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CHAPTER 6

Differential Taxation of Stockholders in the Aggregate

TURNING from the average measures of the differentials that have occupied our attention up to this point, in this chapter we consider the aggregate amount of the "extra" burden on stockholders. For this purpose the relevant material is organized around three questions: What would be the effect on the revenue of the federal government were the "unequal" taxation of stockholders to be abolished by extension to them of the tax treatment accorded members of a partnership? What is the total extra burden (or benefit) of stockholders, and how is it distributed among income classes? Which method would have a more equalizing effect on the distribution of income—that method of taxing corporate earnings on the corporate level when earned and the personal level when distributed, or that involving the abolition of the corporate tax and the full taxation to stockholders of their pro rata share of corporate earnings as personal income?

THE PARTNERSHIP METHOD

Were shareholders to be taxed as partners, the corporate entity, as such, would drop out of the tax picture. Since stockholders would be held accountable under the personal income tax for their pro rata share of corporate earnings, all such earnings would be fully and promptly called to account. Taxwise, corporate earnings would be treated like property income from other sources, and stockholders would be treated as all other taxpayers are. "Under-", "over-", or "differential taxation" of corporate earnings would no longer exist. It is not surprising, therefore, that a number of students have proposed abolishing the corporation income tax and substituting for it current taxation as personal income of stockholders' pro rata share of corporate earnings.[1] (The corporate tax need not be abolished. If the personal

[1] See, for example: T. S. Adams, *The American Economic Review*, Supplement, March 1918, pp. 25-26. Note, however, an apparent change of heart on Adams' part, in 1923, in a speech before the National Tax Association (see page 310 of the *Proceedings* of their 16th Annual Conference, edited by Alfred E. Holcomb); Robert M. Haig, "Final Report of the Committee of the National Tax Association on Federal Taxation of Corporations, 1939," in *Proceedings of the National Tax Association for 1939*, pp. 539-540 and 544; Paul Ellis, *Corporate Tax Structure for Post-War Progress*, an address before Temple Institute on Tax Policies, Temple University, April 6, 1944, p. 10; Edward S. Shaw and Lorie Tarshis, "A Program for Economic Mobilization," *American Economic Review*, March 1951, pp. 44-45. In this article Shaw and Tarshis suggest the partnership method for a period of economic mobilization and make no reference to its desirability one way or another for "normal" periods.

income tax base were defined to include all of corporate earnings, the corporation income tax could be retained but converted to a withholding appendage of the "partnership" method by permitting stockholders to subtract their proportionate share of the corporate levy from their personal income tax liability.)

In what follows, this procedure, i.e., taxing stockholders on their pro rata share of corporate earnings fully and promptly under the personal income tax, will be referred to as the "partnership" method, for this is the way in which members of a partnership are called to account under the personal income tax.[2] Extension of the partnership method to stockholders has been criticized on a number of grounds.[3] In particular, serious doubts have been cast on its administrative feasibility.[4] Also, along with other possible methods of taxing undistributed corporate earnings, it has been opposed, especially for widely-owned corporations, as having undesirable economic effects.[5] Some critics have dismissed it as an impractical ideal. Despite adverse opinions, however, the method invites our interest not solely because, either in its stark form or with modifications toward practicability, it has been suggested by serious students of the subject. More particularly, in the framework of our study it serves as a benchmark, for, accepting the assumption that the incidence of the corporation income tax is on profits only, the partnership method would prevent differential taxation of stockholders. Obviously, a quantitative examination of the partnership method of taxation for stockholders is warranted. And this our data permit rather conveniently.

It cannot be emphasized too strongly that this study neither supports nor opposes this particular proposal.[6] The objective here is two-fold:

[2] There is a minor exception. A provision of the Internal Revenue Code of 1954 (Public Law 591, Chap. 736, Subchap. R, sec. 1361) permits unincorporated business, both individual proprietorships and partnerships, to elect to be taxed as domestic corporations. (A number of qualifications, enumeration of which is not necessary here, attach to this right of election.) But very few partnerships are so taxed.

[3] Full partnership treatment for stockholders would require also raising the basis of valuation (for the determination of capital gains) of their shareholdings by the excess of imputed over distributed earnings.

[4] For example, Richard B. Goode, *The Corporation Income Tax,* Wiley, 1951, pp. 184-190; William Vickrey, *Agenda for Progressive Taxation,* Ronald, 1947, pp. 161-162; Harold M. Groves, *Postwar Taxation and Economic Progress,* McGraw-Hill, 1946, pp. 55-59.

[5] "Both as technicians and as businessmen they [accountants] should oppose any attempt to tax to stockholders, in any way, the undistributed income of the widely owned business corporation, which is the main source of the capital needed for the constant extension of the scope of business activities upon which in turn reasonably full employment depends." (George O. May, "Stock Dividends and Concepts of Income," *The Journal of Accountancy,* October 1953, p. 431.)

[6] At this point it is convenient to note also that the study's sole preoccupation

first, to explore by an additional approach evidence relevant to an evaluation of the differential taxation of stockholders; and secondly, to develop a measure of the aggregate extent of the unequal taxation of stockholders. Such a measure emerges, within the context of the whole investigation, from estimates of the change in federal revenue to be expected from a hypothetical change in the tax structure—substituting, for the corporation income tax, the current taxation to stockholders under the personal income tax of their full share of corporate earnings (both distributed and retained).

Aggregate estimates of this type will complement the findings of Chapters 2, 3, and 4. The four measures used there—the differentials against earning for distribution, earnings for retention, net corporate earnings, and stockholders—summarize the experience at selected "average" or "representative" stockholder income levels; they do not provide, therefore, evidence on the total amount of over- or undertaxation.

EFFECT OF THE PARTNERSHIP METHOD ON TAX REVENUE

Many considerations, of course, are involved in evaluating a possible change in the tax structure. Not the least important of these considerations is the effect on the public revenue, especially if the existing level of government expenditures is to be maintained. The effect on government receipts is not the only basis for evaluation of a proposed change, but it must always be taken into account. Some changes, however desirable on other grounds, might cause such a decline in tax revenue that they would be inadmissible without an alternative proposal that would recoup a substantial part of the revenue loss, and would, on net balance, leave the tax structure improved in terms of equity and economic effects. Such a substitute may be hard to find.

