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Introduction

Paul H. O'Neill, Secretary of the Treasury, recently provided the following commentary on the confusing and complex nature of how the federal government collects taxes from corporations:

> "For a long time we've maintained what I think is clearly a fiction – the idea that somehow corporations and businesses pay taxes. The clear economic truth is that businesses and corporations don't pay taxes, they just collect them for the government …"[1]

Unfortunately, most Americans have serious misperceptions about the actual burden of the corporate income tax, which produces over $200 billion annually in federal collections, or roughly $727 for each American. But economists have long understood that corporations simply collect taxes for the government, while people ultimately bear the cost. Most economists agree on the following facts about the corporate tax:

• *All Americans bear the burden of the corporate income tax.* Our analysis of the economic incidence of the corporate income tax demonstrates that individuals—workers, consumers, and investors—bear the cost of the tax. Corporations are legal structures that provide the nexus for individuals acting in different capacities to accomplish their goals. These people actually shoulder the burden of paying the corporate income tax.

• *The corporate income tax lowers standards of living.* Economists have estimated that for every dollar collected by the federal government through the corporate income tax, an additional one and a half dollar's worth of economic resources are consumed. This means a lower standard of living for all Americans. One study estimates that elimination of the corporate income tax would increase the average American's lifetime standard of living by the equivalent of $10,000. [2]

• *The corporate income tax is a double-tax.* The federal government first collects taxes on corporate profits and then taxes shareholders through the personal income tax code on either their dividend income or their capital gain. Accounting for this double tax, shareholders face a total tax on their income of anywhere from 45 percent to 60.7 percent.

• *The sharp rise in the number of S corporations reflects business owners fleeing the corporate income tax.* The total number of S corporations, which are exempt from the corporate income tax, has grown to over 2.7 million. The average annual growth in the number of S corporations since 1986 is 10.3 percent, versus a 1.1 percent decline in the number of C corporations over the same period.

• *The corporate income tax becomes less progressive as more Americans invest in pensions, real estate, mutual funds and direct stock holdings.* More than 50 percent of American households now own equities either outright or through personal retirement plans. Gains in capital ownership by lower-income individuals will be increasingly punished by double-taxation as their holdings grow.

The clear economic truth is that businesses and corporations don't pay taxes, they just collect them for the government.

—Paul O'Neill, Secretary of the Treasury

• *As a share of all federal tax payments, corporate income tax receipts have increased by 64.5 percent from 1983 to 2001.* Coupled with the rapid rise in stock market participation by American families, the sharp rise in corporate income tax collections highlights the importance of having a firm understanding of the issues surrounding this important levy.

The Variety of Corporate Structures

There are generally three types of business enterprises: sole proprietorships, partnerships and corporations. Athough sole proprietorships, partnerships and some types of corporations do not pay corporate income taxes, they are nevertheless affected by the corporate income tax.

Sole Proprietorships

Sole proprietorships are businesses owned by a single individual and are typically small enterprises such as single-site retail stores, independent consulting firms, and home-based businesses. Sole proprietors pay taxes on their income through the personal income tax structure and are legally liable for business-related obligations. Sole proprietorships constitute 72.6 percent of all businesses in the U.S., and account for just 4.8 percent of annual business receipts. [3]

Partnerships

Partnerships are businesses with more than one owner that are not incorporated. Partnerships can be of various sizes, ranging from a two-person law firm to a large, multi-partner consultancy such as Andersen. Partners pay taxes on their income through the personal income tax structure and are legally liable for business-related obligations of the entire partnership. Partnerships represent seven percent of the total number of businesses in the United States and seven percent of total business receipts.

Corporations

Corporations are businesses that are owned by numerous shareholders who invest in the business by purchasing shares of ownership in the company. Corporations vary widely in size, but it is fair to say that most large businesses are corporations of one form or another. Corporate owners are not generally liable for business-related obligations. Corporations account for just 19.9 percent of all U.S. businesses, but generate 88.0 percent of total sales. In 1998, the most recent year for which firm data are available, 5,241,200 corporations of all types filed tax returns on sales of $17.3 trillion and sent tax payments of $188.7 billion to the U.S.Treasury.[4]

One advantage to the corporate structure is that ownership is relatively easy to transfer through the purchases and sales of stock on the stock markets. Stockholders may easily buy or sell shares in any public corporation, thus quickly either taking or leaving ownership. Corporations also have unlimited life spans because they exist beyond the life of any one stockholder.

Corporations come in several varieties. The most common is the general corporation, which may have an unlimited number of stockholders. By constrast, the close corporation is often restricted to 30–50 owners, and shares of stock are first offered to current stockholders before offering them to the public at large. Close corporations are often businesses operated by small groups of individuals, while general corporations are most commonly the largest corporations in terms of sales and numbers of investors.

General corporations and close corporations are referred to as traditional C corporations and are subject to the federal corporate income tax. The income of C corporations is subject to double taxation, first at the corporate level and then again at the individual level when distributed as dividends or realized as capital gains.

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S Corporations

Another variation of corporate structure is the S corporation. The major benefit of the S corporation structure is that the corporation passes income and expenses immediately to shareholders. Income is taxed only once, at the individual shareholder level through the individual income tax.

The average annual growth in the number of S corporations since 1986 is 10.3 percent, versus a 1.1 percent decline in the number of C corporations.

Exemption from the corporate income tax explains the rise in the number of S corporations over the past 15 years. The total number of S corporations has grown to roughly 3 million based on IRS estimates. The average annual growth in the number of S corporations since 1986 is 10.3 percent, versus a 1.1 percent decline in the number of C corporations over the same period.[5]

While S corporations receive favorable tax treatment by being exempt from the corporate income tax, there are restrictions inherent in this form of corporate charter. S corporations are restricted to no more than 75 shareholders, all of whom must be individuals with U.S. citizenry or residency; a husband and wife are counted as a single shareholder. Additionally, S corporations must be domestic businesses.

