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A Study Of The Elimination Of Corporate income Taxes In America

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A STUDY OF THE ELIMINATION OF CORPORATE INCOME TAXES IN AMERICA

by

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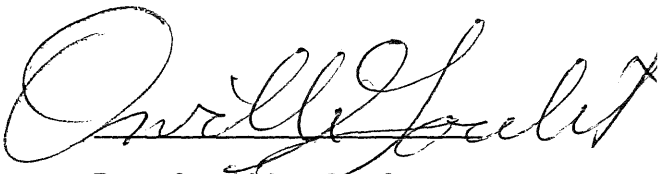

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Title: A STUDY OF THE ELIMINATION OF CORPORATE INCOME TAXES IN AMERICA

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ABSTRACT

A study advocating the elimination of corporate income taxes. Resulting benefits and savings are described including the creation of a more progressive personal tax structure and a reduction of general price levels. The shift in tax burden from public to private sectors is examined along with the determination of an average corporate tax rate used to calculate the expected price reductions. Implementation strategy is discussed and focuses on public acceptance and flexibility.

LIST OF EXHIBITS

CHAPTER 1

Introduction

Every American citizen is subject to the requirements of the Internal Revenue System (IRS) and the federal tax laws. As each person is responsible for determining, reporting and paying personal income taxes, theoretically, every dollar of income that falls into the hands of an individual is considered in the process and the government will receive its fair share. With this in mind, it would seem that the government has the capability to tax every dollar at least once as it moves through the monetary system via the ultimate beneficiary: the American citizen. But then what of the corporate income tax system? The proposal of this thesis is that the United States would be better off relying solely on the personal income tax system and eliminating corporate income taxes entirely. This paper will examine the benefits of such a system, analyze data to predict some of the effects, and form an implementation plan for such a change.

An initial reaction is to think some income would escape a tax system that has no provisions for corporate taxation. When working with individuals and businesses, there are four combinations of transactions that can occur:

(1) individuals buying from individuals, (2) individuals buying from businesses, (3) businesses buying from individuals, and (4) businesses buying from businesses.

When an individual purchases from another individual, the resulting income of the later is considered by the personal income tax system and must be reported except for a few exceptions. Likewise, when a business buys from an individual, the income must be reported under the same rules. This would not change due to this proposal. The last two cases are more involved.

When a business sells to an individual, would that income be untaxed under this proposal? From the sale point on, it would not be taxed until distributed eventually to shareholders. Dividends would become taxable income immediately when paid, but retained earnings would in a sense be a way to defer taxes until eventually distributed. That is the same as it is presently for stockholders. Gains are not taxable until realized upon sale.

Getting back to the original sale to an individual by a business, realize that the money paid by the individual has already been taxed before it becomes income to the corporation. When the individual received the money as income prior to spending it, it was taxed according to the personal tax system. What was left to spend was after-tax income. The individual's purchasing power was already reduced by the government's portion before he or she decided

to buy. Presently, that purchasing power is diminished a second time by the amount a business must add to the price of an article to pay the taxes that will be due. This proposal would save the second process of taxation while providing the desired amount of tax revenue.

The fourth case to look at is the business to business transaction. Here the revenue has not been taxed and will not be taxed until distributed as dividends or realized by stock sale according to this proposal. This is true to some extent and a valid criticism. However, it must be realized that in the long run, all businesses can not survive by selling only to businesses. Eventually, the demand must come from individuals whose purchasing power is their already taxed income. For example, a grocery wholesaler may buy only from other businesses and sell only to other businesses, but that wholesaler could not survive without the ultimate consumer, the individual taxpayer, demanding and consuming groceries. Other cases are more complex but boil down to the same conclusion. At most, taxes from this type of transaction would be deferred until business income is distributed as dividends or stock is sold which would realize the gains caused by profitable operations and retained earnings. Even so, the effect would be small. Corporate dividends and retained earnings for 1987 totaled

only 3.2% of gross national product (GNP)[1]. This deferment alone should not even affect stock prices. Since no businesses would be taxed under this proposal, businesses which sell to other businesses would have no inherent advantage. Taxes from stock price increases are already deferred until sale. In that aspect, nothing would change. Other effects on the stock market will be discussed later.

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[1] Mark S. Hoffman, ed., The World Almanac and Book of Facts: 1989, New York: Newspaper Enterprise Association, 1988, 131.

CHAPTER 2

Benefits

One of the primary benefits of this proposed system has already been mentioned; the IRS could discontinue its corporate tax operations. They could eliminate all of the expenses involved with policing every corporation in America. From writing the regulations, tracking the companies, auditing books, collecting taxes, and fighting court battles; this could all be eliminated. Shifting the tax burden to individuals would cost little compared to the savings involved. For fiscal 1987, the IRS budget was $7.7 billion. This was 1.6% of all corporate and personal taxes collected.[1] Raising individual rates would cost little, though with higher rates, more policing might be required to counteract the increased motivation for cheating on individual tax returns.

An issue that comes up immediately is corporate integrity. Without the IRS looking over their shoulders, would US businesses find it easier to conceal the results of their own operations to their advantage?

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[1] Ibid., 145.

In general, record keeping for tax purposes and record keeping for stockholder reporting purposes is so different that eliminating one would not greatly affect the ability to conceal the facts with the other. It is illegal now and would continue to be. The law requires that records be kept for stockholder reporting purposes and under this proposal that requirement would not change. Those records would be more important and because of this, more stringent supervision by the applicable agencies would probably be needed, but this added expense would be offset by IRS budget savings. Independent auditors' reports would have more importance too, but the basic responsibility of the corporation to keep accurate records would still apply.

