Working Paper No. 979

Is It Time to Eliminate Federal Corporate Income Taxes?

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November 2020

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ISSN 1547-366X

ABSTRACT

As the nation is experiencing the need for ever-increasing government expenditures to address COVID-19 disruptions, rebuild the nation's infrastructure, and many other worthy causes, conventional thinking calls for restoring at least a portion corporate taxes eliminated by the 2017 Tax Cuts and Jobs Act, especially from progressive circles. In this working paper, Edward Lane and L. Randall Wray examine who really pays the corporate income tax and argue that it does not serve the purposes most people believe.

The authors provide an overview of the true purposes and incidence of corporate taxation and argue that it is inefficient and largely borne by consumers and employees, not shareholders. While the authors would prefer the elimination of the corporate profits tax, they understand the conventional thinking that taxes are necessary to help finance government expenditures—even if they disagree. Accordingly, the authors present alternatives to the corporate tax that shift the burden from consumers and employees to those who benefit the most from corporate success.

KEYWORDS: Corporate Taxes; Tax Incidence; Modern Money Theory (MMT); Richard and Peggy Musgrave; Beardsley Ruml; Tax Reform

JEL CLASSIFICATIONS: B52; E12; E6; E62; G30; H20; H25

This paper examines the corporate income tax from the perspectives of both theory and policy. What is the justification for a corporate income tax? Some might point to its importance in raising revenue for the government. Others argue that it represents double taxation: shareholders are taxed on dividends and capital gains, so why also tax the corporation? Others argue that the corporate income taxes incentivize "inversions," offshoring, and transfer pricing (moving the source of profit abroad to low-tax havens). Some wonder whether it is an efficient tax, with high compliance costs borne by corporations as a result of tax-related lobbying efforts.

Given that big corporations have market power as both buyers and sellers, and given that corporations must maintain or improve their profitability in order to remain viable investments, they are most likely to shift the burden of the tax backward (to workers and suppliers) and forward (to consumers) over time. So, do corporations *really* pay the tax? If not, do we really want a tax that hits consumers and workers, taxes shareholders *twice*, and incentivizes bad decision making that is not in the national interest?

And yet there have been numerous proposals to raise the corporate tax rate and to close loopholes so that *more* corporate income gets taxed, and at a higher rate. Some of these are based on the belief that corporations are not paying their fair share given that they benefit greatly (individually and collectively) from public policy. Many believe the tax hits fat-cat management and shareholders. Others see tax hikes as a way to pay for needed social, economic, and environmental programs. Without the tax on corporations, how would government make up the revenue? Would it need to slash spending in other areas?

The new Biden administration is likely to push for at least some progressive policies, and they will be pressured to "pay for" them. During the presidential campaign, many of the Democrat candidates raised the issue of raising revenue by increasing corporate tax rates, as well as raising taxes on high-income and wealthy individuals. We believe it is likely that the debate about raising corporate profits taxes will return in coming months.

In this paper, we will first provide a quick overview of our understanding of the true purposes of taxes from the national government's point of view and that of the economy as a whole. We then use this to examine the view that higher corporate taxes are needed to pay for federal government spending. Next, we briefly examine tax rates and revenues, and then move on to an analysis of some of the corporate income tax's private and social costs, making the argument that it is a particularly inefficient tax. We revisit theories of tax incidence and tax fairness and find the corporate tax wanting in important respects. We close with our recommendations for replacing the corporate income tax.

WHAT ARE TAXES REALLY FOR?

We want to emphasize that our analysis throughout this paper concerns taxes by the national government and, in particular, the federal corporate income tax. In this section we attempt to answer the following question: From the federal government's point of view, what are taxes really *for*?

Let's first turn to two articles written by Beardsley Ruml[1] at the end of World War II ("Taxes for Revenue are Obsolete" [1946a] and "Tax Policies for Prosperity" [1946b]) that lay out the purposes of taxes. The twin experiences of the Great Depression and WWII taught Ruml, policymakers and economists more generally, of the proper role played by government in the economy and as well how to finance the massive buildup of government spending that began with Roosevelt's New Deal and was ramped up even more during WWII (when government spending reached half of GDP and the federal budget deficit peaked at 25 percent of GDP).

In "Tax Policies for Prosperity," he first emphasized that: "We must recognize that the objective of national fiscal policy is above all to maintain a sound currency and efficient financial institutions; but consistent with the basic purpose, fiscal policy should and can contribute a great deal toward obtaining a high level of productive employment and prosperity" (1946b, 266–67).

[1] He was a New Dealer who chaired the Federal Reserve Bank of NY in the 1940s and also the "father" of income tax withholding.

He goes on to argue that the US government gained the ability to pursue these goals after WWII due to two developments. The first was the creation of "a modern central bank," and the second was the sovereign issue of a currency that "is not convertible into gold or into some other commodity." With those two conditions, "[i]t follows that our federal government has final freedom from the money market in meeting its financial requirements. … National states no longer need taxes to get the wherewithal to meet their expenses" (1946b, 267–68).[2]

Why, then, does the national government need taxes? Ruml (1946b, 268) highlights four reasons[3]:

> (1) as an instrument of fiscal policy to help stabilize the purchasing power of the dollar;
> (2) to express public policy in the distribution of wealth and of income as in the case of the progressive income and estate taxes;
> (3) to express public policy in subsidizing or in penalizing various industries and economic groups; and
> (4) to isolate and assess directly the costs of certain national benefits, such as highways and social security.

The first of these is related to the inflation issue—taxes can be used to reduce demand should it be so high as to cause inflation. The second purpose is to use taxes to change the distribution of income and wealth. For example, a progressive tax system would reduce income and wealth at the top, while imposing minimal taxes on the poor—or exempting them altogether. The third purpose is to discourage bad behavior: pollution of air and water, use of tobacco and alcohol, or purchasing imports. These are often called "sin" taxes—whose purpose is to raise the cost of the perceived "sins" of smoking, gambling, purchasing luxury goods, adding to a trade deficit, and so on, in order to reduce "sin."

[2] These views are shared by Modern Money Theory; see Wray (2015).
[3] See the discussion in Wray (2015).

The fourth is to allocate the costs of specific public programs to the beneficiaries. For example, the federal portion of gasoline taxes impose costs on those who use the nation's highways (tolls on highways are another way to do this). Note that while many see these as ways to "pay for" government spending, Ruml clearly denies that view in the title to his other piece, "Taxes for Revenue are Obsolete." The national government does not need the gasoline tax to "pay for" highways; the purpose is to make those who will use highways think twice about their support for building them. He insisted, "The public purpose which is served [by the tax] should never be obscured in a tax program under the mask of raising revenue" (1946a, 268).

We can then use this notion of the public purpose to evaluate which taxes make sense. Ruml used the corporate income tax as an example of a particularly bad tax, as did Hyman Minsky—who argued for abolishing it. In the following sections we will examine arguments to support their view.

