CORPORATIONS' FAIR SHARE OF FEDERAL TAXES

by Norman Ture and John Egger

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In this article, Ture and Egger argue that taxes on corporate income are higher than on other forms of income. The charge that the corporations do not pay a fair share are unfounded. Ture and Egger believe that the tax on corporate income is higher than the tax would have been if the income had been earned by the shareholders. The decline of the corporate income tax as a share of the total Federal tax burden should not be attributed to loopholes but to other events. Other taxes have increased dramatically over the last three decades. Furthermore, the share of gross national product represented by corporate profits also has declined.

An important influence on the shaping of the Tax Reform Act of 1986 (1986 Act) was the widely publicized contention that U.S. corporations were not carrying their fair share of the total Federal tax load. Exploiting the popular resentment generated by this charge, the Congress enacted in the 1986 Act a very large number of provisions that will transfer an estimated $120 billion of Federal income tax liabilities from individuals to corporations over the years 1987 through 1991.

The fair-share critics charged that: (1) corporations were not carrying their fair share of the Federal tax load, placing more of it on individuals; (2) some corporations, taking advantage of tax "loopholes," were able to reduce their effective tax rates dramatically, putting a heavier tax burden on others; and (3) tax loopholes induced corporations to misuse capital, leading to loss of economic efficiency for the economy as a whole. Strangely, these same critics insisted that: (4) loopholes like the investment Tax Credit (ITC) and the Accelerated Cost Recovery System (ACRS) failed to affect corporate decisions and thus did not even "work."

No meaningful standard of fairness against which to evaluate corporate tax liabilities was presented by the fair-share critics. This is not surprising because no objective measure of the fair share of any tax has ever been established. The fair-share critics finesse this problem by pointing out that Federal corporate income tax revenues account for a decreasing share of total Federal tax revenues, and attribute this trend to provisions in the corporate income tax law that erode the corporate income tax base.

Although a tax may be collected at the corporate level, real people bear the tax. A corporation's profits belong to its shareholders; taxes on corporate profits are taxes on shareholders' incomes. Because individuals are the ultimate owners of all corporations, the corporate income tax is equivalent to the withholding of the income tax on individual shareholders' shares of the earnings generated by corporations.

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One way of assessing the fairness of the corporate income tax is to compare the amount of corporate income tax liabilities with the amount of the individual income tax that would have been payable if corporate profits were received directly by individual shareholders. This comparison shows that corporate income taxes have been unfairly large, year-in and year-out in the postwar period. In 1984, to cite one example of a pattern that has held ever since World War II, the corporate income tax was more than 40 percent greater than shareholders would have paid in individual income taxes if they had received these earnings directly.

Ultimately, the burden of the corporate income tax is felt throughout the entire economy. The tax raises the cost of corporate capital, resulting in smaller stocks of capital and less labor employed in the corporate sector and higher prices for corporate output than would otherwise prevail. These effects spread rapidly through the

Table I

Excess Corporate Federal Income Taxes, Selected Years, 1948-1984
(Dollar amounts in billions)

	1948	1950	1960	1970	1980	1981	1982	1983	1984
1. Individuals' adjusted gross income	$163.5	$179.1	$315.5	$631.7	$1,613.7	$1,772.6	$1,852.1	$1,942.6	$2,157.7
2. Individuals' Federal income tax	$18.1	$17.4	$41.8	$88.8	$250.9	$291.5	$296.5	$288.1	$302.8
3. Individuals' average Federal income tax rate [(2)/(1)]	11.1%	9.7%	13.3%	14.1%	15.6%	16.4%	16.0%	14.8%	14.0%
4. Corporations' pre-tax retained earnings[1]	$27.6	$34.0	$31.6	$45.5	$177.3	$146.0	$87.9	$118.5	$150.4
5. Estimated individuals' Federal Income tax on pre-tax retained earnings [(3)x(4)]x2][2]	$6.1	$6.6	$8.5	$12.8	$55.1	$48.0	$28.2	$35.1	$42.2[3]
6. Corporations' Federal income tax[4]	$11.6	$17.0	$20.6	$27.1	$58.6	$51.7	$33.9	$47.2	$59.9
7. Excess corporate Federal income tax [(6)-(5)]	$5.5	$10.4	$12.1	$14.3	$3.5	$3.7	$5.7	$12.1	$17.7

[1]Corporate total receipts less total deductions (IRS), and less net dividend payments to individuals (NIPA).
[2]Assumes that average tax rate of shareholders is twice the individuals' average Federal income tax rate.
[3]Estimated.
[4]Federal corporate profits tax accruals, excluding Federal Reserve Banks' contributions (NIPA), calendar year basis.
Sources: National Income and Product Accounts of the United States, 1929-1976 (Washington, D.C.: U.S. Department of Commerce, 1981) Tables 8.12, 8.13, and 3.2; *Survey of Current Business* (Washington, D.C.; U.S. Department of Commerce, July 1982, July 1984, July 1986).

economy; labor's productivity, employment, and real wage rates are lower than otherwise in all sectors of the economy as a result.

