



Evaluating a Corporate Asset Tax

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Abstract:

This paper examines a tax on corporate assets as an alternative and/or complement to a tax on corporate income. All capital taxes have some degree of distortionary effects by reducing levels of investment, but an efficiently designed tax system may result in higher revenues for any level of distortion. A tax on corporate income results in higher levels of leverage, more cyclical tax revenues, and higher levels of investment in non-operating financial assets compared to a tax on corporate assets. On a macroeconomic level, a corporate asset tax has a greater reduction in investment and produces lower levels of revenue, especially when the Marginal Product of Capital (MPK) curve is relatively inelastic. On the microeconomic level, an asset tax has a greater impact on highly profitable firms while an income tax has a greater impact on scalable firms.

Keywords: Capital Taxation

1. Introduction

Capital taxation has been widely debated from the very beginning. The primary criticism is that taxes reduce the incentive for firms to invest in capital. This is especially true if capital is mobile globally and can be invested in lower-tax jurisdictions. High corporate tax rates also encourage avoidance techniques. This not only includes investing in low-tax jurisdictions, but also shifting intellectual property and profits to these jurisdictions even if the economic activity primarily takes place elsewhere. The effect of this is that high tax rates do not necessarily lead to high tax revenues.

A second concern is who bears the burden of capital taxation. Although it seems as if corporate taxes are paid by the owners of the corporation, part of the burden is borne by employees and customers of the corporation. Gravelle and Smetters (2006) show that the burden depends on the mobility of capital. Capital can be invested wherever has the highest after-tax returns while labor is relatively immobile. They find that workers bear 73% of the burden when capital flows freely. In a summary of research on the topic, Jensen and Mathur (2011) suggest that workers bear greater than 50% of the tax burden. However, Clausing (2012) questions the robustness of these findings and finds no definitive relationship between tax rates and wages.

In addition to the macroeconomic effects, capital taxation also affects decision making at the firm level. The tax deductibility of interest payments results in a gain from leverage and encourages the use of debt. This distortion makes firms more susceptible to business downturns.

Clausing (2013) discusses the need for capital taxation reform in order to combat budget deficits, income inequality, and tax competition by both countries and jurisdictions within a country. Taxation of capital is challenging in part due to its relatively concentrated nature and international mobility. Capital taxation results in distortions to such an extent that several models suggest that a zero tax rate is optimal as discussed in Auerbach and Hines (2002).

On the other hand, Conesa, Kitao, and Krueger (2009) and Piketty and Saez (2012) show optimal rates at or above current levels. Saez and Stantcheva (2018) develop a model for optimal capital taxation that depends on consumption utility functions, cross elasticities between capital and labor, and the elasticities between various types of capital assets. Among their conclusions is that the tax rate on capital should be higher than the tax rate on labor due to equity considerations and the concentrated distribution of wealth.

Capital taxation does have some advantages. Toder and Viard (2014) argue that one purpose for the corporate income tax is to ensure that retained earnings does not escape (or permanently delay) taxation at the individual level. Gordon and Slemrod (2000) discuss the potential for income shifting between labor and capital income when there are different rates.

Stiglitz (2012) argues that some portion of capital income is the result of economic rents and taxation would not cause as many inefficiencies.

While the need for reform is largely agreed upon, the shape of reform is divided. The simplest reforms call for reductions in the corporate tax rate and broadening of the base. The Tax Cuts and Jobs Act of 2017 that was ultimately passed and signed into law largely does this as the top rate was reduced from 35% to 21%.

Altshuler, Harris, and Toder (2010) consider reducing or even eliminating the corporate income tax completely and taxing dividends and capital gains at higher ordinary income tax rates. Indeed, sole proprietorships, S corporations, and other “flow-through” businesses are taxed in this manner. Another suggestion is to have unrealized gains (and losses) taxed on an annual basis instead of when realized. Mirrless (2012) includes an allowance for corporate equity that would go untaxed leaving economic rents and windfall profits to be taxed at higher rates.