A second problem deals with the government's ability to manipulate businesses through the tax laws. For example, investment tax credits are one way the government can increase the level of capital investments in the economy. This could still be done without the corporate tax system. For example, if the government decides more golf courses are needed, an appropriate payment could be provided to anyone who builds a qualifying golf course. There is no difference between a tax break in one hand and a treasury check in the other. In both cases the government is giving something of monetary value for the desired action. In many ways the direct payment is preferable as it does not cloud the issue and hide it in tax regulations. This would also

make it harder for congress to disguise preferential treatment in the form of special tax considerations.

Another emotional issue that would appear if this proposal were to be considered would be the effect on charitable contributions. Corporations would certainly contribute less to these causes, but would not eliminate contributions. Each dollar contributed would in effect cost more without the resulting tax savings, but certainly there is still corporate image, publicity and good will involved. Furthermore, if the government wishes to manipulate the level of charitable contributions, it still could easily do this. By controlling the extent to which contributions could be deducted on individual income tax returns, contribution levels could be controlled as desired. Once again, a suitably long implementation period would smooth the changeover process.

Moving to the corporate side of the issue, many savings besides tax savings would be realized. Already mentioned were reduced record keeping costs. Corporations keep many different sets of books for many reasons, but eliminating one complete set can only save money.

Along with some bookkeepers and their materials would go the corporate tax lawyers. Tremendous amounts of money are spent each year by corporations and the government fighting tax battles in court. This is a zero sum game as no value is added in the process; what corporations lose is

gained by the government and vice versa. Cutting out this non-productive process would reduce operating expenses for both the government and corporations. A long implementation period would soften the blow of job eliminations.

In marketing, sales promotions would often be simplified as no explanation of income tax effects would be necessary. Whether all businesses would consider this an advantage is doubtful as many sales pitches rely on tax effects as a major selling point. For buyers though, the overall picture would be less cluttered with the disappearance of tax considerations.

In management, decisions would often be much less complex. Capital budgeting would be simplified because there would be no more depreciation tax savings, complicated leasing evaluations, and other similar items. Although decisions would still be affected by accounting periods, they would not be affected by tax accounting periods. This would both simplify decision making and would allocate funds to projects more efficiently. The most efficient use of funds would ultimately be unaffected by the presence of any accounting periods. The juggling of revenues and expenses according to the relative benefits of which tax accounting period they fall into would be eliminated. Presently, decisions are often made according to which tax year cash flows would fall in. Funds must also be set aside to allow for the payment of taxes. Both processes are

counterproductive to optimum financial efficiency. Here as in every major corporate department, savings would be realized by the elimination of corporate taxes.

The previous discussion was from the viewpoint of the individual corporation. There are also many benefits from this proposal that are evident to both the public and the financial markets.

First of all, the capital market would be more efficient in allocating funds to the most productive uses. Tax preference items often make investments more desirable than they would be on their own. Because of this, funds often flow to those investments that are inherently less productive on their own merits. As a result of this treatment, investments are often created solely for the purpose of falling into those tax preference categories. Marginal investments are sold based on favorable tax treatment. This type of investment is often needlessly complex and less productive due to demanding requirements of the tax code and the need for lawyers just to understand the tax code. The reason for tax preference items is not to create investments that are inherently poor operations. If the government wants to aid an industry or stimulate investment, the public would be better off in the long run if the government made direct payments as discussed earlier. America is scarred with unused buildings built with funds from poorly understood yet aggressively sold real estate

investment trusts. The reduction in investor confusion alone would be a significant benefit.

Another benefit of this proposal would be the reduction of corporate lobbying in congress. If congress could no longer give tax breaks, organizations would no longer lobby for them. There would still be lobbying for other types of more direct aid, as proposed, but it would be a more difficult situation for congress to dole out preferential treatment. For example, it is one thing for a senator to vote for allowing a tax credit for energy resource exploration; it is another for that senator to vote for direct government payments using money collected through his constituents' personal income taxes. It is mostly a perceptual difference, but getting this type of treatment out of the tax code maze and into greater light would benefit the nation and subject congress to more visible accountability.

Another issue to fall by the wayside would be the value of tax losses to corporations. Under the current system, a company's unprofitable operations have real value as tax losses that are carried forward from year to year. There is logic to this treatment on an individual basis as some businesses are very cyclical. What is less logical is that a business that has built up great losses for one or more years can transfer those losses to a takeover company. This only promotes investment in and continuing operation of

companies that on their own merit failed to produce enough income to continue profitably. Eliminating corporate income taxes would end this situation and guide takeover companies to inherently more productive targets.

The double taxation of corporate dividends under the current regulations is another issue that would be resolved. Dividend income is normally taxable income to an individual, yet it comes out of after-tax earnings on the corporate books. The same before-tax dollar of corporate profit is taxed twice before it reaches the investors' hands. If corporate taxes are eliminated, the same before-tax dollar of corporate profit would only be taxed once under the personal income tax system. Corporate dividends were only 2.1% of GNP in 1987,[2] but their double taxation has long been a sore point with stockholders.

