S. HRG. 101-1065

# DECLINE OF CORPORATE TAX REVENUES

## HEARING

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

MAY 3, 1990

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

35-363 ' s WASHINGTON : 1990

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

## COMMITTEE ON FINANCE

LLOYD BENTSEN, Texas, *Chairman*

DANIEL PATRICK MOYNIHAN, New York
MAX BAUCUS, Montana
DAVID L. BOREN, Oklahoma
BILL BRADLEY, New Jersey
GEORGE J. MITCHELL, Maine
DAVID PRYOR, Arkansas
DONALD W. RIEGLE, JR., Michigan
JOHN D. ROCKEFELLER IV, West Virginia
TOM DASCHLE, South Dakota
JOHN BREAUX, Louisiana

BOB PACKWOOD, Oregon
BOB DOLE, Kansas
WILLIAM V. ROTH, JR., Delaware
JOHN C. DANFORTH, Missouri
JOHN H. CHAFEE, Rhode Island
JOHN HEINZ, Pennsylvania
DAVID DURENBERGER, Minnesota
WILLIAM L. ARMSTRONG, Colorado
STEVE SYMMS, Idaho

VANDA B. MCMURTRY, *Staff Director and Chief Counsel*
EDMUND J. MIHALSKI, *Minority Chief of Staff*

# CONTENTS

## OPENING STATEMENTS



## COMMITTEE PRESS RELEASE



## ADMINISTRATION WITNESSES



## PUBLIC WITNESSES



## ALPHABETICAL LISTING AND APPENDIX MATERIAL SUBMITTED

COMMUNICATIONS

# DECLINE OF CORPORATE TAX REVENUES

THURSDAY, MAY 3, 1990

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:00 a.m., Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Moynihan, Packwood, Danforth, and Durenberger.

[The press release announcing the hearing follows:]

[Press Release No H-19, Mar 7, 1990]

SENATOR BENTSEN ANNOUNCES HEARING ON CORPORATE INCOME TAX; CORPORATE TAX REVENUES FALL SHORT BY $20 TO $30 BILLION YEARLY, CHAIRMAN SAYS

WASHINGTON, DC—Senator Lloyd Bentsen (D., Texas), Chairman, announced Wednesday that the Senate Finance Committee will hold a hearing later this month on the decline of corporate income tax revenues.

The hearing will be held on *Thursday, May 3, 1990 at 10 a.m.* in Room SD-215 of the Dirksen Senate Office Building.

"The share of total income tax revenues contributed by corporations has been steadily declining in past decades. The 1986 Tax Reform Act was expected to alter this trend. One of the key goals—and a major selling point—of the 1986 Act was to shift $120 billion in taxes from individuals to corporations in the first five years. Current figures make it plain that little, if any, of this expected increase in corporate income tax receipts is materializing. In fact, corporate income tax receipts are falling short by some $20 to $30 billion per year," Bentsen said.

"The focus of this hearing will be to examine these figures and to explore possible explanations for the shortfall in corporate income tax revenues. I also am interested in comparing the corporate tax burden in this country with that in other industrialized countries," Bentsen said.

## OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. This hearing will come to order.

Changes made in the 1986 Tax Reform Act were expected to increase revenues from corporate income taxes by about $120 billion over 5 years. But, the preliminary reports show that we are falling far short.

Using the latest estimates from the Office of Management and Budget, the shortfall will amount to $116 billion. The Congressional Budget Office estimates it will be $145 billion. So, we have a mystery on our hands.

Well over $100 billion seems to he missing from the Federal Government's revenues. We need to find the culprit. We do have some clues.

At least part of the explanation is that corporate profits are lower than expected, even though—and this is strange—personal

income taxes are up. I am trying to find out why corporate profits are down.

Economic conditions may be part of the answer, but to affect corporate profits and not personal income taxes is really quite puzzling. What is the reason for that apparent contradiction? What is the influence of the massive move from equity to corporate debt and the resultant higher interest deductions?

I want to know whether corporate profits are down because of that or if there are other factors at work.

We rely on the corporate income tax for a very substantial part of government revenue. It's share of the government's revenue has been steadily declining for some time.

To give you an example, in 1955, corporate income taxes represented 27.3 percent of total tax receipts. 27.3 percent. In 1989, it was down to 10.5 percent. We are always trying to identify where Japanese business has a competitive advantage. But, that is not the case with taxes. While corporations pay 10.5 percent of total government revenue in this country, 21 percent of the total tax revenues come from corporate income taxes in Japan.

I would like to hear the views of the witnesses today about those numbers and their evaluation of those trends. Having spent many years myself building a business, I know the importance of revenue expectations in making intelligent choices for the future. As the budget deficit becomes more and more serious and more difficult for us to close the gap, accurately estimating Federal revenues has become even more critical for us to make intelligent policy decisions. That is why we need some explanation of the shortfall in corporate tax receipts. We have a real puzzle here and we are going to try to find some of the answers today.

I defer to my colleague, Senator Packwood, for any comments he may have.

## OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON

Senator PACKWOOD. Mr. Chairman, I am intrigued with these hearings because I remember when we were doing tax reform we were charged with making that bill revenue neutral over 5 years. The tax reform bill involved total revenues to the Federal Government of around $5 trillion. So, if we were off by 1 percent, we were off, plus or minus, $50 billion over the 5 years. I thought that if we came within 1 or 2 percent of our mark, it wasn't a bad prediction. If a business can predict its gross revenues 2 or 3 years out, and come within 1 or 2 percent, that company is in great shape.

So, I am fascinated as to why individual taxes have increased and corporate taxes decreased. But, we should not reflect solely on the past. I will have some questions of the witnesses about how to make our projections better in the future.

I would like to recount a story I have told any number of times when I was on the Banking Committee. Senator Proxmire used to have an economics professor—I think he was from Wisconsin—who would testify each January and predict what was going to happen the following year. He came for the 7 or 8 years I was on the Banking Committee. One year I read what he had said the previous year

and found that what he had predicted utterly did not happen. It wasn't even close. So I asked him if he could explain why he was so far off last year. And, he said "yes," and "there were unforeseen intervening circumstances."

Well, I said, "do you think there could be any unforeseen intervening circumstances in the upcoming year?" He answered, "no, no, we have got a pretty good handle on it now."

So I may have some questions about the future. And, as much as, I am interested in the past, the past is gone. If we are going to change the laws, or try to produce more revenue or less revenue, or fine-tune what we did, I would like to have some assurance that what we base those changes on, it is reasonably accurate. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Moynihan.

## OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. I would just agree with Senator Packwood. To come within 1 percent of anything as large as that and over that much time is certainly not a bad case of forecasting. On the other hand, we do see this rather dramatic shift in the composition of Federal revenues.

Now, our staff has done a superb table here. The corporate tax in 1955 was 27 percent of our revenues and social insurance was 12 percent and that has now quite reversed. Today, corporate is 10.5 and social insurance is 36. Corporate taxes are down by two-thirds and social insurance up three times. I don't know what that means, but I would be interested if anybody might want to comment in the course of the panel discussions. Thank you.

The CHAIRMAN. I might add on those predictions that I know it was said of one very prominent economist, a very well known one, that he was right about half the time. And that 500 is great for a baseball player but not very comforting from an economist.

The first panel will be Dr. Harvey S. Rosen, Deputy Assistant Secretary for Tax Analysis, and Robert Reischauer, the Director, Congressional Budget Office. Gentlemen, if you would come forward, please.

Dr. Rosen, if you would proceed with your testimony, please.

## STATEMENT OF HARVEY S. ROSEN, PH.D., DEPUTY ASSISTANT SECRETARY FOR TAX ANALYSIS, U.S. DEPARTMENT OF THE TREASURY

Dr. ROSEN. Mr. Chairman and members of the committee, I am pleased to have this opportunity to present the views of the administration on recent trends in corporate tax receipts.

As the committee has requested, my remarks today focus principally on the trend in corporate tax receipts, the importance of the corporate tax in other countries, and the effect of the Tax Reform Act of 1986 on corporate tax receipts

In 1989, the corporate income tax produced $104 billion in revenue for the U.S. Government. The $104 billion was the most revenue ever produced by corporate taxes and represented the sixth

consecutive annual increase in corporate tax receipts. The level of corporate taxes has increased even though pre-tax corporate profits as a percentage of gross national product has fallen sharply.

In the mid 1950's when corporate taxes were at their peak as a percentage of total Federal tax receipts, pre-tax corporate profits were about 11 percent of GNP. By 1986, this percentage had fallen to about 5.1 percent.

Although the level of Federal corporate receipts rose from the mid 1950's to 1986, it fell as a percentage of total receipts. But since 1986, the declining trend in the relative importance of the corporate tax has been reversed.

In 1989, corporate tax receipts accounted for 10.5 percent of total tax receipts, which is the highest percentage since 1980.

I turn now to the issue of corporate taxes in foreign countries.

Because of cultural and historical differences, foreign countries have a wide variety of tax systems. These differences among tax systems make it difficult to directly compare corporate tax burdens across countries. Nonetheless, we can make some general observations.

In 1987, corporate income taxes accounted for an average of 8 percent of total tax receipts for the 22 countries in the Organization for Economic Cooperation and Development for which we have data. The data pertain to corporate taxes at both the central government and local levels.

U.S. corporate taxes as a percentage of total tax receipts was 8 percent in 1987, the average for the 22 OECD countries. Countries that were above the OECD average include Japan, at 23 percent, and the United Kingdom, at 11 percent. Countries that were below the average include Germany, at 5 percent, and France, at 5 percent.

With respect to the Tax Reform Act of 1986, it is clear that the Act made significant changes to the corporate tax system. These changes were expected to increase corporate tax receipts significantly, However, the 1986 Act as a whole was expected to be revenue neutral. For all practical purposes, the 1986 Act has been revenue neutral.

Our most recent estimate indicates that the numerous positive and negative provisions of the 1986 Act sum to a total change in receipts of less than 1 percent over the 1987 to 1991 period.

The 1986 Act was also expected to increase corporate tax receipts and lower individuals receipts as a percentage of total income tax receipts. This has also occurred. The percentage of income tax receipts accounted for by corporate taxes increased from 15 percent in 1986 to 19 percent in 1989. Correspondingly, the percentage accounted for by individual taxes fell from 85 percent to 81 percent.

The Reagan administration's first budget after enactment of the 1986 Act was the 1988 budget. In that budget, corporate tax receipts for 1987 through 1989 were forecast to average $117 billion per year. Actual receipts averaged only $94 billion per year. The Reagan administration was not alone in overestimating corporate tax receipts. In its first budget after the 1986 Act, the Congressional Budget Office also overestimated corporate tax receipts by an average by $21 billion per year for the 1987 through 1989 period. The question then arises: why were corporate tax receipts between $20

billion and $25 billion lower than forecast after the 1986 Act was enacted?

Our analysis of the effect of the 1986 Act on corporate tax receipts today is both preliminary and incomplete. It is always difficult to distinguish quantitatively between the effects of changes in the tax law and other economic factors, but in this case we face special difficulties.

Many of the important and fundamental provisions of the 1986 Act were phased in over time and did not become fully effective until 1988. Large corporations, following their conventional practice, typically did not file their 1988 tax returns until mid-September 1989.

We believe that the primary reason why corporate tax receipts were lower than expected in the Reagan administration's 1988 budget is that pre-tax corporate profits were lower than expected. In the 1988 budget, pre-tax corporate profits were overforecast by an average of $55 billion over the 1987 through 1989 period. This resulted in an average annual overestimate of between $15 and $20 billion in corporate tax receipts.

Why did this occur? An important reason for the overestimate of corporate profits appears to be that actual wage and salaries were higher than expected. Because wages and salaries are deductible expenses for corporations, higher wage and salaries reduce corporate profits. Higher wage and salaries would also have the effect of raising the taxable income of individuals. The higher-than-expected level of wages and salaries is reflected in higher-than-expected individual tax receipts.

To summarize, corporate tax receipts forecasts by both the Treasury and the Congressional Budget Office following the enactment of the 1986 Act exceeded actual corporate receipts by between $20 and $25 billion per year.

Next, the Tax Reform Act of 1986 reversed a long-term decline in the relative importance of corporate taxes in producing revenues for the U.S. Government.

The 1986 Act has been revenue neutral because individual tax receipts are higher than expected.

And lower than expected corporate profits explain much of the underestimate in corporate tax receipts.

This concludes my prepared remarks. I would be happy to answer any questions of the committee. Thank you.

[The prepared statement of Dr. Rosen appears in the appendix.]

The CHAIRMAN. Thank you, Dr. Rosen.

In your testimony, you seemed to skip over the question of corporate debt I raised.

Dr. ROSEN. Yes, sir.

The CHAIRMAN. I would like to pursue this further. It is not just a matter of interest rates having escalated, although that obviously carries a burden, but the massive move from equity to debt in this country and the activity of LBO's. Of course, taxes are figured after interest payments.

I don't know if there's a study of what profits would have been before interest expenses, but I would like to directly respond to that concern.

Dr. ROSEN. Yes, sir.

We believe that the under forecast of wages and salaries and the underforecast of interest rates are the most compelling reasons for the fact that corporate profits were lower than expected. However, one issue that has come up is the influence of LBO activity, which clearly did increase during the 1980's. However, the effect of LBO's on corporate profits is unclear. Because all LBO's to some extent are financed by debt, increased LBO activity is generally expected to result in higher corporate interest payments which, in turn, as you suggested, a lower corporate profit. However, the evidence suggests that LBO's do not have a great impact on total corporate interest payments.

In addition, to the extent that acquired firms are managed more efficiently——

The CHAIRMAN. Let me interrupt, please, on that point for just a minute.

Dr. ROSEN. Yes, sir.

The CHAIRMAN. A lot of the LBO's were quite recent, and considering the filing delay you referred to, I wonder how current your data is?

Dr. ROSEN. For making definitive statements about what has been going on with corporate tax receipts since tax reform, I would say the data are inadequate to make definitive statements. I think anything that anyone could say now is conjectural. I mean, we have some pieces of evidence, and we put together the best story we can, given that evidence, but we don't have the actual tax returns that corporations have filed since tax reform was fully based in; 1988 was the first year, of course, it was fully phased in. So any statements that we can make are certainly preliminary and conjectural.

The CHAIRMAN. Could you further explain why personal income taxes and receipts went up while corporate income taxes went down?

Dr. ROSEN. Yes, sir.

The CHAIRMAN. The economic circumstances affecting them.

Dr. ROSEN. Yes, sir.

The wages and salaries were underforecast in the first budget after tax reform. Now, when wages and salaries go up, that represents a cost to corporations. So with higher wages and salaries, their costs go up, their profits go down, and other things, being the same, corporate receipts go down. But these same wages and salaries go onto the income of individuals. That, other things being the same, increases their tax liabilities. So, at least one possible explanation for the puzzle you mentioned, Senator, is that wages and salaries were underforecast in the 1988 budget.

The CHAIRMAN. One very difficult thing for us is the variance in estimates between OMB and CBO. Your current estimates of corporate tax receipts from 1990 to 1991 are $28 billion higher than CBO's. $28 billion is still a lot of money here.

Dr. ROSEN. Yes, sir.

The CHAIRMAN. Would you explain that for me?

Dr. ROSEN. I am not familiar enough with the details of either model to know why they are so different. I would simply mention that given the good track record that OMB has with respect to its

economic assumptions, at least as of the midsession review, I would be inclined to give the administration the benefit of the doubt.

The CHAIRMAN. Thank you.

Senator Packwood.

Senator PACKWOOD. Dr. Rosen on page 4 of your testimony, referring to your budget projections in the fiscal 1988 budget, you say, "Specifically, real GNP was estimated to grow at 3 percent per year during the period." Is this for 1987 to 1989?

Dr. ROSEN. Yes, sir.

Senator PACKWOOD. You continue to state that the growth was "Significantly below the actual 3.7 percent." Are you saying that in January of 1987, the administration was predicting a 3 percent real growth in 1987, 1988, 1989, and 1990?

Dr. ROSEN. Yes, sir.

Senator PACKWOOD. Real growth?

Dr. ROSEN. Yes, sir.

Senator PACKWOOD. And that the real growth was actually 3.7 percent during the period?

Dr. ROSEN. Yes, sir.

Senator PACKWOOD. Not nominal growth, real growth.

Dr. ROSEN. Correct.

Senator PACKWOOD. So the economy grew faster than we expected.

Dr. ROSEN. Correct.

Senator PACKWOOD. Absent any other factors, this could account for increases in the individual collections, but shouldn't it also have resulted in increased corporate collections?

Dr. ROSEN. Yes, sir. And corporate receipts did go up. They just did not go up as much as had been anticipated.

Senator PACKWOOD. Well, let me ask you, because Nina said she talked with you this morning, and that the forecast that you gave her for 1987, 1988 and 1989 were 4.4 percent, 4.8 percent and 5.1 percent.

Dr. ROSEN. These are the forecasts for——

Senator PACKWOOD. These are the OMB forecasts. The nominal GNP for 1987, 1988 and 1989: 4.4, 4.8, and 5.1.

Dr. ROSEN. That may be the discrepancy, Senator. The numbers in my testimony refer to real growth rates.

Senator PACKWOOD. Those were the projected growth rates I read.

Dr. ROSEN. That's right. The numbers you read I believe are the projected nominal growth rates.

Senator PACKWOOD. As opposed to the projected real growth rates.

Dr. ROSEN. Yes, sir.

Senator PACKWOOD. Thank you.

I was struck by one figure you have here. Roughly, among the OECD countries, 8 percent of total revenues are corporate taxes.

Dr. ROSEN. Yes, sir.

Senator PACKWOOD. Total revenues mean Social Security taxes, Customs' duties, all receipts. In Japan, 23 percent of total revenues are corporate taxes?

Dr. ROSEN. Yes, sir.

Senator PACKWOOD. Based upon the argument we often hear, that we tax corporations too high and capital too intensively, how on earth can Japan compete with 23 percent of their revenues coming from corporations?

Dr. ROSEN. Well, Senator, I think the answer requires that we look at other aspects of their tax system as well, that is, at the whole structure. In particular, I think we also have to look at the way that income generated by capital and income generated by corporations is taxed at the individual level, because the taxation of such capital income also enters into the cost of capital. And what we find is that in Japan, at the individual level, corporate income, when it goes out to the shareholders, is taxed quite a bit more lightly than it is in the United States.

For example, in Japan, the maximum tax rate on capital gains is 20 percent and there is a yearly exemption of 500,000 yen.

Indeed, one academic study that I have seen by Shoven and Tachibonaki suggested that in the early 1980's, when the relation between the total burden here and in Japan was about the same as the one you just mentioned for the late 1980's, they found that it was quite possible that the effective marginal tax rate in Japan, was lower than it was in the United States, despite the fact that the average rate in Japan was higher.

Senator PACKWOOD. Well, here is what I am toying with in the back of my mind. If 23 percent of total Japanese revenues are corporate taxes, and, if we wanted to go to the same level in the United States, we could do a tremendous amount toward eliminating double taxation of dividends. We could probably forego any tax on capital gains and pay for it with an effective 23 percent collection from corporations.

Dr. ROSEN. There are certainly alternative ways to structure the business tax system that would——

Senator PACKWOOD. Roughly, we could almost forego all taxes on individuals investment income? Not wage income but investment income. And, we could put the burden on corporations.

Dr. ROSEN. I have not done that kind of computation, but it certainly sounds like something that would be possible.

Senator PACKWOOD. Well, thank you for the endorsement. [Laughter.]

Thank you, Mr. Chairman.

The CHAIRMAN. Senator, I think you got the pulse rate up on a few of those fellows out there.

Senator Moynihan.

Senator MOYNIHAN. Dr. Rosen, I hope that you will with great expedition bring us the details of the Republican plan to treble the corporate tax rate. [Laughter.]

Just mark it "Republican plan." [Laughter.]

All right. Now, we are getting somewhere I think. [Laughter.]

Can I ask just a question which is almost personal? You mentioned that the actual wages and salaries were higher than expected in your forecast.

Dr. ROSEN. Yes, sir.

Senator MOYNIHAN. Something that just puzzles me is that we still have not gotten median family income back to the 1973 level. And factory wages are lower than they have been since 1966. For

all the prosperity, median family income is still below a 15-year stretch. Now, they were coming back from that dip at 1982, 1983, but could you send us the table of what you forecast and what you find? I am sure you can and I would appreciate it if you did.

Dr. ROSEN. Sir, what we forecast for which year?

Senator MOYNIHAN. For wages, the 5-year period.

Dr. ROSEN. Yes, sir. Would you like it now or would you——

Senator MOYNIHAN. Just send it along. I mean, some part of the committee here is trying to find out why is median family income stagnating for the longest period in American history? There has been no comparable 15-year period. Senator Durenberger and I have talked about this. The depression did not last 10 years; 15 years and nothing has happened to median family income. And there is some redistribution among the quintiles, but I would like just to see what you forecast because your judgment would be as good as anybody's. And if you say that things are better than they were expected, I would like to know what you expected. And maybe you should just comment on that when you get a chance.

Dr. ROSEN. I will comment now if you care.

I am not sure exactly why wages and salaries were higher than were predicted, but we do have the actuals, we do have the predicted, and I would be happy to send them to you.

Senator MOYNIHAN. I appreciate that. Thank you, Mr. Chairman.

[The information follows:]

The following table shows total wages and salaries as predicted in the FY 1988 budget, along with their actual values

CALENDAR YEAR

| | 1987 | 1988 | 1989 |
|---|---|---|---|
| FY 1988 Budget | $2,340 | $2,471 | $2,606 |
| Actual | $2,418 | $2,529 | $2,631 |

As noted in the testimony, the actual values exceeded the predicted values

The Administration does not predict median family income as part of its budget exercises However, it does predict total wages and salaries The following predictions were included in the FY 1991 budget

CALENDAR YEAR

[Billions of dollars]

| 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|
| $2,805 | $2,972 | $3,146 | $3,329 | $3,686 | $3,904 |

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Thank you, Mr. Chairman.

I wanted to disassociate myself immediately from the Republican plan so I can go back and think about it for a little while in the context of the Chairman's reaction and Senator Moynihan's reaction. [Laughter.]

I wonder if I might, Dr. Rosen, just explore with you briefly the issue of wages and salaries as income and as compensation. In general, do you know what percentage of the total expense of corporate activity is represented by this category called wages and salaries?

Dr. ROSEN. I do not know that figure for the corporate sector. For the economy as a whole, it is usually thought to be around 70, 75 percent.

Senator DURENBERGER. Uh huh.

Are you familiar at all in dealing with these kinds of issues with the amount of compensation that is represented not by wage or salary, but is represented by the employer payments on behalf of the employees for a variety of things we commonly characterize as fringe benefits. And what proportion does that represent of total compensation to the workers or the employees of these companies?

Dr. ROSEN. I am sorry, sir, I do not have that figure.

Senator MOYNIHAN. We could use that, couldn't we?

Senator DURENBERGER. It would be very helpful because in the ongoing debate and discussion about what is compensation and what part of compensation is taxed, what part of it is not taxed, thus becoming a sort of an indirect subsidy. I think before we explore Bob Packwood's dramatic change, we probably need to look at what makes up this whole business of the employer's contribution to the employees' income in exchange for the work and the effort. So it would certainly be very, very helpful to have that information.

[The information follows:]

Dr. ROSEN. The attached table shows trends in the ratio of fringe benefits to total compensation over the period 1980-1988. The computations are based on data from the National Income and Product Accounts. For these purposes, "total compensation" is defined as wages and salaries, employer social insurance contributions, and fringe benefits. "Fringe benefits" are defined as "other labor income", which includes employer contributions for pensions and profit sharing, group health and life insurance, workers compensation, and supplemental unemployment.

Since 1980, fringe benefits have represented a decreasing portion of total compensation, ranging from 9.7% in 1980 to 8.6% in 1988. Although fringe benefits have almost doubled since 1980, they have not kept pace with the other components of total compensation.

FRINGE BENEFITS AND TOTAL EMPLOYEE COMPENSATION—PRIVATE DOMESTIC INDUSTRIES

(1980-1988)

| Year | Total compensation | Fringe benefits | Fringe benefits as a percent of total compensation |
|---|---|---|---|
| 1980 | 1,317 | 127 | 9.7 |
| 1985 | 1,899 | 167 | 8.8 |
| 1986 | 2,015 | 178 | 8.8 |
| 1987 | 2,161 | 189 | 8.7 |
| 1988 | 2,341 | 201 | 8.6 |

Department of The Treasury, Office of Tax Analysis

Note Fringe benefits are defined as "Other labor income" from the National Income and Product Accounts "Other labor income" includes employer contributions to pensions and profit sharing, group health and life insurance, workers compensation, supplemental unemployment, and other.

The CHAIRMAN. Thank you.

Dr. Reischauer, would you proceed with your testimony, please?

## STATEMENT OF ROBERT D. REISCHAUER, PH.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. REISCHAUER. Mr. Chairman and members of the committee, it is a pleasure to be here again. I will submit my prepared statement for the record and summarize CBO's assessment of corporate income tax receipts in the post-Tax Reform Act era.

As was expected, corporate income tax receipts grew somewhat faster than the economy over the 1987 to 1989 period. The Tax Reform Act was one contributing factor. It boosted corporate receipts by an estimated $54 billion, or about 24 percent, over this period. Nevertheless, actual corporate receipts for the 1987 to 1989 period did not reach the levels that CBO had projected in 1987.

It appears that the shortfall between actual receipts and those projected by CBO was around $17 billion in 1987, $29 billion in 1988, and $30 billion in 1989. These estimates, I should note, in corporate adjustments for the effects of legislation that was enacted in 1987 and 1988.

Well over half, 58 percent to be precise, of the aggregate 3-year shortfall is attributable to the fact that corporate profits were lower than CBO had projected. Adjusted economic profits, which is the measure CBO uses to approximate the corporate income tax base, were $48 billion below CBO's expectation in 1987, $32 billion below our expectation in 1988, and $98 billion below what we forecast in 1989.

There are several explanations for CBO's overestimate of profits.

First, it turned out that the base which underlay CBO's projections was too high. Shortly after CBO completed its baseline, the Bureau of Economic Analysis revised downward by about $20 billion its estimate of 1986 profits.

A second cause of lower than projected profits during the 1987 to 1989 period was the increased reliance by corporations on debt instead of equity financing.

Finally, the deductible amounts of accelerated depreciation, state and local corporate income tax collections, and the earnings of the Federal Reserve System proved to be larger than CBO had projected in 1987. All of these act to drive a wedge between economic profits and the corporate tax base.

While the bulk of the shortfall in corporate receipts can be related to lower than expected profits, some 42 percent of cumulative shortfall is attributable to other factors. One such factor is the unexpectedly high use of employee stock ownership plans (ESOP's) during the 1987 to 1989 period. As you know, ESOP's can act to reduce tax liability of both the corporation and of the lender to the ESOP. These preferences were reduced in 1989.

A second factor is the increased use of the S corporation and partnership forms of business organization which allow income to be passed through to shareholders or partners, thereby avoiding taxation at the corporate level. While these factors reduced corporate profits and corporate tax receipts, it should be noted that they acted to boost personal income, particular personal business and interest income and capital gains. Thus, some of the loss in corporate tax receipts has been offset by higher individual income tax re-

ceipts which have been running above the levels that CBO anticipated in January 1987.

A third factor contributing to the shortfall is the failure of the Tax Reform Act of 1986 and the other 1980's tax legislation to boost receipts as much as CBO had projected in January of 1987.

CBO's current $54 billion estimate of the revenue gain for the corporate provisions of TRA over the 1987 to 1989 period is some $19 billion below the estimate incorporated in CBO's January 1987 baseline. This 25-percent reduction is the result of offsetting revisions for the different provisions of the act. Corporate base-broadening provisions are now credited with smaller revenue gains than originally estimated while the tax rate reduction is charged with smaller revenue losses than originally estimated.

CBO's revised estimates of the effects of TRA are largely based on new macroeconomic data. For example, more recent National Income and Product Account data suggest the depreciation deductions claimed under TRA rules are larger than originally estimated. In addition, more recent data on investment activities suggest that the estimates of pre-TRA investment tax credits and, therefore, TRA's revenue gain from repealing the credits, were too high. Revisions based on these data reduced the estimated pickup in revenues from the TRA capital cost recovery provisions.

Let me wrap this discussion up by saying a few words about the outlook for corporate receipts for this year and next.

In our January 1990 baseline estimates, we projected that total corporate income tax receipts would be flat this year, totaling $102 billion, compared with the $104 billion collected in fiscal year 1989. This estimate reflected delayed effects of the drop in corporate profits that occurred in 1989.

CBO expects corporate receipts to resume their growth in fiscal year 1991, increasing by about 9 percent to a level of $111 billion.

The CBO baseline estimate for corporate receipts is some $10 billion below the administration's estimate for 1990, and $18 billion below the administration's estimates for fiscal year 1991. But for the current fiscal year, even CBO's lower estimate of $102 billion may prove to be a bit optimistic.

The daily and monthly collections data show corporate receipts running several billion dollars behind the pace assumed in the CBO baseline.

While the tally of current fiscal year collections remains subject to a good deal of uncertainty as the final months of the fiscal year unfold, we should end up with a number that is quite close to CBO's baseline unless profits recover much sooner and much more vigorously than the consensus of private economists and CBO thinks at this time. In keeping with CBO's tradition, let me conclude on that pessimistic note. [Laughter.]

The CHAIRMAN. Dr. Reischauer, I have experienced some of your optimistic estimates in the past too.

Dr. REISCHAUER. The lesson from that, I guess, is never to be optimistic even in the Medicare area.

The CHAIRMAN. Why do you think that corporate profits will resume their upward climb?

Dr. REISCHAUER. We expect corporate profits to rebound, although not vigorously, following the bad experience of 1989. That

should help boost corporate tax receipts. We are not expecting corporate tax receipts to rise really any faster than the growth of the economy as a whole. So we are not presenting a highly optimistic scenario here for corporate tax receipts. We are just saying that they will rebound from a low point, in 1989, beginning in 1990, the current fiscal year.

The CHAIRMAN. Doctor, I have been advised that U.S. subsidiaries offoreign-owned corporations pay less tax on the same gross amount of sales—substantially less—than U.S. corporations in the same line of business.

Dr. REISCHAUER. Yes.

The CHAIRMAN. The concern is that, through intercompany pricing, the profits are attributed to the home corporation, the foreign corporation, enabling the foreign-owned subsidiaries to escape a lot of taxes.

Do you have any evidence of that?

Dr. REISCHAUER. Mr. Chairman, I have heard those reports and arguments, and they certainly sound plausible. But the data necessary to examine that sort of question are not available to CBO. You would need individual returns from corporations, and in effect you would have to examine their books. That can really only be done by Treasury or by the Joint Committee on Taxation.