Can we afford to institute the partnership method? What would be its effect on public revenue?[7] This question cannot be answered in the abstract. The answer depends on a number of factors which vary from year to year—the rates of corporate and personal income taxes,

with the differential taxation of stockholders should not be interpreted to imply a stand either in support of or against the contention that a corporate tax is justifiable and desirable, per se, and should not stand or fall as a substitute for or appendage to the personal income tax. (See Gerhard Colm, "The Corporation and the Corporation Income Tax in the American Economy," *American Economic Review*, May 1954, pp. 486-503.)

[7] The discussion which follows waives the question of the administrative feasibility of the partnership method.

the amount of corporate earnings and its distribution between dividends and retained earnings, and, because the personal income tax is progressive, the degree of concentration of dividend receipts and stockholder incomes. To anchor the discussion, rather careful estimates were made for four of the more recent years for which detailed data were available—1952, 1950, 1949, and 1947—and less refined and accurate estimates for the other years between 1944 and 1955.

What follows is predicated on the assumption that the total of corporate earnings would not have changed had the corporation income tax been rescinded. This assumption, that the corporation income tax is not shifted either forward via higher prices of corporate output or backward through a lower level of returns to the factors of production, qualifies our findings. More particularly, to the extent that removal of the corporation income tax would result in a lower level of corporate earnings due either to a fall in the price of the output of corporations or a bidding up of the cost of their inputs (or some combination of the two), the estimates of the revenue loss presented below are too low. More tax revenue would be lost to the National Treasury than our estimates show because a smaller amount of earnings would be imputable to stockholders. While lower prices of consumer goods are usually followed by increased sales and excise tax collections, and higher incomes for workers and other suppliers of productive factors mean increased personal income tax liability, neither of these expansions would be likely to offset the loss completely. The reasons are not far to seek: not all goods and services are subject to excise taxes, rates of which are probably lower than the prevailing marginal rates for stockholders; the marginal tax rate for the average taxpayer is substantially lower than for the average dividend-receiving taxpayer.

Only a brief description of the procedures used in estimating the effect on public revenue of the partnership method of taxing stockholders appears in this chapter, a more detailed explanation will be found in Appendix B.

Many changes in financial asset prices and the relative attractiveness of stock to various investor groups that would have an effect on federal revenue collections might follow the introduction of the partnership method. For example if, because of this change, the stockholdings of nonprofit institutions were to increase, other things unchanged, tax collections would be lower. No account is taken of this or similar possible effects in the revenue estimates presented in this chapter.

1950

If the corporation income tax had been abolished, the federal government's revenue in 1950,[8] other things unchanged, would have declined by $16.8 billion.[9] This represents a significant proportion—one third—of total federal tax receipts, $50.2 billion.[10] But, of course, everything else would not remain unchanged. Imputation to stockholders of their full pro rata share of net corporate earnings would raise their personal income tax liability. To what extent would this have served to offset the loss of corporation income tax revenue?

Briefly, the offset, while not large enough to prevent a net decline in tax revenue, would have been large enough to keep the decline somewhere in the neighborhood of $3 to $4.5 billion.[11]

How was this conclusion reached? Very simply, by computing the difference between stockholders' personal income tax liability before and after imputation of their full pro rata share of net corporate earnings. For this purpose, the stockholder income-dividend class array was broken down on two bases—joint and separate returns, and returns with and without the alternative tax on capital gains. For each of the 585 stockholder cells, the increase in personal income tax liability that would follow the introduction of the partnership method was com-

[8] As explained previously (see Chapter 2) the data for 1950 were the latest available for analysis when this investigation was under way. Later, 1951 and 1952 tabulations were published, and an analysis for 1952 appears below.

[9] *Statistics of Income for 1950*, Bureau of Internal Revenue, Part 2, pp. 40 and 90. This figure equals the corporate tax liability incurred in that year (including $1.4 billion excess profits tax liability) minus the credit claimed for foreign taxes paid ($0.5 billion). Our discussion runs in terms of liabilities rather than of actual collections. *Statistics of Income* liability figures, used throughout, take no account of revisions due to audit, which, in every year without exception, are positive in the aggregate. Failure to take account of them, however, probably entails only slight error in our estimate of revenue loss because, not only is the foregone tax liability somewhat greater after audit revisions, but also the total of corporate earnings to be imputed to stockholders. Use of these revised aggregates would have yielded a higher personal income tax liability under the partnership method, tending to offset the larger corporation income tax loss. For example, for 1950, increased corporation income tax due to audit has been estimated at about $0.2 billion (*National Income Supplement, 1954, Survey of Current Business*, Dept. of Commerce, p. 93). The same source places profit increases disclosed by audit at $0.6 billion. Since, from the estimate to be discussed below, we find an over-all marginal rate of personal income tax on imputed corporate earnings of something over 40 per cent, the revisions due to audit for 1950 would leave our revenue loss estimate unchanged.

[10] *National Income Supplement, 1954, Survey of Current Business*, p. 171.

[11] The findings are presented in broad ranges initially to point up two features of our estimates: (1) it would be misleading to suggest by a single figure greater precision than the data and our estimating techniques make possible; and (2) different conclusions are reached if we consider the current revenue decline or the aggregate revenue loss over time. This latter problem is elaborated below.

puted. Stockholders' actual personal income tax liability was estimated at $7 billion and their potential partnership method tax liability at $19.1 billion—an increase of $12.1 billion in personal income tax liability. In addition, full taxation of proportionate shares of net corporate earnings applied to taxable fiduciaries (estates and trusts that failed to distribute all their income to beneficiaries) would have increased their personal income tax liability by $1.4 billion.[12] In consequence it appears that the increase in personal income tax liability would have been on the order of $13.5 billion, which leaves $3.3 billion of the foregone corporation income tax not recouped. This revenue loss—about 9 per cent of the total corporate and personal income tax liabilities incurred in 1950[13]—is not unimportant but it is significantly less than the corporate tax liability figure that is frequently cited to support the argument that, good or bad on other grounds, the corporate tax is a mighty revenue raiser, and its abolition cannot be countenanced. One way of placing the revenue loss in perspective is this: In 1950, if the partnership method of taxing corporate earnings had been introduced by Congress, a current fall in federal revenue could have been prevented by raising personal income tax rates (on stockholders and all other taxpayers) by about 3.0 percentage points all along the line.[14]

