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The Corporate Tax Burden

Nation's Dependence on Corporate Tax Collections Continues to Fall But Recent Collections Stronger than During Earlier Recessions

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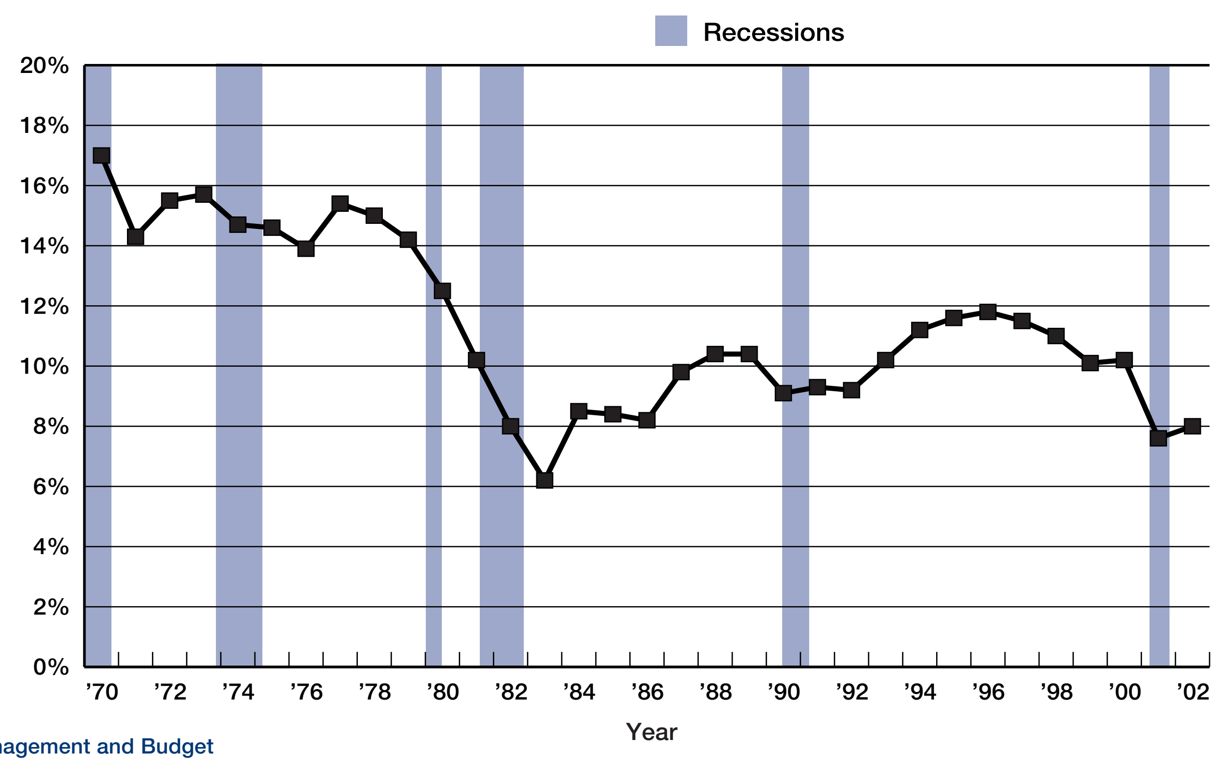
Introduction

In October, the Congressional Budget Office released the final revenue figures for fiscal year 2002.[1] That year, corporate tax collections totaled $140 billion, down from $151 billion in 2001. Though the dollar amount of collections fell, corporate income tax collections as a share of total federal revenue edged up slightly from 7.6 percent in fiscal 2001 to 8.0 percent in fiscal 2002. These are both lower than in any year since 1983. Some policymakers in Washington, including presidential aspirants, have pointed to these figures as proof corporations are not paying their fair share of federal taxes. There is, however, more to the story.

Figure 1
Federal Corporate Income Tax Receipts as a Percentage of Total Federal Receipts
Fiscal Years 1970–2002



Source: Office of Management and Budget

Federal dependence on the corporate income tax peaked during World War II and has declined steadily with occasional blips upward ever since. In 1943 the nation collected 39.8 percent of federal revenue from the corporate income tax, but this figure fell rapidly during the post-war years. During the 1970s, the average share was 15 percent, and during the 1980s it was 9.2 percent (see Figure 1 and Table 1). During the 1990s, corporate tax collections ticked upward to an average of 11.8 percent of federal revenue because of remarkably strong economic activity and President Clinton's 1993 tax package, which raised the top statutory corporate income tax rate from 34 percent to 35 percent. Corporate taxes have since resumed their long-term downward trend.

Rates and Collections

Corporate tax revenue as a portion of the whole is not the only statistic that matters. Federal corporate tax rates and bases have been on a roller coaster ride over the past thirty years as rates have gone up and down and the corporate tax base has expanded and contracted. Since 1950, the top corporate income tax rate has ranged from 30 percent and 50.8 percent (see Table 2).

It is important to note that economic conditions are the main determinants of corporate tax revenue. Because corporate profits are volatile, rising in booms and falling in recessions, so, too, are government receipts from the corporate income tax.

Figure 2 and Table 1 show that federal receipts dipped during the current recession as well as those of the early 1980s and early 1990s. However, the long-term trend of federal corporate tax receipts is upward, from $123 billion collected during 1970 to $136 billion collected during 2000 (both expressed in real dollars). Corporate tax collections for 2002 are still higher in real terms than the corporate tax collections at any time during the recession of the early 1980s or the early 1990s.

Table 1
Federal Corporate Income Tax Receipts
Fiscal Years 1970–2003
($Millions)

Year	Federal Corporate Income Tax Receipts (Current $)	Total Federal Receipts (Current $)	Receipts as a Percentage of Total Federal Receipts	Federal Corporate Income Tax Receipts (Constant Year 2000 $)
1970	$ 32,829	$ 192,807	17.0%	$ 121,136
1971	26,785	187,139	14.3	93,956
1972	32,166	207,309	15.5	107,627
1973	36,153	230,799	15.7	115,668
1974	38,620	263,224	14.7	115,370
1975	$ 40,621	$ 279,090	14.6%	$ 110,358
1976	41,409	298,060	13.9	104,935
1977	54,892	355,559	15.4	129,036
1978	59,952	399,561	15.0	131,967
1979	65,677	463,302	14.2	134,115
1980	$ 64,600	$ 517,112	12.5%	$ 121,469
1981	61,137	599,272	10.2	104,866
1982	49,207	617,766	8.0	79,003
1983	37,022	600,562	6.2	56,887
1984	56,893	666,486	8.5	84,265
1985	$ 61,331	$ 734,088	8.4%	$ 87,984
1986	63,143	769,215	8.2	88,474
1987	83,926	854,353	9.8	114,563
1988	94,508	909,303	10.4	124,980
1989	103,291	991,190	10.4	131,504
1990	$ 93,507	$ 1,031,969	9.1%	$ 114,691
1991	98,086	1,055,041	9.3	116,020
1992	100,270	1,091,279	9.2	115,924
1993	117,520	1,154,401	10.2	132,510
1994	140,385	1,258,627	11.2	154,733
1995	$ 157,004	$ 1,351,830	11.6%	$ 169,470
1996	171,824	1,453,062	11.8	181,962
1997	182,293	1,579,292	11.5	189,821
1998	188,677	1,721,798	11.0	193,989
1999	184,680	1,827,454	10.1	187,441
2000	$ 207,289	$ 2,025,218	10.2%	$ 207,289
2001	151,075	1,991,194	7.6	147,470
2002	148,044	1,853,173	8.0	142,686
2003e	143,186	1,836,218	7.8	136,269

Source: Office of Management and Budget, 2003.