The decline in Federal corporate income tax revenues relative to total Federal taxes has resulted from the more rapid growth of other taxes, especially payroll taxes, and the decline in corporate profits as a fraction of GNP, not from the burgeoning of tax loopholes. As other taxes have risen rapidly, it was only natural that the corporate income tax's share of the total would shrink. This shrinkage occurred despite the fact that Federal corporate income tax revenues have grown significantly, at an average annual rate of 4.3 percent from 1948 through 1985.

Table II

Federal Corporate Profits Taxes as a Share of Total Federal Receipts, Selected Years, 1948-1985
(Dollar amounts in billions)

Year	Federal Corporate Profits Taxes[1]	Total Federal Receipts[1]	Profits Taxes as Percent of Total Federal Receipts
1948	$11.6	$ 43.9	26.4
1950	17.0	50.4	33.7
1955	20.8	73.1	28.5
1960	20.5	96.9	21.2
1965	27.7	125.8	22.0
1970	27.0	195.4	13.8
1975	37.9	294.9	12.9
1980	58.6	553.8	10.6
1981	51.7	639.5	8.1
1982	33.8	635.3	5.3
1983	47.1	659.9	7.1
1984	59.8	726.5	8.2
1985	55.8	786.8	7.1

[1]Excludes amounts paid to the U.S. Treasury by Federal Reserve Banks.
Sources: *National Income and Product Accounts of the United States, 1929-1976* (Washington, D.C.: U.S. Department of Commerce, 1981) Tables 8.12, 8.13, and 3.2; *Survey of Current Business* (Washington, D.C.: U.S. Department of Commerce, July 1982, July 1984, July 1986).

The most important reason for the corporate income tax's declining share of total Federal taxes is the sharp drop in corporate profits as a share of the gross domestic product originating in corporations. Using the national income and product account definition of corporate profits, a concept that is not affected by provisions of the tax law, corporate profits before Federal income taxes have plunged as a share of corporate gross domestic product, from 19.2 percent in 1948 to only 4.9 percent in 1984 before recovering slightly to 8.9 percent in 1985. When the profit share falls, this naturally produces a decline in corporation income taxes relative to other taxes that are not based on profits.

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The fair-share critics erroneously attribute the declining share of the corporate income tax in the total Federal tax load to proliferation of loopholes in the Federal income tax law. They clearly do not rely on a meaningful standard of tax neutrality in order to define a loophole and to distinguish any such provision from one that is required to meet the neutrality standard. The principal loopholes they identify are, in fact, provisions that make the tax law more nearly neutral than it otherwise would be. The chief culprit the fair-share critics point to is the ACRS-ITC capital recovery system enacted in the Economic Recovery Tax Act of 1981. In reality, ACRS-ITC roughly approximated expensing of capital outlays for most machinery and equipment, hence met the test of neutral tax treatment with respect to such production facilities, although falling short of neutrality for other kinds of property. As complemented by safe harbor leasing, another of the fair-share critics' alleged loopholes, the

ACRS-ITC system represented a major advance toward tax neutrality, compared with the system it replaced.

Just as the fair-share critics do not understand the neutrality criterion of taxation, they also misunderstand and misuse the idea of effective tax rates. They identify a corporation's effective tax rate as the amount of taxes the corporation paid in a taxable year divided by its book income in that year. This definition uses the wrong measure of tax liability and the wrong measure of income. The true measure of the effective tax rate requires determining the present value of the taxes that will be paid over all of the years that the assets generating corporate revenues will be in use, dividing that amount by the present value of the gross income these assets would have had to produce over that entire period, to justify investment in the assets had there been no income tax. The correct effective tax rate concept may be likened to a motion picture; the fair-share critics concept is equivalent to a snap shot.

Contrary to the fair-share critics' assertions, the tax incentives or loopholes that they claim account for the erosion of corporate income tax liabilities were highly effective in stimulating capital formation. Capital outlays declined during the 1981-1982 recession intensification, but less sharply than in three of the preceding six postwar recessions. These outlays led the recovery in 1983 and 1984 and increased at annual rates that far outpaced the growth in real nonresidential fixed investment in prior postwar recoveries.

