The Corporate Income-Tax Mystery: Who Pays?

By ALVIN RABUSHKA

The corporate income tax was enacted in 1909, four years before the individual income tax. It has come under repeated assault from economists on the ground of economic efficiency or equity, and from politicians charging that corporations don't pay their fair share in taxes. Indeed, no subject in public finance is more controversial, in the past year only more so.

For starters, President Reagan has occasionally suggested the corporate income tax could profitably be abolished. Under a howl of protests that its abolition would unfairly benefit the rich, White House spokesmen have always explained away the president's musings. Second, since the 1981 Economic Recovery Tax Act created a market for buying and selling tax benefits, a number of prominent corporations have paid no income taxes. Third, corporate tax payments have declined from an average tax of 44% of corporate profits before tax in 1951 to 28% in 1975 to a meager 13% in 1982. Critics of the 1981 tax cut call it a giveaway to big business. In fiscal 1982, corporate taxes were only 8% of all federal revenues. The national income accounts for 1983 show total corporate federal income taxes of $44 billion compared with $290 billion in personal income taxes.

Incidence Hotly Disputed

Economists of all persuasions agree that the current corporate tax is flawed.

It encourages debt finance over equity because interest charges are deductible and dividends are not. It inhibits the flow of saving to corporate equities relative to other forms of investment. It penalizes investment over consumption (intertemporal distortion) by the double taxation of corporate income, first at a 46% rate on profits and then at a taxpayer's top marginal rate of 50% on dividends, for a combined top tax rate of 73%. It discourages entrepreneurship by assessing a capital-gains tax of 20% (assuming all earnings are retained and show up in increases in the value of stock) on top of a profits tax of 46%, for a combined 57% tax rate. It distorts the allocation of resources among industries (intersectoral distortion) through a hodgepodge of variable depreciation rates and investment tax credits that favors machinery over plant and other structures, and discriminates in favor of industries that receive preferential tax treatment—such as energy, natural resources, banking and life insurance.

If the economic distortions of the corporation income tax are widely acknowledged, the incidence—who pays the tax—is hotly disputed. One view is that shareholders, or owners of capital in general, bear the tax. An opposite view is that the tax is shifted partly onto consumers in the form of higher prices. Others argue that workers bear a portion of the tax: The corporate tax depresses investment, which results in reduced labor productivity and lower wages. Before elaborating these divergent views, it is important to recognize that legal entities called corporations don't pay taxes in the sense of bearing the burden of taxation. Rather, people pay taxes. Although corporations actually remit checks to the Internal Revenue Service, these funds represent resources government takes from people, reducing their present or future consumption. So, who really pays the tax?

Economists profess widely different beliefs. Brookings Institution tax specialist Joseph Pechman has recently published a book titled "Who Paid the Taxes, 1966-85?" In it he states that "the supplies of labor and savings are taken to be fixed even in the long run." His view, confirmed in a recent conversation, is that "the corporation tax is paid by owners of capital in general." This view that the tax is borne largely by owners of capital is shared by such other leading economists as the University of Chicago's Arnold Harberger and Stanford's John Shoven.

Stanford's Michael Boskin rejects the thesis that supplies of labor and savings are completely inelastic; to the contrary, his research, along with that of Harvard's Larry Summers, suggests that saving is responsive to the rate of return on capital. If so, the corporate tax decreases capital formation, lowers future productivity and is partly shifted onto labor in the long-run. The Hoover Institution's Milton Friedman is less precise on its incidence: He told me that "unless you assume that the supply of capital is perfectly inelastic, then the corporation income tax is divided into unknown quantities between labor, consumers and capital."

Princeton's Joseph Stiglitz offers a different insight. Assume that firms can borrow at the margin to finance investment with no effect on capital, since interest is deductible at 46% and taxes are paid at 46%. Then, "the corporate tax acts as a tax on entrepreneurship. It favors old established firms with easy access to credit and discourages new riskier enterprises that can't finance by debt."

