Paul Krugman on Corporation Tax, Right first time - Wong this time.

In a recent article in the New York Times *(Why Was Trump's Signature Policy Such a Flop?* 9th April 2021.) Paul Krugman asks a good question to which he gives the wrong answer. When Trump's cut in corporation tax was announced I wrote that it would have little impact on business investment, because this would continue to be depressed by the bonus culture. I sent this to Sam Fleming, then the FT Correspondent in Washington, with copies to other FT journalists (Rob Armstrong, Alan Beattie, Chris Giles and Martin Wolf) and I attach a copy to the end of this paper.

I have recently written a paper which shows that corporation tax is a tax on investment and that plans to raise its level in the UK and the US would badly damage those economies, but importantly that a tax credit for tangible investment would, if made permanent in the UK and introduced in the US, be beneficial. This can be accessed on http://www.smithers.co.uk/news_article.php?id=169.

Corporation tax is a tax on investment, but it is not the only reason why investment fluctuates. All that we know is that rises in its rate will depress business investment and cause growth in output and labour productivity to be slower than they otherwise would be. US corporate investment has risen since 2017 when the rate was cut, but the extent disappointed many economists.

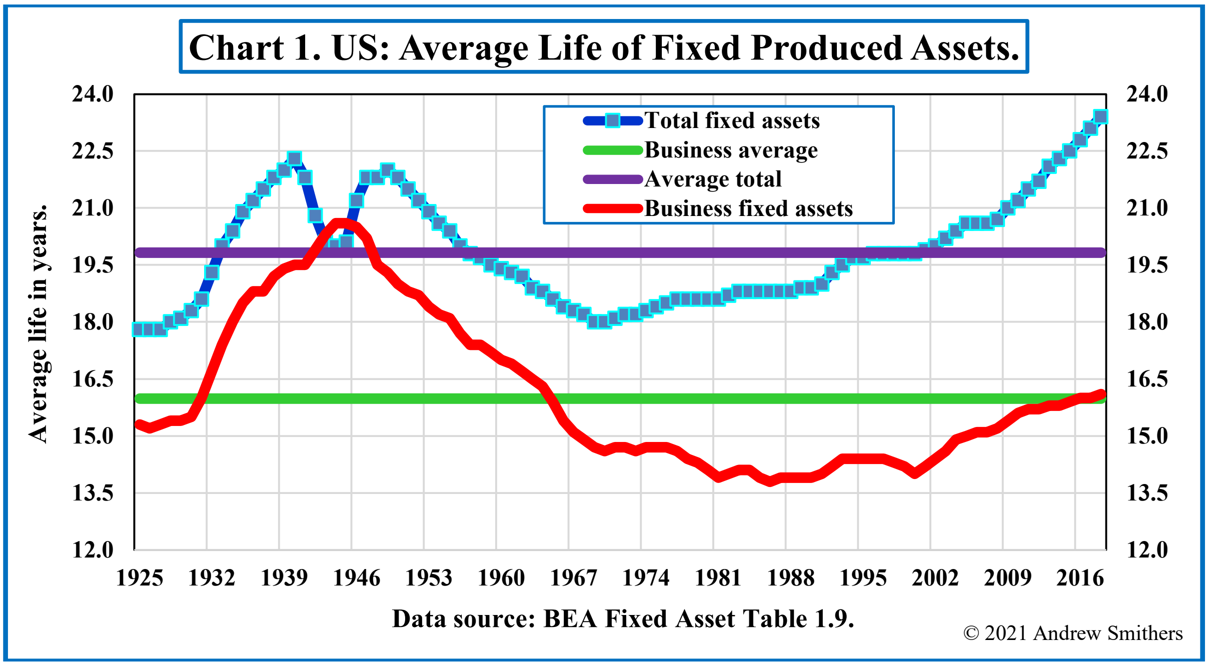
Paul Krugman dismisses the idea that corporation tax deters investment, claiming that "…most business assets are fairly short-lived. Equipment and software aren't like houses, which have a useful life measured in decades if not generations. They're more like cars, which generally get replaced after a few years — in fact, most business investment is even less durable than cars, generally wearing out or becoming obsolete quite fast."

But corporate business capital is long-lived. As I show in Chart 1 below the average life of the assets created by corporate investment is 16 years.

The second pillar of Paul Krugman's argument is that "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."

For profits to have been boosted by an increase in monopoly, they would have to have been accompanied by a rise in the profit share of output. But as I show in Chart 1 of my paper, the profit share of US corporate output is currently at its long-term mean reverting average level and has fallen over the past 6 years.

The cause of the weak response of US corporate investment is due to the perverse incentives of modern management remuneration as I explained in *Productivity and the Bonus Culture* (Oxford University Press 2019).