The CHAIRMAN. I found your testimony quite interesting and a little more definitive than what I had heard from Treasury. But, I would like to see if we can narrow it down some more and get some better information. Could CBO with the Finance Committee to further develop the reasons why corporations are paying much less than anticipated. Can you do that for us?

Dr. REISCHAUER. We would be glad to cooperate and try to put together a more detailed explanation.

The CHAIRMAN. I think you have a good start here. Break it down; give us, some additional reasons. You attribute a little more weight to LBO's than Treasury in your statement.

Dr. REISCHAUER. There is a question on whether we should regard this as LBO activity, in particular, or just an increased emphasis on debt, because LBO's can have an offsetting effect in increasing efficiency.

The CHAIRMAN. Well, sometimes companies went heavily into debt to protect themselves against LBO's.

Dr. REISCHAUER. Yes.

The CHAIRMAN. Right.

Dr. REISCHAUER. Correct.

The CHAIRMAN. All right. Thank you.

Senator Packwood.

Senator PACKWOOD. Doctor, looking on page 12 of your testimony, it doesn't seem to me that CBO is actually so far off on the projection of corporate receipts expected under tax reform over the first 5 years. If I read it right, in January of 1987, over the 5-year period, the projections add up to a total increase in corporate tax revenues under tax reform of $121 billion.

Dr. REISCHAUER. This is page 11 where we are talking about the effects of——

Senator PACKWOOD. Comparison of CBO Estimates of Corporate Provisions in the Tax Reform Act is the major title.

Dr. REISCHAUER. Right. Yes.

Senator PACKWOOD. Okay, if I add your 1987 estimate, it comes to $121 billion over 5 years. In 1990, after taking into account what has actually happened since 1986, CBO projects tax reform would increase corporate income tax receipts by $109 billion over 5 years, so your 1987 project was not very far off.

Dr. REISCHAUER. Well, I like to think that the glass is more than half full if that is what you are pointing out. I think the important point to emphasize is that when the Tax Reform Act was passed it was intended to shift the tax burden toward corporations and away from individuals. Unquestionably, that was the effect. And it did succeed. It did not move quite as far as the Treasury or the Congressional Budget Office or the Joint Committee on Taxation thought it would at the time. But in making these sorts of estimates, we are terribly uncertain. The estimates depend on behavioral responses in the economy, they depend on the rate of growth of the economy, and they depend on the level of foreign investments in the country. So I think by and large the objectives of the act in that respect were fulfilled.

Senator PACKWOOD. Thank you, Doctor. Thank you, Mr. Chairman. I have no more questions.

The CHAIRMAN. Thank you, gentlemen. Thank you for your testimony.

[The prepared statement of Dr. Reischauer appears in the appendix.]

The CHAIRMAN. Our next panel will consist of Dr. James Poterba, professor of economics at MIT; Mr. John Wilkins who is the director of tax policy for economic analysis for Coopers & Lybrand, and Dr. George Plesko, who is assistant professor of economics, Northeastern University. Gentlemen, if you would come forward, please.

Dr. Poterba, if you would lead off with your testimony, please.

## STATEMENT OF JAMES M. POTERBA, PH.D., PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MA

Dr. POTERBA. Thank you, Mr. Chairman. My name is James Poterba, and I am a professor of economics at the Massachusetts Institute of Technology.

It is a great pleasure to have this opportunity to testify before this committee on the factors which explain the long-term decline in corporate profit tax receipts in the United States and potential policies which might address them.

I will have three points in my testimony this morning.

First, unlike some of the other panelists, I will provide a somewhat longer term perspective on why corporate profit tax receipts are now much smaller as a share of GNP or relative to corporate assets than they were during the 1960's and the 1970's.

As some of the early witnesses have suggested, much of that variation is due to changes in the corporate profit rate and not in the statutory taxation of corporate income.

The second point I will address, although more briefly, is what explains the shortfall since the 1986 projections. Again as the earli-

er witnesses note, it is difficult using published data at this point to reach a firm conclusion on this issue. The results I have, though, suggest that leverage increases since 1986 have been quite an important part of the shortfall relative to the initial projection.

And, finally, I will make brief comments on the direction in which one might take reform in an attempt to raise corporate tax receipts.

Let me begin, however, by taking a longer term perspective on the relationship between Federal corporate profit tax receipts and other measures of aggregate economic activity.

Federal corporate profit tax accruals, excluding those contributed by the Federal Reserve Board, averaged 3.8 percent of GNP during the 1960's. They fell to 2.7 percent during the 1970's; 1.6 percent in the first 5 years of the 1980's, and rose slightly but to only 1.7 percent of GNP for the 1986 to the 1989 period.

In 1989, for example, the tax to GNP ratio was 1.6 percent, well above the level of 1.2 percent at the low point in 1982, but below two-thirds of the level at the end of the last decade and only 40 percent as large at the level in 1960.

The question we then turn to is what explains these long-term changes. And here it is essential to remember that corporate tax receipts are in fact the product of two things: the average tax rate on corporate profits, and the size of corporate profits relative to the economy as a whole.

The calculations which I have done in conjunction with Alan Auerbach at the University of Pennsylvania suggest that more than two-thirds of the long-term change is in fact attributable to decline in the corporate profit rate, and less than one-third can be accounted for by changes in the actual structure of corporate taxation.

Unfortunately, economists have little to contribute on the question of why corporate profits have fallen. We are much better at understanding how the corporate tax rules affect revenues. But that does not take away from the fact that a very big part of this change is in fact due to factors which are simply outside the purview of the Tax Code.

Of the factors in the Tax Code, the most important factor explaining the change between the previous decades and the early 1980's was the revision in capital recovery provisions in the 1981 Act. Changes in 1986, at least in the steady state, will undo much of the 1981 reforms.

My preliminary estimate suggests that the average corporate tax rate has in fact increased since 1986 by as much as 10 percentage points.

That brings us to the second point, which is why in the face of that, revenue yields have in fact not been as large as projected. Part of the answer, as the earlier testimony suggests, is that corporate profits have not been as robust as they were forecast to be. That does mean that they are lower than they were in the early 1980's, just that the projections in 1986 might have been too optimistic, given what actually has transpired since.

Second, however, there have been fundamental changes in financial policy of corporations. Not just leverage buyouts, of course, but

simple debt for equity swaps that may or may not be related to takeovers or even takeover pressure.

During the period since the enactment of the 1986 Act, nearly $500 billion of corporate equity has been replaced with corporate debt. If debt pays an interest rate of say 10 percent, that is an immediate deduction of something like $50 billion from the corporate tax base. And that I think has quite an important effect on the actual revenue yields that we observed.

This, of course, is also a long-term effect. Unlike corporate profits which may fluctuate up and down, fundamental changes in corporate financial policy last for a long time.

It is an important footnote that changes in corporate financial policy may affect other tax receipts elsewhere in the system, particularly with interest income tax receipts at the personal level. Unfortunately, I have not been able to do a full calculation of those effects.

The final point I would address is how, if one is concerned with the decline in corporate taxes as a share of GNP, one should proceed. To echo something which the economics profession is nearly unanimous on, there are two directions for reform. One is by changing the tax rate on old capital, the other is by changing the tax rate on new capital.

The 1986 Act, by lowering the statutory tax rate on profits conveyed a windfall to the owners of the existing assets in the corporate sector. Existing capital is the kind of capital that is very hard to encourage more of.

From the perspective of international competitiveness, it is much more attractive to make policy changes which would reduce the marginal cost of new projects and the marginal cost of funds, encouraging new rather than old capital. That suggests, if anything, that changes in the statutory corporate rate and not further changes to make depreciation provisions less attractive would be a natural way to proceed. Thank you very much.

The CHAIRMAN. Thank you. Dr. Plesko.

[The prepared statement of Dr. Poterba appears in the appendix.]

STATEMENT OF GEORGE A. PLESKO, PH.D., ASSISTANT PROFESSOR OF ECONOMICS, NORTHEASTERN UNIVERSITY, BOSTON, MA

Dr. PLESKO. Thank you.

I will only address three issues today that I think are of the most concern to the committee, and that is to quickly review what it is Tax Reform was supposed to do, give you a brief overview of what has actually happened since 1986, and then, finally, by coupling my opinion with what Treasury and CBO have already said, give you some idea as to why there are some observed differences from what was expected.

I will refer to some of the tables in my prepared statement if you want to follow along, although I will present the data as we go along.

The first thing is, what was Tax Reform supposed to do? As we have already heard this morning, and if you look at table 1 of my prepared statement, Tax Reform was expected to increase corpo-

rate receipts on the order of $24 to $29 billion a year. And this was to be done in a revenue neutral way, such that any of the additional revenue that was earned on the corporate side should have been paid back through tax reductions on the individual side.

Clearly, however—and if you look at table 2 in my testimony—some of the subsequent estimates of tax reform in the Tax Reform bill have suggested that in total, Tax Reform has not raised quite as much money as it was supposed to.

In looking at table 3, and in trying to find out what it is that motivates the current concern that we have over tax reform, it is really quite apparent. If you just look at corporate receipts since 1986, and that since the 1986 Act, and compare them to what was projected in 1986 before Tax Reform, you find that receipt levels are about what they were expected, which leaves, obviously, the question of what happened to the $24 to $29 billion of receipts the Tax Reform was supposed to bring in.

The way in which that can be explained—I'll at least try to look at that in a couple of different ways—is twofold. In order to get a handle on exactly how much the shortfall in receipts is, the first thing we have to do is try to get an idea of what it is Tax Reform actually did. If on the surface it looks like Tax Reform raised nothing, then we certainly have to ask the question if is it that Tax Reform did anything. And if we are going to try to find out what it is Tax Reform did, we want to try to specifically quantify the amount of additional revenue gained by Tax Reform.

In table 4 of my testimony, I lay out and produce some rough calculations of how much revenue we would have expected Tax Reform to have raised.

If you look to the 1984 to 1986 period, and you look at corporate receipts as a percentage of GNP, you find that on average it was about 1½ percent of GNP.

Since 1986, the percentage of GNP that is paid in corporate tax receipts has jumped to about 1.9 percent, clearly because of not only the Tax Reform Act but also the three subsequent tax bills of 1987, 1988, and 1989. Those three bills themselves were expected to raise approximately $8 billion when you combined the three of them.

So, clearly, Tax Reform has had some effect, probably on the order of magnitude of about $20 billion a year over what would have been collected in the absence of Tax Reform. However, that leaves a second question.

We were still expecting tax reform to raise $24 to $29 billion. At best, we can attribute approximately $20 billion a year to Tax Reform. Obviously, an important question is what has happened to the other $10 billion? This question has already been addressed by Treasury and by CBO.

The primary reason for the shortfall, that additional shortfall, or what I would refer to as a residual shortfall in corporate tax receipts, is most likely due to the decline in corporate profits.

If you look—and again, in my prepared statement—if you look at figure 1, this is shown graphically. There has been an enormous reduction in the amount of profits of corporations as compared to the projections made around the time of Tax Reform.

In August of 1986, the Office of Management and Budget projected 1988 corporate profits of $356 billion. The most recent figures reported by the Bureau of Economic Analysis report that actual profits came in at $307 billion, fully $49 billion lower than anticipated. To the extent that an additional dollar of profits may generate 20 to 25 cents to the Federal Government, that is approximately $12 billion a year in revenue that is not being realized because the corporate profits forecast in 1986 was wrong.

In addition, I would like to add that there are other assumptions that should be looked at apart from corporate profits, GNP, and the interest rate assumptions which have been talked about today.

On the whole, whenever you look at CBO or OMB, and you look at the aggregate forecast they made for items such as GNP and personal income, they tend to be fairly accurate because that is aggregate data which can be forecast relatively easily. However, as we get into a disaggregated forecast, the accuracy of each of these agencies deteriorates rather rapidly. In addition, there are substantial forecast parameters which are not presented and which are not made public.

As CBO pointed out, one of the factors which would affect the amount of money we raised from Tax Reform was the forecast of investment. Now, this is a forecast which is not published and is not made available to the general public. To the extent that the forecast of investment back in 1986 overestimated the amount of investment that would take place, that clearly would also have overstated the amount of revenue that would have been raised by Tax Reform through the repeal of the investment tax credit.

Now, in addition to that, I would like to comment at least on two other factors which may be affecting corporate receipts. The first, which has already been touched upon, is debt. And I won't spend much time on that except to reiterate the point that clearly as leverage has increased, that will decrease corporate profits. And that as you decrease corporate profits, you will decrease receipts.

The second one, however, is S corporations. To the extent that there has been a movement away from the corporate sector—the corporate taxable sector to the non-corporate sector—that would clearly also decrease the amount of corporate revenue in the system.

Thank you.

The CHAIRMAN. Thank you.

Mr. Wilkins.

[The prepared statement of Dr. Plesko appears in the appendix.]

**STATEMENT OF JOHN G. WILKINS, FORMER VICE CHAIRMAN, COMMITTEE ON FISCAL AFFAIRS, ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, AND DIRECTOR OF TAX POLICY FOR ECONOMIC ANALYSIS, COOPERS & LYBRAND, WASHINGTON, DC**

Mr. WILKINS. Thank you, Mr. Chairman. I am John Wilkins. I am a partner in the accounting firm of Coopers & Lybrand. Until February of this year, I was Senior Advisor to the Treasury, Assistant Secretary for Tax Policy, and last year for a time was acting Assistant Secretary.

Prior to leaving Government service, I was vice chairman of the OECD's Committee on Fiscal Affairs, which is responsible for tax matters and tax statistics, such as those that Dr. Rosen mentioned this morning.

I am here to discuss the role of the corporate income tax in the United States, and to try to place it in perspective with taxes of some of our major competitor nations. In order to do that, I am going to cite OECD tax statistics throughout my testimony.

For reasons explained more fully in my written statement, Mr. Chairman, comparisons of relative corporate tax burdens among countries can be misleading if made simply on the basis of relationships of corporate tax revenue to total revenue.

Like the United States, most of the developed countries have experienced declines in the share of corporate tax revenue over time. However, when you combine individual and corporate income tax revenues and compare them to some stable measure of economic activity, such as gross domestic product, all of the OECD countries report increased income taxes over the period I have examined, 1965 to 1987.

A note, first, on the comparability of data. Almost all of the data cited by witnesses you have heard this morning has referred to U.S. Federal taxes—relative to GNP in some cases. Because the extent to which countries rely upon State and local taxes differs widely around the world, you cannot make intercountry comparisons unless you also include those taxes in the total.

Chart 1 and table 1 of my statement show that these can be quite different. Look at the Federal countries compared to the unitary countries. You cannot compare, for example, the U.S. Government's Federal tax, which is only 57 percent of total U.S. taxes, with the United Kingdom, which is a unitary country with a central government tax of 87 percent of total revenue because the UK does not have State taxes.

Among the OECD countries, the U.S. has a relatively high reliance on the corporate income tax. This is the same figure that Dr. Rosen mentioned. In 1987, corporate income taxes amounted to 8.1 percent of total tax revenues, compared with a 7.9 percent average share for all OECD countries. This is on table 3 of my testimony.

Only 7 countries out of the 22 for which data are available have a higher reliance on corporate income taxes to finance their governments.

Nonetheless, as you are aware, Mr. Chairman, the United States has experienced declining corporate income tax revenues as a share of total government revenue, and this has been going on since 1965. The United States, however, is not unique. Taken as a group, the OECD countries have undergone decline over that same period, shown in the last column of table 3 in my testimony.

Individually, 14 of the OECD countries reporting corporate income tax data, experiencing decline in the corporate share by total government revenue.

As shown on chart 3, these decreases range from 12 percentage points for New Zealand, which is at the bottom of the chart, up to decreases for the United States of 7.7 percent, and still smaller decreases for some other countries. There were a few countries, but not very many, that had increases over this period.

At this point, I want to give a word of caution. These apparent declines can be a little bit misleading. For purposes of international comparison, simply viewing corporate tax revenues as a share of total government revenues has two faults. First, the total revenue basis of comparing can be an apples and oranges comparison because the total revenues can change for a reason quite unrelated to the corporate tax burden. You could have a very stable corporate tax structure in your country but have something else changing, such as an increase in a value added tax or a sharp increase in Social Security taxes. So the denominator is not a stable measure.

Second, the revenue impact of corporate integration plans which most of the countries have introduced, at least in part, over this period that I am examining, is generally scored as a reduction in individual taxes rather than a reduction in corporate taxes. So it throws off our comparison if we are looking only at corporate taxes.

Now, to correct for these shortcomings, what I have done on table 5 and on chart 5 is to simply combine individual and corporate together, and to look at those as a percent of gross domestic product. Unfortunately, we don't have comparable international measures, of corporate profits, but we do have gross domestic product. Relative to gross domestic product all countries have experienced income tax increases over the period 1965 to 1987. However, those increases have varied considerably.

Turning from average tax rates to effective marginal tax rates on new investment, where low rates are generally considered desirable for reasons Professor Poterba mentioned—because they reduce the cost of capital and they attract globally mobil new investment which ultimately is the source of new revenue. The United States ranks favorably low. I do not have international comparisons in a table but a preliminary OECD study shows the United States probably ranking around seventh, that is, seventh best. In other words, our effective marginal tax rates are on the low side as compared to other countries.

In conclusion, Mr. Chairman, relative to other countries, the United States has a high reliance on the corporate income tax, but is within the range of most competitors. The UK and Italy are 3 percentage points higher; Germany and France are 3 percentage points lower.

Thank you.

[The prepared statement of Mr. Wilkins appears in the appendix.]

The CHAIRMAN. Well, I must say, Mr. Wilkins, one would have to study your testimony in some detail. It is really quite interesting, but shows the complexity involved.

Dr. Poterba, in the shift from equity to debt, you quite justifiably said that it is not all attributable to LBO's and defenses against LBO's. But, how else is it driven and motivated? Is it because interest expenses are deductible and dividends paid are not?

Dr. POTERBA. Yes, Mr. Chairman. I think a good deal of recent financial change has in fact been due to tax factors. Not necessarily the changes in the 1986 Act as much as the combined effect of the 1981 and the 1986 Acts. The net attractiveness for a firm to use debt finance as opposed to equity finance depends on the total tax

burden which the debt or equity holders will pay on a dollar earned in the corporate sector.

Since the debt holders' tax burden depends a great deal on the top marginal rates on the personal side, the changes first from 70 to 50 and then from 50 to 28 have radically lowered the tax take on a debt financed project. Although there are offsetting changes to some extent on the equity side—a lower corporate rate, in particular—those changes are not nearly as large. I suspect what has happened, is that it just takes corporate managers a while to catch up with what the ideal policy is. Much of what we have seen during the late 1980's has, in fact, been driven by the now very substantial tax gain associated with using debt versus equity.

The CHAIRMAN. Well, I suppose that is true. Of course, there is an offsetting factor. If you have equity financing, you have a better cushion to carry you through a recession and your company is not in danger. On the other hand, if you have a great deal of equity or cash, you are a much more attractive target for corporate raiders. I don't know how you weigh that as a chief executive.

Dr. POTERBA. Frankly, it is very difficult. I think we know that a firm with more debt does put the managers under somewhat more stress. I have seen a study suggesting the heart attack rate at CEO's at LBO firms is higher than that at firms that have not been involved in such transactions. Frankly, it is very hard to calibrate the cost of reduced slack on those many unmeasured margins in terms of ability to undertake projects without being constrained by the capital market and in terms of flexibility. But there have been no changes that I can think of which radically alter these parts of the debt-equity equation, while tax side really has changed a lot in the last decade.

The CHAIRMAN. Dr. Plesko, you said the move toward Subchapter S is one of the reasons that corporate taxes are lower. Aren't those generally smaller corporations, that wouldn't have much of an impact on revenues of the Treasury? What about large corporations that become highly leveraged as a defensive measure against LBO's or takeovers? Wouldn't higher corporate debt levels have a greater impact on receipts than Subchapter S conversions?

Dr. PLESKO. Let me address your first question having to deal with the impact of S corporations. I was quite surprised when I started looking at S corporations a few years back because I had always thought them to be small, possibly that sophisticated except that they have a good enough accountant or a tax attorney to make sure that they knew what an S corporation was.

In my prepared statement, I present a little bit of data on small C corporations, and these would have been the corporations most likely to want to bail out of the taxable corporate sector after 1986 and into S status. Figure 2 in my testimony shows the amount of interest in becoming S corporations.

If you look at 1986 tax return data, and you look only at corporations that have assets of $100,000 or less—again, the typical small corporation—you find that they were responsible for approximately $4 billion in tax before credits, 3.6 percent of the total Federal receipts from the corporate sector. Now, I am not implying that all of them would have——

The CHAIRMAN. What percent of corporate receipts?

Dr. PLESKO. 3.6 percent of tax before credits. Now, I have not adjusted that—it is hard to adjust that for their net tax liability after credits. But again, it is a substantial amount of revenue and it surprised me when I first looked at that.

If you raise that threshold up to $1 million in assets or less, you move from $4 billion in tax before credits to $8.5 billion in tax before credit. Now again, in 1986, you are talking about nearly 8 percent of Federal corporate tax before credits.

The CHAIRMAN. And, of course, Subchapter S corporations, as I recall, are limited to 35 shareholders. That has to limit conversions.

Dr. PLESKO. Well, 35 shareholders—and that was the limit that was adopted under the Subchapter S Revision Act of 1982—seems to be something that would affect a lot of these corporations. Certainly for the corporations that are already Subchapter S, it is not at all a limiting factor. The average number of shareholders in an S corporation is only about 1.8. If you look at corporations with 10 shareholders or less——

The CHAIRMAN. The average number of shareholders is 1.8.

Dr. PLESKO. Is about 1.8 to 2.

If you look at Subchapter S corporations with 10 shareholders or less, you have well over 80 percent of all S corporations. The 35 shareholder limit is not much of a constraint on most of these corporations.

I see the red light up, but let me just quickly talk about ESOP's. I agree, and I understand, the concern with looking at ESOP's, but as you addressed the question to me, I don't have a very good handle on the extent of the reduction in tax liability.

S corporations, I think, is something that needs to be looked at further.

The CHAIRMAN. Thank you.

Senator Packwood.

Senator PACKWOOD. Mr. Wilkins, I am glad you were using OECD figures because I find them about as good as any that exist in comparing country to country to country.

On page 2 of your charts you show total tax revenue as a percent of gross domestic product. In every country shown, from 1965 onward, taxes have increased as a percent of gross domestic product. Some more than others, but they increased in all countries. Is that correct?

Mr. WILKINS. That's right.

Senator PACKWOOD. As a matter of fact, I have run these charts myself and taken them back to 1950. In the United States, taxes collected by all governments—State, local, and Federal—as a percent of gross domestic product in 1950 was around 20 percent. And we are at about 30 percent now. Does that belie the argument that tax increases should be used to narrow the deficit? They don't historically seem to have resulted in narrowing the deficit even though we have had substantial tax increases.

Mr. WILKINS. Well, I think that's right. Unfortunately, I don't show for these other countries what their deficits are, so we cannot see——

Senator PACKWOOD. As a matter of fact, I have got them, but I don't have them with me. In all cases, taxes are up, and expendi-

tures are up, and in all cases, with one or two exceptions, they are all still running deficits.

Mr. WILKINS. Yes. That doesn't surprise me at all. While the United States has probably had less of an increase than many of the other countries, some countries such as Sweden, have gone up 21 percentage points over my period of analysis, and they certainly have not been running enormous surpluses up to this point in time. So I think your observation is exactly correct. Despite large increases in taxes, in a number of these countries it has not necessarily followed that they have reduced their deficit problems and created surpluses.

Senator PACKWOOD. Well, as a matter of fact, in the United States in 1950 we were taxing 20 percent of the gross national product and we were spending 22 percent. And now we are taxing 30 percent and we are spending 32 percent. So we have had a large increase in taxes and a large increase in expenditures and the deficit continuing on up. So I am curious as to how we can be assured, in your judgment, or how can the argument be made with any feeling of safety, that if we increase taxes we will reduce the deficit?

Mr. WILKINS. Well, I personally don't subscribe to that as being the best way to reduce the deficit. Part of the reason is because it is a bit like shooting ourselves in the foot. If we start raising our tax rates above where we have managed to get them—which is pretty much the envy of the world right now—it will simply hurt us more on competitiveness and cost-of-capital type arguments. In the long run, I suspect that is going to hurt revenues more than it will help revenues. So I don't believe that the best way of reducing the deficit is raising taxes, I would prefer us doing it through the expenditure side.

Senator PACKWOOD. Now, let me ask if Doctors Poterba and Plesko agree with that.

Dr. POTERBA. Well, Senator, I think it is very difficult to simply look at taxes and spending as a share of GNP and draw firm conclusions about how changes in either will translate into the deficit.

There is an accounting identity that says that if we raise taxes without doing anything else, we will in fact have an effect on the deficit, and we know there is no real alternative to fiscal responsibility on this set of questions.

I think cross country comparison evidence actually does not tell us a great deal about whether or not if we pass a tax increase today, that would translate into a spending increase. I think it depends a great deal on the political dynamics at the time when the actual tax change takes effect.

Senator PACKWOOD. But all we can say is that in the past, tax increases have led to increased spending, not deficit reduction.

Dr. POTERBA. I would be somewhat weaker and say that tax increases and spending increases have tended to go hand in hand. I think it is very hard to say that one causes the other.

Senator PACKWOOD. Dr. Plesko?

Dr. PLESKO. I really don't have anything further to add. I find the argument that an increase in taxes automatically leads to an increase in spending to be a very difficult argument to try to support with the evidence. It doesn't seem to me that that necessarily has to follow.

Senator PACKWOOD. But, it just always has followed.

Dr. PLESKO. Well, part of the problem with looking at the data as you are looking at—you are not looking at the fact that people see revenue coming in or you have an immediate tax increase and go out to spend it—you have so many other factors that affect Federal spending over time, regardless of what the amount of revenue would have been.

Certainly if you think that the relationship works one way, you might want to ask the question of why it does not work the other way. And the decrease in receipts we had in the early 1980's certainly didn't lead to an enormous reduction in government spending at that time.

Senator PACKWOOD. Mr. Wilkins, let me ask you another question. In looking at your table 2 from number 16, Austria, downward, all the countries are above 40 percent taxation. Over 48 percent, in the Nordic countries, 44 to 46 percent in Luxemberg, France, and Belgium—how on earth can these countries compete internationally, while the government takes that much of the total gross domestic product of the country out in taxes?

Mr. WILKINS. Well, I think there are two things you have to think about when looking at this. One, it does not show necessarily that marginal rates are going to follow what these average rates are. So at the margin they might be a bit more competitive than they would appear to be looking at average rates. I don't know that for a fact, but that is a possible answer.

Senator PACKWOOD. Are you saying that the total level of taxation in the country is not as relevant as who pays the tax?

Mr. WILKINS. The total level is not as relevant if you are looking at competitiveness, which relies more on marginal concepts. Where are we going to be able to attract new investment? Where are we going to attract companies coming into the country? To answer these questions you want to look at the marginal rate on investment and not simply the average rate.

The other point I was going to make, Senator Packwood, is simply that we are looking here at very different philosophies of government and social systems. And I am not going to say that one is better than another. Some countries clearly like to do much more for their citizens through government than others do. So those that have these very high tax rates also tend to provide in many circumstances much more in the way of public services than some of the countries with very low tax rates. I cannot comment and say one is right and one is wrong. We all have our preferences.

Senator PACKWOOD. Thank you. I will wait for another round. I have one more question to ask.

The CHAIRMAN. All right.

Senator Danforth.

Senator DANFORTH. I would like for each of you in turn to give us your net assessment, adding together the pluses and minuses on whether you think the 1986 Tax Act was good for business or bad for business.

Dr. POTERBA. Well, Senator, my answer is largely couched in terms of this new capital, old capital distinction which I alluded to at the end of my testimony. The rough direction of the 1986 Act was to make it less attractive to undertake new investment

projects and to collect revenue from those projects, partly using that to finance windfall give-backs to the owners of existing assets by cutting the corporate tax rate.

Although investment has remained reasonably strong since then, there is very little doubt in my mind that the net effect of those changes, was to discourage some types of investment—particularly the changes in the investment tax credit and the lengthening of depreciation laws.

So it seems to me that answering the question good or bad for business is a bit broad. Good or bad for the kinds of investments that we may well think are very important for national competitiveness, I think the net effect was negative and we just have to wait a little bit longer to get detailed numbers to know just how we can take apart those effects and calibrate that.

Senator DANFORTH. Dr. Plesko?

Dr. PLESKO. I think that the answer to that is you will get several different answers to that if you ask several different business persons of how they were affected by Tax Reform, certainly anecdotal evidence, and just talking to people who are in the business community. I have heard everyone saying that this is one of the greatest things that happened to them to being something that has affected them very adversely.

In the context of the overall effect that Tax Reform has had on American business and what effect it has had, for example, on their tax burdens, the work that has been done recently, and some work that I had done in looking at what has happened to the marginal tax rates facing corporations—which is going to be the variable they look whenever they are looking at either additional debt or additional income—is that, on average, Tax Reform has not done that much to the average marginal tax rate that will be paid on an additional dollar of income by a corporation.

What it has done—and I think an important feature of Tax Reform that we are going to be seeing as data becomes available—is that you don't see the wide variation in marginal tax rates. You don't see some companies paying 43 percent on the margin and some companies paying 11 or 12 percent on the margin. What you tend to see now is all companies paying reasonably similar amounts of marginal tax rates. And certainly in terms of looking at marginal investment decisions, the fact that all corporations are facing about the same rate makes it easier for people to try to factor out the tax considerations of the next investment that they may make.

Senator DANFORTH. When that has been factored out, but that doesn't say whether it is positive or negative, does it?

Dr. PLESKO. No. Well, given the fact that the average marginal tax rate its face has not changed that much—maybe only 1 or 2 percent I think after Tax Reform—it doesn't seem the Tax Reform would have a very substantial deleterious effect on business in this country.

Senator DANFORTH. Mr. Wilkins?

Mr. WILKINS. I was involved in the Tax Reform process at Treasury, so maybe I have more of a bias. I think there are clearly pluses and minuses. We raised the cost of capital. That was clearly a minus for business. However, it was better allocated in Tax

Reform. That is the only way we feel we are getting some growth as a result of Tax Reform. The tax rates went down sharply, got a lot of people out of tax shelters, and put investments where they ought to be. That's good for business.

As far as coming out with a simplified system, we have clearly failed, especially on the business side. The complications, I think, are horrendous.

The rate inversion we have now, whereby the corporate rate is higher than the individual rate, couple with our double tax on corporate equity income, creates problems that I think it is a shame that we didn't resolve in Tax Reform. That is driving a lot of people out of the corporate sector and into Subchapter S corporations and partnerships that they otherwise wouldn't choose. Absent the corporate tax bias, they would want to be corporations.

On balance, I think I like the results of tax reform. I like the fact that we got the rates down as sharply as we did. And I think the very fact that we see the rest of the world copying us is probably a good endorsement.