This is not the end of the story. A further loss in revenue is to be expected from a change not apparent in 1950. No allowance has been made thus far for the change in basis of valuation used to determine the amount of capital gain that would be the logical corollary of full imputation of corporate earnings. For personal income tax purposes, the amount of capital gain attendant upon the sale of a partnership share is equal to the proceeds from the sale, minus the sum of the initial purchase price plus the partner's pro rata share of all undistributed earnings from the date of purchase to the date of sale. To accord, then, with the procedure now used in the taxation of partner-

[12] This estimate is made assuming that fiduciaries would distribute no more to beneficiaries after imputation than they actually did in 1950 and that, therefore, the full amount of the income imputed was taxed to the fiduciary. This assumption probably provides a minimum figure for the increment in tax liability, for it is reasonable to conjecture that if tax considerations led to less than full distribution of the fiduciary's income the marginal rate for beneficiaries was higher than for fiduciaries. Therefore, if part of the imputed income had been distributed to the beneficiaries the increase in tax liability would have been greater.

[13] As tabulated in *Statistics of Income for 1950*, personal income tax liability (including fiduciaries) came to $18.4 billion; corporate tax liability net of foreign tax credits equalled $16.8 billion.

[14] This figure is merely illustrative. It is not intended to imply that this would have been either the only or the most appropriate way of recouping the revenue loss.

ship shares, the basis of stock valuation for capital gains tax purposes should be raised by the excess of net corporate earnings over dividends received, i.e., by the amount of retained earnings. If this is done, future capital gains and capital gains tax liability would be smaller than they otherwise would have been.

How much smaller? Several imponderables are involved in estimating the quantitative importance of this part of the complex and it is possible to provide only a very rough idea of what its magnitude might be. Our assumptions seem reasonable, but they could be rather far from actuality. However, much the same results would have followed from different assumptions.

Two sets of factors are involved in this estimate. It is not likely that under the partnership method of taxing corporate earnings the entire sum formerly paid as corporation income tax would be distributed to stockholders. The amount of retained earnings probably would be higher than before, and consequently, sometime in the future, stockholders' tax liability for capital gains would be larger. This increase in tax revenue would be outweighed by the revenue effect of the change in basis of valuation of corporate stock described above; because of this adjustment future capital gains and the tax liability on them would be lower. Since the increase in capital gains tax liability would be related to an increment in retained earnings, while the decrease due to the change in basis would be associated with total retained earnings, on net balance these factors would lead to a decline in revenue. It would not show up currently but over time in the form of a lower capital gains tax liability than would have been the case in the absence of the partnership method. Precisely how this revenue loss was estimated is too detailed a matter to go into here.[15]

[15] A full explanation of our method is found in Appendix B. Lest the reader, however, feel that he is being asked to accept too much on faith, a very brief outline of the procedure follows: It was assumed that the rescinded corporation income tax would go into dividends and retentions in the same proportion as corporate earnings (net of the corporation income tax) were actually divided in 1950. Following the reasoning behind variant 2 (see Chapters 1 and 2) it was assumed that only 72 per cent of the increase in retained earnings would show up as capital gains. This sum was subtracted from the new total of retained earnings to get the net future decline in capital gains caused by the change in basis due to the current taxation to stockholders of income not distributed to them. To get from this figure to a revenue loss estimate required two assumptions: only two-thirds of capital gains are realized in taxable form (the remaining one-third being realized by persons who are not taxable, who are negligent about reporting capital gains for tax purposes, or who pass them income-tax free at death); the gains would be long-term, and, therefore, only half would be included in taxable income; on average, an effective rate of 30 per cent would apply to them. (This is reasonable since the alternative tax sets a ceiling of 50 per cent on them.) So far this suggests a revenue

Our principal concern is the result: an estimated loss of $1.4 billion in capital gains tax liability would occur over time due to the retention of earnings in 1950. This figure, it should be noted, is characterized by a much lower order of accuracy than the above current revenue loss estimate.

In summary, under the conditions prevailing in 1950, changing to the partnership method of taxing corporate earnings would have meant an immediate loss in revenues of $3.3 billion, and an additional decline aggregating about $1.4 billion over the years that followed. Interpreting the current revenue loss as the net revenue contribution of the corporate income tax on net corporate earnings, we may conclude that this net contribution came to only a small fraction—less than one-fifth—of the total actual corporate income tax liability.

These findings are particularly dependent on the specific values of the relevant variables in 1950, the relative heights of the corporate and personal income taxes, and the aggregate of corporate earnings and their divisions between dividends and retentions. How will variations in these determinants change our estimate of the revenue effect of the partnership method? One means of tracing the effects of such variations is the previously mentioned analysis of data for other years, to be discussed later. Another means is examination of the effects of hypothetical changes in one or another of the determining variables for the year now under consideration, 1950. For this purpose, tax rates prevailing in 1947 were substituted for 1950 rates.

With other things equal, the higher the effective rate of corporation income tax, the greater the revenue loss connected with a switch to the partnership method. If instead of the actual 1950 effective corporate tax rate (42.5 per cent) the 1947 rate of 36.7 per cent had been in effect in 1950, the current revenue loss would have been considerably less—$1.1 billion as against our estimated $3.3 billion.[16] Again other things unchanged, the higher the personal income tax rate schedule, the smaller the revenue loss if stockholders were taxed as partners. In 1947, personal income tax rates were higher than in 1950; in 1947, the increase in personal income tax liability came to 48.0 per cent of the additional amount imputable to stockholders under the

loss of 10 per cent of the decline in capital gains due to the change in basis. But since it is a loss to be experienced in the future, its present value would be somewhat lower. By assuming the decline to take place evenly in the five years following the year of imputation, and taking 5 per cent as an appropriate rate of discount, a figure for the present value of the future capital gains tax liability revenue loss was obtained equal to 8.6 per cent of the total amount of the decline in capital gains due to imputed retained earnings.

[16] Both rate computations take into account the credit for foreign income taxes paid.

partnership method; in 1950, the percentage was only 44.2. If the 1947 personal income tax rate schedule had been in effect in 1950 with the marginal rate of tax on the amount imputable at 48.0 per cent, the current revenue loss in 1950 would have come to only $2.1 billion.[17] (See Table 28 for evidence on the level of personal income tax rates.)

