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Corporate Taxation in a Modern Monetary Economy:

Legal History, Theory, Prospects

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Abstract

Corporate taxation is a perennially controversial topic in American politics. In fact, it may be the tax policy controversy that most Americans are aware of and even have an opinion about. Nevertheless, the purpose of corporate taxation is unclear in popular, or even for that matter, academic, discourse. In this paper we lay out and critically evaluate contemporary and historical corporate tax policy debates based on three common justifications for taxation: the "revenue" justification, the "distribution" justification, and the "behavior" justification. The revenue theory argues that the purpose of taxes is to raise the money required to finance expenditures. The distribution theory argues that certain taxes are required to produce desirable distributional outcomes. The behavior theory argues that certain taxes are required to change organizational and individual behavior in ways that benefit society.

This paper will trace the application of these justifications in American corporate tax law debates from the late nineteenth century through to the present, and analyze the implications of these debates to the contemporary corporate income tax debate. In particular, we argue that: a) following the observation made in 1946 by former President of the New York Federal Reserve Beardsley Ruml that, in the context of a modern government with a non-convertible currency, a floating exchange-rate, and its own central bank, "taxes for revenue are obsolete," the revenue theory is empirically false; b) The distribution theory case for the modern corporate income tax is weak; and c) from the perspective of the behavior theory, the modern corporate income tax has strongly perverse impacts on corporate behavior.

Keywords: corporate income tax, money, taxation, the firm, market structure, fiscal policy, revenue, firm behavior

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“[T]hese great aggregations of capital owe their very existence to the operation of law. They are the creations of law, and they can be controlled by law”

- Rep. Martin of South Dakota, January 30, 1906.

Federal corporate taxation first made a brief appearance during the Civil War, but did not become properly established until The Tariff Act of 1894 (Bank 2001). Prior to that, the majority of activity relating to corporate taxes and “responsibilities” took place at the state level, following the legal development of the corporate form in the early antebellum United States. State chartered banks were an enormous source of revenue for state governments (Sylla *et al.* 1987). However, because the survival of these banks relied on their reputations (Gorton 1996), as well as the financial stability of the state banking system as a whole, there was also a general acceptance of the need for “behavioral” regulation as well (Degree 2000). As discussed *infra*, these essentially macroprudential regulatory interests often came into conflict with the perceived need to raise public revenue via corporate income taxation. The interdependence of the antebellum banking system militated against the view that corporations were purely sources of revenue. Instead, at this early stage, corporations were still conceived of as “franchisees,” granted for the purpose of serving a public interest (Hockett & Omarova 2015, Lamoreaux 1996). However, according to Lamoreaux, as the state legislatures issued increasing numbers of bank charters throughout the 1820s and 1830s, and the number of banks multiplied, the public began to perceive of banks as increasingly private entities.

Despite possible revenue constraints of the time, The Tariff Act of 1894 was primarily motivated by the perceived inequity of the existing federal tax code, which was largely regressive. Its enactment immediately provoked multiple lawsuits, culminating in the Supreme Court striking down the tax provision pertaining specifically to corporations as unconstitutional in 1895. Corporate specific taxation didn’t return until the Payne-Aldrich Tariff Act of 1909, when the 16th amendment had already been passed by Congress, and was in the final stage of being ratified by the states. Both the 1894 and 1909 Acts attempted to avoid “double taxation” by providing certain exceptions to dividends from personal income taxes.

According to Bank (2001), this approach, which emphasized taxing the corporation, rather than the dividends of shareholders, was adopted primarily due to concerns regarding shareholder tax avoidance--namely, the widespread underreporting and undervaluing of financial assets, as well as underreporting of capital income. Such concerns were amplified by the fragmented nature of capital markets, resulting from the lack of regulatory harmonization between the states. Ultimately, however, this approach only shifted the incentives for tax avoidance from the individual to the institutional level. Today, corporations avoid and evade taxes through many complex mechanisms, notably the misvaluation of intellectual property (Wiederhold 2014), financial derivatives and complex legal and accounting devices (*see infra*). Similar to how income and wealth were ostensibly “hidden” in postbellum corporations, corporations today “hide” wealth and misdirect income to foreign subsidiaries. Meanwhile, corporations have grown in size, and today large firms rely on a veritable army of lawyers, accountants, and financial engineers for assistance in devising creative ways to reduce their tax liabilities.

