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Chapter Title: The Taxation of Corporate Earnings and Progressivity

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CHAPTER 5

The Taxation of Corporate Earnings and Progressivity

It is sometimes argued that, whatever its merits or demerits on other grounds, the corporation income tax does add to the progressivity of our tax system. Starting "from the two propositions: (1) the tax is proportional to corporation income, and (2) a larger proportion of the income of individuals in the higher-income classes is corporation income paid to or accruing to them as shareholders than is the case in the income of poorer individuals," the National Industrial Conference Board reached the conclusion that to "the extent that it is not shifted, the burden of the federal corporation income tax, considered by itself, is what is technically known as 'progressive'—the tax constitutes a heavier burden in proportion to total income upon individuals in the higher-income classes than upon individuals in the lower income classes."¹ Among similar views expressed more recently is: "Another consideration with respect to a tax on corporate income, even if it is deemed as a tax on the shareholders, is that such a tax serves to burden the unearned income, as compared with earned income, and to increase the progressiveness of the individual income tax."²

These contentions, even if valid (and cause for disagreement will be set forth below), are subject to the obvious qualification that this effect, i.e. increased progressivity, applies only to stockholders. Therefore an inequality is injected into our tax system; since all taxpayers at any given income level are not stockholders, individuals with incomes of the same size (but different composition) are subject to different rates of tax. Much the same consideration is relevant when we limit the analysis to stockholders, for not all stockholders at a given income level receive the same proportion of their income from corporation earnings.

Two approaches used in the preceding chapters in the examination of the differential taxation of stockholders are particularly pertinent to the alleged progressivity effect of the corporation income tax: the findings in connection with the net corporate tax; and evidence assembled under the heading of the differential against stockholders. The first approach will be employed to determine the progressivity effect of the corporation income tax per se. The latter approach con-

¹ *The Shifting and Effects of the Federal Corporation Income Tax*, National Industrial Conference Board, Vol. II, 1928, p. 102.

² From Congress of Industrial Organization memorandum, *A Federal Tax Program to Promote Full Employment*, reprinted in *Revenue Revision of 1950, Hearings before the House Committee on Ways and Means*, 81st Cong., 2d sess., Vol. I, *Excise Taxes*, 1950, p. 762.

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siders the effect on progressivity of the existing method of taxing stockholders during the period of our study, by analyzing the effect of both the net corporate tax and the personal income tax saving due to the failure of corporations to distribute all of their earnings.

More specifically, this chapter will examine the question of progressivity effect on two bases.

(1) First, the effect of the corporation income tax alone will be discussed, using the net corporate tax, which is the excess of the corporation income tax on earnings for distribution and earnings for retention over the personal income tax that would have been due had these corporation income tax payments been part of the taxable income of stockholders. It is a measure of the net effect of the corporation income tax alone. This may be considered the narrow definition of the problem, for it fails to take account of corporate distribution policy—more specifically, it fails to take account of the fact that retained earnings (after corporation income tax) escape personal income taxes currently, and, at best, this is made up only partially via future capital gains taxation.

(2) Secondly, the progressivity effects are also considered from a broader perspective that takes account of both the net corporate tax and the personal income tax saving. The excess of the former over the latter is the differential against stockholders.

THE NET CORPORATE TAX AND PROGRESSIVITY

The community's consensus as to the desirable degree of progressivity in our income tax structure is presumably mirrored by the personal income tax schedule. This is taken as the standard or benchmark against which the progressivity effect of the net corporate tax is measured. The comparisons are confined to "average" stockholders, overlooking the complications, noted above, actually introduced by the varying proportions of corporate earnings included in individual incomes. Limiting the examination of progressivity effects to stockholders is consistent with the previously described incidence assumption by which they alone are considered to be affected by the corporation income tax.³

The term "progression" is here employed in its usual sense to denote an increase or decrease in the rate of tax relatively greater than the increase or decrease in the size of the base on which the tax is assessed. Various measures of the degree of progressivity, each of which has

³ Goode makes a similar computation, but for distributed earnings only, and expresses the results in terms of the income of all taxpayers not merely stockholders (Richard B. Goode, *The Corporate Income Tax*, Wiley, 1951, pp. 93-94).