Effective Tax Rates

Total collections tell only part of the story of the impact corporate taxes have on the economy. Effective marginal tax rates, which have a large impact on the level and consumption of corporate investment, have varied widely since 1970. Table 3 and Figure 3 show effective federal, state, and local corporate income tax rates for the years 1970 to 2000 based on data from the National Income and Product Accounts.

The total average effective corporate tax rate held steady in the 1970s and 1980s, averaging a little over 36 percent. It dropped slightly in the 1990s, hovering around 32 percent, and in 1997 it dipped below 30 percent for the first time. This happened again in 2001, but in 2002 the total effective rate ticked back up to 32.1 percent. In fact, both the federal and state effective tax rates for 2002 were higher than the effective tax rates for the years 1995 through 1997. The increase in the state rate could be due to increases in state tax amnesty programs or an increasing number of audits. The business and corporate tax increases enacted by 11 states in 2002 could fuel an even higher effective tax rate in 2003.[2] In sum, while total collections have dipped during the recession, the rate of tax payments as a percentage of profits has been steady and even rose during fiscal 2002.

Changes in Corporate Form Prompt Discussion of Tax Reform

Although the vast majority of business

activity in the United States occurs in C corporations, alternative legal constructs such as S corporations and sole proprietorships have become increasingly popular. Just from 2000 to 2001, the number of S corporations rose 4.7 percent to 3 million, and the number of sole proprietorships rose 2.4 percent to 38.3 million. None of these businesses pay any corporate income tax because the owners report business income on their individual income tax returns.

This is important for two reasons. First, income earned through an S corporation or sole proprietorship is taxed only once, whereas income earned through a C corporation is taxed twice: once through the corporate income tax, and again when investors pay individual income taxes on dividends. Second, as the percentage of business activity conducted through S corporations and sole proprietorships increases, an increasing amount of taxes will be collected through the personal income tax compared to the corporate income tax.

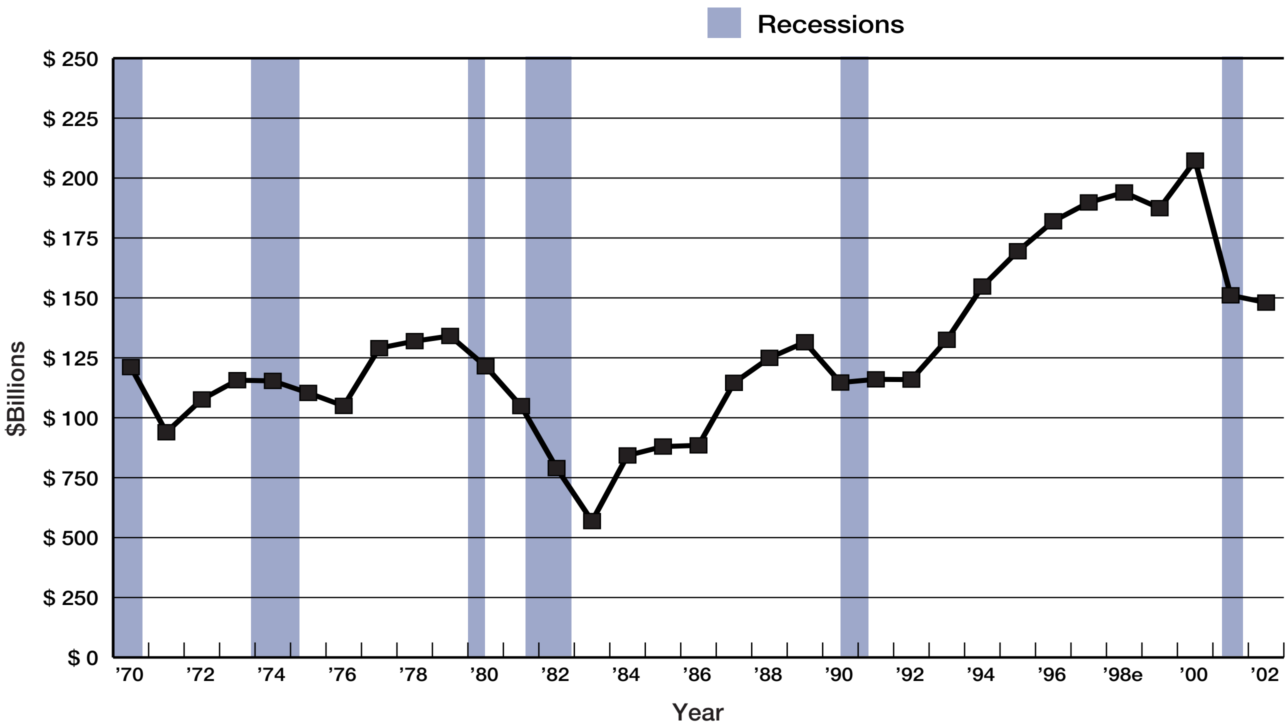
In fact, the corporate income tax is one of the most burdensome and economically inefficient taxes in the federal tax code. Fundamental reform of the corporate income tax deserves heightened attention. Simplifying, lowering, or eliminating this burdensome tax would provide immediate relief for all Americans, remove one very significant source of inefficiency from the capital markets, and promote economic growth.

Numerous proposals to reform or modify the corporate income tax have been discussed since the last major change in 1993 when the top corporate income tax rate was increased from 34 percent to 35 percent. Most significantly, talk of fundamental tax reform in 1996 led to several proposals to replace the corporate income tax with a value-added tax or other consumption-based tax. Other proposals, dating back to at least 1992, call for the integration of the corporate and personal income taxes to simplify overall tax compliance and eliminate the double taxation on savings.

Trends in Corporate Income Taxes Rates

Federal legislation during the last 20 years first cut then raised corporate taxes. The Tax Reform Act of 1986 represented a major reshuffling of tax liability. While the 1986 act lowered the marginal corporate tax rate from 46 percent to 34 percent, it significantly broadened the tax base. As a result, despite the

Figure 2
Federal Corporate Income Tax Receipts in Constant 2000 Dollars
Fiscal Years 1970–2002



Source: *Survey of Current Business,* Department of Commerce, and Tax Foundation calculations.

lower statutory rate, corporate income tax collections rose significantly from 1987 to 1989, then stabilized after 1989 as the economy slipped into recession.