Who Ultimately Pays The Corporate Income Tax

The corporate income tax was first instituted in 1909 when income above $5,000 was subjected to a one percent tax rate. Since then, the structure of the corporate income tax has changed approximately 35 times, reaching a peacetime statutory rate peak of 52 percent on income over $25,000 during the 1950s.[6] Currently, the top statutory rate is 39 percent, although this rate applies only to income between $100,000 and $335,000. Table 1 displays the current corporate income tax schedule.

Federal collections from the corporate income tax have fluctuated along with changes in the statutory rates and changes in deductions and other rules. Figure 1 displays the growth of corporate income tax collections since 1934. Total collections in 1934 amounted to $364 million, $3.9 billion after adjusting for inflation. By contrast, collections from the corporate income tax were estimated to be $207.3 billion in 2000.

The rate of increase in collections has been sharply higher in recent years, even after adjusting for inflation.

Table 1: Statutory Corporate Income Tax Rates

Taxable Income	Rate
$ 0 – $ 50,000	15 %
$50,001 – $75,000	25 %
$75,001 – $100,000	34 %
$100,001 – $335,000	39 %
$335,001 – $10,000,000	34 %
$10,000,001 – $15,000,000	35%
$15,000,001 – $18,333,333	38%
$18,333,333 and above	35%

As Figure 1 makes clear, the rate of increase in collections has been sharply higher in recent years, even after adjusting for inflation.

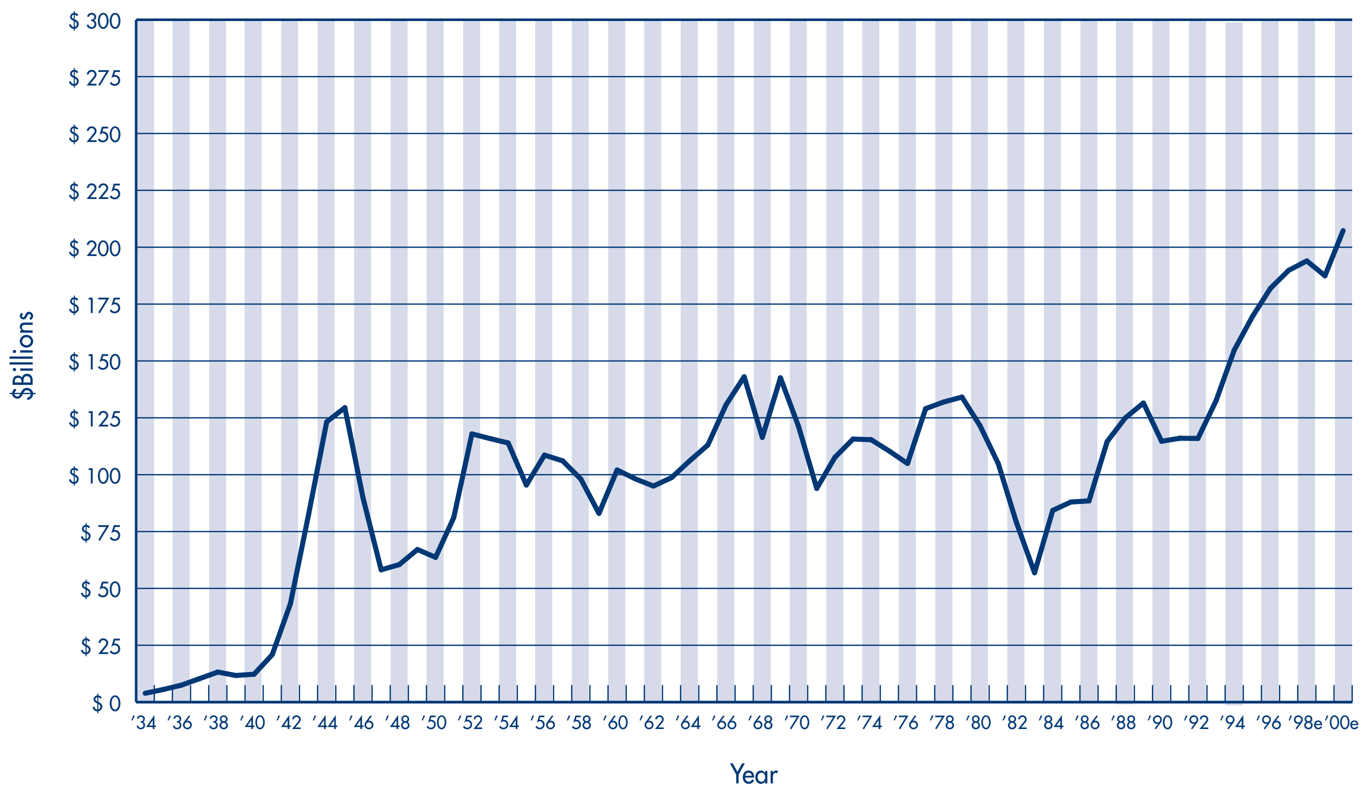
Last year, the corporate income tax accounted for 10.2 percent of total federal tax collections. As Figure 2 shows, corporate income taxes are the third major source of tax collections for the federal government trailing only the personal income tax (49.6 percent of total collections) and social insurance taxes (32.2 percent of total collections). This represents a decline in the relative size of corporate income tax collections. Figure 3 shows that corporate tax collections have fallen as a percentage of all federal taxes over the past 50 years. Corporate income tax receipts were 26.5 percent of all federal taxes collected in 1950. Note, however, that corporate income tax receipts as a share of all receipts have risen sharply from 6.2 percent in 1983 to 10.2 percent in 2000—an increase of 64.5 percent. Growth of receipts reflects rising corporate profits, rather than higher tax rates, as profits rose from 6.5 percent of GDP in 1983 to 9.4 percent in 2000.