Another proposal that was widely discussed in the runup to the 2017 tax reform is the destination-based cash flow tax or border-adjusted tax. Auerbach (2010) suggests a tax on imports and a tax credit on exports resulting in a plan that basically taxes the corporate income on goods and services that are consumed in the US. The proposed plan also includes immediate expensing of capital investments and excludes the deduction for interest expense.

While taxes on corporate income are the norm, some countries include a tax on corporate assets as a method for insuring that corporations are paying at least something even if the firms report no income. Taxation and Investment Guides from Deloitte reports that Argentina has a tax on minimum presumed income with a standard rate of 1% of assets. Colombia has a minimum presumptive income equal to 3% of net assets resulting in a minimum tax equal to .75% of net assets based on their corporate tax rate of 25%. The presumptive minimum income is compared to their regular taxable income to determine the actual taxes due. Luxembourg has a tax of .5% of net assets and Swiss cantons tax corporate assets.

This paper discusses a tax on corporate assets and compares the outcomes to a tax on income. Corporate taxes represent a tax on capital regardless of whether the tax is based on the initial amount of capital (an asset tax) or on the income that results from the capital (an income tax).

2. Macroeconomic Effects

2.1 Capital Investment

With such a variety of possible tax systems, it is important to analyze how tax structures affect businesses and the overall economy. Fehr et al. (2013) simulate the effect of eliminating the U.S. corporate income tax completely. Their model is comprised of five regions (the U.S. is one region) and the production of a single good using both skilled and unskilled labor. Elimination of the corporate income tax led to an increase in the capital stock of 23-37%. This resulted in the real wages of unskilled workers rising by 12% and skilled workers by 13%. This increase in real wages offset approximately one-third of the lost corporate tax revenue. Higher wage tax rates could completely offset the lost revenue as could higher consumption taxes.

The increase in U.S. capital stock and resultant increase in real wages came at the expense of investment and wages in the other regions. There is a concern that the other regions also cut their tax rates resulting in a potential “race to the bottom.” The scenario where all regions eliminate corporate taxation resulted in higher capital flow to the U.S., but to a lesser degree. Higher wage-taxation resulted in benefits to current U.S. retirees and most current and future workers. Higher consumption taxes resulted in losses to retirees but larger gains to workers.

Lower tax rates increase the after-tax return to any investment and reduces the before-tax cost of capital required to induce investment. Djankov et al. (2010), among others, find an elasticity of -.835 between tax rates and capital stock for 85 countries. In the U.S., Ohrn (2018) used data from Domestic Production Activities Deduction and found that a reduction in tax rates increased investment in installed capital and reduced corporate debt. Not only do lower tax rates encourage domestic investment, they attract foreign investment.

The effect of taxes on capital investment is primarily due to higher required before tax returns. Taxation represents a shift in the supply curve and the impact of a tax depends on the shapes of the supply and demand curves. In this case, the demand curve represents the diminishing marginal product of capital (MPK). If the supply of capital is perfectly elastic, then suppliers will demand a constant after tax return of r^* and any tax (T) will result in a higher before-tax return.

$$r_i = r^*/(1-T_i) \quad (1)$$

$$r_a = r^*+T_a+r^*(T_a) \quad (2)$$

If the demand curve is perfectly inelastic, then tax rates can be set that raise equivalent amount of tax revenue.

$$T_a = [(1-T_i)/(1-T_i - T_i r^*)] - 1 \quad (3)$$

As an example, if a 25% tax is placed on income (T_i) and $r^* = 6\%$, then the before-tax required return (r_i) would be 8%. However, an asset tax (T_a) of 2.0408% would raise an equivalent amount of revenue and the before-tax required return would increase to 8.1632%.