On the other hand, individual shareholding has become more dispersed and less of a locus for economic power. To the extent that shareholding is concentrated, it tends not to be in the hands of the wealthy but in institutional investors such as pension funds and sovereign wealth funds. For example, the so-called "shareholder revolution" of the late 1970s was driven by the partnership of private equity funds with pension funds such as CALPERS (Henwood 2005). Thus, historically, corporate taxation was about both revenue and distribution--specifically, the wealth and income of shareholders and rentiers more generally. However, particularly since the 1970s, revenue has become the predominant priority in corporate tax debates, while the historical emphasis on taxing corporations as an indirect form of taxing shareholders and rentiers has been forgotten.

I. The Revenue Theory

The revenue theory of corporate income tax is the one most commonly discussed in public and possibly even in policy circles today. The idea is that corporations have the highest "ability to pay" relative to other sectors of society, and thus deserve to pay their "fair share." This is extremely popular political rhetoric because it combines the "serious" Beltway insider politics of being fiscally conservative with the semi-populist politics of being "hard" on corporations. Hillary Clinton recently gave a speech that captures the relationship between these two ideas quite well:

> I am not going to add a penny to the national debt[;] we're going to go where the money is. We're going to make the wealthy pay their fair share, and we're finally going to close those corporate loopholes.

Thus, those who advocate the revenue theory and want to increase corporate taxes see corporate tax rates primarily as a way to get the funds a government needs to spend on other things, rather than a way to regulate corporate governance *per se*. Indeed, those who follow the revenue theory generally don't discuss the potential effects of taxation on corporate behavior at all. As noted above, this was certainly the purpose of state level corporate taxation in the antebellum period.

Following the observation made in 1946 by former President of the New York Federal Reserve, Beardsley Ruml, that, in the context of a sovereign government with a non-convertible currency with a floating exchange-rate, no foreign debt and its own central bank, "taxes for revenue are obsolete," we argue that the revenue theory is empirically false. Instead, modern governments are able to spend through issuing IOUs, which are either tax receivable or made convertible into tax receivable settlement balances (central bank liabilities) by the monetary policies of their central bank. Thus, taxation is required to give value to government liabilities, but there is no need for such central, currency-issuing governments to collect revenues before, or shortly after, they spend. Full employment of resources, as well as production bottlenecks, can impose a real resource constraint on government spending, which, breached, ultimately manifests itself in higher inflation. However, modern tax systems, and in particular, marginal tax rates, typically exert a stabilizing influence on government deficits, as tax receipts increase in response to higher employment and wage rates.

In such "monetarily sovereign" states, policies do not have to be, and should not be, designed, and projected to be, revenue neutral. Yet, in our view, it is the political desire to be seen as "fiscally responsible" by maintaining a "revenue neutral" fiscal stance that makes raising corporate tax rates, or at least proposals to raise corporate tax rates, so popular among certain segments of the public. A reformulation of the revenue theory along Rumllian (1945, 1946) lines may justify taxes based on their demand-draining impacts, and thus justify corporate income taxes on that basis. Indeed Ruml (1945) provides just such a reformulation when he lists one way of justifying a tax "[a]s an instrument of fiscal policy, to help stabilize the purchasing power of the dollar." However, such a formulation would have to deal with the exact impacts of corporate income taxes and the question of exactly whose spending is drained by corporate taxes.