Corporate income tax receipts as a share of all receipts have risen sharply from 6.2 percent in 1983 to 10.2 percent in 2000.

Collecting Taxes for the Tax Collectors

The question remains: Who actually

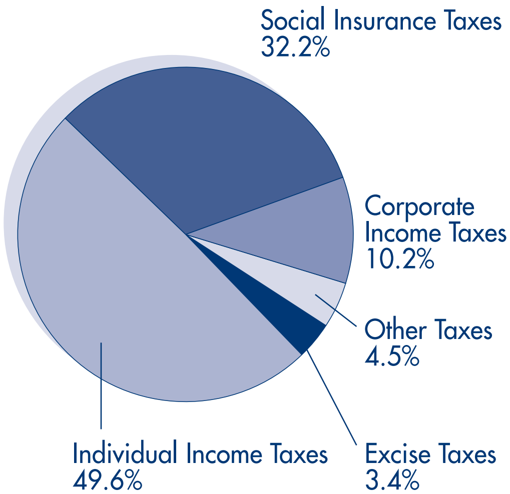
Figure 1: Federal Corporate Income Tax Receipts in Constant 2000 Dollars
Fiscal Years 1934–2000



Source: Budget of the United States, Fiscal Year 2002, Historical Tabes, Table 2.1; Tax Foundation calculations.

Figure 2: Federal Tax Collections by Source

Fiscal Year 2000



Source: Budget of the United States, Fiscal Year 2002, Analytical Perspectives, Table 3.1.

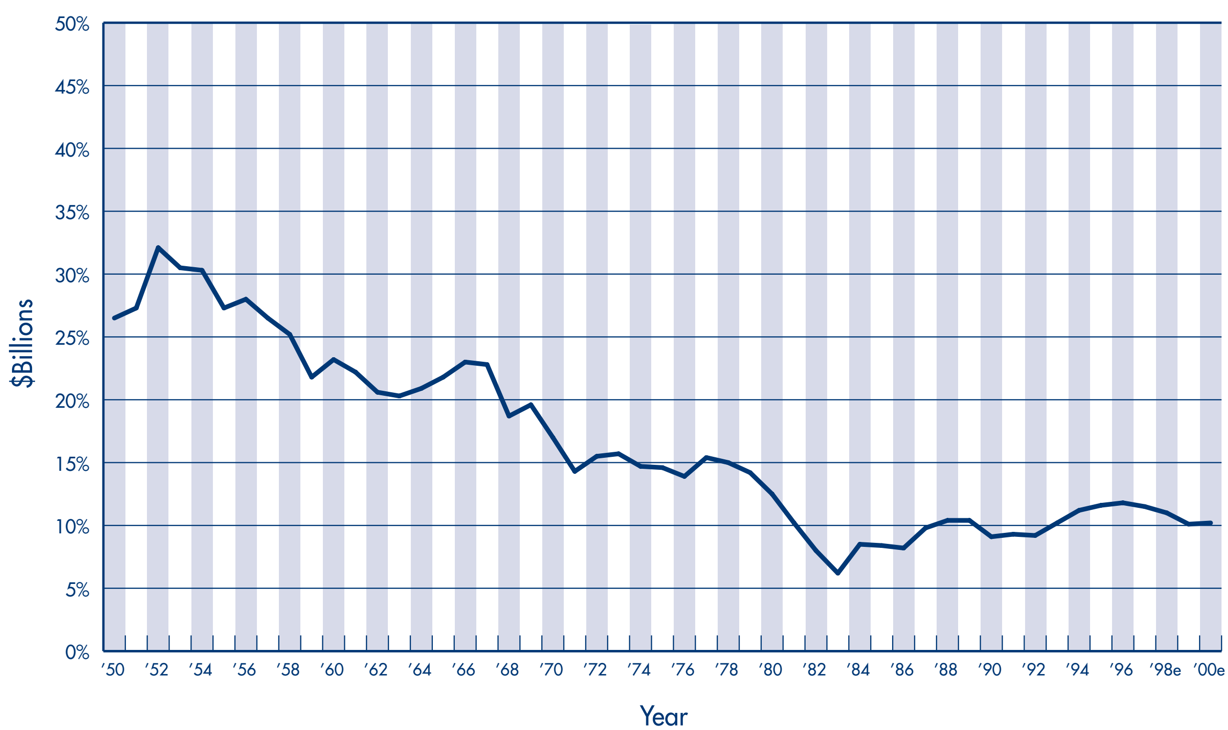
pays the corporate income tax? It may be convenient to think that corporations pay taxes, but only individuals can bear the burden of taxation.[7] Corporations are only legal structures that provide the nexus for individuals acting in different capacities to accomplish their goals. It may also appear that only owners of corporations (i.e., shareholders) bear the burden of the corporate income tax, but this is not correct either.

Again quoting Treasury Secretary Paul O'Neill:

> "The corporations and businesses are just an intermediary between the citizens and the government. And the cost of that intermediate process is enormous because the corporate and business part of the tax code is unbelievably complicated and requires [corporations] to

Figure 3: Corporate Income Tax Collections as a Percentage of Total Federal Tax Collections

Fiscal Years 1950–2000



Source: Budget of the United States, Fiscal Year 2002, Historical Tabes, Table 2.1; Tax Foundation calculations.

engage and employ hundreds of thousands of highly trained and technically competent people to thread their way through the tax code. And the cost of doing that also has to be recovered through the price of the goods that people pay."[8]

In effect, corporations are "tax collectors" in the sense that they are required to send tax payments to the Internal Revenue Service (IRS). But this requirement implies only statutory incidence, or which party is responsible for writing checks to the tax authority. Economic incidence, on the other hand, refers to those individuals that actually bear the cost of the tax.