In this simple model, the demand curve is a linear function of the return where capital investment = 0 at a maximum return (R) and 100 at a minimum required return equal to r^* . As the tax rate on either income or assets rise, the required return raises as in equations 1 and 2 resulting in lower levels of capital investment (K).

$$K = (R - r_{ai}) * 100 / (R - r^*) \tag{4}$$

Table 1 shows the level of capital investment for a selection of tax rates and demand curves. Higher tax rates reduce capital investment regardless of the type of taxation or shape of the MPK curve. When the MPK curve is relatively inelastic as in column 1, an asset tax results in lower levels of investment than an income tax. As the MPK curve becomes more elastic in column 3, the level of investment falls dramatically under the income tax. Investment also falls for the asset tax, but not by s much. Thus the difference between the two tax structures shrinks and even flips when taxes are high and the MPK curve is elastic.

Table 1: Effect of Taxes on Capital Investment for different MPK curves9592496370			
	R=15% and $r^* = 5\%$	R=15% and $r^* = 8\%$	R=12% and $r^* = 8\%$
$T_i = 10\%$; $T_a = 1\%$	94.44; 89.50	87.30; 84.57	77.78; 73.00
$T_i = 20\%$; $T_a = 2\%$	87.50; 79.00	71.43; 69.14	50.00; 46.00
$T_i = 30\%$; $T_a = 3\%$	78.57; 68.50	51.02; 53.70	14.29; 19.00

A similar pattern arises when looking at tax revenues. The tax revenue for the asset tax is simply $T_a K$ while the revenues for the income tax is shown in equation 5.

$$T_i * [(0.5 * K * (R - r_i)) + (K * r_i)] \tag{5}$$

Table 2 shows the tax revenues resulting from the different tax rates and MPK curves. When the MPK curve is fairly inelastic, higher tax rates result in higher levels of tax revenue and taxes on income brings in more revenues than taxes on assets. If the MPK curve is elastic, less tax revenue is generated overall, but the difference between the income tax and asset tax shrinks or even reverses.

Table 2: Effect of Taxes on Tax Revenue for different MPK curves			
	R=15%, $r^* = 5\%$	R=15%, $r^* = 8\%$	R=12%, $r^* = 8\%$
$T_i = 10\%$, $T_a = 1\%$	0.97; 0.90	1.04; 0.85	0.81; 0.73
$T_i = 20\%$, $T_a = 2\%$	1.86; 1.58	1.79; 1.38	1.10; 0.92
$T_i = 30\%$, $T_a = 3\%$	2.61; 2.06	2.02; 1.61	0.50; 0.57

2.2 Wage Income

The Council of Economic Advisors (2017a) fined that a reduction in the corporate tax rate from 35% to 20% would result in large income increases to workers. They point out that the rise in corporate profits has outpaced worker compensation, especially since 1989. A large reason for this is the increase in foreign profits of U.S. multinationals from 10% in the 1970s to over 20% in 2016. The percent of those foreign profits that are repatriated to the U.S. parent has fallen from 58% in 1984 to 30%. Additionally, wage growth in developed countries with the lowest statutory corporate tax rate exceeded the wage growth in countries with higher tax rates.

The reasoning behind the increased wage growth is that lower tax rates would encourage capital investment. Higher levels of capital would then result in higher demand for, and greater productivity of, complementary labor. The higher wages would accrue to both skilled and unskilled labor. Felix (2007) measures the elasticity of wages to tax rates and find that a 1% increase in tax rates leads to a .4% reduction in wages.

While a tax on income or assets reduces capital investment and therefore reduces the demand for complementary labor, a tax on assets would have the effect of increasing the demand for substitute labor. Sachs and Kotlikoff (2013) argue that

smart machines are increasingly a substitute for labor and may result in reductions in general welfare in the future. Guerreiro, Rebelo, and Teles (2018) model that includes falling automation costs that results in greater levels of income inequality. They suggest a tax on robots and an increase in marginal tax rates may mitigate the situation. A tax on robots could be considered a specific type of asset tax.