For pure revenue theorists, a corporate income tax is *prima facie* a good idea. Changing the focus from maximizing the quantity of revenue, to using taxation to reduce demand for output creates complications. Corporate taxation may encourage certain forms of spending (*see infra*), and has different impacts on demand depending on who "bears the burden" of the tax, which varies through time and country (Ruml 1945; Laramie 1993; *see infra*). Some taxes that "produce" a lot of revenue have little effect on current demand. Ruml (1945) gives examples of such taxes stating that "the estate and gift taxes have little or no significance, as tax measures, for stabilizing the value of the dollar." Ruml (1945) rightly focuses attention on the incidence of corporate income taxes to determine their effectiveness as taxes that stabilize "the value of the dollar." While we are not as unequivocal as Ruml about the question of who bears the burden of corporate income taxes, other taxes do a better job of draining demand, especially in response to booms, and have more straightforward effects.

II. Distribution Theory

A stronger argument for corporate income taxes is their effect on income (and thereby ultimately wealth) distribution. Distributional struggles between capital and labor have been important features of political economy for centuries. According to this view, taxing corporate income appropriately places part of the "burden" of taxation in general on corporations (and thereby on those who derive income from their operations and decisions). This justification is clearly a secondary element to many "revenue theory" justifications, which is clear in the claim that corporations should "pay their fair share." The difficulty with this line of argument is that it is not clear that corporate income taxes actually redistribute income away from "capital," and, if so, how exactly it does so. That is, the tax incidence of corporate income taxation is complex.

Theoretically, a corporation could pay corporate income taxes with lower retained earnings, lower investment, lower dividend payments, lower wages, or higher prices (Ruml 1945). Thus, while not obvious at first, understanding the incidence of corporate income taxation requires a theory of corporate price setting, investment decisions, finance decisions, and macroeconomic determination of profits. To complicate things further, which of the preceding factors predominates varies by product line, industry, country and time period. In providing some preliminary comments on this subject, we follow the seminal work of economist Fred Lee (1998, 2012, 2013; Lee *et al.* 1999) and earlier economists such as P.W.S. Andrews (1993) and Gardiner Means (1992).

Tax planning, whether by an internal division or outside law and accounting firms (for an emblematic case study, *see* Cen *et al.* 2014), is a major part of modern corporate governance. Corporate tax planners produce estimates of their effective tax rates in the coming year, similar to the way their cost accountants produce estimates of their future costs. They then treat it as an element of cost and set their before-tax profit margin accordingly (Ruml 1945). Thus, corporations can (in principle, subject to many and variable constraints, *see infra*) pass on the cost of effective tax rates to consumers, in the form of higher prices, just as they can pass on other costs. Laramie (1993) argues that statistical evidence indicates that corporations treat effective tax rates as overhead costs. He uses this evidence to argue that corporations bear some of the incidence of taxation. Ruml (1945) argues that most of this cost is borne by a combination of higher prices and lower wages. However, given his longstanding affiliations with various business interests, and prominence within the Committee for Economic Development, there is reason to view his claims with skepticism (Costantini 2015). On the other hand, other authors with less of a pro-business bias have also come to similar conclusions.

Coutts *et al.* (1978) argues that corporate decision-making is typically so slow moving that tax increases are largely or entirely absorbed by corporations for the first year to eighteen months after they are implemented. However:

> So far as the longer term is concerned, the data cannot resolve the question how much tax shifting occurs and over what period of time. There is, however, some indication of full shifting in the medium run and of more than full shifting in the longest run. If a presumption could be established from other information that the mean lag was about 5 years, the results would indicate that full shifting probably occurs. Conversely, if the presumption of full shifting were established, the results would indicate that this happens with a lag of about 5 years.

As the above implies, knowing the incidence of corporate taxes requires knowing the market context, past sales growth, market structure, et cetera, of particular industries, during defined periods. In other words, there are limitations to statistical data in discovering the incidence of taxation, and, consequently, recourse to qualitative research is necessary (Lee 1998). If all firms have the same costs in a particular product line, profit margins will tend to converge, be it because of price leadership, public price lists, industry conferences, business associations, historically established widely known customs or other social coordination devices (Lee 2012). If some have higher costs e.g. a higher effective tax rate, this may make them a “high cost” firm in that product line, and the extent to which they are able to pass on effective tax rates will depend on their willingness to deviate from the “market” price and possibly even tolerate a fall in sales.