Also eliminated would be the value of tax deductions to a corporation. To many, this would forever end the ethical issue of questionable deductions, three-martini lunches and overly plush business trips. Some would object, such as the charities mentioned earlier and travel agents, but the impetus would be to force corporations to reconsider expenses and their magnified effect on the bottom line. Furthermore, excessive expenses would impact more directly the share holders of each company and less the American

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[2] Sumner N. Levine, ed., The Dow Jones Irwin Business and Investment Almanac: 1989, 131.

taxpayer at large. Presently, corporate expenses reduce reported profits which reduce income taxes collected, to the detriment of the federal budget. Under this proposal, corporate expenses would affect profits available for shareholders dollar for dollar. This too would reduce tax revenues collected due to lowering the personal income of investors. The difference is that the investor is more directly affected by the level of corporate expenses and hence profits. This would increase investor concern and monitoring of corporate expenses and create a greater sense of accountability in corporations.

To this point, many benefits have been discussed along with a few of the problems. The overall premise is that there would be some monetary savings realized along with simplification of the income tax system. This all seems reasonable, but even without these efficiency benefits, the elimination of corporate income taxes would be worthwhile on another basis. Implementation would create a more progressive income tax system in America. The reason for this is that when corporate taxes are eliminated, the free market system should drive prices down. Companies will be able to derive the same after-tax income from lower prices because after-tax income will be the same as before-tax income. As poorer people are, by necessity, forced to spend more of their disposable income they will in effect benefit proportionately more from a general reduction in prices.

They will also have to pay higher taxes, but throughout the rest of this discussion, it will be shown that the increase in taxes is more than offset by lower prices for more than half of all Americans. These are the people from whom support for implementation of this proposal must eventually be sought.

CHAPTER 3

Tax Shift Analysis

Since this thesis is based upon shifting federal tax revenues from the corporate income tax system to the personal income tax system, the magnitude of this shift must be determined. Exhibit 1 shows corporate and personal federal income tax revenues for 1985, 1986, 1987, and estimates for 1988 and 1989. These figures are also shown as percentages of total revenues.[1] The final line shows for each year, the percent increase in personal income tax revenues required to equal total taxes collected assuming corporate taxes to be zero.

The effects of the Tax Reform Act of 1986 are readily seen. Corporate taxes as a percentage of federal tax revenues went up from 15.3% in 1986 to an estimated 22.2% in 1989, a 45% increase. In contrast, personal taxes as a percentage of total tax revenues decreased 8% from 84.7% to 77.8%.

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1 Department of the Treasury, Internal Revenue Service, Statistics of Income Division, Source Book, Statistics of Income 1985: Corporation Income Tax Returns, Government Printing Office, Publication 1053 (Revision 6-88,) 8, 245.

EXHIBIT 1

Federal Tax Revenues

(In millions of dollars)

	1985	1986	1987	1988	1989 (Estimated)
Individual income taxes	334,531	348,959	392,557	393,395	412,353
a.(Percentage of total)	(84.5%)	(84.7%)	(82.4%)	(78.8%)	(77.8%)
Corporate income taxes	61,331	63,143	83,926	105,567	117,704
b.(Percentage of total)	(15.5%)	(15.3%)	(17.6%)	(21.2%)	(22.2%)
Total income taxes	395,862	412,102	476,483	498,962	530,057
	(100.0%)	(100.0%)	(100.0%)	(100.0%)	(100.0%)
Increase in individual taxes required if corporate taxes are eliminated (b / a)	18.3%	18.1%	21.4%	26.9%	28.5%

Source: Department of the Treasury, Internal Revenue Service, Statistics of Income Division, Source Book, Statistics of Income 1985: Corporation Income Tax Returns.

For this study, the percentage increase in personal taxes required to compensate for zero corporate taxes for the year 1988 will be used. This figure is 26.9%, which is to say that if no corporate taxes were collected in 1988, personal tax would have to have been 26.9% more than they actually were for total revenues to be the same. For now, the other savings discussed earlier will not be considered.

Using 26.9% as a target increase, individual tax rates for different taxable income brackets can be calculated. The personal income tax system is designed to be a progressive tax system. For simplicity, 26.9% will be added to each personal income tax bracket. All personal tax rates could be restructured as desired, but the intent of this study is to show that even an across the board flat increase would be to the advantage of over half of all Americans. Exhibit 2 shows current personal tax rates[2] and required rates calculated to conform with this proposal.

What this means is that as proposed, the largest personal income tax increase would be 7.5 percentage points. For everyone in the lower bracket the increase would be only 4.0 percentage points. These are marginal tax rates. In 1987, per capita personal income in the US was $15,340.[3] Not all of this would require reporting to the IRS, but it hints that the average American, from a mathematical viewpoint, is not in the highest income tax bracket. In fact, for 1986 returns, the lowest 50% of all taxpayers had adjusted gross incomes of $17,147 or less and paid only 6.2% of all personal income taxes. They made 15.2% of all

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[2] Sumner N. Levine, ed., The Dow Jones Irwin Business and Investment Almanac: 1989, Homewood, IL: Dow Jones Irwin, 1989, 522-523.

[3] U.S. Bureau of the Census, Statistical Abstract of the United States: 1988 (108th edition,) Washington, DC: Government Printing Office, 1987, 60.

