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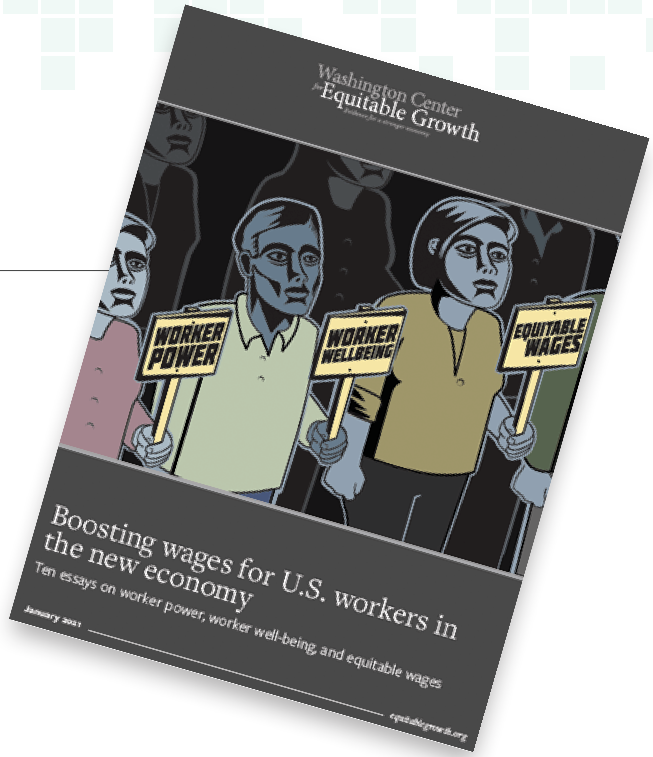

Targeting business tax incentives to realize U.S. wage growth

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By Equitable Growth

Overview

A common argument for implementing broad-based tax cuts is that they boost wages. The rationale behind this argument is that by stimulating investment, business tax incentives lead to employment gains and, under the right labor market conditions, promote wage growth.

The latest academic research, however, does not support the idea that broad-based tax cuts consistently lead to wage gains for workers. Policymakers should therefore turn to alternative policies, such as directly tying tax cuts to wage growth within a firm.

This factsheet examines the potential for targeted tax cuts to deliver wage gains for workers and reviews the academic evidence on the effectiveness of different tax policies to boost investment, employment, and wage growth. It is based on the essay by Juan Carlos Suárez Serrato of Duke University, titled "Targeting business tax incentives to realize wage growth." The essay is part of *Boosting Wages for U.S. Workers in the New Economy*, a compilation of 10 essays from leading economic thinkers who explore alternative policies for boosting wages and living standards in the United States, rooted in different structures that contribute to stagnant and unequal wages.

Can targeted tax cuts be directly designed to ensure wage growth?

Broad-based tax cuts do not consistently deliver gains for workers. Consider the different effects of tax cuts on the following types of firms:

- A firm with established production processes that would not boost investment or employment if faced with a lower tax rate
- A firm that would invest in new modes of production if faced with lower tax rates, but that would opt to replace existing workers through automation[1]
- A firm that would invest in new modes of production if faced with lower tax rates, investing in technologies or worker training that enhance worker productivity

Of the cases outlined above, broad-based tax cuts would only deliver gains for workers in the third type of firm. To boost wages for most workers, then, policymakers should consider a targeted tax cut that is indexed to wage growth.

Per this proposal, a firm would get a tax cut if average wage growth across all of its workers exceeded a certain threshold. To create incentives for continued wage growth, the policy would also reduce taxes based on average wage growth over a period of time, promoting the creation of medium-term investment plans within firms, stimulating investment in productivity-enhancing technologies or worker training, and boosting wages.