One thing that is clear from the above is that raising “book” corporate tax rates makes “tax aggressive” corporations (i.e. those with lower effective tax rates) more competitive by making corporate tax rates a larger element of every corporation’s costs. Raising corporate tax rates also incentivizes larger investments in tax planning and accounting divisions, as well as political lobbying. Conversely, closing tax loopholes shrinks tax rate differentials and thus may not have an effect on before tax profit margins depending on which firms are tax aggressive and the market context. Indeed, there is some evidence (Kubick *et al.* 2015; Isin *et al.* 2016) that “market leaders" tend to have the lowest effective tax rates and show more "sustainable" tax avoidance strategies.

This broad outline is consistent with past studies of how firms set prices, make production decisions and treat costs (*see, e.g.,* Andrews 1993; Coutts *et al.* 1978; Means 1992; Lee 1998, 2012, 2013; Lee *et al.* 1999; Senate 1958). However, past pricing studies have not focused on the impact of effective corporate tax rates on pricing decisions sufficiently, and should be a major area of future research, specifically qualitative research methods. In general, we need a greater and more detailed understanding of actually existing market structures and the current decision-making processes of corporations before making any definitive predictions about the effects of different corporate tax rates.

III. Macroeconomics of Corporate Taxation

Besides the "microeconomic" or industry-level context of corporate taxation, there is also the macroeconomic context. We began discussing distribution theory with the balance of income between labor and capital. This is a macroeconomic question. Since the foundational work of Jerome Levy and Michael Kalecki (Levy 1943; Kalecki 1971; Levy 2001), economists outside the mainstream have emphasized that aggregate profits are determined by macroeconomic spending patterns. Below is the national accounting statement that Kalecki used to analyze these issues:

After Tax Profits= Gross Investment + Current Account Balance + Government Budget Balance + Consumption out of Profits - Worker Saving

Or

$$P = I + NX + DEF + C_c - W_S$$

Thus a "revenue neutral" policy, as is so commonly proposed, means that on the macroeconomic level, after-tax profits will be similar. To show otherwise it must be proven that despite the "revenue" neutral goal, raising corporate taxes increases the current account balance, decreases investment, decreases consumption out of profits or increases the saving of workers. Laramie (1993, 1994) argues that there is little reason to think that corporate income taxes have such secondary effects, and thus the primary determinant of after-tax profits is whether such taxes are, ultimately, revenue neutral. This doesn't mean that raising corporate income taxes doesn't decrease after tax profits for some corporations. Indeed, the distribution of profits between corporations is likely to be profoundly affected, depending on the relative distribution of government spending between industries.

Additionally, just as a microeconomic and/or mesoeconomic view (Dopfer 2012) doesn't necessarily tell us what is going on at the macroeconomic level, the macroeconomic determination of profits doesn't tell us what is going on for after-tax profit margins on individual units of output in individual markets. In other words, many combinations of expansions (falls) in output and prices can be consistent with rises (falls) in government deficits. If output expands and after-tax profit margins fall, the "enterprise" profit share falls. The point is not that the Kalecki-Levy profits equation invalidates any distributional impact of corporate taxation; rather, it simply gives one additional macroeconomic reasons for skepticism. Taking together the microeconomic, mesoeconomic and macroeconomic elements, the case for positive major distributional effects of corporate taxation is weak.

To put the point more bluntly: given corporate control over the means of production and product prices, we don't think that it is possible to "tax corporate income to equality." Like dinosaurs in Jurassic Park, the ability to control a corporation "finds a way." Reducing inequality ultimately requires qualitative regulation of corporate governance, not monetary taxation and fines of the corporate entity (see *infra*). In other words, inequality of income and wealth comes from inequality of control, and government policy must abridge the latter to shrink the former. Nonetheless, more evidence needs to be accumulated and analyzed in order to come to a definitive conclusion on the distributional impacts of corporate income taxation. As such, in our view, distributional grounds are the most valid justification for corporate income taxation. However, as stated *Supra*, we think there are other "capital income" taxes that do a better job of influencing distribution that do not come at the cost of potential and potentially negative effects on corporate governance.

