A Note On Eliminating The Corporate Income Tax

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This policy paper argues that the corporate income tax should be eliminated. The incidence of the tax continues to be debated, but in any case is opaque. We show that the elimination of the tax should increase the efficiency of corporations, lead to greater economic growth and benefit shareholders, workers, and consumers. Over time, those benefits should lead to revenue increases that fully replace and, likely augment, the current revenues generated by the tax. We analyze ways to replace the lost revenues in the shorter term keeping in mind the issue of the unequal distribution of income. We work under the assumption that the goal of the tax system is to produce a fair and transparent revenue generating structure that will help to yield a full employment and stable price economy.

INTRODUCTION

The corporate income tax has long been a controversial issue. Do corporations pay their fair share of taxes? Where does the incidence of the corporate income tax lie? Is the relatively high U.S. corporate income tax rate putting U.S. firms at a competitive disadvantage? Below we argue that there are a number of reasons for eliminating the corporate income tax. However, we do not argue that those reasons include that U.S. corporate income tax rates are too high or that taxes make U.S. companies non-competitive. The jury is still out concerning overall business taxes paid by country. We do assume that the major goal of tax policy is to have an overall tax policy that is fair and effective in generating a full employment stable price economy. We will also take into account the issue of income inequality. In what follows we will discuss the philosophical issues around taxing corporate earnings, the technical issues concerning the efficiency of the corporate income tax, methodologies for replacing revenue lost if the tax is repealed, policy implementation issues, and will end with a summary of our discussion.

PHILOSOPHICAL ISSUES

Corporations are Fictitious Legal Entities

While the Supreme Court appears to struggle with understanding the difference between fictitious and non-fictitious entities, the facts are that only non-fictitious entities, that is people, can pay taxes. Are corporations, because they are not actual people, mistreated, on net, by government tax policy? Probably not. The government subsidy given to corporate shareholders, through the legalization of the corporate form of enterprise, most likely swamps any additional costs placed on corporations via labor laws, environmental restrictions, anti-trust rules, reporting requirements, and taxes. Limited liability has reduced drastically the risk of investing in corporations; greatly lowering the cost of capital from what it would otherwise be and, consequently, stimulating economic growth by encouraging savings over current consumption. In turn, this “fact” may encourage tax policy analysts to argue that the corporate tax rate
should be even higher. The key point here, however, is that corporations are fictitious legal entities. Fictitious entities cannot pay taxes, only people can pay taxes.

The Issue of Tax Incidence

The corporate income tax ultimately has to fall on people. While the empirical evidence is somewhat mixed, most studies indicate that the incidence falls mainly on shareholders (Cronin et al. and Clausing), while noting the reverse position taken by Liu and Altshuler. This point of view is consistent with conservative folk lore that pins the incidence of the corporate income tax on shareholders. After all, the earnings of a corporation belong to the shareholders, so when they are taxed it must come from the funds that belong to shareholders. Adding insult to injury is the fact that dividends are paid out of after tax income and shareholders are taxed again on their dividend income (double taxation). Of course, there is the other side of the argument. Shareholders have quite a large array of options competing for their money. They can invest in non-corporate assets, corporate or other forms of debt, or they can allocate the funds, that they have chosen to invest, to consumption spending. While equity investors could conceivably be non-utility maximizers, we will stick with the usual optimization argument. In short, shareholders certainly would prefer more after tax money to less, but the real after tax returns earned on equity investments appear to be utility maximizing and at least sufficient enough to keep many investors in equity. Investors attempt, given a risk constraint, to maximize their real after tax returns and if those returns are not utility maximizing they would do other things with their money. This does not prove that the tax incidence does not fall on shareholders, but it does imply that the burden is not sufficient to cause mass equity exodus.

Labor, of course, can also shift their resources. While capitalists sell money resources, labor sells physical or cerebral resources. However, the cost of shifting professions and employers is generally high. The greater transactions costs make it more difficult to switch labor investments. While many financial investors may change their portfolio holdings quite frequently, most labor units will hold a far smaller number of positions. This makes labor a better target for paying the corporate income tax. Since the shareholder demands, at least on average, a particular real after tax return or they will employ their liquidity tool, it is far easier for management to switch the incidence to labor in the form of lower wages and benefits. Of course, consumers can also be targeted, but, like shareholders, they have a reasonable amount of low cost switching options.