Senator DANFORTH. Where do you think we should go from here? Dr. Plesko?

Dr. PLESKO. On the corporate side?

Senator DANFORTH. Yes.

Dr. PLESKO. I think that one of the most important things we ought to be looking at on the corporate side is to deal with the issue that we have and we continue to have, a double tax. I think that enough thought has been paid in the past to the idea of integrating the corporate and individual tax systems, and I think that there is a long-term direction on what should be done with the corporate tax system. I think that we could achieve a better tax system in the long run if we start thinking now about the fact that we should be developing a plan towards corporate integration.

Senator DANFORTH. Dr. Poterba?

Dr. POTERBA. I would actually favor restoring some form of accelerated investment incentives, perhaps on an incremental basis to avoid the potential revenue cost of an across the board investment tax credit. And I would, if necessary, actually finance that with higher corporate statutory rates to try and undo some of this old capital, new capital distinction that was built in 1986.

I think it is also very important to try to avoid somewhat arbitrary policies which might, for example dealing with leverage issues, have the effect of unintentionally affecting our competitiveness in cost of capital.

An example of that is that in trying to address the debt for equity incentives that are currently built into the Tax Code, there are several ways one could play. One is to try to eliminate deductibility for some types of interest at the corporate level related to particular transactions. Another would be to try and level the playing field by lowering the tax burdens on equity. It would be much more attractive to try to lower the tax burden on equity rather than to set up a set of distortions which would affect the debt equity margin in somewhat unclear ways.

As a long-term perspective, some type of integration may be an attractive way to go, but I know that there are serious revenue issues which will stick in the minds of everyone in this room.

Senator DANFORTH. My time is up. Mr. Wilkins, do you have a 15 minute, or 15 second—— [Laughter.]

Can you squeeze 15 minutes into 15 second?

Mr. WILKINS. I could go either, 15 minutes or seconds. In 15 seconds, my number one priority I think at this point would be integration. There are only 5 countries out of the 23 in the OECD that don't have some form of integration. And we are competing in this kind of a world. We just have got to get our cost of capital down, and not double tax our corporate equity.

There is a problem with how you pay for it, I would hate to see rates, either individual or corporate, raised at this point. But I think that is something you have to think about as you are developing an integration proposal. We cannot have integration at the expense of a higher deficit.

The CHAIRMAN. Thank you very much, gentlemen.

Senator PACKWOOD. Could I ask just one more question, Mr. Chairman?

The CHAIRMAN. Oh, yes, of course.

Senator PACKWOOD. Mr. Wilkins, again on your tables about the OECD countries and the high taxes in France, or in Europe generally, you said it depends upon where the taxes are at the margin. And you are right. It is true, is it not, that the bulk of the European countries have a significant to very high value added tax?

Mr. WILKINS. That's right. Almost all of them have a value added tax, There are very few countries now that do not.

Senator PACKWOOD. I believe Ireland's value added rate is 30 percent.

The CHAIRMAN. 33.

Mr. WILKINS. I think, in fairness, you have to keep in mind that we do have retail sales taxes in most of our States.

Senator PACKWOOD. Yes.

Mr. WILKINS. They are not anywhere near as high as the rates here you are talking about, of course.

Senator PACKWOOD. The question I wanted to ask is this, should we be moving toward the European system, toward a broader based consumption tax, in order to reduce taxes on capital and income? I am not talking about raising total taxes, but a tradeoff. Increasing taxes on consumption with a VAT or the equivalent of some kind of broad-based consumption tax and using the proceeds to reduce taxes on capital and income.

Mr. WILKINS. There is certainly merit in trying to reduce taxes on income and raise them on consumption as a way of increasing savings in this country to help pay for the investment that is going on, so that we do not need to import all of our investment funds.

I would point out, though that if you look at total consumption taxes—well, I don't actually show that to them but I could provide them for the committee—but what I do show is total income taxes as a percentage of GDP on table 5. And there you see that we are not all that far off the mainstream. In the United States total income taxes are 13.3 percent of GDP. Part of the remainder, obviously, is consumption taxes and property taxes.

Senator PACKWOOD. What chart are you on?

Mr. WILKINS. On table 5.

Senator PACKWOOD. Is that chart 5?

Mr. WILKINS. Table 5.

Senator PACKWOOD. All right, table 5.

Mr. WILKINS. It should be right after----

Senator PACKWOOD. Yes. All right.

Mr. WILKINS. This shows the total income tax as a percentage of GDP, and when I say "total" I mean corporate and individual—State, local, and Federal. So it is all income tax. Now what is missing are pieces that I haven't shown separately. Three big pieces are property taxes, Social Security taxes and taxes on goods and services, which include the VAT and the retail sales tax.

While value added taxes are high in Europe, our retail sales taxes do substitute though, Senator Packwood, in the overall statistics to a larger measure than you might think. So it's not as if we are starting from a zero tax on goods and services as compared to value-added tax countries. That is the only point I would like to make, that we have to keep in mind we do have these fairly high taxes at the State and local levels. I could provide that information for you, Senator.

Senator PACKWOOD. Thank you. I would appreciate it if you would.

[The information follows:]

TAXES ON GOODS AND SERVICES IN THE UNITED STATES COMPARED TO OTHER OECD COUNTRIES

The attached table shows that, while the United States does not have a Value Added Tax (VAT), other consumption taxes in the United States, such as retail sales taxes imposed by State governments, substitute in some degree.

Column 1 shows the 1987 share of total revenues (for all levels of government) coming from a VAT in the 18 OECD countries which have a VAT. (Five OECD countries, including the United States, did not have a VAT in 1987.)

Column 2 shows other consumption taxes, including retail sales taxes, as percentage of total revenues. Last, Column 3 shows total taxes on goods and services (including VAT and retail sales taxes) as a share of total tax revenues.

[COOPERS & LYBRAND]

TAXES ON GOODS AND SERVICES IN THE UNITED STATES COMPARED TO THOSE IN OECD COUNTRIES, 1987

| Country | Value added taxes as a percent of total revenue | Other consumption taxes as a percent of total revenue | All consumption taxes as a percent of total revenue |
|---|---|---|---|
| Australia | — | 29.8 | 29.8 |
| Austria | 20.9 | 11.5 | 32.3 |
| Belgium | 15.7 | 9.0 | 24.7 |
| Canada | — | 28.9 | 28.9 |
| Denmark | 18.9 | 15.0 | 33.9 |
| Finland | 23.3 | 14.9 | 38.2 |
| France | 19.2 | 10.0 | 29.3 |
| Germany | 15.7 | 9.7 | 25.4 |
| Greece | 20.9 | 25.7 | 46.6 |
| Ireland | 20.2 | 22.3 | 42.5 |
| Italy | 14.6 | 11.8 | 26.4 |
| Japan | — | 12.9 | 12.9 |
| Luxembourg | 13.5 | 10.9 | 24.4 |
| Netherlands | 16.4 | 9.6 | 26.0 |
| New Zealand | 16.7 | 15.9 | 32.6 |
| Norway | 20.8 | 19.3 | 40.1 |

TAXES ON GOODS AND SERVICES IN THE UNITED STATES COMPARED TO THOSE IN OECD COUNTRIES, 1987—Continued

| Country | Value added taxes as a percent of total revenue | Other consumption taxes as a percent of total revenue | All consumption taxes as a percent of total revenue |
|---|---|---|---|
| Portugal | 20.9 | 28.4 | 49.3 |
| Spain | 16.0 | 14.4 | 30.4 |
| Sweden | 13.3 | 10.8 | 24.1 |
| Switzerland | — | 19.1 | 19.1 |
| Turkey | 22.8 | 9.2 | 32.0 |
| United Kingdom | 16.1 | 15.3 | 31.4 |
| United States | — | 16.7 | 16.7 |

May 25, 1990.

The CHAIRMAN. Thank you, gentlemen. Thank you very much.

Our next panel will consist of Mr. Robert McIntyre, director of the Citizens for Tax Justice, Washington, DC and Dr. Wayne Gable, president of the Tax Foundation, Washington, DC. I have a hunch we will have a difference of opinion these two witnesses.

Mr. McIntyre, if you would proceed, please.

## STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE, WASHINGTON, DC

Mr. MCINTYRE. Thank you, Mr. Chairman.

When you look at the shortfall that has occurred in corporate taxes compared to predictions after 1986, I think there has been general agreement this morning, first of all, that the Tax Reform Act itself is not at fault. It is doing what it was expected to do to a large degree, both in terms of revenues and in terms of assuring that most companies are paying taxes again. And I am sure you have seen various studies, including ours, which show that the effective rate on companies that are still reporting profits has in fact increased substantially.

The problem that everyone has pointed out today is that corporate profits are not coming in as strong as had been predicted back in 1987. And it seems to me it is very clear that what has happened here is not that the return to corporate capital has declined, nor that wages have risen as a share of output, as the Treasury mistakenly suggested. That is simply not true over any long-term period. In fact, wages are down. Instead, what we have seen is an interest squeeze on profits, a substitution of debt for equity. If you look on page 2 of our testimony, you can see a graph which illustrates how total return to corporate capital has been very stable over the years, but interest as a share of total output has been continuously rising, particularly in the 1980's.

And because interest is deductible, because profits are now being paid to bondholders rather than stockholders—most of these, bondholders, by the way, are tax exempt or largely tax exempt—we are seeing a decline in corporate tax revenues.

Now, what is the source of this increase in interest? Is it higher interest rates? Not really. Long-term interest rates on highly rated bonds are actually down. Short-term rates are up a little in 1989,

but there is no serious upward trend through the period that we are looking at.

The fundamental shift has been that companies are retiring their stock and replacing it with debt. And if you look at the figure on page 3 of our testimony, it is quite dramatic. In 1989, for instance, companies borrowed $196 billion net and they retired $131 billion in stock. The year before it was almost exactly the same. Over the last 5 years, we have seen $1 trillion in debt issued and something in the order of $575 billion in stock retired. That shift to debt is leading to the corporate tax shortfall.

Now, this didn't have to happen. The investment banking community figured out that they could dress up corporate equity as debt, as junk bonds and other types of borrowing, call it debt and deduct the interest. And if you have read the book, "Barbarians At the Gate," you will know that when they sent their hired guns down here to Congress to throw enough sand in the wheels of the legislative process and enough smoke in the air that by the time they were done you couldn't figure out what was going on, they were laughing at you when they got done. That book talks about it at great length.

The LBO movement could have been stopped. It still ought to be stopped. But we know one thing at least, the multimillionaires and billionaires that were created on Wall Street in the 1980's have a cost, and that cost is being borne by the Treasury and by the U.S. taxpayers.

Now, all the talk you have heard about LBO's and stock for debt exchanges supposedly being good for this country, that they shake up management and they lead to more efficiency, well about 99 percent of that is bunk. Such assertions show that you can hire an economist or a lawyer to say just about anything if you pay them enough.

Those deals weren't about efficiency. They were about tax avoidance. Studies have shown that virtually all of the premiums that are paid in these LBO deals reflect the tax avoidance that results from them. Simply put, these deals were about greed. When you hear about "financial innovation," well the innovation was that the people who engaged in these deals figured out a way to enrich themselves at the expense of the rest of us. That is not the kind of innovation that we need. In fact, what has happened is that we have burdened American business with a mountain of debt. We have increased the Federal budget deficit and we have added to burdens on average people and on our children in the future.

Now, the opportunity to deal with these conversions of equity to debt the first time around has been missed. It should have been done 3 years ago but it didn't happen. Much of that revenue now is gone for the future. But you still need to act to avert future problems with this area and to keep things from getting worse. That means limiting interest deductions on debt used to finance stock acquisitions.

Now, some people have said, yeah, we have a problem with debt, and the answer is "let's get rid of double taxation to dividends and that will solve the problem." Well, let me make a couple of comments on that.

First of all, the whole idea of a double tax on dividends is largely a myth. Only about a sixth of corporate profits are distributed as taxable dividends. That is considerably less than the approximately 25 percent of profits that is sheltered at the corporate level. In other words, we don't have a double tax. We have less than a single tax.

There is also a second problem. When someone talks about giving tax relief on dividends, he or she is talking about another tax cut for the wealthiest people in this country. We can't afford it and it's not fair.

Let me conclude by saying that dealing with LBO's is not the only thing this committee needs to do. I will give you an early warning on another one. The increase in foreign ownership is having a major effect on corporate tax revenues in this country because these companies, through transfer pricing, appear to be champion tax avoiders. We need to fix the rules there quickly before they become powerful enough to keep action from happening.

And, finally, we need to continue to build on Tax Reform. Some of the things we did aren't working as well as we hoped. The alternative minimum tax needs to be strengthened. We need to scale back on depreciation deductions and make a number of other changes. We should do these things now so that we deliver on what was promised in Tax Reform. And if Congress doesn't act, you will only have yourself to blame when you face lower revenues, in the future. Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. McIntyre appears in the appendix.]

The CHAIRMAN. Dr. Gable.

## STATEMENT OF WAYNE GABLE, PH.D., PRESIDENT, TAX FOUNDATION, WASHINGTON, DC

Dr. GABLE. Thank you, Mr. Chairman. I appreciate the chance to come here today, I have presented written testimony which has a lot of details and tables. And we have heard a lot of testimony today, so I will refrain from going into that detail.

What I would like to do is just hit on a few basic points if you don't mind. And the first is that something that has been mentioned but I want to emphasize it. Even though corporate income tax revenue has been below projections, it has been growing since 1986. Mr. Rosen pointed to the increase in receipts from 1986 to 1989. And the only reason I bring this up again is that we also have been talking about international competitiveness today, and a growing income tax burden is significant for international competitiveness. Simply put, it is hard to compete when your tax burden is higher. So this should be kept in mind when the committee decides what if anything to do about the shortfall in corporate tax receipts.

Also, I believe the question was asked earlier why Japan can compete with a much higher tax burden than the United States. And I think part of the answer to that lies in the cost of capital, so those things have to be considered at the same time.

I have seen different estimates, but I have often seen that Japan has half the cost of capital for business than the United States does. So maybe even with a higher tax burden, you can combine that with half the cost of capital, and still end up with a more favorable situation.

The second point I would like to mention is that corporate taxation cannot be examined in a vacuum. We must consider the overall corporate tax burden when we analyze a particular tax. In this case, the corporate income tax.

With this in mind, if we look at State and local corporate income taxes, we see that they have increased significantly. And this probably helps to explain part of the shortfall in Federal receipts. Again, Mr. Rosen mentioned that State and local income taxes being higher.

In addition, payroll taxes have grown significantly as an element in the overall corporate tax burden. And although some increases in payroll tax were projected, so they wouldn't necessarily all indicate a shortfall in revenue from projections, to the extent that wages have increased faster than predicted, this would also affect payroll taxes and, therefore, you would end up with lower corporate-tax receipts.

And the third point I would like to mention is really more general than the specific corporate shortfall question. But I think it is important when you are considering tax policy in general and specifically corporate tax policy, and that point is that the distinction between corporate taxation and individual taxation is in an important sense very misleading. And it is misleading in the sense that some individual or some set of individuals ultimately pays the burden, bears the burden of any tax. In a corporation's case, you may be talking about the customers of the corporation bearing the burden through higher prices, the employees of the corporation bearing the burden through lower wages or possibly lower benefits or even layoffs, or the owners of the corporation, stockholders, and others—often they are institutional investors—with lower returns.

So it is always traceable to an individual. And it is important. So I think the distinction between corporate and individual receipts is critical for this committee and for government in general when it is calculating the revenue, but I don't think that we can get away with thinking that corporate taxes somehow don't affect individuals because they do. And many of the stockholders of the corporation, again, aren't rich. If you wanted to tax rich people, there are many more direct ways to tax rich people than to go into corporations to try to get to the owners of the corporation.

Thanks.

[The prepared statement of Dr. Gable appears in the appendix.]

The CHAIRMAN. Mr. McIntyre, how do you respond to Dr. Gable's point that the corporate tax burden has increased historically because of the payroll tax?

Mr. MCINTYRE. Pardon me, Mr. Chairman.

The CHAIRMAN. The impact of payroll taxes on taxable corporate income.

Mr. MCINTYRE. Well, certainly the shortfall in corporate revenues compared to projections is not an issue of the payroll tax; the

payroll tax increases were enacted before then. They were factored into the model.

The CHAIRMAN. I am not relating it to the 1986 tax. He made the point that historical increases in payroll taxes have reduced corporate income below projected levels.

Mr. MCINTYRE. Well, the total return to capital as a share of corporate output has not declined. And that is computed after paying payroll taxes. So you don't see, when you look at total return to capital, a decline in the corporate sector. What you do see is a shift towards debt, which means reduced profits and higher interest payments. And when you see the stability of the return to corporate capital, it suggests that the payroll tax increases were borne by workers or covered by price increases. Profits including interest remained stable.

The CHAIRMAN. Dr. Gable, who bears the burden of increases in the payroll tax? The corporation, on the employer or both?

Dr. GABLE. Well, I figure it just depends on the specific economic circumstances of the business. And elasticity of demand makes a difference, and the elasticity of labor supply makes a difference. So I don't think you can answer that question in general. And what the average elasticity rate for the economy is, I don't know, and I wouldn't have any faith in anyone's estimate of it.

The CHAIRMAN. CBO says it is borne by the employee in the form of lower wages. How would you respond to that?

Dr. GABLE. I would say that in some cases that is extreme likely. And depending on the elasticity of labor supply and demand, you could have the other extreme where the corporation bears a large part of it. And CBO's estimate may be correct. I just don't know the correct number for that.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. Dr. Gable, if all corporate taxes are passed on to individuals, the level of corporate tax should make no difference. It could be 70 percent, 80 percent, 90 percent, and corporations will pass it all along anyway.

Dr. GABLE. Well, I am not saying it doesn't make any difference at all what the level is. If it is 100 percent, obviously you don't have any corporations any more. But what I am saying is there is a burden of taxation, corporate taxation, that is borne by some individuals. And the people that bear the burden of the corporate tax, whoever they are, will obviously be bearing a much higher burden if all taxes were generated from corporations.

But what I am saying is that we don't always know who those people are. Again, it depends on the business that we are talking about, and about the elasticity of demand, about foreign competition where there are foreign alternatives available for the product. I don't think you can make any statements about who exactly bears those things. In fact, that is something I would be interested in seeing studies on and doing some studies on because it is an important question and often gets ignored.

Senator PACKWOOD. I was just taking your statement where you said that—and I am quoting—"Incidents of corporate tax is always borne by people."

Dr. GABLE. That's right,

Senator PACKWOOD. And you say it's either shareholders or employees or consumers.

Dr. GABLE. Right.

Senator PACKWOOD. There aren't any other people as best I know.

Dr. GABLE. That's right.

Senator PACKWOOD. Therefore, whatever the rate of corporate taxation is going to be passed on to this group of people.

Dr. GABLE. Yes.

Senator PACKWOOD. And so the corporation shouldn't complain too much about what their level of taxation is because they are going to pass it along anyway.

Dr. GABLE. Well, if they can pass it along 100 percent, that's fine.

Senator PACKWOOD. But you are saying they do.

Dr. GABLE. A corporation is a legal fiction. There are owners of corporations.

Senator PACKWOOD. Yes.

Dr. GABLE. If they bear the burden of the debt, they might complain. They are customers of corporations. They are also employees of corporations. They all have the right to complain about——

Senator PACKWOOD. But you are saying that all of their taxes are passed along.

Dr. GABLE. That's right. Not passed along to consumers necessarily.

Senator PACKWOOD. No, no.

Dr. GABLE. If all were passed along to consumers, yes, they would have no reason to complain because it wouldn't affect their business in any way. But in fact, if it's borne by the owners, those who are trying to generate capital for, those who are trying to work for the company, then relative to any foreign competitor, especially they have a lot of right to complain.

Senator PACKWOOD. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, gentlemen, for your testimony. That concludes the hearing.

[Whereupon, at 11:45 a.m., the hearing was concluded.]

# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED

---

### PREPARED STATEMENT OF WAYNE GABLE

Thank you, Mr. Chairman. My name is Wayne Gable, and I am president of the Tax Foundation—an independent nonpartisan, nonprofit research and public education organization founded in 1937 to monitor the tax and spending practices of the Federal, state and local governments. The Foundation is supported by a nationwide membership of businesses, large and small, by individuals and by grants from philanthropic foundations. I'd like to thank the committee for inviting us to appear here today to discuss some of our recent findings on the trends in the corporate tax burden.

With the persistent Federal deficit hovering around $130 billion, many policymakers will no doubt continue the search for more revenues. Corporations are often targeted because they are said to be under-taxed. Despite statistical evidence to the contrary, this recurring theme seems to take on a life of its own, and always resurfaces when more revenues are wanted for increased spending. In fact, corporations carry a heavy tax burden and provide a large and growing percentage of the total tax revenue collected by the Federal government. Unfortunately, the most often ignored fact is that no matter how much corporate taxes are increased, it is individuals that bear the burden of corporate taxes, through lower wages, lower investment returns, or higher consumer prices. Corporations may be the conduit for paying taxes but it is clearly the shareholders, employees and customers who absorb the real burden.

#### RECENT CORPORATE TAX HISTORY

In examining the corporate tax trend, it is important to look at the tax environment prior to the 1986 Tax Reform Act. In 1981, Congress enacted a significant corporate tax cut under the Economic Recovery Tax Act of 1981 (ERTA). If it had been allowed to take effect fully, it promised to substantially reduce overall corporate income tax liabilities in the 1980s. But of course, that *did not* happen. Instead there were major contravening tax bills starting with The Tax Equity and Fiscal Responsibility Act (TEFRA) in 1982 and the Deficit Reduction Act (DEFRA) in 1984. Outside of the Tax Reform Act of 1986, the major drive behind most tax legislation after 1981 was purely and simply to increase tax revenues. Despite its reduction in the top corporate tax rate from 46 to 34 percent, the Tax Reform Act of 1986 obliterated the capital recovery and business tax relief of 1981 and effectively piled on significant net increases in corporate tax liabilities after 1986. More recently, we have witnessed further increases in corporate income taxes as a result of the Omnibus Budget Reconciliation Act of 1987, the Continuing Resolution for 1988, and the Omnibus Budget Reconciliation Act of 1989. These recent tax changes will continue to yield significant corporate tax revenue increases over the next few fiscal years.

The Tax Foundation's examination of the recent and projected revenue effects from major enacted legislation in the 1981-1989 period reveals a sharp difference in the tax revenue picture for individuals and corporations. Individuals' taxes are markedly lower than they would have been without the legislation, but the corporate sector is another story entirely. According to the Office of Management and Budget, tax legislation enacted since 1981 has resulted in net decreases in individual income taxes of $201.4 billion in FY 1988 and $243.9 billion in FY 1989. Conversely, the net effect on corporate tax revenue was a $24 billion increase in FY88 and a $28 billion increase in FY89.

### CORPORATE SHARE OF TAX BURDEN

What is the corporate "share" of the income tax burden? Over the long term it has shrunk as a share of *total* income taxes, but with some special factors affecting the trend.

There was a precipitous drop-off in corporate income tax receipts, both absolutely and as a percentage of total income taxes in 1982 and 1983. Corporate profit volatility causes corporate tax receipts to fluctuate more widely than individual receipts, and the severe recession of 1981-1982 had its maximum impact on tax revenues in fiscal 1982 and 1983. This was also the period when the Accelerated Cost Recovery System (ACRS) first took hold. More rapid depreciation, of course, helped depress tax collections initially, although this would tend to be made up in later years.

Starting in 1984, corporate income taxes have been steadily increasing, leaping from a low of $37 billion in 1983 to a record $103.6 billion by 1989. This revenue increase has coincided with better business conditions in recent years, and, of course, the implementation of the 1982, 1984, and 1986 tax bills which increased corporate tax revenues. The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 repealed more than half of the benefits for corporations provided by ERTA in 1981. The Deficit Reduction Act (DEFRA) of 1984 further reduced corporate depreciation allowances. In fact, OMB estimates that the Tax Reform Act (TRA) of 1986, will raise an additional $24 billion in corporate tax revenues this year alone. Much of the corporate tax relief promised in 1981 was eradicated by contravening tax legislation. This was the seesaw effect on corporate taxes caused by the major tax legislation of the 1980s.

### CORPORATE VS. INDIVIDUAL SHARE OF TAX BURDEN

Critical factors involved in the balance of corporate versus individual taxes are both the level of corporate profits and their share of the national income. The trend in corporate profits as a percentage of national income has been irregularly downward since the 1950s when examining Bureau of Economic Analysis data. In fact, this downtrend has closely paralleled that of corporate tax receipts as a percent of total income taxes through 1986, where we start to see a slight upward swing. In 1950, for example, corporate profits represented 18 percent of our national income. Throughout the 1970s, corporate profits accounted for over 11 percent of national income. Now in 1989, corporate profits account for a mere 6.8 percent of our nation's income. This decline in corporate profits as a percentage of national income alone explains much of the long term decline in the proportion of corporate income taxes represented in the total tax revenue picture. The weakened state of corporate profits in recent years resulted in less than expected revenue take.

### THE CORPORATE TAX BURDEN

A good indicator of the corporate tax burden is a comparison of corporate taxes with corporate profits. When looking at corporate taxes, Federal corporate income taxes are only part of the picture. A look at the *complete* corporate tax burden picture is revealing. The overall burden is significantly higher when combined with the rapidly increasing state/local corporate income taxes and corporate payroll taxes. Such payments can be partially deducted for Federal corporate income tax purposes but they are a substantial and growing burden nonetheless.

While Federal corporate income tax revenues have risen 46 percent since 1980, state/local corporate income tax revenues have increased 66 percent for the decade and in 1989 were 28 percent as large as the Federal tax levy. The combined Federal and state/local corporate income tax take has risen significantly since 1982, far surpassing the level of the early 1970s.

While state/local taxes are high and growing, the largest element of the business tax burden has become the payroll sector, particularly Federal social security and hospital insurance. Furthermore, state unemployment insurance and other social insurance funds have intensified the corporate tax burden. These taxes are not imposed on net income, and some economists argue that even the employer share of payroll taxes is borne by employees who receive lower rates of compensation and benefits than they would in the absence of these taxes. But payroll taxes are a cost of doing business and, particularly in labor intensive industries, constitute a very large burden. Where labor is relatively scarce and/or subject to rigidities in compensation, that burden may have been absorbed by the employer. Since corporate payroll taxes are a cost of doing business, their increase will offset corporate income taxes. Therefore, the corporate income tax take cannot be accurately examined in isolation. The corporate share of payroll taxes has outstripped corporate income taxes and currently represents about $150 billion.

Over the past decade, the combined increases in Federal income taxes and the state/local and payroll taxes have caused a tremendous increase in the overall corporate tax burden. Compared to profits, this burden increased 35.1 percentage points from 54.8 percent in 1979 to 89.9 percent by 1989. Throughout the 1970s, this rate averaged only about 60 percent.

The 1989 overall corporate tax burden, representing a whopping 89 percent of corporate profits, is huge by historic comparison. The continued sharp growth trend in state and payroll taxes can easily push this burden even higher.

CORPORATE TAXES ARE PAID BY INDIVIDUALS

Unfortunately, most discussion of corporate tax burdens has been based on perceptions rather than economic reality. The ultimate burden or incidence of corporate taxes is always borne by people, not inanimate corporate structures.

Corporations may be the conduit for paying taxes but it is the shareholders, employees, and customers who absorb the real burden. All corporate taxes are ultimately paid by individuals, either through reduced returns to shareholders, lower wages to employees, or higher prices to the consumer. Investors, workers, or consumers will bear the burden, depending on the economic circumstances of the industry.

It is these same people who bear the expense of what is known as double taxation of profits. When dividends are distributed to the shareholders, that money is again taxed. To create a profit, the corporations must raise the price of their goods and services. No matter how large a corporation is, it is people who own corporations and buy corporate products. The result is that investors and consumers alike end up paying for these corporate taxes. Because the precise proportions of such tax burdens are unknown and the process is obscured from public view, the corporate income tax is a hidden tax on individuals. As long as the tax burden debate continues showing "individual effects" vs. "corporate effects," we are forced to work with what is inherently a flawed framework—the assumption that somehow the corporate tax burden does not affect individuals. But however defined, the combined corporate take is large and growing.

In closing, the Tax Foundation notes that the decline in corporate profits as a percentage of our national income alone explains much of the lower than expected revenue take from corporations. Any tax policy changes clearly should take into account the potential impact of further eroding this tax base.

I thank the committee for inviting the Tax Foundation to testify on our findings and submit the *Corporate Tax Burden* special report for inclusion in the record.

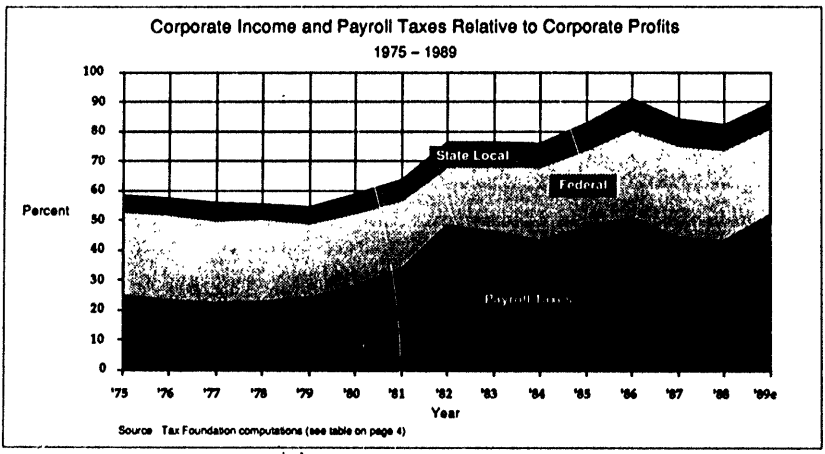
TAX FOUNDATION MARCH 1990

Special Report

# Corporate Tax Burden on the Upswing

by Paul G. Merski

With federal deficits hovering around $130 billion, the government will continue its drive for more revenues. Corporations are often targeted because they are said to be undertaxed. Despite statistical evidence to the contrary, this recurring theme seems to have a life of its own and always resurfaces when more revenues are required for increased spending. In fact, corporations carry a heavy tax burden and provide a large and growing percentage of the total tax revenue collected by the federal government.




## Recent Corporate Tax History

In 1981, Congress enacted a significant corporate tax cut under the Economic Recovery Tax Act of 1981 (ERTA). If it had been allowed to take effect fully, it would have substantially reduced overall corporate income tax liabilities in the 1980s. Instead, there were major contravening tax bills starting with the Tax Equity and Fiscal Responsibility Act (TEFRA) in 1982 and the Deficit Reduction Act (DEFRA) in 1984. Outside of the Tax Reform Act of 1986, the major drive behind tax legislation after 1981 was purely and simply to increase tax revenues. The Tax Reform Act of 1986 obliterated the capital recovery and business tax relief of 1981 and effectively piled on significant net increases in corporate tax

*Paul Merski is Director of Fiscal Affairs at the Tax Foundation.*

liabilities after 1986. More recently, further increases in corporate income taxes have occurred as a result of the Omnibus Budget Reconciliation Act of 1987, the Continuing Resolution for 1988, and the Omnibus Budget Reconciliation Act of 1989. Table I below compares the effect of major enacted legislation in the 1981-1989 period on individual and corporate income taxes currently and projected through 1992. Individuals' taxes are markedly lower than they would have been without the legislation, but the corporate sector is another story entirely.