TABLE 28

Comparison of Effective Rates of Personal Income Tax, 1947, 1949, 1950 and 1952 (*per cent*)

NET INCOME LEVEL (*$000's*)	*Single person—no dependents*				*Married person—two dependents*			
	1947	*1949*	*1950*	*1952*	*1947*	*1949*	*1950*	*1952*
3	16.2	13.6	14.3	18.1	6.3	3.3	3.5	4.4
5	18.4	16.2	16.9	21.0	11.8	8.6	9.0	11.5
10	23.5	21.2	22.0	27.2	18.6	13.6	14.2	17.7
25	37.5	34.4	35.6	43.8	34.1	21.9	22.7	28.0
50	50.3	46.4	48.0	56.9	48.2	33.2	34.3	42.2
100	63.5	58.8	60.8	69.7	62.3	45.6	47.2	56.0
500	81.6	77.0	79.2	87.2	81.3	71.7	73.9	82.2
1,000	84.0	77.0	80.0	88.0	83.9	76.9	79.1	87.1

Source: *Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year Ended June 30, 1950*, pp. 248 and 250; and *for 1951*, p. 502.

Finally, if effective rates equal to the 1947 corporate rate and personal rate had prevailed in 1950 there would have been no current revenue loss accompanying the institution of the partnership method. On the contrary, a slight current increase in revenue, something on the order of $100 million, would have resulted.

Since the partnership method would involve no differential taxation of stockholders, the net revenue contribution of the corporate tax may be taken to be the excess of corporate tax liability over the tax liability stockholders would have if they were taxed as partners. More specifically, the net revenue contribution of the corporate tax is here defined as equal to the current revenue loss under the partnership method. From this point of view it is interesting to note that the net revenue contribution of the corporation tax can be traced in large part to a specific segment of stockholders—viz., those stockholders not reached by the personal income tax either because they were not subject to it as nonprofit institutions or because their income fell short of their exemptions, and those stockholders who failed to report their total dividend receipts.

[17] Reduction in personal income tax rates after 1947 reflects primarily the income-splitting introduced in 1948, and the resulting lower rates applicable to joint returns.

If we restrict our examination to those stockholders who paid the personal income tax (both individuals and taxable fiduciaries) we find that their actual corporate-personal income tax liability for 1950 exceeded their potential current partnership method liability by a very slight margin—about $0.8 billion.[18] But such stockholders accounted for only 83 per cent of all net dividends paid out by corporations. The remaining 17 per cent were not reported for reasons enumerated above. It is from the corporate earnings imputable to this segment of dividends that most of the net revenue contribution of the corporate income tax came. These findings for 1950 also apply for 1947, 1949, and 1952. In other words, the major part of the net revenue contribution of the corporation income tax can be explained by two facts: it is the less discriminating of the two taxes and thus reaches the corporate earnings of those exempt from the personal tax; and it is probably more difficult to underreport corporate earnings for corporate tax purposes than it would be under the personal income tax.

The fact that some dividends were either inadvertently or deliberately not reported on personal income tax returns suggests another qualification to our revenue loss estimates. For if, with enactment of a change in the method of taxing corporate earnings, safeguards were incorporated in the revenue code to insure fuller reporting of dividends, the current revenue loss would be lower than our estimates indicate. In support of a withholding provision for dividend payments, the Treasury has "estimated that the withholding tax system would increase net income tax receipts by $150,000,000."[19] Corporate earnings in 1950 were almost four and one-half times as large as dividends. Therefore, with full taxation of each stockholder's share of corporate earnings, one would expect at least a $0.6 billion increase in personal income tax receipts if unreported dividends (and, presumably, corporate earnings) were ferreted out.[20]

1949

Corporate earnings (and, of course, corporate tax liability) were considerably lower in 1949 than in 1950 ($26 billion of earnings as against $40 billion) but were divided between dividends and retentions in about the same proportion in both years. The corporate rate and the

[18] $0.6 billion for individuals, $0.2 billion for fiduciaries.

[19] *Hearings before the Committee on Finance,* United States Senate, on H.R. 8920, 81st Cong., 2nd Sess., 1950, p. 19.

[20] "At least" because for all of corporate earnings personal income tax marginal rates higher than for dividends alone would be applicable.

personal rate for 1949 were lower than for 1950. In general, then, the factors involved in the revenue change associated with the partnership method were noticeably different from those operating in 1950.

A shift to the partnership method in 1949 would have meant giving up $9.5 billion of corporation income tax liability. But, in that year, all but $2.3 billion of this foregone revenue would have been recouped via increased personal income tax collections. To put this revenue loss in perspective: an estimated over-all percentage point increase of 2.6 in the personal income tax rate schedule would have been required to prevent any revenue loss; or $2.3 billion represents 9.5 per cent of the total corporate and personal income tax liability in 1949. The future revenue loss would be an estimated $0.9 billion. All in all, a decline in tax liabilities of $3.2 billion would have accompanied a shift to prompt and full taxation of stockholders' pro rata share of net corporate earnings under the personal income tax in 1949.

1947

The 1947 results are perhaps the most surprising. For indications are that a revenue gain (albeit of modest proportions) rather than a loss would have been the immediate consequence of a shift to the partnership method. A conjunction of circumstances—relatively high personal rates, a comparatively low corporate rate, and a high proportion of undistributed earnings—led to this result. Corporate income tax liability (after allowance for foreign tax credits) of $10.8 billion would have been lost to the Treasury. But the additional personal income tax liability of stockholders would have come to $9.8 billion, and fiduciaries would have been liable for an additional $1.1 billion. The immediate revenue gain, some $0.2 billion, would have been overbalanced, however, by a revenue loss in later years due to lower future capital gains tax liability of about $1.2 billion.

An apparent oversight in our procedure should be explained. Our revenue calculations have been limited to individuals, estates, and trusts that were liable for personal income tax in a given year. Upon full taxation of corporate earnings under the personal income tax, would not some previously nontaxable stockholders be pushed into the taxable category and should this not be taken into account in our estimate? Such an adjustment made for 1947 was found to be very unimportant—on the order of $20 million. Given the inherent ranges of error in the revenue estimates (making reasonable their rounding to the nearest tenth of a billion for present purposes), it seems unnecessary to take account of this refinement.

