

A CORPORATE TAX FOR THE NEXT ONE HUNDRED YEARS: A PROPOSAL FOR A DYNAMIC, SELF-ADJUSTING CORPORATE TAX RATE

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ABSTRACT—The United States has included some form of income tax on corporations at least since the enactment of the Sixteenth Amendment one hundred years ago. Notwithstanding this long lineage, however, surprisingly little is known about who ultimately ends up bearing the cost of the tax, or whether it even matters. Perhaps in simpler economic times such as 1913, or 1932, or even 1980, this might have been acceptable. But as the world confronts vastly different economic conditions than the ones faced in the past, finding new ways to understand and implement the corporate tax for the next one hundred years will become crucial to its survival. This Article will introduce one such way, by taking into account how macroeconomic conditions, such as high unemployment, impact who bears the cost of the corporate income tax. This insight can fundamentally alter the landscape of the existing corporate tax policy debate, from whether to use corporate taxes to increase the progressivity of the income tax, to lowering the corporate tax rate to stimulate the economy, to abolishing the corporate tax altogether. By explicitly incorporating both macro- and microeconomic considerations into fiscal policy, policymakers can transform the corporate income tax from a blunt and uncertain fiscal tool into a precise instrument robust enough to survive the next one hundred years.

This Article will consider one specific example—proposing a dynamic, self-adjusting corporate tax rate, or DST for short. The DST takes into account the fact that specific macroeconomic conditions, such as high unemployment, can create incentives for employers to shift the cost of the corporate tax onto labor through lower wages, increased layoffs, or otherwise. The DST offsets this by charging employers (through higher marginal tax rates) when they do shift the cost of the corporate tax onto labor while, at the same time, rewarding employers (through lower marginal tax rates) when they make instead new investments in labor. In this manner, the DST could help reduce existing tax-induced distortions to behavior and address high unemployment at the same time.

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INTRODUCTION

The United States has included some form of income tax on corporations at least since the enactment of the Sixteenth Amendment one hundred years ago.¹ Notwithstanding its long lineage, however, little is known about how the corporate income tax actually works or who ends up paying for it. Until recently, this inability to comprehend precisely who bears the cost of the corporate income tax has been accepted as a sort of necessary evil. Perhaps in simpler economic times, such as 1913, 1932, or even 1980,² tax policy could tolerate this lack of understanding without causing any undue harm. But in this anniversary year of the modern income tax, with a large, complex, and multinational economy characterized by very low interest rates, persistently high unemployment, highly mobile

¹ See, e.g., Steven A. Bank, *A Capital Lock-in Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 915–17 (2006). Forms of a corporate income tax were in place prior to the ratification of the Sixteenth Amendment and the enactment of the modern income tax in 1913 as well. See 1 BORIS I. BITTKER & JAMES S. EUSTICE WITH THE COLLABORATION OF GERSHAM GOLDSTEIN, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.01 (Thomson Reuters/WG&L 7th ed. 2013) (1959).

² See, e.g., Ramesh Ponnuru, Op-Ed., *Reaganism After Reagan*, N.Y. TIMES, Feb. 18, 2013, at A17 (“They slavishly adhere to the economic program that Reagan developed to meet the challenges of the late 1970s and early 1980s, ignoring the fact that he largely overcame those challenges, and now we have new ones.”).

multinational corporations, sophisticated financial markets, and near-zero inflation, it is time to rethink what a corporate tax can and should look like for the next one hundred years.

A debate has emerged over using tax policy, and particularly corporate tax policy, to address the ills of the modern economy. One side argues that taxes must be cut to stimulate investment and economic growth, while the other argues that tax cuts would be nothing more than a giveaway to the rich.³ Both sides see the issue as all-or-nothing. In this respect, at least, both sides are wrong. There is no reason the debate need be limited simply to raising or lowering the tax rate, pitting growth against employment. Rather, modern conceptions of macroeconomic theory can be incorporated into the analysis to create a new fiscal policy—one that is uniquely suited for the challenges of the new economy and fosters both economic growth and employment.

The key to doing so in the corporate income tax context is to focus on what economists call the “incidence” of the tax (or, put more simply, who ultimately pays the cost of the tax). Essentially, when a corporation pays a tax, at least one of the following groups must lose: shareholders in the form of lower profits, workers in the form of lower wages, or consumers in the form of higher prices.⁴ Most economists traditionally believed that shareholders bore the cost of the corporate tax in the form of lower profits.⁵ Recently, however, economists have begun to question this conclusion, finding that, in the modern economy, workers often bear a significant portion of the tax in the form of lower wages, lower employment, or both.⁶ This Article, relying on these developments in the theoretical and empirical economics literature, will work under the assumption that, under the unique conditions of the modern economy, increasing amounts of the corporate income tax are often borne by labor rather than capital.⁷

³ See, e.g., David Kocieniewski, *Since 1980s, the Kindest of Tax Cuts for the Rich*, N.Y. TIMES, Jan. 18, 2012, at A12.

⁴ In other words, “[t]he 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. . . . The corporate tax leads to lower returns on capital, lower wages or higher prices. . . .” N. Gregory Mankiw, *The Problem with the Corporate Tax*, N.Y. TIMES (June 1, 2008), http://www.nytimes.com/2008/06/01/business/01view.html?_r=0.

⁵ See Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215 (1962).

⁶ See generally Bruce Bartlett, *Who Pays the Corporate Income Tax*, N.Y. TIMES ECONOMIX BLOG (Feb. 19, 2013, 6:00 AM), <http://economix.blogs.nytimes.com/2013/02/19/who-pays-the-corporate-income-tax> (summarizing four articles on corporate tax incidence published in the March 2013 issue of the *National Tax Journal*); see also *infra* notes 22–30 and accompanying text.

⁷ Although only corporate shareholders own stock in entities that pay the corporate income tax, all capital over time effectively bears whatever share of the corporate income tax is borne by shareholders through operations of the market. See JULIE-ANNE CRONIN ET AL., U.S. DEP’T OF THE TREASURY OFFICE OF TAX ANALYSIS, *DISTRIBUTING THE CORPORATE INCOME TAX: REVISED* U.S. TREASURY

Such a conclusion could radically alter the landscape of the modern corporate tax debate. Almost all proposals to reform the corporate income tax, from those supporting a raise in the corporate income tax (to increase progressivity of the tax system) to those supporting the elimination of the corporate income tax altogether, make some assumption about who is in fact bearing the incidence of the tax. Regardless of one's goals, knowing more about the incidence of the corporate income tax and the impact of macroeconomic conditions on incidence will increase one's ability to meet these goals through the design and structure of the corporate income tax.

To this end, why not envision a corporate tax that is both pro-growth and pro-employment at the same time, while proving self-financing in the long run? This need not be the stuff of science fiction. Building a pro-growth, pro-employment, self-financing corporate income tax may be possible, but it will require fundamentally rethinking how the corporate tax actually works and what it should be intended to accomplish. To do so will require deconstructing a number of well-established and generally accepted propositions about the operation of the corporate income tax and recombining them, for the first time, to take into account the unique conditions of the modern economy.

This Article will provide one example of how to do so, by proposing the repeal of the current fixed corporate income tax rate and replacing it with a new dynamic, self-adjusting tax, or DST for short. To counteract an employer's incentive to shift incidence onto labor due to macroeconomic conditions, the DST ties the corporate tax rate directly to the employment decisions of corporate employers—as employment goes up, taxes go down, and vice versa.

The DST could offer a number of benefits. The first, and primary, benefit would be a traditional microeconomic one. Assuming labor bears an inefficiently high percentage of the corporate tax during periods of high unemployment as compared to periods of more typical levels of unemployment, shifting the burden back to capital should result in efficiency gains. The DST accomplishes this by charging employers for attempting to shift the incidence of the tax onto labor during periods of high unemployment.

Unlike traditional efficiency-driven tax policy proposals, however, the DST could also have a positive macroeconomic feedback effect in addition to its microeconomic benefits. If labor bears an increasing share of the incidence of the corporate tax during periods of high unemployment,

METHODOLOGY 2 (2012), <http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2012-05-Distributing-the-Corporate-Income-Tax-Methodology-May-2012.pdf> (“As capital flows take place, the corporate tax burden is shifted to non-corporate capital over time through reductions in the return to non-corporate capital until after tax returns in both sectors are the same. As such, the tax burden initially falls on current owners of corporate capital and then on future investors of corporate and non-corporate capital.”).

cutting corporate taxes should result in more jobs, higher wages, or both. But rather than merely hoping this occurs,⁸ the DST conditions the corporate tax cut on actually increasing payroll, rather than hoarding cash or paying the savings out as a dividend. Consequently, at least some of the cash savings from the tax cut would go to the benefit of labor, in the form of higher wages or reduced layoffs, while the remainder would be available to the corporation to be invested in productive assets.

But that is not the end of the story, since any corporate tax cut would also need to be paid for.⁹ As an initial matter, the combination of economic growth and increased employment resulting from the DST has the ability to increase revenue itself, at least to some extent. But the DST also has its own automatic, built-in revenue feature¹⁰: raising tax rates on firms that reduce payroll. This has two benefits. First, to avoid this tax increase, corporations would have an incentive to look elsewhere, other than reducing labor costs, to cut costs in the face of a recession. Second, the government would raise revenue as wages decreased or unemployment increased, or both, since the companies that did reduce payroll would incur higher tax rates. By both creating incentives to reduce layoffs or wage cuts and increasing revenue, the proposal could essentially pay for itself over the long run, at least based on relatively conservative assumptions.

Tying together the business cycle, the corporate income tax, and the firm's employment decisions in this manner could permit the corporate tax to embody both pro-growth and pro-employment fiscal policies at the same time. Rather than merely raising or lowering total taxes in response to recessions, the proposal would serve to offset the implicit shift of the incidence of the corporate tax away from capital and onto labor during periods of high unemployment, while at the same time substantially cutting taxes for corporations that increase employment. In this manner, the tax law would—for the first time—be unified toward pro-growth and pro-employment policies, while remaining largely self-financing over the long-term.

Combining economic theory and legal theory in this manner can provide the means to overcome the seemingly intractable, and definitely unhelpful, political and policy stalemate facing the country. By rejecting the binary of demand-side versus supply-side economic theory—exemplified in the “tax cuts for the rich” versus “fairness for the middle

⁸ See Mankiw, *supra* note 4; cf. NILS AUS DEM MOORE & TANJA KASTEN, DO WAGES RISE WHEN CORPORATE TAX RATES FALL? DIFFERENCE-IN-DIFFERENCES ANALYSES OF THE GERMAN BUSINESS TAX REFORM 2000 (2009), <http://piketty.pse.ens.fr/fichiers/MooreKasten2009.pdf> (empirically analyzing whether wages rise when corporate tax rates fall).

⁹ One proposal has been to increase the gasoline tax to offset a corporate tax rate cut. See Mankiw, *supra* note 4 (“[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.”).

¹⁰ See *id.* (“Some economists think that these effects are strong enough to make a corporate rate cut self-financing.”).

class” debate—both sides could rightfully claim victory for their preferred tax policy. Of course, no tax law can prevent or mitigate pure demagoguery or hyperbolic hysteria over tax policy, but this new approach has the potential to challenge, weaken, or even topple, the existing policy rationales underlying the intransigence of the modern debate.

Part I of this Article will summarize and discuss the literature on corporate tax incidence and explain how under conditions of high unemployment, low inflation, and near-zero interest rates, the corporate tax can be borne significantly by workers. Part II.A will then introduce macroeconomic theory into the analysis, discussing how current macroeconomic conditions significantly change the way to think about the corporate tax itself. In response, Part II.B introduces the pro-growth, pro-employment, self-financing DST mechanism as a solution to the current problem. Part II.C will go on to explain how, taking the incidence analysis as a given, the DST can better achieve the fiscal policy goals of the tax system. Part III will then discuss some theoretical and administrative difficulties in implementing the proposal. Lastly, Part IV will review some of the political and rhetorical hurdles facing the use of tax law as fiscal policy, and discuss how the analytic approach of this Article, if not the DST itself, can help overcome these hurdles.

I. THE INCIDENCE OF THE CORPORATE INCOME TAX AND MACROECONOMICS: HISTORY AND LESSONS

Notwithstanding over one hundred years of experience, surprisingly little is known about how the corporate income tax actually works or who ends up paying it. The question of who ultimately bears the cost of the corporate income tax is generally referred to as the problem of the “incidence” of the corporate income tax.¹¹ The root cause behind the incidence problem is pretty straightforward: corporations are not human beings. Rather, corporations are creatures of law, allocations of power and responsibility among people to permit the efficient pooling of capital by separating ownership of capital from the management of it.¹²

Then what does it mean for a corporation to “pay” taxes? It simply means that the corporation transfers wealth to the government instead of to one of its constituencies—shareholders, employees, suppliers, or consumers.¹³ Since income taxes are paid out of profits, and shareholders are generally entitled to the profits of a corporation, it would appear at first that the incidence of the tax must be borne by the shareholders. However, this may not necessarily be correct, as there are other constituencies that

¹¹ See Harberger, *supra* note 5, at 215.

¹² This is true regardless which theory of corporate personhood is applied. See, e.g., David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201; Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183 (2004); R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

¹³ See DANIEL N. SHAVIRO, *DECODING THE U.S. CORPORATE TAX* 58–59 (2009).

could effectively bear the incidence of the corporate tax as well.¹⁴ For example, a corporation could raise the price of its goods or services to account for the income tax thereby ensuring after-tax profits remain the same. In such a case, consumers would effectively bear the incidence of the corporate income tax through higher prices.¹⁵ Alternatively, a corporation could lower employee salaries to maintain the same after-tax profits, in which case labor would bear the incidence of the corporate tax. So which group really bears the brunt of the incidence—capital, labor, or consumers?¹⁶ The well-established answer in the literature is . . . nobody knows.¹⁷ Or, more precisely, that nobody can ever really know.¹⁸ Rather, the answer to “who bears the cost of the corporate income tax?” depends on one’s theory about how corporations and the economy interact, and which constituencies have no other choice but to bear the incidence. The next section summarizes some of these theories.

A. *A Brief Background on Incidence Theory*

Harberger first comprehensively analyzed the incidence of the corporate tax over fifty years ago.¹⁹ Harberger assumed two industries—a taxed one and an untaxed one—and the presence of efficient markets. Under these assumptions, the incidence of the tax on the taxed sector depended on the relative inputs into each industry. In other words, in labor-intensive industries labor would bear more of the tax and in capital-intensive industries capital would bear more of the tax. Crucially, however, Harberger assumed full employment in this model, a standard assumption.²⁰ This was important because it meant that labor would leave the taxed industry and move to the untaxed industry as the tax cost increased. Since there could be no involuntary unemployment, under basic supply and demand theory the increased supply of labor in the untaxed industry would result in lower labor costs, which would also then attract capital, until a

¹⁴ See *id.* at 63.

¹⁵ Although this is possible for a particular consumer, consumers as a whole are generally not considered to bear the incidence of the corporate tax since it would “wash” out over multiple corporations. See SHAVIRO, *supra* note 13, at 63; Harberger, *supra* note 5, at 217–20.

¹⁶ This analysis assumes end-product producers only. There is another possibility, however, that intermediate suppliers would bear the corporate income tax through lower prices. Assuming some fixed costs of production and competition, however, there is a limit to the ability to do so. See, e.g., Kul B. Bhatia, *Intermediate Goods and the Incidence of the Corporation Income Tax*, 16 J. PUB. ECON. 93 (1981).

¹⁷ See William A. Klein, *The Incidence of the Corporation Income Tax: A Lawyer’s View of a Problem in Economics*, 1965 WIS. L. REV. 576, 601 (“[T]he only proper answer to the question ‘Is the corporation income tax shifted?’ must be, ‘Maybe so, maybe not—I just don’t know.’”).

¹⁸ See Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know*, in 20 TAX POLICY AND THE ECONOMY 1 (James M. Poterba ed., 2006); Bartlett, *supra* note 6.

¹⁹ See Harberger, *supra* note 5.

²⁰ *Id.* at 216.

new equilibrium was reached. Under the Harberger model, under most standard assumptions, capital would generally bear most—if not all—of the incidence of the corporate tax.

Subsequent work introduced the impact of other factors.²¹ For example, Atkinson and Stiglitz introduced the impact of unemployment; in other words, they relaxed the standard assumption used by Harberger that the price of labor would always adjust such that there would never be unemployment in the market.²² This proved rather difficult as there was (and is) no single accepted theory for the presence of unemployment in an economy. Importantly, the basis for assuming why there is unemployment in the market impacts how it affects the incidence analysis.²³ Atkinson and Stiglitz introduced an assumption of nonmarket-clearing unemployment by tying wages to sticky prices; in other words they assumed that for some reason the price of labor could not change immediately in the face of unemployment. This could occur, for example, if there were minimum wage laws, union contracts, or other limits on the ability to reduce wages. As a result, in contrast to what Harberger assumed, wages would not drop in the face of excess supply of labor, and there would no longer be full employment in the model.

