A Collectible Corporate Income Tax – OpEd

Dean Baker

March 6, 2019

Bill Niskanen was the rarest of all creatures, an honest libertarian. He actually believed in libertarian ideas, rather than just using them as an excuse for policies to redistribute income upward.

He headed the Cato Institute for more than two decades, from 1985 until 2008. While CATO generally took conservative views, it also followed Niskanen's principled libertarianism. This meant the institute was anti-imperialist. Niskanen argued that we needed a defense budget to protect the United States, not to police the world. Cato regularly called for sharper declines in military spending than almost all the liberal think tanks in DC.

He also was a strong opponent of the Iraq War. I remember in the months leading up to the war, bumping into him at various events. Bill would point to the various Republican foreign policy experts (not those in the Bush administration) who had publicly warned of the dangers of the war.

He would ask me "where are the Democrats?" While I could point to then fringe figures, like Bernie Sanders, the fact was that most of the Democratic leadership had fallen in line in support of the war. (Nancy Pelosi was a notable exception.) Bill's opposition to the war angered many prominent Republicans, including Cato donors.

Anyhow, when I was on a panel with him, it was usually to discuss economic issues. I always appreciated his honesty. I remember, back in the 1990s, debating replacing the progressive income tax with a flat tax, which was a popular idea among Republicans at the time. Most of the flat tax proponents would come up with absurd stories about everyone would pay less, and we would end up with just as much revenue.

Once with Bill, I got to go first, and said something to the effect of "a flat tax is about having the middle class pay more so that the rich can pay less." Bill responded by saying that this is essentially right, but went on to explain how this would be a good thing, because it would lead to a more efficient tax system, and therefore more growth, and make everyone better off. Bill believed this, so he didn't have to lie.

Another time I was on a panel with Bill, where he pointed to some very high marginal tax rate. I quickly responded by saying "no one pays that." Bill replied to effect that if you have a tax that no one pays, it's probably not a very good tax.

This point has stuck with me for decades. It's one thing to write a tax down on paper, it's another to ask what it looks like in the real world. And, the latter is what we really have to be concerned about. If corporations and individuals are going through complex tax avoidance schemes, such as buying "dead peasant" insurance policies or hiding profits and income in the Cayman Islands and other tax havens, then we are not raising the revenue we hoped with our tax rates.

Furthermore, as I pointed out a couple of weeks ago, these tax avoidance schemes are potentially a huge waste of resources. If our marginal tax rate is 70 percent, then a rich person comes out ahead if they have to spend 69 cents to hide a dollar of income from the I.R.S. If the goal of taxation is to free up resources for government spending, then we are going in the wrong direction. We are encouraging rich people to spend money on tax avoidance and evasion, which they otherwise would not have spent, thereby reducing the room for government spending. There are also a lot of people who get rich in the tax gaming system itself, another undesirable side effect.

Just to be clear, not all tax avoidance is bad. Rich people like John D. Rockefeller, Henry Ford, and Bill Gates have given much of their fortune to foundations, which provides them a way of avoiding the estate tax. We may not like everything such foundations do (think of the Koch Family Foundations), but giving these foundations resources is not the same as throwing them in the trash.

Anyhow, this is all a backdrop to my scheme for reforming the corporate income tax. As we all know, Trump and the Republicans pushed through a big cut in the corporate tax rate back in 2017. They lowered the rate from 35 percent to 21 percent. Their economists claimed that this would lead to an investment boom. They also argued that in setting the rate lower, they were eliminated loopholes, so at least we would collect something close to the legislated tax rate.

At this point, we can say pretty definitively that the story of a tax cut induced investment boom is not true. Investment is up only modestly from its 2017 levels. Orders for equipment investment, the largest category of investment, have actually been trending downwards since July, and the December figure was just 2.0 percent above the year ago level. If investment had followed the promised path, it should be 30-40 percent higher than pre-tax cut levels.

While the boom story turns out not to be true, the eliminate the loopholes story is also falling short. In April of 2018 the Congressional Budget Office projectedthat the government would take in $243 billion in corporate income tax in 2018, but the government only collected $205 billion, almost 20 percent less than had been projected. In other words, it seems that companies are finding ways to game even the new lower tax rates, so they are still paying substantially less in taxes than the legislated tax rate.

