

BEYOND THE BUDGET: HOW THE TAX CUTS AND JOBS ACT INCREASES INEQUALITY AND EXACERBATES OUR HIGH-PROFIT, LOW-WAGE ECONOMY

ISSUE BRIEF BY **STEPH STERLING AND MARSHALL STEINBAUM** | JUNE 2018

The Tax Cuts and Jobs Act (TCJA), also known as the Trump tax law, was signed into law on December 22, 2017. The law makes a number of significant changes to the federal tax code: It cuts the corporate tax rate from 35 to 21 percent, lowers individual income tax rates and eliminates a number of personal exemptions, creates a new 20 percent deduction of income from certain pass-through businesses, eliminates the corporate alternative minimum tax, moves to a territorial system with base erosion rules, and doubles the estate tax exemption, among many other changes.

Many progressives have rightly criticized the law on the grounds that the TCJA will cost over \$1.5 trillion in lost revenue over the next decade, at a time when there is already insufficient revenue being generated to meet our country's pressing needs. Many others have argued, again rightly, that deficits resulting from the tax law will be used to justify cuts to Medicare, Medicaid, the Supplemental Nutrition Assistance Program (SNAP), and other public programs. And others still have correctly assessed that the tax law disproportionately benefits the already wealthy, rather than those with lower income or less wealth.

Progressives are right about the need for revenue and about the general unfairness of the tax law's distribution—but there is another, powerful line of argument available against the TCJA and conservative tax orthodoxy: It incentivizes powerful corporations and their executives to take home and keep the lion's share of the winnings, at the expense of corporate investments in higher wages or in innovation and expansion that will lead to jobs. The purpose of this issue brief is to outline and describe this so-called "pre-distributional" (also sometimes known as pre-tax or market-based) argument, and connect it to current debates about the tax law and the state of our economy.



Specifically, after providing background on the relationships among corporate stakeholders in today’s high-profit, low-wage economy, this issue brief describes two ways^a that the TCJA and conservative tax theory incentivize powerful corporations and executives to retain corporate profits for themselves, at the expense of everyone else. First, lowering effective individual tax rates on the wealthy incentivizes corporate executives and managers to bargain for greater levels of compensation than they would otherwise, because a lower effective tax rate allows them to keep more of the compensation they bargain for, rather than paying it to the government in the form of taxes. When more corporate earnings are going to executive and managerial compensation, then less is available for other stakeholders in the corporation, including workers. Second, there is some preliminary indication—though much more research is needed—that lowering corporate tax rates provides both incentive and opportunity for powerful corporations to engage in merger and acquisition (M&A) activities, which would further the already significant levels of corporate concentration, and the pernicious effects of market power, we see throughout our economy.

WHAT DO WE MEAN THAT THE TAX LAW HARMS OUR ECONOMY “BEYOND THE BUDGET”?

Tax policy is among the most powerful tools we have to strengthen—or worsen—our economy. This is because tax policy operates in three interconnected but distinct ways: First, and what has the focus of recent progressive policy arguments, taxes provide the revenues needed—or, depending on tax rates and erosion of the tax base, fail to provide the revenues needed—for the government to provide goods and services to its citizens. Second, tax policy structures the after-tax incomes and wealth of individuals and businesses, in ways that ultimately determine overall income distribution; that is, tax policy can exacerbate income and wealth disparities by taxing those with lower incomes or less wealth more than those with higher incomes or more wealth, or vice versa. Finally, tax policy creates incentives or disincentives for all of us—as workers, individuals, small business owners, multinational corporations, and corporate executives—to behave in certain ways and to engage or not engage in various economic activities.