EXHIBIT 2

Personal Income Tax Rates for 1988

Taxable Income	Marginal Tax Rate	With 26.9% Increase	Percentage Point Increase
Joint Returns:			
0 - $29,750	15.0%	19.0%	4.0%
$29,750 and up	28.0%	35.5%	7.5%
Single Returns:			
0 - $17,850	15.0%	19.0%	4.0%
$17,850 and up	28.0%	35.5%	7.5%

Source: Sumner N. Levine, ed., The Dow Jones Irwin Business and Investment Almanac: 1989.

adjusted gross income and paid an average tax rate of only 6.1%. Furthermore, the average adjusted gross income in this group was $7,415 and the average taxes paid only $455.[4] So what would a 26.9% tax increase mean in dollars for half of America? It would mean an average of $122 more in federal income taxes to pay each year. This alone would surely not get many votes for zero corporate taxes from this group of people, but something else could. If prices indeed

[4] Sumner N. Levine, ed., The Dow Jones Irwin Business and Investment Almanac: 1989, 554.

went down, how much would they have to go down before this group would be better off under the proposed tax system? For the 50% of American taxpayers with the lowest adjusted gross incomes, the average price reductions would have to be 1.6%. This is calculated by dividing the average $122 in extra taxes they would have to pay by the average adjusted gross income for the group of $7,415. Certainly, 50% of America's taxpayers would not be exactly 50% of America's voters, but it is a conservative number. Those eligible voters that do not make enough money to file a tax return would surely lean favorably toward reduced prices. Not all income is spent, of course, and that amount that was not spent each year would not yield immediate price savings benefits. However, when dealing with a group that averaged $7,415 in income, there would not be much left for savings. In fact, for all Americans in 1987, personal saving were only 3.2% of disposable income.[5] Even assuming the group discussed earlier saved 3.2% of adjusted gross income, the break even price reduction required would rise only to 1.7%.

Before moving on, one other income level will be examined. This level is the two wage-earner median family income. In 1987 this figure was $44,617. This family paid $5,319 in taxes, filing jointly and married with two

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[5] Mark S. Hoffman, ed., The World Almanac and Book of Facts: 1989, New York: Newspaper Enterprise Association, 1988, 145.

dependent children.[6] These taxes paid were 11.9% of total adjusted gross income. For them, a 26.9% tax increase would be $1,431. Using the same procedure as before, they would have to have prices reduced 3.2% to break even under this proposal if all adjusted gross income was spent. If they saved 3.2% of their adjusted gross income, the break even price reduction would be 3.3%. Notice that this break even price reduction is about twice that of the lowest 50% of American taxpayers, but is still a small percentage. These numbers will be compared later to some calculated price reductions.

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[6] Sumner N. Levine, ed. The Dow Jones Irwin Business and Investment Almanac: 1989, 554.

CHAPTER 4

Average Corporate Tax Rate Determination

To calculate price reduction estimates, an average income tax rate paid by US corporations must be determined. In determining such a figure, some definitions must be made to suit the application. Changes in tax laws and the economy must also be examined. Given these definitions, an understanding of the tax structure, and the proper data, a usable figure can be obtained.

Since the subject is income taxes, the first definition will be of income. Income will include not only income from continuing operations, but capital gains and losses, extraordinary gains and losses and other sources. As these are all normal occurrences in the economy as a whole, they will be included since the results calculated will be used to project the future for corporations as a whole. The numbers used for income will be reduced by losses for the purpose of this project. For example, if two companies had a profit of $100,000 and a loss of $100,000, respectively, then their average income would be zero, not $50,000. This is an important distinction since some sources do not consider losses when reporting income figures and losses are not negligible. For example, in 1986, over $363 billion of

net income was reported to the IRS, yet if reported losses are deducted, the figure falls to approximately $240 billion.[1] For every dollar of corporate profit reported to the IRS, there is about a third of a dollar loss reported.

The next word defined will be taxes. This will be limited to federal taxes due. State and local taxes are essentially similar, but will not be counted here as this study is concerned with federal tax laws only. However, state and local taxes would change the results only a few percentage points. The Value Line Investment Survey estimates for the average company in their survey, the Value Line Industrial Composite, that state and local taxes would comprise 4.0 percentage points of the total 38% of corporate income lost to taxes under the present laws.[2] The Value Line Industrial Composite is based on over 900 companies chosen for profitability. These are predominantly very large corporations in the top corporate tax bracket with oil related industries heavily weighing the results. For these reasons, statistics on this composite are not entirely suitable for dealing with the whole of US businesses.

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[1] Department of the Treasury, Internal Revenue Service, Statistics of Income Division, Source Book, Statistics of Income 1985: Corporation Income Tax Returns, Government Printing Office, Publication 1053 (Revision 6-88,) 8, 245.

[2] "The Value Line Investment Survey Part II: Selection and Opinion," Value Line Investment Survey (10 February 1989,) 595-598.

For this study, taxes collected by the government will be considered net of tax credits. Paying the government two dollars while getting one back will be considered the equivalent of paying only one dollar in the first place. Again, the difference is not negligible. In 1986, for every corporate tax dollar due the IRS, there was an offsetting 43 cents of tax credit. This treatment not only makes some common sense when analyzing the overall impact of federal taxes on businesses, it also makes accounting for changing tax laws simpler. For example, the reduced federal tax rates that went into effect in 1985 and 1986 were offset by the elimination of many tax preferences and tax credits.[3] Treating taxes and tax credits as offsetting eliminates the need to analyze the impact of the individual parts.

A final definition will be that of US corporations. This term will be synonymous with companies, firms, and businesses. Partnerships, proprietorships and personal corporations will not be included because income from these endeavors is taxed via the personal income tax system.