**Table I**

**Impact of Major Tax Legislation, Enacted 1981-1989[a], on Individual and Corporate Income Tax Receipts**

**Fiscal Years 1988-1992**

**($Billions)**

| Income Tax | 1988 | 1989 | 1990e | 1991e | 1992e |
|---|---|---|---|---|---|
| Individual | $ -201 4 | $ -243 9 | $ -266.9 | $ -295.6 | $ -334 0 |
| Corporate | +24 0 | +27 6 | +35.5 | +45 0 | +47 4 |

[a] Budget effect revenue estimates are prepared by the Office of Management and Budget. They measure only the direct effect of tax legislative changes on receipts with "feedback" effect limited to the overall income forecast and its impact on receipts by major source.

Source: Budget of the U S. Government, FY 1990 and 1991 and Tax Foundation computations

### Corporate Share of Tax Burden

What is the corporate share of the income tax burden? Over the long term it has shrunk as a share of total income taxes, but with some special factors affecting the trend.

*"... corporations carry a heavy tax burden and provide a large and growing percentage of the total tax revenue collected by the federal government."*

As Table II indicates, there was a precipitous drop-off in corporate income tax receipts, both absolutely and as a percentage of total income taxes in 1982 and 1983. Corporate profit volatility causes corporate tax receipts to fluctuate more widely than individual receipts, and the severe recession of 1981-1982 had its maximum impact on tax revenues in fiscal 1982 and 1983. This was also the period when the Accelerated Cost Recovery System (ACRS) first took hold. More rapid depreciation, of course, helped depress tax collections initially, although this would be made up in later years.

Starting in 1984, corporate income tax collections increased steadily, leaping from a low of $37 billion in 1983 to a record $103.6 billion in 1989. The growth in corporate tax revenue has coincided with better business conditions in recent years and, of course, the implementation of the 1982, 1984, and 1986 tax bills which increased corporate tax burdens. The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 repealed more than half of the benefits provided by ERTA to corporations in 1981. The Deficit Reduction Act (DEFRA) of 1984 further reduced corporate depreciation allowances. In fact, the Tax Reform Act (TRA) of 1986 will raise an additional $24 billion in cor-

**Table II**

**Federal Corporate Income Tax Receipts**

**Selected Fiscal Years 1950-1990**

| Year | Federal Corporate Income Tax Receipts ($Billions) | % of Total Federal Income Tax Receipts |
|---|---|---|
| 1950 | $ 10.4 | 39 0 % |
| 1955 | 17.9 | 38.3 |
| 1960 | 21.5 | 34 6 |
| 1965 | 25.5 | 34 3 |
| 1970 | 32.8 | 26 6 |
| 1971 | 26 8 | 23 7 |
| 1972 | 32.2 | 25.3 |
| 1973 | 36.2 | 25.9 |
| 1974 | 38.6 | 24 5 |
| 1975 | 40 6 | 24.9 |
| 1976 | 41 4 | 23 9 |
| 1977 | 54 9 | 25 8 |
| 1978 | 60.0 | 24.9 |
| 1979 | 65.7 | 23.2 |
| 1980 | 64 6 | 20 9 |
| 1981 | 61.1 | 17.6 |
| 1982 | 49 2 | 14.2 |
| 1983 | 37.0 | 11 4 |
| 1984 | 56.9 | 16 1 |
| 1985 | 61.3 | 15.5 |
| 1986 | 63 1 | 15 3 |
| 1987 | 83.9 | 17.8 |
| 1988 | 94 5 | 19 1 |
| 1989 | 103 6 | 18 9 |
| 1990 | 112 0 (e) | 18 6 |

Source: Economic Report of The President, various years and Tax Foundation computations

(e) estimate

porate tax revenues this year alone. Nearly everything provided in the so-called "corporate giveaway" of 1981 was taken back before the benefits could be fully realized.

Critical factors involved in accurately examining the trend in corporate taxes are both the level of corporate profits and their share of the national income. Table III shows that the trend in corporate profits as a percentage of national income has been irregularly downward since the 1950s. In fact, this downtrend has closely paralleled that of corporate tax receipts as a percent of total income taxes through 1986, where we start to see a slight upward swing. The decline in corporate profits alone explains much of the long-term decline in the proportion of corporate income taxes represented in the total tax revenue picture.

*"The Tax Reform Act of 1986 obliterated the capital recovery and business tax relief of 1981 and effectively piled on significant net increases in corporate tax liabilities after 1986."*

### The Corporate Tax Burden

A good indicator of the corporate tax burden is a comparison of corporate taxes with corporate profits. When looking at the corporate taxes, federal corporate income taxes are only part of the picture. Table IV on page 4 illustrates the overall burden of federal corporate income tax when it is combined with the rapidly increasing state/local corporate income taxes and corporate payroll taxes. Such payments can be partially deducted for federal corporate income tax purposes, but they are a substantial and growing burden nonetheless.

*"While Federal corporate income tax revenues have risen 46 percent since 1980, state/local corporate income tax revenues have increased 66 percent for the decade and in 1989 represented 28 percent of the federal tax take."*

For comparability, corporate tax accruals net of Federal Reserve earnings are used instead of actual tax receipts. Given today's full acceleration of corporate tax payments, the accruals figures are close to tax payments.

**Table III**

**Total Before-Tax Corporate Profits**

**Selected Years, 1950-1989**

| Year | Total Before-Tax Corporate Profits ($Billions) | Percent of National Income |
|---|---|---|
| 1950 | $ 42.9 | 18.0 % |
| 1955 | 49.2 | 14.6 |
| 1960 | 49.9 | 11.7 |
| 1965 | 77.4 | 13.2 |
| 1970 | 75.0 | 9.1 |
| 1971 | 87.3 | 9.7 |
| 1972 | 101.5 | 10.2 |
| 1973 | 127.2 | 11.3 |
| 1974 | 138.9 | 11.8 |
| 1975 | 134.8 | 10.4 |
| 1976 | 170.3 | 11.8 |
| 1977 | 200.4 | 12.4 |
| 1978 | 233.5 | 12.7 |
| 1979 | 257.2 | 12.6 |
| 1980 | 237.1 | 10.8 |
| 1981 | 226.5 | 9.3 |
| 1982 | 169.6 | 6.3 |
| 1983 | 207.6 | 7.6 |
| 1984 | 240.0 | 7.9 |
| 1985 | 224.3 | 6.9 |
| 1986 | 221.6 | 6.6 |
| 1987 | 266.7 | 7.3 |
| 1988 | 306.8 | 7.7 |
| 1989(e) | 288.5 | 6.8 |

Source: Department of Commerce, Bureau of Economic Analysis and Tax Foundation computations
(e) - estimate

While Federal corporate income tax revenues have risen 46 percent since 1980, state/local corporate income tax revenues have increased 66 percent for the decade and in 1989 represented 28 percent of the federal tax take. The combined federal, state and local corporate income tax take has risen steadily since 1982, far surpassing the level of the early 1970s.

The largest element of the business tax burden has become the payroll sector, particularly federal social security and hospital insurance. Furthermore, state unemployment insurance and other social insurance funds have intensified the tax burden. These taxes are not im-

posed on net income, and some economists argue that even the employer share of payroll taxes is borne by employees who receive lower rates of compensation and benefits than they would in the absence of these taxes. However, where labor is relatively scarce and/or subject to rigidities in compensation, that burden may have been absorbed by the employer. The corporate share of payroll taxes has far outstripped corporate income taxes and currently costs about $150 billion.

Over the past decade, the combined increases in federal income taxes and the state/local and payroll taxes have caused a tremendous increase in the overall corporate tax burden. Compared to profits, the burden increased 35.1 percentage points from 54.8 percent in 1979 to 89.9 percent by 1985. Throughout the 1970s, this rate averaged only about 60 percent. The 1989 overall corporate tax burden, representing a whopping 89 percent of corporate profits, is huge by historic comparison. Federal deficit pressure and the sharp growth trend in state and payroll taxes can easily push this burden even higher.

Table IV
Federal and State/Local Corporate Income Taxes and Corporate Payroll Taxes
National Income Account Series
1970-1989
(in Billions of Dollars)

| Year | A Corporate Profits | B Federal Corporate Income Tax Accruals[a] | C Effective Rate of Federal Tax (B/A) | D State/Local Corporate Income Tax Accruals | E Effective Rate of Federal and State Local Tax (B+D/A) | F Corporate Payroll Taxes[b] | G Inc. & Payroll Taxes Relative to Corp Profits (B+D+F/A) |
|---|---|---|---|---|---|---|---|
| 1970[c] | $ 76.0 | $ 27.1 | 35.7% | $ 3.7 | 40.5% | - | - |
| 1971 | 87.3 | 30.1 | 34.5 | 4.3 | 39.4 | - | - |
| 1972 | 101.5 | 33.4 | 32.9 | 5.3 | 38.1 | $ 22.7 | 60.5% |
| 1973 | 127.2 | 39.0 | 30.7 | 6.0 | 35.4 | 29.5 | 58.6 |
| 1974 | 138.9 | 39.5 | 28.4 | 6.7 | 33.3 | 33.2 | 57.2 |
| 1975 | 134.8 | 38.2 | 28.3 | 7.3 | 33.8 | 33.6 | 58.7 |
| 1976 | 170.3 | 48.7 | 28.6 | 9.6 | 34.2 | 39.8 | 57.6 |
| 1977 | 200.4 | 55.7 | 27.8 | 11.4 | 33.5 | 45.4 | 56.1 |
| 1978 | 233.5 | 64.4 | 27.6 | 12.1 | 32.8 | 53.7 | 55.8 |
| 1979 | 251.2 | 65.1 | 25.9 | 13.6 | 30.6 | 62.2 | 54.8 |
| 1980 | 237.1 | 58.6 | 24.7 | 14.5 | 30.8 | 66.6 | 58.9 |
| 1981 | 226.5 | 51.7 | 22.8 | 15.4 | 29.6 | 77.6 | 63.9 |
| 1982 | 169.6 | 33.8 | 19.9 | 14.0 | 28.2 | 81.7 | 76.4 |
| 1983 | 207.6 | 43.1 | 22.7 | 15.9 | 30.3 | 89.0 | 73.2 |
| 1984 | 240.0 | 59.2 | 24.7 | 18.7 | 32.8 | 104.4 | 76.0 |
| 1985 | 224.9 | 58.5 | 26.1 | 20.2 | 35.1 | 107.6 | 83.1 |
| 1986 | 221.6 | 66.0 | 29.8 | 22.5 | 39.9 | 113.6 | 91.2 |
| 1987 | 266.7 | 83.3 | 31.2 | 23.7 | 40.1 | 118.1 | 84.4 |
| 1988 | 306.8 | 94.1 | 30.7 | 26.5 | 39.3 | 132.9 | 82.6 |
| 1989[d] | 288.5 | 85.3 | 29.6 | 24.1 | 37.9 | 150.0 | 89.9 |

[a] Net of Federal Reserve Earnings
[b] Includes corporate employer's share of OASDHI, state unemployment insurance tax, federal unemployment tax, railroad unemployment insurance and retirement, and workers' compensation
[c] Includes some effect from Vietnam period surcharge
[d] Estimates based on first three quarters of 1989

Sources: Economic Reports of the President, various years; published and unpublished statistics of the Department of Commerce, Bureau of Economic Analysis; and Tax Foundation Computations

*The Tax Foundation is a nonprofit, nonpartisan research and public education organization founded in 1937 to monitor tax and fiscal activities at all levels of government.*

## PREPARED STATEMENT OF ROBERT S. MCINTYRE

I appreciate the opportunity to appear before the Committee today on behalf of Citizens for Tax Justice. Our coalition of labor, public interest and grassroots citizens groups represents tens of millions of middle- and low-income Americans, who have a vital stake in fair, economically sound tax and budget policies.

There are two questions before the committee today: first, why have corporate income tax receipts for fiscal years 1987 to 1990 been one-fifth lower than was projected following enactment of the 1986 Tax Reform Act and, second, what is to be done about it?

The short answer to the first question is that American corporations have redirected their income streams away from shareholders and toward bondholders by substituting debt for equity. By paying tax-deductible interest rather than dividends, companies have reduced their taxable income. And as taxable income has decreased, so have corporate tax payments.

In other words, the question of who would pay for the instant multi-millionaires and billionaires produced by the corporate buyout craze of the 1980s is now being answered. Mainly, it's the U.S. Government and the U.S. taxpayer.

This testimony will present new evidence on how the huge increase in corporate indebtedness has resulted in a striking decline in reported profits and a concomitant decline in corporate income tax receipts. It will also point out that the increase in foreign ownership of American business has had and will have a negative impact on the Federal Treasury, because foreign-owned corporations appear to be champion tax-avoiders. And it will point to weaknesses in the 1986 Tax Reform Act that may be costing more than was anticipated.

To deal with the corporate revenue shortfall—the second question posed by these hearings—will require Congress to reassert control over corporate tax policy, which is now largely being made by investment bankers and corporate tax lawyers. We urge the Committee and the Congress to amend the tax law so that it no longer permits the unrestricted deductibility of interest payments to undermine the corporate income tax. We urge you to restructure the rules governing the taxation of multinational corporations so that they pay federal income taxes on the profits they earn in the United States. And we urge you to strengthen and build upon the reforms enacted in 1986, to ensure that the Tax Reform Act does the job it was supposed to do.

# The Shortfall in Corporate Taxes

Over the past three years, corporate income tax payments to the Treasury have fallen short of predictions made following the 1986 Tax Reform Act by an average of $21 billion per year. From fiscal 1990 to 1992, the shortfall is expected to exceed $40 billion per year.

**The problem is not primarily a failure of the 1986 Tax Reform Act.** The shortfall in corporate tax payments has not occurred because the Tax Reform Act failed miserably in its goal of restoring the average effective corporate tax rate to a more reasonable level (although, as discussed below, there are weaknesses in the Act). On the contrary, CTJ's analyses of corporate annual reports show that the effective corporate tax rate on reported profits has risen sharply as a result of tax reform.[1]

---

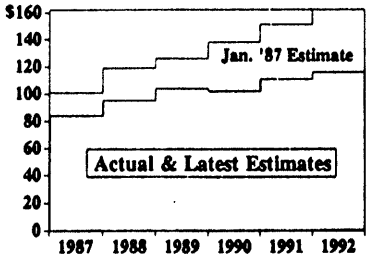
[1] *See* Citizens for Tax Justice, *It's Working, but . . .* (October 1989). Our analysis of 250 of the nation's largest and most profitable corporations found that their overall effective tax rate on reported domestic profits rose from a mere 14.3 percent in 1981-85 up to 26.5 percent in 1988.

## The Shortfall in Corporate Taxes & Corporate Profits

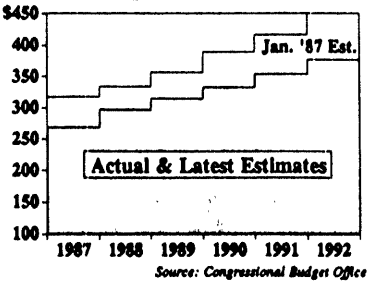
**Jan. 1987 CBO Predictions compared to Actual & Jan. 1990 Estimates**

**(Fiscal years, $-billions)**

### Corporate Income Taxes




### Corporate Profits




*Source: Congressional Budget Office*

**The interest squeeze on profits.** Instead, as the charts above illustrate, the shortfall in corporate tax payments mirrors a shortfall in reported corporate profits. In fiscal 1989, for example, profits (as estimated by the Commerce Department) were $42 billion less than was predicted by the Congressional Budget Office in January of 1987—a factor which accounts for two-thirds of the shortfall in corporate income taxes in that year. (See also Table I.)

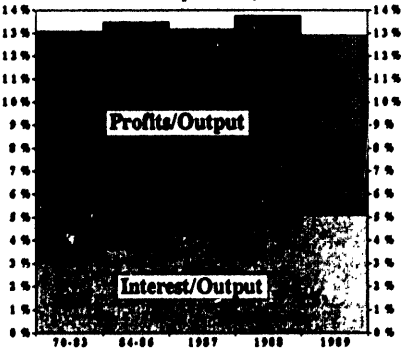
The shortfall in reported profits does *not* reflect a decline in the overall return to corporate capital, however. Instead, it reflects a shift in the *type* of return to corporate capital—away from profits and toward interest payments. What has happened, essentially, is an interest squeeze on profits.

While combined profits and interest as a share of total nonfinancial corporate output have been stable, the interest component has risen steadily. Interest paid rose from 3.2 percent of output over the 1970-83 period, to 3.7 percent in 1984-86, to a record setting 5.1 percent in 1989. (The previous record was set in 1988.) Meanwhile, 1989 reported profits as a share of total output, at 7.8 percent, were lower than in any year except the recession year of 1982. (See Table II.)

- Compared to 1984-86, 1989 profits for non-financial corporations were a 20 percent lower share of total output, while interest payments were a 39 percent *higher* share.
- This shift from profits to interest accounts for five-sixths of the decline in profits as a share of total output over the 1987-89 period compared to 1984-86. (See Table I.)

### The Interest Squeeze on Profits

**Profits & Interest Paid as Shares of Total Output**
**Nonfinancial Corporations, 1970 to 1989**



Does this sharp rise in interest payments stem from a big increase in interest rates? Not really, or at least not interest rates on traditional forms of corporate borrowing. Interest rates on highly rated corporate bonds were actually lower in 1989 than the 1984-86 average, while commercial paper rates and the prime rate were slightly higher. (See Table III.) The fundamental cause of the interest squeeze—the shift away from profits and toward interest payments—is the wave of leveraged buyouts and other debt-financed stock acquisitions in the 1980s.

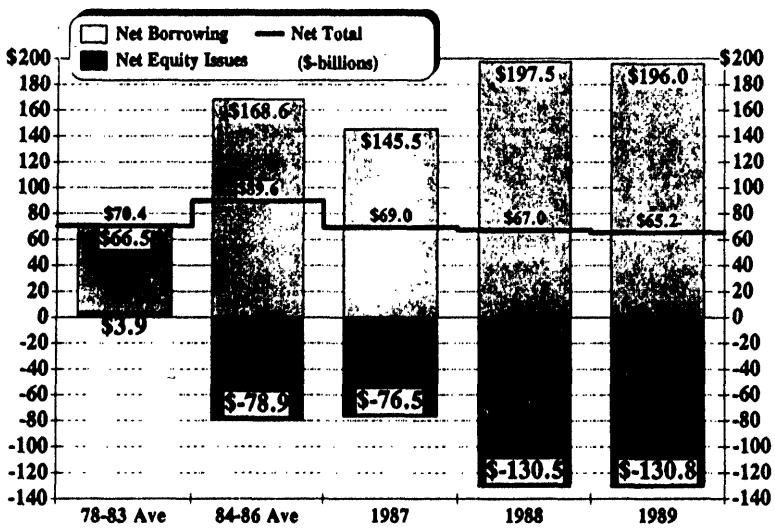
## The Source of the Interest Squeeze on Profits:
### Leveraged buyouts, etc.—The Replacement of Equity with Debt.

In recent years, debt-financed acquisitions, leveraged buyouts, use of leveraged employee stock ownership plans, debt for stock exchanges, and debt-financed stock redemptions and extraordinary dividends have combined to replace huge amounts of corporate stock with debt.

- In every year starting with 1984, net corporate stock issues have been *negative*. In total, from 1984 through 1989, corporate equity (not including the financial sector) has been reduced by $574.6 billion, while net new corporate borrowing was $1,044.7 billion.

- From 1978 through 1983, nonfinancial corporations raised an average of $70.4 billion a year in net new external funds, with $66.5 billion a year coming from net new borrowing and $3.9 billion a year from net new stock issues. Over the next six years (1984-89), external funds raised increased to an average of $78.4 billion a year. But net new stock issues averaged *minus* $99.7 billion a year, while net new borrowing averaged $174.1 billion a year.

## Substituting Debt for Equity
### Sources of Funds for Nonfinancial Corporations, 1978-1989



From 1979 to 1989, total output of non-financial corporations increased by 27 percent in constant dollars (about the same as GNP). Reported profits, however, were up a mere 1 percent over the period, while interest payments more than doubled. Notably, the sum of profits and interest payments grew by almost exactly the same amount as total output. Thus, over this period, $79 billion in deductible interest payments replaced an equivalent amount in (at least partially) taxable profits. (See Table V.)

The "junk bonds" that have replaced so much corporate stock in recent years are generally perceived by the investment banking industry as equity—or at least "equity in drag"—not as debt, given their risk and return. But the tax laws have allowed such junk bonds to dress up as debt, at huge cost to the Treasury.

There is no doubt that the primary moving force behind leveraged buyouts and similar corporate restructurings has been the tax code. Indeed, Secretary of the Treasury Nicholas F. Brady told this Committee as much in January of 1989.[2] Some studies have found that the present value of corporate tax savings obtained through increased interest deductions have accounted for "nearly all" of the buyout premium paid to stockholders in LBO transactions.[3]

Nor can there be any doubt that the financial restructuring of American corporations has been a blow to the federal fisc—indeed, a double blow. Not only has the taxation of dividend income been eliminated in many cases, but because the overwhelming majority of those who hold these "equities in drag" are tax-exempt entities, the shift from equity to debt leaves a large share of corporate profits and distributions *totally* untaxed—except insofar as former shareholders pay one-shot capital gains taxes when they surrender their shares.[4]

Fully 88 percent of bondholders today are either statutorily exempt from taxation on their interest income or, in the case of financial institutions, typically pay low effective tax rates. Moreover, interest income to individual bondholders often goes to tax-deferred accounts (such as IRAs, Keoghs and 401(k) plans). Thus, the shift from dividends to interest has not merely eliminated any so-called "double tax," it has largely eliminated *any* tax on the return to corporate capital.[5]

---

[2]Secretary Brady said: "I am totally convinced that the root cause [of leveraged buyouts] is that the market has found its way around the double taxation of dividends." *Hearing before the Committee on Finance, United States Senate*, 101st Congress, 1st Session, Jan.25, 1989, at 18. As noted below, Secretary Brady understated, since much more than just the mythical "double taxation" is eliminated in these "backdoor integration" transactions.

[3]*See* Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures*. JCS-1-89 (Washington, 1989: Government Printing Office), at 58.

[4]Taxes on forced capital gains that occur during leveraged buyouts and leveraged restructurings cannot make up for the corporate tax revenues lost to the Treasury. Since many of these stock retirements led to forced capital gains realizations by individuals, the increase in stock retirements may help explain the unexpected (temporary) rise in personal income tax payments in recent years. Arguably, a portion of the 50 percent rise in capital gains reported on individual tax returns between 1983 and 1989 could be attributed to forced realizations due to stock retirements. The increase in forced individual capital gains due to stock retirements is actually *larger* than the increase in total reported gains from 1983 to 1989. But these forced gains probably displaced other gains which might otherwise have been realized, so the exact impact of forced retirements on total gains reported is difficult to gauge.

[5]The notion of a "double tax" on corporate profits has always been a misnomer. In 1985, for example, taxable personal dividend income amounted to only 15 percent of total domestic corporate profits, while 59 percent of profits were sheltered on corporate returns. That means that only 55 percent of domestic profits were subject to tax

(continued...)

The cost to the Treasury of subsidizing these equity-to-debt conversions, so far, appears to be $15 to $20 billion annually at present, with larger costs looming in the future.

## Foreign Ownership: It Costs the Treasury, Too

Not all of the shortfall in corporate taxes can be explained by lower reported profits, however. In fact, almost half of the predicted shortfall from fiscal 1990 to 1992 stems from other causes. One factor may be the growth in foreign ownership of American businesses.

From 1979 to 1987, the number of foreign-controlled U.S. corporations grew by more than 80 percent. Their total receipts grew from $242 billion to $591 billion, and their total assets grew from $205 billion to $929 million. In constant dollars, their total receipts increased by 63 percent, and their assets jumped by 203 percent.[6] But their income reported on tax returns and their income tax payments did not keep pace. In fact, from 1979 to 1986 (the last year for which data are available), constant-dollar income reported on U.S. tax returns by foreign-controlled corporations fell by 118 percent (to a *negative* $1.5 billion). Although some companies reported positive taxable income, constant-dollar U.S. income tax payments by foreign-controlled corporations dropped by 18 percent from 1979 to 1986—to a mere $3 billion.

Compared to U.S.-owned companies, foreign-controlled U.S. corporations reported only half as much taxable income as a share of either receipts or assets in 1986. In 1986, fewer than two out of five of foreign-controlled U.S. corporations reported net income on their U.S. tax returns. (The disparity was particularly pronounced in the case of petroleum, chemicals, electronics and auto manufacturers.[7])

---

[5](...continued)
—more of a "half tax" rather than a double tax. Even after tax reform, taxable personal dividend income, at 18 percent of domestic profits, remains less than the 25 percent of profits sheltered on corporate returns. In short, there is not and has not been any "double taxation" of corporate profits in any real, bottom-line sense.

[6]By 1987, the share of total U.S. nonbank business assets held by affiliates of foreign companies rose to 13.2 percent. Leading the list here are stone, clay and glass products (31.2%); chemicals (30.9%); primary metals (19%); petroleum and coal products (17.2%); rubber and plastics products (11.7%); food and kindred products (10.6%); and electric and electronic equipment (10.6%). Rubber & plastics increased notably in 1987, due to the acquisition of a U.S. tire manufacturer by foreign investors.

Foreign affiliates' share of total U.S. manufacturing sales rose to 11.5 percent in 1987. Leading the list here were: chemicals (31.2%); stone, etc. (22.2%); primary metals (19.5%); petroleum products (16.8%); electronics (12.2%); and rubber and plastics products (10.3%).

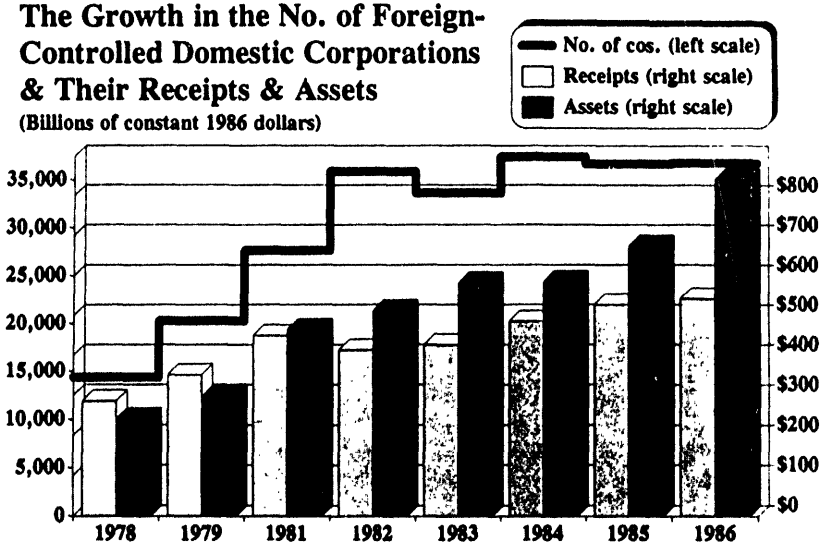
Japanese investors now have the largest and fastest growing share of total foreign-controlled investment in the United States. They held 21.1 percent of total assets of foreign-controlled U.S. companies in 1987—double their 1986 share. And the influx of Japanese direct investment has continued apace. In fact, the 10 largest acquisitions by Japanese interests of major stakes or controlling interests in U.S. companies have all taken place since 1987.These include: Sony's $3.4 billion acquisition of Columbia Pictures in 1989; Bridgestone's $2.7 billion purchase of Firestone in 1988; Seibu Saison's $2.3 billion acquisition of Inter Continental Hotels in 1988; Sony's $2 billion purchase of CBS Records in 1988; Dai-Ichi/Kangyo's $1.3 billion acquisition of CIT Group in 1989; Nippon Mining Co.'s $1.1 billion purchase of Gould Inc. in 1988; Paloma Co.,'s $850 million purchase of Rheem Manufacturing Co. in 1988; Mitsubishi's $846 million purchase of Rockefeller Center in 1989 (completion pending); California First Bank's $750 million acquisition of Union Bank in 1988; and Fujisawa Pharmaceutical Co.'s $660 million purchase of LypoMed in 1989. As in earlier years, most of the increase in foreign-controlled U.S. assets from 1986 to 1987 resulted from acquisitions of U.S. companies by foreign investors.

[7]In 1986, foreign-controlled corporations reported large capital losses because petroleum foreign affiliates lowered the book value of their oil reserves and because chemicals and machinery manufacturing foreign affiliates lowered the book value of various assets.

With foreign-controlled corporations doing business in the United States paying such lower taxes than domestic-owned companies, the continuing rise in foreign ownership may be a significant factor in the decline in corporate tax payments compared to predictions.

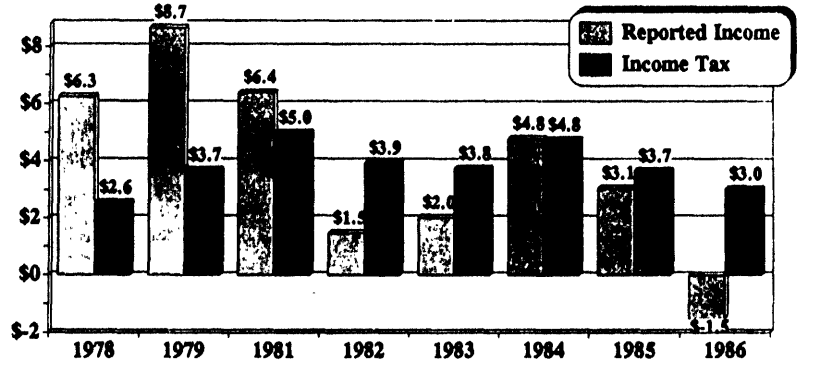
## The Growth in the No. of Foreign-Controlled Domestic Corporations & Their Receipts & Assets

(Billions of constant 1986 dollars)




## The Decline in Reported Income & Income Taxes Paid by Foreign-Controlled Domestic Corporations

(Billions of constant 1986 dollars)



## Other Problems

Corporate tax payments are also being depressed by loopholes that remain in the law after reform, and which in some cases have actually grown larger since 1986. In CTJ's most recent corporate survey (for 1988), we found seven companies that paid zero or less in corporate income taxes that year. A total of 45 companies—almost one out of five of the 250 we surveyed—paid effective tax rates below 10 percent. And 91 companies—more than a third of the total—paid less than the supposed "minimum" amount of 20 percent.