While the theoretical argument and the empirical realities of increased income inequality all speak to the notion that the incidence of the corporate income tax falls on labor, researchers, on average, disagree. However, given the staying power of equity holders and the growing skewness of the income distribution, there is at least a suspicion that our incidence models lack the necessary richness to capture the reality of tax incidence.

In any case, regardless of where the incidence falls, it is people, not corporations, that are paying the corporate income tax. As a reasonable first cut, tax incidence should not be as opaque as it is with the corporate income tax.

TECHNICAL ISSUES

Efficiency

As noted above, the corporate system greatly increases economic growth through shareholder liability reduction. However, the corporate income tax subsidizes, or creates, an abundance of wealth destroying behaviors. First, many large corporations employ a large cadre of professionals to mitigate the corporate taxes they need to pay. These include tax accountants, tax lawyers, and lobbyists. For the most part these professionals are paid interesting sums of money to switch the tax burden to someone else. That is, if we assume the government ultimately has to pay their bills, someone will ultimately have to pay taxes to pay the bills. If corporations do not pay the bill, then someone else will. Therefore, these individuals are working solely to redistribute the tax burden. Their salaries and benefits amount to a deadweight loss to
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In the absence of the corporate income tax, these highly skilled professionals would need to find other types of employment that might be real growth augmenting. Secondly, the large amount of cost savings, due to no longer needing to pay these professionals, will further increase the profitability of the firm. In addition, spending by corporations is expensed against their taxes. Assuming a 35 percent corporate income tax rate, each dollar of expenditure reduction leads to an increase of $0.65 to the shareholder, but in the absence of the corporate income tax, it leads to an increase of $1.00. That is, the shareholder gains a greater than 50 percent increase (35/65) in earnings with the elimination of the corporate income tax for each dollar of expenditure reduction. An increase of greater than 50 percent in after tax earnings may encourage shareholders to be more mindful about corporate expenditures leading to increased economic efficiency and greater profit. The result should be greater economic growth.

All of this appears to be a win/win situation. With the elimination of the corporate income tax, shareholders will gain either directly through the reduction in their taxes, assuming at least some of the corporate tax incidence falls on them, but also through the elimination of non-productive spending. Either Labor will gain from relieving them of the tax incidence, or as non-productive expenditures are eliminated thereby increasing the profitability of firms, hopefully through increases in wages and benefits. Even consumers might benefit from less corporate waste in the form of lower prices. So why is the corporate income tax still in place? The first reason is strictly political. Corporations can earn millions or even billions of dollars and voters struggle to make the link between who writes the tax check and who pays the tax (the tax incidence). In short, the optics of eliminating the corporate income tax are politically risky. The second reason is more technical and, for policy makers, more difficult. If corporations stop paying the corporate income tax, from where will the lost tax revenues come?

In the long-run, we argue that the gains in efficiency from eliminating the corporate income tax will lead to so much additional real economic growth that the automatic increase in tax revenues that comes from economic (income) growth will more than offset the loss of the corporate tax revenues. This view has its detractors, including Gravelle at the Congressional Research Service. Unfortunately, even if we are correct in our analysis, that argument does not speak to the short-term revenue shortfall.

REPLACING THE SHORT-RUN LOSS OF REVENUES DUE TO THE REPEAL OF THE CORPORATE INCOME TAX

The typical methodology for dealing with the elimination of some form of taxation is to create a policy that is either tax, revenue, or deficit neutral. In real life that can only be done in a static environment with a bevy of questionable assumptions. That should not imply that the exercise is not useful. It creates a starting point for thinking about optimal outcomes.

Tax Neutrality

The simplest, though still both economically and politically difficult, is to create a tax neutral policy. We can project what we expect the corporate income tax receipts to be, currently around 300 billion today according to the Congressional Budget Office, and then look at other existing tax sources and calculate how much some or all of them need to be raised or base broadened in order to recapture the lost tax revenues. In real life that is difficult because the increase in tax rates on other sources will immediately increase the reward to tax avoidance in those areas. Projections need to be adjusted for those changes. Congress and the President can also attempt to reach tax revenue neutrality by closing tax loopholes. Unfortunately, the closing of loopholes is politically dangerous. Further, it is unlikely that closing loopholes can make up for the entire lost tax revenue generated by the repeal of the corporate income tax.