Under that set of assumptions, unsurprisingly, the incidence analysis changed significantly from Harberger's analysis. Atkinson and Stiglitz found three effects: (1) a direct effect on labor depending on the relative elasticity of substitution between the taxed and untaxed sector, (2) an indirect "demand" effect where the impact on labor depended on the impact on prices and the labor intensity of the taxed sector, and (3) an effect on labor depending on the relative elasticity of the price of labor in the market.²⁴ The conclusion they drew was that "[w]here the individual is unable to sell all the labour he wishes, an expansion of employment contributes *ceteris paribus* to an increase in welfare."²⁵ Intuitively this makes sense; if something in the economy creates involuntary unemployment, there will be more workers looking for work than there will be jobs. In such a case, workers should be willing to work for less, meaning

²¹ See, e.g., ANTHONY B. ATKINSON & JOSEPH E. STIGLITZ, LECTURES ON PUBLIC ECONOMICS 222–26 (1980); Jennifer C. Gravelle, *Corporate Tax Incidence: Review of General Equilibrium Estimates and Analysis* (Cong. Budget Office, Working Paper No. 2010-03, 2010), https://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/115xx/doc11519/05-2010-working_paper-corp_tax_incidence-review_of_gen_eq_estimates.pdf.

²² See ATKINSON & STIGLITZ, *supra* note 21, at 222.

²³ See, e.g., Leon Bettendorf et al., *Corporate Tax Policy and Unemployment in Europe: An Applied General Equilibrium Analysis*, 32 WORLD ECON. 1319, 1319 (2009) ("There is only little research, however, on the labour market implications of corporate taxation, and virtually no papers on corporate taxes and unemployment. . . . Previous studies that have analysed the relationship between corporate taxes and employment have typically assumed a perfect labour market.").

²⁴ See ATKINSON & STIGLITZ, *supra* note 21, at 225.

²⁵ *Id.*

employers can more easily shift the incidence of the corporate tax onto workers than in a world absent unemployment.

Importantly, regardless of the methodology used, recent work using a number of different theories of involuntary unemployment have found labor bearing a significantly higher share of the incidence of the corporate tax than under the Harberger model. For example, Miyagiwa²⁶ looked at the effects of sectoral unemployment, in which certain sectors of the economy cannot lower wages while others can (for example, when there is a unionized and nonunionized sector of the economy).²⁷ Agell and Lundborg looked at involuntary unemployment as a result of fair wages, meaning employees care not only about total wages, but also about the ratio of wages to returns on capital.²⁸ Parai and Choudhary analyzed incidence where labor was not perfectly mobile.²⁹ Rapanos considered the question under the impact of efficiency wages, comparing not only the dollar cost of wages but also the impact of those wages on the effort of labor.³⁰ Regardless of the theory, all of the above studies concluded that labor bears more of the incidence of the corporate income tax in the presence of unemployment than under the Harberger model.

What emerges from this line of literature is a distinct lack of consensus on how macroeconomic conditions impact the incidence analysis,³¹ since

²⁶ Kaz Miyagiwa, *Corporate Income Tax Incidence in the Presence of Sector-Specific Unemployment*, 37 J. PUB. ECON. 103 (1988).

²⁷ Others have looked at similar questions as well. See, e.g., Leonard F.S. Wang, *Sector-Specific Unemployment and Corporate Income Tax Incidence: A Geometric Exposition*, 37 AM. ECONOMIST 64 (1993).

²⁸ Jonas Agell & Per Lundborg, *Fair Wages, Involuntary Unemployment and Tax Policies in the Simple General Equilibrium Model*, 47 J. PUB. ECON. 299 (1992).

²⁹ Amar K. Parai & Munir A.S. Choudhary, *Imperfect Labor Mobility and Corporate Tax Incidence*, 6 INT'L ECON. J. 75 (1992). If labor were not perfectly mobile, workers who lost jobs in one city would not be able to take jobs in another, leading to some unemployment.

³⁰ Vassilis T. Rapanos, *Tax Incidence in a Model with Efficiency Wages and Unemployment*, 20 INT'L ECON. J. 477 (2006). Efficiency wage theory would explain involuntary unemployment by attributing two motivating factors to the labor wage rate: (1) supply and demand for labor and (2) the effect of the wage rate on the effort of employees. *Id.* at 479. Thus, it could be rational for an employer to pay a higher wage than absolutely necessary if that higher wage resulted in higher effort by workers, making the per-dollar return on labor higher. If this occurs, the labor wage rate is set above the market-clearing rate, resulting in involuntary unemployment. Assuming this is true, higher levels of unemployment would serve to reduce the pure labor wage rate, meaning employers could extract even greater effort out of labor at the existing efficiency wage rate.

³¹ See Uwe E. Reinhardt, *Who Ultimately Pays the Corporate Income Tax?*, N.Y. TIMES ECONOMIX BLOG (July 23, 2010, 6:00 AM), http://economix.blogs.nytimes.com/2010/07/23/who-ultimately-pays-the-corporate-income-tax/?_r=0 (“General-equilibrium models accommodating this wider view of the economy and the longer run go much beyond the compass of a freshman course and show that who actually pays the corporate income tax—the owners of capital or labor—is driven by a number of factors in complicated ways that elude simple intuition.”); see also Peter Mieszkowski, *Tax Incidence Theory: The Effects of Taxes on the Distribution of Income*, 7 J. ECON. LITERATURE 1103, 1116–17 (1969) (criticizing previous studies for omitting significant changes in unemployment over their sample time periods).

one's results depend on how one explains the presence of macroeconomic conditions, such as high unemployment, in the first place.³² But what does emerge is that almost any theory of unemployment, whether it be efficiency wages, lack of labor mobility, unions, or otherwise, leads to labor bearing a larger portion of the incidence of the corporate income tax than under the Harberger model. Thus, if one takes as a given the presence of high, persistent unemployment, low inflation, and near-zero interest rates, such as in the current economy, it is possible to state that the relative elasticity of labor during periods of high unemployment is lower than the relative elasticity of labor during periods of full employment. Under Atkinson–Stiglitz, one effect of this change in relative elasticity of labor would be an increase of the incidence of the tax on labor. Under other approaches, such as Agell and Lundborg or Paraia and Choudharya or Rapanos, this would almost certainly be the effect.

In other words, at some point members of the labor force could become locked into their jobs, meaning labor becomes near inelastic. At such a point, it would be anticipated that capital could much more easily demand increased effort, lower wages, or both, even during times of record profits.³³ The same could be thought of in terms of the incidence of the tax.³⁴

One theory of the incidence of the corporate income tax that adopts a similar approach is sometimes referred to as the “wage bargaining” model.³⁵ Under the wage bargaining model, employers take into account the cost of the tax and then attempt to allocate it among the relative constituencies. As would be expected, who bears the incidence of the tax depends on the relative elasticities of the constituencies. If labor has high bargaining power, capital will bear more of the incidence.³⁶ If consumers highly demand the product, the corporation can raise prices and consumers will bear more of the incidence.

³² See, e.g., CRONIN ET AL., *supra* note 7, at 2–6 (discussing assumptions in previous incidence studies). For example, neoclassical economics assumes that involuntary unemployment cannot exist, Keynesian economics takes it as a given, while New Classical and New Keynesian try to rationalize these positions. See, e.g., Paul Wojick & Mark Pernecky, *The Impossibility of Involuntary Unemployment in New Keynesian Efficiency Wage Models*, 20 E. ECON. J. 291 (1994).

³³ There is some indication that this may be the case. See Neil Irwin, *Who Will Get the Spoils of an Improving Economy: Shareholders or Workers?*, WASH. POST WONKBLOG (Apr. 9, 2013, 5:06 PM), <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/04/09/who-will-get-the-spoils-of-an-improving-economy-shareholders-or-workers>.

³⁴ See SHAVIRO, *supra* note 13, at 59–60 (describing the elasticity theory of tax incidence).

³⁵ For a recent example, see Wiji Arulampalam et al., *The Direct Incidence of Corporate Income Tax on Wages* (Inst. for the Study of Labor (IZA), Discussion Paper No. 5293, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1704266.

³⁶ See R. Alison Felix & James R. Hines, Jr., *Corporate Taxes and Union Wages in the United States* (Nat'l Bureau of Econ. Research, Working Paper No. 15263, 2009), available at <http://www.nber.org/papers/w15263>.

Interestingly, although not the dominant theory under the Harberger line of incidence literature, this wage bargaining model of tax incidence has begun to attract significant empirical support. For example, one recent empirical study found that labor could bear up to 75% of the incidence of the corporate tax,³⁷ while another study found that labor could bear up to 60% of the tax in the face of imperfect competition and capital mobility,³⁸ and a working paper from the Congressional Budget Office estimated the amount to be upwards of 70%.³⁹ Crucially, all of these studies focus on the relative elasticity of labor as compared to capital. To the extent a high inelasticity of labor supply is assumed, for example due to unusually high and persistent unemployment, a corollary assumption would be that labor would bear a disproportionate amount of the incidence of the corporate tax, at least as compared to the situation of full employment.⁴⁰

B. Conceptualizing Incidence in the Modern Economy: An Example

To illustrate, imagine a company—assume it is called General Automotive (GA)—which manufactures and sells cars. In a typical year GA makes 1000 cars, which sell for \$20,000 each, generating \$20 million in gross revenue per year. The raw materials for the cars cost \$10 million, which remains relatively fixed year to year, and GA employs 100 workers who earn \$50,000 per year, for a total labor cost of \$5 million. Taken together, in a typical year GA earns a profit of \$5 million. Then, out of the blue, the economy goes into a deep recession, and people stop buying as many cars. GA's sales drop from 1000 cars per year to 800 cars per year, total revenue drops from \$20 million to \$16 million, and profits drop from \$5 million to \$1 million.

³⁷ Arulampalam et al., *supra* note 35, at 5 (citing Mihir A. Desai et al., Labor and Capital Shares of the Corporate Tax Burden: International Evidence (Dec. 2007) (presented at the International Tax Policy Forum and Urban-Brookings Tax Policy Center 2007 conference), available at <http://www.aea.org/aea/2011conference/program/retrieve.php?pdfid=326>). *But see* Kimberly A. Clausing, *In Search of Corporate Tax Incidence*, 65 TAX L. REV. 433 (2012) (criticizing some of these studies).

³⁸ See Li Liu & Rosanne Altshuler, *Measuring the Burden of the Corporate Income Tax Under Imperfect Competition* 3 (Oxford Univ. Ctr. for Bus. Taxation, Working Paper No. 11/05, 2011), http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_11/WP1105.pdf.

³⁹ See William C. Randolph, *International Burdens of the Corporate Income Tax* 44 (Cong. Budget Office, Working Paper No. 2006-09, 2006), <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/75xx/doc7503/2006-09.pdf>; see also Robert Carroll, *Corporate Taxes and Wages: Evidence from the 50 States* 3 (Tax Found., Working Paper No. 8, 2009), <http://www.taxfoundation.org/sites/taxfoundation.org/files/docs/wp8.pdf> (“[F]or every one dollar increase in state and local corporate tax revenues, wages can be expected to fall by roughly 2.5 dollars.”).

⁴⁰ See, e.g., JIM NUNNS, URBAN INST. & URBAN-BROOKINGS TAX POLICY CTR., HOW TPC DISTRIBUTES THE CORPORATE INCOME TAX (2012), <http://taxpolicycenter.org/UploadedPDF/412651-Tax-Model-Corporate-Tax-Incidence.pdf>. For a good overview of empirical evidence on labor's share of corporate tax incidence, see Matthew H. Jensen & Aparna Mathur, *Corporate Tax Burden on Labor: Theory and Empirical Evidence*, 131 TAX NOTES 1083 (2011).

Assuming raw materials costs are fixed, and dropping the price might sell more cars but would not raise total profits, the only available avenue to increase profit would be to decrease labor cost. Assume GA does so, announcing an across-the-board salary reduction of 20%, reducing its labor cost to \$4 million and thereby immediately doubling its profits from \$1 million to \$2 million—not as good as in a typical year but *much* better than the year before.⁴¹ But why would labor put up with this, and why would a competitor not hire away the disgruntled workers? In periods of deep unemployment, labor has little choice; there are no other jobs as competitors are not hiring. Consequently, in effect, GA managed to shift the bulk of the costs of reduced sales due to the recession onto labor and away from capital, precisely because in a recession labor has nowhere else to go.

Just like the cost of reduced sales during a recession, a corporation can allocate the cost of an income tax among capital, labor, and consumers as well. In a growing economy workers or consumers may have several choices. Thus, if a corporation tries to allocate the tax on workers (through lower wages, for example) workers will simply leave for a different job. This is effectively the Harberger result. In a deep recession, however, workers no longer have the option to leave, or at least to a much lesser extent, because of high unemployment. Meanwhile, a corporation, such as GA, presumably cannot raise prices in a recession because consumers have less money than when the economy was robust. Therefore, just like GA shifted a substantial amount of the cost from lower sales onto labor, GA would also have an incentive to shift its tax burden onto labor during periods of high unemployment.⁴² This is effectively the Atkinson and Stiglitz result.

II. INTEGRATING MACROECONOMICS AND THE CORPORATE INCOME TAX: THEORY AND EXTENSIONS

A. *A Brief Background on the Role of Fiscal Policy in Macroeconomic Theory*

As demonstrated in the example above, it is possible for macroeconomic conditions to distort microeconomic decisionmaking. It follows, therefore, that removing existing implicit tax-induced distortions can theoretically serve both to increase the overall efficiency of corporate hiring decisions from a microeconomic standpoint and, at the same time,

⁴¹ For a discussion of the relative burden of a recession on labor and capital, see ANDREW SUM ET AL., CTR. FOR LABOR MKT. STUDIES, NE. UNIV., THE “JOBLESS AND WAGELESS” RECOVERY FROM THE GREAT RECESSION OF 2007–2009: THE MAGNITUDE AND SOURCES OF ECONOMIC GROWTH THROUGH 2011 I AND THEIR IMPACTS ON WORKERS, PROFITS, AND STOCK VALUES (2011).

⁴² See Arulampalam et al., *supra* note 35, at 28–29.

supplement macroeconomic pro-employment policies.⁴³ Would it not be simpler just to wait until there is a significant increase in unemployment and then implement a targeted tax break to stimulate the economy, rather than make permanent changes to the corporate income tax? The answer, as discussed below, lies in the development of modern macroeconomic theory, or more specifically, on a deep lack of consensus among modern economists on the workings of macroeconomic theory.

As discussed above, neoclassical economics assumes an economy with no involuntary unemployment.⁴⁴ The puzzle, therefore, faced by neoclassical economics, and continued to be faced to this day, has been to explain why there in fact was or is unemployment in the economy.⁴⁵ John Maynard Keynes was the first modern economist to attempt to understand this by addressing the entirety of the economy in one theory.⁴⁶ Keynes posited, very generally, that unemployment resulted from a lack of demand in the economy and that the solution to unemployment was therefore government support for increased demand.⁴⁷

Keynes's theory was ultimately formalized through the "IS-LM" curve model.⁴⁸ Based on the IS-LM model, traditional Keynesian macroeconomic theory holds that as demand drops during recessionary periods, government spending can offset this reduction in demand, either by directly purchasing goods and services or by putting money in the pockets of people who will use it to consume, and thus reduce unemployment.⁴⁹

As the economy emerged from World War II, economists began to question the Keynesian model.⁵⁰ For example, one criticism of the

⁴³ See Yair Listokin, *Equity, Efficiency, and Stability: The Importance of Macroeconomics for Evaluating Income Tax Policy*, 29 YALE J. ON REG. 45, 88–89 (2012).

⁴⁴ See *supra* note 20 and accompanying text.

⁴⁵ See Michael W.L. Elsby & Matthew D. Shapiro, *Why Does Trend Growth Affect Equilibrium Employment? A New Explanation of an Old Puzzle*, 102 AM. ECON. REV. 1378, 1378 (2012) ("Explaining the variation in rates of employment over time has been a central question for labor and macroeconomics and for public policy for several decades.").

⁴⁶ See ROGER E. BACKHOUSE, *INTERPRETING MACROECONOMICS: EXPLORATIONS IN THE HISTORY OF MACROECONOMIC THOUGHT* 7 (1995) (citing JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY* (1936)).

⁴⁷ The classic IS-LM model was developed by Hicks in 1937. See *id.* at 120; Michel De Vroey, *Getting Rid of Keynes? A Survey of the History of Macroeconomics from Keynes to Lucas and Beyond* 2–5 (Nat'l Bank of Belg., Working Paper No. 187, 2010), <http://www.nbb.be/doc/oc/repec/reswpp/wp187En.pdf>.

⁴⁸ See De Vroey, *supra* note 47, at 4 (citing Franco Modigliani, *Liquidity Preference and the Theory of Interest and Money*, 12 ECONOMETRICA 45 (1944)). The IS-LM model has received increased attention and support from some economists in recent years. See, e.g., Paul Krugman, *Destructive Creativity*, N.Y. TIMES (Apr. 21, 2013, 11:45 AM), <http://krugman.blogs.nytimes.com/2013/04/21/destructive-creativity-2>.

⁴⁹ See Paul Krugman, *IS-LMentary*, N.Y. TIMES (Oct. 9, 2011, 3:14 PM), <http://krugman.blogs.nytimes.com/2011/10/09/is-lmentary>.

⁵⁰ See N. GREGORY MANKIW, *PRINCIPLES OF MACROECONOMICS* 498–500 (6th ed. 2012).

Keynesian model was that it called for increased government spending to reduce unemployment, but most economic theory supported the idea that debt-financed government spending would lead to increased inflation and thus could increase unemployment.⁵¹

In response, by the 1960s critics began asserting that stable monetary policy—the tool used to control inflation—should be the single tool used to impact employment, meaning that fiscal policy was mostly irrelevant (or even worse, harmful) to macroeconomic growth or stability.⁵² This was the primary insight of the “monetarist” school of economics, perhaps represented most famously by Milton Friedman.⁵³

Another criticism of the Keynesian model was that it relied on the concept of a multiplier effect where every dollar of demand stimulus generated more than one dollar of growth.⁵⁴ The intuition behind the multiplier effect is that if the government provides one dollar in unemployment insurance, the recipient spends it at a store, which then can hire employees; these employees, in turn, can then consume at a different store, which can then hire even more employees, etc. In other words, a dollar of demand stimulus is worth a lot more than a dollar because it is used multiple times in the economy. Thus, the government was justified in borrowing one dollar to spend on one dollar of demand stimulus because it generated more than one dollar of growth.

