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Insights

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Editor

A BETTER CORPORATE TAX?

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The Byzantine U S. federal corporate tax code often allows corporations that earn accounting profits to avoid tax liability altogether. For example, during the period 1996 to 1998, 41 of the 250 largest American corporations paid no corporate income tax in at least 1 year, despite having pre-tax earnings of $25.8 billion in those years; indeed, by "carrying back" their excess deductions and credits to prior years, these companies actually received $3.2 billion in rebates (McIntyre and Nguyen, 2000, p. 2). Such reports raise concerns about the fairness of the corporate income tax. Furthermore, economists have had lively debates over the years about the desirability of the corporate income tax itself. In combination with the personal income tax, it nominally represents double taxation of income from capital, though the treatment of capital gains under the personal income tax makes it possible for some taxpayers to delay, or even avoid, paying any taxes on increments to their wealth from stock holdings. The corporate income tax and its complex provisions also distort investment decisions, leading to a marginal excess burden, the efficiency losses an economy suffers to raise the marginal dollar of revenue from the tax, of between 17 and 56 cents (Fullerton and Henderson, 1989, p. 435). At the conceptual level, most economists would favor a complete integration of the personal and corporate income taxes, say through annual assignments of profits to stockholders, though they recognize the great administrative costs of doing so (Gravelle, 1994; Hubbard, 1993). Is there a fairer, more efficient, and less administratively costly way to tax corporations? Perhaps, yes: rather than taxing the profits of corporations, tax their capitalized value.

THE CAPITAL VALUE TAX

The capital value tax would operate as follows. At the end of each trading day, publicly traded corporations would calculate their capitalized values based on the clos-

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ing prices of their stocks. They would incur a tax liability based on their capitalized value. At the end of each quarter, they would report their total tax liability and send a check to the U.S. Treasury. Privately held corporations would be exempted from the tax.[1] Instead, they would be treated as "flow-through" entities, as are sub-chapter S corporations currently (Ayers, Cloyd, and Robinson, 2001).

How high would the annual tax rate on capitalized value have to be to generate as much revenue as the current corporate income tax? In 2000, corporations paid $207 billion in corporate income tax. At the end of 2000, the global market value of domestic operating companies listed on the New York Stock Exchange was $11.5 trillion. An additional $3.6 trillion of value was in companies listed on the Nasdaq. An annual tax rate of 1.4 percent applied to this capitalized value would generate about as much as the current tax on profits.

Of course, a 1.4 percent annual tax on the value of an asset is substantial—roughly the order of magnitude of the property tax rate paid by Americans who do not itemize deductions for their federal income tax. As a tax on productive capital has direct relevance to levels of investment and therefore rates of economic growth, it is worthwhile putting its magnitude into perspective. It can be thought of as equivalent to a 1.4 percentage point increase in the overall real economic depreciation rate for corporate capital, which is probably on the order of about 10 percentage points (Hulten and Wykoff, 1981).[2] From this perspective, it represents a modest increment to the annual costs firms must pay to maintain their capital stocks.

CAPITAL VALUE TAX VS THE CORPORATE INCOME TAX

How does the capital value tax compare to the corporate income tax? Using standard criteria for evaluating taxes—revenue, equity, efficiency, and administrative cost—a case can be made for the superiority of the capital value tax

Revenue. The specific rate proposed for the capital value tax makes it equivalent to the corporate income tax in terms of revenue in the short run. Corporate equity value has grown faster than gross domestic product—nearly twice as fast between 1962 and 2000—due primarily to reductions in the effective tax rate on dividends and the growing percentage of equity held by non-taxpaying entities over the period (McGratten and Prescott, 2001, p. 1). As the percentage of equity held by non-taxpaying entities is likely to continue to increase for some time, revenue from the capital value tax would likely grow faster than would revenue from the corporate income tax. Alternatively, the rate of the capital value tax could probably be lowered over time and still provide as much revenue as would have been provided by the corporate income tax.