A simple example demonstrates the difference between statutory incidence and economic incidence. Suppose the federal government imposes a tax of $1 per gallon of gasoline and requires that service stations pay the tax to the IRS. The service stations then write checks to the tax authority as required by law. But sellers will try to shift the tax onto other parties. For instance, service station customers, the end consumers of gasoline, may pay higher prices or perhaps receive lower service quality. In this case, the economic incidence of the tax falls on the customers. In short, statutory incidence indicates the party legally obligated to send payment to the IRS. Economic incidence refers to the indivudual who ultimately bears the cost of the tax.

Sellers may also attempt to lower rents for the properties they lease (i.e., lower payments to owners of land and capital), decrease compensation to workers (e.g., lower salaries or benefits), or raise prices on other services (e.g., oil changes). In each case, somebody other than the seller bears the actual cost of the tax. Sellers only face the economic incidence of the tax when they are unable to shift the tax onto other individuals and therefore realize lower profits. Economic incidence of the tax may be borne by multiple parties including consumers, workers, land owners, capital owners, and the sellers themselves. While the mix of burdens varies by the type of tax and business, the basic implication is that statutory incidence reveals little to nothing about economic incidence.

The same distinction holds true for the corporate income tax. Corporations write checks to the IRS because they bear statutory incidence, but economic incidence may fall on many individuals. These individuals may include: corporate and noncorporate workers, consumers of corporate and noncorporate goods and services, and owners of corporate and noncorporate capital.

An Economic Explanation of the Corporate Tax Burden

There is a framework that economists use to understand the economic incidence of the corporate income tax. Specifically, it is useful to think of the economic incidence in two distinct periods, the short run and the long run.

The short run refers to the period immediately following the levying of a tax, during which time decisions made by investors and corporate managers do not affect the corporation's overall tax position. The long run refers to the period some time after the levying of a tax during which significant business decisions can be made that fundamentally alter the operations of the company and therefore the corporation's tax position.

Short-Run Incidence

There is consensus among economists that the burden of the corporate income tax falls squarely on the owners of the corporation in the short run. This is because investment capital is a fixed input in the short run, which simply means that this resource cannot be varied within this period. Stated otherwise, the short run is defined by the fact that shareholders are unable to shift their capital to different, lower-taxed investments.

Corporate managers could shift burdens by altering prices and output, but this is inconsistent with profit maximization. Microeconomics demonstrates that profits are maximized when marginal revenue equals marginal cost. Marginal revenue is defined as the change in total revenue divided by a change in output. Similarly, marginal cost is the change in total cost divided by the change in output. In other words, marginal revenue is the amount received for the very last item sold; marginal cost is the cost to a firm for producing the final good or service offered for sale.

To see why profits are maximized when marginal costs and marginal revenues are equal, consider cases where they are unequal. If marginal revenue exceeds marginal cost, then the firm has an incentive to increase production. For instance, if marginal revenue equals $10 and marginal cost equals $4, one more unit of production raises profit by $6. If marginal revenue is less than marginal cost, the firm has an incentive to decrease production because they are losing money on each additional item produced. If, for instance, marginal revenue equals $10 and marginal cost equal $15, profits rise by $5 with one less unit of production. Businesses therefore maximize profits by setting marginal revenue equal to marginal cost because only then can profits not rise by increasing or decreasing production.

Profits fall following imposition of the corporate income tax because the tax does not alter marginal revenue or marginal cost and therefore businesses will not alter price or quantity. Consequently, economic burdens fall entirely on stockholders, the owners of corporations, in the form of lower after-tax rates of return on their investments. Profits fall in line with the size of the tax. Simply stated, the only microeconomic variable that can change in the short run is corporate profits. Since profits accrue to shareholders, these individuals bear the burden of the corporate income tax in the short run.

Long-Run Incidence

The economic incidence of the corporate income tax in the long run is much more complex an issue than is the short-run incidence.[9] In the long run, shareholders are able to adjust the holdings in their portfolio, meaning that they are not hit with the economic incidence of the corporate income tax by default.

To understand this better, it is useful to think of all businesses as belonging to one of two general categories, traditional C corporations and all other legal structures, such as partnerships, sole proprietorships and S corporations. C corporations face the statutory incidence of the corporate income tax; the others do not. Economic theory predicts that long-run returns on investment in both sectors are equal. If returns in the two sectors were different, investment would move out of the lower-return sector and into the higher-return sector. Outflows from the lower-return sector raise rates of return, and inflows into the higher-return sector depress rates of return. Funds shift until rates of return are equal across sectors.

The only microeconomic variable that can change in the short run is corporate profits. Since profits accrue to shareholders, shareholders must bear the burden of the corporate income tax in the short run.

Assume that the rate of return on an investment in C corporations and all other businesses is 10 percent before imposition of a corporate income tax. Now suppose an income tax of 35 percent is imposed only on C corporations, which lowers the after-tax rate of return on an investment in this sector from 10 percent to 6.5 percent.[10] The market and after-tax return on an investment in the other sector remains 10 percent because this investment is not subject to the corporate income tax.

A differential now exists between rates of return in the two sectors: C corporations provide 6.5 percent after-tax rates of return, but other businesses provide 10 percent. The division of capital investment between the two sectors is therefore unstable and stockholders will shift investment resources away from C corporations to other businesses.