If the multiplier effect were not true, however, every dollar borrowed by the government and spent by recipients would have the exact same impact on the economy as a whole as if the government had simply left the dollar in the economy to begin with—that is, a dollar is a dollar. If this were the case, the government would be incurring debt (and paying interest) for no benefit or, even worse, actually harming the economy by redirecting resources to less efficient uses than would have occurred had the government left the money in the economy. The empirical evidence of

⁵¹ Olivier Blanchard, *What Do We Know About Macroeconomics that Fisher and Wicksell Did Not?*, 115 Q.J. ECON. 1375, 1385–86 (2000).

⁵² See, e.g., BACKHOUSE, *supra* note 46, at 127 (“[Fiscal] policy could not be used to stabilize the economy. The best policy was to minimize disturbances to the economy by ensuring that monetary policy did not itself become a source of disturbance.”); Alan J. Auerbach, *Is There a Role for Discretionary Fiscal Policy?*, in RETHINKING STABILIZATION POLICY: A SYMPOSIUM SPONSORED BY THE FEDERAL RESERVE BANK OF KANSAS CITY 109, 144–45 (2002), <http://www.frbkc.org/publicat/sympos/2002/pdf/S02auerbach.pdf>.

⁵³ See MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, *A MONETARY HISTORY OF THE UNITED STATES, 1867–1960* (1963). Monetarists such as Friedman have been considered critics of Keynes within the context of the IS-LM model, rather than critics of the model itself. See De Vroey, *supra* note 47, at 6–7; BACKHOUSE, *supra* note 46, at 121 (“Friedman’s . . . theory rests on a theoretical foundation that is just as informal as Keynes’s.”).

⁵⁴ For a good nontechnical summary of the concept, see John Quiggin, *The Big Issues in Macroeconomics: The Fiscal Multiplier*, COMMENT. ON AUSTRALIAN & WORLD EVENTS FROM A SOC.-DEMOCRATIC PERSP. (Jan. 4, 2013), <http://johnquiggin.com/2013/01/04/the-big-issues-in-macro-economics-the-fiscal-multiplier>.

the multiplier effect is unclear, leading some to call for more targeted demand stimulus focused on high multiplier sectors⁵⁵ and others to call for the end of demand stimulus altogether.⁵⁶

These challenges to traditional Keynesian macroeconomics formed the basis for the so-called “New Classical” movement in macroeconomics. The New Classical movement rejected the Keynesian approach and instead adopted microeconomic foundations—taking into account the reactions of rational actors in the model of the economy—into its model.⁵⁷ The New Classical movement effectively replaced the Keynesian approach to macroeconomics with an attempt to extrapolate the macroeconomy based on rational reactions in a so-called “general equilibrium” framework.⁵⁸ Thus, the New Classical movement was much more than a challenge to the conclusions of Keynesian economics—it was a challenge to its fundamental premise.⁵⁹

Under the New Classical model, neither monetary nor fiscal policy mattered per se. Rather, what mattered was how policy differed from the expectations of the market. The conclusion was that maintaining a stable fiscal and monetary policy consistent with the rational expectations of the market was more important than using either to stimulate the economy as a whole.

New Classical economists also criticized the contention that government borrowing to finance demand stimulus was essentially free. Instead, New Classical economists concluded that raising taxes to repay government debt or taxes used to pay for demand stimulus was itself a drag on the economy. To the extent the economic losses caused by higher taxes or higher interest rates resulting from government borrowing outweighed any stimulative effects of the initial spending, demand stimulus would always be a bad idea. Taken together, these attacks from New Classical economists caused traditional Keynesian macroeconomics to fall into disfavor.⁶⁰

A potential synthesis of neoclassical macroeconomics and Keynesian economics arose in response to the New Classical movement, sometimes referred to as New Keynesian macroeconomics. New Keynesian macroeconomics attempted to resolve the theory behind demand stimulus

⁵⁵ See JANE G. GRAVELLE ET AL., CONG. RESEARCH SERV., RL34349, ECONOMIC STIMULUS PROPOSALS FOR 2008: AN ANALYSIS 17–18 (2008).

⁵⁶ See, e.g., Kevin A. Hassett, *Why Fiscal Stimulus Is Unlikely to Work*, 12 INT’L FIN. 75 (2009).

⁵⁷ See BACKHOUSE, *supra* note 46, at 123.

⁵⁸ This was represented perhaps most famously by Robert Lucas and Thomas Sargent. See Alan S. Blinder, *Keynes, Lucas, and Scientific Progress*, 77 AM. ECON. REV. 130 (1987); De Vroey, *supra* note 47, at 1, 9–11.

⁵⁹ This is sometimes referred to as the Walrasian model of macroeconomics. See De Vroey, *supra* note 47, at 10.

⁶⁰ See, e.g., N. Gregory Mankiw, *The Macroeconomist as Scientist and Engineer*, 20 J. ECON. PERSP. 29, 32–34 (2006).

with the microeconomic foundations and empirical results underlying the New Classical movement, explicitly incorporating microeconomic concepts of behavioral responses into their models, among other things.⁶¹

For example, New Keynesians proposed that prices could be “sticky” in that they did not float to match reductions in demand. If prices were sticky, inflation (and thus monetary policy) might have a short-term impact on unemployment, even if it did not have a long-term one.⁶² In such a case, for example, fiscal stimulus paid for with taxes on capital would have a positive multiplier effect because consumption would rise to the sticky price when the price could not drop to the lowered demand.⁶³ This positive multiplier would justify government stimulus, but only if it were targeted at the appropriate group where there were sticky prices, and thus the largest multiplier.

New Keynesian macroeconomics overcame a lot of the New Classical movement’s criticisms of traditional Keynesian macroeconomics, and could actually provide direct policy prescriptions, depending on the assumptions.⁶⁴ A problem with New Keynesian economics, however, was that taking the lessons of the models to their logical extremes often led to contradictory policy results.⁶⁵ This led critics to challenge the entire exercise of incorporating microeconomic foundations into macroeconomics

⁶¹ See *id.* at 34–37; Joseph E. Stiglitz, *Alternative Approaches to Macroeconomics: Methodological Issues and the New Keynesian Economics* (Nat’l Bureau of Econ. Research, Working Paper No. 3580, 1993), available at <http://www.nber.org/papers/w3580>.

⁶² See, e.g., Olivier Blanchard & Jordi Galí, *Real Wage Rigidities and the New Keynesian Model*, 39 J. MONEY, CREDIT & BANKING 35, 55 (2007).

⁶³ See, e.g., Tommaso Monacelli & Roberto Perotti, *Redistribution and the Multiplier*, 59 IMF ECON. REV. 630, 631–32 (2011), available at <http://www.palgrave-journals.com/imfer/journal/v59/n4/pdf/imfer201126a.pdf>. Along these lines, there is a growing body of evidence supporting a higher multiplier effect than previously thought. See Olivier Blanchard & Daniel Leigh, *Growth Forecast Errors and Fiscal Multipliers* (Int’l Monetary Fund, Working Paper No. WP/13/1, 2013), <http://www.imf.org/external/pubs/ft/wp/2013/wp1301.pdf>. Similarly, if interest rates were at the lower bound, a higher multiplier effect for government spending could be effective as compared to when interest rates were positive. See Lawrence Christiano et al., *When Is the Government Spending Multiplier Large?* (Nat’l Bureau of Econ. Research, Working Paper No. 15394, 2009), available at <http://www.nber.org/papers/w15394>; Gauti B. Eggertsson, *What Fiscal Policy Is Effective at Zero Interest Rates?* (Fed. Reserve Bank of N.Y., Staff Report No. 402, 2009), http://newyorkfed.org/research/staff_reports/sr402.pdf.

⁶⁴ See, e.g., John F. Cogan et al., *New Keynesian Versus Old Keynesian Government Spending Multipliers*, 34 J. ECON. DYNAMICS & CONTROL 281 (2010); Bruce Greenwald & Joseph Stiglitz, *New and Old Keynesians*, 7 J. ECON. PERSP. 23 (1993).

⁶⁵ See David Colander, *Post Walrasian Macroeconomics: Some Historic Links*, in POST WALRASIAN MACROECONOMICS: BEYOND THE DYNAMIC STOCHASTIC GENERAL EQUILIBRIUM MODEL 46, 64–67 (David Colander ed., 2006).

at all, either returning to original Keynesian economics or adopting an entirely new approach.⁶⁶

One such new approach was the emergence of the Dynamic Stochastic General Equilibrium model, or DSGE. In short, the New Classical and New Keynesian models both adopted a general equilibrium approach to macroeconomics, incorporating microeconomic foundations into models to determine the overall effect on the economy. DSGE extended and formalized this, taking the empirical realities of the economy and monetary policy effects as a starting point and then attempting to craft robust macroeconomic models that would produce those results. To do so, it introduced “stochastic” changes, or random shocks, to determine changes to the general equilibrium model.⁶⁷ While successful in achieving its stated goals, to critics, the complexity and assumptions necessary to effectuate DSGE models often made them nearly meaningless in terms of actual policy recommendations.⁶⁸

At present, it is safe to say that there is no consensus among Keynesians, Monetarists, New Classical theorists, New Keynesians, or DSGE theorists regarding the proper role of fiscal policy in addressing macroeconomic conditions.⁶⁹ Correspondingly, the deep disconnect among policymakers as to the role of fiscal policy in macroeconomic stimulus is more a reflection of the state of disarray in modern macroeconomics than any fundamental policy or political disagreement. This has led some to claim that modern macroeconomic theory is not particularly helpful in setting real-world policy.⁷⁰ But this cannot be completely correct. Taxes and spending clearly have an impact on the economy as a whole, and macroeconomic fiscal policy should be looked to at least in instances when traditional monetary policy tools appear exhausted.⁷¹

Given what we know about the incidence of the corporate tax, what does it tell us about how corporate taxes should respond in the face of a recession? With traditional monetary policy stimulus virtually exhausted,⁷²

⁶⁶ In other words, what good is a theory if it does not comply with empirics, and what good are empirics if they cannot lead to a theory? See, e.g., Olivier Blanchard, *The State of Macro*, 1 ANN. REV. ECON. 209, 223–25 (2009).

⁶⁷ See MICHAEL WICKENS, *MACROECONOMIC THEORY: A DYNAMIC GENERAL EQUILIBRIUM APPROACH* 4–10 (2d ed. 2011).

⁶⁸ See *id.* at 7 (“Krugman . . . claims that the macroeconomics of the last thirty years is spectacularly useless at best . . .”).

⁶⁹ See Blanchard, *supra* note 66.

⁷⁰ See Giuseppe Fontana, *Whither New Consensus Macroeconomics? The Role of Government and Fiscal Policy in Modern Macroeconomics* 19 (The Levy Econ. Inst., Working Paper No. 563, 2009), available at <http://ssrn.com/abstract=1410615>.

⁷¹ See *id.*; John B. Taylor, *Reassessing Discretionary Fiscal Policy*, 14 J. ECON. PERSP. 21, 29 (2000).

⁷² See Jeffrey M. Lacker, President, Fed. Reserve Bank of Richmond, *Economic Outlook* (Oct. 15, 2012), available at http://www.richmondfed.org/press_room/speeches/president_jeff_lacker/2012/lacker_speech_20121015.cfm.

economists have recently returned to the idea of using fiscal policy as a form of macroeconomic stimulus.⁷³ The problem with doing so, however, especially in the context of corporate income taxes, is that economists cannot agree on what form of fiscal stimulus is appropriate. For example, so-called supply-side theorists would say examples like GA in Part I.B of this Article prove that corporate taxes need to be lowered in a recession to improve employment, while so-called demand-side theorists would disagree, saying examples like GA prove that the problem is not corporate taxes but lack of demand for new cars.⁷⁴

Other critics respond that fiscal stimulus leads to budget deficits, which can actually be counterproductive if fears of government defaults, bailouts, or both lead to spikes in long-term interest rates.⁷⁵ The response to this, of course, is to raise revenue to reduce budget deficits.⁷⁶ Thus, demand-side proponents might oppose reductions in the corporate tax, but also support increasing the corporate tax in the face of a recession to pay for other demand stimulus.⁷⁷ Supply-side theorists would contend that this is exactly backwards because increasing taxes on employers leaves less money to invest in new production, meaning less investment in growth and thus higher unemployment.

But there is another option: firms could just pocket the money from tax cuts and continue to lay off workers.⁷⁸ Assuming labor in a recession becomes highly inelastic, in that workers have few available options, capital has little incentive to share any tax savings with them, at least under a wage bargaining model. This does not necessarily mean demand-side proponents are correct, however. While it is true on average that increased cash flow to unemployed workers will tend to be consumed, increasing

⁷³ See, e.g., Olivier Blanchard et al., *Rethinking Macroeconomic Policy*, 42 J. MONEY, CREDIT & BANKING 199, 205–06 (2010).

⁷⁴ See, e.g., Jeffrey Miron, *The Case Against the Fiscal Stimulus*, 33 HARV. J.L. & PUB. POL'Y 519, 520–25 (2010). This Article generally only considers fiscal policy and not monetary policy, which could also be used to stimulate demand through lower interest rates or other increases in the money supply due to the assumption that monetary policy has been constrained or maximized.

⁷⁵ See, e.g., Gregory Hoelscher, *New Evidence on Deficits and Interest Rates*, 18 J. MONEY, CREDIT & BANKING 1 (1986).

⁷⁶ The problem, of course, is—who should be taxed? Under this approach, much like the saying famously attributed to Willie Sutton, go where the money is . . . , that is, tax owners of capital. See WILLIE SUTTON WITH EDWARD LINN, *WHERE THE MONEY WAS: THE MEMOIRS OF A BANK ROBBER* (Broadway Books 2004) (1976).

⁷⁷ See Diane Lim Rogers, *Why Cutting Taxes to Help the Economy Isn't So Easy*, 132 TAX NOTES 301, 303 (2011). The reality of course is not as clean as a dollar-for-dollar increase in unemployment insurance paid for by an increase in corporate tax rates. Rather, one approach adopted during this current recession has been a payroll tax holiday for workers (intended to increase take-home pay for labor) without reducing corporate taxes. See Robert H. Frank, *The Payroll Tax Needs a Vacation*, N.Y. TIMES, June 26, 2011, at BU4; Nicola M. White, *Payroll Tax Holiday Plan Draws Criticism from Left*, 129 TAX NOTES 1304 (2010).

⁷⁸ See Rogers, *supra* note 77, at 301–02.

aggregate demand, this does not necessarily mean that such increased demand would be high enough to stimulate corporations to increase hiring (or decrease layoffs).⁷⁹

Both theories think of taxes as a form of macroeconomic policy, although in different directions: increasing the amount of money in a particular area will lead to increased amounts of activity in that area.⁸⁰ What lessons can be taken away, then, for fiscal policy in the modern economy? Primarily that the lessons from macroeconomics cannot be ignored in crafting fiscal policy, but, at the same time, no one clear policy prescription emerges from modern macroeconomics.

This does not mean that policymakers cannot use the lessons from macroeconomics to improve the design and structure of the modern corporate income tax. As recent events indicate, doing nothing is not neutral. To the extent the economy is fundamentally changing, the efficiency and distributive consequences of the corporate income tax must be taken into account in crafting any fiscal policy responses.

For example, take the debate over so-called corporate integration. The integration debate concedes that corporations are efficient vehicles to collect taxes, as they are effectively large pools of capital, but argues that there should not be two layers of tax on corporations.⁸¹ Several different policies have emerged out of the integration debate, but two of the primary ones are the dividend exemption and shareholder tax credit models. Under the dividend exemption model, the corporation would pay tax on its income but not on its dividends paid to shareholders.⁸² Under the shareholder tax credit model, the corporation would pay tax on both its income and its dividends paid to shareholders, but the shareholders would be entitled to a credit equal to their pro rata share of the corporate tax paid.⁸³

Regardless of the details, the corporate integration proposals mostly assume that shareholders bear the bulk of the incidence of the corporate tax.⁸⁴ If, however, labor bears a significant portion of the corporate tax, this

⁷⁹ See Deborah Maranville, *Unemployment Insurance Meets Globalization and the Modern Workforce*, 44 SANTA CLARA L. REV. 1129, 1133 (2004).

⁸⁰ See Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1, 8 (2002).

⁸¹ See DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 1–14 (1992), available at <http://www.treasury.gov/te-source-center/tax-policy/Pages/integration-paper.aspx#summary>.

⁸² See Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 TAX NOTES 1767, 1769 (1999).

⁸³ See *id.*; R. Glenn Hubbard, *Corporate Tax Integration: A View from the Treasury Department*, 7 J. ECON. PERSP. 115, 122–23 (1993).