[1] An alternative approach would require privately held corporations to declare a stock value and pay the tax accordingly. To encourage good faith declarations, these corporations would be required to sell some percentage of stock to arms-length bidders at a price slightly higher than the declared price. A similar approach has been employed for property assessment in the past in New Zealand and Columbia but abandoned for political and administrative reasons (Bird, 1984) and it has proposed for the taxation of natural resource rents (Weimer, 1992). As implementing this approach would likely be at least as administratively difficult as treating these corporations as flow-through entities the more familiar approach would probably be preferable, especially as it represents a step toward tax integration, which in itself is desirable

[2] Hulten and Wykoff (1981) estimated a rate of 13.3 percent for manufacturing equipment (about 67 percent of tangible business capital) and 3.4 percent for structures (about 33 percent of tangible business capital). Since they made their estimates, it is likely that computerization and faster product cycles have increased the depreciation rate on manufacturing equipment. I know of no estimates of the depreciation rate for good will, though it might be estimated by looking at advertising expenditures advocating the corporation rather than its products

Equity The appropriate basis for assessing equity is much less clear in the case of corporate taxation than it is in the case of individual taxation. Horizontal equity implies treating equals the same way, but equal in what respect? The corporate income tax has greater relative equity in one respect: it treats large privately held corporations in the same way it treats publicly traded corporations, while the capital value tax would not. Differential opportunity to engage in tax avoidance, however, means that corporations with the same levels of accounting profits often pay very different amounts of taxes under the corporate income tax. Some of these differences have a basis in provisions reflecting legitimate public policy goals; others are accidental or the result of lobbying. As corporations must be profitable in the long run and yield roughly the same rate of return on capital, the capital value tax might very well increase the long run correspondence between profits and taxes actually paid. It most likely would be perceived by the public as fairer.

Efficiency The corporate income tax imposes costs on corporations, and therefore society, beyond the revenue that they actually send to the U.S. treasury. Avoiding the corporate income tax requires corporations to alter the way they use their resources to realize the various loopholes. The capital value tax would virtually eliminate these components of marginal excess burden. Its major cost would be in discouraging some privately held corporations from going public.

The corporate income tax probably has some relative advantage in terms of macroeconomic stabilization—corporate profits respond more quickly to downturns in the economy than stock prices, so that the corporate income tax is more counter-cyclical than the capital value tax. On the other hand, a temporary reduction in the rate of the capital value tax would provide a very direct and fast way of stimulating the economy during recessions.

Administrative Cost. Complying with the corporate income tax, and exploiting preferences and loopholes to the maximum extent possible, requires small armies of lawyers and accountants. The complex rules for measuring depreciation and other business costs make auditing by the IRS very difficult. In comparison, the administrative cost of the capital value tax would be much less. Further, because the personal rewards to CEOs are usually tied to stock values, they would have a personal incentive not to try to manipulate stock prices to reduce tax liabilities. For administrative savings to be fully realized by corporations, however, it would be necessary for states to tie their business taxes to the capital value tax as they now tie them to the corporate income tax. States could simply select an increment to the tax rate as a replacement for their income taxes on publicly traded corporations. Aside from saving their own administrative costs, states would probably find the relative stability of revenue from the capital value tax attractive in reducing the fiscal stress they encounter during economic downturns.

POLITICAL ECONOMY

The political process might also benefit from eliminating the byzantine corporate income tax code. The "Gucci Gulch" of lobbyists observed during the 1986 tax reform debate was only the unusually visible efforts of corporations to gain special treatment under the tax code. Switching to the capital value tax would make the corporate tax code much simpler and provide a clean slate that could be more easily monitored by the press and public for special favors. Recent changes in the rules governing campaign contributions no longer allow corporations to give large donations of "soft money" to political parties. Nevertheless, as long as there is a desire to influence tax writers, some other form of contribution is likely to arise. An effective

way of reducing the influence of corporate money in campaigns is to remove the incentive corporations have to influence the details of the corporate tax code.

Yet the most relevant question of political economy is whether a sufficiently large number of corporations would find the capital value tax more desirable than the corporate income tax. This question cannot be answered without first injecting the idea of the capital value tax into public discussion

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