Share buybacks don't undermine case for corporate tax cuts

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Major companies, including Cisco Systems, Pfizer and Coca-Cola, have said they will use most of the gains from proposed corporate rate cuts to increase dividends to shareholders or buy back their own shares. This has been reported and shared on Twitter as a slam dunk against the Republican tax plan.

After all, a major claim of the administration has been that corporate rate cuts would benefit workers through wage rises, rather than flowing exclusively to capital owners.

Yet, the reaction of these companies is nothing unexpected, at least in the short term. Any substantial cut to the corporate rate provides an immediate windfall to so-called “old capital.”

Investments that have already been made obtain a higher after-tax return than expected. This is a major reason why the stock market has surged as tax reform has become more and more likely.

Given it takes time for the lower corporate tax rate to attract new capital into the sector, economists would say that in the short-run the supply of capital is “inelastic.” That is, it is unresponsive to a change in tax rates. Absent new capital, the primary gainers of rate cuts initially are existing domestic and foreign shareholders. Two questions then are key: Does this matter? And does this hold in the longer-term?

If existing firms have excess capital in the short-term, distributing it to shareholders in some way makes sense. This money is unlikely to sit dormant afterwards. In all likelihood, that money will be deployed elsewhere to find new value.

The market for growth industries through venture capital and angel investment is huge, and these windfalls can be invested in the start-ups and industries of the future.

The key point though is that the lower corporate rate improves the after-tax profitability of investment across the economy, and as such generates new activity. Other things given, domestic companies will have greater incentive to invest.

Foreign companies will be more likely to expand their investments in the U.S. — or even shift their operations here. U.S. companies will repatriate profits earned by their foreign subsidiaries rather than leaving them abroad, and more capital will flow from other less productive U.S. sectors into the U.S. corporate world.

Over time then, capital is more "elastic." With a huge global pool of savings available, a reduction in the corporate income tax rate will bring much more capital into the U.S. corporate sector, and this investment is likely to increase productivity and wages.

Since the tax burden likely shifts more to factors of production that can move less easily in the long run, and workers are less mobile than international capital flows, there's good reason to believe that cuts in corporate taxes will provide significant long-term benefits for workers too.

The empirical evidence on this is strong. A 2009 National Bureau of Economic Research paper analyzing American corporate tax rates at the state level found that "workers in a fully unionized firm capture roughly 54 percent of the benefits of low tax rates," while a more recent analysis found that workers overall bore 30–35 percent of the burden.

A 2015 study from Germany indicated "that workers bear about 40 percent of the total tax burden." The Congressional Budget Office has even estimated that the proportion of the corporate income tax burden borne by labor could be more than 70 percent.

While the exact figures are contested and depend on assumptions about the openness of the economy, there are good reasons to think corporate rate cuts will boost wages for U.S. workers to a significant degree.

Could we achieve the same long-term benefits without the initial shareholder windfall? Theoretically, yes. If you set a clear phase-in plan for the corporate rate cut. But this would come with a big risk: that future politicians would renege on the rate cuts and undermine the growth benefits.

Indeed, the mere uncertainty associated with leaving future tax changes as hostage to political whims may be enough to undermine some of the effects outlined above.

On balance then, it's preferable to get on with cutting the rate of what economists believe is a highly damaging tax. Shareholders might initially be the overwhelming beneficiaries of corporate rate cuts.

But theory and evidence shows that the activity generated by a lower rate will give workers a share of the spoils too, just as the administration has outlined.

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