⁸⁴ For a more detailed description, see Adam H. Rosenzweig, *Affirmative, in The Future of Corporate Tax Reform: A Debate—Resolution #2: “Be it resolved that, assuming integration is desirable, the best way to achieve it is by exempting dividends from taxation in shareholders’ hands,”* 33 A.B.A. SEC. TAX’N NEWSQUARTERLY 10, 10–11 (2013).

analysis may not hold. For example, granting a dollar-for-dollar credit to shareholders for corporate tax paid could overcompensate shareholders who do not, in fact, bear the entire cost of the corporate tax. In fact, it could reinforce the incentive to shift the cost of the corporate tax onto another constituency, since shareholders would receive the credit regardless of who bears the cost of the tax. If true, this would undermine the efficiency analysis of a shareholder tax credit model, at least one designed to be dollar for dollar. To the extent the push for a shareholder tax credit integration model is efficiency driven, therefore, reconsideration may be necessary.

The same analysis holds for any attempt to use the corporate income tax in a way that requires understanding its incidence. For example, the corporate tax has been looked to as a tool for combating unemployment over the past several years.⁸⁵ But if the above incidence analysis is correct, the tools proposed and adopted could be ineffective or, even worse, counterproductive.

Notice what such an approach does, and equally as important, does not do. By taking into account the impact of macroeconomic conditions on traditional microeconomic decisionmaking, previously unaccounted for distortions can be identified; correcting these distortions could, depending on all the moving parts, lead to efficiency gains in the income tax. But in addition, for the first time, since the improvement would take into account macroeconomic trends, it could also have a positive feedback effect on the macroeconomic condition of the economy. Contrast this to the more traditional use of fiscal policy as a macroeconomic tool, such as fixed-dollar hiring tax credits intended to increase hiring and stimulate demand, in which distortions to individual employers' decisionmaking are tolerated for potential macroeconomic benefits.⁸⁶

This is not to say that all monetary and fiscal responses to macroeconomic conditions are unnecessary or inappropriate, or to obviate the need for the Federal Reserve to set short-term interest rates or the government to adopt Keynesian-type stimulus or other responses. Rather, taking into account the impact of macroeconomic conditions into a traditional microeconomic analysis of the corporate income can uncover both efficiency benefits and macroeconomic benefits through a single mechanism. The remainder of this Article will consider one example of such an approach, the DST.

B. Conceptualizing a New Fiscal Policy: An Introduction to the DST

Corporate profits are at all-time highs while unemployment remains stubbornly high; it is unclear who will gain from any future growth—labor

⁸⁵ See, e.g., Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, § 101, 124 Stat. 71, 72–73 (2010).

⁸⁶ See *infra* Part III.A.1.

or capital.⁸⁷ In fact, stubbornly high unemployment has been the defining characteristic of the U.S. economy since the Great Recession of 2008. Regardless of the particular position, economists and policymakers seem to agree that their macroeconomic theories of fiscal policy are, at best, only indirectly related to unemployment.⁸⁸ The incidence analysis in Part I demonstrates that corporate income taxes could well have played some role in creating or exacerbating such unemployment.⁸⁹ So if the debate over fiscal policy turns primarily on “jobs, jobs, jobs,”⁹⁰ why not *directly* tie tax rates to increasing jobs?⁹¹ This is the ultimate premise of the DST.⁹²

In essence, the DST takes the shifting elasticities of labor and capital in a recession and the resulting shift in the incidence of corporate tax on the margins as a given. Under this assumption, higher corporate taxes will tend to shift onto labor in a recession while savings from lower corporate taxes will tend to go to either consumers (in the form of lower prices) or capital.⁹³ To directly address unemployment, therefore, one must tie corporate taxes directly to employment.

The DST does this by replacing the current fixed corporate tax rate with a formula. The formula begins on a year-to-year basis with the preferred initial corporate tax rate, which could be any politically determined amount as appropriate for corporations during the period in

⁸⁷ Irwin, *supra* note 33.

⁸⁸ See, e.g., Rogers, *supra* note 77.

⁸⁹ See Katherine Pratt, *Deficits and the Dividend Tax Cut: Tax Policy as the Handmaiden of Budget Policy*, 41 GA. L. REV. 503, 564–65 (2007).

⁹⁰ Jim Kinney, *Jobs Message Hammered Home*, THE REPUBLICAN, May 28, 2011, at A05; Eugene Robinson, *Dear GOP: Cuts Alone Won't Cut It*, WASH. POST, Mar. 4, 2011, at A17; Eugene Robinson, *What's the Big Idea?*, WASH. POST, July 29, 2011, at A19. This is not necessarily the case, but it is an assumption that will be made for purposes of this Article, especially since under at least the Atkinson and Stiglitz model, increased employment in a world with nonmarket clearing wages will always increase welfare. See *supra* note 25 and accompanying text.

⁹¹ Cf. Peter Orszag, *Link U.S. Payroll Tax Holiday to Unemployment Rate*, BLOOMBERG (June 30, 2011, 7:55 AM), <http://www.bloomberg.com/news/2011-06-30/payroll-tax-should-be-linked-to-unemployment-rate-peter-orszag.html>.

⁹² Directly tying tax policy to macroeconomic decisionmaking represents an emerging trend in the tax literature. See Yair Listokin, *Stabilizing the Economy Through the Income Tax Code*, 123 TAX NOTES 1575 (2009). What is unique about the DST is that it uses corporate tax incidence as the tool to tie corporate tax policy with macroeconomic policy, as opposed to a more generalized and indirect across-the-board increase or decrease in tax rate.

⁹³ Cf. Francesco Daveri & Guido Tabellini, *Unemployment, Growth and Taxation in Industrial Countries*, 15 ECON. POL'Y 47 (2000); see also José M. González-Páramo, *Imperfect Factor Mobility, Unemployment, and the Incidence of Selective Capital Income Taxes* 46 (Instituto de Estudios Fiscales, Working Paper No. 11, 2003), http://www.ief.es/documentos/recursos/publicaciones/libros/Investigaciones/Inves2003_11.pdf (“Thus, if the employment effect of the tax is positive (negative), policies intended to increase the degree of capital mobility will further increase (reduce) the level of employment, with the sensitivity of this relationship being greater the smaller is the initial degree of factor mobility. . . . This implies in turn that taxes which harm capital the most are best from the employment perspective.”).

which the economy is not in a period of high unemployment (under current law the corporate tax rate is 35%).⁹⁴ This rate would then be increased or decreased each year on a corporation-by-corporation basis⁹⁵ based on the particular corporation's percentage increase or decrease in employment,⁹⁶ returning to the baseline rate in each subsequent year. In this manner, the corporate tax rate would directly relate to employers' cost-benefit analysis in the decision to lay off workers or increase hiring.⁹⁷

A dynamic, self-adjusting tax rate like the one described above is not in itself a new idea.⁹⁸ What is new is incorporating the concept of a dynamic, self-adjusting tax into the corporate income tax so as to minimize distortions to the incidence of the corporate tax caused by macroeconomic conditions.

Returning to the GA example from Part I.B, but with the addition of a simplified corporate income tax, assume there is a 35% corporate income tax on the profits of the corporation. In a typical year, GA would earn a pretax profit of \$5 million, incurring a tax liability of \$1.75 million and leaving a net after-tax profit of \$3.25 million for its shareholders. If we further assume that in a typical year GA has maximized the efficiency of its labor pool (meaning it cannot reduce salary because employees would simply go work somewhere else), the market will not bear any increase in the price of the cars (because buyers would just buy cars from somewhere else), and there is no untaxed competitive industry, all \$1.75 million of tax is effectively borne by capital.

Now assume that a deep recession arrives, with high, nationwide unemployment. There are two effects on the economy: first, as jobs become scarcer, employees at GA are less likely to find alternative employment, and second, as fewer people have jobs, there is less demand for GA's cars. The combination of these two effects has a significant impact on the incidence of the corporate tax, holding everything else constant.⁹⁹ GA

⁹⁴ I.R.C. § 11(b)(1)(D) (2012) (imposing 35% tax rate on corporations with taxable income exceeding \$10,000,000).

⁹⁵ It is this targeted response, among other things, that differentiates the DST from other proposals to adjust the payroll tax to overall unemployment rates. *See Orszag, supra* note 91.

⁹⁶ The one-for-one nature of this proposal is mostly for simplicity and as a starting point. There is no reason why the formula could not change the tax rate by 0.5% for each 1% change in employment, or even change the tax rate by the log of the employment, or exponentially, or some other number. This would be both a political and empirical question, but for purposes of this part of the Article, a one-for-one ratio is sufficient. Part III.A.3 will discuss some potential alternatives to take into account structural rather than firm-by-firm unemployment.

⁹⁷ For a general analysis of the marginal impact of fiscal policy on employment decisions, see Peter Birch Sørensen, *Public Finance Solutions to the European Unemployment Problem?*, 12 *ECON. POL'Y* 221 (1997).

⁹⁸ *See Vito Tanzi, A Proposal for a Dynamically Self-adjusting Personal Income Tax*, 21 *PUB. FIN.* 507 (1966) (proposing a self-adjusting personal income tax to prevent capital crowd out).

⁹⁹ Of course, in the real world not everything is held constant. Rather, all that is needed for the argument to hold, at least in part, is for the elasticity of labor to decrease more than the elasticity of

cannot raise prices in the face of a recession; if anything, it might need to drop prices in the face of decreased demand for cars. GA is able to reduce labor costs, however, since the employees of GA have nowhere else to go. There are many ways GA could shift the incidence of the tax onto labor, but for simplicity assume GA uses layoffs as the way to do so.

Now assume GA's sales drop 20% due to the recession. In the original example, GA correspondingly reduced its labor cost by 20%. By doing so, it continued to sell only 800 cars but increased its profits from \$1 million to \$2 million. As a result, however, GA increased its corporate income tax from \$350,000 to \$700,000. The owners of GA now face a choice. If they bear the incidence of this additional \$350,000 in tax, the total profits after tax, after layoff, would be \$1.3 million, as compared to \$3.25 million before the recession. However, due to the recession, they have another choice—cut labor costs even further to increase the after-tax profits. Assume GA does so, saving \$1 million and increasing pretax profits to \$3 million and after-tax profits to \$1.95 million.¹⁰⁰ The effective result is that the bulk of the incidence of the corporate tax on the original \$2 million of pretax profit has shifted from capital to labor, solely due to the change in the relative elasticities of the two caused by the recession.¹⁰¹ In other words, even though capital is losing real money in the recession, capital no longer bears any of the tax on these smaller profits. In contrast, prior to the recession, capital bore the entire cost of the corporate tax on the higher profits it earned.

Of course, everyone (including capital) would prefer to sell more cars and make more money, even if it meant bearing the incidence of the corporate tax. Given the reality of decreased demand due to the recession, however, capital will have an incentive to shift some or all of the corporate tax burden to labor, at least as compared to pre-recession times.

Continuing with the GA example, on an after-tax basis, the shareholders of GA earn \$3.25 million in a pre-recession year and approximately \$1.95 million in a recession year—a drop of approximately 40%. A 40% drop in after-tax profit is significant to be sure, but nowhere near the 80% drop in before-tax profits. Essentially, in this example the interaction of the corporate income tax and the relative elasticities of

capital during periods of deep unemployment. Assuming some alternative investment is available, either internationally or through U.S. Treasury Bonds, capital will always have some elasticity while labor is generally considered a much less elastic base. See Felix & Hines, *supra* note 36, at 3 (surveying studies finding up to 70% of the incidence of the corporate tax falls on labor when capital is mobile).

¹⁰⁰ GA would also have to increase productivity from the remaining employees to continue producing the 800 cars, but that does not impact the analysis so will be disregarded for purposes of this section. See *infra* Part III.A.4 for a discussion of productivity innovation.

¹⁰¹ Of course in reality the numbers would be different in that the relative elasticities would be continuous and reduced pay and benefits such as pension contributions and health care contributions would also be used to reduce labor costs rather than just layoffs, but for purposes of this Article the example is sufficient.

capital and labor act as a form of implicit subsidy to capital, at the expense of labor, during periods of deep unemployment.

Now introduce the DST. Under this scenario, GA would again face the choice of bearing the burden of the tax on \$2 million of pretax profit or attempting to shift that burden to labor. In the case of the DST, however, the shift to labor is no longer free. Rather, the initial reduction in payroll of 20% would increase the tax rate from 35% to 55%, meaning the total corporate tax bill due on \$2 million of pretax profit would no longer be \$700,000 but rather \$1.1 million, leaving an after-tax profit of only \$900,000. GA may try to increase this amount further by reducing payroll by another 20%, but doing so would increase the tax rate from 55% to 75%, resulting in pretax profit of \$3 million but after-tax profit of only \$750,000, a net decrease. Assuming the shareholders of GA would rather keep the \$900,000 of after-tax profit with 20% reduction in payroll than the \$750,000 with 40% reduction in payroll, GA will not undertake the second reduction in payroll. In this manner, the automatic and self-adjusting nature of the DST would partially discourage shifting the incidence of the corporate tax onto labor, but would not prevent reductions in payroll arising as a result of real decreases in demand. At the same time, the increasing tax rate would serve to raise additional revenue precisely when needed most.

In effect, under the DST, the shareholders of GA would choose to bear some of the incidence of the corporate tax rather than shift it onto labor—the opposite of what occurs under the current fixed corporate tax rate. Although the nominal tax rate increased due to the initial round of layoffs, capital was still better off from a total after-tax profit standpoint as a result of the layoffs; but, unlike before the DST, capital would be worse off from the second round of layoffs due to the self-adjusting feature of the corporate tax rate under the DST. Thus, under the DST, job losses would be minimized as compared to what they otherwise would have been in the face of reduced sales.

Unlike some fiscal stimulus proposals, however, these benefits would not accrue only while the economy is shrinking and unemployment is increasing. The reciprocal nature of the DST provides that if and when GA hires new employees, it will face a lower marginal tax rate as well. For example, assume in the next year demand returns and GA projects it will sell 1000 cars again, and thus has to add 20% more in payroll (through increased hours or hiring new workers). Absent the DST, GA would have pretax profit of \$5 million and after-tax profit of \$3.25 million. With the DST, the rate faced by GA would be reduced from 35% to 15%, resulting in after-tax profit of \$4.25 million—an increase of \$1 million. GA, knowing this to be the case, could use some or all of the \$1 million to pay

for the increase in salary.¹⁰² In the subsequent year when GA retains all 100 workers and sells 1000 cars, the rate will return to 35%. Since there was no change in employment in that year, GA would return to making \$5 million pretax profit and \$3.25 million after-tax profit.

In effect, the DST operated to raise tax revenue in the face of layoffs, which could be used to pay for demand stimulus, and then subsequently subsidized hiring by cutting taxes when corporations hired to meet increased demand. At the margins, on both the downturn and the upswing, the DST served to incentivize employers to invest in labor. The DST in effect, rather than providing a one-time subsidy to hiring only after massive job losses have already occurred, served to smooth the impact of the severe economic shock by slowing down the pace of layoffs during the downturn and accelerating the pace of hiring in the upswing.¹⁰³

The DST's key insight is that macroeconomic trends can have microeconomic effects—in this case, high unemployment in the economy as a whole can affect the incentives of employers to hire and fire for tax purposes. It is for this reason that the DST differs from some other recent proposals to tie the tax rate to other metrics, such as taxing inequality,¹⁰⁴ notwithstanding that they share a similar mechanism. Instead of proposing to raise taxes as a form of punishment or to lower taxes as a form of subsidy, the DST attempts to reduce existing tax-induced distortions from a microeconomic standpoint while also addressing economy-wide issues such as high unemployment and low aggregate demand. Because the DST attempts to address both, it makes sense to examine how economists think about the interaction of the micro- and macroeconomic analyses.

¹⁰² The match between the cost of hiring and the tax benefit is merely a coincidence of the numbers used in this example. Challenges in calculating the specific rate will be discussed in more detail in Part III. In reality, however, making a not unusual but somewhat strong assumption of constant employment over time (that is, a natural rate of unemployment) and equal per unit profit, the netting effect of the DST will wash out, meaning that it would have no net impact on an employer's long-term efficient level of employment. For a description of the natural rate of unemployment, see MANKIW, *supra* note 50, ch. 22.

¹⁰³ By resetting to the baseline each year, the DST should smooth the swings of hiring and firing in the face of economic shocks caused by the implicit subsidy to employers, providing the macroeconomic employment benefit (holding monetary policy constant). *Cf.* MANKIW, *supra* note 50, at 495–503.

¹⁰⁴ See Ian Ayres & Aaron S. Edlin, Op-Ed., *Don't Tax the Rich. Tax Inequality Itself*, N.Y. TIMES, Dec. 19, 2011, at A29; Mark Schmitt, *How Tax Reform Represents Obama's Greatest Shot at Hope and Change*, THE NEW REPUBLIC (July 24, 2011), <http://www.tnr.com/article/economy/92529/debt-ceiling-tax-reform-inequality>. These proposals are in the nature of Pigouvian taxes, that is, taxing something bad to have less of it. See Agnar Sandmo, *Pigouvian Taxes*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS (Steven N. Durlauf & Lawrence E. Blume eds., 2d ed. 2008).

C. *The DST as an Example of Integrating Macro and Micro Policy into Tax Law*

The challenge of the DST, or any fiscal policy response to macroeconomic conditions, is to craft a policy that can maximize the efficiency of the tax laws from a microeconomic perspective while also taking into account desired macroeconomic policy goals related to issues such as employment, interest rates, and public debt.