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its own peculiarities, are consistent with this general concept, and different indications as to changes in progressivity may be obtained according to the formula adopted. For this reason two measures have been used.⁴

1) *Average rate progression*, which is based on the rate of change of the effective rate of tax and is defined as

$$\frac{(T_1/Y_1) - (T_0/Y_0)}{Y_1 - Y_0}$$

where *T* stands for tax liability and *Y* for income, and the subscripts 1 and 0 denote adjacent income levels. Average rate progression remains unchanged if a rate schedule is raised or lowered the same number of percentage points at all levels of taxable income.⁵

2) *Liability progression* which is "the ratio of the percentage change in tax liability to the concurrent change in income."⁶ It is defined as

$$\frac{T_1 - T_0}{T_0} \cdot \frac{Y_0}{Y_1 - Y_0}$$

The coefficient of liability progression remains unchanged if the rates of a given schedule are raised or lowered proportionately.⁷

⁴ The measures and the methods used in their computation are taken from R. A. Musgrave and Tun Thin, "Income Tax Progression, 1929-48," *Journal of Political Economy*, December 1948, pp. 498-514.

⁵ Write T_0/Y_0 as E_0 (E standing for effective rate) and T_1/Y_1 as E_1 . Then the formula for average rate progression becomes $(E_1 - E_0)/(Y_1 - Y_0)$. Let there be an increase of a given number of percentage points in effective rate, say K . Then average rate progression will equal $[E_1 + K - (E_0 + K)]/(Y_1 - Y_0)$. But this, of course, is the same as $(E_1 - E_0)/(Y_1 - Y_0)$. Therefore, if one effective rate schedule exceeds another by the same number of percentage points they are, in terms of this measure, equally progressive. Thus a comparison of progressivity based on average rate progression is relatively simple. A constant ratio of net corporate tax to imputed gross income signifies that the personal and the combined corporate-personal income taxes were equally progressive; a falling ratio differential, moving up the income scale, is an indication that the corporate-personal tax system was less progressive, while the converse conclusion follows from a rising net corporate tax ratio (*ibid.*, p. 501).

⁶ *Ibid.*, p. 504.

⁷ In any comparison of two schedules at a given income level or over a given range $Y_0/(Y_1 - Y_0)$ will be unchanged, so it is necessary only to watch what happens to $(T_1 - T_0)/T_0$. Let the tax due at each income level be raised by a fixed percentage K . Then $(T_1 - T_0)/T_0$ is replaced by $(KT_1 - KT_0)/KT_0$. But this is the same as $(T_1 - T_0)/T_0$. Thus a proportionate change in tax liability (and hence tax rate) associated with a given income level leaves the degree of liability progression unchanged (see *ibid.*, p. 505). This facilitates comparison of the progressivity of two rate schedules under this definition. When the net corporate tax rate, reading up the income scale, represents a continually growing percentage increase in the effective rate of tax, liability progression has increased. The opposite result connotes a decrease in progressivity, while a constant proportionate increase in effective tax rates signifies an equal degree of progressivity.

The findings on those on liability because of the negatively than the the - sign indicates progressivity for

Summary of th

IMPUTED GROSS INCOME RANGE (\$000's)	1940	1941
1-2		
2-3	-	+
3-4	-	+
4-5	+	+
5-6	-	+
6-8	+	=
8-10	+	-
10-12	-	-
12-15	+	-
15-20	+	+
20-25	-	=
25-50	-	-
50-75	+	+
75-100	-	-
100-150	-	-
150-200	-	-
200-250	-	=
250-500	+	-

(+) means that, because of than they would have
 (-) means the reverse find
 (=) means equal progressivity