Congress passed an increase in the corporate income tax in 1993, raising the top marginal rate from 34 to 35 percent (see Table 2). Coupled with a strong economy, this rate increase led to an inflation-adjusted increase of 77.6 percent in corporate income tax collections between 1992 and 2000.

Table 2
Federal Corporate Income Tax Rates
1950 – Present

1950	First $25,000	
	(Normal Rate)	23%
	Over $25,000	
	(Add Surtax of 19%)	42%
	Excess Profits Tax	30%
1951	First $25,000	
	(Normal Rate)	28.75%
	Over $25,000	
	(Add Surtax of 22%)	50.75%
	Excess Profits Tax	30%
1952	First $25,000	
	(Normal Rate)	30%
	Over $25,000	
	(Add Surtax of 22%)	52%
	Excess Profits Tax	30%
1953–1963	First $25,000	
	(Normal Rate)	30%
	Over $25,000	
	(Add Surtax of 22%)	52%
1964	First $25,000	
	(Normal Rate)	22%
	Over $25,000	
	(Add Surtax of 28%)	50%
1965–1967	First $25,000	
	(Normal Rate)	22%
	Over $25,000	
	(Add Surtax of 26%)	48%
1968–1969	First $25,000	
	(Normal Rate)	22%
	Over $25,000	
	(Add Surtax of 26%)	48%
	With 10% Surcharge	
	First $25,000	
	(Normal Rate)	24.20%
	Over $25,000	
	(Add Surtax of 26%)	52.80%
1970	First $25,000	
	(Normal Rate)	22%
	Over $25,000	
	(Add Surtax of 26%)	48%
	With 2.5% Surcharge[a]	
	First $25,000	
	(Normal Rate)	22.55%
	Over $25,000	
	(Add Surtax of 26%)	49.20%
1971–1974	First $25,000	
	(Normal Rate)	22%
	Over $25,000	
	(Add Surtax of 26%)	48%
1975–1978	First $25,000	
	(Graduated Normal Rate)	20%
	Next $25,0000	
	(Graduated Normal Rate)	22%
	Over $50,000	
	(Add Surtax of 26%)	48%
1979–1981[b]	First $25,000	17%
	$25,000 to $50,000	20%
	$50,000 to $75,000	30%
	$75,000 to $100,000	40%
	Over $100,000	46%
1982	First $25,000	16%
	$25,000 to $50,000	19%
	$50,000 to $75,000	30%
	$75,000 to $100,000	40%
	Over $100,000	46%
1983–1984	First $25,000	15%
	$25,000 to $50,000	18%
	$50,000 to $75,000	30%
	$75,000 to $100,000	40%
	Over $100,000	46%
1985–1986	First $25,000	15%
	$25,000 to $50,000	18%
	$50,000 to $75,000	30%
	$75,000 to $100,000	40%
	$100,000 to $1,000,000	46%
	$1,000,000 to $1,405,000[c]	51%
	Over $1,405,000	46%
1987[d]–1993	First $50,000	15%
	$50,000 to $75,000	25%
	$75,000 to $100,000	34%
	$100,000 to $335,000[e]	39%
	Over $335,000	34%
1994–Present	First $50,000	15%
	$50,000 to $75,000	25%
	$75,000 to $100,000	34%
	$100,000 to $335,000[e]	39%
	$335,000 to $10,000,000	34%
	$10,000,000 to $15,000,000	35%
	$15,000,000 to $18,333,333[f]	38%
	Over $18,333,333	35%

[a] The Tax Reform Act of 1969 extended the Surcharge at a five percent rate from January 1, 1970 through June 30, 1970. On an annualized basis, the Surcharge would be 2.5 percent.

[b] The Revenue Act of 1978 repealed the corporate normal tax and surtax and in their place imposed a graduated rate structure with five brackets.

[c] The Deficit Reduction Act of 1984 placed an additional 5 percent to the tax rate in order to phase out the benefit of the lower graduated rates for corporations with taxable income between $1,000,000 and $1,405,000. Corporations with taxable income above $1,405,000, in effect, pay a flat marginal rate of 46 percent.

[d] Rates shown effective for tax years beginning on or after July 1, 1987. Taxable income before July 1, 1987 was subject to a two tax rate schedules or a blended tax rate.

[e] An additional 5 percent tax, not exceeding $11,750, is imposed on taxable income between $100,000 and $335,000 in order to phase out the benefits of the lower graduated rates.

[f] An additional 3 percent tax, not exceeding $100,000, is imposed on taxable income between $15,000,000 and $18,333,333 in order to phase out the benefits of the lower graduated rates.

Source: *Facts and Figures on Government Finance,* 37th Edition, Tax Foundation.

Other Factors Affecting Corporate Tax Receipts

Several additional factors and trends have affected the impact of the corporate income tax on businesses and federal tax collections over the past thirty years. For example, corporate profits as a percentage of national income have fluctuated over the past thirty years, reaching a peak of over 13.2 percent in 1978 before falling to a low of 6.9 percent in 1986, only to rise to their current level of about 8 percent (see Table 4).

This has affected federal corporate taxes measured as a percentage of total federal receipts. Corporate tax receipts averaged 15.0 percent of total receipts annually during the 1970s. The average during the 1980s dropped to 9.3 percent annually, only to rise again during the 1990s to 10.5 percent of total receipts.

The Alternative Minimum Tax

The Corporate Alternative Minimum Tax (CAMT) as it exists today first appeared in 1987 after passage of the Tax Reform Act of 1986. Congress enacted the CAMT in response to claims that some companies were able to avoid the corporate income tax altogether using exclusions, deductions, and credits. The CAMT operates as a parallel, or alternative, tax structure to the corporate income tax. All corporations with annual revenues greater than $7.5 million are required to go through CAMT calculations each year to determine whether they owe taxes through the standard corporate income tax or the CAMT. The CAMT applied to 13,135 companies in 2000, the most recent year for which official data are available.[3] Collections from the CAMT were $3.9 billion, up 27 percent from 1999.

Since 1987, the federal government has collected roughly $60 billion through the CAMT. Yet, at what economic cost? As a previous Tax Foundation report noted, the CAMT "discourages investment," is "administratively burdensome," and ultimately "makes for poor fiscal policy."[4]

Disincentive to Invest

As does the conventional corporate income tax, the CAMT causes double taxation of capital. This places a heavy burden on savings and is a strong disincentive to invest in capital. Moreover, the CAMT is a particularly onerous tax on capital because it requires longer depreciation and amortization schedules than required under the regular corporate income tax. Also, the CAMT is not indexed to keep pace with inflation.[5] This means that firms investing in capital receive less favorable treatment under the CAMT than under the regular corporate income tax.