1952

Corporate earnings were $4 billion lower in 1952 than in 1950, yet because of rate increases between these two years corporate tax liability was $1.6 billion greater in 1952. This presages a larger revenue loss under the partnership method for 1952, a loss made more substantial by the fact that less would have been recouped under the 1952 personal income tax. The added loss, despite increased personal income tax rates, would result from the smaller total to be imputed in 1952, causing the increment in personal income tax liability to fall short of the comparable 1950 figure by $800 million.[21]

More particularly, the revenue loss that would have occurred in 1952 had the partnership method been instituted would have been around $5.7 billion, the amount by which the estimated increase (partnership method) in personal income tax liability of $12.7 billion would have fallen short of the corporate tax liability of $18.4 billion.[22] A loss in revenue of this amount could have been recouped by raising the 1952 personal income tax rate schedule by 4.4 percentage points. That the current revenue loss would have come to $5.7 billion indicates that the corporate tax, when evaluated against the alternative procedure of taxing corporate earnings as part of personal income, was responsible for a net addition to federal revenue of less than one-third of the total sum ostensibly raised by it. As in the preceding years, the future capital gains tax liability would be lower than it might have been; for 1952 this future revenue loss is estimated at $900 million.

1955

Especial interest always attaches to the most recent experience. Therefore, the net revenue contribution of the existing method of taxing corporate earnings was estimated with the data for 1955. This estimate, it must be pointed out, is considerably rougher than those we have just discussed; the data used were less reliable; the method of estimation much more summary.

If the partnership technique had been adopted in 1955, the Treasury would have suffered a considerable loss in revenue. Increased personal income tax liability would have fallen short of the foregone corporate tax liability by some $4.9 billion.[23] A 3.3 point increase in

[21] The amount imputed was $30.6 billion in 1950, $26.5 billion in 1952. The difference is due to the lower level of corporate earnings and the greater relative importance of distributed earnings in 1952.

[22] The corporate tax liability is taken net of the credit for foreign corporation income taxes paid.

[23] This figure takes no account of the individual tax relief provisions introduced

the personal income tax rate schedule would have been required to recoup the current revenue loss. In addition, the future capital gains tax revenue loss would have been on the order of $1.3 billion.

Summary

By way of summary Table 29 presents the revenue effects (both current and future) of a shift to the partnership method. Also, to place the current revenue loss in perspective, the estimated percentage point rise in the personal income tax rate schedule necessary in each year to recoup the loss appears in column 3. (Table B-13 incorporating greater detail appears in Appendix B.) Of the data in Table 29, the entries for 1947, 1949, 1950, and 1952 are the most firmly based.

Quite varied are the results for these twelve years. In every one of them, of course, the net contribution of the corporate income tax to the public fisc was substantially less than its face amount.

1. In 1946 and 1947, no loss in revenue would have occurred currently by a shift to the partnership method.

2. Nor was the corporate tax a very powerful revenue raiser on a net basis in a number of other years—1948, 1949, and 1950. Most of its net contribution in these years can be explained by the fact that it reached the corporate earnings of stockholders who were either exempt from or failed to report their dividends for the personal income tax.

3. In the other years of this period, however, sizeable amounts of revenue resulted from the fact that two income taxes—corporate and personal—were levied on corporate earnings.

4. One way of giving the current loss figure some meaning, as noted above, is to estimate by how much the schedule of personal income tax rates (personal income now defined to include stockholders' pro rata share of net corporate earnings) would have to be raised to recoup it (see column 3). This figure, of course, varied considerably over our period; between 1950 and 1955 it ranged from 3 to 5 points. In 1955, by a rough estimate it would have required a 3.3 percentage point rise in personal income tax rates to leave the federal revenue intact after switching to the partnership method.

5. The net revenue obtained currently by taxing corporate income separately when earned and again when distributed—i.e., the revenue loss associated with the partnership method—represented only a fraction of the total corporate income tax liability (column 4). This fraction varied considerably from slightly less than zero (1947) to a little over one-third (1944). These findings suggest that, at the present time, were the federal revenue requirements to develop in such a way

TABLE 29

Estimated Partnership Method Revenue Loss, 1944-1955
(dollars in billions)

YEAR (1)	*Current revenue loss due to shift to partnership method* (2)	*Percentage point rise in personal tax rates required to recoup current revenue loss*[a] (3)	*Net current revenue yield of corporate tax as % of total corporate tax liability* (4)	*Present value of future revenue loss by shift to partnership method* (5)	*Total revenue loss due to shift to partnership method* (2) + (5) (6)
1944	$5.2	7.3	35.1%	$0.7	$5.9
1945	3.5	5.1	32.7	0.5	4.0
1946	0.3	0.4	3.4	0.9	4.2
1947	—0.2	—0.2	—1.9	1.2	1.0
1948	1.9	2.0	16.4	1.3	3.2
1949	2.3	2.6	24.2	0.9	3.2
1950	3.3	3.0	19.6	1.4	4.7
1951	6.5	5.2	30.2	1.2	7.7
1952	5.7	4.4	31.0	0.9	6.6
1953	6.1	4.3	30.8	1.0	7.1
1954	4.5[b]	3.3	28.3	0.9	5.4
1955	4.9[b]	3.3	24.4	1.3	6.2

[a] 1944-1947 based on taxable income estimates in Joseph A. Pechman, "Yield of the Individual Income Tax During a Recession," *National Tax Journal*, March 1954 (Vol. VII, No. 1) p. 7. For 1944 and 1945, income subject to normal tax was used; for 1946 on, when exemptions applied to both normal and surtax, surtaxable income was used. From 1948 on, Pechman's worksheet estimates were used. The imputations under the partnership method were added to taxable income. The method used in deriving the values in column 3 leads to an overstatement of the rate increase required. A somewhat smaller rise than indicated would probably be sufficient to recoup the current revenue loss (see footnote j to Table B-13).

[b] These estimates take no account of the dividend credit and exclusion, in effect since 1954. Very roughly, these two relief provisions lowered the personal income tax burden on stockholders, in the aggregate, by about $200 million in 1954 and $300 million in 1955. The entries in column 2 might more accurately be, therefore, $4.3 and $4.6 respectively because, with the partnership method in effect there would be no reason, on equity grounds at least, to keep the exclusion and credit. These changes, of course, carry through the rest of the columns in the table.

that a cut of, say, 25 per cent in corporation normal and sur-tax rates could be seriously contemplated,[24] it would also be feasible, from the revenue point of view, to abolish the corporation income tax entirely if corporate earnings were fully and promptly taxed to stockholders as part of their personal income.

