Forbes

How Would Corporate Tax Reform Benefit Workers?

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May 22, 2017

Reducing the tax on capital income by reducing the corporate tax rate would undoubtedly result in an increase in capital investment, most economists would agree. Bob Lucas, the nobel-prize winning economist at the University of Chicago, once remarked that reducing or eliminating taxation on capital income was the closest thing he has ever seen to a free lunch, in terms of the concomitant increase in investment and economic growth that would create.

However, in the debate over the current tax reform, few people have discussed the impact that a lower corporate tax rate would have on the labor market. In a research paper forthcoming in *Tax Notes,* Andrew Hanson of Marquette University and I look at the empirical literature that examines the impact that corporate taxation has on the labor market–an aspect of tax reform that is not as well understood.

Put broadly, there are two different channels through which a lower capital tax rate can impact labor market decisions. The first is via the substitution effect: a lower capital tax rate makes plant and equipment cheaper, so firms have an incentive to substitute capital for labor.

But there is also the scale effect: reducing the cost of capital lowers the effective cost of doing business, so firms increase their scale of operations. As a result, businesses invest in more capital *and* labor.

The essential question is which effect dominates. Andrew and I reviewed the economic studies pertinent to this question and the evidence suggests that a lower corporate tax rate boosts employment and wages.

Put briefly, there are two different strands in the literature pertinent to this question: One strand studies the question via different corporate tax rates at the state level while the other looks at corporate tax rate differences across countries.

We believe that the state corporate tax rate differences are most relevant for understanding how a corporate tax rate reduction at the federal level may impact labor markets, because the economic environment is–of course–the same as it would be for federal rate changes.

The research is by no means unanimous of course, but the most relevant studies by our account (most notably by William Harden and William Hart) find that a one percentage point *increase* in the corporate tax rate would increase unemployment by .2%-.5%. A 10-20% reduction in the rate–the range that the Trump Administration has proposed– would translate to a 2%-10% boost in long-run employment.

The impact on income is of a similar magnitude: The studies we find most compelling (by Alexander Ljungqvist and Michael Smolyansky, as well as Harden and Hart) suggest that a one percentage point reduction in the corporate income tax would boost income by .3% to .6%; for the 10-20% rate reduction on the table, that translates to a long-term boost in income of 3%-12%.

The most interesting research that uses international data looks at how corporate tax rate differences impacts foreign direct investment and the location of international firms.

Work by Johannes Voget suggests that the location of multinational corporations is quite sensitive to the corporate tax rate, and that an increase in repatriation taxes of 10 percentage points boosts the number of firms relocating by 2.2%.

Research by Harvard economist Mihir Desai suggests that workers bear somewhere between 45% and 75% of the burden of the corporate tax rate, meaning that high corporate rates reduce employment and wages, harming workers more than consumers and shareholders.

Taxing corporate income is a very expensive way to collect income or to achieve tax rate equity in terms of foregone economic growth. We can do better.

A lower corporate tax rate isn't a panacea, but it would make the U.S. economic environment more competitive and boost investment. Both would benefit the American worker.

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