Another strong disincentive to invest inherent in the current CAMT structure is the disallowance of the Research and Development (R&D) tax credit applicable in the regular corporate income tax calculation. Firms facing the CAMT therefore have less incentive to invest in research and development efforts that have the potential to increase long-run productivity than do firms facing the regular corporate income tax.[6]

Table 3
Average Effective Tax Rate on Corporate Profits
Calendar Years 1970–2002

Year	Corporate Profits Before Tax ($Billions)	Federal Corporate Profits Tax Accruals ($Billions)	State/Local Corporate Profits Tax Accruals ($Billions)	Effective Rate of Federal Tax	Effective Rate of State/Local Tax	Effective Rate of Federal and State/Local Tax
1970	$ 80.6	$ 30.6	$ 3.7	38.0%	4.6%	42.6%
1971	92.4	33.5	4.3	36.3	4.7	40.9
1972	107.3	36.6	5.3	34.1	4.9	39.0
1973	134.2	43.3	6.0	32.3	4.5	36.7
1974	146.8	45.1	6.7	30.7	4.6	35.3
1975	$ 144.8	$ 43.6	$ 7.3	30.1%	5.0%	35.2%
1976	178.6	54.6	9.6	30.6	5.4	35.9
1977	209.0	61.6	11.4	29.5	5.5	34.9
1978	244.9	71.4	12.1	29.2	4.9	34.1
1979	270.1	74.4	13.6	27.5	5.0	32.6
1980	$ 251.4	$ 70.3	$ 14.5	28.0%	5.8%	33.7%
1981	240.9	65.7	15.4	27.3	6.4	33.7
1982	195.5	49.0	14.0	25.1	7.2	32.2
1983	231.4	61.3	15.9	26.5	6.9	33.4
1984	266.0	75.2	18.8	28.3	7.1	35.3
1985	$ 255.2	$ 76.3	$ 20.2	29.9%	7.9%	37.8%
1986	243.4	83.8	22.7	34.4	9.3	43.8
1987	314.6	103.2	23.9	32.8	7.6	40.4
1988	381.9	111.1	26.0	29.1	6.8	35.9
1989	376.7	117.2	24.2	31.1	6.4	37.5
1990	$ 401.5	$ 118.1	$ 22.5	29.4%	5.6%	35.0%
1991	416.1	109.9	23.6	26.4	5.7	32.1
1992	451.6	118.8	24.4	26.3	5.4	31.7
1993	510.4	138.5	26.9	27.1	5.3	32.4
1994	573.4	156.7	30.0	27.3	5.2	32.6
1995	$ 668.5	$ 179.3	$ 31.7	26.8%	4.7%	31.6%
1996	726.3	190.6	33.0	26.2	4.5	30.8
1997	792.4	203.0	34.2	25.6	4.3	29.9
1998	721.1	204.2	34.6	28.3	4.8	33.1
1999	762.1	213.0	34.8	27.9	4.6	32.5
2000	$ 782.3	$ 223.8	$ 35.6	28.6%	4.6%	33.2%
2001	670.2	170.2	29.1	25.4	4.3	29.7
2002	665.2	179.8	33.5	27.0	5.0	32.1

Source: Survey of Current Business, Department of Commerce; and Tax Foundation computations.

Countercyclical Effect

Because of the structure of the CAMT, the tax hits corporations particularly hard during economic downturns, when these businesses can least afford large tax burdens. This countercyclical effect comes about because the CAMT essentially disallows corporations to take certain deductions, credits, and exclusions against their taxable income in calculating their CAMT tax liability. Some of the primary deductions disallowed by the CAMT come about from economic events associated with downturns in the market.[7] Therefore, just as corporations are fighting through a tough economic time the CAMT hits them with a relatively large tax burden on the basis of minimal income and few deductions, credits, and exclusions.

For example, under the CAMT tax calculation, a firm may report net operating losses of no more than 90 percent of its tentative minimum tax. This prevents firms from smoothing out their tax liability over several years as is allowed under the regular corporate income tax. This limitation is complicated further by the CAMT's limitation on a corporation's use of foreign tax credits that are intended to eliminate a double tax on U.S. firms operating abroad. Limiting use of this credit prevents firms from adequately protecting themselves from regional downturns by diversifying into international markets.

Complexity and Compliance Costs

The Joint Economic Committee estimated in 1999 that CAMT compliance costs can run as high as 16.9 percent of a company's total personnel and nonpersonnel costs of filing federal income taxes.

The IRS's Office of the Inspector General found that over 2,100 small corporations, those with annual gross receipts of less than $7.5 million, paid the CAMT although a change in law in 1997 specifically exempted them from paying the tax.[8] These corporations paid over $25 million in CAMT despite being legally exempt.[9] Such costly mistakes highlight the complexity and the attendant economic burden created by the CAMT.

The Trend in Corporate Structures

One of the least noted trends affecting corporate tax collections has been the dramatic rise in alternative corporate structures such as subchapter-S corporations and sole proprietorships. These business structures are taxed under different rules than C corporations, often making them more attractive.

S Corporations

S corporations are similar to regular C corporations in that they provide owners with such benefits as limited liability and freely transferable ownership rights. However, unlike C corporations, all S corporation income is taxed through the personal income tax code, not the corporate income tax code. Thus, the double taxation of earnings is eliminated; all earnings are taxed once at the individual owner's level. S corporations agree to certain limitations in exchange for this benefit, including limiting their number of shareholders to 75 or fewer and limiting ownership to U.S. citizens and resident aliens.

The benefits of this legal organizational structure have led to a steady increase in the number of businesses filing as S corporations. Between 1986 and 2001, the number of S corporations have more than quadrupled, while the number of all other corporations have grown by 6% in the same period. In 1999, for the first time, the number of corporations filing as S corporations outnumbered all other corporate structures (see Figure 4.)

The existence of a dual corporate structure creates inequalities between companies in similar economic situations but of different legal structures. This inequality creates inefficiency and has an impact on corporate income tax collections.

