**The Corporate Tax Myth**
By R. Glenn Hubbard
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Today Treasury Secretary Hank Paulson will lead a discussion on the effects of the corporate tax on our economy. It will, in part, be a political discussion, as Democrats want to increase taxes on corporate capital while Republicans want to cut the corporate tax rate (a position championed by President George W. Bush).

But the more interesting part of the discussion may well come on two issues: Whether corporate taxes are an effective way to raise revenue for the government. And, importantly, who really pays the tax.

Economists have stressed for generations that corporate taxes distort the allocation of capital between the corporate and noncorporate sectors and that they also distort corporate investing and financing decisions. This distortion prevents the tax from "efficiently" raising revenue -- that is, the tax imposes a larger cost on the economy than it raises in revenue.

In the early 1990s, both the Treasury Department and the American Law Institute recommended removing one layer of our current double taxation of corporate equity capital, which is subject not only to the corporate tax but to investor-level taxes on dividends and capital gains. In 2003, President Bush's tax cuts reduced -- though they didn't eliminate -- this double taxation.

That the corporate tax is inefficient in these ways is not controversial among economists.

A traditionally less-settled question has been one of incidence: Who bears the corporate tax burden? Some may be tempted with a quick answer, "corporations." But that is clearly wrong. The Econ 101 admonition that people pay taxes -- in this case, suppliers of capital through lower returns, workers through lower wages, and/or consumers through higher prices -- remains true even when the tax is aimed at capital. And the category "owners of corporate capital" (that is, stockholders) is also too narrow. In his celebrated analysis of the corporate tax almost 50 years ago, Arnold Harberger showed, for a closed economy, that a separate tax on corporate capital would reduce returns to all owners of capital, making it a tax on saving (and, in a framework more general than Mr. Harberger's, on investment).

Recent research has cast an eye in a somewhat different direction, showing that the tax may be borne not entirely (or even principally) by owners of capital, but by workers. Globalization plays a role. In an open economy, with mobile capital, a source-based tax like the corporate tax will lead to a capital outflow, reducing investment and productivity and wages. Indeed, Mr. Harberger's updated research on the incidence of the corporate tax concluded that labor bears not just the brunt of the tax, but a burden that may be larger than the tax itself.

In other research assuming that the world-wide capital stock is fixed, William Randolph of the Congressional Budget Office finds that labor bears about 70% of the corporate tax. More generally, the burden on labor is higher to the extent that saving is responsive to after-tax returns and the country has a small effect on world prices of goods.

Most of this research has relied on theoretical models, albeit sometimes with parameters calibrated from actual experience. But direct empirical tests of the effects of openness, corporate taxes and their combination on workers' wages tell a similar story.

A recent paper by Kevin Hassett and Aparna Mathur of the American Enterprise Institute analyzes data across countries and over time, concluding that for countries that are part of the Organization for Economic Cooperation and Development (OECD), a 1% increase in corporate tax rates results in a 0.8% decrease in manufacturing wage rates. (Economic intuition suggests significant negative effects of the corporate tax on manufacturing wages because of the complementarity of capital and labor for skilled workers.)

Wage effects of this size suggest labor bears much of the burden of the corporate tax. In fact, workers collectively would be better off if they voted for higher taxes on labor with corresponding cuts in the corporate tax.

Sound crazy? Well, while this economic research has been carried out in the U.S., tax action has occurred abroad. Not only has the U.S. corporate tax rate been high by the standards of the rest of the industrial world, but other countries continue to reduce their rates.

A recent survey and study by KPMG shows, for example, that competition for investment continues to drive down tax rates around the globe, with further cuts in the pipeline from China, Germany, Singapore and Britain, among others. The desire for these cuts comes in part from the significant responsiveness both of real investment and taxable income to corporate tax rates.

Among our European competitors, reductions in corporate tax rates are being financed by increases in consumption taxes, akin to the "vote" I described earlier. This is also similar to the fundamental tax reform advocated by many economists, where corporate taxes are replaced by consumption taxes.

How much offsetting revenue (or lower government spending) would we need to finance a cut in corporate taxes? The answer is not entirely clear. The old economists' maxim of "broaden the base, lower the rates" is sound advice, though economically wise base-broadening alone is not likely to finance a significant rate cut.

Recent research by Michael Devereux of the University of Warwick suggests, though, that the revenue-maximizing corporate tax rate in OECD countries is likely less than 30%. That is, higher corporate investment (and subsequent corporate profits and corporate tax revenue) and shifts in taxable income by multinational firms will substantially reduce the revenue "cost" of a corporate rate cut from the present 35% to, say, 30%.

Cutting the corporate tax rate would be positive for investment, productivity and economic growth. It would also reduce a tax burden now borne in large part (or even entirely) by labor, bolstering wages. And business responses to the tax cut will offset much of the "static" revenue cost.

I think Secretary Paulson is on to something.

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