IV. Behavior Theory

Finally, the last major justification of taxation is the "Behavior" theory. This theory is used to justify certain taxes based on their effect on the behavior of individuals and institutions. Some taxes are justified on the basis of encouraging "good behavior," such as taxes on cigarettes and alcohol, although this has changed since the economic theory of "externalities" gained influence in legal doctrine during the twentieth century. The idea of externalities is that in an ideal neoclassical model of the economy, the prices of goods, services, property, et cetera, reflect all the costs that entered their production or use. In other words, private cost and social cost are identical. Since the world may, for various reasons, deviate from the ideal model, a large number of neoclassical economists posit that taxes should be used to "price in" the negative effect of certain behaviors and decisions on others. The neoclassical theory of externalities developed by A.C. Pigou (1920) has come to have an enormous influence on law. Examples of taxes now considered "pigouvian" include carbon taxes, alcohol taxes, cigarette taxes, and corporate fines.

Can corporate income taxes be justified on behavioral grounds? We do not think so. The incentive to pursue profits remains and no theoretical defense of corporate income taxes, as far as we can tell, claims that its aim is to disincentivize profit-seeking. Indeed, justifying corporate income taxes on revenue grounds requires that tax avoidance be insignificant and/or extremely difficult. In contrast, with behavioral taxes the purpose is usually to minimize revenue because the tax is meant to discourage that behavior. In other words, most of the time the ostensible goal of behavioral taxes is to take in as little revenue as possible while still being effective. Advocates of corporate income taxes have generally not discussed the possible behavioral effects of corporate income taxes, except to say tax avoidance (and evasion) should be minimized.

In our view, corporate income taxes do not merely fail to deliver the purported benefits; they also have strong perverse impacts on corporate behavior. As stated *Infra*, they encourage investments in accountants, lawyers, lobbyists and political connections. From our point of view, since these investments are purely intended to lower tax burdens, and not promote the production of better quality and higher quantity output, they are socially unproductive. As Ruml (1946), Minsky (1986) and others argue, corporate income taxes also encourage debt financing over equity financing, which encourages financial instability. There is also evidence that the desire to avoid corporate income taxes encourages the use of financial derivatives (Donohoe 2014, 2015). This is the case because accountants, lawyers and corporate executives believe that regulators and tax authorities struggle to crack down on tax avoidance strategies that are achieved via such complex instruments.

The difficulty of regulators to deal with the complexity of new financial and legal innovations is also a major component of financial instability. Derivative-based tax shelters overseas are also extremely difficult to detect and stop (GAO 2012). Thus corporate income taxes also incentivize increasing use of financial products, innovations and financial departments by traditionally non-financial corporations. They also incentivize Boards of Directors to pick CEOs with expertise in corporate tax aggressiveness (Chyz 2013), and complex financial instruments. Additionally, CEOs are themselves incentivized to pursue aggressive tax avoidance strategies with incentive pay based on corporate after-tax profits (Powers et al. 2016). We would argue that these types of CEOs are more likely to commit accounting control fraud (Black 2016) than those promoted through the company or with expertise in e.g. plant-level and supply-chain management.

