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## **The Problem With the Corporate Tax**

**By N. GREGORY MANKIW**

AT this point in the presidential campaign, Senator John McCain is the candidate of ideas on issues of tax policy. Too many ideas, in fact. While some of his ideas are great, others are almost laughable.

The one that has received the most attention recently — a gas-tax holiday — falls in the second category. Many economists and policy wonks advocate raising the tax on gasoline to address problems ranging from global climate change to local traffic congestion. It is hard to find one who thinks that a temporary cut in the gas tax is a sensible response to the current spike in gas prices.

Lost in this hubbub, however, is a bigger idea that Mr. McCain and his economic team have put forward: a cut in the corporate tax rate, to 25 percent from 35 percent. It is perhaps the best simple recipe for promoting long-run growth in American living standards.

Cutting corporate taxes is not the kind of idea that normally pops up in presidential campaigns. After all, voters aren't corporations. Why promise goodies for those who can't put you in office?

In fact, a corporate rate cut would help a lot of voters, though they might not know it. The most basic lesson about corporate taxes is this: A corporation is not really a taxpayer at all. It is more like a tax collector.

The ultimate payers of the corporate tax are those individuals who have some stake in the company on which the tax is levied. If you own corporate equities, if you work for a corporation or if you buy goods and services from a corporation, you pay part of the corporate income tax. The corporate tax leads to lower returns on capital, lower wages or higher prices — and, most likely, a combination of all three.

A cut in the corporate tax as Mr. McCain proposes would initially give a boost to after-tax profits and stock prices, but the results would not end there. A stronger stock market would lead to more capital investment. More investment would lead to greater productivity. Greater productivity would lead to higher wages for workers and lower prices for customers.

Populist critics deride this train of logic as “trickle-down economics.” But it is more accurate to call it textbook economics. Students in introductory economics courses learn that the burden of a tax does not necessarily stay where the Congress chooses to put it. That lesson is especially relevant when thinking about the corporate tax.

In a 2006 study, the economist William C. Randolph of the Congressional Budget Office estimated who wins and who loses from this tax. He concluded that “domestic labor bears slightly more than 70 percent of the burden.”

Mr. Randolph’s analysis stresses the role of international capital mobility. With savings sloshing around the world in search of the highest returns, he says, “the domestic owners of capital can escape most of the corporate income tax burden when capital is reallocated abroad in response to the tax.” When capital leaves a country, the workers left behind suffer. (According to Mr. Randolph, however, some workers do benefit from the American corporate tax: those abroad who earn higher wages from the inflow of capital.)

A similar result was found in a recent Oxford University study by Wiji Arulampalam, Michael P. Devereux and Giorgia Maffini. After examining data on more than 50,000 companies in nine European countries, they concluded that “a substantial part of the corporation income tax is passed on to the labor force in the form of lower wages,” adding that “in the long-run a \$1 increase in the tax bill tends to reduce real wages at the median by 92 cents.”

Despite these findings, a corporate tax cut as a way to help workers may strike some people as needlessly indirect. Why not just pass an income tax cut aimed squarely at working families, as Senator Barack Obama proposes?

The answer is that while most taxes distort incentives and shrink the economic pie, they do not do so equally. Compared with other ways of funding the government, the corporate tax is particularly hard on economic growth. A C.B.O. report in 2005 concluded that the “distortions that the corporate income tax induces are large compared with the revenues that the tax generates.” Reducing these distortions would lead to better-paying jobs.

Of course, a corporate tax cut would affect the federal budget. And any change in tax policy has to be made against a background of a looming fiscal crisis, which threatens to unfold as baby boomers retire and start collecting Social Security and Medicare. In 2007, corporate taxes brought in \$370 billion, representing 14 percent of federal revenue. Cutting the rate to 25 percent would seem to cost the Treasury about \$100 billion a year.

Part of that revenue loss, however, would be recouped through other taxes. To the extent that shareholders would benefit, they would pay higher taxes on dividends, capital gains and withdrawals from their retirement accounts. To the extent that workers would benefit, they would pay higher payroll and income taxes. Increased economic growth would tend to raise tax revenue from all sources.

SOME economists think that these effects are strong enough to make a corporate rate cut self-financing. A recent study by Alex Brill and Kevin A. Hassett of the American Enterprise Institute, looking at countries in the Organization for Economic Cooperation and Development, supports exactly that conclusion. But

even if that turns out to be too optimistic, both theory and evidence make it reasonable to expect a significant discount from the sticker price. In the end, the net budgetary cost of the tax cut might be, say, \$50 billion a year.

Senator McCain wants to fill that hole in the budget by restraining spending. If he can stop bloated legislation like the recent \$300 billion farm bill from becoming law, more power to him.

But in case that quest proves quixotic, I have a back-up plan for him: increase the gasoline tax. With Americans consuming about 140 billion gallons of gasoline a year, a gas-tax increase of about 40 cents a gallon could fund a corporate rate cut, fostering economic growth and reducing a variety of driving-related problems.

Indeed, if we increased the tax on gasoline to the level that many experts consider optimal, we could raise enough revenue to eliminate the corporate income tax. And the price at the pump would still be far lower in the United States than in much of Europe.

Don't laugh. I'm serious.