One important constraint in this study is the long lead time involved with the compilation of IRS statistics. There is nearly a two year delay involved which causes complications due not only to normal business fluctuations, but especially when tax laws change in the interim.

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[3] "The Value Line Investment Survey Part IV: Revisions," Value Line Investment Survey (26 September 1986.)

For example, the latest IRS data used in this study covers accounting periods ending July 1985 through June 1986.[4] Since then, the 1986 Tax Reform Act has completely changed the structure of the corporate tax system. Because of this, same assumptions will have to be made in order to forecast the current effects of the new tax laws.

More than one method will be used to derive an average corporate income tax rate. What is hoped to be the most precise method will utilize all of the previous definitions. However, this result will be compared with different source data and other methods. The goal is to find a relatively accurate number that can be defended by several means as an average tax rate for US corporations.

The Tax Reform Act of 1986 brought many changes to the corporate tax system. The top rate dropped from 43% to 34% to be phased in and fully effective July 1987. To counteract the federal budget effect of the lower rates, several other reforms went into effect: the investment tax credit was repealed 18 months prior to the lower tax rates going into effect, deductions and exemptions were reduced in January of 1987, and rules changed making many deferred tax liabilities payable.[5] The overall effect was designed to be

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[4] Department of the Treasury, Internal Revenue Service, Statistics of Income Division, Source Book, Statistics of Income 1985: Corporation Income Tax Returns, 8, 245.

[5] "The Value Line Investment Survey Part IV: Revisions," Value Line Investment Survey.

an increase in federal revenues under the new system. The current corporate income tax system is a graduated rate structure. Taxable income of $50,000 and below is taxed at a flat 15% rate and taxable income from $50,000 to $75,000 is taxed at a 25% rate. Between incomes of $75,000 and $335,000, the rates are graduated with a maximum marginal rate of 39%. Above this, profits are taxed at a flat 34%, much less than the former 43%.[6]

The target year for much of these computations will be July 1985 through June 1986 as it is the most recent year with suitably detailed data available. Looking at IRS data for 1985 (returns dated July 1985 through June 1986,) the numbers in Exhibit 3 are extracted or calculated and an average corporate tax rate for 1985 estimated.[7] Thus, 23.8% is the average tax rate paid by all US companies in 1985. By making the same calculations for only profitable corporations in the same period, an average rate of 38.8% is determined. This is eight percentage points less than the top corporate tax rate at the time. Another way to look at it is that the average corporation in 1985 paid only 62% (23.8% / 38.3%) of what the average profitable corporation

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[6] Sumner N. Levine, ed., The Dow Jones Irwin Business and Investment Almanac: 1989, 530.

[7] Department of the Treasury, Internal Revenue Service, Statistics of Income Division, Source Book, Statistics of Income 1985: Corporation Income Tax Returns, 8, 245.

EXHIBIT 3

Average Corporate Tax Rate Computation

(In thousands of dollars)

Income subject to tax, total		266,060,609
Income tax (before credits), total		111,340,839
Foreign tax credit	24,263,487	
US possessions tax credit	2,450,583	
Orphan drug credit	204	
Nonconventional source fuel credit	43,267	
Research activities credit	1,627,997	
General business credit	19,607,097	
Total tax credits		47,992,635
Income tax less tax credits		63,348,204

Average tax rate = Tax less credits / Income subject to tax

= 63,348,204 / 266,060,609

= 23.8%

Source: Department of the Treasury, Internal Revenue Service, Statistics of Income Division, Source Book, Statistics of Income 1985: Corporation Income Tax Returns.

paid in taxes.

At this point, a rough estimate of the current average tax rate would be to take the current maximum tax rate and subtract eight percentage points. This would yield an average tax rate of 26% (34% - 8%). This estimate has some obvious weaknesses, but is a place to start.

Another estimate of the average corporate tax rate under the new laws can now be made by comparing the results already obtained from the detailed IRS figures from 1985 to summarized data for the same year and for two years after. This spans the time frame of the implementation of the new tax laws and is shown in exhibit 4.[8] The term apparent tax rate is used here because the data is not sufficiently detailed by the sources to ensure it meets the definitions stated. Accounting periods are not necessarily the same.

Notice first that the apparent tax rate from this calculation for 1985 is 21.8% compared to the previously calculated 23.8% average tax. These numbers being only two percentage points different lends support to the possibility that the summarized data cited follows closely to the definitions stated herein. Perhaps the only difference is the accounting cycle used.

In effect, this is a second estimate of the average corporate income tax in 1985. By assuming the relationship between these two estimates and other figures holds true for later years, one can estimate the average tax rate under the new laws. First, the average tax rate for 1985 is divided by the apparent tax rate of 1985, yielding a factor of

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[8] Information Please Almanac: 1989, (42nd edition,) Boston: Houghton Mifflin, 1989, 60, 61; Department of the Treasury, Internal Revenue Service, Statistics of Income Division, Source Book, Statistics of Income 1985: Corporation Income Tax Returns, 8, 245; And Sumner N. Levine, ed., The Dow Jones Irwin Business and Investment Almanac: 1989, 292.