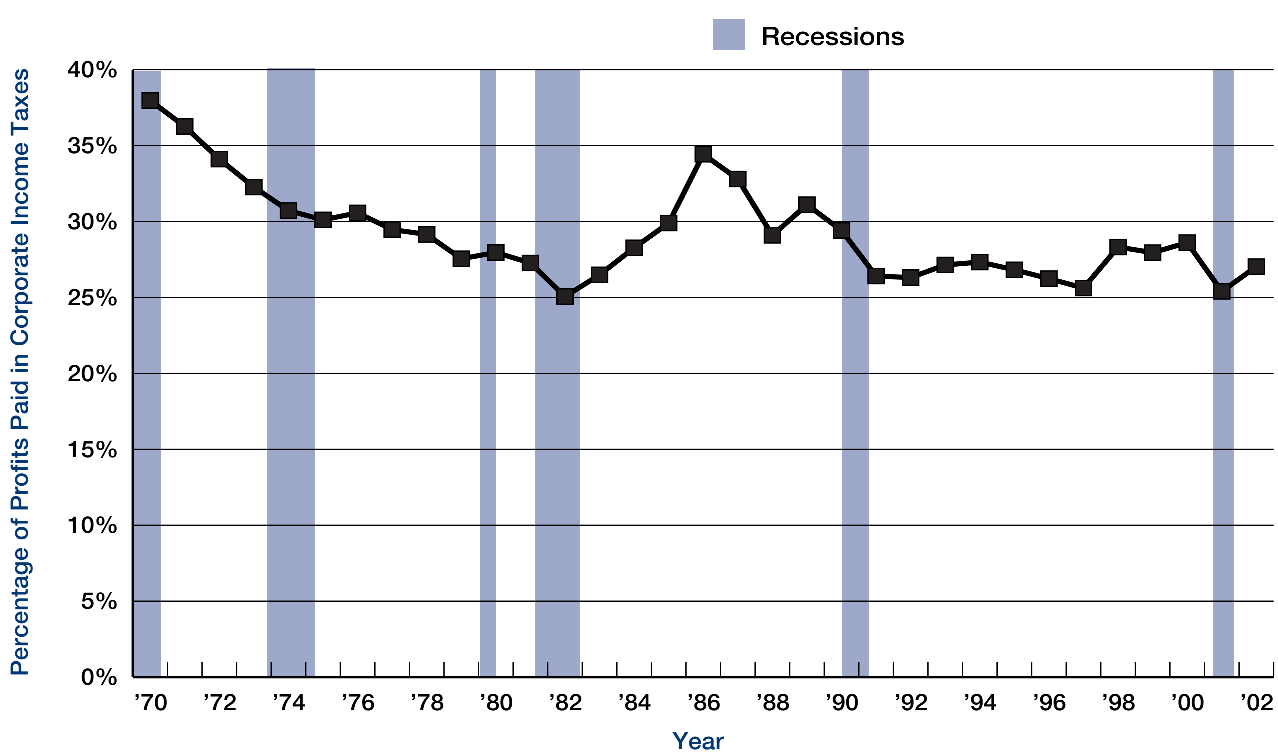
Sole Proprietorships

An increase in the number of sole proprietorships has exhibited a growth pattern similar to that of S corporations. In 1985, there were 11.9 million non-farm sole proprietorships. By 1990, this number had grown to 14.8 million - an increase of 23.5 percent - and by 2001 the number had grown to 18.3 million. The attractiveness of incorporating a business subject to the personal income tax code instead of the corporate tax code will likely grow as the recent personal income tax cuts promoted by the Bush Administration are phased-in.

International Competitiveness

At a time when being economically competitive internationally is of paramount importance, the corporate income tax rates in the U.S. have not fallen nearly as fast as most of the

Figure 3
Average Effective Tax Rate on Corporate Profits
Calendar Years 1970–2002



Source: *Survey of Current Business,* Department of Commerce, and Tax Foundation calculations.

other countries in Europe. As seen in Table 4, the period of international corporate tax cutting, which started with the 1986 tax reforms in the U.S., has been substantial.

However, in terms of effective marginal tax rates, the U.S. lost ground by raising the top corporate tax rate in 1993 and keeping it there, while the industrialized world continues to cut corporate income tax rates. (See Table 5). As Eric Engen and Kevin Hassett note, "The median EU rate was 30 percent in 1985 and dropped to 20 percent by 2001; the average effective marginal corporate tax rate in the EU declined a similar magnitude. Moreover, the effective marginal corporate tax rate in the EU in 2001 was 4 percentage points below the effective marginal corporate tax rate in the United States."[10]

Who Collects the Corporate Income Tax?

The federal government, through the Internal Revenue Service, collects the corporate income tax from businesses of all sizes and in all industries. In 2000, the latest year for which official data are available, there were a total of over 5 million corporate income tax returns filed. Of these, 2.8 million recorded net income. Total corporate income tax collected, after credits, amounted to $207 billion, or 10.2 percent of total federal revenues collected.[11]

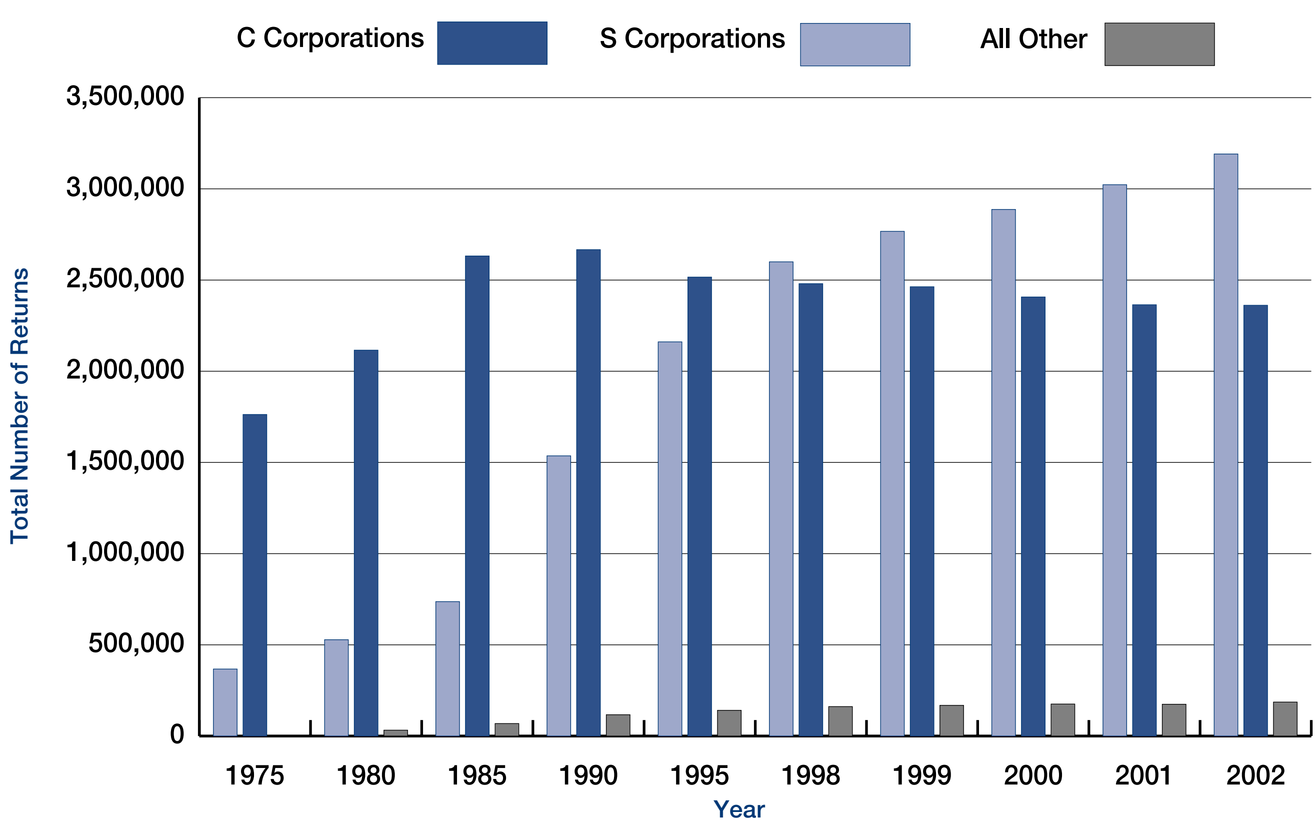
What is striking is that the bulk of corporate income taxes are collected from a few relatively large corporations. In 2000, companies with over $250 million in assets made up 0.2 percent of all corporate tax filings, yet paid over 82 percent of the total corporate income taxes collected (see Figure 5).