⁸ These two measures results, therefore, are pose at hand. Much base for each of the ured by computing th potential rate if their been paid to them as tax was computed as adjusted gross income This comparison is ne

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The findings on average rate progression are summarized in Table 23, those on liability progression in Table 24. The + sign means that, because of the net corporate tax, stockholders were taxed more progressively than they would have been under the personal income tax; the - sign indicates the reverse result, and the = sign denotes equal progressivity for the two systems.⁸

TABLE 23
Summary of the Progressivity Effect of the Net Corporate Tax,
1940-1941; 1944-1952
AVERAGE RATE PROGRESSION

IMPUTED GROSS INCOME RANGE (\$000's)	1940	1941	1944	1945	1946	1947	1948	1949	1950	1951	1952
.1-2				+	+	-		+	+		+
2-3	-	+	+	+	-	-	-	-	+	+	+
3-4	-	+	+	-	+	+	+	-	-	-	-
4-5	+	+	+	+	+	+	+	+	+	-	-
5-6	-	+	+	+	+	+	+	+	-	-	-
6-8	+	=	+	+	+	+	+	+	+	+	+
8-10	+	-	-	+	+	-	+	+	+	+	+
10-12		-	-	-	=	+	-	+	+	+	-
12-15	+	-	-	-	-	-	+	+	+	+	-
15-20	+	+	-	-	-	-	+	+	+	+	+
20-25	-	=	-	-	-	-	+	+	+	+	-
25-50	-	-	-	-	-	-	=	+	+	-	-
50-75	+	+	-	-	-	-	=	-	-	-	-
75-100	-	-	-	-	-	-	-	-	-	-	-
100-150	-	-	-	-	-	-	-	-	-	-	-
150-200	-	-	-	-	-	-	-	-	-	-	-
200-250	-	=	-	-	-	-	-	-	-	-	-
250-500	+	-	-	-	+	=	-	-	-	-	-

(+) means that, because of the net corporate tax, stockholders were taxed more progressively than they would have been under the personal income tax.

(-) means the reverse finding.

(=) means equal progressivity for the two systems.

⁸ These two measures of progressivity did not correspond at all points, and the results, therefore, are not precisely comparable. But they serve for the rough purpose at hand. Much laborious computation was saved by using a slightly different base for each of the measures. The change in average rate progressivity was measured by computing the excess of the actually effective rate for stockholders over the potential rate if their full pro rata share of corporate income tax payments had been paid to them as personal income. With liability progression, the net corporate tax was computed as a proportion of the effective rate of personal income tax on adjusted gross incomes of the same size as the selected imputed gross income levels. This comparison is not strictly confined to stockholders, the adjusted gross income

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TABLE 24
Summary of the Progressivity Effect of the Net Corporate Tax,
1940-1941; 1944-1952
LIABILITY PROGRESSION

IMPUTED GROSS INCOME RANGE (\$000's)	1940	1941	1944	1945	1946	1947	1948	1949	1950	1951	1952
1-2				-	-	-	-	-	+		-
2-3	-	-	-	-	-	-	-	-	+	-	+
3-4	-	-	-	-	+	-	-	-	-	-	-
4-5	+	-	+	-	-	-	-	-	-	-	-
5-6	-	-	-	-	+	+	-	-	-	-	-
6-8	-	-	+	-	-	-	+	+	+	+	+
8-10	-	-	-	-	-	-	-	-	-	-	-
10-12	-	-	-	-	-	-	-	-	-	-	-
12-15	+	-	-	-	-	-	+	-	-	-	-
15-20	-	-	-	-	-	-	-	-	-	-	-
20-25	-	-	-	-	-	-	-	-	-	-	+
25-50	-	-	-	-	-	-	-	-	-	-	-
50-75	+	-	-	-	-	-	-	-	-	-	-
75-100	-	-	-	-	-	-	-	-	-	-	-
100-150	-	-	-	-	-	-	-	-	-	-	-
150-200	-	-	-	-	-	-	-	-	-	-	-
200-250	-	-	-	-	-	-	-	-	-	-	-
250-500	+	-	-	-	-	-	-	-	-	-	-

(+) means that, because of the net corporate tax, stockholders were taxed more progressively than they would have been under the personal income tax.
(-) means the reverse finding.
(=) means equal progressivity for the two systems.