^a It should be noted that, while this issue brief focuses on the effects of the TCJA on compensation bargaining and corporate concentration, there may be other ways that the TCJA and conservative tax orthodoxy affect inequality predistributionally. For example, conservative tax policy that preferences capital over income has contributed to what is known as “corporate financialization,” in which a rising proportion of a company’s profits are earned off of financial assets, relative to the business profits earned from the regular trade of the corporation. Furthermore, the substantial tax benefit that accrued to financial institutions as a result of the TCJA could exacerbate the increasingly extractive behavior of the financial services industry—just as the tax benefit was used by corporate entities will exacerbate the increasingly extractive behavior of executives and shareholders in the form of buybacks and other shareholder payouts. For more information on these two phenomenon, see *Corporate Financialization and Worker Prosperity: A Broken Link* (available at <http://rooseveltinstitute.org/corporate-financialization-and-worker-prosperity-broken-link/>) and *Rewriting the Rules of the American Economy* (available at <http://rooseveltinstitute.org/rewriting-rules-report/>).



The focus of this issue brief is on the latter: that is, the ways that exacerbating *post-tax* income inequality leads to *pre-tax* incentives that reinforce inequality. Together, these interact with each other in ways that worsen the kinds of unproductive and extractive economic behaviors that have led to the high-profit, low-wage economy we have today.

BACKGROUND ON OUT-OF-BALANCE CORPORATIONS AND OUR HIGH-PROFIT, LOW-WAGE ECONOMY

To understand how tax policy creates pre-tax incentives that contribute to our high-profit, low-wage economy, it first requires some basics about the ways in which the power relations among the various stakeholders in a corporation have shifted over the past 30 years, and how that has led to the economy we see today. Every corporation consists of a variety of stakeholders: CEOs and managers who oversee operations; employees who perform the labor; other businesses, often smaller, who are part of the corporation's supply chain; wealthy shareholders who hold a piece of the firm; and consumers who purchase the company's products or services. These stakeholders all have their own set of interests—at times overlapping, at times competing. When power is evenly distributed among these stakeholders, each serves as a check on the others as they struggle over who gets the greatest share of the company's earnings. In the past, when power was more evenly distributed, this struggle resulted—while still quite far from the ideal—in a more even distribution of profits among corporate stakeholders than what we see today. Relative to profit, companies also invested more in things like research and innovation, because each of the stakeholders stood to gain from the company's long-term growth. When stakeholder interests—including the interests of CEOs and their wealthy shareholders—are more balanced, then a business's growth can be more broadly shared.

Today, however, the relative wealth and power of executives and shareholders have grown, while the relative power of workers, consumers, and suppliers has shrunk. This shift in relative bargaining power—the increased power of executives and wealthy shareholders and the decreased power of workers, consumers, and smaller businesses along the supply chain—has resulted in a substantial change in how a company's earnings are allocated. Executives and wealthy shareholders have used their increased leverage and power to demand more of the company's profits for themselves; the average CEO made 30 times higher pay than the average worker in 1978, but 271 times more than the average worker in 2016,¹ and payouts to wealthy shareholders now account for more than 90 percent of all corporate profit—with stock buybacks, the dominant way companies pay shareholders, at a record high in 2018.² As more of the company's earnings have gone to executives and shareholders, less has gone to other stakeholders—because a rising proportion of profit flowing to shareholders means a decline in what is available for the others; in this case, workers, suppliers, and the long-term capital expenditures that, over time, grow the company.



Beyond differences in relative bargaining power within a corporation, a lax antitrust environment over the last few decades has meant that some corporations now have far more power in the market than others and thus much greater bargaining power over a range of stakeholders. As a result of high concentration and low competition, the powerful firm knows that the other stakeholders—namely, workers and suppliers—have no place else to go.