Ruml (1946b, 269) concluded both of his articles by arguing that once we understand what taxes are for, then we can go about ensuring that the overall tax revenue is at the right level: "Briefly the idea behind our tax policy should be this: that our taxes should be high enough to protect the stability of our currency, and no higher. … Now it follows from this principle that our tax rates can and should be lowered to the point where the federal budget will be balanced at what we would consider a satisfactory level of high employment."[4]

This principle is also adopted in Modern Money Theory (MMT), but with one caveat. Ruml was addressing the situation in which the external sector balance[5] could be ignored (which was not unreasonable in the early postwar period). In today's world, in which some countries have very high current account surpluses and others have high current account deficits, the principle must be modified. We would restate it as follows: tax rates should be set so that the government's budgetary outcome (whether in deficit, balanced, or in surplus) is consistent with full

[4] This is in line with Abba Lerner's well-known principles of functional finance, and as well with Milton Friedman's (1948) lesser-known proposal.
[5] "Sector balance" refers to the concept of a balance between financial flows in the public sector equating to financial flows in the government sector and international trade, an approach developed by Wynne Godley.

employment.[6] A country like the United States (with a current account deficit and a high average level of unemployment) might have a budget deficit (equal to the sum of the current account deficit and the domestic private sector surplus) even at full employment. A country like Japan (with a current account surplus) will have a relatively smaller budget deficit at full employment (equal to the domestic private sector surplus less the current account surplus). The main point remains: the government should not be adding more demand to the economy once it has reached full employment—so beyond that point, if government is going to spend more it must impose taxes or issue debt sufficient to offset the impact of its spending.

BUT "HOW YA GONNA PAY FOR IT?"

As we found out over the course of the presidential campaign last spring, those are the six scariest words any progressive policy proposal must face down. Where will you find the money to pay for Medicare for All, for the Green New Deal, for free public colleges, for student debt relief, and so on? Invariably, the favorite targets of progressives are billionaires, Wall Street, and corporations. Bernie Sanders had his billionaire tax; Elizabeth Warren had her financial transactions tax; and just about everybody had a proposal to hike taxes on corporations.

In the view of those who subscribe to MMT, the question, itself, is misguided. We'll pay for progressive policies the same way we pay for any other kind of spending: through Congressionally authorized credits to the bank accounts of suppliers and recipients of transfer payments via an approved expenditure. Really, there's no other way. Sure, we might need more taxes (or debt issuance) if aggregate demand leads to excessive inflation, if we want to punish sin or if we want to reduce inequality. But the national government does not need taxes for revenue—as Ruml argued.[7]

[6] For present purposes, we would use a broad measure of unemployment—going beyond even the U-6 definition used by the Bureau of Labor Statistics; see Dantas and Wray (2017).
[7] This is true only at the national government level.

We recognize, however, that no presidential candidate can say this in public—not even Bernie, whose main economic advisor was Stephanie Kelton, an MMT proponent. Still, progressives ought to think more deeply about such tax proposals. In our view, the favored tax proposals that are popular with progressives are misguided—at least as sources of revenue.

The first two—taxing billionaires and high-speed stock trading—each have contradictory goals. Bernie wants to tax billionaires to minimize their number if not entirely eliminate them.[8] This would lead to significant structural changes in our economy as public corporations, private equity firms, and wealthy individuals make adjustments to get billionaire wealth (or income, depending on the type of tax developed) below the taxable thresholds. Some combination of changes to reward structures, offshoring of income, charitable giving, or increased use of loopholes would reduce taxable income and wealth below thresholds. Some of these might be desired (lower pay for top CEOs, more contributions to charity) but others might not be (offshoring and using loopholes to avoid taxes).

If effective, a financial transactions tax would slow the speed and reduce the number of transactions, perhaps reducing the role of pure speculation in financial markets. One potential flipside cost is that the liquidity of financial assets included in the scheme would be reduced.

But, importantly, such taxes have an inherent contradiction: as taxes work to reduce inequality and high-speed trading, the tax revenue falls. In theory, the most effective billionaire tax would raise no revenue because it would eliminate billionaires. Similarly, if the goal is to eliminate rapid turnover in financial markets, the ideal transactions tax would raise no revenue because high-speed turnover would be taxed to death.

Of course, in the real world we will not eliminate billionaires or speculative transactions; policy never reaches the *ideal*, but the conflict between the ideal and the attempt to produce revenue should be obvious. If your policy does reduce financial transactions or succeeds in reducing the

[8] To be sure, Elizabeth Warren proposed only a very small tax on wealth—so low that she claimed it would not even hurt the billionaire class. While it might raise revenue, it would likely have only a small effect on concentration of income and wealth at the top of the distribution—by her own admission. As such, her wealth tax would do little to reduce inequality.

number of billionaires, you will be tempted to raise the tax rates to garner revenue from the remaining billionaires and high-speed traders. But that will increase your success at containing the sins of rapid trading or the continued existence of billionaires, lowering your revenue and forcing you to raise tax rates again. The logical conclusion is that you move toward the ideal: zero revenue and euthanasia of high-speed traders and billionaires.[9] Do you then celebrate or despair? The conflict is visceral.

Raising the corporate tax would appear to have much more going for it. Corporate taxes have a long history and can be justified from several angles. From inception, the idea is that corporations are supposed to serve a public purpose—which is why they get charters and special treatments such as limited liability. They receive other benefits both explicitly and implicitly. In return for these benefits—many of which are supplied by government—it is argued that they should pay taxes, their "fair share" of the costs of public provisioning.

In recent years, many of them have earned bad reputations for innumerable scandals: destruction of the environment; irresponsible treatment of employees, customers, or neighbors; offshoring to hide income and avoid taxes; inversions; union busting; selling data or inadequate protection of data from hackers; and for the shenanigans that led up the last global financial crisis. They've become a favorite enemy of many progressives, which is part of the reason why they are targeted for profits tax hikes[10]—along with other perceived "evils" like billionaires and high-speed trading.

While we are sympathetic to such justifications for corporate taxes, we think it is worthwhile to examine the wisdom of such taxes. We believe the downside to the corporate income tax outweighs any benefits and, therefore, alternatives ought to be considered.

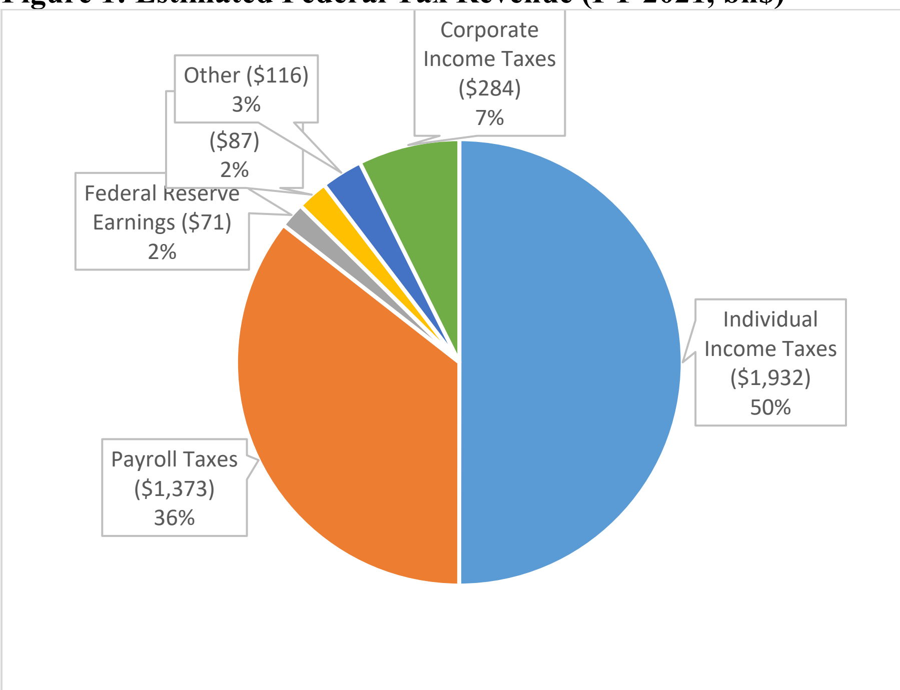
First let's look at some of the facts about corporate taxes and then move to accepted theory about their impacts. We can then assess whether it makes sense to replace them.