Among the notable problems we found are:

A series of "temporary" laws keeping the IRS from enforcing its interest and R&D allocation rules has essentially taken IBM off the tax rolls since 1985. From 1986 through 1988, IBM reported $7.3 billion in U.S. profits to its shareholders. But instead of paying $2½ billion in federal income taxes as the statutory rate implies, IBM received $310 million in total tax *refunds* over the 1986-88 period, apparently because it deducted so much foreign-related R&D in computing its U.S.-source taxable income. This problem almost certainly extends—albeit probably less dramatically—to other companies as well. And it relates directly to the problems in taxing foreign-owned multinationals discussed earlier.

The Alternative Minimum Tax enacted in 1986, while working reasonably well in many instances, is often vitiated through tax "loss" carrybacks.

Despite tax reform, excessive depreciation on business equipment and real estate is expected to cost the Treasury some $127 billion over the next five years. Buying and selling of depreciation tax breaks remains rampant.

These and similar problems may be larger than originally anticipated.

## Conclusion

The job of tax reform is not completed. The Alternative Minimum Tax needs to be strengthened, by eliminating the use of "loss" carrybacks by companies that owe the minimum tax, by reinvigorating the link to corporate "book" profits and by increasing the AMT rate. In addition, loopholes that were not addressed in the 1986 Act, such as accelerated depreciation on equipment, should be addressed.

The evidence indicates that billions of dollars a year in taxes are being avoided by both U.S. multinationals and foreign-controlled U.S. corporations. We need to overhaul our rules so that they require companies to pay taxes on the profits they earn in this country. The ultimate goal should be to move away from the unworkable "arm's length" approach and toward a system of formula apportionment.

Finally, and perhaps most important in the context of today's hearing, the tax code should stop subsidizing the replacement of corporate equity with debt. We hope that Congress will recognize that the new wave of corporate borrowing is equity masquerading as debt—that it is, in the investment bankers' colorful phrase, "equity in drag." We urge the Committee and the Congress to elevate substance over form, and disallow corporate interest deductions on debt incurred to finance stock acquisitions.

# Appendix—Tables:

## Table I. Predicted & Actual Corporate Taxes After Tax Reform & the Growth in Interest Payments as a Share of Output

($-billions)

| Fiscal years | 1987 | 1988 | 1989 | 1990e | 1991e | 1992e |
|---|---|---|---|---|---|---|
| Predicted profits (CBO, Jan. 87) | $317 | $334 | $357 | $389 | $417 | $451 |
| *Actual profits (& new est., Jan. 90)* | *269* | *297* | *315* | *333* | *354* | *377* |
| Predicted corp. inc. tax (Jan. 87) | 101 | 119 | 126 | 138 | 151 | 162 |
| *Actual corp. tax (& new estimates)* | *84* | *95* | *104* | *102* | *111* | *116* |
| Corporate income tax shortfall, $ | -$17 | -$25 | -$22 | -$36 | -$40 | -$46 |
| Predicted CIT/Profits (Jan. 87) | 32% | 36% | 35% | 35% | 36% | 36% |
| *Actual CIT/Profits (& new est.)* | *31%* | *32%* | *33%* | *31%* | *31%* | *31%* |
| % Profit Shortfall | -15% | -11% | -12% | -14% | -15% | -16% |
| % Effective Rate Shortfall | -2% | -11% | -7% | -14% | -13% | -14% |
| % Corp. Income Tax Shortfall | -17% | -21% | -18% | -26% | -26% | -28% |
| Share of Tax Shortfall Explained by Profit Shortfall | 90% | 53% | 67% | 56% | 57% | 58% |

### Non-Financial Corporations—The Rise in Interest Payments as a Share of Output

| Calendar years | 1984-86 | 1987 | 1988 | 1989 | |
|---|---|---|---|---|---|
| Profits/Total Output | 9.8% | 8.9% | 9.1% | 7.8% | |
| Change from 1984-86 | | -0.9% | -0.7% | -2.0% | |
| % Change | | -9% | -7% | -20% | |
| Interest/Total Output | 3.7% | 4.2% | 4.6% | 5.1% | |
| Change from 1984-86 | | +0.6% | +0.9% | +1.4% | 87-89 Ave. |
| % Change | | +15% | +25% | +39% | |
| Interest/Output Increase as a Share of Profit/Output Decline | | 64% | 141% | 72% | 83% |

SOURCES: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1988-1992* (Jan. 1987); CBO, *The Economic and Budget Outlook: Fiscal Years 1991-1995* (Jan. 1990); *The Economic Report of the President* (Feb. 1990), Tables C-12 and C-2; and the Bureau of Economic Analysis.

| Table II | | | |
|---|---|---|---|
| **Interest Paid as a % of Total Output The 10 Highest Years on Record** | | **Profits as a % of Total Output The 10 Lowest Years on Record** | |
| 1989 | 5.1% | 1982 | 6.3% |
| 1988 | 4.6% | 1989 | 7.8% |
| 1982 | 4.3% | 1980 | 8.0% |
| 1987 | 4.2% | 1981 | 8.3% |
| 1981 | 3.9% | 1974 | 8.5% |
| 1984 | 3.7% | 1983 | 8.7% |
| 1986 | 3.7% | 1987 | 8.9% |
| 1983 | 3.6% | 1986 | 9.0% |
| 1980 | 3.6% | 1988 | 9.1% |
| 1985 | 3.6% | 1979 | 9.8% |
| *All other years since 1960* | *2.5%* | *All other years since 1960* | *13.0%* |

SOURCE: *The Economic Report of The Presidents* (Feb. 1990), Table C-12; and the Bureau of Economic Analysis. Data are for nonfinancial corporations, and are based on domestic output. The 10 lowest and highest years are for the 1940-89 period.

| Table III. Interest Rates, 1984 to 1989 | | | | |
|---|---|---|---|---|
| | **Aaa Bonds** | **Baa Bonds** | **Comm. Paper** | **Prime Rate** |
| 1984 | 12.71% | 10.15% | 10.16% | 12.04% |
| 1985 | 11.37% | 9.18% | 8.01% | 9.93% |
| 1986 | 9.02% | 7.38% | 6.39% | 8.33% |
| 1987 | 9.38% | 7.73% | 6.85% | 8.21% |
| 1988 | 9.71% | 7.76% | 7.68% | 9.32% |
| 1989 | 9.26% | 7.24% | 8.80% | 10.87% |
| Note: 1984-86 | 11.03% | 8.90% | 8.19% | 10.10% |

*Source: Economic Report of the President (Feb. 1990) tab. C-71.*

## Table IV. Changes in Domestic Profits & Interest Paid for Non-Financial Corporations from 1979 to 1989

(all figures are in constant 1989 dollars)

| | 1979 | 1989 | $-Change | %-Change |
|---|---|---|---|---|
| Total output | $2,277.6 | $2,907.1 | $ +629.5 | +28% |
| Wages, dep.& indir.bus.taxes | 1,984.2 | 2,531.8 | +547.6 | +28% |
| PROFITS | 223.5 | 226.3 | +2.8 | +1% |
| INTEREST PAID | 69.9 | 148.9 | +79.0 | +113% |
| Note: Profits & Interest | 293.4 | 375.3 | +81.8 | +28% |
| Note: Dividends paid | $63.2 | $93.2 | $ +30.1 | +48% |
| Addendum: Real GNP | $4,030.4 | $5,234.0 | $ +1,203.6 | +30% |

SOURCE: *The Economic Report of the President* (Feb. 1990), Tables C-12, C-1 and C-3; and the Bureau of Economic Analysis. Note: Total output (gross domestic product) equals the sum of wages, depreciation, indirect business taxes, profits and interest paid (as listed in the table).

## Table V. Holdings of Corporate Stock & Corporate Bonds, 1988 ($-billions)

| Type of Holder: | Stocks | Bonds | Total | % of Stocks | % of Bonds | % of Total |
|---|---|---|---|---|---|---|
| Individuals[1] | $1,715 | $170 | $1,885 | 55% | 12% | 42% |
| Pensions[2] | 735 | 341 | 1,076 | 23% | 25% | 24% |
| Financial institutions[3] | 341 | 658 | 830 | 5% | 47% | 18% |
| Foreigners | 198 | 180 | 379 | 6% | 13% | 8% |
| Tax-exempts[4] | 310 | 43 | 353 | 10% | 3% | 8% |
| Totals | $3,130 | $1,392 | $4,522 | 100% | 100% | 100% |

Source: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts, Financial Assets and Liabilities Year End, 1965-1988* (Sept. 1989).

[1]Includes mutual funds, amounts in self-administered pension plans, such as IRAs and Keogh plans, and small amounts held by brokers.

[2]Includes private pension plans and state and local retirement plans.

[3]Includes insurance companies, commercial banks, savings and loans, and mutual savings banks.

[4]Calculated from household sector data based on 1982 shares as estimated by the Federal Reserve.

PREPARED STATEMENT OF GEORGE A. PLESKO

Mr. Chairman and Members of the Committee: My name is George A. Plesko. I am an Assistant Professor of Economics at Northeastern University in Boston, Massachusetts. Prior to joining the faculty at Northeastern University I was a financial economist in the Office of Tax Analysis (OTA) of the U.S. Department of the Treasury from 1985 to 1989. My responsibilities at OTA centered on corporate taxation, and included the analysis of proposed and enacted corporate tax provisions and the preparation of the Administration's projections of corporate tax receipts for the Budget. I would like to thank the Committee for inviting me here today to share my views on recent trends in corporate tax collections.

An important feature of the Tax Reform Act of 1986 (TRA86) was the intended transfer of the collection of approximately $120 billion in revenue from individuals to corporations for fiscal years 1987 through 1991. This transfer of liability was in the broader context of a desire for the bill to be "revenue-neutral:" reductions in tax collections from individuals were to be offset with increases from other sources. Now, as we approach the end of this period, questions are arising concerning the magnitude of the increased corporate liability.

I will begin by outlining the expected revenue consequences of TRA86. This is followed by an analysis of recent tax collections in order to determine how much additional corporate revenue has been collected since 1986. I will then discuss some of the reasons for the differences between the projections of corporate receipts after TRA86 and recent collections.

I. ANTICIPATED EFFECTS OF TAX REFORM ON CORPORATE RECEIPTS

Table I presents estimates by the Joint Committee on Taxation (JCT) and OTA of the amount of additional revenue that was expected to be collected from corporate because of TRA86. The differences between these two sets of estimates, made less than three months apart, were due to differences in the underlying economic assumptions upon which each was based. The JCT estimates were based upon economic assumptions produced by the Congressional Budget Office (CBO), while the OTA estimates were based upon the Administration forecast produced by the Council of Economic Advisors (CEA) for the Office of Management and Budget (OMB) These are the only publicly available estimates of the effects of TRA86 by source. From these estimates one can reasonably infer that TRA86 was expected to increase corporate collections by $22 to $28 billion each year Since 1986.

Table 2 presents the estimates of the total revenue effect of TRA86. The first two lines correspond to the same set of estimates reported in Table I and show the "revenue-neutral" feature of the final bill. The following two lines show subsequent estimates of the effect of TRA86. Without knowing the detailed estimates of the various TRA86 provisions it is possible to identify the reasons for the changes. Assistant Secretary of the Treasury Gideon recently testified that these earlier estimates have since been revised, and that "(f)or all practical purposes, the 1986 Act was revenue neutral, as intended." [1]

The apparent shortfall of corporate receipts since TRA86 can best be seen in Table 3.[2] Column (a) of Table 3 lists actual corporate receipts for each fiscal year from 1984 to 1989. Column (b) lists the level of receipts forecast in August 1986 under the Administration's assumptions, not including the effects of TRA86. Column (c) contains the estimated corporate receipt effects of TRA86 as reported by OTA in January 1987. The fourth column, (d) represents the implied corporate receipts forecast at that time, and is obtained by adding columns (b) and (c) As can be seen in columns (e) and (f) this implied forecast overstated the annual level of re-

[1] K.W. Gideon, statement before the Committee on Ways and Means, February 7, 1990, p. 17-18. The definition of revenue neutrality employed by Treasury is defined as "a total change in receipts of less than 1 percent over the 1987-91 budget period." FY 1989 receipts totalled $990.7 billion, 1% of which is $9.9 billion. For the five-year period (FY 1987-1991) this definition implies a revenue gain or loss of approximately $50 billion. It is worth noting that this is a cash flow concept which ignores the effects on the deficit of changes in the timing of collections.

[2] Data for Tables 3 and 4 were obtained as follows: GNP and corporate profits from Executive Office of the President, *Economic Report of the President*, (U.S. GPO, Washington, D.C., January 1989) and U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, July 1989; receipts data from U.S. Office of Management and Budget, *Budget of the United States Government*, (U.S. GPO, Washington, D.C.), selected years; the 1986 economic assumptions from the U.S. Office of Management and Budget, "Mid-Session Review of the 1987 Budget," (U.S. GPO, Washington, D.C., August 6, 1986); and the estimates of TRA86 from H.W. Nester, "A Guide to Interpreting the Dynamic Elements of Revenue Estimates," in *Compendium of Tax Research 1987*, (U.S. GPO, Washington, D.C.), pp. 13-41.

ceipts through 1988 by more than 20 percent. While this error is severe, it is not an indictment of the TRA86 estimates themselves, since the baseline corporate profits forecast upon which they were based could contain a substantial amount of error. The corporate profits forecast will be discussed in section III.

In column (g), the estimated effect of TRA86 for each year is subtracted from the actual level of corporate collections. If the TRA86 estimates in column (c) are correct, this column would provide the best estimate of what receipts would have been in the absence of the change in the law. The pattern in column suggests corporate receipts would have declined between 1986 and 1987 even though corporate profits rose. This pattern seems unlikely. Accepting for the moment the possibility that receipts would have remained constant between 1986 and 1987 (at $63.1 billion) the maximum amount of additional corporate revenue generated from TRA86 would have been $20.8 billion (83.9-63.1), far less than the $28.3 billion reported at the time.

As a result of this analysis it is understandable why there have been questions about the impact of TRA86.[3] Actual receipts since 1986 (column (a) are generally below the forecast of corporate receipts prior to the enactment of TRA86.

## II. TAX REFORM AND CORPORATE TAX COLLECTIONS

In this section I address the question of how much additional Federal revenue was generated by the TRA86. While the exact revenue effect of the corporate changes of TRA86 will never be known with certainty, an estimate of the approximate magnitude can be inferred by examining published data for the past several years. As detailed corporate tax return data for 1987 and later become available, more accurate estimates of the effect of TRA86 will be possible.[4]

In Table 4, corporate receipts for fiscal years 1984 through 1988 are presented along with BEA estimates of the levels of GNP and NIA corporate profits. Examining the ratio of corporate net receipts to either series shows that collections increased following 1986. Corporate receipts as a share of GNP jumped from a 1984-1986 average of .0151 to a 1987-1989 average of .0193, an implied increase in collections of $20.34 billion in 1988. A similar calculation using NIA profits suggests a 1988 revenue gain of $21.8 billion. These gains are substantial—the $20.34 billion estimate represents 21.52% of total corporate receipts for 1988.

Clearly, TRA86 has increased tax collections from the corporate sector. Equally clear, the amount of additional revenue collected is not as great as originally estimated in 1986 and 1987 (presented in Table 1). The remaining issue, then, is to account for the residual "shortfall" in collections.

## III. REASONS FOR THE CORPORATE "SHORTFALL"

### *a. Economic assumptions*

Table 5 presents the evolution of the Administration forecast for three economic variables: corporate profits, personal income, and GNP.[5] My focus here on the Administration forecast is for expositional purposes only; the same type of exercise could be performed for CBO forecasts.[6]

By reading across any row you can see the forecast for that variable at any given time. Reading down a column yields the evolution of forecasts for a variable, ending with the actual value at the bottom. The "Mid-Session Review of the 1987 Budget," released August 6, 1986, presented the macroeconomic assumptions used to estimate

---

[3] See, for example, *The New York Times*, "Big Shortfall in Corporate Taxes Thwarts Key Goal of 1986 Law," March 6, 1990, page 1.

[4] It would be hard to overstate the difficultly in determining the economic and revenue effects of enacted legislation. One has to account both for changes in economic conditions (which may have been caused by the law change) as well as changes in economic behavior. In addition, there is a substantial lag between the end of a tax year and the availability of data. While it is expected imminently, corporate tax return data for 1987 is not yet available. Without such data it is nearly impossible to untangle the effects of a change in tax law.

[5] Data in Table 5 will differ from Tables 3 and 4 since they are drawn from different sources at different times. The data in Table 5 was drawn from the various Budget documents and do riot reflect technical revisions in the GNP accounts.

[6] The forecasts of CBO and the Administration have not appeared to be very different. The forecast accuracy of selected macroeconomic variables has been tested by M.S. Kamlet, D.C. Mowery, and T.T. Su in "Whom Do You Trust? An Analysis of Executive and Congressional Economic Forecasts," *Journal of Policy Analysis and Management*, Spring 1987, pp. 365-384. An examination of budget aggregates (receipts, outlays, and the deficit) can be found in G.A. Plesko, "The Accuracy of Government Forecast and Budget Projections," *National Tax Journal*, December 1988, pp. 483-501. To date, however, no one has examined the forecast accuracy of less aggregate data such as corporate profits and personal income.

the effects of TRA86 at the time of its enactment. At that time, corporate profits were estimated to reach $356 billion in 1988—$49 billion higher than eventually reported by the Department of Commerce.

This divergence between forecast and realized corporate profits is plotted in Figure 1. The upper line presents the projection of corporate profits published in the August 1986 "Mid-Session Review." The lower line shows actual corporate profits through 1989. Given the inaccuracy of the corporate profits forecast, it follows that corporate receipts are lower than expected. If each additional dollar of corporate profits before tax yields 25 cents to the Treasury, the $49 billion difference in 1988 profits accounts for more than $12 billion in corporate receipts.

By quantifying the effect of reduced profits I do not mean to imply any cause for concern. Revisions to economic assumptions are routine and expected. Although they may not have been the focus of debate in 1986, subsequent downward revisions to the profits forecast should have anticipated.

One thing that is surprising, however, is that even with recent history as a guide the FY 1991 Administration Budget (released in January 1990) contains what appears to be an extremely unlikely scenario: a growth in corporate profits of nearly 20% during 1990 (from $303 billion to $360 billion).

As shown in the second panel of Table 5, the overstatement of corporate profitability has been accompanied by a systematic understatement of personal income. In both absolute terms, and as a percentage of GNP, personal income has grown faster than anticipated. As a result, it is still likely that TRA86 has maintained its goal of "revenue neutrality," with the decline in corporate receipts being offset by higher individual receipts.

*b. Other factors*

A final set of issues to address concern adjustments corporations might have made to mitigate the effects of the corporate income tax generally, and TRA86 in particular. I will briefly examine two: the substitution of debt for equity, and the use of S-corporations.

*Debt.*—The substitution of debt for equity has received considerable attention over the past few years in both the popular press and professional journals. While corporations can reduce their taxable income, and hence their tax liability, by substituting debt for equity,[7] it is not clear that the provisions of TRA86 caused an increase in the desired level of corporate debt. By itself, the decline in the top corporate tax rate should have decreased the tax benefit of additional interest deductions. This effect may be offset by the general increase in tax liability, which increases the likelihood that a tax benefit can be used. Until post-TRA86 data becomes available it is not possible to determine which of these effects will dominate.

*S-corporations.*—One reaction to TRA86 that could be reducing corporate collections is the election of eligible corporations to be taxed as S-corporations, and therefore no longer be subject to the corporate income tax.[8]

TRA86 dramatically changed the incentives of using a taxable corporation to defer the recognition income. The reversal of the relationship between the maximum individual and corporate tax rates, the elimination of the preferential treatment of capital gains, and the repeal of *General Utilities,* make Subchapter S a more attractive organizational form than it was prior to TRA86.

Figure 2 shows the recent trend in the filing of IRS form 2553: applications to be taxed as an S-corporation. During the first half of 1987 more than 370,000 corporations requested permission to convert to S-corporation—nearly 30,000 more than had requested the treatment for all of 1986. While much of this is a one-time shift in response to TRA86, the incentive for firms to want to operate as S-corporations has clearly increased. The revenue effects of a large number of corporations electing Subchapter S could be substantial. By way of example, in 1986, corporations with $100,000 or less of assets were responsible for $12.37 billion of income subject to tax, and $4.07 billion in tax before credits. The respective figures for corporations with assets of $1 million or less were $31.92 billion and $8.45 billion. By way of compari-

---

[7] J. Shoven has suggested that share acquisitions could have reduced 1985 liabilities by as much as $27 billion. See "The Tax Consequences of Share Repurchases and Other Non-Dividend Cash Payments to Equity Owners," in L.H. Summers, ed., *Tax Policy and the Economy,* Vol. 1, (MIT Press, Cambridge, 1987).

[8] A discussion of the eligibility requirements and the effect of TRA86 on the decision to elect Subchapter S along with the data cited in this section, can be found in G.A. Plesko, "Choice of Corporate Entity: The Use of S Corporations Before and After the Tax Reform Act of 1986," mimeo, 1988.

son, income subject to tax for all corporations in 1986 was $276.2 billion, and total tax before credits was $111.1 billion.

## IV. CONCLUSION

At this point in time it is still difficult to determine all of the effects of the Tax Reform Act of 1986. In the case of corporate tax collections, however, receipt5 are undoubtedly higher than they otherwise would have been—regardless of the level of economic activity. TRA86 and subsequent legislation have increased corporate tax payments by approximately $20 billion a year.

Concern over any remaining shortfall in corporate receipts should be analyzed in the context of two criteria: the goal of revenue neutrality, and any implicit or explicit intent to achieve a particular distributional objective.

Will total collection through 1991 be the same as they would have been in the absence of TRA86? While corporate receipts are not as large as originally projected, individual receipts may have made up the difference. If Treasury's broad definition of revenue neutrality is used as a measure, I do not see any compelling evidence at this time that TRA86 is not revenue neutral. A more detailed analysis of the revenue effects of increased personal income clearly needs to be performed.

A second question is whether the distributional goals of TRA86 have been achieved, regardless of revenue. It is important to remember that distributional objectives are not merely the mix of government receipts, but rest on who ultimately pays the tax. While a shifting of tax liability from individuals to corporations will affect the progressivity of the system, we do not have sufficient information to accurately measure the effects of such changes.

This concludes my prepared remarks. I will be pleased to answer any questions of the Committee. Thank you.

### Table 1.—REVENUE ESTIMATES OF THE EFFECTS OF TAX REFORM ON CORPORATE RECEIPTS

[All amounts in billions of dollars]

| | Fiscal Year | | | | | |
|---|---|---|---|---|---|---|
| | 1987 | 1988 | 1989 | 1990 | 1991 | Total |
| Joint Committee on Taxation (October 1986) | 25.310 | 23.941 | 22.464 | 23.398 | 25.187 | 120.300 |
| Office of Tax Analysis (January 1987) | 28.252 | 25.155 | 23.395 | 25.320 | 27.717 | 129.838 |

Sources: Joint Committee on Taxation, ***General Explanation of the Tax Reform Act of 1986***, May 4, 1987, page 1378; H.W. Nester, "A Guide to Interpreting the Dynamic Elements of Revenue Estimates," in ***Compendium of Tax Research 1987***, (U.S. GPO, Washington, D.C.), p. 40.

### Table 2.—TAX REFORM: CHANGE IN TOTAL UNIFIED BUDGET RECEIPTS

[All amounts in billions of dollars]

| | Fiscal Year | | | | | | |
|---|---|---|---|---|---|---|---|
| | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | Total |
| Joint Committee on Taxation (October 1986) | 11.538 | −16.705 | −15.128 | 8.048 | 11.990 | | −0.257 |
| FY 1988 Budget (January 1987) | 18.625 | 0.856 | −11.680 | −9.004 | −4.198 | | −5.401 |
| FY 1989 Budget (January 1988) | 21.5 | −4.5 | −17.2 | −13.5 | −9.5 | | −23.2 |
| FY 1990 Budget (January 1989) | −8.9 | −24.4 | −20.3 | −16.4 | −20.9 | | |

Sources: Joint Committee on Taxation, ***General Explanation of the Tax Reform Act of 1986***, May 4, 1987, page 1378; U.S. Office of Management and Budget, ***Budget of the United States Government***, chapter 4, selected years

## Table 3.—EARLY ESTIMATES OF TAX REFORM AND CORPORATE RECEIPTS

| Fiscal year | Corp. actual (a) | Receipts forecast Aug. 1986 (b) | Effect of TRA86 (c) | Forecast + TRA86 (d) | Error (e) | Percent Error (f) | Actual less TRA86 (g) |
|---|---|---|---|---|---|---|---|
| 1984 | 56.9 | 56.9 | | 56.9 | | | |
| 1985 | 61.3 | 61.3 | | 61.3 | | | |
| 1986 | 63.1 | 61.6 | | 61.6 | +1.5 | | |
| 1987 | 83.9 | 75.0 | 28.3 | 103.3 | −19.3 | −23.03 | 55.7 |
| 1988 | 94.5 | 92.6 | 25.2 | 117.8 | −23.2 | −24.60 | 69.4 |
| 1989 | 103.6 | 104.9 | 23.4 | 128.3 | −24.7 | −23.84 | |

## Table 4.—EFFECT OF TAX REFORM ON CORPORATE RECEIPTS

| Year | Net FY corporate receipts (a) | CY GNP (b) | Receipts as a share of GNP (c) | CY NIA profits (d) | Receipts as a share of profits (e) |
|---|---|---|---|---|---|
| 1984 | 56.9 | 3772.2 | .0151 | 266.9 | .213 |
| 1985 | 61.3 | 4014.9 | .0153 | 282.3 | .217 |
| 1986 | 63.1 | 4231.6 | .0149 | 282.1 | .224 |
| 1987 | 83.9 | 4524.3 | .0186 | 298.7 | .281 |
| 1988 | 94.5 | 4880.6 | .0194 | 328.6 | .288 |
| 1989 | 103.6 | [1] 5233.2 | .0198 | n/a | |

[1] Preliminary.
Sources: See text
Notes: Receipt data is for fiscal years

## Table 5.—SELECTED ADMINISTRATION ECONOMIC ASSUMPTIONS

[All amounts are in billions of dollars]

| | Calendar Years | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 |
| **Corporate Profits Before Tax** | | | | | | | | |
| August 1986 | | 246 | 299 | 356 | 366 | 383 | 394 | |
| January 1987 | | 240 | 309 | 341 | 377 | 411 | 444 | 459 |
| January 1988 | | | 275 | 310 | 353 | 406 | 448 | 471 |
| January 1989 | | | | 301 | 351 | 396 | 442 | 475 |
| January 1990 | | | | | | 360 | 421 | 472 |
| Actual | 223 | 232 | 277 | 307 | 303 | | | |
| **Personal Income** | | | | | | | | |
| August 1986 | | 3504 | 3726 | 3963 | 4235 | 4475 | 4701 | |
| January 1987 | | 3493 | 3700 | 3941 | 4201 | 4452 | 4703 | 4959 |
| January 1988 | | | 3746 | 3978 | 4245 | 4521 | 4806 | 5081 |
| January 1989 | | | | 4052 | 4326 | 4633 | 4924 | 5202 |
| January 1990 | | | | | | 4701 | 5039 | 5384 |
| Actual | 3314 | 3534 | 3780 | 4064 | 4424 | | | |
| **Nominal Gross National Product** | | | | | | | | |
| August 1986 | | 4224 | 4536 | 4894 | 5251 | 5594 | 5914 | |
| January 1987 | | 4218 | 4493 | 4816 | 5165 | 5524 | 5879 | 6214 |
| January 1988 | | | 4486 | 4779 | 5113 | 5481 | 5850 | 6207 |
| January 1989 | | | | 4857 | 5211 | 5570 | 5939 | 6296 |
| January 1990 | | | | | | 5583 | 6002 | 6439 |
| Actual | 3998 | 4235 | 4527 | 4881 | 5233 | | | |
| **Corporate Profits Before Tax as a Percent of GNP** | | | | | | | | |
| August 1986 | | 5.8% | 6.6% | 7.3% | 7.0% | 6.8% | 6.7% | |
| January 1987 | | 5.7 | 6.9 | 7.1 | 7.3 | 7.4 | 7.6 | 7.4 |

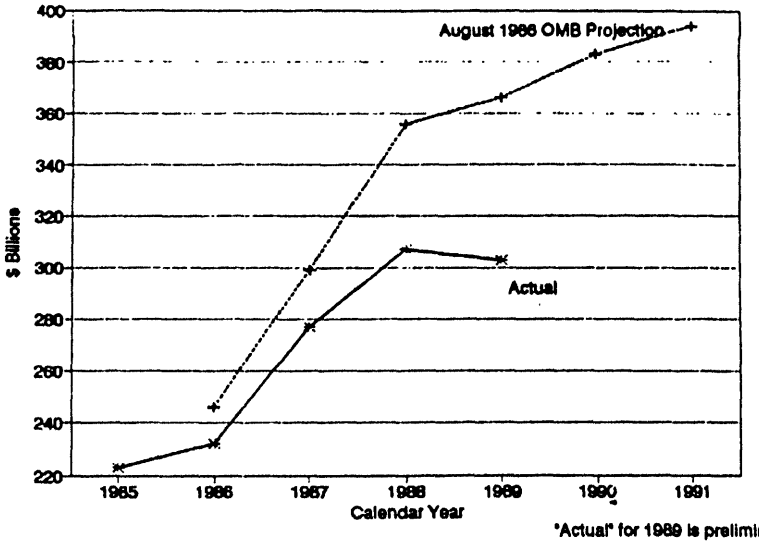
## Table 5.—SELECTED ADMINISTRATION ECONOMIC ASSUMPTIONS—Continued

[All amounts are in billions of dollars]

| | Calendar Years | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 |
| January 1988 | | | 6.1 | 6.5 | 6.9 | 7.4 | 7.7 | 7.6 |
| January 1989 | | | | 6.2 | 6.7 | 7.1 | 7.4 | 7.5 |
| January 1990 | | | | | | 6.4 | 7.0 | 7.3 |
| Actual | 5.6 | 5.5 | 6.1 | 6.3 | 5.8 | | | |
| | Personal Income as a Percent of GNP | | | | | | | |
| August 1986 | | 83.0% | 82.1% | 81.0% | 80.7% | 80.0% | 79.5% | |
| January 1987 | | 82.8 | 82.4 | 81.8 | 81.3 | 80.6 | 80.0 | 79.8 |
| January 1988 | | | 83.5 | 83.2 | 83.0 | 82.5 | 82.2 | 81.9 |
| January 1989 | | | | 83.4 | 83.0 | 83.2 | 82.9 | 82.6 |
| January 1990 | | | | | | 84.2 | 84.0 | 83.6 |
| Actual | 82.9 | 83.4 | 83.5 | 83.3 | 84.5 | | | |

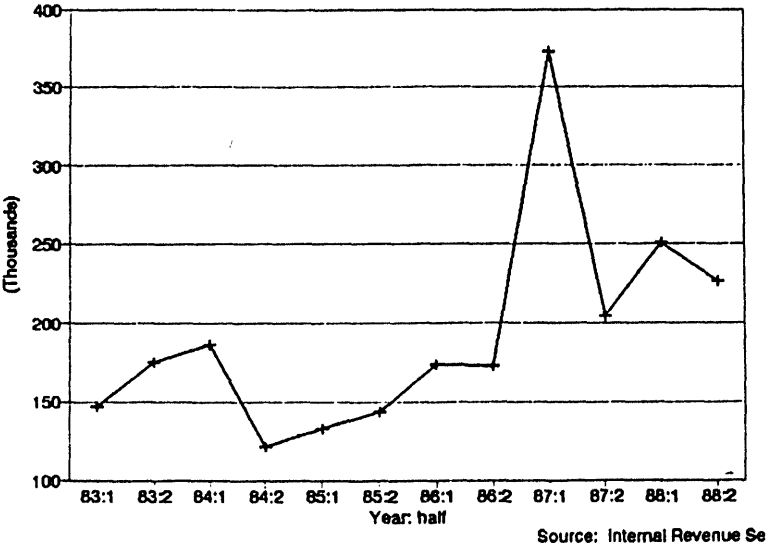
Source: U.S. Office of Management and Budget, ***Budget of the United States Government,*** selected years. "Actuals" for 1989 are preliminary.