It is this shift in the relative increase in the power of corporations, executives, and shareholders, and the relative decrease in the power of workers and small businesses, that has led to the high-profit, low wage economy we see today. Today's companies are earning record profits, but they are not investing those profits back into their companies or into the economy. In the 1960s and 1970s, 40 cents were invested for every dollar a company earned or borrowed—but since the 1980s, less than 10 cents of each borrowed dollar is invested.³ Instead, executives are using their profits to pay themselves and their wealthy shareholders—at the expense of investments in research, capital expenditures, or employee compensation. Before the 1970s, American corporations paid out 50 percent of profits to shareholders and retained the rest for investment.⁴ Today, payments to wealthy shareholders account for 90 percent of reported profits, with fewer and fewer dollars available for the productive investments that make our economy grow.⁵

Perhaps most importantly, although Americans are working more productively than ever, most workers have seen little of the benefits: From 1973 to 2016, net productivity rose 73.7 percent, while the hourly pay of typical workers essentially stagnated—increasing only 12.5 percent over 43 years, after adjusting for inflation.⁶ Taken together, the share of income held by the bottom 60 percent of Americans decreased by 4.4 percentage points between 1979 and 2014, while the share moving up to the top 1 percent increased by 5.7 percentage points.⁷ The wealthy are taking the lion's share of the winnings—and at the expense of the rest of us.

It is important to note the racialized effects of this shift. Today, the top 20 percent of the income distribution, a group that is overwhelmingly and disproportionately white, own 92 percent of all shareholder wealth.⁸ Black and Latinx households are significantly less likely to own any stock than are white households,⁹ an economic divide rooted in the history of slavery and subsequent public policies—like redlining and unregulated predatory lending—that have led to massive inequities in the intergenerational transfer of wealth available to people of color.^b The shift in the relative power of corporate stakeholders to executives and shareholders, at the expense of workers and consumers, has also been a shift in the relative power of white people at the expense of people of color.

^b For an excellent discussion on the racialized effects of the TCJA, see *Hidden Rules of Race Are Embedded in the Tax Law*, available at <http://rooseveltinstitute.org/hidden-rules-new-tax-law/>.



TAX POLICY AND OUR HIGH-PROFIT, LOW-WAGE ECONOMY

This shift in the relative power of corporate stakeholders is the result of a number of changes, most notably a substantial shift in the policy landscape starting in the early 1980s and continuing throughout the 1990s. Policy changes in antitrust law, corporate governance, securities law, labor and employment law—and tax policy—resulted in real changes to the rules and incentives that governed corporate behavior.

The past 40 years has seen a dramatic shift in our tax laws. The Economic Recovery Act of 1981, the Tax Reform Act of 1986, and the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (together known as the Bush tax cuts) resulted in, among other things, a dramatic lowering of effective top marginal tax rates, which continued with the TCJA. The top marginal rate was 70 percent in 1980 prior to passage of President Ronald Reagan’s Economic Recovery Tax Act of 1981; today, following passage of the TCJA, the statutory rate is just 37 percent. Other changes made over the past 40 years, and continued with the TCJA, include a sharp decrease in the federal estate tax; a decrease—most notably in the TCJA itself—in the corporate tax rate, which has disproportionately accrued to the benefit of wealthy shareholders in the form of stock buybacks;^c and a substantial decrease in the capital gains tax, among several others. Altogether, given these loopholes for income derived from wealth, the effective tax rate on the rich is far lower than the statutory 37 percent—even lower than the tax rate on what many consider the middle class.

Executive Compensation Bargaining and Our High-Profit, Low-Wage Economy

This change in the effective tax rates for high earners has resulted in two interrelated shifts: First, it has resulted in far greater post-tax income inequality. The Center of Budget and Policy Priorities notes, based on analysis from the Tax Policy Center,¹⁰ that in 2025, the new tax law will boost the after-tax incomes of households in the top 1 percent by 2.9 percent, roughly three times the 1.0 percent gain for households in the bottom 60 percent.¹¹

This change in the effective tax rates for top earners has also had an effect on pre-tax (sometimes also known as pre-distributional, or market-based) inequality. There is relatively recent economic evidence that the dramatic lowering of top marginal tax rates, as well as the overall lower tax rates paid by wealthy individuals over the past 30 years, has resulted in higher pre-tax incomes of corporate executives—in ways that have affected