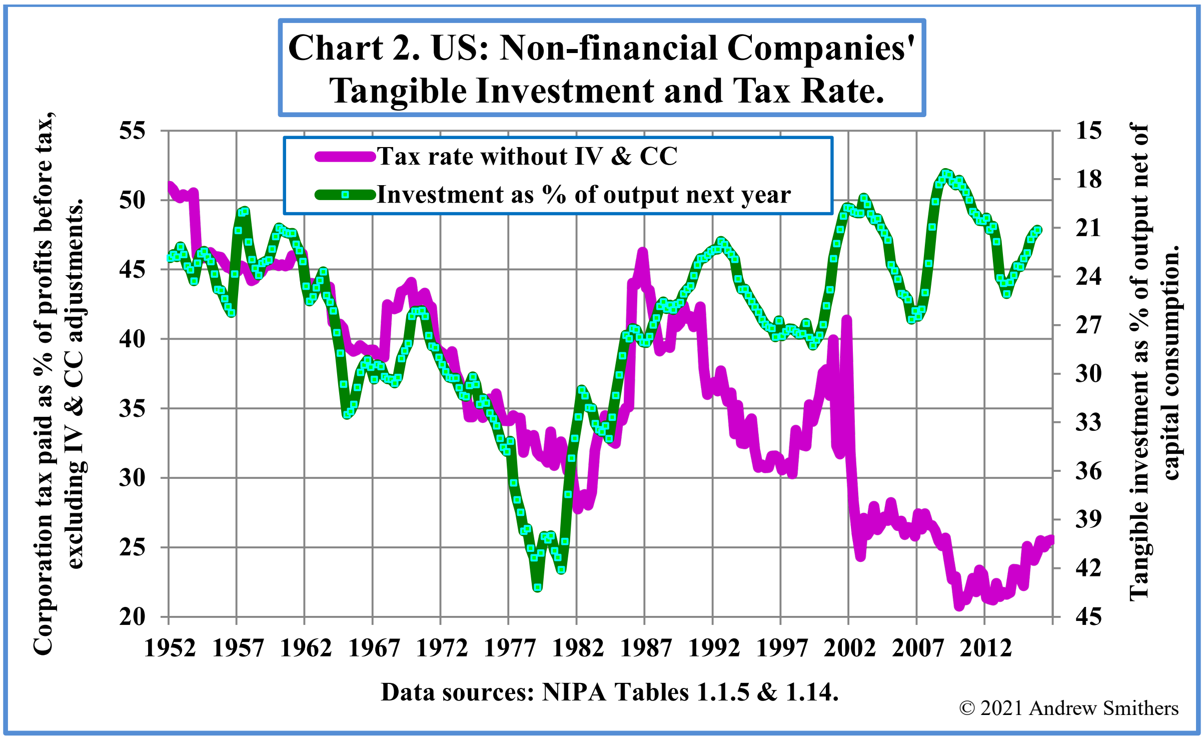
Attachment to email to Sam Fleming 02.12.17

Trump's Tax Overhaul.

I agree that the proposed cut in the statutory rate of Federal corporation tax is unlikely to have much impact on business investment, but not on the grounds that "There was a large cut in the statutory corporation tax from 50% in the 1960s and 1970s to about 35% in 1988, but little response in the rate of business investment."

Correlations between US non-financial companies' non-tangible investment and effective rate of corporation tax. (Data sources: NIPA Tables 1.1.5, 1.14 & 5.1.)			
	Coincident	**Investment one year later**	**Investment two years later**
	Coefficients of correlation		
Q1 1952 to Q4 1999	- 0.62	- 0.63	- 0.60
Q1 2000 to Q4 2016	+ 0.60	+ 0.22	- 0.18
	R^2		
Q1 1952 to Q4 1999	0.39	0.39	0.36
Q1 2000 to Q4 2016	0.36	0.05	0.05

There was a strong correlation, as shown in Chart 2 below and the Table, from 1952 to 2000 between US tangible investment and the effective tax rate for non-financial companies. Since then there has been either no correlation or a perverse one, as there was for the coincident relationship. The change follows, and probably results from, the change over the decade 1990 to 2000 in management remuneration (the perverse incentives of the bonus culture). Prior to 2000 there was therefore a strong probability that a cut in the effective rate of corporation tax would boost tangible investment, but not since.



The impact of a cut in the Federal statutory rate is even less likely to boost investment because the effective tax rate in 2016 was only 25%, measured without the IV & CC adjustments, and some of the deductions, which brought down the effective rate so much below the statutory Federal + state taxes ≈ 40%, are likely to be reduced and the state taxes are unlikely to fall. (It is appropriate to use the tax rate without the IV & CC adjustments as this, unlike the tax rate with these adjustments, approximates to corporations' published P&L accounts.)

It is possible that some small stimulus would occur, because the disincentive to invest from the bonus culture applies mainly to quoted companies, if there was no change in the fiscal deficit. This is, however, likely to rise and any stimulus that it gives to demand e.g. through higher dividends and indirectly via increased buy-backs, will need to be nullified by increased interest rates, which will have a negative impact on profits and investment.

Your source is not necessarily wrong as you quote the impact of the statutory rate, and I show the relationship with the effective rate. However, I suspect that it is wrong and, if not, it is misleading to use the statutory rate in preference to the effective rate.

PS The Table and Chart and a fuller explanation are set out in my paper *Building a New Testable Model to Estimate Total Factor Productivity* published in World Economics Vol 18 No 2 April/June 2017.