[9] High taxes on highly addictive behavior—say, taxes on use of crack cocaine—might escape this logic. Only experimentation can determine if high-speed trading or accumulations of billions is as addictive as OxyContin.
[10] And, of course, there are other kinds of taxes that can be added to the profits tax to target specific bad behaviors such as air pollution or job losses due to offshoring.

THE FEDERAL CORPORATE INCOME TAX TODAY

Federal tax revenue for the fiscal year ending in 2021 is estimated in the president's budget to be nearly $3.9 trillion. Of that amount, corporations are expected to pay about $284 billion or about 7.4 percent of the total. Individuals are expected to pay about 50 percent, payroll taxes are expected to amount to about 35.5 percent, and excise, estate, and other taxes plus Fed net earnings will make up the difference of about 7.1 percent (Amadeo 2020a).

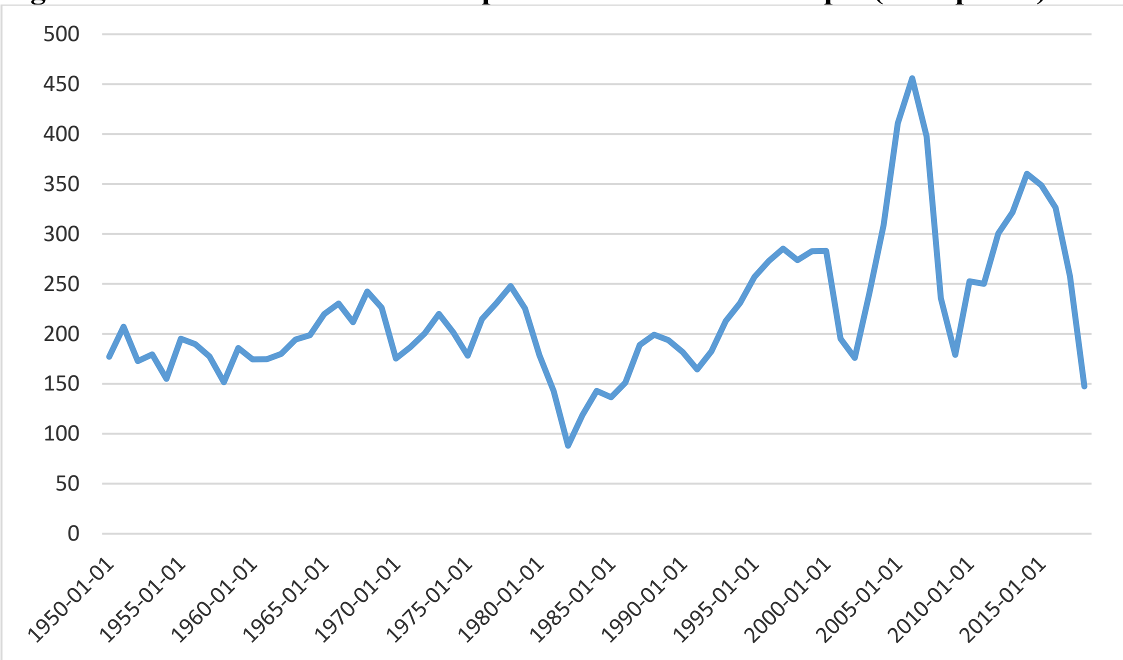
Figure 1: Estimated Federal Tax Revenue (FY 2021, bn$)



Source: Amadeo (2020a)

As the following series of figures shows, federal corporate tax revenue is highly cyclical, and also affected somewhat by changes to tax rates. The first set shows the long-term trend of receipts. In inflation adjusted terms, the trend looks like this:

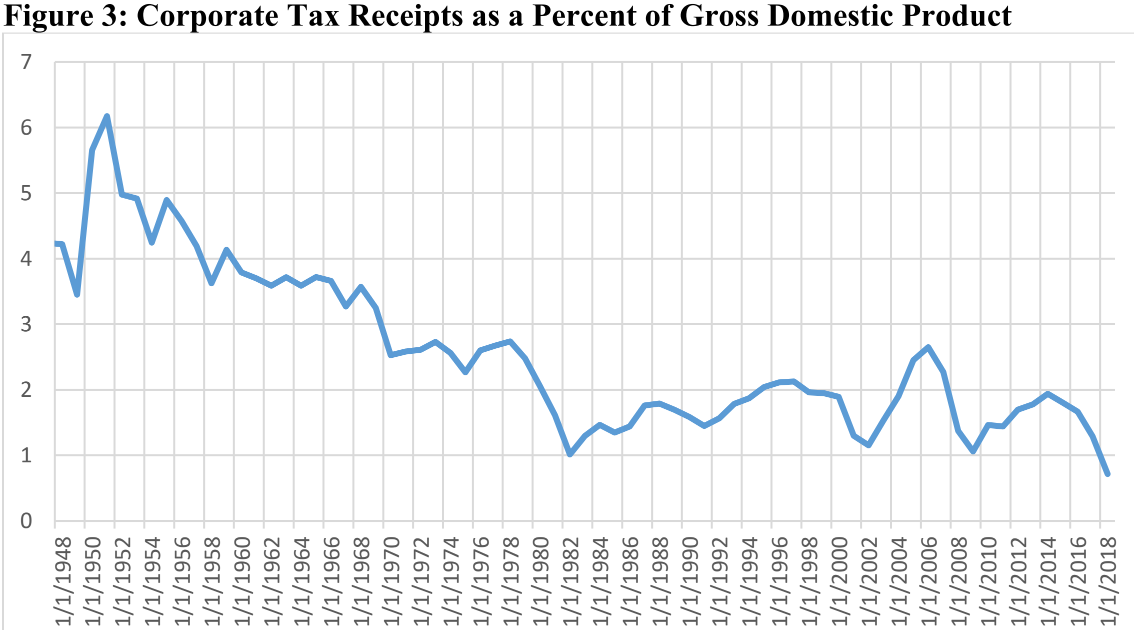
Figure 2: Federal Government Corporate Income Tax Receipts (2018 prices)



Source: Economic Research, Federal Reserve Bank of St. Louis

This next figure shows annual corporate tax receipts as a percentage of GDP have been falling on trend. The 2017 Trump tax change contributed to unusually low receipts even during an extended recovery period.