The basic idea behind the DST is to recognize the economic reality that macroeconomic conditions can change the microeconomic analysis of the tax laws, and that microeconomic decisionmaking can have different macroeconomic consequences depending on the macroeconomic conditions. In this manner, the DST directly confronts an unspoken assumption in the tax literature: that very little is known theoretically or empirically about how these two interact or operate within the tax laws. Taking as a given, however, that the tax law applies to the economy as a whole, directly confronting this question becomes rather important, especially as policymakers increasingly look to fiscal policy as a macroeconomic tool.¹⁰⁵

The DST attempts to integrate these macroeconomic analyses of tax policy into a more traditional microeconomic efficiency analysis to see if any answers emerge. First, the DST asks if empirically identified macroeconomic trends can impact the microeconomic decisionmaking assumptions upon which tax policy analysis rests. Assuming the answer is yes—that is, that higher rates of unemployment lead employers to act differently with respect to taxes—the question that arises is whether a change to the tax law is available to minimize these distortions, and thereby minimize deadweight loss (or pure social waste), while raising the same amount of revenue.¹⁰⁶

The DST does this by crafting a policy that offsets incentives on an employer-by-employer basis. Specifically, the DST ensures employers no longer have an incentive to change from an efficient level of employment solely to shift the incidence of the corporate tax onto labor. Properly structured, as discussed in more detail below, the DST would reach only this tax-induced behavior, making it more efficient than current tax policy. Thus, from a traditional microeconomic standpoint, the DST makes sense as a tax policy tool, under the crucial but realistic assumption that changes in macroeconomic conditions distort incentives to employers on the margins.

¹⁰⁵ See, e.g., Listokin, *supra* note 92; see also Klein, *supra* note 17, at 590 (“In order to know what nontax variables need to be taken into account and to know how to correct for them so as to isolate the effect of the tax variable, it is necessary to have some theory about how the economy operates . . .”).

¹⁰⁶ See David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627 (1999).

But what about the DST's impact on macroeconomic conditions more broadly? Could the DST be used to reduce unemployment across the entire economy? This is a much harder question, especially given the uncertain state of macroeconomic theory generally.¹⁰⁷ Even so, looking at the DST as a whole, it is possible that the DST could achieve these macroeconomic goals under most modern theories of macroeconomics.

The DST has two potential, and reciprocal, employment benefits. First, the DST removes the incentives of employers to increase unemployment during a downturn, at least as a means to shift the incidence of the corporate tax, which results in marginally less severe downturns in the business cycle. Second, the DST provides an incentive for employers to hire as the economy picks up, accelerating periods of growth out of a recession.

Taken together, the DST's employment benefits should have a smoothing effect on employment over the business cycle, which is important because of the concept of the natural rate of unemployment.¹⁰⁸ The natural rate of unemployment theory stands for the proposition that the economy, absent swings from the business cycle, has a single "proper" rate of unemployment. Divergences from this natural rate of unemployment are troubling because they indicate something is wrong, that is, the economy is either above or below its natural rate.¹⁰⁹ Accordingly, stabilizing these swings under the natural rate of unemployment theory, such as would occur under the DST, would create macroeconomic benefits.¹¹⁰

Even under a theory of macroeconomics that does not hold to a natural rate of unemployment, the DST should have a positive impact on growth. For instance, assuming a high multiplier effect of demand stimulus, the government should spend on demand stimulus during periods of high unemployment. The problem is that borrowing to do so can increase total debt in the economy. What this means is that, as the economy begins to grow again, and demand for credit increases, there will be less capital available to lend within the private sector. This, in turn, leads to spikes in long-term interest rates, which then undercut long-term growth and employment under this theory.¹¹¹ The threat of long-term interest rate

¹⁰⁷ See *supra* notes 69–70 and accompanying text.

¹⁰⁸ See, e.g., N. Gregory Mankiw, *The Inexorable and Mysterious Tradeoff Between Inflation and Unemployment*, 111 *ECON. J.* C45, C47–C48 (2001).

¹⁰⁹ See Hian Teck Hoon & Edmund S. Phelps, *Macroeconomic Shocks in a Dynamized Model of the Natural Rate of Unemployment*, 82 *AM. ECON. REV.* 889 (1992); Edmund S. Phelps, *Macroeconomics for a Modern Economy*, 97 *AM. ECON. REV.* 543, 549–50 (2007).

¹¹⁰ See Mankiw, *supra* note 50, ch. 22 (describing the natural rate of unemployment theory); see also Per Krusell et al., *Is Labor Supply Important for Business Cycles?* (Nat'l Bureau of Econ. Research, Working Paper No. 17779, 2012), http://app.ny.frb.org/research/economists/sahin/KMRS4_EFG.pdf.

¹¹¹ See, e.g., Olivier J. Blanchard, *Current and Anticipated Deficits, Interest Rates and Economic Activity*, 25 *EUR. ECON. REV.* 361, 379 (1984).

spikes, at least under this theory, makes debt-financed demand stimulus ineffective at best and counterproductive at worst.

The potential remedy to this is a “credible commitment” by the government to pay down the debt as soon as the economy begins to grow again, although to date there has been little agreement as to what would constitute a sufficiently credible commitment to achieve this goal.¹¹² The DST, by raising revenue during periods of demand stimulus and lowering revenue during periods of growth, potentially avoids this problem. From at least one macroeconomic standpoint, the permanent, reciprocal, and automatic nature of the DST should make it roughly revenue neutral over time,¹¹³ meaning fears of fiscal stimulus leading to huge budget deficits or even potential government default along the lines of Greece¹¹⁴ should be mitigated as well. Accordingly, fears of long-term interest rate spikes should be reduced under the DST as compared to other forms of demand stimulus.

Lastly, since the DST allocates the costs and benefits of fiscal policy in a manner that, theoretically, should maximize the multiplier effect,¹¹⁵ it should find support under New Keynesian approaches that favor focusing demand stimulus on particular sectors of the economy rather than simply stimulating the general economy as a whole. It is the unique attempt to combine the benefits from all these disparate macroeconomic theories that distinguishes the DST from other types of fiscal stimulus.

III. IMPLEMENTING A DYNAMIC, SELF-ADJUSTING CORPORATE TAX RATE: THEORETICAL AND PRACTICAL ISSUES

A. Theoretical Benefits and Limitations of the DST

1. *Why Not a Simple Hiring Tax Credit?*—The immediate question that arises from any discussion of a proposal to use the tax system to reduce

¹¹² See James D. Hamilton & Marjorie A. Flavin, *On the Limitations of Government Borrowing: A Framework for Empirical Testing*, 76 AM. ECON. REV. 808 (1986).

¹¹³ In general, raising revenue to offset fiscal stimulus through a permanent and automatic mechanism such as the DST could theoretically satisfy the “credible commitment” necessary to minimize the concern over future deficits and thus increases in the long-term interest rate. See *Countries Face Choices to Reduce Debt and Deficits*, IMF SURVEY (Dec. 17, 2010), <https://www.imf.org/external/pubs/ft/survey/so/2010/POL121710A.htm> (“Fiscal stimulus needs to be combined with a credible commitment to a medium-term fiscally responsible policy . . .” (quoting Alan Auerbach)).

¹¹⁴ See Michael G. Argyrou & John D. Tsoukalas, *The Greek Debt Crisis: Likely Causes, Mechanics and Outcomes* (CESifo, Working Paper No. 3266, 2010), available at <http://ssrn.com/abstract=1719032>.

¹¹⁵ See, e.g., Tommaso Monacelli & Roberto Perotti, *Redistribution and the Multiplier* 36 (Innocenzo Gasparini Inst. for Econ. Research, Working Paper No. 409, 2011), available at <http://econpapers.repec.org/paper/igiigierp/409.htm>.

unemployment is: why not just directly pay corporations to hire people?¹¹⁶ Why not use a relatively simple fixed-dollar hiring tax credit instead of this more complicated mechanism? For example, why not wait until the National Bureau of Economic Research declares a recession to implement an across-the-board or targeted tax break for employers?

A fixed-dollar tax credit approach might satisfy one theory of macroeconomic stimulus, but it fails others. Since macroeconomics as a field cannot say with certainty which approach dominates, it is difficult to justify basing policy on only one theory over another. This is not to say that any one fiscal policy approach necessarily must displace all others; in fact, a policy such as the DST would not displace the need for broader macroeconomic policy more generally, whether monetary or fiscal. It is even possible that specific tax proposals such as a fixed-dollar hiring credit could be a good idea in addition to the DST. In fact, the DST is structured to make macroeconomic conditions more stable and thus potentially make tolls such as the fixed-dollar hiring credit more robust.

The real problem with temporary and targeted tax cuts as the only or primary means of addressing unemployment in the face of a recession is that they could prove distortive to the efficient allocation of resources, meaning not only that such a proposal could have little macroeconomic benefit, but that it also could potentially increase deadweight loss. Only a permanent, comprehensive approach can address all of these considerations at the same time. Of course, permanent solutions raise other, sometimes difficult, questions, but none of these negate the benefits of taking a comprehensive look at fiscal policy from both a micro- and macroeconomic point of view.

Assuming one were forced to choose between fiscal policy instruments, there are three reasons why the DST would be preferable to a simple fixed-dollar hiring tax credit. First and foremost, the largest benefit of the DST is that it is tailored to individual employers. Each employer best knows its own business and its labor needs. The purpose of the DST is to allow employers to make the most efficient employment decisions absent taxes and only then have the tax mechanism kick in to prevent layoffs from being used solely to shift the incidence of the corporate income tax. It does so by using tax rates, which apply only to taxable income (gross profits less expenses, such as wages); as wages go down, profits go up (holding all else equal). The more a company increases profits through layoffs or other labor costs, the more it will pay through the DST, not only through the increased rate, but also by applying the increased rate to a larger taxable income base. By using rates applied to taxable income, the DST actually has two self-

¹¹⁶ Such an approach would more closely resemble a Pigouvian tax rather than an attempt at maximizing the efficiency of the tax laws on its own terms. *See supra* note 104. Regardless, this approach has effectively been U.S. policy in recent years. *See* Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, § 102, 124 Stat. 71, 75-76 (2010).

adjusting features, the rate and the base. Conversely, if a company were unable to make a profit despite laying off workers, the DST would have no negative impact for the simple reason that any tax rate multiplied by zero profits will always be zero.¹¹⁷

By contrast, any fixed-dollar, “one size fits all” solution would not have this automatic adjustment quality in that it would be worth the same amount per employee regardless of the profits of the employer.¹¹⁸ Thus, fixed-dollar credits do not necessarily target those firms that need the most help, nor do they necessarily increase total employment if the only firms that claim the credits would have hired anyway even absent the credit.¹¹⁹

Second, a fixed-dollar tax credit does not work on both the downside and the upside. A credit for hiring new workers might provide an incentive to *hire* on the margins, but it does nothing to dissuade tax-induced layoffs in the first place. To the extent the problems created in the modern economy are due to the intense and sudden increase in unemployment during economic shocks, fixed-dollar hiring tax credits do nothing to prevent this.

Perhaps more importantly, however, the reciprocal nature of the DST is intended to undo an existing tax distortion to hiring decisions, which, holding all else equal, creates a deadweight loss in the economy. Any “one way” hiring credit not incorporating this feature, therefore, would be addressing the distortion to hiring decisions on an imprecise level, if at all. In other words, for a fixed-dollar credit to work, one would have to hope that the size and scope of the fixed-dollar credit is precise enough to offset both the hesitancy to hire out of the recession *and* the implicit subsidy to layoffs in the first place; any subsidy in excess of the efficient amount would lead to deadweight loss from inefficient hiring and any subsidy less than the efficient amount would not return employers to the efficient hiring level. The DST, by being reciprocal, automatic, and more finely tuned, minimizes this risk. Relatedly, a fixed-dollar credit creates incentives for employers to cheat the system by firing workers (which would have no tax penalty) and then hiring new workers to replace them, solely to obtain the credit.¹²⁰ The DST does not create this incentive.

¹¹⁷ In fact, rather than be harmful, the higher tax rate of the DST could actually prove beneficial to loss companies by increasing the value of their deductions. *See infra* Part III.B.2.

¹¹⁸ This is only completely true if the credit was refundable, but is still partially true even if it is not. *See, e.g.,* Lily L. Batchelder et al., *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23 (2006).

¹¹⁹ *See infra* Part III.A.3. There is evidence that the bulk of the benefit from fixed-dollar credits do in fact benefit only such inframarginal hiring, thus causing pure waste from an economic standpoint. *See, e.g.,* John H. Bishop & Mark Montgomery, *Does the Targeted Jobs Tax Credit Create Jobs at Subsidized Firms?*, 32 INDUS. REL. 289, 302 (1993).

¹²⁰ *See* Hiring Incentives to Restore Employment Act § 102(b) (“For purposes of this section, the term ‘retained worker’ means any qualified individual (as defined in section 3111(d)(3) or section 3221(c)(3) of the Internal Revenue Code of 1986)—(1) who was employed by the taxpayer on any date

Third, any ad hoc solution faces two political economy problems: (1) the need to pass any hiring credit through Congress and (2) the inability of employers to plan for the credit in advance.¹²¹ The self-adjusting nature of the DST addresses both of these problems. Because the DST adjusts tax rates automatically, it would only require one vote by Congress—at the time of enactment.¹²² Further, as discussed in more detail below, having the self-adjusting tax embodied in current law would require corporate employers to take the DST into account when reporting earnings and tax liabilities on their yearly public financial statements, potentially giving the DST current influence on corporate behavior with respect to future decisions.¹²³ This certainty supplements the smoothing effect over time, providing an additional benefit over ad hoc solutions.

2. *Why Only Public Corporations?*—On its face, perhaps the DST's toughest challenge in combating actual unemployment rates is that not all employers are corporations (or at least corporations subject to an entity-level income tax). There are sole proprietorships, partnerships (including limited liability companies treated like partnership for federal income tax purposes), S Corporations, Real Estate Investment Trusts (REITs),¹²⁴ and tax-exempt organizations including Section 501(c)(3)¹²⁵ organizations,¹²⁶ among others, which represent a sizeable percentage of all employment in the country. If employees working for corporations do not make up the bulk of workers, why spend so much time creating a special tax rate only for corporations to solve the unemployment problem?¹²⁷

The short answer is: those entities do not pay income tax, so the income tax cannot be used as a fiscal tool to impact their behavior. The longer answer is: the DST is uniquely suited toward corporations due to the nature of the incidence of the corporate tax, which does not apply to entities that do not pay a net income tax.¹²⁸

during the taxable year, (2) who was so employed by the taxpayer for a period of not less than 52 consecutive weeks, and (3) whose wages (as defined in section 3401(a)) for such employment during the last 26 weeks of such period equaled at least 80 percent of such wages for the first 26 weeks of such period.”). The DST avoids these problems by effectively penalizing the layoffs as well as subsidizing the hiring.

¹²¹ See David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CALIF. L. REV. 749, 752, 782 (2010).

¹²² Cf. *id.* at 771, 796.

¹²³ See *infra* Part III.B.2.

¹²⁴ There is some evidence that the use of REITs is actually growing as well. See Nathaniel Popper, *Restyled as Real Estate Trusts, Varied Businesses Avoid Taxes*, N.Y. TIMES, Apr. 22, 2013, at A1.

¹²⁵ I.R.C. § 501(c)(3) (2012).

¹²⁶ E.g., organizations such as Washington University in Saint Louis. See *University's Tax Status*, WASH. U. ST. LOUIS, <http://tax.wustl.edu/general/Pages/status.aspx> (last visited June 8, 2014).

¹²⁷ By contrast, virtually all employers pay payroll tax. See I.R.C. § 3111.

¹²⁸ While the incidence analysis applies to all types of taxes, the unique nature of the income tax on corporations as an entity separate from its owners makes the incidence analysis unique from other taxes,

In addition, focusing on large corporations takes into account the difference in size of the employment base. For example, if an employer with five employees were to lay off one employee, under the DST that employer would face a 20% increase in its marginal tax rate (assuming all employees were equally compensated and the tax rate adjusted 1% for each 1% change in wage base).

Regardless of the relative benefits of marginally inducing employers to bear the cost of the corporate tax, such a large increase would appear on its face to be killing a gnat with a sledgehammer.¹²⁹ Of course, this could be resolved by changing the formula such that employers with a small number of employees would face a lower marginal tax rate increase, say only 10% of the decrease in their wage deduction, in which case the hypothetical employer above would face only a 2% marginal tax rate increase. The problem is that such a formula would result in negligible impacts on large employers. For example, if a corporation employed 100,000 workers and laid off 1000, that would represent only a 1% drop in employment (assuming the workers are equally compensated for ease of calculation). As a result, the employer would face only a 0.1% increase in marginal tax rate, an amount unlikely to have any effect.

This does not mean that it would be impossible to create two DSTs, one for large employers and one for small employers, but such a bifurcated approach would significantly increase the complexity of the proposal without necessarily targeting large amounts of workers. Thus, if choosing between the two, on a case-by-case basis a DST on large employers would have a greater impact because large corporations are the only ones that engage in mass layoffs and mass hiring at any one point in time (notwithstanding that small employers as a whole employ almost half of all workers).¹³⁰

Assuming this is correct, what remains is drawing a meaningful line between large and small employers. The Internal Revenue Code currently provides two models to do so. The first would be to define large employers based on some arbitrary number of employees, revenues, or assets. For example, the Internal Revenue Code exempts employers who employ at least fifty employees in a separate line of business from certain pension obligations¹³¹ and grants special reduced capital gains rates to shareholders of corporations with gross assets below \$50 million.¹³² The other approach

including flow-through entities which act solely as accounting mechanisms. *See* Harberger, *supra* note 5, at 217–20.

¹²⁹ *Yates v. Hendon*, 541 U.S. 1, 24 (2004) (Scalia, J., concurring in the judgment) (“The Court uses a sledgehammer to kill a gnat . . .”).