Figure 1
Corporate Profits Before Tax




"Actual" for 1989 is preliminary

Figure 2
Form 2553 Filings, 1983 - 1988




Source: Internal Revenue Service

PREPARED STATEMENT OF JAMES M. POTERBA

My name is James Poterba. I am a Professor of Economics at the Massachusetts Institute of Technology and the Deputy Director of the Taxation Research Program at the National Bureau of Economic Research. I am pleased to have this opportunity to testify before this distinguished committee on the factors which explain the long-term decline in Federal corporate income tax receipts.

Federal corporate tax accruals, excluding revenue from Federal Reserve Banks, averaged 3.8% of GNP during the 1960s, 2.7% during the 1970s, 1.6% for the 1980-1985 period, and 1.7% for the 1986-1989 period. In 1989, the tax-to-CNP ratio of 1.6%, while significantly above its minimum value of 1.2% in 1982, was less than two-thirds its level in 1979 and only forty percent as large as its level in 1960.

My remarks examine the long-run decline in corporate taxes, with only brief attention to their rebound in the years after the Tax Reform Act of 1986. My principal conclusion is that legislative changes, while important contributors to the decline in corporate taxes, account for less than half of the reduction since the 1960.[1] Declining profitability, which has narrowed the corporate tax base, is the single most important cause of the long-term trend toward declining corporate taxes.

The withering of the corporate income tax began long before the passage of the Economic Recovery Tax Act in 1981. Corporate tax payments as a share of CNP or the value of corporate assets have been declining for nearly three decades. This trend accelerated during the early 1980s when real corporate taxes also declined, but was arrested by the passage of the Tax Reform Act in 1986.

Table I presents three measures of the net Federal corporate tax payments of *nonfinancial* corporations (NFCs) for the period 1961-1985.[2] Tax payments are net of refunds obtained from carrying losses back to offset prior taxes, and include additional collections in audits and other retabulations. I focus on nonfinancial corporations both because they were significantly affected by the changes in capital recovery provisions in the 1981 and 1986 Acts, and because it is less difficult to measure the profit rate for these firms than for their financial counterparts. Federal tax payments by nonfinancial corporations accounted for nearly 90% of non-Federal Reserve corporate tax receipts in the mid-1980s.

The first column in Table 1 shows that real corporate tax payments fell between the late 1970s and early 1980s. The decline in corporate taxes is particularly remarkable when viewed in the context of a growing economy. The second column of Table 1 shows that nonfinancial corporate taxes averaged 3.3% of CNP during the 1960s, compared with 1.3% during the early 1980s. My preliminary estimates for the period 1986-1989 suggest a slight increase in NFC taxes as a share of CNP, to 1.4%.[3] An equally pronounced decline emerges from column three, which shows the ratio of tax payments by nonfinancial corporations to the replacement value of their tangible assets. From 4.5% of assets in the 1960s, tax payments fell to less than 1.5% in the early 1980s. My preliminary data suggest an increase to approximately 1.7% of asset. value in the 1986-1989 period.

The corporate income tax is levied on corporate profits. The decline in corporate taxes as a share of corporate assets can therefore be divided into two components: a decline in the rate at which corporate profits are taxed, and a decline in the corporate profit rate on assets in the nonfinancial corporate sector. The first component is the average tax rate, which attracted widespread attention in policy debates leading up to the 1986 Tax Reform Act. The second, the corporate profit rate, is defined as the economic profits earned by equity holders as a share of the replacement value of corporate assets.

Table 2 presents data on the tax-to-asset ratio, the average tax rate, and the profit rate for the period 1961-1985. The data clearly indicate that both falling average tax rates and a decline in profitability have contributed to lower corporate taxes. The first column shows that the average tax rate was 42% during the 1960s, compared with 31% during the first five years of the 1980s. My preliminary estimates suggest that the average tax rate increased as a result of the 1986 Tax Reform Act, with a change of approximately ten percentage points between 1984-85 and 1988-89.

---

[1] My testimony draws heavily on Alan J. Auerbach and James M. Poterba, "Why Have Corporate Tax Revenues Declined?," in Lawrence Summers, ed., *Tax Policy and The Economy* 1 (1987), pp. 1-29.

[2] The unfortunate data restriction to the pre-1986 period is due to long lags in the public availability of corporate tax data.

[3] This estimate is based on a crude allocation of total nonfinancial corporate tax *accruals* between Federal and state/local governments, using data reported in the *Survey of Current Business.*

The second column of Table 2 reports the economic profit rate on nonfinancial corporate capital. The profit rate trends down throughout the data sample, and drops sharply in the early 1980s. From an average of 10.9% during the 1960s, the profit rate fell to 7.2% during the 1970s and 4.9% during the first five years of the 1980s. Although profits accruing to equity holders have rebounded since then, averaging more than 6.5% of corporate assets for the last five years, the profit rate is still well below its level in the 1960s and early 1970s. The source of this decline remains poorly understood.

The dramatic decline in corporate profitability is an important source of lower corporate tax receipts. The last column of Table 2 shows that the tax-to-asset ratio at the beginning of the 1960s, for example, was 3.1 times that at the beginning of the 1980s. The average tax rate was 1.35 times its level in recent years, and the profit rate was 2.2 times its recent value. Declining profitability is therefore substantially more important than changes in the average tax rate in accounting for the reduction in corporate taxes.

The relative importance of changes in tax rates and the tax base can be illustrated by calculating what corporate tax receipts in the early 1980s would have been if either the average tax rate or the profit rate had remained at its earlier level while the other changed over time. Actual corporate tax receipts from NFCs averaged $49.6 billion (1986 dollars) during the 1981-1985 period. If the profitability of corporate assets had been the same as in the 1960s, tax receipts would have more than doubled to $110.4 billion. Even setting the profit rate to its 1976-1980 value would have increased annual revenues by over $20 billion, to $72.5 billion.

Fixing the average tax rate at its earlier level would also have raised taxes in the early 1980s, though not by as much as the return to earlier profit levels. If the tax rate during the 1981-1985 period had equalled its level in the early 1960s, taxes would have averaged $68 billion per year. Replacing the actual tax rate with its average value for the late 1970s would raise tax receipts by $13 billion to $62.5 billion per year.

It is difficult for policy to affect the profit rate on corporate assets, at least in the short run. The average tax rate, however, is directly influenced by tax policy. Table 3 presents information on the source of changes in average tax rates, isolating the influence of changes in the statutory maximum rate, capital recovery provisions, the varying prevalence of firms with tax losses, increased use of investment credits in some periods, and other factors. The first row of Table 3 shows the maximum statutory tax rate for each year. The entries in the next six rows describe how various factors have caused the average tax rate to differ from the statutory rate. Negative entries indicate factors which reduce the average rate relative to the statutory rate, while positive entries increase the average tax burden. The average tax rate, reported in the last row, is the sum of the statutory tax rate in the first row and each of the six intervening adjustments.

The results in Table 3 suggest that the most important factor causing divergences between average and statutory rates is capital recovery. In the first five years of the 1980s, capital recovery provisions depressed the average tax rate by 14 percentage points more than in the 1960s and 1:3 percentage points more than in the late 1970s. The other important change which reduced average rates in the 1980s was the changing pattern of inflationary effects. Inflation historically tended to raise taxable profits and hence taxes through spurious inventory valuation gains. Rising corporate debt levels in the early 1980s, however, reversed the net effect since the untaxed inflationary gains on corporate debt became large enough to offset the adverse effects of inflation through inventory profits.

It is unfortunately premature to present detailed calculations of the type considered here for the period since 1985. However, preliminary evidence suggests that changes in the tax-to-asset ratio since 1986 have been Me primarily to legislative changes which affected the average tax rate, rather than to fluctuations in the rate of profit on corporate assets.

The substantial increase in average tax rates during a period of robust economic activity, however, has translated into a relatively small increase in corporate taxes at least in part because of increasing corporate leverage. NFC Federal taxes as a share of NFC equity earnings plus interest has changed much less than the average tax rate on equity earnings. The last five years have witnessed the replacement of nearly five hundred billion dollars of corporate equity with corporate debt, a development which has lowered the flow of equity earnings relative to the corporate capital stock and hence reduced the corporate tax base.

Table 1.—FEDERAL CORPORATE TAX REVENUES, 1961–1985

| | Federal Receipts from Nonfinancial Corporations | NFC Taxes as a Percentage of: | |
|---|---|---|---|
| | | GNP | NFC Fixed Assets |
| 1961–1965 | $74.5 | 3.4% | 4.6% |
| 1966–1970 | 82.6 | 3.1 | 4.4 |
| 1971–1975 | 72.1 | 2.4 | 3.2 |
| 1976–1980 | 80.6 | 2.3 | 2.8 |
| 1981–1985 | 49.6 | 1.3 | 1.5 |

Source: Alan J. Auerbach and James M. Poterba, "Why Have Corporate Tax Revenues Declined?," in Lawrence H. Summers, ed., *Tax Policy and the Economy* 1 (1987), page 3.

Table 2.—AVERAGE TAX RATES AND CORPORATE PROFITABILITY, 1961–1985

| | Average Tax Rate | Corporate Profit Rate | Taxes/NFC Assets |
|---|---|---|---|
| 1961–1965 | 42% | 11.0% | 4.6% |
| 1966–1970 | 41 | 10.9 | 4.4 |
| 1971–1975 | 44 | 7.4 | 3.2 |
| 1976–1980 | 40 | 6.9 | 2.8 |
| 1981–1985 | 31 | 4.9 | 1.5 |

Source: Alan J. Auerbach and James M. Poterba, "Why Have Corporate Tax Revenues Declined?," in Lawrence H. Summers, ed., *Tax Policy and the Economy* 1 (1987), page 6.

Table 3.—CAUSES OF CHANGING AVERAGE TAX RATES, 1961–1985

| | 1961–65 | 1966–70 | 1971–75 | 1976–80 | 1981–85 |
|---|---|---|---|---|---|
| Statutory Rate | 50.8% | 50.2% | 48.0% | 47.2% | 46.0% |
| Capital Recovery | −8.2 | −9.5 | −9.5 | −9.5 | −22.1 |
| Other Inflation Effects | −1.3 | −1.6 | 0.4 | 1.3 | −3.5 |
| Tax Losses | 2.9 | 3.6 | 4.7 | 4.1 | 11.8 |
| Foreign Tax Effects | 0.4 | −0.5 | 1.6 | −0.5 | 0.4 |
| Progressivity | −3.5 | −3.6 | −2.7 | −3.0 | −3.5 |
| Other Factors | 1.4 | 1.5 | 1.9 | 0.4 | 1.8 |
| Average Tax Rate | 42.5 | 41.1 | 43.5 | 40.1 | 30.8 |

Source: Alan J. Auerbach and James M. Poterba, "Why Have Corporate Tax Revenues Declined?," in Lawrence H. Summers, ed., *Tax Policy and the Economy* 1 (1987), page 10.

PREPARED STATEMENT OF ROBERT D. REISCHAUER

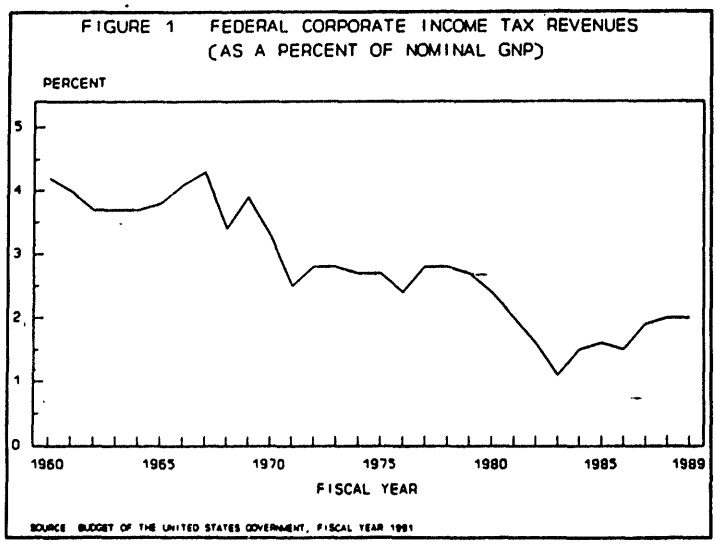
Mr. Chairman, I am pleased to have this opportunity to appear before the Committee. This morning I will review the recent performance of the corporate income tax, assess the effect on receipts of the Tax Reform Act of 1986 (TRA), and present the Congressional Budget Office's (CBO's) current estimates of corporate income tax receipts in 1990 and 1991. My statement makes the following three points.

- While corporate income tax receipts grew over the 1987–1989 period somewhat faster than the economy, receipts were below projected levels, primarily because corporate profits were lower than projected.
- TRA boosted corporate receipts substantially over the 1987–1989 period, although it boosted them by less than originally estimated.
- CBO estimates that total corporate income tax receipts will be flat this year and then resume growth in 1991, when they will increase at about the same rate as the economy at large.

SOME BACKGROUND ON CORPORATE INCOME TAXES

It is instructive to examine our recent experience with corporate income tax receipts in a longer-term context. While receipts have continued to increase in dollar terms over the last three decades, their growth has failed to keep pace with the

growth in the economy (see Figure 1). Corporate taxes measured 4 percent of gross national product (GNP) in 1960; by 1986, that amount had declined to 1.5 percent. Corporate receipts now contribute only 10 percent of total revenues compared with 20 percent in the 1960s. This long-term decline in GNP's share of corporate receipts reflects both economic conditions and legislated changes in liability.




First, corporate profits have not kept pace with the overall economy. For most of the 1960s, profits were about 10 percent to 11 percent of GNP; for most of the 1980s, they measured 6 percent to 7 percent of GNP. The reason for this decline is somewhat of a puzzle. One possible explanation is that the slower pace of technological progress, coupled with strong capital accumulation, has reduced the rate of return to capital. In addition, the portion of the return to capital that has been absorbed by interest payments, which reduce reported corporate profits, has increased over time as a result of both a higher volume of debt and higher interest rates.

Second, tax legislation through 1981 reduced corporate taxes through the investment tax credit, accelerated asset cost recovery, reductions in the corporate tax rate, and the introduction or expansion of preferences for specific industries and types of transactions. The Tax Reform Act of 1986 repealed the investment credit, tightened cost recovery rules and reduced some preferences, and restored the corporate receipts share of GNP to its 1981 level. But it did not reverse the long-term trend, nor did it promise to do so.

### RECENT EXPERIENCE WITH CORPORATE INCOME TAX RECEIPTS

Each year over the 1987-1989 period, corporate income tax receipts increased and reached an all-time high level of $104 billion in 1989. However, receipts were below the levels estimated by CBO and the Administration in January 1987.

#### *The Magnitude of the Revenue Shortfall*

In January 1987, both CBO and the Administration projected extremely strong growth in receipts for fiscal year 1987. These projections assumed that profits would continue to make a strong recovery after a pause in growth in 1986 and that large revenue gains would accrue from the just-enacted Tax Reform Act of 1986. In fact, actual receipts fell $17 billion below the January 1987 CBO estimate in fiscal year 1987, $24 billion below this estimate in 1988, and $22 billion below this estimate in 1989 (see Table 1).

Table 1.—THE CORPORATE INCOME TAX SHORTFALL: CBO AND ADMINISTRATION PROJECTIONS OF JANUARY 1987 COMPARED WITH ACTUAL RECEIPTS

[By fiscal year, in billions of dollars]

| | 1987 | 1988 | 1989 |
|---|---|---|---|
| Projections of Corporate Receipts in January 1987: | | | |
| CBO | 101 | 119 | 126 |
| Administration | 105 | 116 | 127 |
| Actual Receipts [1] | 84 | 95 | 104 |
| Shortfall: | | | |
| Actual less CBO [1] | −17 | −24 | −22 |
| Actual less-Administration [1] | −21 | −21 | −23 |

[1] Includes the effect on receipts of legislation enacted after January 1987

SOURCE: Congressional Budget Office.

Furthermore, the shortfall was even larger than these numbers suggest because the CBO and Administration projections did not include the effects of legislation passed in 1987 and 1988 that increased corporate receipts. Taken together, the Omnibus Budget Reconciliation Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988 are estimated to have increased 1989 corporate receipts, for example, by about $8 billion. Adjusting the apparent shortfall shown earlier for the expected increase in receipts stemming from the new legislation results in an even larger estimated shortfall: $29 billion in 1988 and $30 billion in 1989 (see Table 2).

Table 2.—THE ROLE OF PROFITS IN THE SHORTFALL IN CORPORATE RECEIPTS

[By fiscal year, in billions of dollars]

| | 1987 | 1988 | 1989 |
|---|---|---|---|
| Shortfall [1] | −17 | −24 | −22 |
| Alternative Shortfall Measure Assuming Constant January 1987 Tax Law [2] | −17 | −29 | −30 |
| Factors in Shortfall: | | | |
| Lower-than-projected profits | −12 | −13 | −19 |
| All other factors [3] | −5 | −17 | −11 |

[1] Includes the effect on receipts of legislation enacted after January 1987.

[2] Adjusted for the revenue increases enacted in the Omnibus Budget Reconciliation Act of 1987, the Technical and Miscellaneous Revenue Act of 1988, and the Omnibus Budget Reconciliation Act of 1989.

[3] The contributions of specific factors cannot be calculated. Factors include lower-than-projected revenues from the corporate base-broadeners in the Tax Reform Act as well as in legislation enacted in 1982, 1984, 1987, and 1988, unexpectedly high use of employee stock ownership plans; and increased dependence on the S corporation and partnership form of business organization.

SOURCE: Congressional Budget Office.

*The Shortfall in Profits*

Approximately 58 percent of the shortfall in corporate income tax receipts over the 1987–1989 period is attributable to lower-than-projected profits. Corporate profits are volatile and, therefore, notoriously difficult to forecast. The Bureau of Economic Analysis's estimates of corporate profits in 1986, which underlay CBO's projections, were revised downward by almost $20 billion after the projections were prepared. In addition, growth in corporate profits was weaker than CBO forecast for the 1987–1989 period. As a result, in 1987, economic profits, according to the National Income and Product Accounts (NIPA) measure of total corporate earnings, were $22 billion below the CBO forecast; in 1988, they were $11 billion below; and in 1989, they were $65 billion below (see Table 3).

The NIPA measure of economic profits, however, is not a close approximation of the corporate income tax base, which was weaker than indicated by economic profits alone. Economic profits must be adjusted to exclude deductible amounts of accelerated depreciation and state and local corporate income taxes, and the earnings of the Federal Reserve System, which are not subject to the corporate income tax.

All three of these "wedges" were larger than CBO projected in January 1987, further reducing our measure of the corporate tax base, which we call "adjusted economic profits," below the CBO estimate (see Table 3). Depreciation deductions were larger because TRA resulted in a larger-than-expected amount of up-front depreciation deductions for new investment. The higher Federal Reserve System earnings

reflected higher-than-projected interest rates. When measured with these "wedges," adjusted economic profits were nearly $100 billion less than expected in 1989.

Table 3.—CBO BASELINE PROJECTIONS FOR CORPORATE PROFITS COMPARED WITH ACTUAL PROFITS

(By calendar year, in billions of dollars)

| | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|
| **Economic Profits** | | | | |
| Actual | 282 | 299 | 329 | 301 |
| January 1987 Baseline | 300 | 320 | 340 | 365 |
| Difference | −18 | −22 | −11 | −65 |
| **Adjusted Economic Profits** | | | | |
| Actual | 150 | 188 | 219 | 198 |
| January 1987 Baseline | 168 | 235 | 251 | 296 |
| Difference | −18 | −48 | −32 | −98 |

SOURCE Congressional Budget Office

An important cause of lower-than-projected profits during the 1987-1989 period was further increased reliance by corporations on debt financing instead of equity financing. Interest payments on this debt are deductible from gross corporate income and, therefore, reduce measured economic profits. In addition, the deductions of corporations for interest paid were further boosted during the 1987-1989 period by higher-than-projected interest rates.

While corporate profits were overestimated in the January 1987 CBO forecast, wages and salaries were underestimated. Such misallocations are common because macroeconomic forecasters tend to be more accurate in forecasting total income than in forecasting the allocation of income among factors of production. This forecasting error had the opposite effect on receipts, raising individual income tax receipts above projected levels and offsetting some of the shortfall in corporate receipts.

*Other Factors*

While the corporate receipts shortfall was substantially attributable to lower profits, preliminary CBO calculations indicate that $33 billion of the cumulative shortfall, or $11 billion per year on average, was attributable to other factors (see Table 2). CBO has made a distinction in this respect between all other factors affecting corporate tax liability and economic conditions—in particular, corporate profitability—to highlight factors that are of potential interest to the Committee. However, it should be emphasized that corporate profitability and the other factors interact and, therefore, it is not possible to fully disentangle the effects of different factors. For example, the increased reliance on corporate debt, which reflects the tax advantage of debt financing, directly reduces corporate profits. Furthermore, we lack the data necessary even to approximate the effect on receipts of some factors.

Other factors that reduce corporate liability and that were present during the 1987-1989 period include the unexpectedly high use by corporations of employee stock ownership plans (ESOPs), which reduce the tax liability of the corporation and of lenders to the ESOP. This drain has been curtailed by the Omnibus Budget Reconciliation Act of 1989. Among other factors are the lower-than-projected boosts in revenue from the Tax Reform Act of 1986 and other 1980s tax legislation.

In addition, during the 1987-1989 period, use of the S corporation and partnership forms of business organization increased. These forms of business avoid corporate-level taxes by "passing through" income to individual shareholders or partners, thereby avoiding taxation at the corporate level. Because S corporation profits are included in NIPA corporate profits, increased use of the S corporation reduces corporate tax liability without reducing measured profits. The more widespread use of the S corporation and partnership forms of organization is most likely an indirect effect of TRA, which lowered the top individual marginal tax rate below the top corporate rate for the first time.

Some of these factors increase personal income while reducing corporate profits. Personal business and interest income and capital gains were among the components of the individual income tax base that were higher than projected over the 1987-1989 period. This increase is consistent with tax-minimizing behavior by businesses, such as the increased use of S corporations and partnerships. Some of the

tax liability lost to the corporate income tax through such behavior is eventually realized under the individual income tax. The size of the offset to the reduction in corporate income tax receipts in the form of increased individual income tax receipts is unclear. One recent estimate suggests the scale. Professor Lawrence R. Klein and his associates at the University of Pennsylvania estimated that, over the 1950-1988 period, "On balance, a dollar of taxes avoided in the corporate sector eventually ends up as 25 cents collected in the personal sector."

### CORPORATE RECEIPTS AND THE TAX REFORM ACT OF 1986

The Tax Reform Act increased 1987-1989 corporate receipts substantially—by an estimated $54 billion, or 24 percent (see CBO's estimate in Table 4). It temporarily reversed the long-term decline in GNP's share of corporate receipts, boosting 1987-1989 receipts to about 2.0 percent of GNP from an average of 1.5 percent of GNP during the 1982-1986 period. Without TRA, the share of receipts of GNP would have remained essentially flat before settling further to 1.4 percent in 1990. This would have been the lowest revenue share of GNP since 1940, with the exception only of 1983, the year in which the 1981-1982 recession was reflected in corporate receipts.

Table 4.—COMPARISON OF CBO ESTIMATES OF CORPORATE PROVISIONS IN THE TAX REFORM ACT, BY MAJOR TYPE

[By fiscal year, in billions of dollars]

| | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|
| **All Corporate Provisions** | | | | | |
| January 1990 | 18 | 18 | 18 | 26 | 29 |
| January 1987 | 27 | 25 | 21 | 23 | 25 |
| **By Major Type of Provision** | | | | | |
| Rate Reduction: | | | | | |
| January 1990 | 5 | 17 | 22 | 21 | 22 |
| January 1987 | 6 | 20 | 28 | 30 | 33 |
| Capital Cost Recovery: | | | | | |
| January 1990 | 9 | 12 | 18 | 25 | 32 |
| January 1987 | 16 | 19 | 24 | 30 | 38 |
| All Other: | | | | | |
| January 1990 | 15 | 23 | 22 | 22 | 19 |
| January 1987 | 16 | 26 | 25 | 23 | 20 |

SOURCE Congressional Budget Office The January 1987 estimates approximated the October 1986 estimates of the Joint Committee on Taxation

The CBO estimate of $54 billion in revenue gains for TRA over the 1987-1989 period is $19 billion below the estimate incorporated in the CBO baseline of January 1987. Macroeconomic data make important contributions to the revisions in the TRA estimate. For example, more recent NIPA data suggest that the depreciation deductions claimed under TRA rules are larger than originally estimated. In addition, more recent data on investment activity suggest that the estimates of pre-TRA investment tax credits and, therefore, the TRA revenue gain from repealing the credits, were too high. Revisions based on these data reduce the estimated pickup in revenue from the TRA capital cost recovery provisions. Most of the "other" TRA provisions CBO reestimated since 1987 are accounting provisions. Specifically, CBO research has led to downward revisions in the revenue pickup from the uniform capitalization rules, the completed contract accounting rules, and the bad debt rules for financial institutions.

Overall, CBO's revision of the estimated revenue gain from TRA is the result of offsetting revisions in estimates of different provisions: the base-broadening provisions are now credited with smaller revenue gains than originally estimated, while the tax rate reduction is charged with smaller revenue losses than originally estimated. Because CBO's estimate of the tax base is lower now than it was in 1987, the loss for the rate reduction is less. Overall, CBO revisions reduce the estimated TRA revenue gain over the 1987-1989 period, and raise it slightly in 1990 and beyond.

### THE OUTLOOK FOR CORPORATE RECEIPTS IN 1990 AND 1991

The CBO January 1990 baseline projection of corporate income taxes incorporates the delayed effect on payments of the drop in corporate profits in 1989. Corporate receipts are estimated to remain essentially flat in fiscal year 1990, totaling $102

billion, compared with the $104 billion collected in 1989 (see Table 5). Only in 1991 are economic profits projected to return to their 1988 level. Corporate receipts are projected to increase by 9 percent to $111 billion in 1991. CBO projects that corporate receipts will not quite hold their own relative to GNP over the period. They are estimated to claim 1.9 percent of GNP in 1990 and 1991, down slightly from 2.0 percent in 1988 and 1989.

Table 5.—THE CBO JANUARY 1990 CORPORATE BASELINE

[In billions of dollars]

| | Actual | | | | Projection | |
|---|---|---|---|---|---|---|
| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
| Corporate Tax Receipts (Fiscal year) | 63 | 84 | 95 | 104 | 102 | 111 |
| Percentage Change | 3.0 | 32.9 | 12.6 | 9.6 | −1.7 | 9.2 |
| Economic Profits (Calendar year) | 282 | 299 | 329 | 301 | 308 | 335 |
| Percentage Change | −0.1 | 5.9 | 10.0 | −8.6 | 2.5 | 8.7 |
| Adjusted Economic Profits (Calendar year) | 150 | 188 | 219 | 198 | 226 | 262 |
| Percentage Change | −3.9 | 25.3 | 16.3 | −9.4 | 14.1 | 16.2 |

SOURCE: Congressional Budget Office.
Note: Adjusted economic profits most closely represent the corporate tax base.

The CBO baseline estimate is $10 billion below the Administration's estimate for 1990 and $18 billion below it for 1991. The lower CBO estimate is primarily attributable to the fact that CBO forecasts lower corporate profits than does the Administration (see Table 6).

Table 6.—JANUARY 1990 CORPORATE INCOME TAX PROJECTIONS: CBO AND ADMINISTRATION

[By fiscal year, in billions of dollars]

| | 1990 | 1991 |
|---|---|---|
| Administration Current Services Estimate | 112 | 129 |
| Source of Difference | | |
| Economic forecast difference | −7 | −13 |
| All other factors | −3 | −4 |
| Total Difference | −10 | −18 |
| CBO Baseline Estimate | 102 | 111 |

SOURCES: Congressional Budget Office; Budget of the United States Government, Fiscal Year 1991.

Even the $102 billion estimate for 1990 may prove to be too high. Daily and monthly data on tax collections, currently available through April 1990, show receipts running several billion dollars behind the baseline estimate of $102 billion. While the tally of current fiscal year collections remains subject to significant swings through the final month of the year, we believe that this shortfall will persist unless profits recover sooner and more vigorously than the CBO economic forecast assumes.

---

PREPARED STATEMENT OF HARVEY S. ROSEN

Mr. Chairman and Members of the Committee: I am pleased to have this opportunity to present the views of the Administration on recent trends in corporate tax receipts.

INTRODUCTION

Since its inception in 1913, the corporate income tax has generated a sizable share of total U.S. tax receipts. As the Committee has requested, my remarks today focus principally on the trend in corporate tax receipts, the importance of the corporate tax in other countries, and the effect of the Tax Reform Act of 1986 on corporate tax receipts.

## HISTORY OF CORPORATE INCOME TAX RECEIPTS

In 1989, the corporate income tax produced $104 billion in revenue for the U.S. Government. The $104 billion was the most revenue ever produced by corporate taxes and represented the sixth consecutive annual increase in corporate tax receipts. In general, corporate tax receipts have increased over the past 40 years. In the 1950's, corporate tax receipts averaged $19 billion per year; in the 1960's, $26 billion per year; in the 1970's, $38 billion per year; and from 1980 to 1986, $56 billion per year. Since 1986, corporate tax receipts have averaged $94 billion per year.