As capital supply falls for C corporations and rises for other businesses, the laws of supply and demand require that rates of return fall for other businesses as investors must undertake additional, less productive, investments. But capital outflow from C corporations means that after-tax rates of return on their investments rise as dollars are withdrawn — lowest-return investments are withdrawn first which insures that rates of return rise as dollars are withdrawn from the least productive investments.

Capital flees C corporations and flies to other businesses until after-tax rates of return are again equal. Notice, however, that returns fall below 10 percent for all businesses. Capital flows into the other businesses for their higher return push new capital into investments yielding below 10 percent, but the corporate capital outflow pushes surviving investments above 6.5 percent. Rates are equalized somewhere between 6.5 and 10 percent, obviously lower than the rate of return all businesses earned prior to the tax.

Implications of the Corporate Income Tax's Long-Run Incidence

The critical difference between the short- and long-run incidence of corporate income taxes changes the way numerous actors in the economy respond to corporate taxes.

Burdens Imposed on All Businesses

In contrast to the short-run impact that is felt only by corporations, rates of return for all businesses fall in the long-run. The higher the tax, the lower after-tax returns will be for investments made in any business. The corporate tax is, in effect, a tax on all investors, despite its statutory incidence falling only on corporate investors.

Burdens Imposed on Corporate Managers

All managers eventually offer identical after-tax rates of return, but corporate managers are at a competitive disadvantage in the race for securing capital investment. The following example demonstrates why corporate managers must generate rates of return that exceed those of managers in non-corporate businesses. An after-tax return of 8 percent requires that corporate managers earn 12.3 percent market returns on investments when the corporate income tax rate is 35 percent. That is, to provide capital owners with an 8 percent return, managers must realize not only this actual return but also enough (4.3 percent) to cover the 35 percent tax rate. However, sole proprietorships and partnerships need earn only a market return of 8 percent because their earnings are not subject to the corporate income tax.

Burdens Imposed on Shareholders

The corporate income tax is a tax on the corporate form of business because it discourages investment in corporations. The tax fosters too few corporations and a smaller corporate sector than would otherwise arise when investors searched only for the most productive uses for their capital. Corporate taxation thus leads to overall less productive investments that translate into a lower future standard of living.

Burdens Imposed on Consumers

As investment in corporations falls, product prices rise because of a lower supply of goods and services. This is known as a "forward-shifting" of taxation by corporations onto consumers. The reverse occurs for other businesses because higher supply of goods and services lowers product prices. The net effect of these opposing price changes is likely to be higher prices for most consumers because corporations provide the vast majority, 88 percent, of the American economy's goods and services.

Burdens Imposed on Workers

Workers bear part of the burden of the corporate income tax because their productivity is linked so closely to capital productivity. Burdens imposed on labor represent "backward-shifting" of taxation by businesses. Workers will bear rising burdens as economies become more open to international capital flows.

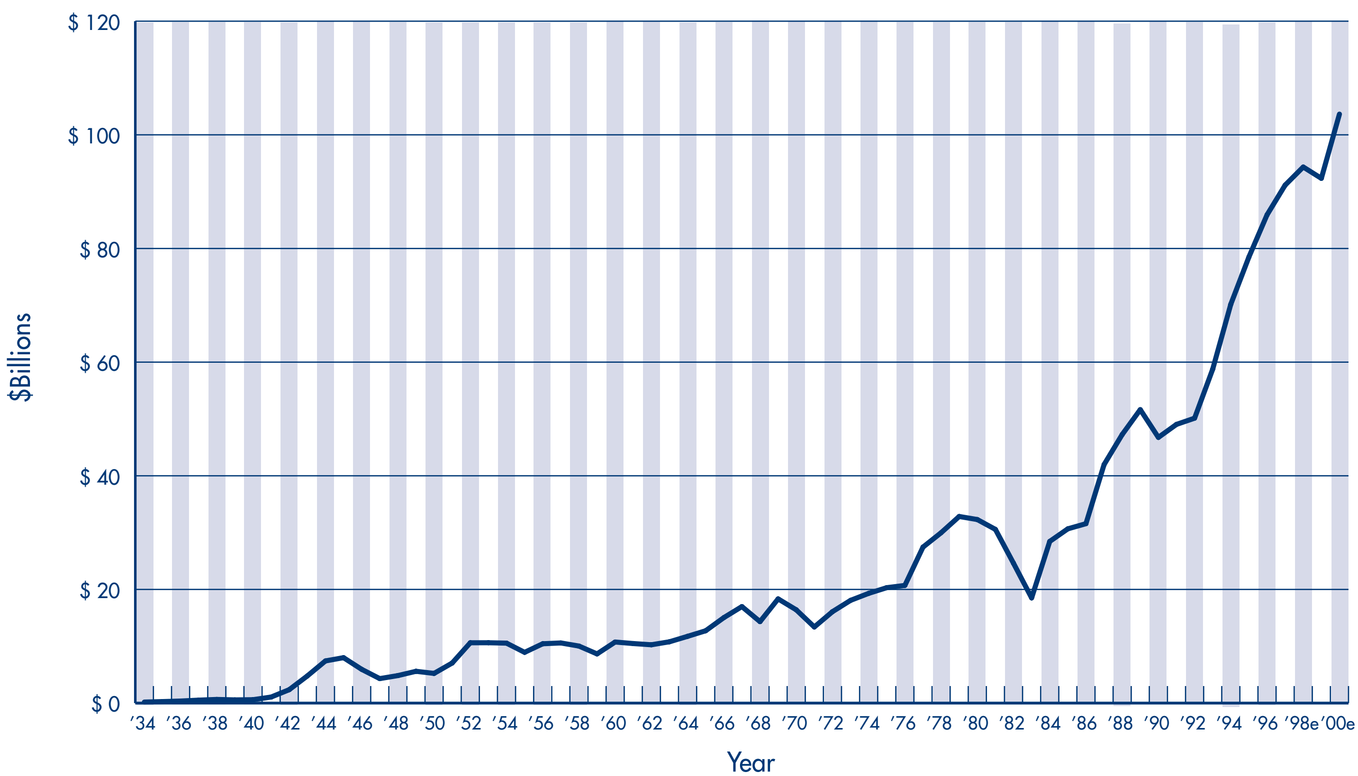
Evidence is accumulating that low-tax locations are drawing more of the world's capital. A 1999 study demonstrates that taxes influence the location of foreign direct investment.[11] A 1998 study has shown that, over the period 1984 to 1992, American multinational businesses became twice as likely to locate operations in lowest-tax locations.[12] As capital flees to other countries, economic incidence is more easily shifted onto workers because they are less mobile than capital and consumers.