EXHIBIT 4

Apparent Tax Rate

(In billions of dollars)

	1985	1986	1987
a. Corporate Profits	280.7	300.7	304.7
b. Corporate income taxes	61.3	63.1	83.9
Apparent tax rate (a / b)	21.8%	21.0%	27.5%

Sources: Information Please Almanac: 1989, (42° edition,); Department of the Treasury, Internal Revenue Service, Statistics of Income Division, Source Book, Statistics of Income 1985: Corporation Income Tax Returns,; and Sumner N. Levine, ed., The Dow Jones Irwin Business and Investment Almanac: 1989.

.92 (21.8% / 23.8%). Next, this is multiplied by the apparent tax rate for 1987 to yield 25.2% (27.5% X .92). This is the estimated average corporate tax rate paid in 1987 under the new laws.

A final estimate of the average tax rate can be made using the data from the Value Line Industrial Composite and some prior calculations and figures. Internal Revenue Service data for 1985 showed that the average corporation paid only 62% of the tax rate paid by the average profitable corporation. If it is assumed the Value Line Industrial Composite approximates the average profitable corporation, the average tax rate for all corporations under the new laws

can be calculated. Overall, Value Line chooses companies for profitability, so the assumption has merit. Performing this calculation for 1987 yields an average tax rate of 23.2%. That is 62% of the 37.4% federal tax rate paid by the Value Line Industrial Composite.[9]

In all three cases, the estimate of the current average tax rate is greater than the average tax rate in 1985. This increase in light of the new lower rates can be explained. As stated earlier, many tax preference items, deductions, and credits were eliminated by the new laws.[10] This resulted in an increase of reported profits. Second, the highest tax bracket was reduced twelve percentage points from 46% to 34%, but the rates for the lower brackets were not reduced as much.[11] Third, the economy has improved over this time frame and hence average corporate profits have increased more than losses, creating a type of bracket creep (inflation has also contributed to this). The Dow Jones Industrial Average high for 1985 was 1,553 and rose to 2,727 in 1987.[12] These explanations are consistent with the

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[9] "The Value Line Investment Survey Part II: Selection and Opinion," Value Line Investment Survey, 595-598.

[10] "The Value Line Investment Survey Part IV: Revisions," Value Line Investment Survey.

[11] Ibid.

[12] Mark S. Hoffman, ed., The World Almanac and Book of Facts: 1989, 134.

government's goals. The Tax Reform Act of 1986 indeed lowered the official tax rates, but the intent was to increase revenues collected. In fact the projected increase in revenue from the 1986 change alone is approximately $25 billion per year through 1990.[13]

Although three different methods were used to determine the average income tax rate paid by US corporations and the methods and data were less than perfect, the results were approximately the same. The three methods yielded values of 26.0%, 25.2%, and 23.2%, with the last figure coming from the method of least confidence. From these results, a figure of 25.% would be appropriate to use through the rest of this proposal and is defendable by several means using the data presented.

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[13] Sumner N. Levine, ed., The Dow Jones Irwin Business and Investment Almanac: 1989, 530.

CHAPTER 5

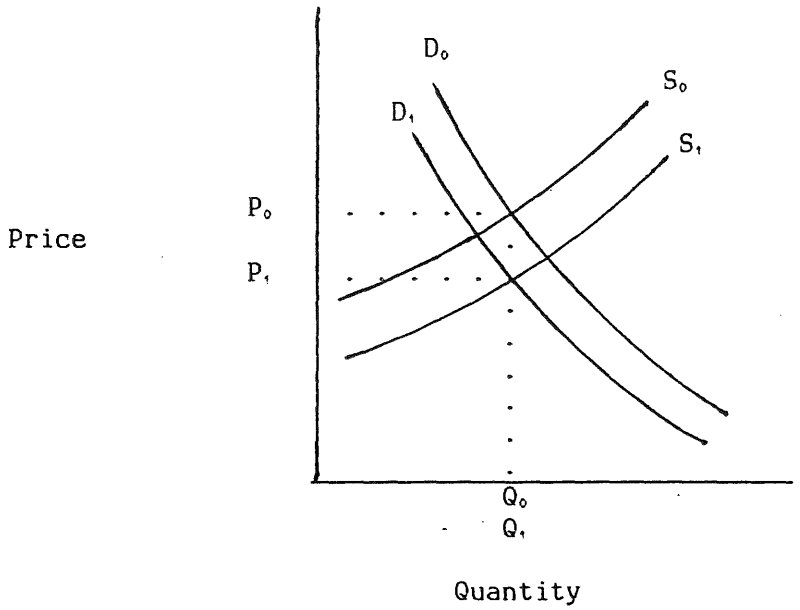
Expected Price Reduction Calculations

Now that an average corporate income tax rate has been determined, the expected price reductions caused by zero corporate taxes can be estimated. In order to do this, some assumptions must be made. The first two are that for the average corporation, the cost of all its non-labor related expenses will go down and labor costs will not change significantly. The non-labor price reductions would be simply the free market's response to zero corporate taxes. Exhibit 5 demonstrates this using standard supply and demand curve analysis. On the demand side, higher personal taxes would decrease disposable income and therefore shift the aggregate demand curve to the left from D_0 to D_1. On the supply side, the elimination of corporate taxes is essentially a reduction in production expenses which will shift the aggregate supply curve to the right from S_0 to S_1. The result of these shifts is that the equilibrium quantity will remain unchanged, $Q_0 = Q_1$, but the equilibrium price will fall from P_0 to P_1.