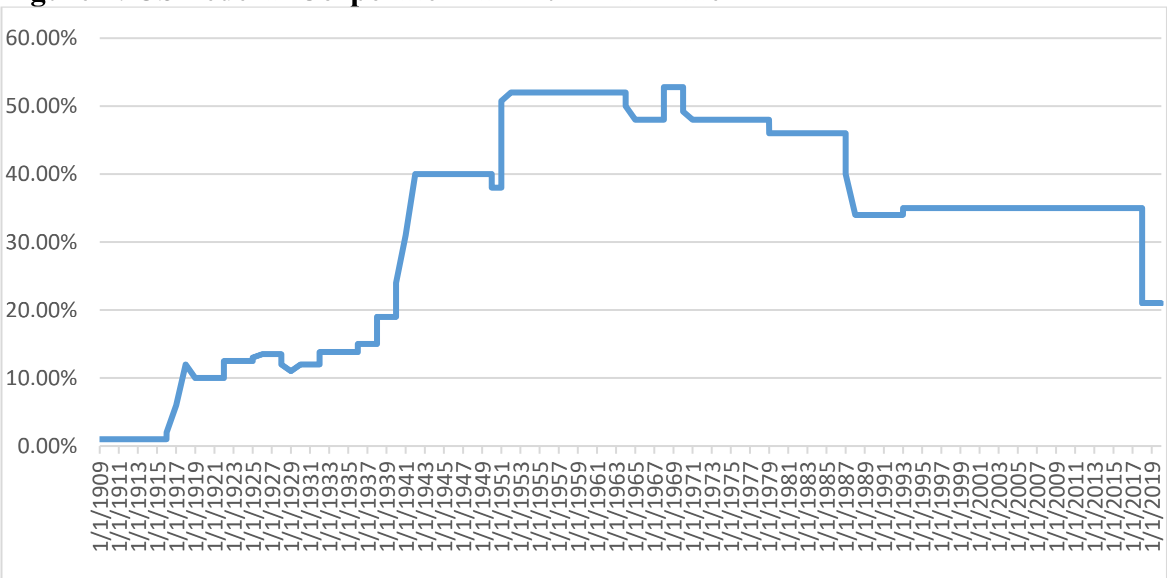
Figure 3: Corporate Tax Receipts as a Percent of Gross Domestic Product



Source: Economic Research, Federal Reserve Bank of St. Louis

Figure 4 shows ups and recent downs of the maximum statutory corporate tax rate.

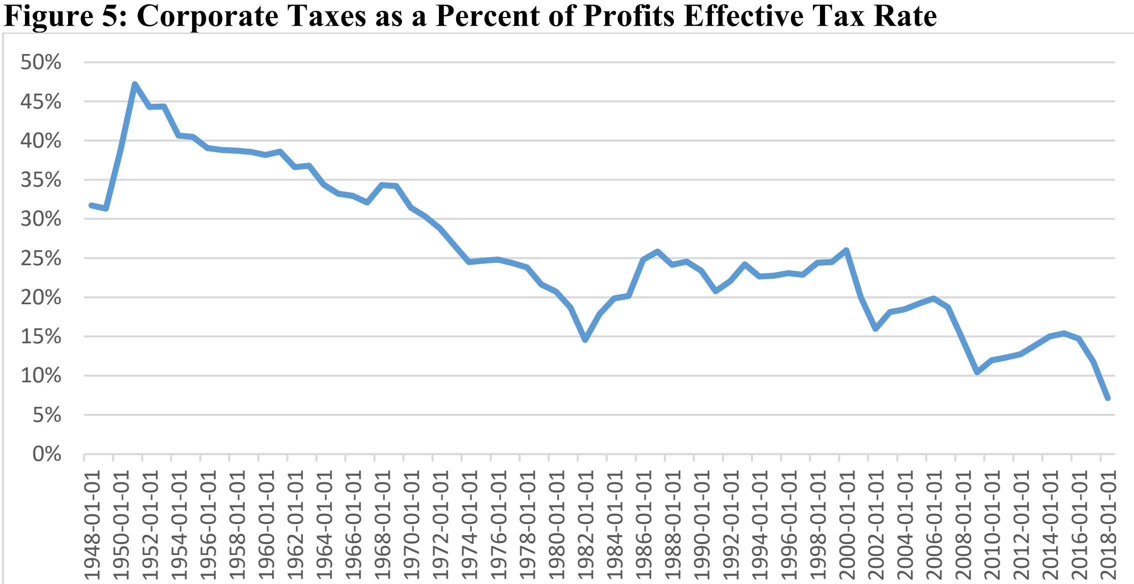
Figure 4: US Federal Corporate Maximum Tax Rate



Source: Amadeo (2020b)

The figure 5 shows the "effective" corporate tax rate—the percentage of profits actually paid as taxes—and can be compared with the above chart showing the maximum tax rate. For example, whereas the maximum statutory tax rate was 21 percent after the president's tax cuts in 2017, the actual rate of taxation for corporations in 2018 was closer to 7 percent.

Figure 5: Corporate Taxes as a Percent of Profits Effective Tax Rate



Source: Economic Research, Federal Reserve Bank of St. Louis

The upshot is that in spite of the economy's ups and downs and as well changes to tax rates, inflation-adjusted receipts from the corporate income tax averaged round $200 billion a year over the postwar period; thus, as a percent of GDP and total tax revenue, they have become much less important over time.

To put that $200 billion average revenue received in perspective, a 2016 analysis by the nonpartisan Tax Foundation found that the estimated tax compliance costs for US businesses was about $147 billion, with another $46 billion spent by owners of S-corporations (it's not likely this number went down significantly in recent years).[11] Is it any wonder the costs were so high with (at the time) 2.4 million words in the tax code, another 7.7 million words in tax regulations, and 60,000 pages of tax-related case law? If we add that cost to the taxes paid, it approximately doubles the corporate income tax's total cost of to business.

Add to that the cost of lobbying: Public Citizen, a government watchdog group, reported that over 6,200 lobbyists worked on taxes in 2017, over half of all lobbyists in Washington that year. Opensecrets.org estimated that companies spent some $3.5 billion on lobbying (not all of which was tax related) in both 2017 and 2018. (Note that lobbying expenses to influence legislation are not tax deductible [Lincoln 2017, 2018a, 2018b].)

Prior to President Trump's corporate tax reform (the Tax Cuts and Jobs Act or TCJA) that became effective in 2018, many inversions (moving corporate headquarters to low tax countries) had been undertaken to reduce federal as well as state and local tax liability. While the TCJA was meant to reduce or eliminate inversions, some attempts continue (Pomerleau 2018). Other companies avoid locating in the United States in the first place to take advantage of lower tax rates abroad. According to Allan Sloane[12] in 2014: "So far, by Fortune's count, some 60 U.S. companies have chosen the never-here or the inversion route, and others are lining up to leave… [they] include household names such as Garmin, Michael Kors, Carnival and Nielsen. Pfizer, the giant pharmaceutical company, tried to invert this spring, but the deal fell through. Medtronic,

[11] This same study (Hodge 2016) estimated that tax compliance costs for all taxpayers was $409 billion, over 2 percent of 2016 GDP.
[12] Sloan (2014) was *Fortune* magazine's senior editor at large at the time of this writing.

the big medical-device company, is trying to invert…. Walgreens is talking about inverting, too — it's easier to boost earnings by playing tax games than by fixing the way you run your stores."

