Tax cuts and Leprechauns

By Paul Krugman
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The political news seems even more horrible than usual today. So to get away from the headlines a bit, I'm going to commit some economics. Specifically, I want to pull together some thoughts — some inspired by Gabriel Zucman's recent work, some of my own — about the case or lack thereof for corporate tax cuts, the centerpiece of the only major legislation enacted under Trump.

Tax cuts: The rationale

As Figure 1 shows, the immediate effect of cutting the corporate tax rate has been, surprise, a big fall in taxes collected from corporations. We're looking at something on the order of $110 billion in revenue loss at an annual rate, which is real money – roughly the total cost of the insurance expansion under the Affordable Care Act. And of course the corporate tax cuts aren't the only source of revenue loss from the 2017 Tax Cuts and Jobs Act (TCJA).

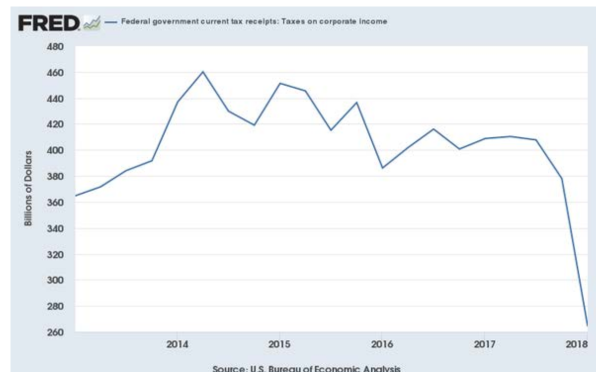

Figure 1

Why give up this revenue? The story told by modern advocates of corporate tax cuts, like the Trump CEA and the Tax Foundation, hinges critically on international mobility of capital. The U.S. is now part of a global capital market, they say, in which investment flows to whichever country offers the highest after-tax rates of return.

So cutting the tax rate, according to this story, will bring in lots of capital from abroad. This will drive the rate of return down and wages up, so that in the long run the benefits of the tax cut will flow to workers rather than shareholders.

Even if this story were right, long run effects aren't the whole story for policy – in the long run, we are all dead, and meanwhile capital owners have a chance to take the money and run. So even if the eventual effect of the tax cut were to raise wages, there might well be years, even decades, when a tax cut for corporations is mainly a tax cut for wealthy shareholders.

And as Figure 2 shows, so far there has been no visible effect on wages. All those stories about worker bonuses were essentially bogus; real wages of ordinary workers are slightly lower than they were a year ago, while after-tax profits are way up.

Figure 2

You can argue that this was only to be expected – but it's not the way the bill was sold, or promoted when those bonuses were being hyped. In any case, is there good reason to believe that the tax cut will do what it promised even in the long run? Specifically, are international capital movements really all that sensitive to tax rates?

Leprechauns everywhere

There is no question that multinational corporations like low-tax countries like Ireland, and report earning a lot of their profits in those countries. But does this really reflect large-scale capital movements to those low-tax jurisdictions?

No, say Gabriel Zucman and co-authors. They produce strong evidence that most of what we see is basically a statistical illusion: corporations use transfer pricing, allocation of rents on intangible assets, etc. to make profits appear in low-tax countries; but there's very little real production or employment behind those profits. As Figure 3 shows, tax-haven countries end up showing ridiculously high levels of profits relative to wages, basically because the profits aren't being earned where they're being reported.

Figure 3

And as Figure 4, which focuses on Ireland, shows, this divergence has been growing rapidly over time.

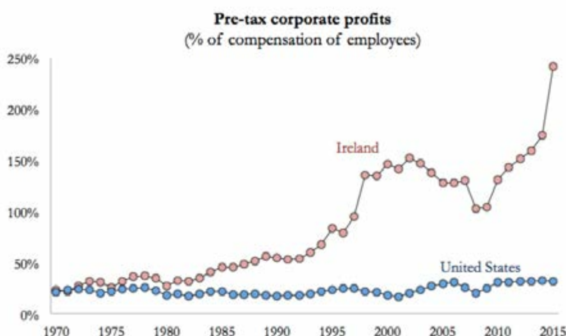

Figure 4

One interesting question is, how much actual inflow of capital has Ireland experienced since 1980, as it became the go-to-location for multinationals to report their profits? This is a bit tricky to answer, because the methods corporations use to shift their profits abroad also distort balance of payments statistics. But I think we can use Ireland's measured current account balance as a rough guide, because the strategies corporations use to shift profits to Ireland should affect the composition of that balance but not its overall level.

For example, suppose a multinational shifts reported profits to Ireland by paying its Irish subsidiary an excessive transfer price on its exports. This will inflate reported exports – but it will also inflate reported investment income paid to foreigners. Or suppose it assigns intellectual property rights for some technology to its Irish subsidiary, and pays that subsidiary inflated royalties. Again, an inflation of Irish exports, in this case of services, offset by increased investment income paid abroad.

So if I'm doing this right, we can look at Ireland's current account deficit as a measure of true capital inflow. From 1980 to 2014 the cumulative deficit was $68 billion, which is less than a quarter of Irish GDP. That's significant, but not huge. And remember, this is a small country with dramatically lower taxes than other advanced countries.