The effect of the corporate income tax on the degree of progressivity applying to the taxation of stockholders is clearly uneven. If one particular definition—average rate progression—is adopted, the general conclusion is that stockholders were taxed more progressively than other income taxpayers similarly circumstanced in terms of the size of their income, up to about the \$12,000 income level, in the earlier years of the decade, and to the \$50,000 level from 1948 through 1952; taxation was less progressive over the rest of the income range. Under

levels being derived from averages for all taxpayers. The adjusted gross incomes are of different compositions, and, because they include different proportions of capital gains, are subject to somewhat different rates from those implied in the average rate progressivity computation. But this difference in base is a relatively minor factor that tends to be submerged by the much more pronounced force exercised by the net corporate tax in the final results. The findings on progressivity are, therefore, both comparable and, for the purpose at hand, informative.

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⁹ *Ibid.*, p. 510.

TABLE 25
Progressivity of the Corporate-Personal Income Tax on Stockholders
Compared with the Progressivity of the Personal Income Tax,
1940-1941; 1944-1952
AVERAGE RATE PROGRESSION

IMPUTED GROSS INCOME RANGE (\$000's)	AVERAGE RATE PROGRESSION										
	1940	1941	1944	1945	1946	1947	1948	1949	1950	1951	1952
	Variant 1										
1-2				+	+	-		+	+		+
2-3	-	+	+	+	-	-	-	-	-	=	+
3-4	-	=	+	-	+	+	+	-	+	-	-
4-5	+	+	+	+	-	-	+	+	+	-	-
5-6	-	+	+	+	+	+	+	+	=	-	=
6-8	+	-	+	+	-	-	+	+	+	+	+
8-10	+	-	-	-	-	-	+	+	+	+	+
10-12	-	-	-	-	-	-	+	=	+	=	-
12-15	+	-	-	-	-	-	=	-	-	-	-
15-20	+	-	-	-	-	-	-	-	-	+	+
20-25	-	-	-	-	-	-	-	-	-	+	+
25-500 ^a	- ^b	-	-	-	-	-	-	-	-	-	-
	Variant 2										
1-2				+	=	-		+	+		+
2-3	-	+	+	+	-	-	-	-	+	+	+
3-4	-	=	+	+	+	+	+	-	-	-	-
4-5	+	+	+	+	-	-	+	+	+	-	-
5-6	-	+	+	+	+	+	+	+	=	-	=
6-8	+	-	+	+	-	-	+	+	+	+	+
8-10	+	=	-	-	-	-	+	+	+	+	+
10-12	-	-	-	-	-	-	+	-	+	=	-
12-15	+	-	-	-	-	-	+	-	-	-	-
15-20	+	-	-	-	-	-	-	=	+	+	+
20-25	-	-	-	-	-	-	-	-	-	+	+
25-500 ^a	- ^b	-	-	-	-	-	-	-	-	-	-
	Variant 3										
1-2				+	=	-		+	+		+
2-3	-	+	+	+	-	-	-	-	+	+	+
3-4	-	+	+	-	+	+	+	-	-	-	-
4-5	+	+	+	+	=	+	+	+	+	-	-
5-6	-	+	+	+	+	+	+	+	=	-	=
6-8	+	-	+	+	+	=	+	+	+	+	+
8-10	+	=	-	-	-	-	+	+	+	+	+
10-12	-	-	-	-	-	+	+	+	+	+	-
12-15	+	-	-	-	-	-	+	=	-	-	-
15-20	+	-	-	-	-	-	+	+	+	+	+
20-25	-	-	-	-	-	-	=	=	=	+	+
25-500 ^a	- ^b	-	-	-	-	- ^c	-	-	-	-	-

(+) means that stockholders were taxed more progressively than they would have been under the personal income tax.