^c For a complete discussion on how stock buybacks influence corporate behavior and the economy overall, see *Stock Buybacks: Driving a High-Profit, Low-Wage Economy*, available at <http://rooseveltinstitute.org/stock-buybacks-high-profit-low-wage/>.



the allocation of profit within a firm. This is because the tax code shapes how corporate executives behave, and, in this case, bargain for themselves. Recent work by economists Piketty, Saez, and Stancheva found that lower tax rates for the wealthy encourage corporate managers and executives to bargain for higher compensation for themselves.¹² Essentially, a lower top tax rate increases the rate of return from bargaining for higher compensation, which has encouraged corporate executives and managers to do so. Since—as described above—a greater proportion of profits flowing to one set of stakeholders results in a smaller proportion of profits flowing to others, the tax incentive—created by lower effective tax rates—to bargain for a greater share of corporate profits has necessarily resulted in a smaller share of corporate profits flowing to other stakeholders. Andrew Fieldhouse of the Economic Policy Institute summarized this dynamic well:

“[T]he post-World War II reduction in top marginal income tax rates has encouraged ‘rent-seeking’ behavior by executives and managers to bargain for a higher share of total income, without changing the overall size of the pie being divided up. Essentially, a lower top tax rate increases the rate of return to efforts demanding greater compensation from boards of directors, and successful efforts will come out of workers’ paychecks, not shareholders’ portfolios.”¹³

Let’s take a hypothetical executive as an example. Prior to President Reagan’s Economic Recovery Tax Act of 1981, when the top marginal rate was 70 percent, any salary increase for Mr. Smith, the CFO of GenenCorp, went mostly to taxes. As a result, Mr. Smith was disinclined to bargain for compensation beyond the level at which any additional compensation would largely be spent on taxes. Mr. Smith’s effort to bargain for compensation above \$1 million, since he retained only 30 percent of the income earned over that amount, would largely be wasted from his perspective. The higher effective tax rates of the pre-Reagan era gave Mr. Smith incentive not to bargain for an increasing share of the corporation’s profits. This, in turn, left the \$500,000 in corporate earnings that Mr. Smith did not bargain for in compensation for other uses—leaving more available for other types of corporate investments in GenenCorp, including capital expenditures, resources spent along the supply chain, and higher wages for workers.

While there is not yet evidence of a direct effect from the TCJA that the lower effective tax rates have resulted in the same compensation bargaining effects, the logic is nonetheless instructive. Conservative tax changes over the past 40 years have contributed to economic inequality by inducing corporate executives—and, logic suggests, wealthy shareholders—to bargain for an ever-greater share of corporate earnings, resulting in fewer resources available for the corporation’s other stakeholders, including workers, smaller businesses along the supply chain, and the long-term interests of the company. Moreover, there is



evidence that the converse is true: Substantially increasing the effective tax rates of the wealthy removes the incentives high-earners currently have to extract an outsized share of corporate profits and leaves more profit available for corporate investments that result in higher wages and longer-term economic growth.

Reduced Corporate Tax Rates, Increased Merger & Acquisition Activity, and Corporate Concentration in Our High-Profit, Low Wage Economy

Though it is early to fully assess its impact, passage of the TCJA during a time of enormous inter-firm inequality—when some corporations have far greater power over others within the market and far greater power over some stakeholders, including workers—may similarly exacerbate economic inequality in sometimes overlooked ways.