He goes on:

> A major barrier to inversion used to be that companies moving offshore were kicked out of the Standard & Poor's 500-stock index. … Companies were angry at being excluded, and index investors wanted to own some of the excluded companies. Moreover, S&P feared that a competitor would set up a more inclusive, rival index. So, in June 2010, S&P changed its definition of American. Now all it takes to be in the S&P 500 is to trade on a U.S. market, be considered a U.S. filer by the Securities and Exchange Commission, and have a plurality of business and/or assets in the United States. The result: S&P now has 28 non-American companies in the 500.

He reported at the time that the corporate tax rate in Ireland stood at 12.5 percent and in Britain at 20 percent ("or less, if you make a deal"), while the US rate was 35 percent—providing a big incentive to leave. We do not know how much tax revenue is "lost" to inversions or to other attempts to offshore income, nor do we know the costs incurred by firms to avoid the corporate tax.[13] But the costs to the American economy go well beyond the lost taxes, as we must include the lost jobs and other forgone domestic spending as companies relocate jobs and source other inputs abroad—and US imports will likely increase as a result.

Alternatively, firms can use favorable "transfer pricing" to reduce the tax bill. If they own suppliers abroad, they can charge themselves high prices on inputs to production in the United States, effectively shifting profits to foreign operations where tax rates are lower: "Estimates vary as to how much tax revenue is lost by governments due to transfer mispricing. Global Financial Integrity in Washington estimates the amount at several hundred billion dollars annually. A March 2009 report estimated $1.1 trillion in bilateral trade mispricing into the EU and the US alone from non-EU countries from 2005 to 2007" (Tax Justice Network, n.d.). Although we do not have solid numbers on profits shifting to avoid taxes, it raises business costs and worsens the US current account balance—at least on paper.

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[13] Of course, corporate taxes are not the only reason that firms move abroad. They might also be escaping regulations, seeking lower wages, or undermining US labor union power—among other reasons.

We conclude that while corporate profits taxes have declined in importance, the costs to firms of complying with, and avoiding, them may be high.

WHO REALLY PAYS THE CORPORATE TAX?

It might seem silly to ask the question, but who really pays those corporate taxes? While it would appear that corporate taxes fall on shareholders through reduced profits, this is only true in the short run. In order to remain viable investments for current and potential shareholders, in the long run corporations strive to maintain and improve their profit margins—and do so by raising prices and/or cutting costs, including wage and benefit costs. Consequently, the burden of an increase in corporate taxes is ultimately shared by consumers and the factors of production, including labor (RPC 2017), with the shifting dependent on the elasticity of product revenue/demand (Bartlett 2013).

Given that the higher proportion of wealth belongs to the shareholder (wealthier) class (notwithstanding 401k ownership by working class employees), it is a safe assumption that consumers and workers, in general, ultimately bear the greater burden of corporate tax increases. Moreover, as was demonstrated following President Trump's 2017 tax changes in the TCJA resulting in a $233 billion reduction in corporate taxes over two years (Hendricks and Hanlon 2019), most of the savings went to stock buybacks and profits to shareholders (Troise 2019; Knott 2019; Bartlett 2013).

In the following figures, note the increase in stock buybacks in 2018 following the TCJA's adoption at the end of 2017.

Figure 6a: Corporate Stock Buybacks, Trend Comparison

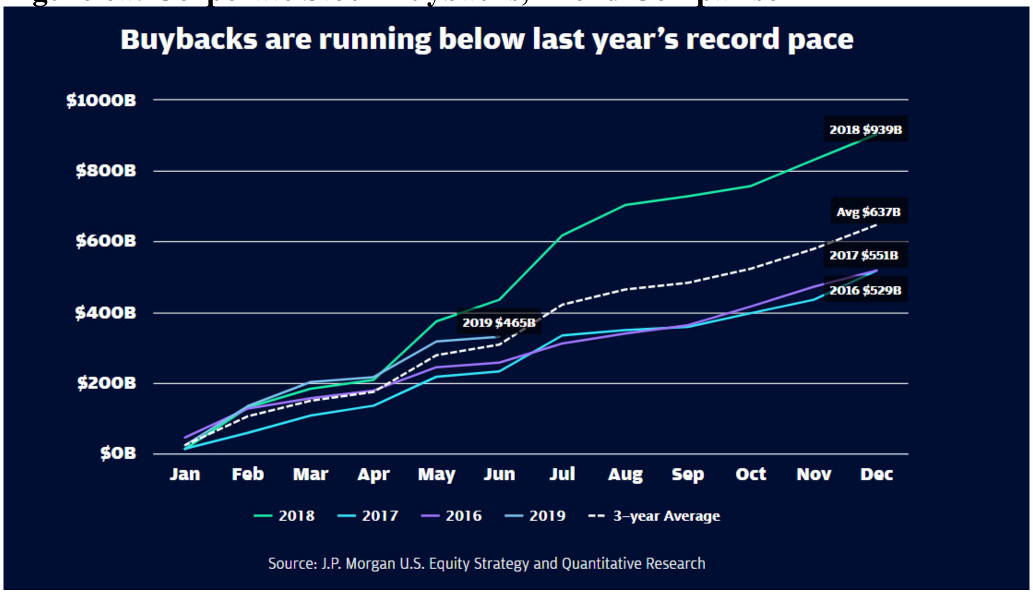
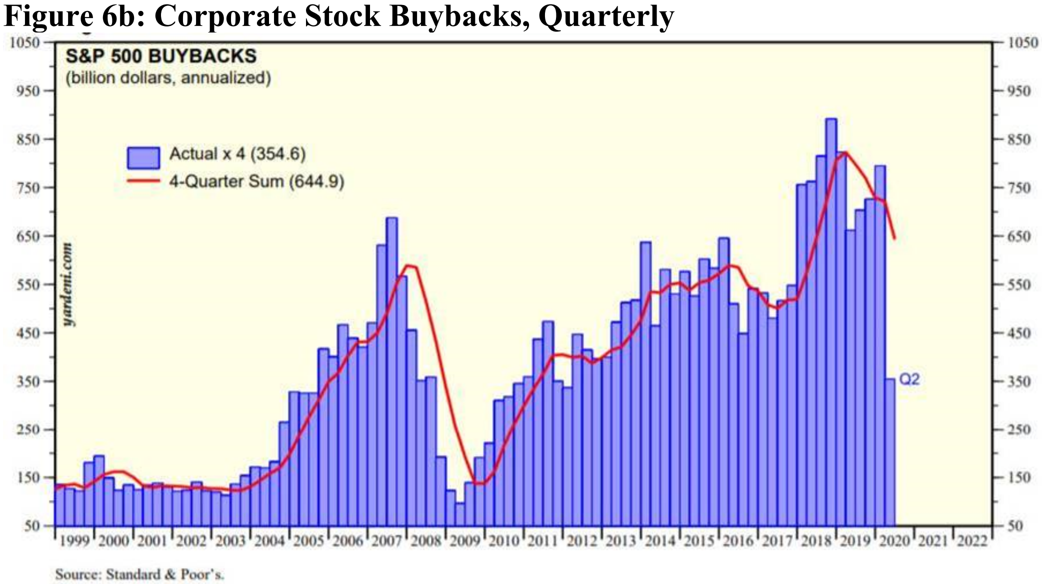