(-) means the reverse finding; (=) means equal progressivity for the two systems.

^a (-) applies to each of the following income classes (thousands of dollars), for which separate calculations were made: 25 to 50; 50 to 75; 75 to 100; 100 to 150; 150 to 200; 200 to 250; 250 to 500.

^b For 1940, the progressivity was + in the \$50,000 and under \$75,000 class.

^c Under variant 3, in 1947, the progressivity was equal for the \$150,000 to \$200,000 class.

Progressivity of the
Compared with

IMPUTED GROSS INCOME RANGE (\$000's)	AVERAGE RATE PROGRESSION	
	1940	1941
1-2		
2-3	-	-
3-4	-	-
4-5	+	-
5-6	-	-
6-8	-	-
8-10	-	-
10-12	-	-
12-15	+	-
15-500 ^a	-	-
1-2		
2-3	-	-
3-4	-	-
4-5	+	-
5-6	-	-
6-8	-	-
8-10	-	-
10-12	-	-
12-15	+	-
15-500 ^a	-	-

(+) means that stockholders were taxed more progressively than they would have been under the personal income tax.

(-) means the reverse finding; (=) means equal progressivity for the two systems.

^a (-) applies to each of the following income classes (thousands of dollars), for which separate calculations were made: 150 to 200; 200 to 250; 250 to 500.

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gression, the actual combination of corporate and personal tax led to less progressive taxation of stockholders than would have followed from the personal income tax alone.

ERRATIC IMPACT OF THE PROGRESSIVITY EFFECT

Finally, it will be instructive to return to a problem noted as a complication and temporarily set aside—the unevenness of the alleged progressivity effect of the corporation income tax due to the fact that stockholders with about the same total income have varying amounts of net corporate earnings.

From stockholder cells for 1947, the chosen sample year, entries were picked for individuals having almost identical levels of taxable income after full imputation of corporate earnings. But the corporate earnings component comprises different proportions of total taxable income; thus the combination of corporate tax on all earnings and of personal tax on dividends constitutes a varying incremental burden. How uneven and indiscriminate the progressivity effects actually are is demonstrated by the evidence in Table 27.

Among three stockholder cells, for example, for which the taxable income was about \$1,850, the extra burden due to the corporate tax amounted in one cell to 3 per cent of income, in another to 9 per cent, and in a third to 28 per cent.¹⁰ Reasons for the highly uneven effect on progressivity are suggested by the data in column 8: the extra burden of a 3 percentage point increase in effective rate of tax occurred in a stockholder cell in which corporate earnings represented only 12 per cent of taxable income; the extra burden of 9 percentage points characterized a cell in which 38 per cent of taxable income came from corporate earnings; while the 28 percentage point extra burden arose in a cell in which income was very heavily weighted with corporate earnings, about 115 per cent of taxable income. (This happens when income from sources other than corporate earnings is so small that it is outweighed by deductions.) The type of results found at this particular taxable income level was also observed at others (see Table 27).

This evidence warrants the conclusion that even if it were true at least over much of the income scale that, because of the corporation income tax, stockholders are taxed more progressively than other tax-

¹⁰ These calculations are based on a comparison of the actual combined corporate-personal tax and an estimate of what would have been due under the personal tax both currently and in the future (from capital gains taxes on realized increments in stock prices due to reinvestment). They correspond, therefore, to our variant 2 measure described in Chapter 1 and discussed in Chapter 2.