We can do better. A few years ago, I proposed a system where the government would require companies to turn over non-voting shares of stock in place of paying the corporate income tax. If the targeted tax rate is 21 percent, as is now the case, then the non-voting shares should be equal to 21 percent of total outstanding shares. If the targeted rate is 28 percent, then the non-voting shares would be equal to 28 percent of outstanding shares.

These non-voting shares would be treated just like standard common shares. If the company paid a $2 a share dividend, then it would pay a $2 dividend to the government for each of its shares. If it bought back 10 percent of its shares for $100 a share, then it buys back 10 percent of the government's shares at $100 a share. This way, it is virtually impossible for the company to cheat the government out of its tax revenue, unless it also rips off its shareholders. (Matthew Klein probably had the best write-up of the proposal in a Financial Times column.)

Since I first tossed this idea out, three or four years ago, there have been two types of objections: one from those on the center and the right, and one from those on the left.

Starting with the objection from the center-right, several people have pointed out that some companies have complex share structures, so they could give the government a category of shares that gets ripped off, while preserving the gold star shares for wealthy shareholders. I really like this objection, because it is a beautiful example of wrongheaded thinking about the tax code.

It is not the government's obligation to structure its tax law around corporate practices. It is the obligation of corporations to structure their practices around the law.

My favorite example where this confusion comes up is in the tax treatment of "carried interest," which typically accounts for the bulk of the pay of hedge fund and private equity managers. Carried interest is the money that partners earned from having a 20 percent stake in the funds they managed. This is part of a standard contract, whereby the managers get something like a management fee of 2 percent of assets, and then they get 20 percent of earnings above a threshold. The 20 percent is the carried interest.

As it stands carried interest is taxed at the capital gains rate. Before the tax cut, this was 20 percent, as compared to the 39.6 percent Obama era rate, plus a 2.95 percent Medicare tax. This meant that some of the richest people in the country were being taxed at a lower rate than many school teachers and firefighters, who were in the 25 percent tax bracket.

When people proposed taxing carried interest as normal wage income, the hedge fund and private equity crew would complain that much of their earnings was in fact capital gains. The argument is that they earned their commissions and then effectively re-invested them in the funds. They argued that it was impossible to disentangle the extent to which a partner's earnings was based on their work, as opposed to the money they had invested.

They are of course right that it is impossible to disentangle the portion of their carried interest that was due to work from the portion that represented returns on their investment, but we don't have to. We can just write the law so that they have be paid annually, bi-annually, or whatever, based on their work. If they want to show their commitment to their fund, they can write contracts that require them to invest 50 percent, 60 percent, or 100 percent of their earnings back into the fund.

The point is that hedge funds and private equity funds have to write their contracts to conform to the law, it is the not the government's obligation to write laws that conform to their current practice. It is the same story with companies offering different classes of shares.

The government can say that the company has to offer just one type of common stock, and the government gets its 21 percent, or 28 percent, stake based on these shares. It can issue as many preferred shares (which have specified payout, similar to bonds) as it wants, but it doesn't have an option to play games with different classes of shares of common stock.

The objection from the left is that if we're requiring companies to give the government shares, then they should be voting shares so the government actually gets a say in how the company is run. I find this one bizarre, because the point of getting the shares is so to ensure that the company actually pays its taxes.

Somehow, these nationalizers don't think we have to get a say in how a company is run because we require them to pay a corporate income tax, but if we structure the tax in a way where we can actually be sure of collecting it, then we have to get a say in how the company is run. I suppose there is some logic there, but I fail to see what it is.

While I do want to make sure that the government can collect the corporate income tax, I actually don't want to see the government have a direct say in running corporations in general. There are examples of well-run public companies, but there are also plenty of examples of failed nationalizations. Leaving companies free to pursue profits in the market has actually been a very effective way of generating wealth in the United States and elsewhere.

In my view, we should look to nationalizations in cases where we have a good argument why a publicly run company would be better than a privately run company. It is not an end in itself. Will the government's ownership of non-voting shares inevitably lead to ownership of voting shares? That's hard for me to see, any more than the corporate income tax inevitably leads to socialism. It's not clear what the dynamic here would be.

Anyhow, if there were any interest in designing a corporate income tax that we actually could collect, it seems the non-voting share route is the best way to go. I understand why Republicans, who don't think the rich or corporations should ever pay tax, are not interested, but I don't see why progressive Democrats would not be.