The Excess Burden Of the Corporate Income Tax

Economists define "excess burden" as costs that arise when taxation misallocates scarce economic resources.[13] Resources are misallocated when they are not put to their highest-value uses.

For instance, in a market free of outside distortions, greater demand for books relative to chairs will cause the price of books to increase. This will lead suppliers to allocate more resources toward the production of books. A similar reallocation of investment away from chairs and toward books would also follow an increase in the pro-

Figure 4: Excess Burden of the Federal Corporate Income Tax in Constant 2000 Dollars
Fiscal Years 1934–2000



Source: Tax Foundation calculations.

duction cost of chairs since the price of chairs would rise relative to book prices. Consumers, in this situation would prefer relatively more books.

How Targeted Taxes Lower Economic Efficiency and Create Excess Burden

Now consider how the economy reacts when resources are re-allocated because of taxes instead of market forces. If a tax is placed on chairs, but not on books, producers will reallocate resources toward books and away from chairs. But in this case, reallocation does not reflect resources seeking higher-valued uses. Resources are simply chasing changes in after-tax income driven by the tax code. Reallocation does not reflect changes in consumer preferences (demand) or costs (supply).[14] The result is lower economic efficiency, which is an excess burden and reflects the fact that the tax code drives resources away from higher-valued uses. This discussion works the same for the corporate income tax because it imposes a tax on corporations, but not on sole proprietorships and partnerships. The excess burden of the corporate income tax refers to the lower efficiency that emerges when taxation artificially drives resources away from corporations and toward sole proprietorships and partnerships. This move is unrelated to changes in consumer preferences or resource costs.

When resources are reallocated because of taxes instead of market forces, resources are not seeking higher-valued uses. They are simply chasing changes in after-tax income driven by the tax code.

A corporate income tax that results in collections of $200 billion means at least an additional $100 billion of economic gain is never realized due to the misallocation of resources. This is the excess burden recognized by economists but not represented in official tax collection numbers.

A recent and comprehensive survey of the literature on the excess burden of the corporate income tax concludes that "the cost of the misallocation of the physical resources may be more than half the revenue gained from the corporate income tax."[15] In other words, a corporate income tax that results in collections of $200 billion means at least an additional $100 billion of economic gain is never realized due to the misallocation of resources. This is the excess burden recognized by economists but not represented in official tax collection numbers.

Figure 4 displays estimates of the excess burden of the corporate income tax based on this 50 percent estimate. Excess burden is estimated to have been $103.6 billion in 2000, or 50 percent of $207.3 billion of taxes raised. Put another way, total resource cost is $310.9 billion, not $207.3 billion. Placed in the perspective of our population, the annual excess burden is roughly $373 for every American man, woman and child. These dollars represent "wasted" resources that would otherwise be available for higher-valued uses in investment or consumption.

Comparing Corporate Tax Payments Can Be Misleading

Many politicians and lobbying groups compare the total tax bills of various corporations to argue the injustice of some corporations paying relatively less than others.[16] In fact, a simple comparison of tax bills is of little value in determining equity in the tax code.

The most common way to lower tax bills is to take advantage of provisions in the tax code that were deliberately legislated to achieve some desirable goal. For example, the Research and Development (R&D) tax credit was implemented to spur innovation, which leads to increased productivity, new goods and services, higher wages, and economic growth. A tax deduction for investing in alternative energy technology may have been passed with the intention of reducing environmental impacts. If the public policy goals underlying such measures are worthwhile, lawmakers should be pleased to see corporations taking advantage of them, and subsequently lowering their corporate income tax liability.

The desirability of any particular credit or deduction and the effect these provisions have on the overall effectiveness of the tax code are matters for consideration but outside the scope of this paper. What is evident and relevant is that not all corporations find it possible, or even advantageous, to claim identical tax relief. Corporations that experience similar sales therefore do not ordinarily incur similar tax bills, and the range of tax paid relative to income varies greatly. This is the natural outcome of a tax code used to achieve specific public policies beyond collecting taxes.

An example clarifies why it is misleading to claim that corporate tax payments somehow allow us to determine whether various corporations pay their "fair share." Suppose two corporations have equal sales of $100 million, but one of them takes advantage of $50 million worth of tax deductions and the other takes advantage of only $20 million. Further, suppose that both corporations are taxed at the 35 percent rate. The first pays $17.5 million in taxes (35 percent of $50 million) and the second corporation pays $28 million in taxes (35 percent of $80 million), a difference of $10.5 million. This difference represents not an unfairness necessarily but only the effect of a tax code filled with deductions and credits deliberately legislated to achieve certain public policies beyond collecting taxes.

