After banner year of elections, tax policy is on the agenda

Corporate tax changes may hit investment, jobs and firm creation.

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By Martin Jacob

If 2024 was the year of elections, with about half the planet going to the polls, often to unseat incumbents, 2025 may be the year of taxes, as politicians everywhere scramble to fulfill all those campaign promises.

Tax policy may not sound as compelling as putting global democracy to the test. But the reality is that policymakers around the world are eyeing their countries' tax codes to find ways to raise revenue to fulfill pledges to raise spending on social programs, to narrow gaping budget deficits, and to improve infrastructure. Still other governments (a minority) are looking to scale back taxes to encourage economic growth. And cracking down on tax evasion is another — and usually less controversial — option to bring in extra funds.

Tax changes don't occur in a vacuum, however, and they don't always have the impact that politicians expect, as several new pieces of research show. Policy uncertainty can temper the new investments that a corporate tax cut would normally spur. Corporate tax rises, meanwhile, may depress investment in multinational and domestic firms. And even the relatively safe option of enforcing existing taxes can slow business activity, leading to lower job creation.

And while in most countries adjusting corporate tax rates is more palatable than hiking personal income or value-added taxes, corporate taxes only account for around 12% of the total tax intake in Organization for Economic Cooperation and Development (OECD) countries, meaning they can only go so far in paying for promises.

Tax changes, managers' expectations and corporate investment

Research I conducted with John Gallemore of the University of North Carolina, Tilburg University's Stephan Hollander and Xiang Zheng of Nanyang Technological University looked at managers' expectations of tax changes, and how they influence companies' investment decisions.

We looked at expectations around two big events in the U.S.: the surprise 2016 election of Donald Trump, who had campaigned heavily on tax policy; and the 2017 passage of Trump's Tax Cuts and Jobs Act (TCJA), the most significant reform to U.S. corporate tax policy in over 30 years.

Conventional wisdom would indicate that once these two major events had passed, uncertainty would decrease, especially given the generally positive sentiment that corporate-friendly changes to tax policy were in the works. That turned out not to be the case: we found uncertainty rose after the election and, while it decreased overall with the TCJA passage, it still remained high in many firms.

Interestingly, there was wide variation among managers. Some found the situation unambiguous and were confident taxes were heading downward; others questioned the staying power and implementation of changes. Managers' feelings toward tax policy varied depending on firm location and business model, but also on their access to private information or their political leanings.

The lingering doubts were important because they informed managers' decisions to invest. After the election, firms with higher tax policy uncertainty reduced investments relative to other firms. After the TCJA, positive-sentiment firms invested twice the amount as others that did not stand to benefit from the new legislation. In contrast, uncertain firms did not change their investments even if they were supposed to benefit from the TCJA.

Corporate tax hikes and multinational investment

Apart from the U.S., where policy talk is around lowering corporate taxes, a more likely scenario for companies will be higher taxes. In research with Antonio De Vito of the University of Bologna, Dirk Schindler of Erasmus School of Economics and Rotterdam School of Management's Guosong Xu, we looked at how corporate tax hikes in one country spill over into the subsidiary networks of multinationals, and alter investments in other countries.

Prior research has tended to show that hiking taxes in one country benefits others where the company has subsidiaries: parent firms simply shift resources from the higher-taxation subsidiary to a place with relatively lower taxes.

But that may not be the full picture, since multinational production operations are highly intertwined. Because of links between downstream and upstream operations in the same company, tax hikes anywhere may prompt companies to pare back investment elsewhere. The research covered more than 3,000 multinational firms' subsidiaries across 20 European countries.

We found that subsidiaries exposed to a tax hike from abroad reduced investment relative to other multinationals' subsidiaries without such exposure; the negative effect of intra-firm production linkages outweighed positive spillover from tax competition. On average, a 1%

increase in the foreign corporate tax was associated with a drop in subsidiary investment of 0.5%.

Tax enforcement, jobs and firms

Does this mean that cash-strapped politicians should focus on collecting taxes that already exist, leaving the tax code alone? Perhaps, but new research shows that even that has a downside, in terms of fewer jobs and firms.

Again working with John Gallemore of the University of North Carolina, we looked at what happened to companies in the U.S. when authorities started auditing corporate tax returns more aggressively. While the government tax intake may have risen, we also found that fewer jobs and new companies were created, highlighting the policy trade-offs involved.

For example, an increase in the corporate tax return audit rate by 5 percentage points was associated with a reduction in employment growth of 0.9%, which represented approximately 459,000 fewer jobs in our sample. A 5-percentage-point increase in the audit rate was also linked to an aggregate decrease of approximately 590 new companies established.

Importantly, the negative effects could be partially attenuated with greater access to external capital. Governments looking to cut down on corporate tax evasion should consider not only the potential revenue to be gained but also the supplemental measures they can take to mitigate the broader impact.

Talk of taxing the rich or punishing corporate giants plays well on the campaign trail. But the reality of government is another. Policymakers looking to raise or cut corporate taxes, or to clamp down on avoidance, must take into account not only their revenue potential but also their impact on business activity, especially since they represent only a small part of total government revenues. Leaders may still decide to adjust their corporate tax policies, but they should also ensure that companies can invest, hire employees and thrive.

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