Communist Party
Political Economy
Commission Briefing

THE POLITICAL ECONOMY OF TAXATION

January 2022

TAKE THE ROAD TO SOCIALISM

The Political Economy of Taxation

This is to provide factual ammunition and arguments against some of the ideas propagated by bourgeois economists and right-wing parties on taxation, particularly those that associate low taxes on the rich and on corporates with economic growth.

It will additionally cover some of the implications of low marginal taxes on the wealthy for the workings of the economy.

Overview:

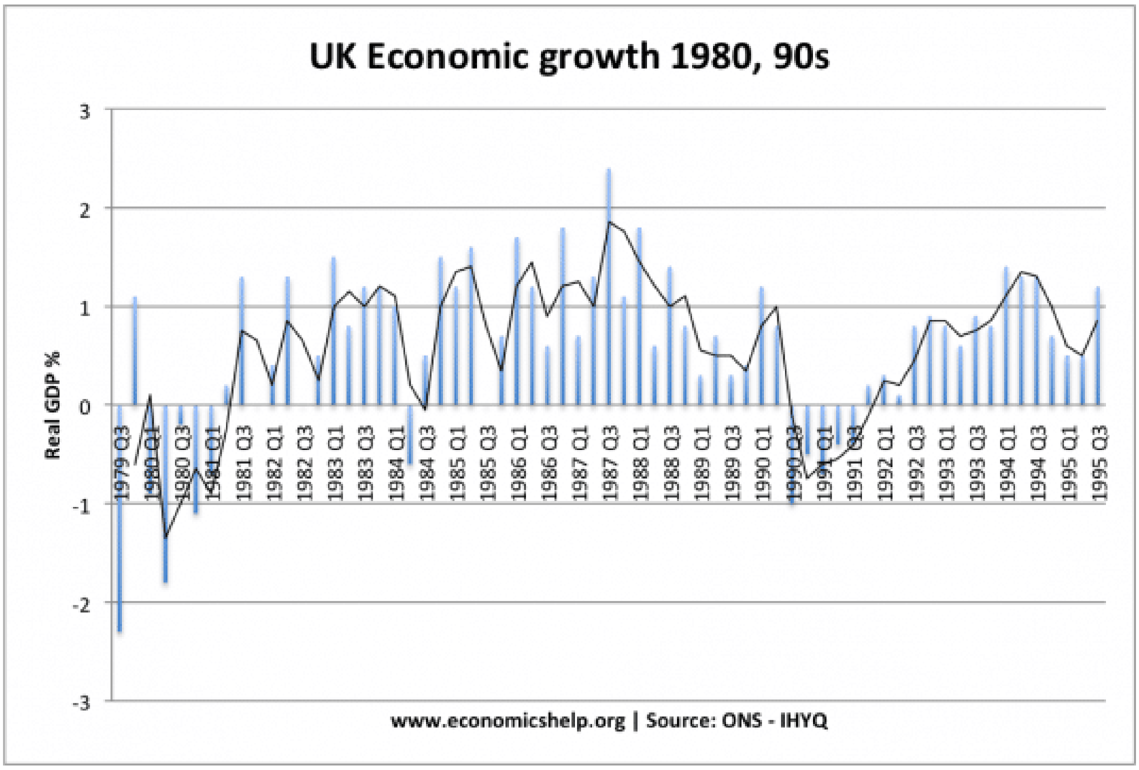
Writes Stewart McGill, convenor of the Communist Party political economy commission...

In 1988 I was working in the financial sector and was listening to Nigel Lawson's budget speech on the dealing floor of Kleinwort Benson, an aspiring Investment Bank. There was a huge cheer as Lawson announced a cut in the top rate of tax from 60% to 40%

In the following days, weeks, months and years, did those cheering stockbrokers, market makers, merchant bankers, and analysts work any harder as a result of this cut in taxes and take more risks? Were their animal spirits unleashed?

