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Opinion

Paul Krugman

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By Paul Krugman
Opinion Columnist

Alert! Wonk warning! This is an additional email that goes deeper into the economics and some technical stuff than usual.

Hello readers! As you may have noticed, this is a second newsletter send on top of my existing production. Before I get going on the substance, a word about what this extra thingie is meant to do.

Until 2017 I had a blog at The Times that was distinct from my column; it was, for the most part, where I put my wonkier, less readable work, often the homework that underlay the regular column. It was, you might say, where I talked to other dismal scientists, although anyone could listen in.

When The Times folded the blog into the regular online paper, I retained the ability to post material above and beyond the scheduled column. But these "blog posts" looked just like columns, and I found that they ended up as the worst of both worlds. Readers looking for wonkier stuff assumed that because the pieces looked like columns, they wouldn't cover blog-like material; readers of the regular column would click on an article and say, what the heck is this?

So I felt I needed something clearly demarcated as "not the regular column" — something where people would expect more jargon and less comprehensibility. I experimented with an off-site blog, but we're now trying a within-Times arrangement that will go out as a newsletter but also be on-site and readable as a blog. We'll see how it goes.

And with that, let's get into the substance.

Today's column is about the Biden administration's proposal for corporate tax reform — a term I use advisedly. For this isn't just about raising the tax rate, although that's part of it. It's also an attempt to crack down on tax avoidance, in particular the strategies multinational corporations use to shift reported profits to low-tax jurisdictions.

Will this happen? Probably, although it will be tricky keeping the Democratic caucus in line (there won't be any Republican votes). But it wouldn't be happening if the 2017 Trump tax cut for corporations hadn't been such a complete flop, hadn't failed so completely to deliver the promised surge in business investment.

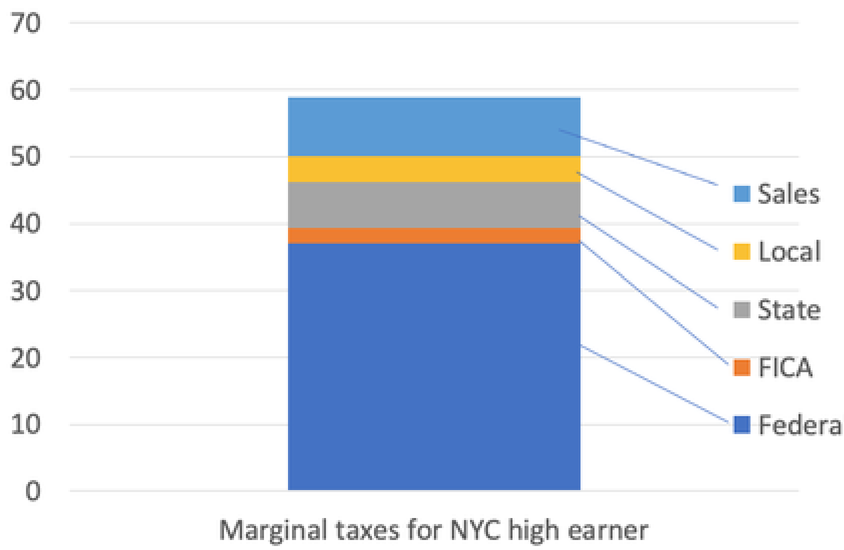
So what I want to talk about here is why even many critics, myself included, thought the Trump tax cut was less bad than the usual Republican tax plan, followed by three reasons we were, it turned out, too kind.

The least bad idea?

Republican tax cuts are usually concentrated on high-income individuals, and are justified with the claim that cutting marginal tax rates will lead to an explosion in individual effort, entrepreneurship, and so on.

There have been many debunkings of this claim. Here's another: I happen to be familiar with the taxes facing fairly high-income individuals in New York City — specifically, people who rely on earned income, not income that, like the income of fund managers and so on, can be engineered to face low taxation. Think of this category as the figure in one of my favorite lines from the movie *Wall Street*: "A $400,000 a year working Wall Street stiff, flying first class and being *comfortable*."

Here's my estimate of the marginal tax rate — the share of an additional $1 in income that goes to government — facing a guy like that in New York City:



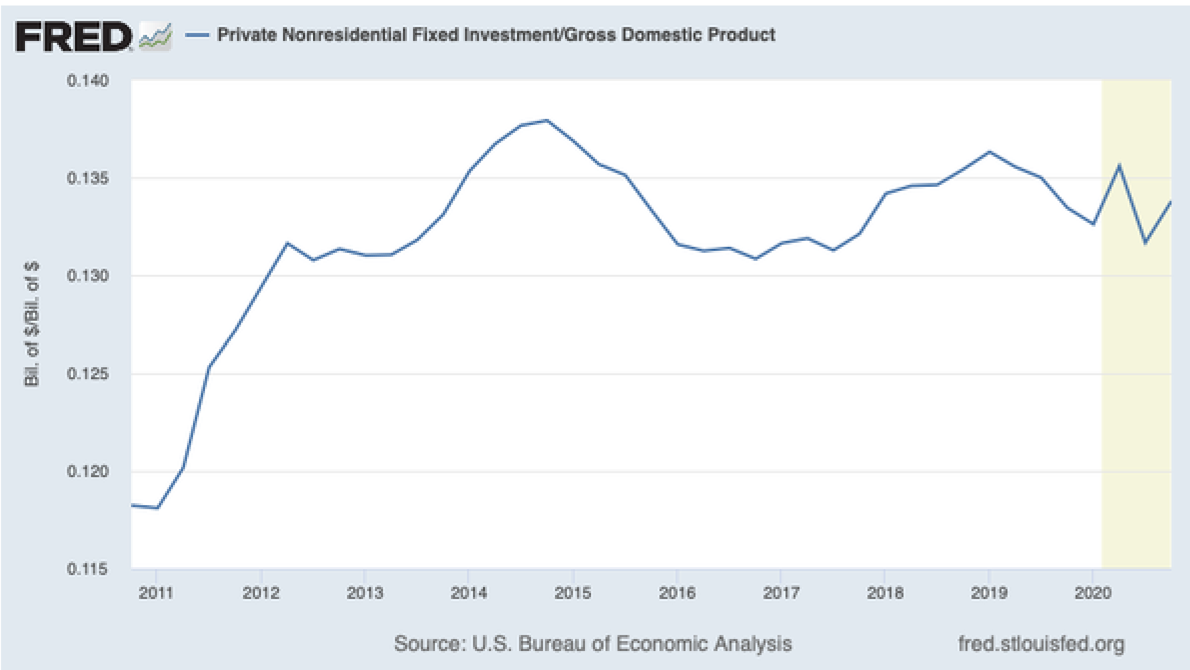
Pity the $400K a year working stiffAuthor's calculations

It's pretty high! My point, however, is that even with a marginal tax rate close to 60 percent, high-earning New Yorkers are not exactly noted for being slow-moving and lazy. So the claim that personal taxes are a major disincentive to work and productivity never made much sense.

The rationale for the corporate tax cut was, however, quite different. It wasn't about individual work effort; instead, it was about incentives to invest in the United States as opposed to other nations. That's clearly a real issue in a world of mobile capital. And the tax cut's advocates argued that lower profit taxes would bring higher investment here, leading over time to faster growth and higher wages.

At the time I accepted this logic, at least as a qualitative matter. I still thought the tax cut was a bad idea, but that was because I believed that the inflow of capital would be smaller and take much longer than the plan's advocates claimed, and as a result wouldn't be enough to compensate for the loss of revenue.

But I was, it turned out, being too generous. As a 2019 analysis by the [International Monetary Fund](#) found, the Tax Cuts and Jobs Act ended up having no visible effect at all on business investment, which rose no more than you would have expected given the growth in demand. Here's a quick way to see that, namely business investment as a share of G.D.P.:



Where's my investment surge?FRED

How can we understand this abject failure? I see three reasons, one of which I missed completely back in 2017, two of which I knew about but didn't give sufficient weight. Let's run through them.

A tax on profits isn't a tax on capital

I've been spending some time talking to tax policy experts inside and outside the Biden administration, and one point they make is that what might seem obvious — taxing profits deters corporations from investments they might otherwise make — isn't obvious at all.

Imagine a company considering whether to borrow money to invest in some new project. If there were no profits tax, it would proceed if and only if it expected the rate of return on the project to exceed the interest rate on the loan. Now suppose that there is, say, a 35 percent tax on profits. How does this change the company's decision? *It doesn't*.

Why? Because interest on the loan is tax-deductible. If investment is financed with debt, profit taxes only fall on returns over and above the interest rate, which means that they shouldn't affect investment choices.

OK, not all investment is debt-financed, although that itself poses a puzzle: There's a clear tax advantage to issuing debt rather than selling stock, and the question of why companies don't use more leverage is subtle and hard. The immediate point, however, is that the corporate profits tax isn't a tax on capital, it's a tax on a particular aspect of corporate financial structure. Analyses — mine included! — that treat it simply as raising the cost of capital are being far too generous to tax cutters.

Business investment isn't that sensitive to the cost of capital, anyway

Suppose we ignore the deductibility of interest for a moment, and consider a company that for some reason finances all its investment with equity. Imagine also that investors know they can earn a rate of return r in the global marketplace. In that case they'll require that the company earn $r/ (1-t)$ on its investments, where t is the rate of profit taxes. This is how advocates of the Trump tax cut looked at the world in 2017.

Under these conditions, cutting t, by reducing the required rate of return — in effect, by cutting the cost of capital — should induce corporations to increase the U.S. capital stock. For example, the Tax Foundation predicted that the capital stock would rise by 9.9 percent, or more than $6 trillion.

But these predictions missed a key point: most business assets are fairly short-lived. Equipment and software aren't like houses, which have a useful life measured in decades if not generations. They're more like cars, which generally get replaced after a few years — in fact, most business investment is even less durable than cars, generally wearing out or becoming obsolete quite fast.