The base-broadening provisions in the 1986 Act, adopted to finance the statutory rate reductions for individuals and corporations, substantially increase the tax burden on saving and investment relative to that on current consumption. The repeal of the ITC, the cutback of ACRS, the adoption of a corporate alternative minimum tax, and numerous other provisions of the 1986 Act resulted in enormous additions to the punitive taxation of saving and capital formation. In doing so, the 1986 Act moved the tax law farther away from the goal of tax neutrality. The new law not only tips the playing field away from saving and investment, is also fills it full of potholes.

Misuse of the concept of fairness contributed to increasing the tax burden on corporations, resulting in an adverse economic thrust. If a better tax system is ever to be achieved, tax policymakers will have to recognize that the fair share of the total tax load to be assigned to corporations is zero.

Table III

Shares of Corporations' Gross Domestic Products, Selected Years, 1948-1985

Year	Corporate Gross Domestic Product	Indirect Business Taxes	Capital Consumption Allowances[1]	Compensation of Employees	Corporate Employer's Payroll Taxes	State Corporate Profits Taxes	Net Interest	Corporate Profits[2]	Federal Corporate Profits Taxes[3]
A. Billions of Dollars									
1948	$ 142.4	$ 12.5	$ 11.0	$ 88.9	$ 2.4	$ 0.7	$(0.3)	$ 27.3	$11.6
1950	158.1	14.5	12.8	95.6	3.2	0.8	(0.5)	31.8	17.0
1955	226.5	19.9	19.4	140.1	4.8	1.0	(0.5)	41.8	20.8
1960	291.4	29.9	27.3	182.2	8.6	1.2	(0.3)	42.4	20.5
1965	412.4	43.3	33.4	247.4	12.3	2.0	1.2	72.2	27.7
1970	593.3	66.3	54.1	378.5	22.3	3.5	10.8	57.8	27.0
1975	931.9	101.7	99.5	573.9	43.5	7.1	21.5	84.7	37.9
1980	1,625.2	155.5	179.3	1,027.3	84.7	14.5	45.7	118.3	58.6
1981	1,824.4	185.9	202.6	1,131.5	96.7	15.4	57.2	135.6	51.7
1982	1,874.7	176.9	235.0	1,183.0	104.9	14.0	68.2	92.7	33.8
1983	2,032.0	194.1	242.7	1,247.6	113.0	15.9	65.2	153.5	47.1
1984	2,260.4	215.8	253.9	1,374.7	128.8	195.5	69.6	198.1	59.8
1985	2,396.3	230.2	268.2	1,466.9	135.9	18.2	64.1	212.8	55.8
B. Percentage Distribution									
1948	100.0	230.2	7.7	62.4	1.7	0.5	(0.2)	19.2	8.2
1950	100.0	9.2	8.1	60.5	2.0	0.5	(0.3)	20.1	10.8
1955	100.0	8.8	8.6	61.9	2.1	0.4	(0.2)	18.5	9.2
1960	100.0	10.3	9.4	62.5	3.0	0.4	(0.1)	14.6	7.0
1965	100.0	10.7	8.1	60.0	3.0	0.5	0.3	17.5	6.7
1970	100.0	11.2	9.1	63.8	3.8	0.6	1.8	9.7	4.6
1975	100.0	10.9	10.7	61.6	4.7	0.8	2.3	9.1	4.1
1980	100.0	9.6	11.0	63.2	5.1	0.9	2.8	7.3	3.6
1981	100.0	10.2	11.1	62.0	5.3	0.8	3.1	7.4	2.8
1982	100.0	9.4	12.5	63.1	5.6	0.8	3.6	4.9	1.8
1983	100.0	9.6	11.9	61.4	5.6	0.8	3.2	7.6	2.3
1984	100.0	9.6	11.2	60.0	5.7	0.9	3.1	8.8	2.7
1985	100.0	9.6	11.2	61.2	5.7	0.8	2.7	8.9	2.3

[1]With capital consumption adjustments.
[2]Excludes earnings of Federal Reserve Banks.
[3]Excludes payments by Federal Reserve Banks to the U.S. Treasury.

Sources: *National Income and Product Accounts for the United States, 1929-1976* (Washington, D.C.: U.S. Department of Commerce, 1981) Tables 8.12, 8.13, and 3.2; *Survey of Current Business* (Washington, D.C.: U.S. Department of Commerce, July 1982, July 1984, July 1986.)