EconoFact Chats – Taxing Corporations: Efficiency, Equity, and Revenue
Kimberly Clausing, UCLA
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I'm Michael Klein, executive editor of EconoFact, a nonpartisan, web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein
The recent debate over raising the debt ceiling highlighted the fiscal challenges facing the United States. The national debt held by the public was 97 percent of national income at the end of 2022, and the government budget deficit that year was $1.36 trillion, representing 5.4 percent of GDP. Much of the debate over raising the debt ceiling centered on cutting spending. But of course the other way to lower the deficit would be to raise taxes. In particular, there has been a debate about the tax on corporations, which was lowered starting in 2018 under the Tax Cuts and Jobs Act. Raising the corporate tax could raise revenues, but would it also lead to reduced economic activity, companies moving offshore and a less dynamic entrepreneurial economy? To address these questions, I'm joined today by Professor Kimberly Clausing. Kimberly, an economist, is the Eric M. Zolt Professor of Tax Law and Policy at the UCLA School of Law. She's a recognized expert on public finance, and testified before the U.S. Senate Committee on the budget this past spring. Kim, welcome to Econofact Chats.

Kimberly Clausing
Thanks so much, Michael. It's a pleasure to be here.

Michael Klein
Kim, the Senate Budget Committee invited you to testify about the corporate tax. How much revenue does the federal government receive from the corporate tax, as opposed to other taxes like the personal income tax?

Kimberly Clausing
So if you look at the average over the last five years, the federal government raises about 17 percent of GDP in tax revenue from all sources, a little under a fifth of the size of the economy, and about half of that revenue comes from the individual income tax. Another third comes from the payroll tax that people pay on their wages, and corporate taxes account for about 7 percent of that total.

Michael Klein
Some people argue that the corporate tax represents double taxation. Corporate profits are taxed, and then the distributed dividends or capital gains are also taxed as personal income. What are some of the arguments for and arguments against an entity tax, that is, the tax on corporations, as opposed to just taxing personal income?

Kimberly Clausing
So ultimately the tax system is trying to do a few things. It wants to raise revenue, and it wants to do that as fairly and efficiently as possible. I mean, that would be the goal of tax policy in general. Taxing capital income is an important part of that. You don't want to leave one part of the tax base. For one thing people could try to disguise capital income as labor income. Then the question is how to get to the capital income. First, I think it's important to note that U.S. equity income, in many cases, is not double taxed. If you look at the U.S. government, less than 30 percent of U.S. equity income is taxed at the individual level. It's only taxed at the corporate level. The reason why is a lot of that income is held in non-taxable accounts, or by non-taxable entities. Examples would be foreigners, or retirement savings accounts where you don't pay as the capital income accrues, or 529 accounts, or endowments like the Harvard endowment that doesn't pay tax. One option would be to better tax the individual level and say, okay, we're not going to tax entities, but we're going to tax individuals when they earn capital income, but it'd be very hard to undo those preferences. You can't reach the foreigners because their own governments are taxing them, and you don't want to undo these retirement and endowment preferences and other things like that. That leaves the entity levels the main way to get to capital income. It's easier for practical reasons, but it also might be easier politically because it's easier to get people behind the idea that we might tax Microsoft or Amazon than to say, oh, we're going to tax your retirement. It's also a tool for affecting corporate behavior. If you're not taxing corporations, you can't nudge them one way or another by giving them a tax break. And sometimes that's something we want to do as we see recently, for instance, with the green energy tax credits. But also there are market power reasons to think about this too, and we can get to those later.

Michael Klein
In a recent analysis that you wrote, you discussed corporate taxation when corporations make what economists call excess profits. What's meant by excess profits as opposed to, say, normal profits? And how do we know that these excess profits are not just a reward for taking big risks or being entrepreneurial?

Kimberly Clausing
Yeah, so if you kind of go back to intro economics, when we first teach how firms behave, we often talk about a hyper-competitive industry. And one example might be wheat farmers. Wheat farmers earn just enough to cover the costs of labor, their costs of capital, but they don't tend to