The evidence of increased concentration and growing market power is striking.^d Perhaps most notably, the number of mergers and acquisitions each year has skyrocketed—up from less than 2,000 in 1980 to roughly 14,000 per year since 2000.¹⁴ As a result, researchers have found that between 1997 and 2012 more than 75 percent of U.S. industries became more concentrated, meaning a smaller number of larger firms account for most of the revenue.¹⁵ Importantly, there are new findings that labor markets themselves are highly concentrated. According to recent research using online vacancy data, labor market concentration is well in excess of the threshold for high concentration contained in the antitrust agencies' guidelines for certain kinds of mergers.¹⁶

This increased concentration is harming workers. First, through fewer jobs, both directly as a result of mergers and indirectly as a result of what happens to workers when companies accrue power in the market; second, through lower wages, with one study finding that going from the 25th to the 75th percentile of the concentration distribution in the labor market reduces posted wages by 17 percent;¹⁷ third, through a number of discrete anti-competitive strategies used by employers to stifle worker mobility; and finally, through changes to the structure of employment that are available to powerful employers and create a systematic disadvantage for workers.

There is at least anecdotal evidence that the TCJA is leading powerful, already profitable firms to engage in additional merger and acquisition activity, ultimately exacerbating the inequality that has resulted in part from the high levels of concentration in our economy. First, M&A activity is on the rise. According to estimates, global merger and acquisition

^d For an extended discussion on the rise of market power and its effects on our economy, see *Powerless: How Lax Antitrust and Concentrated Market Power Rig the Economy Against American Workers, Consumers, and Communities*, available at <http://rooseveltinstitute.org/powerless>.



activity had its strongest start ever in the first quarter of 2018, totaling \$1.2 trillion in value.¹⁸ According to a late 2017 survey of 1,000 corporate executives conducted by Deloitte prior to the tax law's passage, "Nearly 70 percent of executives at U.S.-headquartered corporations and 76 percent of leaders at domestic-based private equity firms say deal flow will increase in the next 12 months."¹⁹

Some analysts have predicted that, following a round of stock buybacks, mergers and acquisitions will increase as a result of the TCJA. For example, a partner at Pillsbury Winthrop Shaw Pittman LLP recently predicted a rise in so-called "M&A activity," directly as a result of the TCJA: "While the implications of the influx of cash into [U.S.] corporates are still developing, we are already seeing an increase in dividends and share buybacks, and we expect an increase in [U.S.] mergers and acquisitions (M&A) to follow. The cash infusion may prove irresistible to M&A teams that now have access to funds that were previously tied up overseas."²⁰ The reason for this expected rise in M&A activity as a result of these tax changes is similar to the reason we are seeing historic levels of stock buybacks: Passage of dramatic tax cuts, at a time when corporations, executives, and wealthy shareholders have far greater bargaining power than other stakeholders, results in those powerful firms, executives, and shareholders being able to claim the lion's share of the winnings. In the case of M&A activity, powerful firms are able to use the funds made available as a result of the tax cut to purchase smaller firms, including smaller companies along the supply chain, which will exacerbate the inequality that this era of corporate concentration has wrought. Significantly more research is needed on the relationship between the TCJA and M&A activity, as well as the effects of this dynamic on workers, small businesses, and consumers that may result.

CONCLUSION

The imbalance of power—who has it, what is done with it, and what does this mean for those without it—remains an overriding concern in today's high-profit, low-wage economy. The Tax Cuts and Jobs Act was passed during a time of enormous and widening inequality—and an enormous and widening imbalance of power across our economy. As a result, the TCJA's effects go beyond the loss of revenue that will result, or even the post-tax inequality that will result. The TCJA will exacerbate inequality, in part, because it gives those who already hold power even greater resources, and even more incentive, to take the lion's share of a firm's earnings for themselves, at the expense of the other stakeholders—workers, small businesses, and consumers—in the economy. As progressives continue efforts to argue against the TCJA and for a new vision for the tax code, it is this case—that conservative tax policy increases incentives for the rich and powerful to take even more of the economic pie, without doing nearly enough to grow it—that should be front and center.



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ACKNOWLEDGMENTS

The authors thank Lenore Palladino for her comments and insight. Roosevelt staff Nell Abernathy, Kendra Bozarth, Devin Duffy, and Katy Milani all contributed to the issue brief.

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