The long-run increase in corporate taxes occurred even though pre-tax corporate profits as a percentage of gross national product ("GNP") fell sharply. In the mid-1950's, when corporate taxes were at their peak as a percentage of total Federal tax receipts, pre-tax corporate profits were about 11 percent of GNP; by 1986, this percentage had fallen to 5.1 percent.

Although the level of Federal corporate receipts rose from the mid-1950's to 1986, they fell as a percentage of total receipts. But, since 1986, the declining trend in the relative importance of the corporate tax has been reversed. From 1987 to 1989, corporate taxes accounted for an increasing share of total tax receipts. In 1989, corporate tax receipts accounted for 10.5 percent of total tax receipts, which is the highest percentage since 1980. We expect this trend to continue into the future. By 1995, we expect corporate tax receipts to account for 11.4 percent of total tax receipts.

It is important to note that the level of corporate tax receipts depends heavily on the strength of the U.S. economy. When the U.S. economy is growing, as it has been for the past 7 years, corporate profits are strong, and corporate tax receipts increase. But when the economy is in recession, corporate profits tend to fall, and corporate taxes decrease. During the 1982–1983 recession, for example, corporate taxes as a percentage of total receipts fell from 10.2 percent in 1981 to 6.2 percent in 1983. A significant portion of this decline was attributable to the fall in pre-tax corporate profits, from $202 billion in 1981 to an average of $178 billion in 1982 and 1983.

## CORPORATE TAXES IN FOREIGN COUNTRIES

Because of cultural and historical differences, foreign countries have a wide variety of tax systems. For example, some countries have separate individual and corporate tax systems, similar to the U.S. tax system. Others have integrated tax systems, which generally relieve part or all of the double tax on distributed corporate earnings. These differences among tax systems make it difficult to directly compare corporate tax burdens across countries. Nonetheless, we can make some general observations.

In 1987, corporate income taxes accounted for an average of 8 percent of total tax receipts for the 22 countries in the Organization for Economic Cooperation and Development (the "OECD") for which we have data. The data pertain to corporate taxes at both the central government and local levels. Comparisons of corporate tax receipts for central governments only would be misleading because some countries have much greater corporate taxation at the local level than others.

Although U.S. corporate taxes as a percentage of total tax receipts was 8 percent in 1987, the same as the average for the 22 OECD countries, the U.S. percentage will be higher in subsequent years if current trends continue. Countries that were above the OECD average in 1987 include Japan at 23 percent, the United Kingdom at 11 percent, and Italy at 11 percent. Countries that were below the average include Germany at 5 percent, France at 5 percent, and Switzerland at 6 percent.

In 1980, corporate income taxes also accounted for 8 percent of total tax receipts in the 22 OECD countries. Thus, there does not appear to be any general trend toward increased or decreased reliance on corporate taxes among OECD countries.

## THE TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 (the "1986 Act") made significant changes to the corporate tax system. These changes were expected to increase corporate tax receipts significantly. Our most recent estimates indicate that the 1986 Act will increase corporate tax receipts by $140 billion over the 1987–1991 period.

*Corporate Changes in the 1986 Act*

The 1986 Act adopted base-broadening measures designed to increase the overall level of corporate income taxes, even though the maximum marginal tax rate was reduced from 46 percent to 34 percent. The corporate tax base broadening was accomplished primarily by repealing the investment tax credit, limiting depreciation deductions, restricting the use of net operating losses, enacting the corporate alter-

native minimum tax, and adopting important changes in accounting rules, for example, by requiring uniform capitalization of certain expenditures.

The 1986 Act also made three changes that affect the taxation of corporations and their shareholders and the desirability of operating in the corporate form: (1) the relative relationship of the top individual and corporate tax rates was reversed, with corporations now subject to a higher marginal tax rate than most individuals; (2) the preference for both corporate and individual capital gains was eliminated; and (3) the so-called *General Utilities* doctrine was repealed.

*Effect on Corporate Tax Receipts*

The 1986 Act was expected to be revenue neutral. As we testified in February, for all practical purposes, the 1986 Act has been revenue neutral. Our most recent estimate indicates that the numerous positive and negative provisions of the 1986 Act sum to a total change in receipts of less than 1 percent over the 1987-1991 period.

The 1986 Act was also expected to increase corporate tax receipts and lower individual receipts as a percentage of total income tax receipts. This has also occurred. The percentage of income tax receipts accounted for by corporate taxes increased from 15 percent in 1986 to 19 percent in 1989; correspondingly, the percentage accounted for by individual taxes fell from 85 percent to 81 percent.

ECONOMIC FORECASTS IN THE 1988 BUDGET

The Reagan Administration's first budget produced after enactment of the 1986 Act was the 1988 budget. In that budget, corporate tax receipts for 1987-1989 were forecast to average $117 billion per year; actual receipts averaged only $94 billion per year.

The Reagan Administration was not alone in overestimating corporate tax receipts after the 1986 Act. In its first budget after the 1986 Act, the Congressional Budget Office also overestimated corporate tax receipts by an average of $21 billion per year for the 1987-1989 period. Table 1 shows actual corporate tax receipts for the 1987-1989 period, and compares them with the Administration and CBO forecasts made for the 1988 budget.

The question then arises: why were corporate tax receipts between $20 billion and $25 billion lower than forecast after the 1986 Act was enacted? Our analysis of the effect of the 1986 Act on corporate tax receipts today is both preliminary and incomplete. It is always difficult to distinguish quantitatively between the effects of changes in the tax law and other economic factors, but in this case we face special difficulties. Many of the important and fundamental provisions of the 1986 Act were phased-in over time and did not become fully effective until 1988. Large corporations, following their conventional practice, typically did not file their 1988 tax returns until mid-September 1989. The most recent detailed data on corporate tax payments are for 1987. Hence, detailed data even for the first year in which the 1986 Act became fully effective cannot yet be analyzed.

Until more detailed data become available, our judgments and observations must remain tentative. We do have aggregate data through 1989 for tax receipts and corporate profits, although the most recent profits data may be revised.

*The Main Explanation—Lower Corporate Profits*

We believe that the primary reason why corporate tax receipts were lower than expected in the FY 1988 budget is that pre-tax corporate profits came in below expectations. It is worth noting that although the Administration 1988 budget overestimated book value profits, it was conservative in its forecast of economic growth in 1987-89. Specifically, real GNP was estimated to grow at 3 percent per year during the period, significantly below the actual 3.7 percent. In the 1988 budget, pre-tax corporate profits were projected to average $342 billion per year over the 1987-1989 period; actual pre-tax corporate profits averaged $287 billion per year over this period. The overestimate of $55 billion in average annual corporate profits resulted in an average annual overestimate of between $15 billion and $20 billion in corporate tax receipts.

*Wages and Salaries.*—An important reason for the overestimate of corporate profits appears to be that actual wages and salaries were higher than expected. Because wages and salaries are deductible expenses for corporations, higher wages and salaries reduce corporate profits.

The 1988 budget projected that wages and salaries would average $2,376 billion per year over the 1987-1989 period. Actual wages and salaries for this period averaged $58 billion more per year than forecast. Although the economy was stronger than expected during 1987-1989, wages and salaries as a percentage of GNP were also higher than expected during this period.

Higher wages and salaries would also have the effect of raising the taxable income of individuals. The higher-than-expected level of wages and salaries is reflected in higher-than-expected individual income tax receipts. In the 1988 budget, individual income tax receipts for the 1987-1989 period were forecast to average $391 billion per year. Actual income tax receipts for this period averaged $413 billion per year. Similarly, in the 1988 budget, individual income tax receipts for the 1990-1992 period were forecast to average $488 billion per year. In the 1991 budget, individual taxes for the period were forecast to average $526 billion per year.

*Interest Rates.*—Higher-than-expected interest rates also appear to have been a factor in the overestimate of corporate profits. Nonfinancial corporations are large net borrowers, so that higher interest rates result in higher interest payments and, thus, lower profits. Financial corporations are large net lenders, but because they generally lend long-term and borrow short-term, their profits also suffer with higher interest rates. Actual interest rates for 1987-1989 were generally between 1.5 and 2 percentage points higher than interest rates forecast in the 1988 budget. Similarly, interest rate forecasts in the 1991 budget for the 1990-1992 period are between 1.5 and 2 percentage points higher than interest rate forecasts in the 1988 budget for the same period.

*Other Explanations*

Although lower-than-expected corporate profits explain much of the underestimate in corporate tax receipts from the 1988 budget, corporate profits do not explain all of it. Our analysis shows that even if actual corporate profits had reached the levels forecast in the 1988 budget, corporate tax receipts would still not reach the levels forecast in the 1988 budget. Several other factors may account for the overestimate in corporate tax receipts.

*S Corporations.*—The changes in the top marginal tax rates in the 1986 Act caused some taxpayers to prefer the S corporation form over the corporate form. An S corporation is treated as a corporation for most legal considerations, but it is treated as a "passthrough" entity for tax purposes. That is, net income (or loss) from an S corporation flows through and is taxed directly to shareholders with no corporate-level tax. In order to elect this passthrough treatment, a corporation must satisfy certain requirements. For example, the number of shareholders cannot exceed 35, and shareholders must be individuals (other than nonresident aliens) and certain estates and trusts. In addition, an S corporation can have only one class of stock.

The preliminary evidence on S corporations clearly indicates a surge in S corporation activity. Filings of the form required to elect S corporation status increased 67 percent between 1986 and 1987, from 346,000 to 578,000. Since then, the number of filings has receded somewhat, but the 435,000 filings in 1989 remain well above levels before the 1986 Act.

More importantly for tax receipts, income earned by S corporations also appears to be rising considerably since 1986. Net income from S corporations reported on individual returns for 1987 more than doubled, rising by about $12 billion. Advance information on 1988 returns suggests that substantial growth in net income has continued. Although no explicit prediction was made about the use of S corporations, the increased use of S corporations may be well beyond what was implicitly predicted at the time the forecast was made.

S corporation profits are accounted for and forecast as part of corporate profits. Thus, other things being the same, higher-than-expected use of S corporations would not affect the measurement of corporate profits. S corporation profits, however, are not taxed at the corporate level, but rather, are taxed at the individual level. Thus, for a given corporate profits forecast, if S corporation profits are higher than forecast, corporate tax receipts will be lower than forecast. In addition, individual receipts will be greater than forecast. As we have already discussed, individual receipts have been greater than forecast.

*Federal Reserve Earnings.*—Higher-than-expected interest rates contributed to a shift in corporate profits from the taxed sector to the nontaxed sector. The earnings of the Federal Reserve System (the "Fed") are reported as part of corporate profits. Fed earnings come primarily from the interest earned on the Treasury securities held by the Fed. Fed earnings have been higher than forecast, in part because interest rates have been higher than forecast in the 1988 budget. Thus, for a given forecast of corporate profits, higher interest rates would cause Fed earnings to account for a greater share of corporate profits than had been forecast. But because Fed earnings are not taxed, corporate tax receipts would fall short of their forecast levels. (After paying its operating expenses, the Fed turns all excess earnings over to the Treasury.) Thus, even if corporate profits had been at levels forecast by the

1988 budget, corporate tax receipts would have been several billion less than the forecast level because of higher than expected Fed earnings.

*Possible Explanations*

We believe the above reasons are the most compelling, but we cannot rule out two other possible explanations. There is currently no evidence that these factors contributed substantially to the underforecast of corporate tax receipts.

*Increased Leveraged Buyouts.*—Although leveraged buyout ("LBO") activity increased significantly during the 1980's, the effect of LBOs on corporate profits is unclear. Because all LBOs are to some extent financed by debt, increased LBO activity is generally expected to result in higher corporate interest payments, which in turn, lower corporate profits. But the evidence suggests that LBOs had little impact on total corporate interest payments. In addition, to the extent that the acquired firms are managed more efficiently, LBOs may increase corporate profits and corporate receipts.

I should also add that increased LBO activity may increase individual income tax receipts. For example, a portion of capital gains generated by LBOs goes into the individual income tax base, as does interest received by taxable investors.

*Shift from C Corporations to Partnerships.*—As discussed earlier, the 1986 Act made the top corporate tax rate higher than the top individual tax rate. It was expected that this change in relative top tax rates would lead to greater use of the partnership form, which provides income that is taxed at the individual level, and lesser use of the corporate form. Preliminary evidence is mixed, perhaps because the 1986 Act's limitations on passive activity losses and 1987 legislation on publicly traded partnerships tended to discourage partnership activity. If the use of partnerships has increased, personal income would increase and corporate profits decline.

CONCLUSION

In summary, I would characterize recent trends in corporate tax receipts as follows:

—Corporate tax receipts forecasts made by both the Treasury and the Congressional Budget Office following the enactment of the 1986 Act exceeded actual corporate tax receipts by between $20 billion and $25 billion per year for the 1987-1989 period.

—The Tax Reform Act of 1986 reversed a long-term decline in the relative importance of corporate taxes in producing revenues for the U.S. Government. The share of total taxes paid by corporations has been steadily rising since 1986. This trend is expected to continue throughout most of the budget period.

—The 1986 Act has been revenue neutral because individual tax receipts are higher than expected.

—Lower than expected corporate profits explain much of the underestimate in corporate tax receipts.

In short, the 1986 Act was revenue neutral and significantly increased corporate tax receipts both in absolute terms and as a proportion of all income tax receipts.

This concludes my prepared remarks. I would be happy to answer any questions of the Committee. Thank you.

Table 1.—CORPORATE RECEIPTS FORECASTS

[In billions of dollars]

| | Fiscal Years | | |
|---|---|---|---|
| | 1987 | 1988 | 1989 |
| THE REAGAN ADMINISTRATION'S 1988 BUDGET VS. ACTUALS | | | |
| 1988 Budget | 105 | 117 | 129 |
| Actual | 84 | 95 | 104 |
| Overestimate in FY 1988 Budget | 21 | 22 | 25 |
| THE CONGRESSIONAL BUDGET OFFICE'S FY 1988 BUDGET VS. ACTUALS | | | |
| 1988 Budget | 101 | 119 | 126 |
| Actual | 84 | 95 | 104 |
| Overestimate in FY 1988 Forecast | 17 | 24 | 22 |

Source: Department of The Treasury, Office of Tax Analysis.

PREPARED STATEMENT OF JOHN G. WILKINS

Mr. Chairman and Members of the Committee: I am pleased to be here today to discuss the role of the corporate income tax in the United States and to place it in perspective with taxes of some of our principal competitor nations which, along with the United States, are members of the Paris-based Organization for Economic Cooperation and Development (OECD). I thank the Committee for inviting me to share my views on this subject.

Until February of this year, I was Senior Advisor to the Treasury Assistant Secretary for Tax Policy and I had held various tax policy positions in the Department of the Treasury without interruption since 1966. One of my last major assignments in government was serving as acting Assistant Secretary for Tat: Policy during the early months of the Bush Administration. In that capacity, I testified on behalf of the Treasury Department before this Committee and before the House Ways and Means Committee on a number of occasions, presenting the Administration's views on topics such as the corporate alternative minimum tax, leveraged buyouts, airline mergers and acquisitions, regulated utility company tax normalization, and the catastrophic health care tax.

I am now a partner of the international accounting firm of Coopers & Lybrand, where I am in charge of tax policy economic analysis. I am appearing today on my own behalf. I am not speaking for Coopers & Lybrand, and I am not presenting testimony on behalf of any Coopers & Lybrand client.

The OECD publishes annually detailed statistics on tax revenues of its member countries. Since 1973, I have been associated with the OECD working group that prepares these statistics. Prior to my leaving government service I was vice chairman of the OECD's Committee on Fiscal Affairs, which is responsible for all tax policy, tax statistics, and tax administration matters taken up by the OECD. My statement is based on OECD tax revenue statistics, which enable us to compare the United States' reliance on the corporate income tax and various other revenue sources with that of most of the other major developed economies.[1] These data also reflect the impact on revenues from changes that have occurred over time as governments reform their tax structures, introduce new revenue sources, and get rid of inefficient and inequitable ones.

For reasons I will explain, comparisons of relative corporate income tax burdens among countries can be misleading if made simply on the basis of the relationship of corporate tax revenue to total revenue. Like the United States, most developed countries have experienced declines in the share of corporate tax revenues over time. However, when individual income taxes and corporate income taxes are combined and compared to gross domestic product (GDP), all OECD countries report increased income taxes over the period examined, 1965-1987. In my statement I provide reasons why this latter measure is the best available for making international comparisons.

COMPARABILITY OF INTERNATIONAL TAX DATA

The data I am presenting today do not conform precisely to the revenue figures found in the United States Budget. One reason for this is that the OECD does not classify all budget revenues as tax revenues. Although these differences in classification are fairly insignificant for the United States, major adjustments are made to national budget totals by some countries in order to conform to the OECD revenue statistics definitions. A second, more important, reason why these data differ from budget data is that, unless otherwise stated, my statistics include state and local taxes along with Federal Government taxes.

Because the extent to which countries rely upon state and local taxes varies widely, meaningful international tax comparisons cannot be made without expanding the view beyond central governments. For example, as shown on Chart 1, among the six Federal countries that are members of the OECD (Australia, Austria, Canada, Germany, Switzerland, and the United States), central government taxes accounted, on average, for 58 percent of all non-social-security tax revenues in 1987, the latest year for which detailed statistics are available.[2] State taxes averaged 28 percent of the revenue pie, and local taxes accounted for the remaining 14 percent.

---

[1] The source of all data referred to in this statement is *Revenue Statistics of OECD Member Countries, 1965-1988,* Organisation for Economic Co-operation and Development, Paris, 1989.

[2] The OECD revenue statistics do not generally permit social security taxes to be allocated according to levels of government in all countries; however, intercountry comparisons made later in my statement focus on the overall level of taxation in each country and do include social security taxes.

This picture is in sharp contrast with the 17 unitary countries reporting tax data to the OECD. These countries are identified in the detailed information appearing in Table 1. For this group, central government taxes averaged 84 percent of the (non-social-security tax) total, and local taxes accounted for the remaining 16 percent. (In unitary countries there are, or course, no state taxes.) Even among the unitary countries, there are considerable differences concerning the relative size of local taxes. In the Nordic countries (Denmark, Finland, Norway, and Sweden) and in Japan, local taxes accounted for about 30 percent or more of total (non-social-security tax) revenues, while in the remaining 12 unitary countries local taxes averaged less than 9 percent of all government revenue.

In the United States, 57 percent of all tax revenue is raised by the Federal government, 26 percent by state governments, and 17 percent by local governments. Sources of tax revenues differ greatly according to where the tax is levied. As shown on Chart 2, the principal source of tax revenue for the Federal Government is the income tax, both individual and corporate, accounting for nearly 90 percent of non-social-security revenues in 1987. For state governments, the main source of tax revenues is the sales tax (57 percent) followed by the income tax (39 percent). Local governments rely chiefly upon property taxes (74 percent) followed by sales taxes (20 percent).

The conclusion to be drawn from this discussion is that, because of the significant differences in the ways that countries levy taxes at different levels of government, information on tax revenues must be combined for all levels of government in order to maintain international comparability.

### OVERALL RATES OF TAX

Although comparisons of tax revenues, adjusted for exchange rates, can be made directly between counties, more meaningful comparisons of overall tax burdens require relating tax revenues to their claim on resources. One way to provide a common denominator is to relate taxes to gross national product (GNP). The OECD uses a similar device of relating tax revenues to gross domestic product (GDP). GNP is the value of all goods and services produced *by a country* even if some producing resources are located abroad. GDP is the value of all goods and services produced *within a country,* even if foreign-owned resources are employed.

In 1987, the latest year for which comparable international data are available, total tax revenues—including social security taxes—in the United States were equal to 30 percent of GDP, the lowest for all OECD member countries except Turkey. As shown in Table 2, these overall tax rates on GDP in 1987 ranged from a low of 24 percent for Turkey up to 57 percent for Sweden. The average for the 23 OECD countries reporting data was 39 percent.

The increasing trend over time in tax revenues as a percentage of GDP is remarkable. The average of tax revenues as a percentage of GDP for all OECD countries in 1965 was 27 percent. By 1987, this average had risen 12 percentage points—representing an increase in the overall effective tax rate of more than 45 percent—over the span of 22 years.

That effective tax rates would increase this much—even in the absence of legislated tax increases—over a period during which prices rose 250 percent or more is not a surprising result. The application of generally progressive income tax rates to incomes that are driven up by inflation generates more tax revenue than the proportional increase in nominal incomes—the phenomenon known in this country as "bracket creep." What is surprising is that most governments failed to apply indexing or ad hoc tax reductions sufficient to offset these increasing effective tax rates.

In the United States, where indexing now replaces *ad hoc* tax reductions that formerly mitigated the effects of bracket creep, the overall rate of tax on GDP has remained extremely flat, having risen only 4 percentage points since 1965. In contrast to this picture, there are six countries for which the effective tax rate has increased 15 percentage points or more since 1965 and another nine for which the tax rate has increased more than 10 percentage points but less than 15 percentage points. Seven other countries have experienced effective tax rate increases of 10 percent or less. And, in no country did the effective tax rate remain constant or decline between 1965 and 1987.

### INTERNATIONAL TRENDS IN INCOME TAX REVENUES

Corporate income taxes in the United States have declined as a percent of total tax revenue each decade since the end of World War II. As other testimony received by this Committee explains, this is due in part to a decline in corporate profits as a share of GNP and in part to an increase in other forms of government revenue—

most notably social. security taxes, which have increased as a share of the total revenue pie for each post-war decade. Individual income taxes have maintained a remarkably stable share of' total government revenues over this time period.

In 1965, U.S. corporate income taxes at all levels of government (Federal, state, and local) accounted for nearly 16 percent of all government tax revenue. By 1975, this fraction had dropped to about 11 percent. And, by 1985 it had declined further to just over 7 percent. In 1987 there was a slight rebound to 8 percent in the corporate income tax share of total revenues.

For other countries in 1987, the ratio of corporate taxes to total government revenues ranged from a low of 3 percent for Ireland to a high of 23 percent for Japan (see Table 3). The United States ranked 15th among the 22 countries shown.[3]

Using 1965 as the base year from which to measure changes, the United States experienced nearly an 8 percentage point decline in the share that corporate taxes were of all revenues (from 15.8 percent in 1965 to 8.1 percent in 1987). This amounted to nearly a 5-percent drop in the share. The United States was not alone, however. All together, 14 OECD countries saw their corporate income taxes decline as a share of total tax revenues while only eight countries experienced an increase. As shown on Chart 3, changes ranged from a reduction of about 12 percentage points for New Zealand up to an increase of 6 percentage points for Luxembourg. As I will explain, however, this measure of relative corporate tax burden is seriously flawed—especially with respect to international comparisons—and consequently policymakers should not rely upon it.

There are two difficulties in making the comparisons just described. First, as noted above, a change in another source of revenue—such as a sharp rise in social security taxes or the introduction of a value added tax—can mask a stable corporate income tax, making it appear to have changed when in fact it has not. Second, because the OECD generally "scores" relief from the double taxation of corporate equity as an individual tax reduction rather than as a corporate tax reduction, reductions in corporate tax burdens attributable to integration proposals enacted throughout the world during the last two decades do not appear in these data as reduced corporate income taxes.

There are now only *five* OECD countries that provide no relief from the double taxation of dividends: Belgium, Luxembourg, the Netherlands, Switzerland, and the United States. *Seven* countries provide full relief: Australia, Germany, Italy, and New Zealand provide relief at the shareholder level; Greece, Norway, and Turkey provide relief at the company level. *Eleven* countries provide *partial* integration relief.

The first shortcoming can be skirted by looking at changes in overall corporate effective tax rates instead of changes in the corporate tax share of taxes paid. Although corporate profits are not consistently measured from country to country, gross domestic product is consistently defined and is a scale factor that provides a rough proxy for corporate profits. As shown on Chart 4, over the 1965-1987 period examined, the United States experienced a 1.65 percentage point decline in the share of corporate taxes to GDP—falling from 4.09 percent in 1965 to 2.44 percent in 1987. Seven other countries, including New Zealand, Canada, Ireland, Finland, Germany, Australia, and Austria, also experienced declines in the percent of GDP represented by corporate income taxes. Fourteen countries experienced increases in effective corporate taxes during this 1965-1987 period. The average for all OECD countries was an increase of 0.59 percent. These figures appear in Table 4.[4]

Eighteen OECD countries provide partial or full relief from the double taxation of corporate income. This relief is generally accomplished by so-called imputation plans, whereby shareholders pay tax on the sum of dividends they actually receive plus a "gross up" amount that represents the corporate-level tax paid on those dividends. The shareholder is then allowed a credit against individual income tax for that corporate-level tax. The gross up and credit may be for the entire amount of corporate-level tax on dividends or for' some fraction. For these 18 countries, the reduced tax burden resulting from corporate tax integration is reflected by lower individual income taxes, even though the relief is often considered to be a reduction in corporate rather than in individual income taxes. Since virtually all corporate integration plans have been enacted since 1965, *increases* in corporate tax burdens between 1965 and 1987 may be considerably *overstated* by corporate tax shares of GDP and decreases in corporate tax burdens may be considerably *understated.* On

[3] For the years examined, income taxes for Portugal cannot be allocated between corporations and individuals.

[4] Portugal is excluded because corporate tax figures are unavailable.

the other hand, because only individuals pay tax in the last analysis, a more accurate picture may be painted by combining corporate and individual income taxes.

Total income taxes (corporate plus individual) did not decline as a share of GDP for any OECD country between 1965 and 1987 (Chart 5). On average, total income taxes for OECD member countries increased as a share of GDP from 9.51 percent in 1965 to 14.71 percent in 1987. This is a 5.2 percentage point rise but represents an increase in the effective tax rate of more than half. These averages, as well as data for each OECD country reporting revenue statistics, appear in Table 5. For the United States the increase was a modest 1.32 percentage points. The Netherlands, at 1.26 percentage points, had the smallest 22-year increase in total income taxes as a percent of GDP. Eleven other countries also experienced increases less than 5 percentage points, while 10 had increases of more than 5 percentage points, the highest being Denmark at 15.62 percentage points.

### EFFECTIVE TAX RATES ON INVESTMENT

So far, this analysis focuses only on the level of tax revenues and average rates of tax that generate them. Future tax revenues will be generated by new investments and, in the context of the global economy, investments will be located where returns are most attractive. Taxes on new investment vary considerably among the OECD countries. The OECD is currently undertaking a study of effective marginal tax rates on new investment in each member country.[5]

According to preliminary calculations, when only corporate equity investments are considered and personal tax rates are ignored, the United States' marginal tax rate ranks 12th from lowest (most favorable) among the 23 OECD countries participating. When debt financing is considered, the United States' marginal tax rate ranking improves to 9th lowest. This change in ranking occurs because countries with partial integration provide tax treatments for debt and equity that are more nearly the same. When top personal tax rates are also taken into consideration, the United States' rank further improves to 7th lowest. This change reflects the fact that the top income tax rates in the United States are generally lower than those in the other OECD countries.

It is interesting to note that the corporate tax bias in favor of debt financing over equity investments is clearly reflected not only in the effective marginal tax rates on new corporate investment for the United States but also for those found in virtually every other country. Partial integration mitigates this bias but does not eliminate it entirely.

### CONCLUSION

The OECD data show that the share of total tax revenues attributable 'to the corporate income tax has declined between 1965 and 1987 for the United States as well as for 13 other OECD countries. It has risen for only eight countries. However, the superficial measure of corporate taxes as a share of total tax revenues is flawed and cannot be relied upon for making sound policy decisions from international comparisons.

These data on the apparent relative decline in the corporate income tax may be misleading as a guide for policy making for the following reasons:

- First, all countries have experienced huge increases in total revenues over this period. These large increases in total revenues—whether from sharply rising social security taxes in one country or from newly enacted value added taxes in another country—raise the denominator and make corporate taxes appear to shrink even when they represent a stable or increasing source of revenue.
- Second, corporate income tax integration plans enacted in all but five of the 23 OECD reporting countries during the time period covered in this analysis have been generally reported in the OECD revenue statistics as reductions in individual taxes rather than reductions in corporate taxes. However, since most people regard corporate tax integration as a means to reduce the corporate double tax (and thereby lower the cost of corporate equity capital), apparent reductions in the share of corporate taxes in most other countries are understated relative to the United States, where no integration exists.

A better way to overcome these deficiencies in order to make meaningful international comparisons is to relate the combined revenues from the corporate and the

[5] This study employs an extension of a methodology pioneered by Professor Don Fullerton, former Treasury Deputy Assistant Secretary for Tax Analysis; United Kingdom Professor Mervyn King; and their collaborators.

individual income taxes to a broad measure of economic performance such as GDP. On this basis—which is consistent with the fundamental notion that only people are the ultimate taxpayers—over the period 1965 to 1987, taxes have increased for taxpayers in all OECD countries, including the United States and its major trading partners.

Finally, if there is concern about future corporate tax revenues, international competition for investment dollars suggests that it may be better to focus on ways to keep the effective marginal tax rate on new investment low in the United States rather than to focus on the overall corporate tax share. This is particularly crucial for equity-financed investments since the United States is one of the few remaining OECD countries with no mechanism for reducing the double tax on returns from corporate equity.

That concludes my formal statement, Mr. Chairman. I will be happy to answer questions you and members of the Committee may wish to ask.

## Table 1.—PERCENTAGE SHARE OF TAX COLLECTED AT DIFFERENT LEVELS OF GOVERNMENT, 1987

[Excluding Social Security Taxes]

| Country | Level of Government | | | |
|---|---|---|---|---|
| | Central | State | Local | Total |
| Federal Countries: | | | | |
| Australia | 80.8% | 15.8% | 3.4% | 100.0% |
| Austria | 67.1 | 18.2 | 14.7 | 100.0 |
| Canada | 49.5 | 40.0 | 10.5 | 100.0 |
| Germany | 50.4 | 36.6 | 13.0 | 100.0 |
| Switzerland | 42.7 | 33.2 | 24.1 | 100.0 |
| United States | 56.7 | | 16.9 | 100.0 |
| Unwtd. Average | 57.9 | | 13.8 | 100.0 |
| Unitary Countries: | | | | |
| Belgium | 92.5 | 0.0 | 7.5 | 100.0 |
| Denmark | 69.9 | 0.0 | 30.1 | 100.0 |
| Finland | 69.4 | 0.0 | 30.6 | 100.0 |
| France | 83.9 | 0.0 | 16.1 | 100.0 |
| Greece | 98.7 | 0.0 | 1.3 | 100.0 |
| Ireland | 97.2 | 0.0 | 2.8 | 100.0 |
| Italy | 98.3 | 0.0 | 1.7 | 100.0 |
| Japan | 63.7 | 0.0 | 36.3 | 100.0 |
| Luxembourg | 84.0 | 0.0 | 16.0 | 100.0 |
| Netherlands | 96.0 | 0.0 | 4.0 | 100.0 |
| New Zealand | 94.2 | 0.0 | 5.8 | 100.0 |
| Norway | 72.4 | 0.0 | 27.6 | 100.0 |
| Portugal | 92.2 | 0.0 | 7.8 | 100.0 |
| Spain | 83.1 | 0.0 | 16.9 | 100.0 |
| Sweden | 64.5 | 0.0 | 35.5 | 100.0 |
| Turkey | 88.4 | 0.0 | 11.6 | 100.0 |
| United Kingdom | 86.6 | 0.0 | 13.4 | 100.0 |
| Unwtd. Average | 84.4 | 0.0 | 15.6 | 100.0 |

May 3, 1990.