earn more. And if they did, that would attract entry into the wheat farming industry. If they start to lose money, that causes exit. And we think of those types of firms as not earning what economists would refer to as economic profit. An economic profit is profit above and beyond what it takes to reward capital and labor with their normal going returns. So in our economy, the corporate tax base, though, is mostly comprised of a different kind of firm from the wheat farmer. And much more of these normal returns that the wheat farmer earns are already tax exempt. We allow deductions for labor. We allow deductions for interest, finance, investment. And in many years, we offer full expensing for many other types of investment. So that means that the corporate tax base ends up falling on these profits that are above that normal return. And those profits can result from market power. They can result from luck. They could be a result of some key resource that the company controls. So if you're thinking about a big tech company or a big pharma company or a big oil company, those are the kinds that we might expect to earn these rents or above normal returns. One statistic that might be useful for thinking about this is there are about 500,000 companies or corporations in the U.S. economy and less than 2,000 of them, so about less than one half of 1%, are accounting for 87% of the corporate tax base. So there's a lot of wheat farmers out there or small firms that aren't earning above normal profits and aren't really paying a lot of corporate tax. But there are a handful of firms – about 2,000 – that are really comprising most of the corporate tax base. And they're larger than normal and they're much more likely to be earning economic rents.

Michael Klein
There's been talk lately of a windfall tax, for example, on oil companies that enjoyed large profits because of the spike in the price of oil after the invasion of Ukraine. So I guess that would be an example of excess profits as well, right?

Kimberly Clausing
Yes. And I think a good corporate tax system could handle that kind of situation already because if you think about the corporate tax base, it's really close to already being a tax on windfall profits. So if oil prices go up due to a political event, that's going to automatically generate corporate profits. And if we have a reliable corporate tax system, it should already be taxing those profits as we go.

Michael Klein
So you spoke earlier about the arguments for an entity tax that is a tax on corporations, not just an income tax. How does the existence of windfall profits or excess profits alter the best way to approach corporate taxation? Should tax policy be different in the presence of these excess profits as compared to when corporations make normal profits?

Kimberly Clausing
You know, I think it should be. And part of the reason why is there's just a lot of evidence from the literature, not just in public, but in industrial organization and elsewhere that documents this sort of big rise in the importance of market power and rents in the U.S. economy. And you can see that in the data on markups. You could see that in the data on firm concentration, rising profit shares of GDP, falling labor shares, all of these data sort of point to the importance of market power. And that has implications for our tax system. If you're taxing companies that have market power, you're more likely to have a more efficient tax. And one way of thinking about that is to kind of go back to the wheat farmer. Like, if you tax the wheat farmer, they don't have room to pay a lot of tax without altering something that they're doing, right? They might hire fewer workers or they might invest in fewer tractors. You know, that can have consequences for the efficiency of their farm. But if you're taxing a big company that has above normal returns, right, they're earning more than they need for all of the decisions that they're making. And if you take some slice of that extra profit, it's not like they're going to then decide to change their optimizing decisions about capital or labor or hiring, right? So you can grab some of that profit without having big consequences for the economy. And that makes the tax more efficient, but it also makes it more progressive. Because if we think about who's going to bear the burden of that tax, when you're taxing the excess profit, it's more likely to burden the shareholders. Whereas when you're taxing the wheat farmer, they're going to have to do something differently and that could result in fewer tractors for, you know, each worker to work with which could reduce wages, right? So we think that the tax and the normal return to capital is going to have more distortion, but it's also more likely to impact, you know, the workers and other people in the economy.

Michael Klein
So you just raised two important issues in public finance and I'd like you to just explain those a little bit. One is efficiency and the other is progressivity. So can you explain very briefly what do we mean as economists when we talk about the efficiency of a tax system, and what do we mean as economists when we talk about the progressivity of the tax system?

Kimberly Clausing
Yeah, those are really good questions. So by efficiency, we mean that it's not distorting the economy away from, you know, what it would ordinarily be doing. And of course, you're going to have some distortions with almost every type of tax. Like there's only two that I could think of that aren't distortionary, a head tax where you're just taxing people for existing and that's very unpopular. It led to the downfall of the British government once when they proposed something like that. And the other is what is sometimes referred to as a Pigouvian tax, where you tax something that's bad that the economy overproduces. So an example would be a carbon tax, right? That is kind of a wonderful tax instrument because you can actually move the economy towards something more efficient if it's overproducing carbon, at the same time that you're collecting revenue. But as we noticed at the beginning, you're like mostly we're taxing things like

labor. And, you know, when you tax labor, that's going to have inefficiency too, right? So, you know, there's the difficulty in public finance is trying to generate adequate revenue, not while having zero distortion, because that's hard to get to, but while minimizing, you know, extra distortion that you might be creating by putting in too many, you know, behavior altering features of the tax code, right? So that's the efficiency side. The progressivity side is the idea that ability to pay should influence how much we tax. So for instance, we think shareholders are richer on average than labor earners. And you can tell this with the data, like the top 1% of households in the United States control about 52% of positive capital income; that's income earned by profitable companies. But they control a much, much lower fraction of labor income. I think the number is 12%, but I'd have to check it. All these numbers are coming from the Treasury distribution tables that you can look up online. So if you look at that, to have a progressive tax system, you want to be able to tax capital income because it's much more concentrated among the rich than is labor income. So a second goal in addition to trying to reduce distortion is to try to make sure that, you know, you're not overly burdening those with the lowest incomes in society and that you're collecting what's deemed to be a fair amount from those at the top. Now there's going to be disagreements about how much that would be. But almost everyone thinks that the rich should pay more than the poor, even as a share of their income.