Lower tax rates may also increase overall GDP. The Council of Economic Advisors (2017b) estimate that reducing corporate tax rates from 35% to 20% would result in an increase in GDP of 3-5% based on findings in Benzell, Kotlikoff, and Lagarda (2017). Evidence using archival data is difficult because changes in tax laws are not random and are usually associated with the business cycle. However, Barro and Redlick (2011) and Mertens and Ravn (2013) find results that support the argument that lower income tax rates result in higher levels of GDP.

2.3 Tax Revenues

As discussed in Jensen and Mathur (2011), corporate taxes are borne by providers of capital, labor in the form of lower wages, and consumers in the form of higher prices. A tax on assets is effectively a tax on wealth rather than income and may result in shareholders bearing a greater share of the burden. Given the concentrated nature of wealth, this facet would make the tax system more progressive overall.

Using data from the Federal Reserve Bank of St. Louis, Nonfinancial Corporate Profits before Tax had an average annual increase of 6.95% with a standard deviation of 16.1% between 1952 and 2016. Similarly, tax receipts had an average increase of 5.99% with a standard deviation of 14.9%. Nonfinancial Corporate Assets had an average increase of 7.12% with a standard deviation of 4.7%.

An asset tax may provide several benefits relative to an income tax. The relative stability of corporate assets means that tax revenues would become less cyclical under an asset tax. Asset valuations may also be less susceptible to fraud. There would also be less incentive for firms to shift profits overseas as a domestic parent would still own the assets of a foreign subsidiary.

3. Microeconomic Effects of an Asset Tax

Corporations consider many factors in their decision making. Graham (2003) reviews how taxes affect a variety of decisions including financing, dividends, and investment. While taxes are certainly a consideration, it does not seem to be an overriding factor in many of the cases. This section examines how an alternative taxation on assets instead of income would affect these decisions.

3.1 Capital Structure

Since Interest Expense, but not dividends, is deductible from taxes, there is an incentive for companies to use more debt if tax rates are high. Indeed, Modigliani and Miller (1963) suggest that debt ratios should approach 100% if the tax rate is positive. However, the evidence on this is mixed as pointed out in Myers (1984). The tax benefits of debt may be offset by bankruptcy costs, agency costs, and underinvestment. De Mooij (2011) reviews several papers and finds evidence that higher corporate tax rates lead to higher debt levels.

Several early papers investigated whether a firm's capital structure affected firm value. Masulis (1980) examined exchange offers and found that leverage increasing offers had positive returns to shareholders while leverage increasing offers had negative returns. However, other research such as Myers and Maljuf (1984) suggest that the exchange offer may be signaling information and that this new information is the cause of the change in firm value.

Firms may have different expected tax rates which may affect their choice of capital structure. Bradley, Jarrell, and Kim (1984) hypothesize that firms with more nondebt tax shields such as depreciation or investment tax credits will receive less benefit from using debt and will therefore use less debt. However, they found a positive correlation between the use of debt and these other shields.

MacKie-Mason (1990) examined 1,747 issuances of debt and equity from 1977-1987. The primary finding is that firms with higher marginal tax rates were more likely to issue debt instead of equity. As an additional finding, firms with nondebt tax shields that were near "tax exhaustion" were less likely to issue debt suggesting that the surprising results in Bradley et al. were the result of profitable, high tax rate firms benefitting from both debt and nondebt tax shields.

Faccio and Xu (2015) examine nearly 500 changes in corporate and personal tax rates to address whether tax rates affect capital structure. These tax rate changes include 184 corporate tax rate changes and 298 personal tax rate changes in OECD countries from 1981-2009. By using a firm and year-fixed effects approach, they are able to eliminate cross sectional correlations that affect both debt and taxes. Their primary findings are that firms increase leverage following increases in corporate taxes or personal taxes on dividends. Leverage is reduced following increases in the personal tax rate on interest income.