Finally, corporate income taxes have negative effects on the federal government's general approach to the application of the rule of law to corporate activity and the regulation of corporate governance generally. In particular, a focus on corporations as sources of revenue encourages leniency to corporate malfeasance and crimes. This also leads to the use of monetary fines as the primary way to punish corporate malfeasance. Indeed, since the financial crisis, criminal investigations of major banks have led to monetary settlements, and the lack of prosecutions has been widely noted (Ramirez 2017; Dayen 2016). At the state level, this dynamic is very clear:

> Delaware dominates the business of chartering publicly traded firms; indeed, Delaware behaves like a monopolist in this field. As such, Delaware can afford to ignore the issue of controlling agency costs, which would alienate management interests holding control of incorporation decisions. The need to maintain its revenue stream from franchise taxes paid by firms incorporated in Delaware acts [as] a prime motivating factor of Delaware policymakers. Thus, Delaware harbors little interest in allowing corporate law to evolve in response to events or new empirical findings regarding corporate governance law. Only pro-management evolution can occur in Delaware.

We think a similar case can be made at the federal level. The revenue theory is in profound conflict with behavioral justifications when applied to corporate taxation. As noted, we believe the revenue theory is false when it comes to the United States government and thus federal corporate income taxes should instead be judged primarily on behavioral and distributional grounds.

Corporate malfeasance and crime primarily impact individuals qualitatively. There is no way to put a precise monetary price tag on the effects of pollution, the loss of a home to foreclosure, the denial of medical care, lack of credit access, the loss of retirement security or the way these damages combine and interact to produce emergent negative effects at the macrosocial level. White-collar regulation and law enforcement need to refocus on these qualitative and social effects (Black 2016; Dayen 2016). Boards of Directors and corporate executives need to face personal consequences and in extreme cases regulators need the ability to reorganize the decision-making apparatus of firms. We are extremely enthusiastic about novel regulatory approaches, such as the "corporate death penalty" (Ramirez 2017). This one in particular is an extremely strong example of qualitative law enforcement that is up to the task of returning law and order to corporate America.

V. Conclusion

We have analyzed corporate income taxes based on what we see as the major justifications for taxation: the revenue theory, the distribution theory and the behavioral theory. Because the United States is no longer revenue constrained since it has a central bank, issues its own currency, with a floating exchange rate, and has a paucity of foreign denominated debt (and zero public foreign denominated debt), "revenues" are not a valid or helpful way to frame and discuss questions of corporate taxation at the federal level. The case for corporate income taxes is on sturdier ground when grounded in distribution theory; however, there are many reasons to doubt that corporations and their shareholders truly bear the costs of these taxes. Further, there are alternative taxes that are more effective at reducing inequality. Lastly, the corporate income tax has extremely negative effects when analyzed using the behavioral theory; consequently, the latter provides the strongest argument for eliminating corporate income taxes.

It could be argued that many of the criticisms discussed *supra* do not so much concern questions of corporate income taxation, but their enforcement and the general difficulties of allowing complex legal financial instruments and practices to proliferate. While this is likely true, a tax that encourages a technical expertise and political influence arms-race between corporations, legislatures and administrative agencies, and that has, at best, uncertain actual effects on distribution over time, is wholly undesirable in our view. Regulating for financial stability is difficult enough in capitalist economies already. The tax code should not be compounding the difficulty of this task. There will of course remain a systemic tendency towards financial instability, as well as towards corporate investments in accounting and legal expertise, without corporate income taxation, but we think this pressure will be somewhat lessened in the absence of (federal) corporate income taxes.

Nonetheless, despite the criticisms raised *supra*, we are not recommending the elimination of corporate income taxes as a stand-alone policy change. We recognize that based on current evidence, the incidence of these taxes may very well fall to a significant extent on capital income, with positive social effects for economic equality and egalitarian-oriented growth. Instead, we think higher marginal personal tax rates on overall income, as well as high capital gains taxes, would replicate or even outperform corporate taxation in regulating the "capital" share of income. One reason for this is that individual shareholders have very limited ability to invest in tax avoidance relative to corporations, especially multinational ones. Further, they cannot as easily legally conglomerate and experience the "economies of scale" that corporations themselves have with regard to investments in accounting, law and sophisticated financial instruments strategies. Ultimately, rather than unequivocally defending an entire new policy regime, we would like to provoke discussion about what the exact purpose or purposes of corporate taxation are and whether public purpose would be better served by a different set of corporate taxation and corporate governance policies.

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