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in 1954. (They are discussed in the next chapter.) We estimate the revenue loss due to the dividend exclusion and credit at $350 million in 1955. So the current revenue loss under the partnership method (which implies also the repeal of these relief provisions) might more properly be set at $4.5 to $4.6 billion.

[24] This would leave them a little above the rates prevailing in the period 1946-1949.

6. Additional comparisons are represented in Table 30. The corporation income tax, apparently, is a mainstay of our revenue structure. Over the years included in this investigation corporate tax liability was second to the personal income tax as a source of federal revenue. (Compare lines 1 and 2.) On these simple grounds alone it might be called our "second best" tax, accounting for anywhere from one-fifth to over one-third of total revenue.[25] But as a net revenue raiser, i.e., in terms of additional revenue over and above the aggregate liability calculated by the partnership method of taxing corporate earnings, the picture is not so imposing (line 8).[26] In only two years did the net revenue contribution of the corporation income tax exceed 10 per cent of federal revenue. Typically it ran between 5 and 9 per cent of federal tax and non-tax receipts, and in two years came to less than 1 per cent of this total (line 9). Moreover, on a net revenue basis, the corporate tax was less important in the flow of federal receipts than excise taxes or contributions to social security (lines 12 and 13), and, also, of course, than the personal income tax.

It would be interesting to check our figures against those of other investigators. The only somewhat comparable estimate I have discovered was made by Louis Shere who found that, in 1948, the repeal of the corporate tax and the introduction of the partnership method would have involved a probable revenue loss of around $3 billion.[27] This estimate is one billion dollars higher than ours for the 1948 current revenue loss.[28] Allowing for the wide margins of error attaching to all such estimates, our estimate and Shere's can be considered to constitute mutually corroborative rather than conflicting evidence.

[25] Total revenue in Table 30 is defined as the sum of personal and corporate tax liability as tabulated in *Statistics of Income*, plus all other tax and non-tax collections. This definition fits most appropriately the data used in our study, but it means for some taxes we use liability and for other collections. If the collections figures had been used in all cases, the results would not have been very different.

[26] The net revenue contribution is the current revenue loss estimated for the partnership method.

[27] Louis Shere, "Federal Corporation Income Tax—Revenue and Reform," *National Tax Journal*, June 1949, p. 114. Shere does not state explicitly that the estimate is for 1948, but his text implies it. In *Corporate Tax Structure for Post-War Progress*, Paul Ellis provided a figure for 1945. But, in deriving it, he was forced to use estimated data that fell so far off the mark from the actual data for that year that his figure and ours are not comparable. W. L. Crum has estimated the partnership method revenue loss for 1941, not for all returns, but for a major category—individual returns with normal and surtax only (W. L. Crum, "The Taxation of Stockholders," *Quarterly Journal of Economics*, February 1950, p. 53).

[28] It is likely, from the context and the lack of any explicit statement that he was allowing also for future losses in capital gains tax revenue, that Shere's estimate is concerned solely with the revenue loss effective in the given year 1948.

TABLE 30

Net Revenue Contribution of the Corporation Income Tax Compared with Other Sources of Federal Revenue, 1944-1952

(dollar amounts in billions)

	1944	*1945*	*1946*	*1947*	*1948*	*1949*	*1950*	*1951*	*1952*
Sources of federal revenue:									
1. Personal income tax liability	$16.3	$17.3	$16.3	$18.3	$15.6	$14.6	$18.6	$24.4	$28.0
2. Corporation income tax liability[a]	14.8	10.7	8.7	10.8	11.6	9.5	16.8	21.5	18.4
3. Excise taxes	5.3	6.2	7.3	7.3	7.5	7.6	8.3	8.7	9.6
4. Contributions for social insurance	4.8	5.8	5.5	5.1	4.5	4.9	5.9	7.1	7.5
5. Other tax and nontax revenue	1.7	1.8	1.5	1.5	1.6	1.5	1.6	1.7	1.9
6. Total revenue	42.9	41.8	39.3	43.0	40.8	38.1	51.2	63.4	65.4
Corporation income tax:									
7. Liability as a per cent of total revenue	34.5%	25.6%	22.1%	25.1%	28.4%	24.9%	32.8%	33.9%	28.1%
8. Its net revenue contribution[b]	$5.2	$3.5	$0.3	$—0.2	$1.9	$2.3	$3.3	$6.5	$5.7
Net revenue contribution of corporation income tax as a per cent of:									
9. Total revenue	12.1%	8.4%	0.8%	—0.5%	4.7%	6.0%	6.4%	10.3%	8.7%
10. Personal income tax liability	31.9	20.2	1.8	—1.1	12.2	15.8	17.7	26.6	20.4
11. Gross corporation income tax liability	35.1	32.7	3.4	—1.9	16.4	24.2	19.6	30.2	31.0
12. Excise taxes	98.1	56.5	4.1	—2.7	25.3	30.3	39.8	74.7	59.4
13. Contributions for social insurance	108.3	60.3	5.5	—3.9	42.2	46.9	55.9	91.5	76.0

Source: For lines 1 and 2, *Statistics of Income*; for line 3, line 12 of Table 8, *National Income* (1954 ed.); for line 4, line 21 of Table 8, *National Income* (1954 ed.); for line 5, lines 16, 17, and 18 of Table 8, *National Income* (1954 ed.).

[a] Net of credit for foreign taxes paid.

[b] Current revenue loss under partnership method.