No. They were all pretty motivated ambitious people who wanted to rise up the corporate ladder, the tax cut didn't make them work harder; regarding risk, the risks they took were a function of the targets they were set and the appetite for various forms of risk established by the organisation; nothing to do with government tax cuts. (As we all discovered 20 years later in 2008, unleashing the animal spirits of people in this profession and encouraging them to take more risk didn't end well for the wider economy, more on this later from the taxation point of view.)

Did it lead to greater economic growth? No, see the graph below. After Q1 of 1988 the UK economy's performance actually started to decline compared with the preceding years. There were a number of factors contributing to this, but it's clear from the data that the higher rates of tax that applied before the 1988 cuts did not act as a serious constraint on growth.



Nor have they ever:

from 1949 to 1980, the years of high marginal taxes on the big income earners, strong trade unions, nationalised industries at the heart of the economy, exchange controls, a regulated financial sector, decent public services, free university education, growing equality, UK economic growth averaged 3.09% year on year;

from 1980 to 2019, the years of Thatcher, much reduced taxes on the wealthy, the ascendancy of an unfettered financial sector, liberalised trade, privatisation, declining public services, free flows of capital, growing inequality, and the destruction of the trade union movement, UK economic growth averaged 2.15% year-on-year.

The Evidence on Personal Income Tax

Much of the quality research in this area has been done in the USA and this paper will reflect that bias, the results will have applicability beyond the USA.

A 2013 study by the non-partisan Congressional Research Service (CRS), Congress's policy research arm, examined tax rates and economic growth since World War II. The study concluded:

"changes over the past 65 years in the top marginal tax rate and the top capital gains tax rate do not appear correlated with economic growth. The reduction in the top statutory tax rates appears to be uncorrelated with saving, investment, and productivity growth. The top tax rates appear to have little or no relation to the size of the economic pie."

The CRS study, however, did find that the lowering of top tax rates appeared to exacerbate income inequality by concentrating income among the rich.

From the summary:
"Throughout the late-1940s and 1950s, the top marginal tax rate was typically above 90%; today it is 35%. Additionally, the top capital gains tax rate was 25% in the 1950s and 1960s, 35% in the 1970s; today it is 15%.

The real GDP growth rate averaged 4.2% and real per capita GDP increased annually by 2.4% in the 1950s. In the 2000s, the average real GDP growth rate was 1.7% and real per capita GDP increased annually by less than 1%.

This analysis finds no conclusive evidence, however, to substantiate a clear relationship between the 65-year reduction in the top statutory tax rates and economic growth. Analysis of such data conducted for this report suggests the reduction in the top tax rates has had little association with saving, investment, or productivity growth. It is reasonable to assume that a tax rate change limited to a small group of taxpayers at the top of the income distribution would have a negligible effect on economic growth. For instance, the tax revenue projected from allowing the top tax rates to rise to their pre- 2001 levels is $49 billion for 2013 or 0.3% of projected 2013 gross domestic product."

The top tax rate reductions appear to be associated with the increasing concentration of income at the top of the income distribution. The share of income accruing to the top 0.1% of U.S. families increased from 4.2% in 1945 to 12.3% by 2007 before falling to 9.2% during to the 2007-2009 recession. During a portion of that time period, however, the share of the tax burden borne by top taxpayers increased. For instance, the top 0.1% of taxpayers paid 9.4% of all income taxes in 1996 and 11.8% in 2006, but their share of income paid in taxes decreased from 33% in 1996 to 25% in 2006.

See:
https://ecommons.cornell.edu/bitstream/handle/1813/79450/CRS_Taxes_and_the_Economy.pdf?sequence=1&isAllowed=y

More Historical Cases

- Strong growth following the Oregon Measure 66 tax increase. In January 2010, Oregon voters enacted Measure 66, which raised the top marginal tax rate on high-income households. Yet in 2010 and 2011, when the highest temporary marginal rates were in place, Oregon's gross state product increased by a total of 13.2 percent. This was nearly three times the growth of the national economy and ranked second among all states.