## Table 2.—TOTAL TAX REVENUE AS A PERCENT OF GDP

[Ranked by 1987 Percentages]

| | Country | 1965 | 1970 | 1975 | 1980 | 1985 | 1986 | 987 | Percentage Point Change 1965 to 1987 |
|---|---|---|---|---|---|---|---|---|---|
| 1 | Turkey | 14.96 | 17.66 | 20.74 | 21.68 | 19.67 | 22.79 | 24.12 | 9.16 |
| 2 | United States | 25.85 | 29.23 | 29.04 | 29.51 | 29.19 | 28.89 | 30.02 | 4.17 |
| 3 | Japan | 18.32 | 19.70 | 20.95 | 25.45 | 27.99 | 28.87 | 30.16 | 11.84 |
| 4 | Australia | 23.25 | 24.22 | 27.65 | 28.96 | 30.40 | 30.97 | 31.26 | 8.01 |
| 5 | Portugal | 18.41 | 23.06 | 24.72 | 28.69 | 31.63 | 33.38 | 31.38 | 12.96 |
| 6 | Switzerland | 20.71 | 23.81 | 29.61 | 30.78 | 32.00 | 32.54 | 31.98 | 11.27 |

## Table 2.—TOTAL TAX REVENUE AS A PERCENT OF GDP—Continued

[Ranked by 1987 Percentages]

| | Country | 1965 | 1970 | 1975 | 1980 | 1985 | 1986 | 987 | Percentage Point Change 1965 to 1987 |
|---|---|---|---|---|---|---|---|---|---|
| 7 | Spain | 14.46 | 16.90 | 19.59 | 24.07 | 29.10 | 30.98 | 33.02 | 18.56 |
| 8 | Canada | 25.43 | 31.35 | 32.37 | 31.60 | 32.93 | 33.19 | 34.52 | 9.09 |
| 9 | Finland | 29.53 | 31.44 | 35.08 | 32.95 | 36.80 | 38.06 | 35.89 | 6.36 |
| 10 | Italy | 25.50 | 26.12 | 26.21 | 30.18 | 34.43 | 36.11 | 36.24 | 10.74 |
| 11 | Greece | 20.58 | 24.30 | 24.64 | 29.38 | 35.21 | 36.79 | 37.38 | 16.81 |
| 12 | United Kingdom | 30.43 | 36.96 | 35.66 | 35.31 | 37.84 | 38.49 | 37.52 | 7.10 |
| 13 | Germany | 31.60 | 32.93 | 35.73 | 38.00 | 37.95 | 37.64 | 37.64 | 6.04 |
| 14 | New Zealand | 24.72 | 27.36 | 31.29 | 33.09 | 33.93 | 34.93 | 38.57 | 13.86 |
| 15 | Ireland | 26.00 | 31.21 | 31.56 | 34.05 | 38.38 | 39.54 | 39.86 | 13.86 |
| 16 | Austria | 34.67 | 35.71 | 38.64 | 41.17 | 43.06 | 42.86 | 42.34 | 7.67 |
| 17 | Luxembourg | 30.40 | 30.20 | 39.18 | 40.92 | 43.56 | 42.79 | 43.84 | 13.44 |
| 18 | France | 34.49 | 35.07 | 36.90 | 41.71 | 44.46 | 44.13 | 44.78 | 10.29 |
| 19 | Belgium | 30.76 | 35.22 | 41.06 | 43.50 | 46.54 | 45.75 | 46.13 | 15.37 |
| 20 | Netherlands | 33.24 | 37.59 | 43.66 | 45.82 | 44.90 | 45.93 | 48.00 | 14.76 |
| 21 | Norway | 33.31 | 39.26 | 44.87 | 47.09 | 47.57 | 49.89 | 48.32 | 15.01 |
| 22 | Denmark | 29.90 | 40.38 | 41.35 | 45.47 | 49.03 | 51.00 | 51.99 | 22.09 |
| 23 | Sweden | 35.39 | 40.23 | 43.88 | 49.36 | 50.57 | 53.72 | 56.72 | 21.33 |
| | Unweighted Average. | 26.60 | 30.00 | 32.80 | 35.16 | 37.27 | 38.23 | 38.77 | 12.16 |

Note. Total tax revenue includes all tax revenue received by central, state and local governments.

## Table 3.—CORPORATION INCOME TAXES PERCENT OF TOTAL TAX REVENUES

[Ranked by 1987 Percentages]

| | Country | 1965 | 1970 | 1975 | 1980 | 1985 | 1986 | 987 | Percentage Point Change 1965 to 1987 |
|---|---|---|---|---|---|---|---|---|---|
| 1 | Ireland | 9.06 | 8.81 | 4.83 | 4.54 | 3.22 | 3.52 | 3.24 | −5.82 |
| 2 | Austria | 5.38 | 4.39 | 4.35 | 3.50 | 3.44 | 3.46 | 3.28 | −2.10 |
| 3 | Finland | 8.34 | 5.52 | 4.26 | 4.46 | 4.01 | 3.74 | 3.90 | −4.44 |
| 4 | Sweden | 6.14 | 4.41 | 4.35 | 2.45 | 3.48 | 4.74 | 4.13 | −2.01 |
| 5 | Greece | 1.92 | 1.70 | 3.48 | 3.76 | 2.72 | 3.95 | 4.41 | 2.49 |
| 6 | Denmark | 4.54 | 2.64 | 3.12 | 3.23 | 4.85 | 6.20 | 4.48 | −0.05 |
| 7 | Germany | 7.83 | 5.67 | 4.46 | 5.46 | 6.12 | 5.97 | 5.01 | −2.82 |
| 8 | France | 5.27 | 6.29 | 5.19 | 5.13 | 4.45 | 5.04 | 5.18 | −0.09 |
| 9 | Switzerland | 7.08 | 7.55 | 7.73 | 5.79 | 5.95 | 6.27 | 6.24 | −0.83 |
| 10 | Belgium | 6.18 | 6.85 | 7.23 | 5.68 | 6.45 | 6.56 | 6.57 | 0.39 |
| 11 | Norway | 3.80 | 3.28 | 2.85 | 13.27 | 17.04 | 13.32 | 6.66 | 2.86 |
| 12 | Spain | 9.19 | 8.17 | 6.91 | 5.08 | 5.22 | 5.55 | 6.72 | −2.47 |
| 13 | Netherlands | 8.07 | 6.69 | 7.71 | 6.59 | 6.95 | 7.29 | 7.69 | −0.38 |
| 14 | Canada | 15.14 | 11.26 | 13.61 | 11.62 | 8.25 | 8.03 | 8.02 | −7.12 |
| 15 | United States | 15.81 | 12.71 | 10.79 | 10.16 | 7.11 | 6.97 | 8.12 | −7.69 |
| 16 | New Zealand | 20.66 | 17.85 | 11.78 | 7.76 | 8.34 | 6.59 | 8.87 | −11.79 |
| 17 | Australia | 16.28 | 16.97 | 12.40 | 12.20 | 9.34 | 9.09 | 10.28 | −6.00 |
| 18 | Italy | 6.89 | 6.55 | 6.31 | 7.79 | 9.25 | 10.59 | 10.55 | 3.66 |
| 19 | United Kingdom | 7.15 | 9.05 | 6.68 | 8.38 | 12.67 | 10.29 | 10.64 | 3.49 |
| 20 | Turkey | 4.80 | 6.42 | 5.13 | 4.14 | 9.47 | 12.01 | 10.72 | 5.92 |
| 21 | Luxembourg | 11.04 | 19.26 | 15.69 | 16.50 | 18.20 | 16.67 | 17.12 | 6.08 |
| 22 | Japan | 22.20 | 26.29 | 20.65 | 21.81 | 21.01 | 20.67 | 22.94 | 0.74 |
| | Unweighted Average. | 9.22 | 9.02 | 7.70 | 7.70 | 8.07 | 8.02 | 7.94 | −1.27 |

Note: Includes taxes levied by all levels of government.

## Table 4.—CORPORATION INCOME TAXES AS A PERCENT OF GDP

[Ranked by Percentage Point change]

| | Country | 1965 | 1970 | 1975 | 1980 | 1985 | 1986 | 987 | Percentage Point Change 1965 to 1987 |
|---|---|---|---|---|---|---|---|---|---|
| 1 | New Zealand | 5.11 | 4.88 | 3.69 | 2.57 | 2.83 | 2.30 | 3.42 | −1.69 |
| 2 | United States | 4.09 | 3.71 | 3.13 | 3.00 | 2.07 | 2.01 | 2.44 | −1.65 |
| 3 | Canada | 3.85 | 3.53 | 4.40 | 3.67 | 2.72 | 2.66 | 2.77 | −1.08 |
| 4 | Ireland | 2.36 | 2.75 | 1.52 | 1.55 | 1.23 | 1.39 | 1.29 | −1.06 |
| 5 | Finland | 2.46 | 1.74 | 1.49 | 1.47 | 1.47 | 1.42 | 1.40 | −1.06 |
| 6 | Germany | 2.47 | 1.87 | 1.59 | 2.07 | 2.32 | 2.25 | 1.88 | −0.59 |
| 7 | Australia | 3.79 | 4.11 | 3.43 | 3.53 | 2.84 | 2.82 | 3.21 | −0.57 |
| 8 | Austria | 1.86 | 1.57 | 1.68 | 1.44 | 1.48 | 1.48 | 1.39 | −0.48 |
| 9 | Sweden | 2.17 | 1.77 | 1.91 | 1.21 | 1.76 | 2.55 | 2.34 | 0.17 |
| 10 | France | 1.82 | 2.21 | 1.92 | 2.14 | 1.98 | 2.23 | 2.32 | 0.50 |
| 11 | Switzerland | 1.47 | 1.80 | 2.29 | 1.78 | 1.90 | 2.04 | 2.00 | 0.53 |
| 12 | Spain | 1.33 | 1.38 | 1.35 | 1.22 | 1.52 | 1.72 | 2.22 | 0.89 |
| 13 | Denmark | 1.36 | 1.07 | 1.29 | 1.47 | 2.38 | 3.16 | 2.33 | 0.97 |
| 14 | Netherlands | 2.68 | 2.51 | 3.37 | 3.02 | 3.12 | 3.35 | 3.69 | 1.01 |
| 15 | Belgium | 1.90 | 2.41 | 2.97 | 2.47 | 3.00 | 3.00 | 3.03 | 1.13 |
| 16 | Greece | 0.40 | 0.41 | 0.86 | 1.11 | 0.96 | 1.45 | 1.65 | 1.25 |
| 17 | United Kingdom | 2.17 | 3.35 | 2.38 | 2.96 | 4.79 | 3.96 | 3.99 | 1.82 |
| 18 | Turkey | 0.72 | 1.13 | 1.06 | 0.90 | 1.86 | 2.74 | 2.59 | 1.87 |
| 19 | Norway | 1.27 | 1.29 | 1.28 | 6.25 | 8.10 | 6.65 | 3.22 | 1.95 |
| 20 | Italy | 1.76 | 1.71 | 1.65 | 2.35 | 3.18 | 3.82 | 3.82 | 2.07 |
| 21 | Japan | 4.07 | 5.18 | 4.33 | 5.55 | 5.88 | 5.97 | 6.92 | 2.85 |
| 22 | Luxembourg | 3.36 | 5.82 | 6.15 | 6.75 | 7.93 | 7.13 | 7.50 | 4.15 |
| | Unweighted Average | 2.38 | 2.55 | 2.44 | 2.66 | 2.97 | 3.00 | 2.97 | 0.59 |

Note: Includes taxes levied by all levels of government. May 3, 1990

## Table 5.—TOTAL INCOME TAX (INDIVIDUAL & CORPORATION) AS A PERCENT OF GOP

[Ranked by Percentage Point change]

| | Country | 1965 | 1970 | 1975 | 1980 | 1985 | 1986 | 987 | Percentage Point Change 1965 to 1987 |
|---|---|---|---|---|---|---|---|---|---|
| 1 | Netherlands | 11.89 | 12.57 | 15.18 | 15.05 | 11.83 | 12.61 | 13.15 | 1.26 |
| 2 | United States | 11.98 | 14.00 | 12.67 | 13.88 | 12.49 | 12.25 | 13.30 | 1.32 |
| 3 | Norway | 14.46 | 15.09 | 15.42 | 19.43 | 18.69 | 18.09 | 15.99 | 1.53 |
| 4 | Portugal | 4.53 | 5.46 | 4.31 | 5.66 | 8.14 | 6.74 | 6.09 | 1.57 |
| 5 | Germany | 10.67 | 10.65 | 12.39 | 13.33 | 13.20 | 13.00 | 12.80 | 2.12 |
| 6 | Austria | 8.84 | 8.99 | 10.10 | 11.01 | 11.37 | 11.49 | 11.01 | 2.17 |
| 7 | France | 5.48 | 6.43 | 6.50 | 7.55 | 7.70 | 7.89 | 8.05 | 2.57 |
| 8 | United Kingdom | 11.25 | 14.94 | 15.88 | 13.34 | 14.64 | 14.74 | 13.96 | 2.71 |
| 9 | Sweden | 19.42 | 21.80 | 22.15 | 21.47 | 21.26 | 22.95 | 23.43 | 4.01 |
| 10 | Turkey | 4.42 | 5.91 | 8.78 | 11.23 | 7.28 | 8.81 | 8.59 | 4.17 |
| 11 | Greece | 2.01 | 2.99 | 3.38 | 5.69 | 6.14 | 6.45 | 6.37 | 4.36 |
| 12 | Finland | 13.04 | 14.95 | 18.51 | 16.20 | 18.77 | 19.74 | 17.76 | 4.72 |
| 13 | Switzerland | 7.92 | 9.71 | 12.98 | 12.74 | 13.07 | 13.46 | 12.88 | 4.96 |
| 14 | Australia | 11.79 | 13.15 | 15.49 | 16.26 | 16.66 | 17.36 | 17.41 | 5.62 |
| 15 | Japan | 8.04 | 9.41 | 9.33 | 11.74 | 12.81 | 13.19 | 14.17 | 6.13 |
| 16 | Spain | 3.55 | 3.41 | 4.32 | 6.25 | 7.63 | 7.67 | 9.76 | 6.21 |
| 17 | Canada | 10.00 | 13.97 | 15.30 | 14.72 | 14.53 | 15.21 | 16.34 | 6.34 |
| 18 | Luxembourg | 10.92 | 13.08 | 17.04 | 17.73 | 19.36 | 18.47 | 18.58 | 7.66 |
| 19 | New Zealand | 14.96 | 16.72 | 20.82 | 23.09 | 23.32 | 23.11 | 22.93 | 7.97 |
| 20 | Ireland | 6.69 | 8.46 | 9.47 | 12.43 | 13.24 | 14.30 | 15.10 | 8.41 |
| 21 | Italy | 4.55 | 4.55 | 5.63 | 9.40 | 12.68 | 13.07 | 13.09 | 8.55 |
| 22 | Belgium | 8.50 | 11.05 | 16.13 | 17.82 | 18.91 | 18.40 | 18.14 | 9.64 |
| 23 | Denmark | 13.74 | 20.68 | 24.41 | 25.01 | 27.85 | 28.74 | 29.36 | 15.62 |

## Table 5.—TOTAL INCOME TAX (INDIVIDUAL & CORPORATION) AS A PERCENT OF GOP—Continued

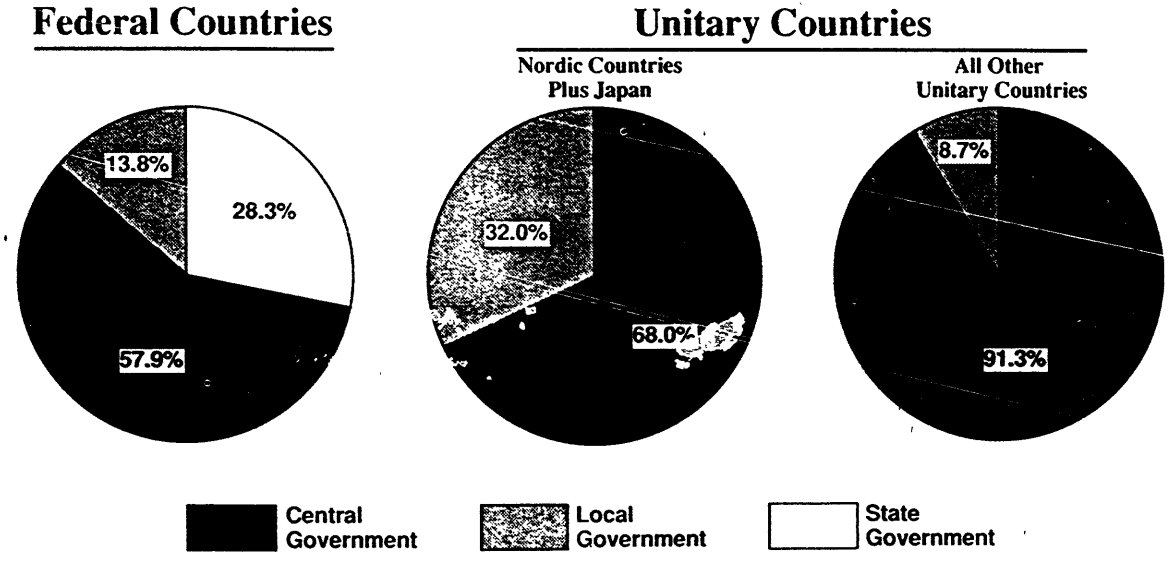
[Ranked by Percentage Point change]

| Country | 1965 | 1970 | 1975 | 1980 | 1985 | 1986 | 987 | Percentage Point Change 1965 to 1987 |
|---|---|---|---|---|---|---|---|---|
| Unweighted Average | 9.51 | 11.22 | 12.88 | 13.96 | 14.42 | 14.68 | 14.71 | 5.20 |

Note: Includes taxes levied by all levels of government.

Coopers &Lybrand

# OECD Member Country Taxes, by Level of Government, 1987*

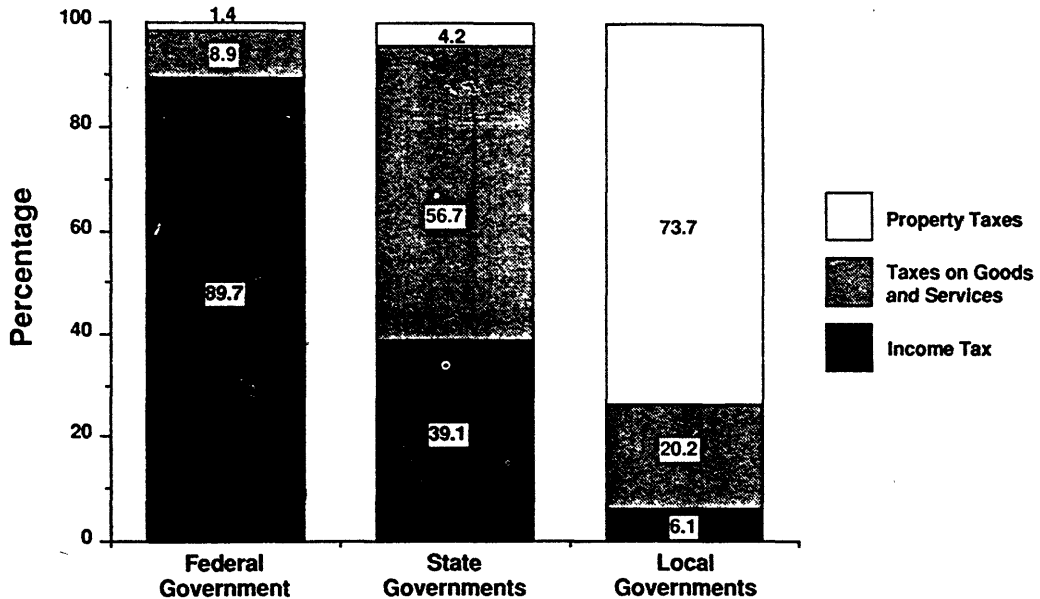



* Excludes Social Security taxes

Chart 2

Coopers &Lybrand

# Sources of Tax Revenues in the United States by Levels of Government, 1987*

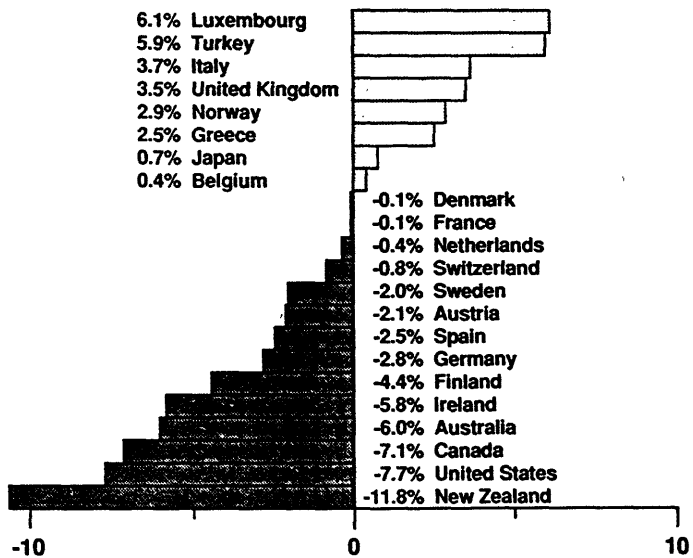



* Excludes Social Security taxes

Chart 3

Coopers &Lybrand

# Change in Corporation Income Tax Revenue as a Share of Total Tax Revenue, 1965-87*

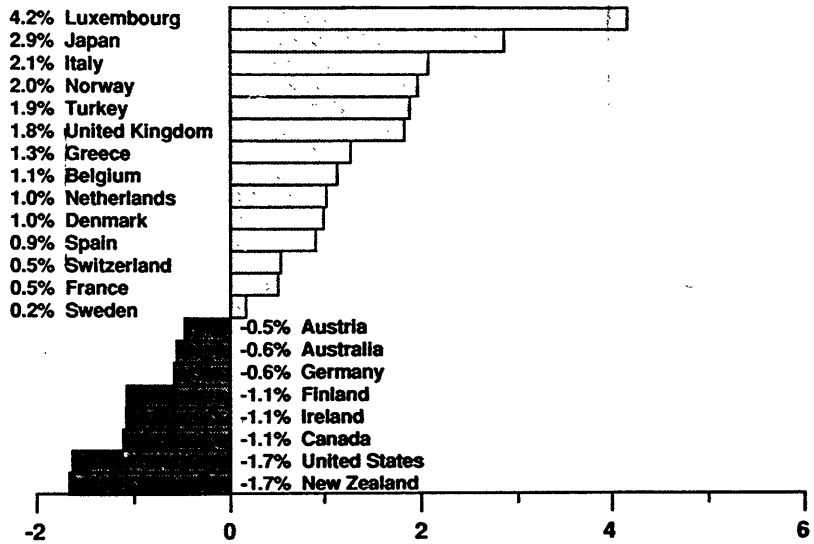



* Percentage point increase or decrease from 1965 to 1987

Chart 4

Coopers &Lybrand

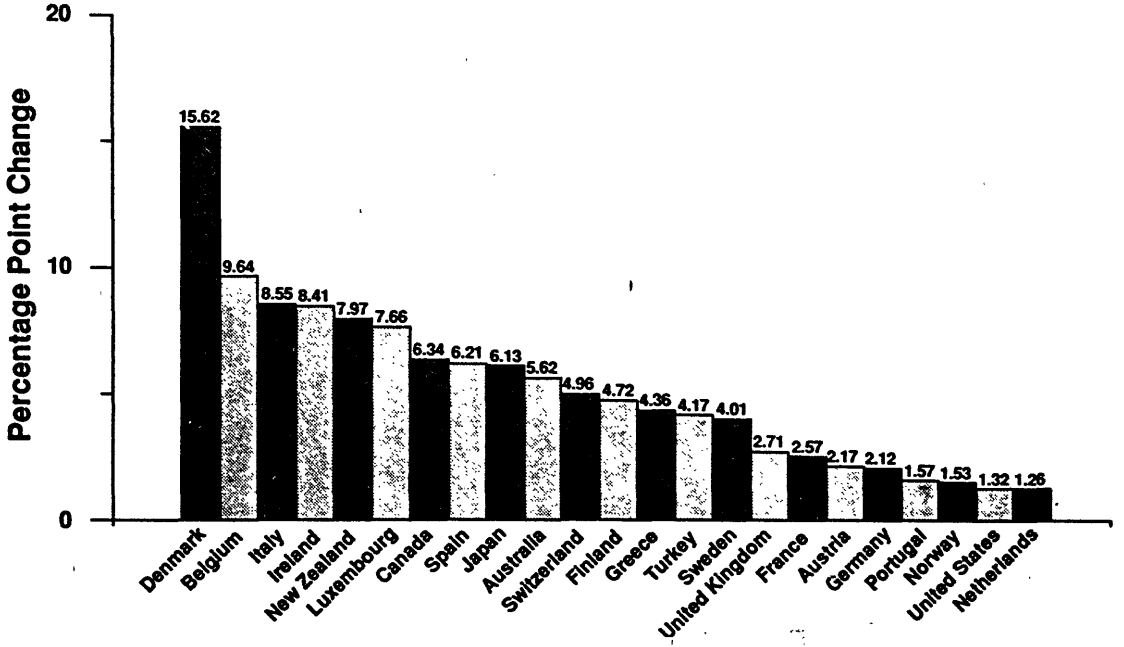
# Change in Corporation Income Tax Revenue as a Share of GDP, 1965-87*




* Percentage point increase or decrease from 1965 to 1987

Coopers &Lybrand

# Change in Total (Individual and Corporation) Income Tax Revenue as a Share of GDP, 1965-87



# COMMUNICATIONS

## STATEMENT OF THE AMERICAN INSURANCE ASSOCIATION

The American Insurance Association (AIA) is a national trade association representing 220 property and casualty (P/C) insurance companies which write multiline coverage throughout the United States. Combined premiums of members of the AIA represent more than 28 percent of direct P/C insurance premiums written in the United States.

AIA appreciates having this opportunity to comment upon the reported corporate income tax shortfall under the Tax Reform Act of 1986 (the Act).

Under the Act, P/C companies are subject to a number of fundamental tax law changes that are specific to the P/C industry, including the discounting of loss reserves, the offset of unearned premium reserves, and the proration of tax-exempt interest and the dividends received deduction. Also applicable to P/C insurers, like other corporate taxpayers, is the reduction in the corporate tax rate (*i.e.*, to 40 percent in 1987, and 34 percent thereafter), reduction of the deduction for dividends received, and the alternative minimum tax (AMT). Together, these provisions have imposed an enormous Federal tax burden on the P/C insurance industry.

AIA, joined by other P/C insurance trade associations, has commissioned Price Waterhouse to survey the effects of the Act upon P/C insurers in 1987 and 1988, the first two taxable years under the Act. The 1987 and 1988 surveys are based upon actual tax return and annual statement data provided to Price Waterhouse by P/C insurers that comprised companies writing some 80 percent and 70 percent, respectively, of the industry's net written premiums (extrapolated by Price Waterhouse to full industry figures). A copy of each survey is attached to this statement.

The industry tax survey for 1987, released on April 20, 1989, reflects that the P/C insurance industry's Federal income tax liability in 1987 was almost $3.5 billion. More than half of this tax liability, well in excess of the original congressional revenue estimates for 1987, was attributable to the foregoing provisions of the Act that were specifically targeted at the P/C insurance industry.

The survey for 1988 was released on March 27, 1990. It reflects that the P/C insurance industry's Federal income tax liability increased 15 percent over 1987, to almost $4 billion; this in a taxable year when the top marginal corporate rate *dropped* by 15 percent. The tax liability attributable to the P/C-targeted provisions in the Act increased 32 percent over 1987, also well in excess of congressional revenue estimates. Indeed, in the first two years under the Act combined, the P/C insurance industry paid almost one-third more than the Congress estimated that it would pay at the time the Act was adopted.

Tax liability, however, does not completely reflect the effect of the foregoing three provisions on the P/C insurance industry because net operating losses (NOLs) carried into 1987 and 1988 were available to offset P/C taxable income. The P/C industry's taxable income before reduction by NOLs, which provides a more appropriate indication of the long-term effects of the Act, increased as a result of the three P/C-specific provisions of the Act by over $9.5 billion in 1987 and over $10 billion in 1988.

The Price Waterhouse tax surveys demonstrate that the Act already has placed a substantial new tax burden on the profitability of the industry. There is every reason to believe that this will continue to be the case.

Entering the 1990's, the P/C insurance industry faces certain latent effects of the Act that should further deepen its impact. Beginning in 1990, the AMT is significantly broadened, with the 75 percent adjustment for "adjusted current earnings," replacing the 50 percent adjustment for "book income." To an increasing extent, the otherwise tax-exempt portion of P/C investment portfolios will become fully subject to proration under the Act as the stock of "grandfathered" bonds diminishes.

Furthermore, the Treasury Department, which was authorized in the Act to provide in regulations for the "proper treatment" of salvage (and reinsurance) attributable to unpaid losses, now is seeking legislation to require the reduction of the deduction for losses incurred by estimated salvage (including subrogation) recoverable, at an estimated cost to the P/C industry, over six years, of $1 billion.

In announcing this hearing, the Chairman stated that:

> One of the key goals—and a major selling point—of the 1986 Act was to shift $120 billion in taxes from individuals to corporations in the first five years. Current figures make it plain that little, if any, of this expected increase in corporate income tax receipts is materializing. In fact, corporate income tax receipts are falling short by some $20 to $30 billion per year.

The Price Waterhouse surveys make it clear that the increase in corporate income tax receipts expected from the P/C insurance industry is materializing. Moreover, this is an industry that is paying far in excess of its expected share of such receipts.

The effects of the Act upon individual P/C insurers will vary. Some P/C companies will be forced to increase prices, increasing the costs of insurance to policyholders and/or losing market share to foreign competition or self-insurance. Some will try to maintain prices, suffering a slowed growth of statutory surplus and reduced rates of return on that surplus. At a time when virtually all P/C insurers still are in the process of adjusting to the fundamental changes in the Act, we urge you to recognize this industry's contribution and resist any efforts to further aggravate its already severe Federal tax burden under the Tax Reform Act of 1986.

O