Figure 6b: Corporate Stock Buybacks, Quarterly



Once we account for tax incidence (who pays), one can look at corporate taxes as a regressive form of taxation. However, in truth, incidence is hard to measure. Further, simply because the tax is (largely?) passed to workers and consumers does not necessarily tell us it is a "bad" tax. We need to dig deeper into the principles of taxation. Fortunately, the Musgraves—Richard and Peggy—"wrote the book" on public finance, so we can use that as a guide (Musgrave and Musgrave 1984). Let's examine in some detail their theory of taxation.

Introduction to the Principles of Taxation

The Musgraves (1984, 224–45) lay out the desirable characteristics of a tax structure as follows:

> 1. "the distribution of the tax burden should be equitable"; everyone pays their "fair share";
> 2. it should "minimize interference with economic decisions," to avoid excess burdens;
> 3. where tax policy is used to achieve other objections (such as to incentivize behavior) it should be done so as to "minimize interference with the equity" of the tax system;
> 4. the "tax structure should facilitate use of fiscal policy for stabilization and growth objectives";
> 5. it should be perceived as fair and nonarbitrary and "should be understandable to the taxpayer"; and
> 6. "[a]dministration and compliance costs should be as low as is compatible with the other objectives."

In this section, we focus on points 1 and 2—which concern fairness and interference with good business decision making; we already dealt above with compliance costs.

The Musgraves (1984, 227–28) discuss two main approaches to determining what constitutes a "fair share": a) the benefit principle, where in an equitable tax system each pays according to benefits received; and b) the ability to pay, where independent of the expenditure system, each taxpayer should contribute according to ability to pay.[14] The Musgraves argue that we cannot apply the benefit principle to much of national government spending (unlike local government spending, where benefits might be more easy to determine), so we need to rely extensively on the ability to pay.

[14] They recognize this leaves aside the benefits of the expenditures, but in the real world tax policy is largely determined independently of expenditures so we need a principle divorced from expenditure; further "transfer expenditures" cannot be handled through the benefit principle, as the beneficiaries by definition cannot be expected to pay.

A corporate tax on profits would seem to be a good tax from the perspective of the ability to pay *if it were true that the burden largely hit shareholders*—but that depends on tax incidence (the topic of their chapter 12). Further, if it is difficult to avoid or evade the tax, the profits tax would also appear to satisfy both horizontal and vertical equity considerations.[15] However, the tax burden is shared by shareholders, consumers, workers, and management. Corporate shifting of the burden leads to a final distribution of tax incidence that is different from the statutory incidence.

The Musgraves (251) argue that this is especially true for the corporate profit tax. In the 1984 edition of their text, they examine the incidence of the federal corporate tax to determine effects on households by income quintiles (257).[16] Depending on assumptions adopted, they find that the bottom quintile pays 4.6–5.5 percent of its income toward the corporate profits tax, the top decile pays 5–3.7 percent of its income, and the ninth decile pays 2.4–2.9 percent of its income.[17] They conclude that the corporate profits tax is largely regressive while the federal personal income tax is progressive. If they had included another set of assumptions, with some shifting of the corporate tax to workers (in the form of lower wages), the corporate tax could be more regressive.

To be sure, there is a great deal of uncertainty over the actual incidence of the profits tax, and there have been changes to the tax code since that edition of their text. In theory, if markets are competitive, the incidence depends on the elasticities of demand. If factors are mobile, a corporate tax causes capital to flow to the noncorporate sector until the after-tax rate of return in the corporate sector rises to the untaxed sector's rate of return (which falls and so some of the burden of corporate tax burden goes to the noncorporate sector). Eventually the corporate tax burden is shared by capital in both sectors. And there can be further effects on labor and consumers—as the tax is shifted forward to consumers in prices and backward to workers through lower wages.

[15] Horizontal equity means that those with equal ability pay the same amount; Vertical equity: means that those with greater ability pay more (232).
[16] Estimates are for taxes paid in 1979. While they include estimates for state and local taxes, we focus only on the federal tax structure.
[17] The first estimate in each pair assumes the corporate tax hits capital income while the second assumes half is shifted to consumers. The first assumption results in a more regressive pattern of incidence (256).

The Musgraves argue that as the profits tax is based on income, it can be seen as a device for integrating corporate-sourced income into the individual income tax. There are two views on this:

> *Integrationist view*: "all taxes must be borne by people" (386). If profits are distributed then they are taxed twice—first as corporate income and second as dividends. As such, no corporate income tax is needed. If they are not distributed, then the rate paid by the corporation may be lower than that paid by the individual (who benefits from the impact of retained profits on shares owned). Integrationists say profits should be taxed at the individual rate whether distributed or not. This raises a problem: we must tax retained profits—and they should be taxed "similarly to other income under the individual income tax" (387).
>
> *Absolutist view*: The corporation is a separate entity with separate taxable capacity and all its profits should be taxed (387).

The Musgraves reject the absolutist view as "hardly tenable" ([387]; we might add, in spite of the Supreme Court's later ruling that corporations are people). Yes, corporations are distinct decision-making bodies and need to be regulated at the corporate level—and taxes could be useful for regulatory purposes. But in the end taxes must fall on people; their profits are incomes to individuals and should be taxed as part of individual income. And as taxes are shifted, anyway, this thwarts the effort to tax corporations (388).

If we adopt the Musgraves' approach, this will lead to a recommendation to impute corporate earnings to real people and to tax it as individual income, again resulting in double taxation if there is a corporate profits tax, as "earnings" are after tax, by definition.

If we assume that corporations could not shift the tax to workers or consumers, then it would be borne by shareholders. In that case the corporate tax would be progressive, with high-income individuals paying a higher percent of income in taxes—and its progressivity is enhanced by the "double taxation" of the income tax imposed on owners and the profits tax imposed on the corporation. (The double taxation would be a "feature not a bug" if the desire is to have progressive taxes on individuals.) However, the lower the dividend payout ratio, the less progressive the corporate tax is (because it doesn't get double-taxed)—indeed, the extra burden of double taxation turns negative for the highest incomes as payouts decline: high profit retention firms become a *tax shelter* for high-income earners (394).

The Musgraves (1984, 395) conclude that if "the corporate tax burden is viewed by comparison with a horizontally equitable system, the extra burden concept is what matters. Seen this way, the corporation tax is not progressive, and at very high incomes it becomes regressive. Integration, therefore, would increase the progressivity of the tax structure at the top of the scale." This consideration would favor elimination of the corporate income tax, replacing it with an integrationist-based approach that would impute earnings to owners and tax those earnings as regular income.

