped shape the pro-growth approach to tax policy during the 1990s. A package of tax cuts designed by the NCPA and the U.S. Chamber of Commerce in 1991 became the core of the Contract with America in 1994. Three of the five proposals (capital gains tax cut, Roth IRA and eliminating the Social Security earnings penalty) became law. A fourth proposal — rolling back the tax on Social Security benefits — passed the House of Representatives in summer 2002. The NCPA's proposal for an across-the-board tax cut became the centerpiece of President Bush's tax cut proposals.

NCPA research demonstrates the benefits of shifting the tax burden on work and productive investment to consumption. An NCPA study by Boston University economist Laurence Kotlikoff analyzed three versions of a consumption tax: a flat tax, a value-added tax and a national sales tax. Based on this work, Dr. Goodman wrote a full-page editorial for *Forbes* ("A Kinder, Gentler Flat Tax") advocating a version of the flat tax that is both progressive and fair.

A major NCPA study, "Wealth, Inheritance and the Estate Tax," completely undermines the claim by proponents of the estate tax that it prevents the concentration of wealth in the hands of financial dynasties. Actually, the contribution of inheritances to the distribution of wealth in the United States is surprisingly small. Senate Majority Leader Bill Frist (R-TN) and Senator Jon Kyl (R-AZ) distributed a letter to their colleagues about the study. In his letter, Sen. Frist said, "I hope this report will offer you a fresh perspective on the merits of this issue. Now is the time for us to do something about the death tax."

Retirement Reform.

With a grant from the NCPA, economists at Texas A&M University developed a model to evaluate the future of Social Security and Medicare, working under the direction of Thomas R. Saving, who for years was one of two private-sector trustees of Social Security and Medicare.

The NCPA study, "Ten Steps to Baby Boomer Retirement," shows that as 77 million baby boomers begin to retire, the nation's institutions are totally unprepared. Promises made under Social Security, Medicare and Medicaid are inadequately funded. State and local institutions are not doing better — millions of government workers are discovering that their pensions are under-funded and local governments are retrenching on post-retirement health care promises.

Pension Reform.

Pension reforms signed into law include ideas to improve 401(k)s developed and proposed by the NCPA and the Brookings Institution. Among the NCPA/Brookings 401(k) reforms are automatic enrollment of employees into companies' 401(k) plans, automatic contribution rate increases so that workers' contributions grow with their wages, and better default investment options for workers who do not make an investment choice.

The NCPA's online Social Security calculator allows visitors to discover their expected taxes and benefits and how much they would have accumulated had their taxes been invested privately.

Environment & Energy.

The NCPA's E-Team is one of the largest collections of energy and environmental policy experts and scientists who believe that sound science, economic prosperity and protecting the environment are compatible. The team seeks to correct misinformation and promote sensible solutions to energy and environment problems. A pathbreaking 2001 NCPA study showed that the costs of the Kyoto agreement to reduce carbon emissions in developed countries would far exceed any benefits.

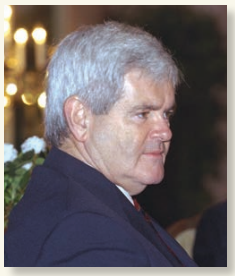
Educating the next generation.

The NCPA's Debate Central is the most comprehensive online site for free information for 400,000 U.S. high school debaters. In 2006, the site drew more than one million hits per month. Debate Central received the prestigious Templeton Freedom Prize for Student Outreach.

Promoting Ideas.

NCPA studies, ideas and experts are quoted frequently in news stories nationwide. Columns written by NCPA scholars appear regularly in national publications such as the *Wall Street Journal*, the *Washington Times*, *USA Today* and many other major-market daily newspapers, as well as on radio talk shows, on television public affairs programs, and in public policy newsletters. According to media figures from Burrelles*Luce*, more than 900,000 people daily read or hear about NCPA ideas and activities somewhere in the United States.

What Others Say About the NCPA



"The NCPA generates more analysis per dollar than any think tank in the country. It does an amazingly good job of going out and finding the right things and talking about them in intelligent ways."

Newt Gingrich, former Speaker of the U.S. House of Representatives

"We know what works. It's what the NCPA talks about: limited government, economic freedom; things like Health Savings Accounts. These things work, allowing people choices. We've seen how this created America."

John Stossel,
former co-anchor ABC-TV's *20/20*

"I don't know of any organization in America that produces better ideas with less money than the NCPA."

Phil Gramm,
former U.S. Senator

"Thank you . . . for advocating such radical causes as balanced budgets, limited government and tax reform, and to be able to try and bring power back to the people."

Tommy Thompson,
former Secretary of Health and Human Services

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