AGGREGATE DIFFERENTIALS

In deriving the differential against earnings for distribution, earnings for retention, net corporate earnings, and stockholders' income at selected levels of imputed gross income, by the standard method developed in this investigation (see Chapters 1 and 2), it was assumed that the incidence of the corporate tax is on profits. On this assumption stockholders are currently subject to what is called here the corporate-personal income tax system, i.e., one income tax on corporate earnings at the corporate level when earned and another at the personal level when earnings are received as dividends. The corporate tax in this complex is a gross tax; on a net basis it would be lower because if the amount taken away by the corporation income tax had been distributed to stockholders it would have been reached by the personal income tax. Likewise, if retained earnings had been distributed personal income taxes would have increased. This section is concerned, not with the average experience at selected levels of imputed gross income, but with a comparison for all stockholders, arrayed by imputed gross income classes, between the aggregate tax liability incurred under the corporate-personal income tax system and the aggregate tax liability calculated by the partnership method. The difference between the two liabilities constitutes a differential measured on an aggregative basis—i.e., the total differential for all the stockholders in each imputed gross income class.[29]

Results of such a comparison made with the data for 1947, 1949, 1950, and 1952 are shown in Table 31. Much the same sort of comments are in order for all four of these years; the discussion concentrates on one of them—1950. In that year, as far as taxable dividend recipients were concerned, both income tax systems—the actual corporate-personal and the personal income tax alone (the partnership method)—involved substantially the same amount of aggregate tax liability.[30] But this virtual equality masks important diversities among

[29] Because our computations deriving the aggregate differential take no account of the future capital gains tax liability due to the retained earnings of a given year, the measure used corresponds conceptually to variant 1 rather than variant 2 which was used as the standard measure in earlier chapters (see Chapter 2), and to the current revenue loss under the partnership method.

[30] That for "double-taxed" stockholders a relatively slight decline in tax liability of $600 million would have been associated in 1950 with the partnership method is not a contradiction of our earlier conclusion that a current revenue loss of about $3.3 billion could have been expected had a switch to the partnership method been made in that year. For not all net dividend outpayments of corporations show up on taxable returns; for this year I was able to trace only 83 per cent of net corporate dividends to the taxable returns of individuals and estates and trusts. (Percentages were similar in the other years.) For a variety of

TABLE 31

Comparison of Tax Liability of Stockholders under the Corporate-Personal Income Tax System and the Partnership Method, 1947, 1949, 1950, and 1952

IMPUTED GROSS INCOME CLASS ($000's) (1)	TAX LIABILITY: Corporate-personal tax system ($ in millions) (2)	TAX LIABILITY: Partnership method ($ in millions) (3)	(3) as a per cent of (2) (4)	Number of stockholders with liability higher under partnership than under corporate-personal income tax (5)	Per cent of total returns in class undertaxed (6)
		1947			
Under 2	56.7	36.1	64		
2 and under 4	475.6	316.5	67		
4 and under 5	274.0	191.5	70		
5 and under 7	557.2	383.4	69		
7 and under 10	739.2	526.0	71		
10 and under 25	2,575.5	2,211.7	86	16,401	2.9
25 and under 50	2,309.2	2,447.0	106	155,110	92.3
50 and under 100	2,549.2	3,213.6	126	75,691	100.0
100 and under 500	2,894.9	4,136.8	143	28,939	100.0
500 and under 1,000	658.8	1,034.5	157	1,790	100.0
1,000 and over	803.1	1,281.1	160	648	100.0
Total	13,893.4	15,778.2	114	278,579	8.6
		1949			
Under 2	26.7	14.5	54		
2 and under 4	276.7	167.5	61		
4 and under 5	231.8	144.7	62		
5 and under 7	628.4	391.6	62		
7 and under 10	714.8	438.7	61		
10 and under 25	2,393.1	1,652.0	69		
25 and under 50	1,649.4	1,353.9	82	10,220	6.1
50 and under 100	2,093.7	1,983.4	95	28,363	32.2
100 and under 500	2,985.5	3,492.8	117	37,447	99.5
500 and under 1,000	699.2	945.7	135	2,321	100.0
1,000 and over	849.6	1,153.3	136	801	100.0
Total	12,548.9	11,738.1	94	79,152	2.5

(*continued on next page*)

income classes. By the partnership method, a smaller aggregate tax than actually levied would have been set on stockholders in the income classes (imputed gross income definition) below $50,000, while a higher

reasons cited above the remaining 17 per cent escapes or evades the personal income tax mill. Thus the partnership method corporate earnings tax base used in calculating the revenue loss was only 83 per cent of the corporate income tax base.

Table 31, *concluded*

IMPUTED GROSS INCOME CLASS ($000's) (1)	TAX LIABILITY: Corporate-personal tax system ($ in millions) (2)	TAX LIABILITY: Partnership method ($ in millions) (3)	(3) as a per cent of (2) (4)	Number of stockholders with liability higher under partnership than under corporate-personal income tax (5)	Per cent of total returns in class undertaxed (6)
		1950			
Under 2	23.0	13.1	57		
2 and under 4	269.8	160.4	59		
4 and under 5	250.8	153.9	61		
5 and under 7	729.7	473.0	65		
7 and under 10	720.8	406.3	56		
10 and under 25	3,077.0	2,032.7	66		
25 and under 50	2,896.8	2,316.9	80	12,252	5.3
50 and under 100	3,706.6	3,619.8	98	63,182	55.5
100 and under 500	5,104.3	6,022.3	118	50,496	99.3
500 and under 1,000	1,216.7	1,660.1	136	3,149	100.0
1,000 and over	1,692.4	2,225.4	131	1,213	100.0
Total	19,687.9	19,083.9	97	130,292	4.0
		1952			
Under 2	34.9	19.5	56		
2 and under 4	339.6	204.2	60		
4 and under 5	350.7	231.7	66		
5 and under 7	1,046.5	747.0	71		
7 and under 10	1,178.2	729.9	62		
10 and under 25	4,288.5	3,086.6	72		
25 and under 50	3,361.8	2,553.9	76	246	0.1
50 and under 100	4,148.7	3,832.2	92	12,428	11.1
100 and under 500	5,139.6	5,622.3	109	45,920	96.9
500 and under 1,000	1,046.5	1,281.6	122	2,460	100.0
1,000 and over	1,328.8	1,626.8	122	897	100.0
Total	22,263.8	19,935.7	90	61,951	1.6

tax liability would have been the lot of all income classes $100,000 and over. (Between $50,000 and under $100,000 the tax liability would have been about the same under either system.) Another way of putting it is this: Had the partnership method replaced the existing system of taxing corporate earnings, but with the corporate tax retained as a withholding measure, in the aggregate stockholders in the imputed gross income classes up to $50,000, would have received refunds; those in the section of the income array over $100,000 would have owed more. Also, as we can see in column 4 of Table 31, for classes under $50,000, the lower the income class, the more pronounced the excess

of the corporate-personal tax liability over the partnership method, while for classes over $100,000, generally the higher the income class, the higher the partnership method liability tended to be in relation to the corporate-personal income tax.