Who Bears the Burden of Corporate Income Taxes?

Corporations collect and subsequently pay the corporate income tax. However, the question remains, "Who ultimately bears the burden of this tax?"

Every dollar a corporation spends, whether on taxes or anything else, eventually comes out of the pockets of individuals, spe-

Figure 4
The Proliferation of S Corporation Tax Returns at the Expense of C Corporation Returns
Selected Calendar Years 1975–2002



Source: Statistics of Income, Internal Revenue Service.

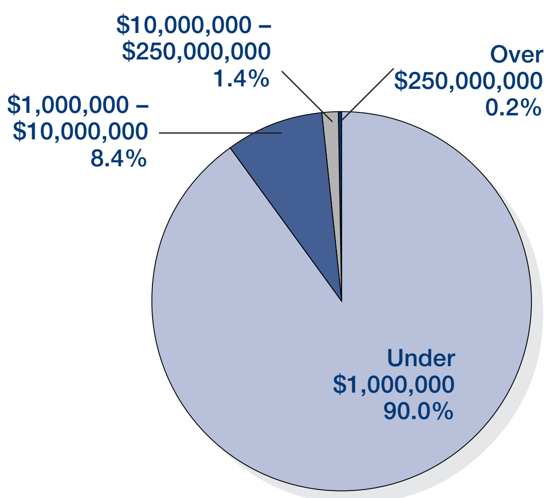
cifically three groups of individuals: the corporation's workers, its customers, and its owners (shareholders). It is usually a combination of these groups that ultimately bears the brunt of corporate income taxes.

To make matters more complex, the distribution of the tax burden varies from industry to industry, and even within each industry it changes with the flow of the economy at any point in time. Recent research even indicates that the burden of the corporate income tax may be exported to foreign consumers and investors, raising prices abroad for our exported goods.[12]

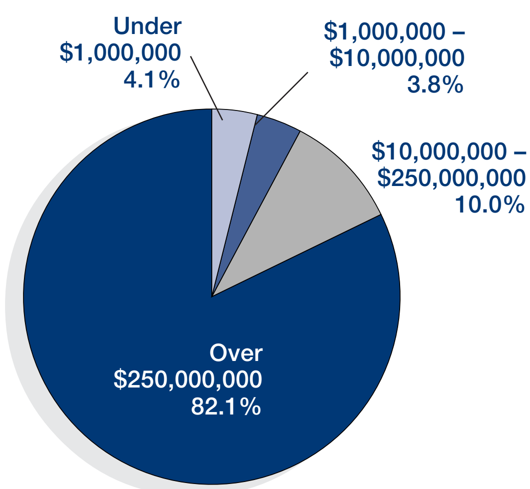
The debate over which group of individuals - workers, shareholders, or consumers - ends up paying the bulk of corporate taxes will go on forever, but the undisputed and most important point is that individuals pay taxes, not corporations.

Figure 5
Corporate Income Tax Returns and Collections by Asset Size
Calendar Year 2000

Corporate Tax Returns by Asset Size



Tax Collections by Asset Size



Source: *Statistics of Income,* Internal Revenue Service.

The True Cost of the Corporate Income Tax

In addition to the direct costs imposed by the corporate income tax, workers, owners, and customers also bear the indirect costs of complying with the code. A recent Tax Foundation study reported that compliance with the corporate income tax accounts for 34 percent of total compliance costs each year.[13] American corporations spend roughly 2.8 billion hours filling out IRS forms and schedules annually. Assuming an average hourly wage of $37.26, total corporate income tax compliance costs run over $100 billion annually.

There are other compliance costs that are not included in this figure but nevertheless add significantly to the overall burden imposed by the federal corporate income tax. Corporate executives spend tremendous amounts of money and effort planning their business activities to minimize taxes or take advantage of special tax provisions or changes in the law. Firms typically hire outside tax attorneys and consultants to help in this process. Most large and even medium size firms spend some time and money lobbying Congress and state lawmakers for more favorable tax treatment. Large firms have entire teams of IRS agents on site at all times, yet many corporations still find themselves in the unenviable position of having to hire defense attorneys to represent the company in tax court.

All of these additional expenditures are what economists refer to as "deadweight" costs because they are not economically productive investments. Contrary to conventional wisdom, these costs are not all unavoidable costs of doing business in a complex world. Many could be mitigated or eliminated, allowing the resources now being devoted to the tax code to be directed toward increasing productivity, which would benefit consumers, workers and shareholders through lower prices, higher wages, and/or greater profits.

The total economic cost of the corporate income tax is difficult to measure. Recent estimates suggest that the excess burden of the corporate income tax amounted to around 50 percent. In other words, a corporate income tax that results in collections of $200 billion means at least $100 billion of economic gain is never realized due to the misallocation of resources.[14] It is important to remember, therefore, that official estimates of corporate income tax collections measure only a small part of the total economic cost imposed by the tax.

Table 4
Statutory Corporate Tax Rates in Selected European Union Countries and the United States
Selected Years, 1985–2001

Country	1985	1990	1995	2001	Percentage Point Change from 1985 to 2001
Austria	61%	39%	34%	34%	– 27
Belgium	45	41	40	40	– 5
Finland	43	25	25	29	– 14
France	50	37	37	36	– 25
Germany	63	58	57	38	– 25
Greece	44%	40%	40%	38%	– 6
Italy	46	46	53	40	– 6
Ireland	50	43	38	20	– 30
Netherlands	43	35	35	35	– 8
Portugal	55	40	40	35	– 20
Spain	35%	35%	35%	35%	0
Sweden	60	45	28	28	– 32
United Kingdom	40	34	33	30	– 10
EU Median*	46	40	37	36	– 11
United States	50	38	39	39	– 11

* Median of listed countries. Data for Denmark and Luxembourg are unavailable.

Source: Michael Devereux, Rachel Griffith, and Alexander Kemm, "Can International Tax Competition Explain Corporate Income Tax Reforms?," as cited in Eric Engen and Kevin A. Hassett, "Does the U.S. Corporate Tax Have a Future?" *Tax Notes,* 30th Anniversary Issue, p. 24.