¹³⁰ *See* Regina F. Burch, *Financial Regulatory Reform Post-financial Crisis: Unintended Consequences for Small Business*, 115 PENN ST. L. REV. 409, 410 (2010).

¹³¹ I.R.C. § 414(r).

¹³² *Id.* § 1202(a), (d).

would be to define large employers as only publicly traded corporations. For example, the Internal Revenue Code denies the ability to be treated as fiscally transparent (with some limited exceptions) to publicly traded entities¹³³ and limits the application of certain “golden parachute” rules only to publicly traded corporations.¹³⁴ So which should it be—size or public trading?

Based solely on the criteria of the Internal Revenue Code, no one answer necessarily jumps out as obviously correct. The answer can become clearer, however, when taking into account benefits outside the bounds of the Internal Revenue Code. In particular, using public trading rather than number of employees as the dividing line between small and large employers begins to look especially attractive once one takes into account nontax considerations. First, and perhaps most importantly, public trading is a “sticky” line¹³⁵ in that going public is already quite costly, so those companies that go public must perceive significant value in doing so.¹³⁶ For instance, corporations desire to be publicly traded for a number of reasons—cheaper access to capital markets, monetization by existing shareholders, ease of valuation, equity compensation of management, among others—but not necessarily for income taxes. In other words, if a corporation wants to go public, it is not for tax reasons.¹³⁷

Presumably, therefore, a corporation would be unlikely to *change* its decision to go public solely because it may face the DST as a public corporation as opposed to a fixed income tax rate as a private corporation. This is especially true considering the DST could result in a *lower* tax rate for the corporation if, for instance, the corporation planned on using proceeds from its initial public offering to hire new workers as part of a business expansion. Conversely, corporations do not necessarily go private (that is, cease to be publicly traded) primarily for tax reasons. For example, many corporations go private because they are being purchased by private equity funds or other financial buyers for financial reasons.¹³⁸

¹³³ *Id.* § 7704.

¹³⁴ *Id.* § 162(m)(1)–(2).

¹³⁵ This is often thought of as the ideal place to impose a tax since a tax law which does not affect behavior raises revenue without imposing a deadweight loss on society. *See* Weisbach, *supra* note 106. *But see* Terrance O’Reilly, *Principles of Efficient Tax Law: Apocrypha*, 27 VA. TAX REV. 583 (2008).

¹³⁶ *See* Richard A. Booth, *Going Public, Selling Stock, and Buying Liquidity*, 2 ENTREPRENEURIAL BUS. L.J. 649 (2008).

¹³⁷ *See* Stephen J. Redner, *Thinking of Going Public? Think Twice, Then Read the Sarbanes–Oxley Act of 2002*, 6 J. SMALL & EMERGING BUS. L. 521, 522 (2002); William K. Sjoström, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. 639, 641–43 (2009).

¹³⁸ *See* Ronald J. Gilson & Charles K. Whitehead, Essay, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 COLUM. L. REV. 231, 233–35 (2008). Even this may not be as large as once thought, however. *See* Alan R. Palmiter, *Staying Public: Institutional Investors in U.S. Capital Markets*, 3 BROOK. J. CORP. FIN. & COM. L. 245 (2009). Other corporations may go private because they become delisted from being too small to qualify for trading on the exchange. *See, e.g.*, Jonathan Macey et al., *Down and Out in the Stock Market: The Law and*

This does not address one potential problem with going private, that is, financial buyers who plan to lay off a substantial number of workers as cost savings. Under this scenario, a company could engage in layoffs as a private company, which, if done while public, would have led to a higher tax rate. This effectively makes it cheaper for financial buyers to acquire public companies (at least on the margin) for which it might have otherwise been more efficient to remain public. This can be addressed, however, by adding a transition rule. Specifically, the DST could apply to a corporation for the entire taxable year in which it went private. Thus, if a buyer wanted to use layoffs to finance an acquisition, it would have to artificially wait until the beginning of the subsequent year to do so or artificially wait until the end of the taxable year to acquire the company, imposing real risk in the transaction.¹³⁹ This risk could be avoided, however, by structuring the transaction so it closes at the end of the taxable year of the public company. There are limits to this,¹⁴⁰ but if they prove insufficient, one solution could be to “taint” the year following a year in which a company goes private by making it subject to the DST as well. Regardless, this issue should only apply to a relatively small number of companies and solutions are available.

Contrast this to using number of employees (or payroll deductions) as the dividing line between large and small employers. The primary issue with using such an arbitrary bright line is that it creates a “cliff effect”—an extremely high marginal tax on the action that crosses the line.¹⁴¹ Given this cliff effect, firms face a choice: choose not to cross the line, or find some other way to do so without falling off the cliff. This leads to the single biggest problem with using number of employees as the dividing line: it creates a powerful incentive for employers to “hide” full-time employees by converting them into independent contractors or part-time workers.¹⁴² If this incentive causes small employers to actually change their employment methods from what would be preferred, it would be undesirable in that it would impose a deadweight loss on society.¹⁴³

Economics of the Delisting Process, 51 J.L. & ECON. 683 (2008). These situations only serve to further the argument that using public trading as a proxy for size in the DST may be preferable.

¹³⁹ This is precisely the approach adopted in other similar areas of the law, such as claiming a foreign tax credit on dividends and certain similar items of income. See I.R.C. § 901(k), (l).

¹⁴⁰ For example, one way to close the year would be to treat the acquisition as a purchase of assets, but any built-in gain would effectively be subject to double tax, significantly raising the cost.

¹⁴¹ See Stephen D. Holt & Jennifer L. Romich, *Marginal Tax Rates Facing Low- and Moderate-Income Workers Who Participate in Means-Tested Transfer Programs*, 60 NAT'L TAX J. 253, 259 (2007).

¹⁴² See Myron Hulen et al., *Independent Contractors: Compliance and Classification Issues*, 11 AM. J. TAX POL'Y 13 (1994); Susan Schwochau, Note, *Identifying an Independent Contractor for Tax Purposes: Can Clarity and Fairness Be Achieved?*, 84 IOWA L. REV. 163 (1998).

¹⁴³ See Weisbach, *supra* note 106.

Likewise, if this incentive results in employers simply playing games to make it appear that their full-time employees are really something else or—even worse—flat out defrauding the government, it would also be undesirable because it would increase transaction costs (for example, by paying for tax advisors) with no corresponding increase in social benefit. In other words, since number of employees is less sticky than public trading, both in actual and planning terms, it is a less desirable line to use in imposing the DST. Using revenues as the dividing line suffers from the same malady.¹⁴⁴

3. *Inframarginal Hiring*.—One of the thorniest problems for any tax incentive is the problem of inframarginal behavior, or behavior that would have occurred absent the tax incentive. Inframarginal behavior is troubling because a tax incentive is inefficient in such a case, since the taxpayer would have undertaken the behavior even absent the tax incentive. Yet, the taxpayer receives a windfall in the form of the tax benefit.¹⁴⁵ Inframarginal behavior is particularly troubling in the case of employment, since presumably the primary reason for companies to hire or fire workers is for business reasons, not tax reasons.

The immediate response to this concern is that the DST is no worse, and should be better than, any other fiscal employment stimulus.¹⁴⁶ Providing a hiring tax credit or payroll tax holiday to hiring workers is also available regardless of whether the hiring would have occurred absent the tax incentive.¹⁴⁷ Given the nature of the world, it just is not possible to create a counterfactual scenario after enacting a tax incentive in which the

¹⁴⁴ In addition, it is possible that some companies have large revenues with very small payrolls, for example if they are driven primarily by owning intellectual property. For instance, it is not hard to imagine a company consisting of a small number of individuals who invent the greatest computer software program of all time generating massive revenues with only a small staff. The primary counterexample for a time was Facebook, which generated massive revenue and had a large employee base, and yet remained private; Facebook was effectively forced to go public rather than file disclosures with the SEC as a private company due to having over 500 shareholders. See William K. Sjostrom, Jr., *Questioning the 500 Equity Holders Trigger*, 1 HARV. BUS. L. REV. ONLINE 43 (2011), <http://www.hblr.org/?p=1028>; Evelyn Rusli et al., *The Education of Zuck*, N.Y. TIMES, May 13, 2012, at BU1, available at <http://www.nytimes.com/2012/05/13/technology/facebooks-mark-zuckerberg-at-a-turning-point.html?pagewanted=all>.

¹⁴⁵ See Michelle Scholastica Paul, *Bridging the Gap to the Microfinance Promise: A Proposal for a Tax-Exempt Microfinance Hybrid Entity*, 42 N.Y.U. J. INT'L L. & POL. 1383, 1402–04 (2010).

¹⁴⁶ See Batchelder et al., *supra* note 118, at 45–46 (arguing that a tax incentive need not be optimal but rather the best “bang for its buck”).

¹⁴⁷ See Bishop & Montgomery, *supra* note 119. This is the case for broad-based credits, but targeted credits such as the previous tax credit for hiring Vietnam veterans carry less concern. See Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973, 1033–35 (1986) (“The credit for hiring economically disadvantaged Vietnam veterans is a tax incentive which can survive both substantive and procedural scrutiny.”). Under the “nothing new under the sun” heading, the United States recently enacted a similar hiring tax credit for Iraq and Afghanistan war veterans. See Vow to Hire Heroes Act of 2011, Pub. L. No. 112-56, §§ 201–265, 125 Stat. 711, 712–33.

incentive is not part of the law. Thus, if it is agreed that some hiring tax incentive is necessary, a more directly tailored tax incentive, such as the DST, is more efficient than a broad-based fixed-amount hiring credit, even if the DST is subject to the inframarginal problem.¹⁴⁸

In this sense, however, the main drawback of the DST is the flip side of one of its main strengths—that it is permanent. For this reason, it will always apply to some hiring that would have occurred absent the DST, unless one were to make the nonsensical assumption that no change in employment would ever occur absent the DST. Theoretically, however, it is possible that the DST would not impact efficient levels of hiring in the long run because it is reciprocal, meaning the detriment when the rate goes up would be offset by the benefit when the rate goes down.¹⁴⁹

Even if the reciprocal nature of the DST did not result in completely offsetting rates in the long run,¹⁵⁰ the inframarginal problem should not apply to the DST because it is intended to apply only to those changes in payroll meant to shift the incidence of the corporate tax away from capital and onto labor and not to any “real” employment decisions. The problem with this answer, however, is building a rate mechanism in the real world that would exempt “real” employment decisions and impact incidence-based decisions. To do so, ideally there would be some proxy for “real” changes in employment on an employer-by-employer basis, which could be backed out of the calculation, thereby reaching only payroll decisions applicable to shifting the incidence of taxes.

One possibility would be for the DST mechanism to change tax rates based on the percentage change in payroll for a corporation less the percentage change in national unemployment rate for the same period. This would allow the DST to capture an approximation of the firm-specific change in employment as opposed to systemic changes in employment. In other words, this approach would assume that changes in the national unemployment rate reflect the inframarginal changes in employment by a particular firm, and then only apply the DST to changes in excess of the inframarginal changes.

This may not necessarily make sense, however, considering national changes in unemployment are national averages and do not take into account regional or sectoral differences in employment levels. For example, certain states, such as California and Michigan, have suffered

¹⁴⁸ Cf. Aki Kangasharju, *Do Wage Subsidies Increase Employment in Subsidized Firms?*, 74 *ECONOMICA* 51 (2007).

¹⁴⁹ See *supra* notes 108–10 and accompanying text.

¹⁵⁰ This could be due to limitations on the ability to claim deductions, limitations on carrybacks or carryforwards over years, or changes in the tax rate over time, among others. See Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 *TAX L. REV.* 423, 428–31 (2000).

much deeper unemployment than other states in recent years.¹⁵¹ Similarly, certain industries, such as construction, have suffered much deeper losses than other industries, such as finance and health care.¹⁵² Thus, it might be more appropriate to have a regionally or sectorally adjusted DST, backing out the specific unemployment rate applicable to a particular employer and then applying the DST to other changes in firm-by-firm employment.

The problem with taking these regional and sectoral differences into account is that they still remain a rough proxy for individual firm inframarginal hiring, although possibly a better one than national unemployment. Thus, it may be more appropriate to analyze each firm's specific employment decisions with its specific profits as compared to profits of competitors in its field. In this manner, issues common to all competitors in a field would "wash out" and only firm-specific employment decisions would remain.

For a simplistic example, assume an industry has two competitors: General Automotive (GA) and United States Automotive (USA). GA has pretax profits of \$1 million and payroll of \$2 million in Year 1, and USA has pretax profits of \$2 million and payroll of \$4 million in Year 1. Both GA and USA suffer a 25% reduction in sales in Year 2. USA reduces its payroll by 12.5%, resulting in a payroll of \$3.5 million and a profit of \$2 million in Year 2. GA, however, reduces its payroll by 25% causing payroll to drop to \$1.5 million and pretax profits to increase to \$1.25 million (for the purposes of this example, presumably shifting some of the incidence of the corporate tax onto labor). As a result, USA would have no increase in its tax rate under the DST, while GA would face an increase of 12.5% in its tax rate under the DST.

There are a few problems with such an approach, however. The first problem is that certainty becomes reduced, thus diminishing some of the DST's incentive effect. If a company does not have access to the employment decisions of competitors, it will not know what effect any given level of change in its employment will have on its tax rate. Second, such an approach substantially increases the complexity of administering the DST because before a tax rate could be calculated, the taxpayer would have to identify which companies are "competitors" and compare changes in payroll among the competitors before a tax rate could be calculated. Even assuming this were possible, it makes using the wage deduction on the face of the tax return difficult because tax returns are confidential and thus the Internal Revenue Service (IRS) cannot share one corporation's payroll data with another corporation.¹⁵³ Conversely, such an approach

¹⁵¹ See News Release, Bureau of Labor Statistics, U.S. Dep't of Labor, Regional and State Employment and Unemployment—September 2011 (Oct. 21, 2011).

¹⁵² See News Release, Bureau of Labor Statistics, U.S. Dep't of Labor, The Employment Situation—October 2011, tbl.A-14 (Nov. 4, 2011).

¹⁵³ I.R.C. § 6103 (2012).

raises the specter of collusion among employers in sectors with few actors and high barriers to entry. Competitors would have a huge incentive to collude and agree to consistent levels of hiring and layoffs solely to maximize the rent extraction from labor, much in the same way employer collusion can extract rent from labor more generally.¹⁵⁴ For these reasons, even if it is a more blunt approach, it is arguably preferable to use publicly available data that cannot be manipulated, such as regional or sectoral changes in employment, rather than the more difficult to determine and easier to manipulate taxable profits of individual firms.

Other proxies might be possible as well, such as using a weighted average or a three-year average of employment changes, which would smooth and net out the effects of inframarginal hiring by averaging the effects over several years instead of looking on a single year-to-year basis.¹⁵⁵ Of course, no method would perfectly match the real-world mechanism with the theoretical goal of acting only on the incidence of corporate tax. Nonetheless, such proxies could result in fiscal stimulus being more closely tailored to the ideal than other tax incentives for employment, which even more indirectly address unemployment through macroeconomic effects.¹⁵⁶

4. Efficient Layoffs: Employment and Innovation.—A similar concern to inframarginal hiring is efficient layoffs. Assume an employer faces a substantial reduction in demand due to a recession. Rather than reduce compensation to shift the cost of reduced sales onto the existing labor pool, the employer could innovate a new process to manufacture a good of equal quality that requires 20% less labor to produce. This increase in production means that the marginal cost per unit of good decreases, thereby increasing efficiency and thus social surplus. The result, however, is a reduction in employment, which under the DST would result in a higher marginal tax rate.

Traditional microeconomic efficiency analysis would say that innovation is good because it increases total social surplus, even if it results in the loss of a job for a particular employee.¹⁵⁷ While there could be a legitimate debate between employment versus innovation as the source of

¹⁵⁴ See Anthony B. Sanders, *Multiemployer Bargaining and Monopoly: Labor-Management Collusion and a Partial Solution*, 113 W. VA. L. REV. 337 (2011).

¹⁵⁵ Cf. Lily L. Batchelder, *Taxing the Poor: Income Averaging Reconsidered*, 40 HARV. J. ON LEGIS. 395 (2003); Mark Campisano & Roberta Romano, *Recouping Losses: The Case for Full Loss Offsets*, 76 NW. U. L. REV. 709 (1981).

¹⁵⁶ See Bishop & Montgomery, *supra* note 119; cf. David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221, 241–42 (2009).

¹⁵⁷ In more technical terms, innovation provides Kaldor–Hicks but not Pareto efficiency. See generally Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 YALE L.J. 1211 (1991).

social policy, the analysis changes significantly when the law basically chooses one over the other. This is the potential criticism of the DST—that it favors employment over innovation and thus could be inefficient from a microeconomic standpoint. There are several reasons why this would not be the case, however, or at least why this would be less worrisome than it may first appear.

First, innovation does not always, or even most of the time, result in reduced payroll. Rather, innovation can be a way to increase productivity out of existing resources, including labor. In such a case, an employer could increase productivity with no decrease in total payroll and thus no change in its marginal tax rate under the DST. Accordingly, in many circumstances, the DST would simply result in an employer facing the default statutory tax rate. Since the tax rate would remain the same, the decision to innovate should not be affected by the DST.