Michael Klein
So you've told us what the best policy would be. You've told us about the progressivity. But in fact, what are the features of the US corporate tax system? What types of activities does it promote? What does it discourage? And in fact, how progressive is it?

Kimberly Clausing
Yeah, so our tax system, if you look at the corporate side, I think needs a lot of work. For one thing, it gives a big edge to large companies relative to small companies, and that kind of works against some of the efficiency goals that we just talked about. If you're a big multinational company, you can move profit offshore. That profit is tax preferred compared to domestic profit, right? So that gives these companies an incentive to earn income abroad rather than earning it at home. And it also lets them have lower tax rates than the small companies, right? So if you're kind of encouraging, through the tax code, the big companies to get bigger, and you're making the small companies pay more, you're also kind of inhibiting the free functioning of capitalism itself, where we kind of count on competition among firms to erode excess profits. But instead, the tax system is putting a thumb on the scale for the big guys, right? So I suggest in some of my work that we do the opposite, that we kind of try to tax these enormous companies a little more heavily than we're taxing the small guys, right? And that can raise a lot of revenue without affecting, you know, 99% of companies, because most of them are really small. There's other ways, of course, that you can affect the efficiency of the economy through the corporate tax system. And our tax system does try to put a thumb on the scale in favor of some beneficial

things that companies do. So examples would be R&D or research and development, and clean energy, right? Right now you can get some big tax credits if you invest in clean energy. Research and experimentation has always been tax preferred in our tax code; a little less so this past year than in general. But, you know, those are both ways that we usefully encourage some types of behavior by giving tax breaks as well.

Michael Klein
Kim, you mentioned offshoring, and a big issue related to corporate taxation is the concern that companies will shift their headquarters, or the [inaudible] site of sales to take advantage of tax differentials across countries. There have been some efforts to establish a global minimum tax. Would raising corporate taxes lead to more tax avoidance? And if so, what can be done about this?

Kimberly Clausing
I think the first starting point for thinking about this question is to distinguish two types of ways that companies respond to taxes. So one is a real response, like you get taxed more and you move actual economic activity to another country like factories and jobs, right? And the other is a financial response where you get taxed more and you're like, oh, we're still going to do what we were doing, but we're going to report the profit offshore, right? And we think both types of tax responses exist, but the data suggests in a really clear and compelling way that this financial response is really quite large. And if you look at sort of recent years, you can see an enormous amount of profit in some of these rock bottom tax rate jurisdictions where you can get profits per employee that are in the millions or tens of millions of dollars, whereas worldwide, the average would be just in the tens of thousands of dollars. So orders of magnitude higher profit in these little tiny rock bottom tax sanctuary jurisdictions. So what the international agreement is trying to do is lower the pressures on the tax base that come from having these really low tax rate jurisdictions out there in the world. And it does this in a sort of clever way, like first of all, about 95% of the world economy signed up to this agreement in 2021. So there was a very comprehensive agreement. It sort of started with a smaller set of countries, but expanded outward to reach most of them. But it also comes with an enforcement mechanism, which is nice. So the agreement sort of says, okay, we're all going to tax this multinational income at least 15 percent. You can go higher if you want, and many countries will choose to do so, but you're going to, the minimum is going to be 15, not zero. So that's helpful. But let's say you don't adopt. So the concern is always what happens if you get a country that decides to just not join this club, and then erode everybody with a zero rate nonetheless. Well, in this instance, there's also something called the under tax payments rule that says if you're a company and you want to serve, say the European Union or the Japanese market, and you're operating there, then you have to be subject to that 15 percent minimum tax, even if you're based in some country that's decided it's not going to adopt. So it applies that sort of threshold 15 percent to any company in the world that wants to

serve an adopting market. And so that kind of makes the agreement hold together more than it would if one country could defect and just unravel it.

Michael Klein
What's the likelihood that, in fact, this will be enacted and go into effect?