The second assumption is that for the economic system as a whole, labor prices would not decline. On the supply

EXHIBIT 5

Supply and Demand Analysis of Non-Labor Expenses



side, Americans under this proposal would have less aggregate disposable income due to higher taxes, but would also experience lower prices, as explained. The two should counteract each other such that the labor supply curve will not shift appreciably. People would have less after-tax income to spend, but prices would be lower. There would be a change in the distribution of income towards the lower income levels, but the aggregate should remain the same. On the labor demand side, lowered corporate taxes would be offset by lowered revenues due to price reduction.

Thus, the aggregate demand should remain the same. Therefore, if the supply and the demand for labor is unchanged overall, the price should remain unchanged. If the phase in period is of sufficient length, the free market system should keep production levels approximately the same. To recapitulate, the following discussion of estimated price reductions will assume that for corporations as a whole, all non-labor costs will go down and all labor costs will remain unchanged.

What is needed next is a simplified income statement for all US corporations so that price reductions can be calculated. This is shown in Exhibit 6 which assumes the quantity of goods sold is unchanged and the overall price level decreases. Also, labor costs will not be changed, nor will the bottom line: income after taxes. The whole purpose of this exercise is to determine the price change that will occur if taxes are eliminated, yet profits remain the same. By inserting actual figures into some of the variables, resulting price changes can be calculated.

According to the IRS, for all active corporations with accounting periods ended July 1985 through June 1986, total net income after taxes was $240.1 billion from receipts of $8.4 trillion. Thus, after-tax profits were 2.9% of sales ($240.1 billion / $8.4 trillion) and this is the figure that will be used for "NI" in the simplified income statement.

EXHIBIT 6

Simplified Corporate Income Statement

	Before Proposal	After Proposal
Sales (Price X Quantity)	PQ	pQ
Less: Labor costs	L	L
Non-labor costs	M	m
Income before taxes	GI	gi
Less: Taxes	T	-
Income after taxes	NI	NI

(Lower case items are those that would change under this proposal)

3.9%, which is the 2.9% after-tax income ratio divided by .75, which is one minus the average tax rate of 25%. Taking Exhibit 6 and inserting these amounts in percentage form results in Exhibit 7.

Now there are only two elements of this income statement left to calculate that will change under implementation. They are prices (p), which are what is to be determined, and non-labor costs (m). To get a figure for the relative amount of labor costs versus non-labor costs in

EXHIBIT 7

Simplified Corporate Income Statement

	Before Proposal	After Proposal
Sales (Price X Quantity)	100.0%	pQ
Less: Labor costs	L	L
Non-labor costs	M	m
Income before taxes	3.9%	2.9%
Less: Taxes	1.0%	-
Income after taxes	2.9%	2.9%

(Lower case items are those that would change under this proposal)

the economy, Exhibit 8 was constructed.[1] Labor costs as a percentage of sales were not available for all segments of GNP, but were available for segments representing 52.6% of the total. Looking at the remaining segments, it would appear to be a reasonable assumption to expand the weighted average of the segments covered to the entire amount. This yields a figure of 23.0%. This will be used to approximate labor costs as a percentage of sales. So, if total costs

[1] U.S. Bureau of the Census, Statistical Abstract of the United States: 1988 (108th edition,) 408, 734, 743, 745.

EXHIBIT 8

Labor Cost Analysis

(In billions of dollars)

Gross National Product for 1986

	Amount	% of Total	Labor Costs as % of Sales	Weighted Contribution
Total	4,235.0	100.0%	na[1]	
Agricultural, forestry fisheries	93.0	2.2%	na[1]	
Mining	95.3	2.3%	na[1]	
Construction	197.9	4.7%	na[1]	
Manufacturing	824.3	19.5%	25.0%[2]	4.90
Transportation public utilities	391.4	9.2%	na[1]	
Wholesale trade	294.6	7.0%	4.8%[2]	.34
Retail Trade	407.9	9.6%	11.6%[2]	1.11
Finance, insurance, real estate	695.0	16.4%	na[1]	
Services	700.2	16.5%	34.7%[2]	5.73
Government, government enterprises	505.6	12.0%	na[1]	
Other, statistical discrepancy	28.8	0.7%	na[1]	
Total of weighted contributions calculated				12.08
Percent of whole represented by weighted contributions				52.6%
Weighted average labor costs as percent of sales (Assumes weighted segments represent whole)				23.0%

[1] not available
[2] based on 1982 data

Source: U.S. Bureau of the Census, Statistical Abstract of the United States: 1988 (108th edition.)

are 100%, labor costs would be 23.0% and non-labor costs would be 77.0%.

Referring to Exhibit 7, it is evident that in the left hand column, total labor and non-labor costs would be 96.1% of sales (100% sales - 3.9% profit before tax.) Using the labor to non-labor cost breakdown described, labor costs would be 22.1% of sales (96.1% X 23.0%), and non-labor costs would be 74.0% of sales (96.1% X 77.0%.) Inserting these figures into the simplified income statement yields Exhibit 9.

Now, the only variables left on the right side are sales and non-labor costs. These can both be expressed in terms of the previous costs times a cost reduction factor, which is simply the new equilibrium price level divided by the old equilibrium price level: p / P. Therefore, the new sales amount will be the cost reduction factor times PQ, or (p / P) X PQ. Similarly, the new non-labor cost will be the cost reduction factor times the old non-labor costs, or (p / P) X 74.0%. Exhibit 10 inserts these relationships into the right side of the simplified income statement.