A simple comparison of corporations' tax bills is of little value in determining equity in the tax code.

A simple comparison of corporate tax bills to determine equity is also misleading because it ignores the fact that people pay taxes, not corporations. In this context, corporations are nothing more than the nexus of workers, customers, and owners. These stakeholders bear the burden of the corporate income tax. Accordingly, any fairness comparison should be based on how the tax's burden falls on these individuals, not a misunderstanding that somehow corporations face the economic incidence of the corporate income tax.

It bears repeating that statutory incidence does not reveal economic incidence and that the variation in corporate tax payments is a natural result of a complex tax code filled with deductions and credits. Simple comparisons of tax bills across corporations designed to argue the injustice of some corporations' lower payments is misleading and adds nothing to our understanding of the incidence of the corporate income tax.

The Corporate Income Tax Is Less Progressive as Capital Ownership Widens

Progressivity of the corporate income tax rests on how its economic burdens fall on individuals of various income levels. A progressive tax is one for which tax burdens rise with income and is a characteristic that many believe is fair or desirable.

However, progressivity is much more difficult to measure for corporate taxes than for individual taxes. For corporate taxes, progressivity can not be measured using corporate tax payments because these reveal statutory incidence placed on the corporations only. The progressivity of the corporate income tax should be measured using the income characteristics of the workers, consumers, and shareholders who are hit by the long-run economic incidence of the corporate income tax.

Even limiting distribution analysis to the owners of corporate capital—for example, a short-run distribution analysis—deserves closer scrutiny than simply assuming—as is often done—that shareholders are relatively wealthy and therefore the tax is relatively progressive. Consider the following facts:

• Lower-income individuals, who are often workers and always consumers, are left out of the equity discussion. Lower-income individuals are often "hidden" owners of capital who invest in real estate, mutual funds, life insurance, stocks and pensions. For instance, much of the capital stock is owned by pension funds, which means they are ultimately owned by lower-income, as well as higher-income, workers.

• Mutual funds own about one-fifth of publicly traded U.S. corporate equities and provide lower income investors a relatively low-cost way of holding a diversified stock portfolio.[17] Mutual funds also provide the benefits of professional management services provided by their managers. By August 2000, mutual funds held about $7.5 trillion in assets and are the largest type of financial institution. In 1999, households held 81 percent of total mutual fund assets and almost 40 percent of mutual fund shareholders have annual incomes below $50,000.

• The percentage of households that directly or indirectly own stock in publicly traded companies increased from less than one-third in 1989 to roughly one-half in 1998. That means that over 50 million households directly own corporate capital today.

• The rising trend of capital ownership across all income groups is supported by many other studies. A recent survey, for instance, found that stock ownership doubled between 1965 and 1990, and then doubled again between 1990 and 1997.[18] Stock ownership has risen 46 percent since 1989 among households with incomes between $25,000 and $50,000, and by 78 percent among households with incomes between $10,000 and $25,000.

• Data also indicate that low-income households have experienced rapid increases in their abilities to invest in corporations. A new study by the Federal Reserve found that between 1992 and 2000, the savings ratio of the richest fifth of households dropped from 8.5 percent to -2.1 percent.[19] Meanwhile, households in the middle fifth of the income distribution slightly increased their savings ratio, and those in the poorest two-fifths doubled their savings rate to over 7 percent.

The basic point is that the corporate income tax will become relatively less progressive as lower-income individuals continue to increase ownership in our nation's capital stock. As more individuals from across the income spectrum own capital, lower-income households will bear an increasing proportion of the economic burdens of the corporate income tax.

Reforming Corporate Income Taxes

There are many reasons to reform the corporate income tax, but we will concentrate on the benefits of eliminating double taxation, thus removing what many critics consider the corporate income tax's most objectionable feature. This is the path advocated by Treasury Secretary O'Neill as demonstrated by his recent answer to the question of whether or not he favors elimination of the corporate income tax. He replied:

> "Absolutely. In economic logic there is no reason to have this phony process as though somehow individual human beings didn't pay the taxes that are embedded in the prices of goods and services."[20]

One option is to simply scrap the tax, which would have the additional benefit of allowing corporations to conduct their business without constant attention to locating opportunities for lowering taxes. The mechanics of removing the tax could be achieved through attributing all corporate earnings (distributed or not) to stockholders, as is the case for partnerships, sole proprietorships and S corporations. Each stockholder then would be liable for income tax on his or her share of earnings; if you own 3 percent of a corporation, your taxable income is 3 percent of its taxable earnings. The corporation then becomes just a conduit for transmitting earnings to stockholders, rather than being an institution that merely passes taxes along to investors, workers and consumers. While this reform would raise challenging accounting issues, they are unlikely to be any more complex than those under the current tax system.

One comprehensive study estimates that removal of the tax would, on average, yield $10,000 to each U.S. citizen over their lifetime as its removal fostered a more efficient economy.[21] This study also estimates that higher-income stockholders would gain less than lower-income stockholders because the former face higher marginal tax rates on their personal income. Overall tax revenues are predicted to grow as higher economic growth raises revenues from other tax sources.

One comprehensive study estimates that removal of the tax would, on average, yield $10,000 to each U.S. citizen over their lifetime as its removal fostered a more efficient economy.

Another less radical option is to retain a separate corporate tax but allow corporations to deduct dividends from taxable income as they do with interest payments to bondholders. This would also eliminate double taxation of income, but would keep the door open to the possibility that corporate income would be taxed at a different rate than other forms of business income. An inconsistent taxation of different forms of business structure would be economically inefficient.