Another interpretation of incidence is that in a world-wide economy with free movement of capital, a corporate tax in one country would cause capital to flow out until rates of return were everywhere equalized, thus shifting the burden in that particular country onto other domestic factors. Disagreement on who pays the corporate tax is summarized in a 1985 textbook, Public Finance, written by Princeton's Harvey Rosen. He concludes that if the corporate income tax is viewed as a partial factor tax, not as a profits tax, then "the incidence and efficiency effects remain as much a puzzle as ever."

Despite Mr. Pechman's professional assessment that the corporate tax is borne by owners of capital, he honestly represents divergence of opinion in the form of five different incidence assumptions in his book: (1) shareholders, (2) capital, (3) half to shareholders/half to capital, (4) half to shareholders/one-fourth to consumers/one-fourth to labor, and (5) half to capital/half to consumers. Nor is this listing exhaustive. Precisely who pays the corporate tax remains a mystery!

Which view one holds on incidence can affect one's policy preferences for altering, reforming or abolishing the corporation income tax.

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Mr. Pechman favors retaining the corporate tax on the equity ground of progressivity (since he views the corporate tax as borne by disproportionately wealthy owners of capital) but would refine depreciation to eliminate distortions among different classes of assets. Some worry that eliminating the corporate tax without requiring that all income be assigned to taxpaying individuals would permit incorporated individuals to accumulate untaxed earnings. Mr. Boskin believes that the corporate tax inflicts its greatest damage by holding down investment, and therefore favors reform that promotes neutrality both across assets and over time. Rising investment, over time, would increase productivity and wages. On narrowly political grounds, Milton Friedman favors abolishing the corporate tax because it is largely invisible; making individuals pay this tax directly would, in his view, increase political pressure to hold down taxes and reduce public spending.

President Reagan has made tax reform a high priority of his second term. Growing interest in tax-rate reduction and simplification has resulted in the development of several reform proposals: the highly publicized Bradley-Gephardt and Kemp-Kasten modified flat-tax plans, named after their Democratic and Republican sponsors; the pure flat-rate consumption tax I developed with Robert Hall (introduced by Democratic Sen. Dennis DeConcini of Arizona and GOP Sen. Steve Symms of Idaho), and Donald Regan's Treasury Department plan of last December. James Baker, the new Treasury secretary, has promised a revised Treasury plan by mid-May. All of

these plans include changes in the tax treatment of corporations. The Treasury's plan came under sharp criticism from business because it proposed to finance a reduction in individual income taxes through higher corporate taxes.

Academic and congressional critics of these proposals have expressed concern that rich people would gain from marginal tax-rate reductions at the expense of middle- and lower-income households. They insist that tax reform preserve the current tax burden by income class. But this task is impossible, since no one really knows who pays the corporate tax. If we don't know who pays it now, how can we know who will pay after reform? Besides, since the corporate tax generates only 15% as much revenue as the personal income tax, it makes no sense to let the equity tail wag the efficiency dog, when little in the way of equity is really at stake.

Remember, economists agree more on questions of efficiency than equity. Putting aside the murky question of who pays, greater efficiency—reducing intersectoral and intertemporal distortions—would be achieved by several changes in the corporate tax.

What to Do

First, replace arbitrary depreciation schedules with true economic depreciation. One strongly favored mechanism is expensing of investment, which shifts the income tax in the direction of a consumption tax, thus maximizing investment incentives. Second, integrate the personal and corporation taxes to eliminate double taxation. Either let corporations deduct dividends from taxable income or give taxpayers a credit for taxes paid. Abolish the capital-gains tax to eliminate double taxation on risk taking. Third, cut the corporate tax rate as far as possible to increase after-tax earnings. Fourth, permit unlimited carryforward with interest.

How do the major proposals fare on these efficiency criteria? Both Bradley-Gephardt and the Regan Treasury plan lower tax rates but stretch out or reduce the value of depreciation, which would discourage investment if inflation returns; raise taxes on capital gains, which will depress capital formation; and fail to integrate the corporate and individual income taxes, thus continuing double taxation (though the Treasury plan grants partial relief). Kemp-Kasten fares better on these counts, but its failure to integrate imposes excessive taxes on entrepreneurship. The Hall-Rabushka 19% tax on consumption accomplishes all four efficiency objectives, along with true simplification, thus maximizing the prospects for economic growth.

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