Table 5
Effective Corporate Tax Rates in Selected European Union Countries and the United States
Selected Years, 1985–2001

Country	1985	1990	1995	2001	Percentage Point Change from 1985 to 2001
Austria	25%	32%	28%	17%	– 8
Belgium	30	26	26	26	– 4
Finland	43	25	14	20	– 23
France	26	20	19	21	– 5
Germany	43	38	37	28	– 15
Greece	33%	30%	30%	28%	– 5
Italy	23	31	38	9	– 14
Ireland	0	6	7	7	7
Netherlands	31	24	24	24	– 7
Portugal	48	24	24	20	– 28
Spain	22%	25%	26%	29%	+ 7
Sweden	43	29	16	16	– 27
United Kingdom	17	23	23	20	+ 3
EU Median*	30	25	24	20	– 10
United States	22	23	23	24	+ 2

* Median of listed countries. Data for Denmark and Luxembourg are unavailable.

Source: Michael Devereux, Rachel Griffith, and Alexander Kemm, "Can International Tax Competition Explain Corporate Income Tax Reforms?," as cited in Eric Engen and Kevin A. Hassett, "Does the U.S. Corporate Tax Have a Future?" *Tax Notes,* 30th Anniversary Issue, p. 24.

Recent Proposals to Reform the Corporate Income Tax

The economic inefficiencies and high cost of the corporate income tax have not gone unrecognized by policy makers. Several proposals have been made over the past decade that would address the double taxation of corporate income, simplify the process of compliance, or eliminate the tax completely. Some of these proposals have received more legislative attention than others, but they are all important to discuss since each addresses a different aspect of the existing system.

Integration Proposal

A 1992 Department of the Treasury Report, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once,* has received renewed attention recently as one possible way to reform the existing corporate income tax. One of the report's principal co-authors, Professor R. Glenn Hubbard, was recently the Chairman of President Bush's Council of Economic Advisers.

The general idea behind this proposal is to integrate the corporate income tax into the individual income tax structure. This would eliminate the double taxation that currently exists on most earnings from investment in corporate equity. As the 1992 Treasury report states, "Under [the current] system of corporate income taxation, two levels of income tax are generally imposed on earnings from investments in corporate equity. First, corporate earnings are taxed at the corporate level. Second, if the corporation distributes earnings to shareholders, the earnings are taxed again at the shareholder level."[15] Even if the earnings are retained by the firm as reserves for development of the company, to increase wages or decrease prices a second tax incidence occurs through the capital gains tax or the regular individual income tax.

The 1992 Treasury report highlights three "prototypes" of integration of the corporate and individual income tax systems.

Dividend Exclusion Prototype

Under the dividend exclusion prototype, dividends paid to corporate shareholders would be taxed only once, at the corporate level. Thus, individual shareholders would exclude their dividend income from their taxable income base. Capital gains attributable to retained earnings also would be excluded from taxation at the individual level.

Shareholder Allocation Prototype

The shareholder allocation prototype directly attributes a company's retained earnings to its shareholders who receive a credit for corporate taxes paid on their portion of retained earnings. Dividends are excluded from the individual's income tax base, just as under the dividend exclusion prototype. Thus, the shareholder allocation prototype treats retained earnings and dividends the same. The shareholder allocation prototype suffers from extremely high administrative costs as each corporation must allocate its income, earnings, and expenses to each shareholder. The 1992 Treasury report estimates that these costs outweigh the benefits associated with the proposal.

Comprehensive Business Income Tax (CBIT) Prototype

The CBIT prototype is a long-term plan to equalize the treatment of corporate debt and equity. In general, the CBIT prototype calls for a uniform tax, levied at the business level, and exemption from taxation of interest and equity income at the individual level. Corporations and non-corporate businesses would be taxed at the same, uniform rate. "In theory, CBIT would apply to all businesses, without regard to size or legal form of organization."[16] As with the other prototypes included in the 1992 Treasury report, the CBIT would effectively eliminate the double taxation of investment income.

Fundamental Tax Reform Proposals

Initial talk of integration plans in the early 1990s was one factor that led to discussion of more comprehensive, or fundamental, tax reform proposals during the mid 1990s. The candidacy of Steve Forbes for president in 1996 put fundamental tax reform on the front burner of public policy debate. Most proposals of this period included two primary goals: overall simplification of the U.S. tax code and the elimination of at least one if not both taxes on investment. As such, integration of the corporate and individual income tax was an inherent part of most fundamental tax reform proposals.

While most of the fundamental tax reform proposals put forth during the mid 1990s are not under active consideration by the Congress, the principles that underlie these plans continue to drive discussion of tax cuts and tax code complexity. Therefore, understanding the impact these proposals would have on businesses and investment income is helpful in analyzing potential changes to the corporate income tax that are under active consideration.

Flat Tax Proposal

The flat tax, as outlined by economists Robert E. Hall and Alvin Rabushka, would replace the current federal tax code with a single 19 percent tax on all forms of income.[17] Individuals would be taxed on their wages or salary and any amounts received from employer-provided pension plans. All businesses, without regard to their legal structure, would pay the flat 19 percent tax on revenue net the purchases of goods, services, materials, capital equipment, structures and land and the amount paid to employees in the form of wages, salaries, and pensions.

The flat tax would replace all depreciation and amortization schedules with immediate expensing. All investment income would be taxed only once and levied at the corporate level. Thus, similar to the three prototypes presented in the 1992 Treasury report, interest income, capital gains, and dividends derived from equity investments would be taxed only once, at the corporate level.

Value Added Tax (VAT) Proposal

The VAT Proposal calls for a tax to be levied on the increase in value of goods and services as they pass from one stage of production to another. In theory, the VAT would replace the existing corporate and individual income tax regimes but this would not be automatic, as would be the case with the flat tax or the integration of the individual and corporate income taxes. In fact, the experience of most European countries is that the VAT is added onto existing income tax regimes thus creating an overall more burdensome and economically depressing environment.

Companies, without regard to their legal structure, would be responsible for paying the VAT depending upon the value they add to goods and services. However, consumers would probably end up bearing the cost of the VAT in the form of higher retail sales prices. Some policy makers maintain that the VAT would increase the competitiveness of American companies because border tax adjustments could be used to level the playing field between imports and exports.

National Sales Tax Proposal

The National Sales Tax is similar to the VAT in that it is levied only on consumption goods and, in theory, could replace the existing system of corporate and individual income taxes. Unlike the VAT, however, the entire tax is collected at the point of retail sale. The National Sales Tax would reduce compliance costs because collection could be "piggybacked" on the current system used to collect state-level sales taxes. The National Sales Tax, like all the other fundamental tax proposals described in this section would eliminate the double taxation of investment income.

S Corporation Expansion

While the stated goal of many policy makers remains fundamental tax reform or the integration of corporate and individual income taxes, some policymakers have begun a parallel effort to expand the legal definition of the S corporation as a step toward this goal. Proposals such as those put forward a few years ago by Representatives Clay Shaw (R-FL), Robert Matsui (D-CA), Rob Portman (R-OH), and Scott McInnis (R-CO) would change the definition of the S corporation in several ways.