- Strong growth with 90 percent top marginal tax rate. In the 1950s, when the top federal marginal tax rate exceeded 90 percent, the national economy grew by more than 4 percent per year on average, when factoring in the effects of inflation. By contrast, the economy grew at less than half that rate during the 2000s, when the top marginal tax rate stood at 35 percent for most of the period.

- Weak growth following the Bush-era tax cuts. In 2001 and 2003, Congress enacted legislation lowering the top federal marginal tax rate from 39.5 percent to 35 percent and cutting the income tax on capital gains and dividends. However, the period from the end of the 2001 recession to the start of the Great Recession at the end of 2007 constituted the weakest economic expansion since the end of World War II.

- Weak growth among non-oil producing states that made large income taxes cuts in 2000s. Of the six states that enacted large income tax cuts in the 2000s, before the Great Recession, three states saw their economies grow more slowly than the national economy. The three that grew more quickly than the national average were major oil-producing states, which benefitted from a sharp rise in oil prices following enactment of income tax cuts.

- Weak job growth and dismal personal income growth among the five states that cut income taxes the most in 1990s. The five states that enacted large income tax cuts in the 1990s and did not follow them with tax increases in the 2000s on average experienced slower job growth than the average rate of other states during the economic expansion of the 2000s. Moreover, all five states saw their personal income growth lose out to inflation during the next economic cycle.

Changes in corporate tax rates don't stimulate the economy either. In the immediate aftermath of the tax hikes in the 1950s, real US economic growth accelerated above 8%. Following the Reagan tax cuts, real economic growth hovered around 4% without receiving much of a boost.

Lowering the corporate income-tax rate would not spur economic growth. The analysis in this report by the Economic Policy Institute found no evidence that high corporate tax rates have a negative impact on economic growth (i.e., it found no evidence that changes in either the statutory corporate tax rate or the effective marginal tax rate on capital income are correlated with economic growth).

https://www.epi.org/publication/ib364-corporate-tax-rates-and-economic-growth/

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Why does corporate tax exist?

The corporate income tax serves three important functions:

1. It raises a significant amount of revenue for the federal government, around 8% of total tax receipts in the UK, about 10% in America. However, the corporate income tax is less important now than in the 1950s, when it accounted for about 30 percent of total revenues.
2. The corporate income tax contributes to the overall progressivity of the tax system to the extent that the corporate tax burden falls on capital. While some recent research has estimated that most or all (in some cases over 100 percent) of the corporate tax burden falls on labour (e.g., Hassett and Mathur 2010), other evidence suggests that these findings are not robust to alternative specifications and do not address many of the theoretical issues associated with the burden of the corporate income tax (e.g., Gravelle and Hungerford 2008; Clausing 2011–2012; Clausing 2013). Many tax policy analysts and government agencies distribute the majority of corporate tax burden to capital (between 75 percent and 82 percent). Consequently, it is safe to say that the corporate income tax contributes to the progressivity of the overall tax system.

The corporate income tax serves as a backstop to the individual income tax because it precludes using the corporation as a tax shelter for high-income taxpayers. Gravelle and Hungerford (2008, 422) note that if there were no corporate tax, "high-income individuals could channel funds into corporations and, with a large part of earnings retained, obtain lower tax rates than if they operated in partnership or proprietorship form."

Top 20 Years for GDP and Tax Rate of Top Bracket

Year	GDP Change	Top Tax Rate
1942	18.9%	88.0%
1941	17.7%	81.0%
1943	17.0%	88.0%
1936	12.9%	79.0%
1934	10.8%	63.0%
1935	8.9%	63.0%
1940	8.8%	81.1%
1950	8.7%	84.4%
1951	8.1%	91.0%
1939	8.0%	79.0%
1944	8.0%	94.0%
1984	7.3%	50.0%
1955	7.1%	91.0%
1959	6.9%	91.0%
1966	6.6%	70.0%
1965	6.5%	70.0%
1962	6.1%	91.0%
1964	5.8%	77.0%
1973	5.6%	70.0%
1978	5.6%	70.0%

Current tax rate of the top bracket- 39.6%

politicsthatwork.com

(CURRENT TAX RATE IN THE USA IS ACTUALLY 37%)

There are a variety of factors at play behind the very high growth rates shown in these years, the high-top tax rate being just one of them—more later on why they contribute to high growth rates—and there are issues re causality for all of them. But, at the very least, the data proves beyond a doubt that much higher taxes on the rich are compatible with much faster economic growth than we have today.