From here, the upper four constraints of the right hand column of Exhibit 10 can be put into formula form and solved. This is done in Exhibit 11. Therefore, if the assumptions are true, the expected price reduction from adopting this proposal would be 3.5%. Recalling from chapter three, the calculated breakeven price reduction for

EXHIBIT 9

Simplified Corporate Income Statement

	Before Proposal	After Proposal
Sales (Price X Quantity)	100.0%	pQ
Less: Labor costs	22.1%	22.1%
Non-labor costs	74.0%	m
Income before taxes	3.9%	2.9%
Less: Taxes	1.0%	-
Income after taxes	2.9%	2.9%

(Lower case items are those that would change under this proposal)

the lower income half of all Americans in 1986 was 1.7%. Even if this proposal's calculated price reduction is off by 100%, more than half of all taxpayers would still save more in price reductions than they would pay in increased taxes. Even for the two wage-earner median family discussed earlier, the break even price reduction was 3.3%, still less than the calculated 3.5% reduction.

EXHIBIT 10

Simplified Corporate Income Statement

	Before Proposal	After Proposal
Sales (Price X Quantity)	100.0%	(p / P) (100.0%)
Less: Labor costs	22.1%	22.1%
Non-labor costs	74.0%	(p / P) (74.0%)
Income before taxes	3.9%	2.9%
Less: Taxes	1.0%	-
Income after taxes	2.9%	2.9%

(Lower case items are those that would change under this proposal)

EXHIBIT 11

Solving for the Price Reduction Factor

[Sales] - [labor costs] - [non-labor costs] = Income before taxes

[(p / P) (100.0%)] - [22.1%] - [(p / P) (74.0%)] = 2.9%

[(p / P) (100.0%)] - [(p / P) (74.0%)] = 25.0%

(p / P) (100.0% - 74.0%) = 25.0%

(p / P) (26.0%) = 25.0%

(p / P) = (25.0%) / (26.0%)

p / P = .962

Price reduction factor = .962

Price reduction equals 1 - (p / P) = 3.8%

CHAPTER 6

Implementation

The first step of implementation would be to educate the public and convince them of the benefits of this proposal. Phase-in would have to occur slowly. This would make changes from year to year slight and give the public confidence that the benefits would be realized. Emphasis on savings in government and private sectors should be stressed as any savings would benefit everyone. Much of this proposal dealt with ignoring these things to show that even without them taxes would be more progressive. The overall idea though, is that increased efficiency by corporations and the government would free both labor and financial resources for more productive activities. Enough of the public must be convinced this proposal is desirable or congress will not promote it.

Another important part of implementation would be to design a phase-in program of sufficient length and with sufficient lead time to allow corporations and individuals time to plan and react efficiently. An example would be to announce that beginning in two years, corporate tax rates would be reduced 10.0% of the current amounts every year until they reached zero. At the same time, personal tax

rates would be increased 2.69% of the current levels per year for ten years. This would eliminate corporate taxes and increase personal tax rates the required 26.9% estimated in chapter three.

This would give the financial markets time to react slowly, managers time to plan ahead efficiently and the expected price reductions time to occur gradually without great jumps in corporate profits or investment in capital. If corporate taxes were eliminated abruptly, prices may not drop in proportion to taxes and corporate after-tax profits could rise quickly. This would take the benefits of this program initially away from consumers and bestow them on stockholders. If the program is implemented slowly enough, competitive pressure between corporations will drive prices down. The phasing out of taxes would allow corporations to operate with smaller margins and still maintain after-tax profits. They would have to do this to maintain market share and hinder others from entering their markets.

Establishing a monitoring and control program to track all of the relevant figures would also be important. This would be necessary in case any unanticipated detrimental effects occurred and also to keep the public informed of progress.

One assumption of this proposal was that total IRS revenues would not be changed as the individual taxes took on the tax burden of corporations. Due to the extreme

complexity of the processes involved, mid-implementation variance of personal tax rates may be necessary to fund the government at the desired level. This would be unfortunate if the variance were large, but potentially inevitable even with the finest economic predictions.

What must not be done is to alter the phasing out of corporate taxes. Once implemented, the plan must be adhered to until completion if the benefits are to be realized. If congress manipulated both sides of the equation, that is corporate tax cuts and personal tax increases, at the same time, confidence would suffer. As confidence goes, so does the ability of all involved to make optimum long-term plans.

Even though phase-in of this proposal would have widespread effects in every sector of the economy, actual phase-in costs would be low. The simplest solution would be to change only tax rates and none of the other tax laws. Along with some monitoring and adjustments during implementation, the entire process would be a predictable series of tax rate changes.

CHAPTER 7

Summary

The purpose of this study was to explain the benefits of eliminating corporate income taxes. Many of the benefits were discussed along with the processes involved in achieving them. It was shown that personal income taxes would have to be increased approximately 26.9% to make up for lost corporate income taxes. For more than half of American taxpayers in 1988, estimates show this would be a $122 average tax increase. Counteracting this tax increase would be a general decline in prices as corporations adjusted to lower tax expenses. An average corporate tax rate of 25% was derived and used to calculate an estimated 3.5% decrease in the general price level. This is approximately twice the price reduction necessary to recover $122 in increased taxes for half of all taxpayers. Since this proposal would benefit more than half of all Americans, sufficient support should be available for congress to carry out the required changes if the public was sufficiently educated concerning the benefits and processes of the proposal. Finally, this could be done most efficiently with a suitable implementation program of sufficient time span to allow changes to occur slowly, but surely.

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