In sum, there are multiple problems with the corporate tax from a tax-theoretic perspective. It potentially creates double taxation as profits are taxed once at the level of the corporation and again as individual income if dividends are paid. This could increase progressivity of tax rates if the taxes cannot be shifted forward and backward—which is otherwise desired. However, to the degree that the tax is shifted to workers and consumers, it may be regressive (or at least less progressive than the individual income tax). Even if it is not shifted, if the corporate profits tax is lower than the individual income tax, higher-income shareholders are benefited by retained profits, turning the double taxation into a benefit for the highest earners.

In addition to these fairness issues (on the bases of horizontal and vertical equity as well as ability to pay), it is difficult to argue that tax incidence is related to benefits received from public spending—since the tax is based on profitability rather than on public spending benefiting the corporation on which the tax is imposed.

Finally, it seems plausible to us that major corporations today are under tremendous pressure to avoid, evade, or shift taxes in our hypercompetitive, globalized world. Effective tax rates have fallen considerably over the years since the Musgraves analyzed incidence—both due to reduction of legislated tax rates but also through accounting maneuvers and "offshoring" for tax purposes. If one takes the integrationist perspective, it would seem to be increasingly difficult to maintain that the corporate tax is either progressive or in the national interest.

How Might We Reform Corporate Taxes to Ensure Owners Are Taxed?

So how could we reform the tax system to ensure that shareholders—the owners of the corporations--get taxed? First, let us assume that no shifting occurs—shareholders bear the burden of corporate taxes. The Musgraves then consider two possible types of reforms given that assumption:

> a) *The partnership method*: Impute total profits to shareholders and tax them under the individual income tax: "where earnings are retained, the corporation would inform its shareholders that a specified amount has been retained on their behalf and added to their equity; the shareholders would then include this amount in computing their taxable income… Just as the corporation acts as a withholding agent for the individual income tax on the wage income of its employees, so it will act as withholding agent for the profit income of shareholders" (395–96). The corporation wouldn't need to withhold at different rates—it could withhold for everyone at, say, 25 percent. Each taxpayer then figures their own tax liability and gets a refund or pays additional tax at their marginal rate: "Shareholders, in other words, are treated for tax purposes as if they were partners in an unincorporated business. Since their tax is paid when the profits accrue, capital gains which reflect an increase in share value caused by retention of profits must then be excluded from subsequent capital gains taxation. This is done by permitting shareholders to write up the base (add to the purchase cost of their shares) by an amount equal to their share in retentions. … This procedure seems eminently fair, and it has been among the standard proposals made by tax reformers for a long time" (396).

This approach is not without its problems, however. Some argue the taxpayer would have to pay taxes on a portion of income not received and would face a liquidity problem. But with tax withholding,[18] there is no liquidity problem until tax day (at which point those who still owe

[18] Which is why Ruml proposed income tax withholding, of course—so that taxpayers wouldn't be hit with huge bills on tax day.

taxes can sell shares if necessary). And, with high churning of stocks, how do we allocate the taxes if shareholders hold stocks only briefly? This would be a serious problem today, so we might need to revisit the transactions turn-over tax after all! (And) this would amount to double taxation as profits, by definition, have been taxed at the corporate level—unless we eliminate the corporate profits tax, which is our preferred solution.)

> b) *The capital gains method*: Move to full taxation of all capital gains including the unrealized gains. An advantage is that no determination of taxable profits is needed—simply tax dividends as income and tax unrealized gains as imputed capital gains.

The Musgraves worry that this will make it difficult to give investment incentives such as investment tax credits to corporations. There is also the liquidity problem, compounded in this case by the absence of withholding. (It also is another form of double taxation as long as taxes are retained at the corporate level.)

The Musgraves also advance a more limited approach that would be dividend integration only, so that shareholders would only be taxed on dividends received. In that case, we could retain the corporate profits tax only for retained profits, while allowing a credit for dividends paid out (since those would be taxed as income). Taxpayers would then compute their individual taxes based on grossed-up income with a credit against taxes withheld by the corporation. If a generous tax deduction were allowed for the use of retained earnings for capital expenditures (but not for purchasing financial assets), public policy could push corporations in the right direction to boost real investment.

While any of these three approaches would represent a useful reform of the corporate tax system, we believe they do not go far enough and prefer replacement over reform. And, obviously, they do not deal with the problem of shifting the burden forward and backward if a corporate profits tax is retained. Still, they provide some guidance for eliminating the corporate tax and replacing it with reforms of individual taxes—as we'll discuss below.

Other Reasons for Retaining Corporate Taxes

Are there other reasons for retaining a corporate tax that we need to examine before recommending its replacement? The Musgraves (1984) consider two objections to eliminating the corporate tax—the first of which we briefly examined above:

> 1. *Benefits*: government provides benefits to corporations (388). However, as the Musgraves argue, most of these do not fall specifically on corporations alone (noncorporate business also benefits), so there should be a general tax on all firms if we are trying to impose taxes based on benefits received from public spending.[19] Further, most of the benefits of government spending come from state and local government spending, not from federal spending—justifying state and local government taxation of businesses.[20] In any case, the appropriate tax base from the benefits perspective would not be profits—which are not a good measure of government spending's benefits (they are in some sense a measure of success at taking advantage of the benefits). They conclude that perhaps the tax should be based on total business costs or value added, but certainly not on corporate profits—an argument that would even apply at the state level (a topic we are not pursuing here).
>
> 2. *Regulatory objectives*: government should control the power of monopolists. In this case, the tax should be on monopoly power, not on corporate profits. Perhaps we should simply tax bigness: the tax should be based on firm size, not on profits. We could also consider an excess profits tax in periods of emergency—i.e., in periods of high inflation when direct controls over wages and profits are needed (for example to punish profiteering during war). Or, if we wanted to stimulate investment, we could impose a tax on dividends paid out to promote retention of earnings. Of course, we already provide investment tax credits to encourage investment.

[19] S-corps and partnerships are already taxed as ordinary income. Nonpublic C-corps could be treated as public corporations for tax purposes. Still, it would be difficult to apply taxes according to benefits received.
[20] This varies greatly by sector and also by geographical reach of each firm, of course.

In both of these cases, taxes on corporations might be desired, but the Musgraves argue that the best form would not be a profits tax, and the taxes might be better administered at the state and local government level. Alternatively, we can directly regulate behavior (rather than incentivizing through taxes) and could offer direct financial incentives to promote the public interest.

Other Considerations Regarding Elimination of Corporate Taxes

An argument for eliminating corporate taxes, favored especially by conservatives, is the elimination of double taxation—the taxing of corporate income and distributed dividends. This is a fair argument but, in our view, the problem is more one of unnecessary and costly complexity than unfair taxation, as well as the incidence issues and incentivized poor decision making discussed above.

Another benefit from the elimination of corporate taxes would be a significant boost to equity prices as we saw following Trump's 2017 tax cuts. While this would certainly benefit wealthy investors, it would also be hugely beneficial to individual investors and all owners of invested IRAs and 401k (or similar) plans—not a small matter considering the retirement challenges many face today.