Broaden the Shareholder Base

Ownership of S corporations is limited to a maximum of seventy-five shareholders. The reform proposals could increase this number to at least 150 shareholders. This would allow S corporations to raise additional capital or explore alternate financial arrangements.

Issue Preferred Stock

Currently, S corporations are able to issue only one class of equity to shareholders. This limitation prevents some companies from raising the necessary funds to expand operations, hire more employees, or make additional investments in productivity-enhancing capital. The ability to issue preferred stock also would give S corporations the option to diversify their financial structure.

Increase the Diversity of Shareholders

S corporation ownership is limited under current law to individuals resident in the United States. Many of the reform proposals would expand possible S corporation ownership to include non-resident aliens, special investment funds such as bank-managed IRA's, and family trusts. This diversification would allow S corporations to broaden their financial base and thereby raise additional capital and hedge against economic downturns.

All of these reform proposals would more closely align the permitted activities of S corporations with regular C corporations without sacrificing the S corporation's primary advantage, single tax treatment. S corporations, even with these additional legal freedoms, would still be able to pass profits through to owners tax free. Income is taxed only once, at the individual level when owners file their individual income tax forms. Because the S corporation structure eliminates the double taxation on earnings, many policy makers view this as a step toward fundamental tax reform or integration. More and more companies would organize under the S corporation definition as it is expanded. An increasing percentage of income produced in the economy would be taxed only once and the inherent benefits of a single tax system would begin to materialize.

However, it should be recognized that there are limitations to S corporation expansion. First, single taxation is economically more efficient than double taxation and typically results in greater after-tax income for the owners and workers, and better value for consumers. In this respect, S corporations enjoy a substantial competitive advantage over C corporations. The existence of a dual corporate structure creates inequalities between companies in similar economic situations, and this inequality creates inefficiencies in the marketplace.

Second, no matter how greatly the definition of S corporation is expanded, it will be difficult for many large corporations to reorganize themselves to take advantage of the S corporation tax benefits. Corporations like GE, Microsoft, IBM, and many others have hundreds of thousands of shareholders and various levels of stock. These large organizations will always be at a tax disadvantage compared to their S corporation competitors. Therefore, policy makers intent on fundamental reform or true integration need to reform the existing C corporation structure in parallel with expanding the S corporation definition.

Conclusions

The specifics of the corporate income tax have changed significantly over the past thirty years. Statutory and effective rates have increased and decreased. The tax base has narrowed and expanded. Collections have risen and fallen. And tangential statutes such as the creation of the S corporation structure and the imposition of an alternative minimum tax have complicated overall compliance and created additional economic inefficiencies.

What has not changed is that the corporate income tax remains one of the most economically inefficient and burdensome taxes on the books. Moreover, individual workers, consumers, and owners bear the economic cost of the corporate income tax, not corporations, which are merely legal entities. So, while corporations are responsible for physically complying with and paying the corporate income tax, individuals ultimately pay the price.

Several members of the current Administration and Congress have recently raised the prospect of significantly reforming the corporate income tax. Such attention deserves credit given the current economic downturn. Fundamental reform of the corporate income tax would remove a major source of inefficiency from the federal tax code and support increased economic growth. Reform may take one of various forms, as part of more fundamental tax reform, integration of the corporate and individual income tax, or expansion of existing tax-free structures such as the S corporation. In any case, the key is that the double taxation imposed by the corporate income tax and the accompanying compliance burdens are eliminated.

The corporate income tax is one of the most burdensome and economically inefficient taxes in the federal tax code. Fundamental reform of the corporate income tax deserves heightened attention.

Notes

[1] Congressional Budget Office, *Monthly Budget Review,* October 9, 2003.

[2] National Conference of State Legislators, *State Tax Actions 2002,* March 5, 2003.

[3] Lucy Altounian and George Contos, "Corporation Income Tax Returns, 2000," *Statistics of Income Bulletin,* Volume 23, Number 1 (Washington, DC: Internal Revenue Service, Summer 2003), and related tables.

[4] Terrence R. Chorvat and Michael S. Knoll, "The Economic and Policy Implications of Repealing the Corporate Alternative Minimum Tax," *Tax Foundation Background Paper,* Number 40 (Washington, DC: Tax Foundation, 2002).

[5] Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Washington, DC: Brookings Institution Press, 1997).

[6] In general, it is desirable to eliminate as many credits and deductions as possible and concurrently lower rates. What is troubling in the current tax code is that the R&D credit exists under one corporate tax regime (the regular corporate income tax) and not the other (the CAMT). This creates horizontal inequity between firms in otherwise similar economic positions.

[7] Gary and Aldona Robbins," Complicating the Federal Tax Code: A Look At the Alternative Minimum Tax (AMT)," *Policy Report,* Number 145 (Lewisville, TX: Institute for Policy Innovation, 1998).

[8] A small corporation is defined as a corporation that meets the "gross receipts criteria as established in Section 448(c) of the Internal Revenue Code. Specifically, an eligible small corporation "meets the ... gross receipts test of this subsection for any prior taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with such prior taxable year does not exceed $5,000,000." For purposes of the CAMT calculation, the maximum allowable gross receipts is now set at $7,500,000.

[9] Office of the Department of Treasury's Deputy Inspector General for Audit, "Letter Report: More Small Corporate Taxpayers Can Benefit from the Alternative Minimum Tax Exemption Provision," November 2000, Reference Number: 2001-30-019.

[10] Eric Engen and Kevin A. Hassett, "Does the U.S. Corporate Tax Have a Future?" *Tax Notes,* 30th Anniversary Issue, pp. 23-24.

[11] Lucy Altounian and George Contos, "Corporation Income Tax Returns, 2000," *Statistics of Income Bulletin,* Volume 23, Number 1 (Washington, DC: Internal Revenue Service, Summer 2003), and related tables.

[12] Jane G. Gravelle and Kent Smetters, "Who Bears the Burden of the Corporate Tax in The Open Economy?" *NBER Working Paper,* No. 8280, (Cambridge: National Bureau of Economic Research, May 2001).

[13] J. Scott Moody, "The Cost of Complying with the U.S. Federal Income Tax," *Tax Foundation Special Report,* Number 114 (Washington, DC: Tax Foundation, July 2002).

[14] Michael L. Marlow, "A Primer on the Corporate Income Tax: Incidence, Efficiency and Equity Issues," *Tax Foundation Background Paper,* No. 38, November 2001, pp. 9-10. Also see Jane G. Gravelle, *The Economic Effects of Taxing Capital Income* (Cambridge: MIT Press, 1994), p. 81 and Austan Goolsbee, "Taxes, Organizational Form, and the Deadweight Loss of the Corporate Income Tax," *Journal of Public Economics,* Vol. 69, July 1998, pp. 143-152.

[15] Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington, D.C.: January 1992, p. 1).

[16] Ibid., p 41.

[17] Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Stanford, CA: Hoover Institution Press, second edition, 1995).

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