And demand for short-lived assets isn't very sensitive to the cost of capital. The demand for houses depends hugely on the interest rate borrowers have to pay; the demand for cars only depends a bit on the interest rate charged on car loans. That's why monetary policy mainly works through housing, not consumer durables or business investment. And the short lives of business assets dilute the already weak effect of taxes on investment decisions.

Monopoly

Financial industry types often talk about the FAANGs: Facebook, Apple, Amazon, Netflix, Google — tech companies that loom large in the stock market. These companies look very different from past market leaders like General Motors in its heyday; it's much harder to link their value to the tangible assets they own.

True, there are more of those assets than are visible to the naked eye. For example, Amazon's warehouses employ a vast number of workers. Still, the value of these companies mainly reflects their market power, the quasi-monopoly positions they've established in their respective domains.

There are many issues relating to this market power, but in the current context what matters is that taxes on monopoly profits are as close as you can get to revenue-raising without side effects. They certainly don't deter investment, because monopoly profits aren't a return on capital.

And the profit tax is at this point largely a tax on monopoly or quasi-monopoly profits. Officials I've spoken to cite estimates that around 75 percent of the tax base consists of "excess" returns, over and above the normal return on capital, and that this percentage has been rising over time. Loosely speaking, this means that most of a corporate tax cut just goes to swelling monopoly profits, with any incentive effects limited to the shrinking fraction of corporate income that actually reflects returns on investment. That I.M.F. study of the Trump tax cut suggested that rising monopoly power might help explain its lack of impact.

Maybe the way to think about all this is to say that naïve calculations of the effect of tax cuts on business investment have to be "geared down" in multiple ways. Debt-financed investment shouldn't be affected; the cost of capital has a limited effect on investment in any case because of short asset lives; and a lot of any tax cut goes to monopolists whose behavior won't be affected. Even with all of this, there should be some effect from lower taxes, but it could easily be small enough to vanish in the statistical noise.

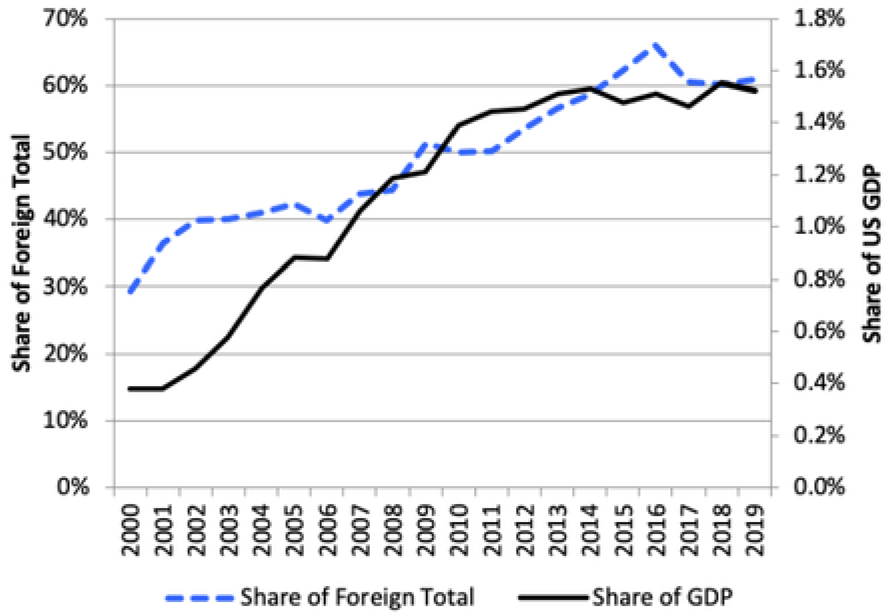
But why did anyone ever believe that corporate tax cuts would do great things for the economy?

Leprechauns

The big argument for cutting corporate taxes has long been that if we don't, corporations will move capital and jobs to lower-tax nations. And a casual look at the data suggests that this actually happens. U.S. corporations have a lot of overseas assets, and seem to favor countries with low tax rates.

What we've learned over the past 7 or 8 years, however, is that we're mainly looking at accounting tricks rather than real capital flight to avoid taxes. There are multiple ways to make this point; in my column on the subject I used "leprechaun economics," the crazy swings in Irish growth that demonstrate the fictitious nature of corporate investment in Ireland's economy. Another way to make the point is to note that most — most! — overseas profits reported by U.S. corporations are in tiny tax havens that can't realistically be major profit centers. Here's a chart from the Biden administration's fact sheet on its tax plan:

Figure 4: Share of U.S. Multinational Corporation Income in Seven Big Havens, 2000-2019



Leprechauns ruleU.S. Treasury department

So one way to think about the failure of the Trump tax cut is that it didn't reverse capital flight because the capital flight never happened in the first place. In effect, the U.S. government gave up hundreds of billions of dollars to fix a nonexistent problem.

Now the Biden administration wants to go after the real problem, which was always tax avoidance, not loss of jobs to foreigners. Will they manage to pass the necessary legislation? We'll just have to wait and see.