Overall, an asset tax should result in lower levels of leverage and reduce the risk of bankruptcy. Bankruptcy has costs beyond the cost to firms as employees, customers, and suppliers are disrupted. There are also the costs of the legal system which is borne by tax payers. The government may have a legitimate interest in reducing bankruptcy by using a tax based on assets.

3.2 Capital Budgeting

Sureth-Sloane and Maiterth (2005) investigate a corporate wealth tax used as an alternative minimum tax that only affects firms that lack sufficient income, primarily in the early years of operation. They conclude that a wealth tax has a negative distortionary effect on firms with volatile earnings but limited impact on profitable firms. Additionally, they find that total tax revenues may even fall if the reduction in investment is significant enough.

Instead of taxing the corporations, wealth taxes are more likely to be done at the individual level. Several European countries have a tax on individual wealth, although others have eliminated theirs. Hansson (2008) looks at the effect of individual wealth taxes on entrepreneurship. He posits that a wealth tax negatively affects both the available capital to start a business and the rewards to success. Using a difference-in-difference approach, he finds that OECD countries that eliminated their wealth tax saw a small but perceptible rise in entrepreneurial activity relative to those that either kept their wealth tax or never had a wealth tax.

Swanstrom (2017) classifies firms based on profitability and scalability to determine revenue-maximizing tax structures. If a firm is scalable, an asset tax has a big negative impact on investment resulting in smaller firm sizes and tax revenues. An income tax will also reduce investment and firm size, but not to the same degree. Alternatively, an asset tax is more efficient for taxing profitable firms. Interestingly, the revenue maximizing income tax rate for scalable firms falls as they become more scalable.

3.3 Financial Assets

An asset tax may affect both the amount and type of investment made by firms. Nonfinancial corporate businesses have increasingly invested in financial assets over the past forty years. Based on information from the Federal Reserve Bank of St. Louis, the proportion of total assets comprised of financial assets has risen from 26.9% in 1978 to 49.5% at the end of 2017.

A tax on corporate assets would negatively impact these kinds of investments. Ownership of securities issued by other corporations would effectively be taxed twice by the asset tax. Whether this effect is a feature or a bug of the asset tax is undetermined, although a law excluding financial assets from taxation would certainly be possible.

4. Conclusion

If the MPK curve is relatively inelastic, then an income tax has a less distortionary effect on investment and brings in more tax revenues. However, an asset tax performs better (or doesn't decline as much) as the MPK flattens and becomes more elastic. A tax regime that includes both income taxes and asset taxes (at lower rates) may be optimal. Brunner, Eckerstorfer, and Pech (2013) demonstrate that a comprehensive tax structure that includes taxes on wealth, earnings, and consumption is optimal in the presence of tax evasion. A small tax on both corporate income and assets may reduce incentives to avoid any single tax.

If some countries have an asset tax regime while others have an income tax, there could be incentives for multinational firms to incorporate and base their assets in income tax countries while reporting most of their profits in countries with asset tax regimes. A tariff, possibly combined with a subsidy for exports, could also be incorporated.

Replacing the corporate income tax with a tax on corporate assets results in comparable levels of tax revenues and firm size depending on the tax rates. Specifically, an income tax brings in more money from scalable firms while an asset tax brings in more money from profitable firms.

A tax on corporate assets may have other advantages as well including reduced bankruptcy costs, more stable tax revenues, and international tax competition. Lower levels of leverage may reduce the risk of bankruptcy. Corporate assets are also more stable than corporate income and less susceptible to fraud resulting in lower drops in tax revenue during economic downturns. There would also be less incentive for firms to shift profits overseas as a domestic parent would still own the assets of a foreign subsidiary.

An asset tax may also reduce income and wealth inequality. Corporate taxes are borne by a combination of owners, employee, and customers. A tax on corporate assets may result in a more progressive tax system where owners bear a greater share of the burden. Additionally, there may be a shift away from capital and towards labor resulting in higher wages.

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