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PROGRESSIVITY EFFECT

payers, the progression is of a rude, uneven, and indiscriminate type. Of the 711,683 stockholders in the sample potentially subject to an effective rate of personal income tax between 19 and 20 per cent (see column 4), over three-fifths were actually taxed at between 20 and 25 per cent; one-quarter at between 25 and 30 per cent; one-tenth at between 30 and 35 per cent; 1.6 per cent at between 35 and 40 per cent; and almost 2 per cent at more than 45 per cent.

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PROGRESSIVITY EFFECT

TABLE 27
Examples of Varying Effective Rates of Corporate-Personal Tax on Stockholders with Taxable
Incomes of Substantially the Same Size, 1947

AVERAGE TAXABLE INCOME LEVEL OF STOCK-HOLDERS ^a (1)	Number of stockholders (2)	Potential personal income tax (3)	Effective rate of potential personal income tax (3) ÷ (1) (4)	Total estimated corporate-personal tax (5)	Effective rate of corporate-personal tax (5) ÷ (1) (6)	Difference in effective rates (6) - (4) (7)	Corporate earnings as a per cent of taxable income (8)
\$1,491	7,513	\$ 283	19.0%	\$ 685	45.9%	27.0	112
1,470	136,238	279	19.0	335	22.8	3.8	16
1,855	243,694	352	19.0	408	22.0	3.0	12
1,833	44,662	348	19.0	520	28.4	9.4	38
1,861	5,997	354	19.0	869	46.7	27.7	115
2,192	23,673	420	19.2	695	31.7	12.5	53
2,215	98,720	425	19.2	587	26.5	7.3	31
2,925	61,953	573	19.6	729	24.9	5.3	24
2,933	26,840	575	19.6	945	32.2	12.6	55
2,915	11,457	571	19.6	1,055	36.2	16.6	71
3,281	33,614	648	19.7	907	27.6	7.9	35
3,292	17,322	650	19.8	1,125	34.2	14.4	63
5,292	17,155	1,117	21.1	1,544	29.2	8.1	40
5,294	15,657	1,118	21.1	2,395	45.2	24.1	109

(continued on next page)

Table 27, concluded

AVERAGE TAXABLE INCOME LEVEL OF	Potential	Effective rate of potential personal income tax	Total estimated	Effective rate of corporate-personal tax	Difference in effective rates	Corporate earnings as a per cent
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Table 27, concluded

AVERAGE TAXABLE INCOME LEVEL OF STOCK-HOLDERS	(1)	Number of stockholders	(2)	Potential personal income tax	(3)	Effective rate of potential personal income tax	(4)	Total estimated corporate-personal tax ^b	(5)	Effective rate of corporate-personal tax	(5) ÷ (1)	(6)	Difference in effective rates	(6) - (4)	(7)	Corporate earnings as a per cent of taxable income	(8)
\$ 8,894	1,580			\$ 2,151		24.2%		\$ 4,189		47.1%		22.9			117		
8,862	36,957			2,140		24.2		2,728		30.8		6.6			40		
13,623	21,047			3,893		28.6		4,033		29.6		1.0			12		
13,658	5,290			3,907		28.6		5,759		42.2		13.6			94		
18,560	21,770			6,172		33.2		6,610		35.6		2.4			43		
18,476	8,035			6,130		33.2		8,515		46.1		12.9			112		
33,864	20,578			14,888		43.9		15,488		45.7		1.8			105		
33,378 ^c	4,948			14,588		43.8		14,337		43.0		-0.8			17		
74,160	25,953			43,215		58.3		35,954		48.5		-9.8			107		
74,513 ^c	589			43,487		58.4		40,364		54.2		-4.2			28		
194,284 ^c	3,218			144,092		74.1		107,320		55.2		-18.9			90		
190,906 ^c	548			141,204		74.0		124,771		65.4		-8.6			39		

^a Includes imputed pro rata share of net corporate earnings.

^b Equals sum of personal income tax on taxable income from sources other than corporate earnings, plus personal income tax on dividends, plus corporate tax on pro rata share of net corporate earnings.

^c Estimated returns with normal and surtax only.

(continued on next page)