Similarly, the DST, being a rate mechanism, applies only to profits. Thus, the DST would not have any marginal effect on changes in innovation or productivity that do not raise net profits. This could occur, for example, if increases in productivity merely offset changes in demand during and after a recession. In particular, the DST would have no impact on the decision to innovate as a way to maintain profitability in any given year because the DST applies annually. For example, if in Year 1 a firm increased productivity and fired workers in response to a decrease in demand, there would be no increase in net profits and thus no marginal effect, even though the tax rate would be increased under the DST due to the reduction in payroll. But in Year 2, if demand increases, the increased productivity from Year 1 would lead to much higher profits with no change in workforce in Year 2, meaning that under the DST the tax rate would not go up on these higher profits. Thus, the only impact from the increased tax rate in Year 1 would be inframarginal and there would be no impact at all on profits in Year 2.

If, however, a firm increases productivity and all else is held constant, there will be an increase in net profits. This, in turn, means the firm would face higher tax rates on those marginal profits under the DST, potentially discouraging some efficient innovation. There is no way to know what effect the higher marginal tax rates will have on a particular innovation with increased profits, however. Even with the higher marginal rates, net after-tax profits should increase because the benefits of innovation tend to be discontinuous; that is, a single innovation leads to a jump in cost savings or productivity which continues going forward. Thus, employers would only decline to pursue the innovation if the one-year tax increase under the DST exceeded the present value of all the increased cost savings over the life of the firm. So long as the one-year marginal tax increase did not exceed the present value of the innovation's cost savings, employers would pursue the innovation notwithstanding the tax, making it efficient from an economic standpoint.

But this leads to the next difficulty: there could be a macroeconomic “crowding out” effect—increasing total taxes in the economy could result in less capital available for new investment by business.¹⁵⁸ This raises the question of whether the crowding out effect itself is sufficient to undermine the benefits of the DST or whether the DST’s macroeconomic benefits could outweigh this cost. Although this is ultimately an empirical question, it is at least possible that the macroeconomic benefits of smoothing employment and budgets over time could well exceed the macroeconomic costs of reduced assets available for reinvestment. This is especially true in situations where there is plenty of private capital that is going unused due to the lack of growth in the economy as a whole.

Further, there is some evidence indicating that so long as real wages adjust to clear the labor market over time, employment and productivity gains will settle toward the natural rate of employment, meaning any crowding out effect would only be temporary.¹⁵⁹ To the extent growth is stagnant, temporary stimulus could well offset the cost of that stimulus through increased growth (assuming a positive multiplier).

More importantly, however, there is nothing in the DST proposal that would prevent the enactment of other provisions intended to offset or ameliorate any inframarginal crowding out effect. Since the DST is aimed at the incidence of the corporate tax, it is theoretically unrelated to innovation stimulus. Thus, a tax subsidy for innovation could potentially be enacted in addition to the DST.

For example, accelerated depreciation, increased expensing of capital goods, or research and development tax credits could all be adopted in addition to the DST. The tax benefits of these investment stimulus programs could offset or even exceed any increased taxes from the DST. These investment stimulus programs often reduce taxable income but not pretax profits, thereby reducing the impact of any increased tax rate under the DST. In fact, the value of tax benefits, such as accelerated depreciation and equipment expensing, is higher for corporations facing higher tax rates than for those facing lower ones.¹⁶⁰

Further, the combination of the DST and innovation stimulus, such as a research and development tax credit, could work together to overcome the second-best problem inherent in any tax-based incentive analysis: that the United States taxes net income. There are several benefits to using net income as a base for taxation, but the single biggest problem with using net

¹⁵⁸ See ROGER W. SPENCER & WILLIAM P. YOHE, FED. RESERVE BANK OF ST. LOUIS, THE “CROWDING OUT” OF PRIVATE EXPENDITURES BY FISCAL POLICY ACTIONS (1970); Christina D. Romer & David H. Romer, *The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks*, 100 AM. ECON. REV. 763, 780–87 (2010).

¹⁵⁹ See Olivier Blanchard & Lawrence F. Katz, *What We Know and Do Not Know About the Natural Rate of Unemployment*, 11 J. ECON. PERSP. 51, 56–57 (1997).

¹⁶⁰ See *infra* Part III.B.2.

income is that it masks taxpayer-specific attributes.¹⁶¹ Under the DST, this means that it is impossible to distinguish with certainty between taxpayers who reduce employment as a means to shift the incidence of the corporate income tax and taxpayers who reduce employment due to innovation, since only the change in net income is observable. Thus, the DST, as with any rate-based mechanism, must apply to both types of taxpayers, even though the first-best solution would be to apply the DST only to the former.

The research and development tax credit can serve as a second-best form of sorting mechanism for the above problem under two key assumptions. First, it must be assumed that taxpayers who reduce employment due to innovation have a lower cost of innovation than taxpayers who reduce employment to shift the corporate income tax, perhaps due to economies of scale, expertise, start-up costs of innovation, or some other reason. Under this assumption, only those taxpayers actually engaged in innovation would avail themselves of the research and development tax credit, since it would be costly for the other taxpayers to actually switch to innovation. Second, it must be assumed that it is costly for a taxpayer to disguise itself as an innovator due to substantiation costs, such as creating fraudulent receipts or work orders, or enforcement costs, such as “red flag” audit triggers.¹⁶² Under these relatively realistic assumptions, the DST combined with a properly designed research and development tax credit could be structured so as to benefit taxpayers primarily engaged in innovation. Taken together, the DST could not only serve to offset an inefficiency in the corporate income tax and result in a form of macroeconomic feedback, it could also make research and development subsidies more efficient and effective.

B. Practical Challenges to Implementing the DST

Even if the DST sounds promising in theory, how could it be implemented? Although several sticking points emerge, each has a solution that overcomes any fatal blows to the DST’s adoption.

1. How to Calculate Employment.—The single biggest logistical issue with implementing the DST is calculating each firm’s increase or decrease in employment, which is required to calculate its ultimate tax rate. At first this may seem fatal to the real world applicability of the DST, since almost all labor data is calculated at the aggregate level.¹⁶³ Upon closer inspection, however, it need not be. In fact, there is a proxy within the

¹⁶¹ See Lawrence Zelenak, Essay, *Taxing Endowment*, 55 DUKE L.J. 1145 (2006).

¹⁶² See Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-adjusting Penalty*, 106 COLUM. L. REV. 569 (2006).

¹⁶³ See News Release, Bureau of Labor Statistics, U.S. Dep’t of Labor, The Employment Situation—July 2011 (Aug. 5, 2011), available at http://www.bls.gov/news.release/archives/empst_08052011.pdf.

Internal Revenue Code that could be utilized to approximate firm-level employment data—the deduction for wages.¹⁶⁴ Corporate income tax is imposed on a corporation's profits, calculated as gross income less expenses, such as the cost of raw materials and the cost of wages;¹⁶⁵ thus, as wages go down, taxable income goes up, all else being equal. Consequently, corporations already calculate and provide precisely the information *on their own tax returns* necessary to calculate the DST. Thus, the DST could use the percentage increase or decrease in the amount deducted from gross income for wages on a company's yearly tax return.

Although such an approach would solve the informational problem of implementing the DST, it potentially creates two other problems. First, the amount of wages paid by a corporate employer can change due to influences other than total employment, such as inflation (and deflation as well, although that has been less of an issue historically).¹⁶⁶ Using nominal wage amounts would therefore give a tax rate reduction to corporations for increases in wages solely attributable to inflation rather than actual increases in employment. One potential fix for this problem would be to index the wage base for inflation,¹⁶⁷ such that an employer would only have an increase or decrease in their tax rate to the extent of changes in the wage deduction from the prior year's deduction after adjusting for inflation.

This would not be novel in the Internal Revenue Code. In fact, the tax brackets for individuals (among other things) have been indexed for inflation since 1981,¹⁶⁸ with many other features being indexed for inflation subsequently.¹⁶⁹ Thus, since a mechanism for adjusting for inflation already exists within the tax law, implementing such an approach within the DST would simply require applying it to the salary deduction.¹⁷⁰

An alternative, however, would simply be to allow for reductions in the corporate tax rate due to increases in wages attributable to inflation. After all, employers are not required to give cost-of-living raises to employees—they do so typically as a matter of market competition for labor. Although it is unrelated to the purpose of the DST per se, providing an incentive to capital to allocate a portion of inflation-based returns to labor could be adopted as a separate policy goal of the DST mechanism. Regardless, the inflation issue is not one unique to the DST, and the

¹⁶⁴ I.R.C. § 162(a)(1) (2012).

¹⁶⁵ *Id.* §§ 61–62, 162.

¹⁶⁶ *But see* Jeff Strnad, *Deflation and the Income Tax*, 59 TAX L. REV. 243 (2006).

¹⁶⁷ *See* Yoram Margalioth, Student Paper, *The Case for Tax Indexation of Debt*, 15 AM. J. TAX POL'Y 205 (1998).

¹⁶⁸ *See* Richard J. Kovach, *Technical and Policy Standards for Inflation Adjustments Under the Internal Revenue Code*, 33 OKLA. CITY U. L. REV. 603, 605 (2008).

¹⁶⁹ *See id.* at 605–07.

¹⁷⁰ In fact, the IRS publishes official inflation adjusted brackets, deductions, exemptions, and credits for each year. *See, e.g.*, Rev. Proc. 2009-50, 2009-45 I.R.B. 617.

solutions to the inflation problem should not be outside the realm of possibility given that inflation adjustments are already part of the tax laws.¹⁷¹

Another problem with using wages as a proxy for employment is that wages can remain flat or even go up while total employment goes down, simply by firing low-cost labor and using the savings to compensate highly paid management. This poses a significant challenge to the effectiveness of using wage deductions as a proxy for employment, as it could actually incentivize regressive allocations of wealth from labor to management, the opposite of the intended effect.¹⁷² The incentive for directors and management to enrich themselves at the expense of labor or capital is not unique to this proposal, however.¹⁷³ For example, this issue has been the focus of recent corporate law revisions, such as the “say on pay” rules enacted as part of the recent Dodd–Frank law, which require shareholders to have an opportunity to vote on executive pay.¹⁷⁴ To the extent these rules have any mitigating impact on management self-enrichment, which has been debated,¹⁷⁵ this impact would also apply for purposes of the DST.

Regardless of any corporate governance restrictions on management self-dealing, however, the tax law could structure limits on the ability of executives to manipulate the tax law for their own benefit. This is the other benefit of using wage deductions as the baseline for calculating the DST base—since the DST is also a creature of tax law, it can be made to work within the existing mechanisms of the tax law.

For example, the Internal Revenue Code already restricts employers’ ability to deduct excessive executive salaries.¹⁷⁶ The big exception to this limitation is salary tied to performance, such as stock options.¹⁷⁷ Thus, one possibility to mitigate the problem of highly paid executives distorting the

¹⁷¹ This is not to say it is an easy issue, but rather that it is not unique to the DST nor has it prevented other policy decisions from going forward. See Jim Chen, *The Price of Macroeconomic Imprecision: How Should the Law Measure Inflation?*, 54 HASTINGS L.J. 1375, 1430 (2003).

¹⁷² See, e.g., Nancy L. Rose & Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation*, 20 J. LABOR ECON. (COMPENSATION STRATEGY & DESIGN) S138 (2002).

¹⁷³ See, e.g., JOHN GILLESPIE & DAVID ZWEIG, *MONEY FOR NOTHING: HOW THE FAILURE OF CORPORATE BOARDS IS RUINING AMERICAN BUSINESS AND COSTING US TRILLIONS* (2010).

¹⁷⁴ See Sandeep Gopalan, *Say on Pay and the SEC Disclosure Rules: Expressive Law and CEO Compensation*, 35 PEPP. L. REV. 207, 220–21 (2008). That the oversight is increased does not say whether it is a good idea generally, only that it mitigates the potential agency problem in the context of the DST. See Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355, 1389–90 (2010).

¹⁷⁵ See, e.g., Stephen M. Bainbridge, *Dodd–Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1810 (2011) (“The effectiveness of say-on-pay is highly contested.”).

¹⁷⁶ I.R.C. § 162(m) (2012). This provision prevents corporations from taking a deduction for salaries in excess of \$1 million per highly compensated executive with certain exceptions.

¹⁷⁷ See David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 VAND. L. REV. 611, 626 n.49 (2011).

DST would be to take away the salary tied to performance exception and deny a deduction to corporations for excessive salaries paid to executives in the form of stock options or other equity instruments.¹⁷⁸ Capping the deduction for management wages in this manner would prevent management from enriching itself at labor's expense by denying the corporation the ability to maintain the same total deductible wages.¹⁷⁹

This broad proposal is not necessarily required to protect the DST, however. Alternatives include a requirement that amounts attributable to stock options or other equity compensation remain deductible but separately listed on the corporation's tax return and excluded from the DST, or a requirement that all compensation of "highly compensated individual[s]" (a term already defined in the Internal Revenue Code¹⁸⁰) be excluded from a corporation's tax returns solely for purposes of the DST. This would allow the DST to more directly target the broader labor market rather than the narrow and highly compensated executive market. A similar approach could apply to any other type of compensation not included in the deduction for wages, such as reimbursements for employee travel,¹⁸¹ the cost of office supplies, and other employee amenities, like free coffee.¹⁸²

Similarly, using the income tax deduction for wages proves superior to using other wage base numbers, such as the payroll tax wage base. In general, for payroll tax purposes, wages are specifically defined to include all amounts paid to employees with only a few limited exceptions,¹⁸³ making it seem like the ideal proxy for the DST. One problem with this, however, is that wages do not include other nonemployee payments, such as payments to certain independent contractors.¹⁸⁴ Thus, payments made to independent contractors, such as payroll systems or customer support, would be deductible for income tax purposes but not included in wages for payroll tax purposes. Assuming the decision to utilize an independent contractor is a business decision and not one intended to shift the incidence of the corporate tax onto labor, excluding these payments under the DST would be inappropriate since doing so would increase tax rates on pure business decisions. Accordingly, the income tax deduction for salary and salary-type payments would be a more appropriate baseline for the DST than the payroll tax wage base.

¹⁷⁸ See Meredith R. Conway, *Money for Nothing and the Stocks for Free: Taxing Executive Compensation*, 17 CORNELL J.L. & PUB. POL'Y 383, 425–26 (2008).

¹⁷⁹ A policy similar to this was adopted with respect to companies participating in the Troubled Asset Relief Program. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–20.

¹⁸⁰ I.R.C. § 105(h)(5).

¹⁸¹ Treas. Reg. § 1.62-1 (as amended in 1992).

¹⁸² I.R.C. § 132.

¹⁸³ *Id.* § 3401.

¹⁸⁴ Treas. Reg. § 31.3401(c)-1 (1970).

Another concern with the DST is that using total salary deduction data would not ameliorate the incentive to shift jobs overseas, since salaries paid to offshore employees are deductible. This is not a problem unique to the DST proposal, however. For example, recent proposals have been made to defer a deduction for wages attributable to the activities of foreign business unless and until the income from such business is repatriated to the United States.¹⁸⁵ Assuming these proposals were to become law, the incentive to employ workers offshore solely to minimize the DST would be reduced, although not completely offset. In other words, if deductions attributable to employing workers outside the United States are undesirable, they would be so regardless of whether the DST were in place.¹⁸⁶

Lastly, by building the DST adjustment into the tax code itself, it becomes easier to monitor and punish inflated or fraudulent employment numbers intended to game the DST. For instance, theoretically, the IRS could easily raise a red flag over a tax return where profits declined sharply but the deduction for wages remained unchanged.¹⁸⁷ This increased chance of detection would make it riskier for corporations to artificially inflate wage deductions solely for purposes of manipulating the DST.¹⁸⁸ Further, corporations already have an incentive to inflate the wage deduction under current law since every dollar of the wage deduction benefits the corporation approximately thirty-five cents (the tax savings from one less dollar of taxable profit). Moreover, whatever limits are in place currently to prevent artificial inflation of the wage deduction on tax returns could remain in place under the DST as well, further limiting corporations' ability to artificially inflate wages solely to game the system.

2. *Loss Corporations or Corporations Without Income.*—On its face, one weakness of the DST could be that precisely when it is needed the most, it may matter the least. In particular, the deeper a recession becomes, the more important unemployment becomes as a national policy matter. At the same time, corporate taxpayers are earning less and less profit. At some point, corporations will start *losing* money, at least on an annual basis. Since the DST is a rate mechanism, a corporation with no taxable income

¹⁸⁵ See STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL, PART THREE: PROVISIONS RELATED TO THE TAXATION OF CROSS-BORDER INCOME AND INVESTMENT 13–24 (2009).

¹⁸⁶ It is interesting to note that it is not entirely clear whether such deductions are good or bad for the U.S. economy, with at least one study claiming there is a substantial positive domestic spillover potential. See Mihir A. Desai et al., *Domestic Effects of the Foreign Activities of US Multinationals*, 1 AM. ECON. J.: ECON. POL'Y 181 (2009).

¹⁸⁷ See Raskolnikov, *supra* note 162, at 589.

¹⁸⁸ This also dovetails nicely with one of the intellectual predecessors of the DST, the self-adjusting tax penalty. See *id.* at 599–605. The self-adjusting penalty described in Raskolnikov's article would apply a higher penalty on tax fraud accomplished through recurring items such as the wage deduction rather than extraordinary items, which are easier to detect. In this way, the self-adjusting penalty and the DST would complement each other.

would be indifferent to the rate, and thus at first glance, the DST would be useless as a tool with respect to such a corporation.

This problem, however, may not actually be so bad. First, tax liability is calculated on a year-by-year basis.¹⁸⁹ What this means is that, except in dramatic crashes where profits go negative in less than one taxable year, the DST would still act as a marginal disincentive to layoffs as the profits of corporations begin to decline in the face of a recession. Accordingly, the DST could theoretically slow layoffs during the front years of a recession, at least as a method of shifting the incidence of the corporate income tax. Second, the DST would provide an incentive for corporations to rehire as the economy began to recover and corporate profits began to rise. Therefore, even if the DST did not serve its function as a deterrent to layoffs in the face of a recession, it could serve to subsidize hiring as the economy picks back up.