An Additional Problem; Income Inequality

In recent times, much has made of the inequality of income in the United States. It might seem reasonable that any changes in what is taxed, at a minimum, does not increase income inequality. Of course throwing income inequality into the mix further complicates the tax neutrality issue. If we believe that the full incidence of the corporate income tax falls on shareholders, then it may be reasonable to have
the full incidence of increased taxes elsewhere also fall on shareholders. That generally implies a direct tax on earnings on capital. However, increasing the tax on capital earnings (capital gains, dividends and interest income), without increasing the tax rate on the earned income of shareholders would lead, ceteris paribus, to a shift to consumption. Since it is known that, on average, equity holders and bondholders are in the upper income classes, the tax rates on all income would need to be more graduated. The net tax position of shareholders would then presumably be the same as before the corporate income tax elimination. Why would shareholders support such a move? The reason is that the efficiency gains from eliminating the corporate income tax will fuel better firm performance and lead to greater after tax income over time. If instead, however, we believe the incidence is shared, then the tax neutral argument would lead us to share the tax increase.

Other Issues of Tax Neutrality

Another interesting issue concerns whether or not there should be different tax rates for different sources of income. That is, should the tax rates be the same for “earned” income (income from a job) as for unearned income (income as a return to capital invested)? One way to place more of the revenue replacement burden on shareholders is to increase unearned income tax rates to a greater extent than the increase in earned income tax rates. However, as noted earlier, such a shift will reduce the incentive to save. It is also possible to tax other forms of wealth. Taxes on wealth, especially if the tax comes with a deferral amount, are likely to fall more heavily on shareholders. The wealth tax most often discussed is the estate tax, though a federal property tax or a tax on financial wealth holdings is also possible.

Of course, tax increases do not have to be in the form of an increase in income or wealth tax rates. Several tax policy researchers have argued for some type of sales tax. The most effective sales tax methodology seems to be a value-added tax (VAT) which is a sales tax at each level of production as opposed to only at the retail level. This tax form is common in much of the world. The biggest complaint is that the value added tax is typically regressive since poorer families spend a larger percentage of their income on consumption than do the rich. That is, the rich save a bigger share of their income. If that income (savings) generates excess returns (returns beyond the pure time value of money) that are not sufficiently taxed, then the rich gain relative to those who choose not to save and those who cannot save. It is possible, of course, to have higher VATs on luxury goods or other specified products. Tax revenues can also be increased by closing tax shields or lowering the amount of deductions an individual can take on certain items.

Revenue Neutrality

An alternative to tax neutrality is revenue neutrality. Here the idea is that the revenue lost from the repeal of the corporate income tax is replaced with either tax increases elsewhere or fee revenue. Government can increase fees for services of different types such as patent applications, airport security, food inspections, national park entrance, and passports. The government could even attempt to profit or increase profits involved in businesses related to their provided facilities. For example, the federal government could invest in restaurants and hotels at federal government sites. The government could also sell advertising or naming rights to government facilities. The strategy is to employ a portfolio of revenue generating variables to replace the revenue lost due to the repeal of the corporate income tax.

Deficit Neutrality

Finally, deficit neutral models can also be designed. In this case, the lost tax revenues can be offset by tax increases elsewhere, additional fee income, or budget cuts. Once again, the issue of the unequal distribution of income rears its head. Many government expenditure programs are pro poor. Cutting back on such programs is likely to shift the benefits of the elimination of the corporate income tax toward the rich thereby increasing the level of income inequality. To protect against that result, government expenditure cuts would need to come in areas where benefits are more egalitarian or oriented to benefit
the higher income classes such as cuts to the perquisites of political officials, expenditures on homeland security, or from redundant defense projects.