The Evidence on Corporate Tax

There is no correlation and no identifiable causation between corporate tax rates and corporate profits. Neither the level of corporate taxes nor changes in corporate taxes have any effect on corporate profitability. The same holds true for either effective corporate tax rates or the top corporate tax rates.

Consequently, there is also no relationship between lower corporate tax rates and higher economic growth. Tax rates don't matter much: the United States currently has one of the lowest corporate tax rates in its history, yet economic growth has been significantly below historical averages.

https://blogs.cfainstitute.org/investor/2017/04/04/

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The Value of High Marginal Taxes on Top Earners

Not only does the above demonstrate that high taxes on the wealthy and corporates do not constitute a barrier to economic growth, many of the figures and correlations suggest a positive relationship between such taxes and economic growth.

There are two main factors at play here:

1. Wealthy people tend to spend proportionally less of their income, tax policies that take money from the wealthy to finance government expenditure, reduce the tax burden of lower paid people, supplement the incomes of those lower paid etc will tend to stimulate the economy as opposed to leaving the money in the hands of people who would just invest the money in shares, commodities or some other scheme. This is one of the factors behind the IMF's belated recognition that inequality is not good for growth.
2. https://www.theguardian.com/business/2014/feb/26/imf-inequality-economic-growth
3. https://www.theguardian.com/business/2020/jan/07/imf-boss-says-raise-taxes-on-the-rich-to-tackle-inequality
4. Allowing top earners to keep more of their money means they are more likely to (i) award themselves excessively high remuneration through high salaries and/or share-related reward schemes utilising company profits in pursuit of their enrichment rather than investment in innovation and the economy's future, and (ii) the wealthy are able to build up a super-surplus of funds that they invest in the stock and other securities markets, asset prices become inflated, commodities prices are heightened by speculation and the resultant increase in food prices pressurises the poor, the booming markets eventually collapse and the economy needs to be rescued, with government money.

The latter summarises what happened to the global economy in 1929 and in 2008. Indeed, fear of a repetition of 1929 was one of the factors behind America's embrace of high marginal rates on top earners even before the outbreak of WW2, see the table above comparing marginal taxes and growth rates.

Effects of High CEO Pay

Average pay of CEOs at the top 350 firms in the USA in 2018 was $17.2 million—or $14.0 million using a more conservative measure. Stock options make up a big part of CEO pay packages, and the conservative measure values the options when granted, versus when cashed in, or "realized."

CEO compensation is very high relative to typical worker compensation (by a ratio of 278-to-1 or 221-to-1). In contrast, the CEO-to-typical-worker compensation ratio (options realized) was 20-to-1 in 1965 and 58-to-1 in 1989.

CEOs are even making a lot more—about five times as much—as other earners in the top 0.1%. From 1978 to 2018, CEO compensation grew by 1,007.5% (940.3% under the options-realized measure), far outstripping S&P stock market growth (706.7%) and the wage growth of very high earners (339.2%).

In contrast, wages for the typical worker grew by just 11.9%

See https://www.epi.org/publication/ceo-compensation-2018/

Marginal tax rates for top rate tax earners and corporations dropped dramatically in the 1980s. High pay increased as did the incentive for managers to use the corporate surplus to award themselves and shareholders through a succession of short-term, financialised schemes rather than using the surplus to invest in the future.