A shortcoming of the above proposal is that in taking the form of a lower corporate tax rate, the tax incentive might only benefit workers in firms with current profits. To address this drawback, an alternative would be to give firms with sufficient and sustained average wage growth a refundable tax credit for new investment.[2]

The effects of U.S. business tax policies on wage growth

New research and sources of data provide valuable insight into the many ways tax incentives can affect investment, employment, and wage growth. It is possible that some policies may be justified by their effects on investment and employment, especially when new jobs benefit low-wage workers. At the same time, the findings do not paint an optimistic picture for the specific goal of using broad business tax cuts to spur wage growth.

Below are four ways in which tax incentives designed to boost wage growth may or may not be effective:

- **A tax cut may not stimulate investment or employment.** Research finds that the 2003 dividend tax cut, which lowered the top tax rate on dividend income in the United States from 38.6 percent to 15 percent, did not lead to investment or higher earnings for workers.[3]

- **A tax cut may stimulate investment and employment, but not wage growth.** Evidence shows that policies such as bonus depreciation can stimulate investment.[4] Bonus depreciation lowers the cost of investment by allowing firms to claim depreciation deductions earlier, increasing the present value of this deduction. Yet there is evidence that the policy does not lead to an increase in earnings per worker.[5]

- **Tax incentives may impact firm-level wage growth in different ways.** The Domestic Production Activities Deduction of 2004 increased average wages in firms that claimed the deduction. Yet most wage gains were concentrated among the highest-earning workers.[6]

- **Tax incentives may have varied impacts on regional wage growth.** For instance, research using regional variation in tax rates finds that business tax cuts can lead to job growth and wage gains for workers over a period of time but might lead to an increase in income inequality.[7]

Read the full essay

"Targeting business tax incentives to realize U.S. wage growth," by **Juan Carlos Suárez Serrato**

This essay is part of Boosting Wages for U.S. Workers in the New Economy*, a compilation of 10 essays from leading economic thinkers who explore alternative policies for boosting wages and living standards, rooted in different structures that contribute to stagnant and unequal wages.*

Endnotes

1 Daron Acemoglu and Andrea Manera of the Massachusetts Institute of Technology and Pascual Restrepo of Boston University argue that the current tax system inefficiently favors excessive automation of production tasks. See Daron Acemoglu, Andrea Manera, and Pascual Restrepo, "Does the US Tax Code Favor Automation?" Working Paper 27052 (National Bureau of Economic Research, 2020), available at https://www.nber.org/papers/w27052.

2 This formulation would also avoid gaming of the program by re-timing income to years that coincide with high wage growth.

3 Danny Yagan, "Capital Tax Reform and the Real Economy: The Effects of the 2003 Dividend Tax Cut," *American Economic Review* 105 (12) (2015): 3531–3563, available at https://www.aeaweb.org/articles?id=10.1257/aer.20130098.

4 Eric Zwick and James Mahon, "Tax Policy and Heterogeneous Investment Behavior," *American Economic Review* 107 (1) (2017): 217–48, available at https://www.aeaweb.org/articles?id=10.1257/aer.20140855; Eric Ohrn, "The Effect of Tax Incentives on U.S. Manufacturing: Evidence from State Accelerated Depreciation Policies," *Journal of Public Economics* 180 (2019), available at https://www.sciencedirect.com/science/article/abs/pii/S0047272719301458.

5 Daniel G. Garrett, Eric C. Ohrn, and Juan Carlos Suárez Serrato, "Tax Policy and Local Labor Market Behavior," *American Economics Review: Insights* 2 (1) (2020): 83–100, available at https://www.aeaweb.org/articles?id=10.1257/aeri.20190041.

6 Christine Dobridge, Paul Landefeld, and Jacob A. Mortenson, "Corporate Taxes and the Wage Distribution: Effects of the Domestic Production Activities Deduction" (2019), available at https://conference.nber.org/conf_papers/f130241.pdf.

7 Juan Carlos Suárez Serrato and Owen Zidar, "Who Benefits from State Corporate Tax Cuts? A Local Labor Markets Approach with Heterogeneous Firms," *American Economic Review* 106 (9) (2016): 2582–2624, available at https://www.aeaweb.org/articles?id=10.1257/aer.20141702.

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