Kimberly Clausing
So already it's basically happening. We've got a number of really important jurisdictions that are implementing as we speak. The European Union has passed a directive that instructs every country to implement and many of them are moving forward and all are expected to move forward in the next year or so. Japan, Korea, the UK, Canada, Australia, and New Zealand have adopted it. So if you think about a US multinational and you ask, are they operating in one of those countries? The answer in almost all cases is going to be yes. So it's reaching US multinationals. It's reaching Chinese multinationals. It's reaching all the major players already. So even if not another single country does anything, I think it will come into effect and have some of the intended consequences. But as I mentioned, there is a strong intention of the majority of the world economy to join in, in part because they view this as solving a global collective action problem. It's very difficult to have a fair and efficient tax system if you can't reach capital income. And this mobile capital income, partly because we live in this nice open global economy, this mobile capital income is very hard to tax if you can't cooperate with other countries. So this is a huge step forward, I think.

Michael Klein
Another concern, Kim, is that raising corporate taxes would cause a loss of entrepreneurship and dynamism in an economy. What's the evidence on this? Is their argument just a version of trickle down economics?

Kimberly Clausing
There isn't a lot of evidence that this is a big concern at the types of tax rates that we're talking about. I think if you had more expropriative tax rates, you could imagine this being a concern. Like let's say I tell you that I'm going to take 80% of everything you do, you might be less likely to do things. But Warren Buffett once said that he never met an investor that didn't undertake an opportunity for tax reasons. And I think there's a lot of entrepreneurs and investors who are going to do what they're going to do, whether the tax rate is 10 percent or 20 or 30, like in those ranges. And if you look at the literature here, it's a little hard to see a link, but it's also a little hard to control for everything that you might want to control for. You've got this problem that you don't have a lot of great experiments out there that aren't simultaneously affecting a lot of other things. So I think it's a little bit of a muddy research area. But I think one important thing that all public finance economists should remember is that there are a lot of other policy levers that affect those kinds of things. So if we're really interested in entrepreneurship, for instance, the

kinds of things that I would want to focus on as a policymaker are things like immigration policy. Like we know immigrants are disproportionately entrepreneurial. They've founded a lot of great American companies. So the more open you are to the talents of the world, the more likely you are to have an entrepreneurial culture. Skills of the labor force, that translates into successful business activity too. Are your institutions stable? Are you open to the world economy? Are you avoiding things like war and conflict? Those are really first order things that determine how successful your culture will be for encouraging entrepreneurship. Tax is important. You don't want to mess things up by having an expropriative level of tax. But I think you can come along and take a fifth or a third of excess profits without really affecting anything on the entrepreneurial culture front.

Michael Klein
So Kim, if you're elected President in 2024 – I guess you haven't declared yet, right? Unlike lots of other people. But if you were elected President and then you had your hands on the lever of corporate tax policy, what would you like to see instituted? Policies that would raise revenue, maybe be more progressive, but not lead to offshoring or the throttling of economic activity. And even if you were President, could the political system support these changes in the face of the influence of special interests?

Kimberly Clausing
Yes. So I don't think I would have to be President because I think luckily the President that we have right now is already kind of interested in the types of corporate tax reforms that I happen to be interested in. I think the more difficult matter is Congress. And you sort of alluded to what might stand between us and good policy here. And I do think that concentrated interests can be very influential in Congress in a way that makes corporate tax reform difficult. Like if you look at voters and you ask them, do you think corporations should pay a fair amount of tax similar to what workers pay? Almost all voters are going to say yes to that question. They think the tax burden on corporate shareholders should be higher than it is now. And they want it to be closer to what they pay in terms of taxes. And so if you look at the Biden proposals, the Biden administration suggests raising the main corporate rate to 28%, but also raising the foreign income rate to be closer to that main rate to be three quarters of it at 21%. If you couple that with the international agreement where the minimum is 15%, you're charging a little bit higher on foreign income in the United States, but only a 6% difference from what the rock bottom is in the rest of the world. So that's pretty sustainable on a competitiveness front. And that package of reforms getting to 28 on the corporate side and 21 for foreign income could raise an enormous amount of revenue. That revenue would be very useful for offsetting deficits, for addressing urgent fiscal priorities, and for lowering tax burdens elsewhere in the system. There's a lot of things you can do with revenue, but I think that that's a pretty fair and a pretty efficient place to look for some more revenue when we're looking at those kinds of fiscal needs in the future.

Michael Klein
So I guess one of the advantages of you not running for President is that instead of going to Iowa and New Hampshire in the coming months, you can work more on your research, which is important because you're very influential and your insights have been very appreciated. And I appreciate you sharing them with our listeners today. So Kim, thanks for being on EconoFact Chats.

Kimberly Clausing
Thanks so much for having me. It's been a pleasure talking with you about these issues.

Michael Klein
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