POLICY ISSUES

Regardless of the replacement methodology employed, at least four issues need to be considered. The first is that laying against that lost revenue problem is the probable gains in economic efficiency from eliminating the corporate income tax. We argue that the elimination of non-productive professional services, the incentive to increase the effectiveness of shareholder governance, due to the 50 percent increase in shareholder expense burden from company expenditures, and the freed up cash flow which is then available for companies to invest, will all bolster economic growth and the growth of shareholder returns and labor income. That increased income will generate government revenues to help replace the lost corporate tax revenues. Therefore, any revenue replacement strategy should be able to be backed out over time as economic growth yields automatic increases in tax revenues. Conversely, tax neutrality is likely to lead to attempts to avoid the new taxes. If the tax base is broadened and or rates are increased, economic units will almost immediately change their allocation strategies. Therefore, the likely impact of the tax change needs to be understood and the necessary policy adjustments need to be made. Third, it can be argued that the repeal of the corporate income tax creates a tax shield for the rich. That is, the rich can invest in non-dividend paying securities and gain wealth while refraining from paying taxes. As noted earlier, that issue can be offset by a tax on financial holdings. Such a tax is a wealth tax which causes cash flow concerns and would necessarily require a deferral amount since there is a notion that people should save for retirement. One can also argue that in the absence of liquidating the stock, there is little to gain in terms of a better lifestyle for the rich. In lieu of taxing wealth, a greater capital gains tax could be installed. In both cases, disincentives need to be understood. The final issue is the sensitive question of income distribution. While an egalitarian distribution of income is generally not a goal of interest, there is concern about income distributions that are viewed as too unequal. It is generally agreed that any distribution of income is consistent with current state efficient capitalism, but, on social grounds, when the income distribution is too unequal, the economic system is deemed socially flawed. Further, going forward, unequal economic opportunity tends to increase with income inequality and that does not bode well for economic growth and economic creativity. Therefore, it would be helpful if broad bands for income distribution were employed when evaluating tax and revenue strategies. Automatic mechanisms should come into force when income inequality becomes too great, such as lowering taxes on those in lower income brackets including the possibility of a negative income tax and/or increased expenditures on education, training, and health care directed at low income families and individuals. These benefits can scale back when income inequality reaches lower levels. Such a policy would require dynamic tax and expenditure planning.

The elimination of the corporate income tax raises many questions. If we assume that the repeal of the corporate income tax needs to be married to either a tax neutral, revenue neutral or deficit neutral policy, we strongly suggest that flexible strategies be modeled. We understand that it is likely that only one strategy can be employed at a time, but we think that it is important to be creative and flexible.

The Goal of Tax Policy

What is the goal of tax policy? As noted above, this study works under the assumption that the major goal is to have an overall tax policy that is fair and effective in generating a full employment stable price economy. We also need to consider whether income inequality should be prominent in any policy choices. Given the goals, should the implementation of the corporate tax repeal be tax, revenue, or deficit neutral? Once that question is answered, “hard” goals need to be established and a generally accepted legislative policy applied. If the goals are not reached in a reasonable time, a new policy should be tried and that should be part of the original agreement. In public policy, creativity and flexibility are likely to lead to better outcomes than will political intransigence.
SUMMARY

We argue on philosophical and efficiency grounds that the corporate income tax should be repealed. Only people can pay taxes, and this particular tax has led to a bevy of ineffective and wasteful business practices. Further, there remains some controversy around the incidence of the tax. We argue that the elimination of the corporate income tax is likely to improve efficiency and stimulate economic growth. While the discussion of tax policy necessarily focuses on revenue generation, we believe it should primarily serve long-term economic goals.

A typical starting point for practical tax policy implementation is to ask from where will the lost revenue, caused by the elimination of the corporate income tax, come. Tax, revenue, or deficit neutral models can all be employed as a starting point for discussion, but any changes in where money comes from will alter incentives to the point where either more or less revenue will be generated than would the steady state models suggest. Models analyzing the impact of increased income or wealth taxes [caused by rate increases, rate broadening, or tax shield decreases], value added taxes, increased fee income, government expenditure cuts, or a combination of these policies should all be considered. We argue that hard goals should be established and creative and flexible policies should be implemented. Policies that do not work should be altered in quick order.

We believe that eliminating the corporate income tax will make the tax system more transparent and will lead to greater economic efficiency. In considering tax, revenue, or deficit neutrality we suggest that the issue of income inequality in the United States be considered and employed as a constraint to effective corporate income tax repeal policy. Repealing the corporate income tax should not be about gifting U.S. equity holders. It should be about establishing a tax regime that is more effective in reaching the goal of full employment and stable prices.

REFERENCES


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