Further, facing a higher tax rate under the DST could actually prove beneficial to loss companies (companies with tax losses), the opposite of the intuition behind tax rates. This is due to the “upside-down” nature of tax deductions—the higher the tax rate, the more tax deductions are worth.¹⁹⁰ In a simplified example, providing one dollar of deduction to a taxpayer facing a 35% tax rate would save the taxpayer thirty-five cents, while the same dollar of deduction would be worth fifty-five cents to a taxpayer facing a 55% rate. For a company with tax losses, therefore, the higher the rate imposed, the more valuable those losses become.

Perhaps just as important as the cash tax effect for loss companies are the financial statement benefits of a higher nominal statutory tax rate in the form of more valuable tax deductions. Assuming the DST applies only to publicly traded corporations, those corporations would be required to file financial statements, such as balance sheets, with the Securities and Exchange Commission.¹⁹¹ In particular, one of the items required to be reported on the balance sheet under Generally Accepted Accounting Principles (GAAP) is an amount set aside to be paid for projected future tax liabilities.¹⁹² Very broadly speaking, accountants calculate this “tax reserve” by calculating taxable income and multiplying it by the statutory tax rate.¹⁹³ Thus, any raises to the statutory tax rate could increase the amount of tax liabilities reflected on a corporation’s balance sheet, impacting the

¹⁸⁹ I.R.C. § 441 (2012).

¹⁹⁰ See Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343, 352 (1989).

¹⁹¹ See 15 U.S.C § 78m (2012); Dennis J. Ventry, Jr., *Protecting Abusive Tax Avoidance*, 120 TAX NOTES 857, 872 (2008).

¹⁹² Financial Accounting Standards Board, Accounting Standards Codification § 740-10 [hereinafter ASC § 740-10]. For years prior to 2009, see Statement of Financial Accounting Standards No. 109 [hereinafter FAS 109].

¹⁹³ ASC § 740-10; FAS 109 ¶ 19.

corporation's total reported profits, even if the corporation had no taxable income in that particular year.¹⁹⁴ Assuming shareholders and executives of corporations put at least some weight on reported earnings,¹⁹⁵ this impact on earnings would provide corporations with a significant disincentive to face a higher statutory tax rate, even if the corporation owes no cash taxes in a particular year. Conversely, the value of tax *losses* on financial statements increases as the tax rate increases, meaning a loss corporation would welcome higher marginal tax rates because they would bolster the corporation's assets on the balance sheet.¹⁹⁶ Thus, loss corporations could actually benefit from any increased rates of the DST during periods of deep recessions.

3. *Do Rates Even Matter?*—Another question that might arise with respect to a rate-based proposal, such as the DST, especially for large multinational corporations, would be whether rates even matter. Corporations have numerous ways to strip profits out of the tax base and thus avoid tax altogether. For example, recent reports claim that General Electric has paid virtually no U.S. taxes in recent years¹⁹⁷ and Google has only paid 2.4% in taxes,¹⁹⁸ notwithstanding the nominal 35% corporate tax rate. At first glance, these examples seem to suggest that the statutory rate is meaningless. If so, what good is a proposal that focuses on corporate tax rates?

The most simplistic answer would be that, holding everything else constant, rates matter. Even assuming the existence of deferral and income-shifting techniques that allow companies to minimize their taxes, an increased rate matters for the portion of income that remains subject to the income tax. Further, although not entirely clear, there is emerging empirical evidence that increased marginal tax rates can actually lead to increased effective tax rates, even with all of the income stripping and tax haven

¹⁹⁴ ASC § 740-10; FAS 109 ¶ 18. Further, the new rules require companies to calculate separately the reasons why reserves change rather than just create a lump-sum reserve. See Bret Wells, *Voluntary Compliance: "This Return Might Be Correct But Probably Isn't,"* 29 VA. TAX REV. 645, 660 (2010) ("Tax departments no longer have 'cookie jar' reserves that represent a general overall reserve. The tax reserve of today represents an issue-by-issue, bottom-up, reserve analysis.").

¹⁹⁵ See Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal*, 97 GEO. L.J. 423 (2009).

¹⁹⁶ See James M. Poterba et al., *Deferred Tax Positions and Incentives for Corporate Behavior Around Corporate Tax Changes*, 64 NAT'L TAX J. 27, 53 (2011) ("Managers at firms with significant net deferred tax assets may lobby against statutory corporate tax rate cuts if they are primarily concerned with the short-term effect of such policy changes on reported after-tax income.").

¹⁹⁷ David Kocieniewski, *At G.E. on Tax Day, Billions of Reasons to Smile*, N.Y. TIMES, Mar. 25, 2011, at A1.

¹⁹⁸ Jesse Drucker, *Google 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes*, WASH. POST (Oct. 21, 2010, 6:00 AM), <http://www.washingtonpost.com/wp-dyn/content/article/2010/10/22/AR2010102203253.html>.

maneuvers available to modern multinational corporations.¹⁹⁹ Lastly, there is evidence that marginal rates matter to corporations when determining which countries to invest in, even if they do not translate directly into total effective tax rates.²⁰⁰

In addition, the key feature of the DST is that marginal tax rates can either go up or down. To the extent the DST would result in a reduction in marginal rates, such a result should create an incentive to reduce the shifting of income or other tax minimization or evasion strategies. Thus, the DST could potentially replace the incentive to engage in tax avoidance or evasion (through structural tax planning or otherwise) with the incentive to reduce marginal tax rates through increased hiring, in effect a double benefit for the United States.²⁰¹

IV. THE DST AND THE RHETORIC OF TAX POLICY

Heated rhetoric over tax policy is nothing new.²⁰² In fact, much has been written about how proponents of certain fiscal policy proposals have utilized rhetoric to achieve their goals.²⁰³ These include labeling the estate tax the “death tax” and labeling other taxes as “job killers,” among others.²⁰⁴ The rise of such rhetoric has generally been attributed to the Reagan tax cuts of 1981, although the critiques of such rhetoric have cut across administrations and party affiliation.²⁰⁵

Two responses have generally been adopted to challenge the use of rhetorical devices in fiscal policy. First, the rhetoric has been challenged with empirical facts. Thus, one challenge to the rhetoric that all taxes kill jobs has been to look at the effect of the 1993 Clinton tax increases and point out that the tax increases led to economic growth both in terms of GDP and employment.²⁰⁶ Second, the rhetoric has been challenged as

¹⁹⁹ See Nathan M. Jensen & Adam H. Rosenzweig, *Can Government’s Tax Footloose Capital?: Measuring the Effects of Globalization on Domestic Taxation* (Feb. 13, 2014) (unpublished manuscript), http://pages.wustl.edu/files/pages/imce/nathanjensen/globalization_and_domestic_taxation_working_paper.pdf.

²⁰⁰ See Org. for Econ. Co-operation & Dev., *Policy Brief: Tax Effects on Foreign Direct Investment*, OECD OBSERVER, Feb. 2008, at 1–3, <http://www.oecd.org/daf/inv/investment-policy/40152903.pdf>.

²⁰¹ See Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. REV. 1159, 1185 (2006).

²⁰² See, e.g., Marjorie E. Kornhauser, *The Rhetoric of the Anti-progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465 (1987).

²⁰³ See, e.g., Karen C. Burke & Grayson M.P. McCouch, *Turning Slogans into Tax Policy*, 27 VA. TAX REV. 747 (2008).

²⁰⁴ See, e.g., Neil H. Buchanan, *What Kind of Environment Do We Owe Future Generations?*, 15 LEWIS & CLARK L. REV. 339, 361–64 (2011); Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C. L. REV. 993, 1051 (2004).

²⁰⁵ McMahon, *supra* note 204, at 1118–21.

²⁰⁶ *Id.* at 1089.

disingenuous. Challenges to the use of the label “death tax” have been made by pointing out that “death tax” implies everyone must pay a tax on death when, in reality, the estate tax applies to a miniscule percentage of the population and only on the transfer of wealth to heirs, not on death itself.²⁰⁷

Both of these challenges to tax policy rhetoric have existed for decades. Yet, for the most part, the rhetoric has not changed since the debates over the Reagan tax cuts; if anything, it seems to have gotten worse.²⁰⁸ Those advocating for increased progressivity in the tax law are no longer merely accused of hurting the economy,²⁰⁹ but of being socialist,²¹⁰ waging war against success,²¹¹ or worse. Those advocating for tax incentives to invest in factors of production are accused of giving away tax cuts to millionaires²¹² and acting indifferently or even hostile to the working and middle classes.²¹³

The DST takes a different approach to challenging the overheated rhetoric of the modern fiscal policy debate: affirmatively reclaiming the term “tax cut” to prevent it from being used as a rhetorical tool. By focusing on both short-term employment and long-term budget balance, the DST undermines the polar critiques of tax proposals that only focus on one or the other. Similarly, by looking at both demand-side stimulus, in the form of shifting tax burdens away from labor during periods of high unemployment, and supply-side stimulus, in the form of lower tax rates for new investments, the DST undermines the narrative that pro-employment policies are inherently anti-business, and vice versa.

²⁰⁷ See Burke & McCouch, *supra* note 203, at 757.

²⁰⁸ See McMahon, *supra* note 204, at 1122 (“Clearly, the ‘tax deception’ . . . characterizing the 1980s has continued unabated through the 1990s and into the twenty-first century.”).

²⁰⁹ See, e.g., Catherine Ho, *Romney Attacks Obama’s Record on Small Businesses*, WASH. POST (May 6, 2012), http://www.washingtonpost.com/business/capitalbusiness/romney-attacks-obamas-record-on-small-businesses/2012/05/04/gIQAvRKK6T_story.html.

²¹⁰ It is not entirely clear in this specific political context what is meant by the term “socialist.” See, e.g., Scot Lehigh, *Opinion, Obama a Socialist? Not Quite*, BOS. GLOBE, Mar. 11, 2009, at A15, available at http://www.boston.com/bostonglobe/editorial_opinion/oped/articles/2009/03/11/obama_a_socialist_not_quite.

²¹¹ E.g., Emily Miller, *Editorial, Obama’s War Against Success*, WASH. TIMES (Feb. 10, 2012), <http://www.washingtontimes.com/news/2012/feb/10/obamas-war-against-success> (“President Obama is waging war against personal success and economic prosperity. Raising taxes on Americans is the centerpiece of his re-election campaign, a plan that respects no earthly or heavenly bounds.”).

²¹² See, e.g., Devin Dwyer, *Team Obama Skewers Romney on Tax Fairness*, ABC NEWS (Apr. 9, 2012, 5:38 PM), <http://abcnews.go.com/blogs/politics/2012/04/team-obama-skewers-romney-on-tax-fairness>.

²¹³ See, e.g., Devin Dwyer, *Joe Biden Lays into Romney, GOP: “They Don’t Get Who We Are!”*, ABC NEWS (May 16, 2012, 5:47 PM), <http://abcnews.go.com/blogs/politics/2012/05/joe-biden-lays-into-romney-gop-they-dont-get-who-we-are> (“The Romney economics which says as long as the government helps the guys at the top to do well, workers and small business communities, they can fend for themselves but the country will be OK if the big guy is doing well.” (quoting Joe Biden)).

Perhaps more importantly, the dynamic and self-adjusting nature of the DST could itself serve to undermine the political strength of the “tax hike” and “tax cut” rhetoric by reducing its salience. In other words, by being automatic it is possible for people to adjust their expectations to it, at least as compared to ad hoc measures. Rather than be accused of a tax hike or claim credit for a tax cut, the automatic nature of the DST makes it more like a “new normal”—just part of the legal landscape. No politician would have to risk proposing a tax hike or pander to offer a tax cut.

This is not a new idea; other tax proposals have adopted a permanent and self-adjusting feature for precisely this reason.²¹⁴ The difference is that the DST would be intended not only to exploit its automatic nature, but also to actually undermine the usefulness of the “tax cut” rhetoric as a political tool during periods of recession, opening space for a more reasoned and reasonable fiscal policy debate to occur. The need for a more sober debate in the area of fiscal policy has become increasingly pressing as a policy matter, especially as it becomes clear that even when policymakers agree on substance, the politics of the moment and the rhetoric of the debate may prevent any useful U.S. fiscal policy from being implemented.²¹⁵

Even worse, the rhetorical power of the “tax cut” label has been pointed to as a leading cause for people unintentionally supporting policies contrary to their own preferences.²¹⁶ In fact, some claim that certain policymakers intentionally utilized the policy rationale underlying “tax cuts” to further a separate and unrelated agenda, which on its own might not fare as well.²¹⁷ Using the promise of “tax cuts” for the general population as a “Trojan horse”²¹⁸ to deliver tax benefits to small subgroups

²¹⁴ See Gamage, *supra* note 121, at 799–801.

²¹⁵ Ezra Klein, *The Political Failure that Worsened the Crisis*, WASH. POST WONKBLOG (Mar. 7, 2012, 12:22 PM), http://www.washingtonpost.com/blogs/ezra-klein/post/the-political-failure-that-worsened-the-crisis/2011/08/25/gIQA0HG5wR_blog.html?hpid=z3 (“What doomed this package wasn’t a theoretical divide. I spoke with many freshwater economists who thought a package like this would be sensible. Rather, it was politics wot done it.”).

²¹⁶ See McMahon, *supra* note 204, at 1118–19 (“To put it bluntly, the average voter has been deceived by the politicians seeking tax cuts for the wealthy. The political rhetoric of tax cuts always focuses on tax cuts for the struggling middle class family. The tax cuts that are delivered are anything but that. This aspect of the class warfare of the past twenty years has been seriously explored by a handful of political analysts and investigative journalists over the past two decades.”).

²¹⁷ See Paul Krugman, *The Tax-Cut Con*, N.Y. TIMES (Sept. 14, 2003), <http://www.nytimes.com/2003/09/14/magazine/the-tax-cut-con.html?pagewanted=all&src=pm> (“So the tax-cut crusade has two faces. Smiling supply-siders say that tax cuts are all gain, no pain; scowling starve-the-beasters believe that inflicting pain is not just necessary but also desirable. Is the alliance between these two groups a marriage of convenience? Not exactly. It would be more accurate to say that the starve-the-beasters hired the supply-siders—indeed, created them—because they found their naïve optimism useful.”).

²¹⁸ *Id.* (“David Stockman famously admitted that Reagan’s middle-class tax cuts were a ‘Trojan horse’ that allowed him to smuggle in what he really wanted, a cut in the top marginal rate. The Bush administration similarly follows a Trojan horse strategy, but an even cleverer one.”).

is precisely the type of tactic that has prevented any meaningful progress in fiscal policy. To the extent the DST undermines the theoretical foundation of the argument by providing a policy tool that can be both a tax cut and tax increase at the same time, depending on one's perspective, such tactics would no longer be possible.

By reclaiming the label "tax cut" and replacing it with an actual policy proposal that incorporates both supply-side and demand-side policies, proposals like the DST could defuse some of the political and rhetorical power of the term. By attacking the foundation of the debate, rather than attempting to disprove the rhetoric with empirical data or theoretical critiques, proposals like the DST could destabilize the political power of the term. Ideally, removing this rhetorical hammer could open up space for policymakers to engage in substantive debates on fiscal policy, permitting new ideas targeted to the unique circumstances of the modern economy to rise to the surface.

CONCLUSION

The country finds itself in a dramatically different world than the one it faced during the adoption of the Sixteenth Amendment in 1913, or even those of 1932, 1961, or 1980. Technological and financial innovations are obvious; it is difficult to believe that anyone could have envisioned computers, let alone the Internet or smartphones, during those times. But macroeconomic trends have changed as much, if not more. The national debt as a percentage of GDP is approaching all-time highs, and the traditional monetary and fiscal policy tools used to combat unemployment and encourage economic growth appear to have been exhausted. But rather than fall prey to the analytical trap of rehashing the fiscal policy debates of these vastly different economic times, policymakers need to embrace novel solutions for the novel problems facing the modern economy.

More specifically, the impact of macroeconomic conditions, such as high unemployment, on the incidence of the corporate tax should be taken into account in structuring a corporate tax robust enough to survive the next one hundred years. The DST provides one such approach: a targeted policy of tying the tax rate faced by public corporations to their employment decisions. The DST achieves this by increasing a corporation's marginal income tax rate when it decreases payroll, while decreasing the corporation's marginal income tax rate when it increases payroll. This mechanism takes into account the economic reality that employers can more easily shift the incidence of the corporate tax onto labor during periods of deep unemployment. The DST offsets this by imposing higher marginal tax rates on employers that shift the incidence of the corporate tax onto labor, while at the same time, rewarding employers through lower marginal tax rates for new investment in labor. In this manner, the DST can directly help subsidize employment, while also providing tax relief for

capital, thereby proving both pro-growth and pro-employment, all while being partly if not completely self-financing.

As part of a larger project, however, the DST can hopefully provide a model for how fiscal policy can be used to respond to the modern challenges of the economy. If true, the DST, even if not adopted, could help lead to solutions uniquely tailored to the problems facing the modern economy—moving forward rather than continuing to re-fight the unproductive tax policy battles of older, much different, times. Through proposals such as the DST, real progress can be made toward solving the pressing fiscal and economic problems facing the country, and a new, modern corporate income tax can be built to survive the next one hundred years.