Results:

- The head of Blackstone Asset managers in 2015 accused corporate bosses of underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long term growth.
- In 2014 the top 500 US companies returned the equivalent of 95% of their profits to shareholders in dividends and share buybacks.
- Tangible investment in plant and machinery by US private industry steadily declined from 14% of output in 1980 to around 7% in 2011.
- Harvard Business Review 2018: investment low given the extraordinarily low-cost of equity and debt, and the amount of cash on corporate balance sheets. Measured against GDP, corporate after-tax profits are almost double what they were 25 years ago—and higher than at any time since World War II—yet business investment as a share of GDP only rose by 13% over the same period.

The growth of the use of stock buy-backs since a change in legislation in 1982 has been extraordinary and highlights the issue:

It can make sense for a company to leverage retained earnings with debt to finance investment in productive capabilities that may eventually yield product revenues and corporate profits. Taking on debt to finance buybacks, however, is bad management, given that no revenue-generating investments are made that can allow the company to pay off the debt. In addition to plant and equipment, a company needs to invest in expanding the knowledge and skills of its employees, and it needs to reward them for their contributions to the company's productivity. These investments in the company's knowledge base fuel innovations in products and processes that enable it to gain and sustain an advantage over other firms in its industry.

The investment in the knowledge base that makes a company competitive goes far beyond R&D expenditures. In fact, in 2018, only 43% of companies in the S&P 500 Index recorded any R&D expenses, with just 38 companies accounting for 75% of the R&D spending of all 500 companies. Whether or not a firm spends on R&D, all companies have to invest broadly and deeply in the productive capabilities of their employees in order to remain competitive in global markets.
Stock buybacks made as open-market repurchases make no contribution to the productive capabilities of the firm. Indeed, these distributions to shareholders, which generally come on top of dividends, disrupt the growth dynamic that links the productivity and pay of the labour force. The results are increased income inequity, employment instability, and anaemic productivity.

Buybacks' drain on corporate treasuries has been massive. The 465 companies in the S&P 500 Index in January 2019 that were publicly listed between 2009 and 2018 spent, over that decade, $4.3 trillion on buybacks, equal to 52% of net income, and another $3.3 trillion on dividends, an additional 39% of net income. In 2018 alone, even with after-tax profits at record levels because of the Republican tax cuts, buybacks by S&P 500 companies reached an astounding 68% of net income, with dividends absorbing another 41%.

Why have U.S. companies done these massive buybacks? With the majority of their compensation coming from stock options and stock awards, senior executives have used open-market repurchases to manipulate their companies' stock prices to their own benefit and that of others who are in the business of timing the buying and selling of publicly listed shares. Buybacks enrich these opportunistic share sellers - investment bankers and hedge-fund managers as well as senior corporate executives—at the expense of employees, as well as continuing shareholders.
https://hbr.org/2020/01/why-stock-buybacks-are-dangerous-for-the-economy

And what did Corporate America do with the Trump tax cuts? Stock buy-backs.

“In 2018, however, as stock buybacks by companies in the S&P 500 Index spiked to more than $800 billion for the year, the proportion that were financed by debt plunged to about 14% in the last quarter. Why was there a sharp decline in 2018, when the dollar volume of buybacks far surpassed the previous peak years of 2007, 2014, and 2015.....
The answer is clear: Corporate tax breaks contained in the Tax Cuts and Jobs Act of 2017 provided the corporate cash for the vastly increased level of buybacks in 2018. First, there was a permanent cut from 35% to 21% in the tax rate on corporate profits earned in the United States. Second, going forward, the 2017 law permanently freed foreign profits of U.S.-based corporations from U.S. taxation...
In 2018 compared with 2017, corporate tax revenues declined to $205 billion from $297 billion, hypothetically increasing the financial capacity of U.S.-based corporations to do as much as $92 billion more in buybacks in 2018 without taking on debt. Given that from 2017 to 2018 stock buybacks by S&P 500 companies increased by $287 billion (from $519 billion to $806 billion), the reality is that, through the corporate tax cuts, the federal government essentially funded $92 billion in buybacks by issuing debt and printing money to replace the lost corporate tax revenues.”

https://hbr.org/2020/01/why-stock-buybacks-are-dangerous-for-the-economy

The new Roosevelt Institute and NELP research examines public firms in three major but notoriously low-wage industries—food production, retail, and restaurants—weighing buybacks against worker compensation. Unsurprisingly, they found that companies were aggressive in purchasing their own shares.