While eliminating corporate taxes would be good for the economy in many ways (including, but not limited to, possibly lower prices, reduced economic distortions, improved retirement income, and eliminated uncertainty from changing tax regimes), eliminating corporate taxes would create windfall gains to many shareholders and top management holding stock options. This could also generate inflation—if the windfall gains are spent. (Given that the income and wealth of the winners are well-above average, the propensity to consume is low so that inflation is probably not a major concern. Trump's big tax cuts for the rich did not generate any inflation pressure in our pre-pandemic world.)

We should, then consider a replacement for the corporate profits tax—not because the federal government needs revenue, but rather because we do not want to increase inequality. In fact, we need to reduce inequality so we will want any replacement taxes to hit higher earners.

Replacing Corporate Profits Taxes

We have argued that if the corporate profits tax is borne by shareholders it is progressive, but if it is shifted by corporations it is regressive and probably violates both of the main fairness considerations: the tax burden is not closely related to ability to pay nor is it closely related to benefits received from federal government spending. Even if it is not shifted, its excess burden is large, as administrative and compliance costs to corporations appear to be equal to much of the revenue raised. The tax apparently incentivizes inversions that are not in the national interest.[21] Our belief is that much of the tax burden is shifted and done so in a regressive manner.

A profits tax does not seem to be aligned with the goal of controlling corporations in the public interest—it is difficult to see why a barrier should be placed specifically on pursuit of profits. If a tax is to be used to control corporations, it should be placed on what is perceived to be "bad behavior"—pollution, excessive remuneration of top management, inversions, and stock buybacks. Regulation and oversight of public corporations would probably be more effective in regulating their behavior, in any event.

If the corporate tax is eliminated, there will be windfall gains and could increase aggregate demand—although unlikely, this could be inflationary (especially post-pandemic). While we do not believe it is necessary to replace lost corporate profits taxes dollar for dollar, in the interest of fairness (and as well avoiding a boost to aggregate demand—although we emphasize that this is not likely to be a serious problem even in a post-pandemic economy) we should explore reforms that would shift some of the corporate tax burden to individuals, but in a progressive manner if a replacement tax is deemed necessary.

There have been a number of proposals for new taxes. Keep in mind that corporate taxes amount to approximately $200 billion annually, around 7 percent of federal government income:

[21] While this may be less of an issue today following the TCJA, any increase in federal corporate income taxes could incentivize a new rash of inversions.

- According to estimates made by the *Wall Street Journal* (Saunders 2018) for 2017 and 2018 (the latest data available), the top 1 percent of wage earners paid approximately 40 percent of all personal income taxes, or approximately $660 billion (our estimate). The top 5 percent of wage earners paid approximately $1 billion. A 20 percent surcharge for the top 5 percent of wage earners would be an estimated $200 billion.

- Senator Warren and others proposed a "mark-to-market" or "accrual" basis of taxation on capital gains. According to the Brookings Institution, the revenue raised would be about $170 billion per year in addition to aligning the tax treatment of capital gains with the tax treatment of interest and ordinary income, a more equitable distribution of tax incidence.[22] If this idea was combined with the elimination of federal income taxes at the corporate level, along with the elimination of the problems of corporate taxation described above, the incremental revenue raised would be substantially higher, reflecting the impact on security prices of the corporate tax elimination.

Some combination of such tax reforms would completely offset the reduction of corporate taxes and place the tax burden on those who can most afford it. Of course, certain states also tax corporate income. Ideally, solutions comparable to the ones above at the federal level (surcharges and mark-to-market) could be found at the state level in order to completely eliminate the undesirable effects of corporate taxation. Unlike for the federal government, states do depend on tax revenue to finance expenditures. As far as the federal government goes, the purpose of these new taxes is not to provide revenue but to forestall windfall gains (an equality issue) and inflation (an aggregate demand issue) that could be engendered by elimination of the corporate tax. But if the states were to eliminate the corporate profits tax, they really would need to find another revenue source. The best solution would be to replace corporate taxes with more progressive income taxes (overall, state and local taxes are, on average, highly regressive). Or, better yet, have the federal government replace lost revenues.[23]

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[22] See Enda and Gale (2020a, 2020b).
[23] See Wray (2019) for a discussion of the justification for this.

As discussed, our preference would be to eliminate the corporate profits tax and replace it with progressive income taxes on the beneficiaries of corporate profits, namely, shareholders. This would mean taxing realized and unrealized equity price gains,[24] which would potentially be much higher as a consequence of eliminating taxes at the corporate level and could be structured to generate the desired revenue flow. In addition to eliminating all the distortions, inefficiencies, extra burdens, and the uncertainty about who actually pays the corporate income tax, by eliminating taxation at the corporate level, this approach has the merit of placing all businesses, publicly and privately held, on the same footing.[25]

Alternatively, if elimination of the corporate income tax is infeasible for political reasons, our recommendation would be to impose a mark-to-market tax on unrealized gains (as stated above), retain the personal income tax on dividends, and allow corporations to deduct dividend payments as they do interest payments on debt. This might discourage retaining of earnings and hence allot more of the tax burden to owners.

CONCLUSION

Above we examined Ruml's arguments against the view that tax revenue is needed to finance government spending. He also targeted the corporate income tax as a particularly bad tax that should be eliminated. He raised the issue of tax incidence—shifting the tax forward and backward—as well as the double taxation of distributed profits. In addition, he worried that corporate taxes distort decision making, inducing firms to take actions based on minimizing taxes rather than what would be good business. He pointed to taking on debt (to write-off servicing costs) and relocation to lower-tax homes as undesired consequences of the corporate profits tax.

[24] A provision for which already exists in the tax code for professional traders, namely, mark-to-market accounting.
[25] It would also eliminate the distorting effect on capital structure caused by the tax deductibility of interest payments on debt.

Hyman Minsky (1986, 340) made similar arguments, but expanded the list of incentivized undesirable behaviors: encouraging spending on advertising, marketing, and perks for executives that could be written off taxes. However, like Ruml he worried that if the corporate income tax were eliminated (without substitution), this would encourage incorporation to avoid taxes. Ruml argued that the best way to ensure that income accruing to the corporation (retained earnings) would be taxed is to allocate it to shareholders and subject it to progressive individual income taxes.

We saw that the Musgraves had come to similar conclusions: much of the tax is shifted, and largely in regressive ways. They also considered reforms to make the system more progressive, including ways to impute profits to shareholders and to tax individual income progressively.

We also examined corporate taxes from the perspective of issues of fairness, compliance costs, benefits, and regulation. The conclusion is that the tax on corporate profits is not the best way to address each of these issues. While we might not like some corporate behavior, taxing profits is not tackling the problems head on.

We have concluded that rather than raising corporate taxes to fund progressive policies, the best course of action would be to replace federal corporate income taxes with reforms that would shift the tax burden to the firms' shareholders. While we do not endorse the view that the federal government needs the revenue, we would not argue with reforms that would attempt to preserve revenue neutrality while shifting taxes from the corporations to individuals. This would almost certainly result in a more progressive tax system, as it would relieve workers and consumers of the portion of the tax that is shifted and replace that with a tax on higher income and wealth shareholders.

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