Conclusion

A popular argument for the corporate income tax is that it forces corporations to pay taxes. However, this is misleading because only individuals pay taxes. Corporations are only legal structures that provide the nexus for individuals acting in different capacities to accomplish their goals. The economic incidence, or actual burden, of the corporate income tax must, therefore, fall on consumers, workers and investors in the form of higher prices, lower wages, and diminished returns on investment.

The extent to which each of these groups of stakeholders bears the burden of the corporate income tax is a hotly debated topic. There is consensus among economists that the burden of the corporate income tax falls squarely on the owners of the corporation in the short run. This is because within this time frame business decisions cannot be made to adjust prices or wages and shareholders cannot shift their capital to other, lower-taxed investments.

In the long run, managers are able to make business decisions that adjust wages and prices and shareholders are able to shift their capital to other investments. These facts make the economic incidence of the corporate income tax in the long run much more complex an issue than is short-run incidence. While the extent to which each of the following groups of individuals bears the long run burden of the corporate income tax is questionable, that each is affected is not.

(1) All businesses, not just corporations – Because rates of return will stabilize across all possible investment opportunities, an increase in the corporate income tax actually reduces the rate of return for all investments made by all businesses.

(2) Corporate managers – Corporate managers must realize a higher rate of return compared to non-corporate managers on their activities to cover the corporate income tax and expected return of investors.

(3) Burdens imposed on shareholders – The corporate income tax is a double tax on investment in the corporate sector. This burden falls on the corporation's shareholders.

(4) Burdens imposed on consumers – As investment in corporations falls, product prices rise because of a lower supply of goods and services.

(5) Burdens imposed on workers – Workers bear part of the burden of the corporate income tax because their productivity is linked so closely to capital productivity.

Corporate stakeholders are not only affected by the direct level of taxation but also the indirect costs associated with the tax. Recent research indicates that for each dollar collected, at least another 50 cents worth of resources are consumed in compliance costs, inefficient capital allocation, rent-seeking activity, etc. This means that the corporate income tax imposes a total burden of not $207.3 billion (total collections for 2000) but $310.9 billion. This amounts to roughly $1,089 for each American man, woman and child—or $2,999 per household—and reflects resources that otherwise could be devoted to economically productive investment or consumption.

For all these reasons—that individuals pay taxes not corporations, that various groups of stakeholders including workers bear the burden of the corporate income tax and because there are tremendous indirect costs associated with the corporate income tax—it is misleading to compare corporate income tax payments across companies as a measure of fairness. An assessment of fairness should focus on the burdens imposed on consumers, workers and investors, not on the tax returns of a few large corporations.

For the same reasons, but primarily because people pay taxes, not corporations, lawmakers should reconsider the corporate income tax as a source of tax collections. The popularity of alternative corporate structures such as the S Corporation indicates that there would be significant economic benefits to removing the double taxation represented by the corporate income tax. This would benefit workers, consumers, shareholders, and the economy in general.

Notes

[1] Interview with Paul O'Neill, U.S. Secretary of the Treasury, *Financial Times,* May 21, 2001. This statement is his response to the question: "What are some of the areas you see needing fixing?"

[2] Don Fullerton and Diane Lim Rogers, *Who Bears the Lifetime Tax Burden?,* The Brookings Institution, 1993.

[3] Internal Revenue Service, Statistics of Income.

[4] Internal Revenue Service, Statistics of Income.

[5] Susan Wittman, "S Corporation Returns, 1998," *SOI Bulletin,* Spring 2001.

[6] Between 1942 and 1949 the top statutory corporate income tax rate reached 53 percent on income between $25,000 and $50,000.

[7] Department of Commerce, Bureau of Economic Analysis.

[8] Discussion of economic incidence follows discussion in Michael L. Marlow, *Public Finance: Theory and Practice,* Dryden Press, 1995.

[9] Interview with Paul O'Neill, U.S. Secretary of the Treasury, *Financial Times,* May 21, 2001.

[10] This section follows the model introduced in Arnold C. Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy* 70:215-240, June 1962.

[11] Most large corporations face a top corporate income tax rate of 35 percent.

[12] James Hines, "Lessons from Behavioural Responses to International Taxation" *National Tax Journal,* June 1999.

[13] Rosanne Altshuler, Harry Grubert and T. Scott Newlon, "Has US Investment Abroad Become More Sensitive to Tax Rates?" NBER Working Paper No. XX (Cambridge, Mass.: National Bureau of Economic Research, January 1998).

[14] Allocative efficiency is consistent with intersection of supply and demand curves in private markets since resources are allocated until marginal social benefits are equal to marginal social costs.

[15] This rise in cost caused by the tax is considered "artificial" because it is not connected with higher input costs or a fall in technology, which are considered "natural" or market-driven changes.

[16] See Jane G. Gravelle, *The Economic Effects of Taxing Capital Income* (Cambridge, Mass.: MIT Press, 1994), p. 81.

[17] For instance, see Robert S. McIntyre and T. D. Coo Nguyen, "Corporate Income Taxes in the 1990s," Institute on Taxation and Economic Policy, October 2000.

[18] Eric M. Engen and Andreas Lehnert, "Mutual Funds and the U.S. Equity Market," *Federal Reserve Bulletin,* December 2000.

[19] See, for instance, James K. Glassman, "The Rise of the Investor Class," *AEI on the Issues,* May 1999.

[20] Dean Maki and Michael Palumbo, "Disentangling the Wealth Effect: A Cohort Analysis of Household Saving in the 1990s," Federal Reserve, April 2001.

[21] Interview with Paul O'Neill, U.S. Secretary of the Treasury, *Financial Times,* May 21, 2001.

[22] Fullerton and Rogers, *Who Bears the Lifetime Tax Burden?*