But if Ireland hasn't actually been attracting all that much real foreign investment, how do we explain the "Celtic tiger" growth rates it had for a number of years? The answer is that a lot of the growth isn't real: it's leprechaun economics, in which tax avoidance strategies produce fictitious growth.

That's not to say that Ireland has done badly. It has in fact done quite well. But it's much less of a miracle than it seems, with real wages doing fine but nowhere nearly as well as measured productivity (Figure 5).

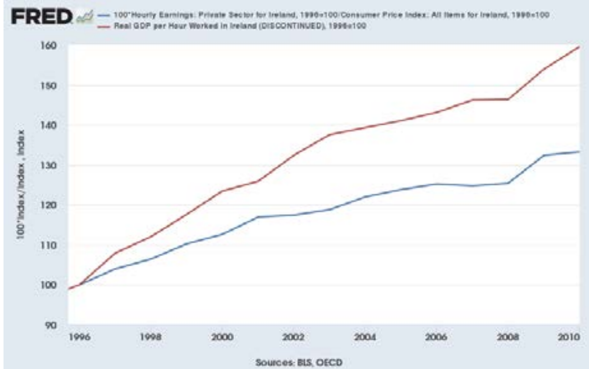

Figure 5

In short, the supposed rationale for big corporate tax cuts is based on a misinterpretation of the evidence. Multinational corporations move *profits* – as reported — around based on tax considerations; actual capital, and hence actual economic activity, not so much.

But why aren't actual capital movements that sensitive to tax rates? There is, I think, an important point about business investment that a lot of discussion has missed.

The business cost of capital doesn't matter very much

Anyone who follows real-world monetary policy is aware of a dirty little secret about what economists used to call the "transmission mechanism": interest rates don't have much direct effect on business investment. In fact, in general it's hard to find any effect at all. Monetary policy works through housing and, these days, the exchange rate; if it affects business spending, the effect is indirect, through changes in sales that were caused by housing and the exchange rate.

You can see what I'm talking about by looking at investment during the great slump of 1979-82, which was more or less deliberately engineered by the Fed to squeeze inflation down (Figure 6). Interest rates shot up, residential investment plunged, but nonresidential investment more or less kept plugging along.

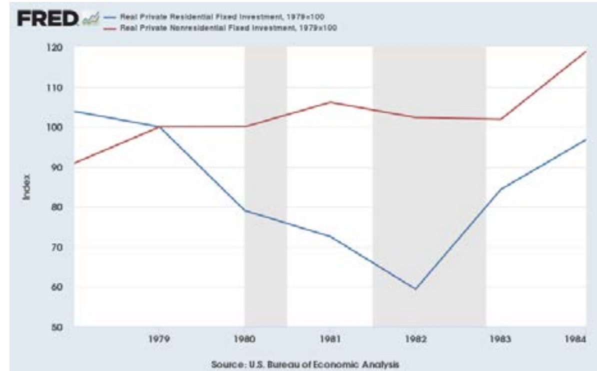

Figure 6

Why doesn't business investment respond more to interest rates? Because many though not all business investments are relatively short-lived. If you build a house, it's going to last for decades, generating implicit or explicit rents all the way, so the rate at which you discount those rents matters a lot. If you're buying a computer that will be obsolete in three years, the interest rate hardly matters at all.

One way to say this is that a business considering investing a dollar will compare the marginal product of that dollar's worth of capital with a cost that includes both the cost of capital and the rate of depreciation. If the rate of depreciation is high, the cost of capital will be a fairly small factor. And if you compare average rates of depreciation for residential and nonresidential capital, the business rate is much higher (Figure 7).

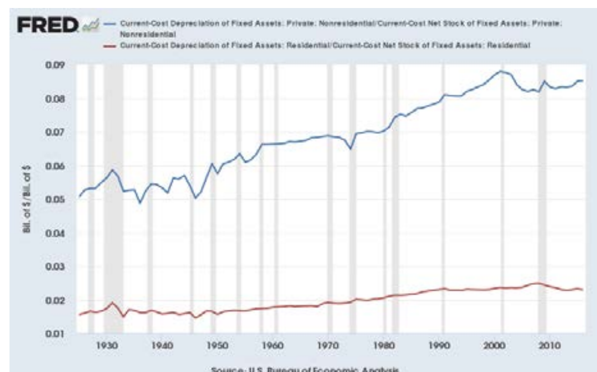

Figure 7

What does this have to do with taxes? One way to think about corporate taxes in a global economy is that they raise the effective cost of

capital. Suppose global investors demand an after-tax rate of return r^*. Then the *pre-tax* rate of return they'll demand in your country – your cost of capital — is $r^*/(1-t)$, where t is the marginal tax rate on profits. So cutting the corporate tax rate reduces the effective cost of capital, which should encourage more investment.

But given the relatively short lives of business investments, this effect should be fairly small. Tax cutting as a way to encourage investment is fairly ineffective for the same reasons that monetary policy has relatively little direct traction over business spending.

No pot of gold in sight

So, am I saying that the case for cutting corporate tax rates is unadulterated nonsense? No, it's adulterated nonsense. There's some reason to believe that lower tax rates will, other things equal, have some positive effect on capital formation. But the vision of a global market in which real capital moves a lot in response to tax rates is all wrong; most of what we see in response to tax rate differences is profit-shifting, not real investment. And there is no reason to believe that the kind of tax cut America just enacted will achieve much besides starving the government of revenue.