The restaurant industry spent 140 percent of its profits on buybacks from 2015 to 2017, meaning that it borrowed or dipped into its cash allowances to purchase the shares. The retail industry spent nearly 80 percent of its profits on buybacks, and food-manufacturing firms nearly 60 percent. All in all, public companies across the American economy spent roughly three-fifths of their profits on buybacks in the years studied.

“The amount corporations are spending on buybacks is staggering... then, to look a little deeper and see how this could impact workers in terms of compensation, was staggering...

What did publicly traded corporations do with [the tax cut money]? Buy back shares and issue dividends, mostly. There was strong anecdotal evidence that that would be true even before the law passed. At a Wall Street Journal CEO confab held last fall, the former Trump economic adviser Gary Cohn asked a room of executives, “If the tax-reform bill goes through, do you plan to increase your company’s capital investment? Show of hands.” Most participants sat still, prompting Cohn to ask, “Why aren’t the other hands up?” Surveys showed that corporations were planning to shunt money to shareholders, rather than putting it into research, mergers and acquisitions, equipment upgrades, training programs, or workers’ salaries...

And new research by Germán Gutiérrez and Thomas Philippon of New York University suggests growing business concentration, a lack of competition, and short-term thinking on the part of investors have all contributed to firms spending a disproportionate amount of free cash flows buying back their shares, fostering an environment of investment-less growth.”

https://www.theatlantic.com/ideas/archive/2018/07/are-stock-buybacks-starving-the-economy/566387/
“We’ve been collecting data on the pay and distribution policy, buybacks and dividends of the companies that were signatories. Boeing is a signatory of this, and its obsession with keeping its stock price up contributed to its planes crashing.

How so?

They did $43 billion in buybacks in 2013, right up to the time of the second airplane crash. After they acquired McDonnell Douglas in '97, they became a highly financialized company and had been totally focused on using whatever profits they could get, or prospective profits in this case, to prop up their stock price.

A lot of the companies that are doing the largest purchases are now collapsing, like General Electric. It has now kind of gone totally towards financialization, or what I call value extraction. Or Cisco. It was the fastest-growing company in the world in the 1990s. It's now about twice the size as it was in 2000 but totally not innovative. It had been the highest market capitalization in the world in 2000, and the stock came down and all the profits went into propping up the stock price. As a result, it's not simply that the money disappears, it's that the leadership of the company is not focused on the next round of innovation. That's precisely what's going on with Apple, which has done $270 billion in buybacks…"
https://www.worth.com/stock-buybacks-threaten-economic-growth/

There are other factors behind this tendency to financial exploitation of the corporate surplus: the tendency of rates of profit to fall; diminishing investment opportunities; financial de-regulation etcetera. Globalisation has made the extraction of surplus value from labour in the developing world much easier and the shift in production to low-wage countries has been enthusiastically pursued as an alternative to investment in new plant and machinery.

Milberg: "the impetus to the process of financialization is a result of the rapid expansion of manufacturing productive capacity in low wage countries supporting capital flows from low-wage to the industrialized countries."

https://www.cambridge.org/gb/academic/subjects/economics/industrial-economics/outsourcing-economics-global-value-chains-capitalist-development?format=PB&isbn=9781107609624

However, the process began with the advent of the neoliberal era in the early 1980s and the fall in the taxation rates on the wealthy, along with the scrapping of exchange controls and other financial deregulation in the UK that helped turn the City of London into the global hub of international tax avoidance. This coincided with concerted attacks on the trade union movements that further enabled the ruling classes to increase their share of the cake.

There are fundamental problems inherent in the basic capitalist imperative of accumulation, those problems are clearly exacerbated by income inequalities and tax regimes that allow the wealthy to arrogate even more of the economic surplus and utilize it for activities that range from non-productive to dangerous.