In the aggregate, then, comparison of the two tax systems suggests that in 1950 the existence of income taxes at both the corporate and personal level led to a differential *against* stockholders in income classes under $50,000 (with the differential against them higher, the lower the income class), to roughly neutral taxation of those in the $50,000 and under $100,000 class, and to a differential *in favor of* stockholders in the income classes $100,000 and over (with the differential in their favor increasing with the level of income). With reference to our benchmark, the personal income tax as indicative of the community's consensus on how heavily income of a given size should be taxed, it is apparent that under the corporate-personal tax system, on the whole, "overtaxation" prevailed in the case of stockholders with incomes under $50,000, equal taxation characterized those falling between $50,000 and $100,000, while "undertaxation" ruled for those in the higher income classes.

While in 1950 the amount of "overtaxation" at lower income levels and of "undertaxation" at upper levels was almost the same, the overwhelming majority of stockholders were "overtaxed." Only 130,000—some 4.0 per cent of the total—fell in the undertaxed group (column 5). This, of course, merely reflects the high degree of concentration of dividends and claims to corporate earnings. Small in numbers, the undertaxed group was rich in corporate earnings; about 44 per cent of all corporate earnings of taxable stockholders was accounted for by the undertaxed returns.

The findings for the other three years—1947, 1949, and 1952—are very similar to those reported for 1950.

Rather dramatic is the conclusion that in 1947 from the corpus of taxable stockholders the partnership method would have extracted close to $2 billion more than did the existing two taxes on corporate earnings (the corporate tax on all earnings, the personal tax on the distributed portion). But this is not inconsistent with our finding that no appreciable current revenue gain would have accompanied a switch to the partnership method in this year. For taxable stockholders, the corporate and partnership method bases were the same, but for all stockholders the latter was only 82 per cent as large as the former. Hence, it is reasonable that the partnership method would have involved a decidedly higher liability on taxable stockholders but a total liability about the same as the corporate-personal income tax system.

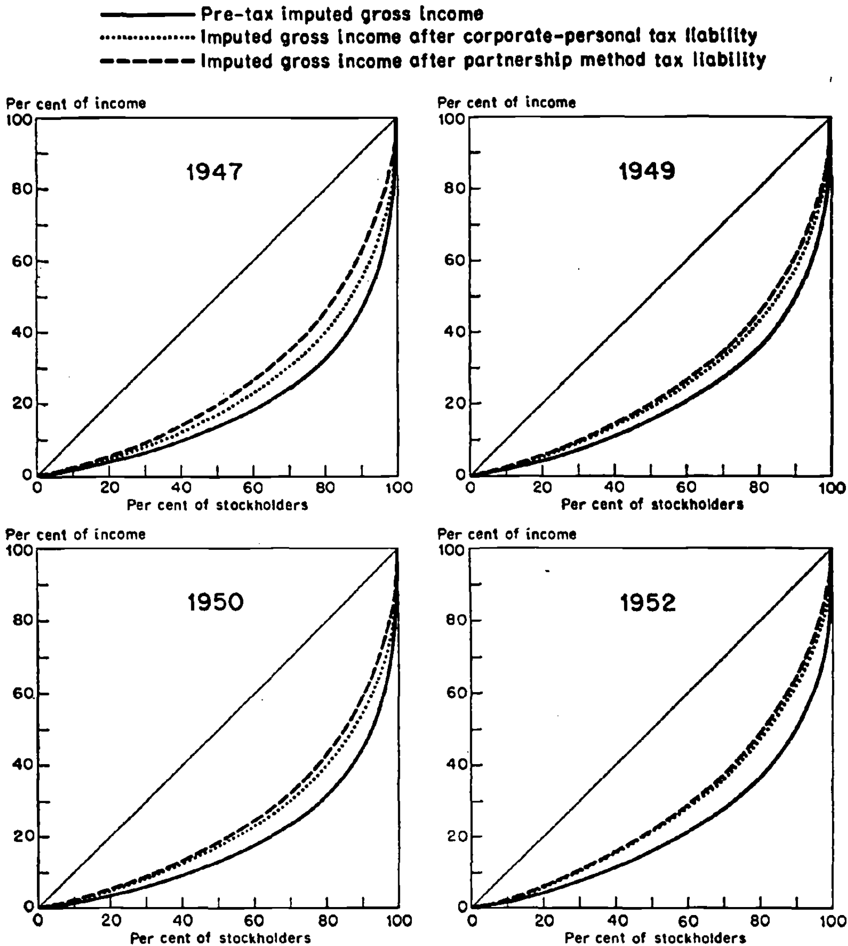
Comparing 1947, 1949, and 1952 with 1950 highlights some of the determining factors. In 1947, we find a greater degree of undertaxation, more than twice as many undertaxed stockholders (280,000 as against 130,000), and a higher proportion of corporate earnings falling in the undertaxed category (68 per cent compared with 44 per cent). For 1949 we get a higher degree of overtaxation in the aggregate, fewer undertaxed stockholders (79,000 as against 1950's 130,000), and a smaller fraction of all corporate earnings going to undertaxed stockholders (40 per cent compared with 44 per cent). Finally, for 1952 we also get fewer undertaxed stockholders (62,000 as against 130,000), and a smaller fraction of all corporate earnings going to undertaxed stockholders (39 per cent compared with 44 per cent). Variations among these four years in the extent of over- and undertaxation depend on the spread between the corporate and personal income tax rates, a relation commented upon earlier in this chapter in connection with revenue loss estimates. In the four years analyzed, this spread was largest in 1947, smallest in 1952. The large number of undertaxed returns found for 1947 may be explained by an additional factor: prior to the introduction of income-splitting in 1948, some married couples probably divided their dividend receipts to minimize tax liability; such returns, heavily weighted with dividends, would on imputation of corporate earnings fall in a much higher income class and would tend, therefore, to swell the ranks of the undertaxed.

EFFECT OF TAXATION ON THE DISTRIBUTION OF STOCKHOLDERS' INCOME

One of the most pertinent considerations in evaluating both the equity and economic effects of an income tax system is its effect on the distribution of income. The marked differences noted above in the occurrence of over- and undertaxation among income classes under the partnership method of taxation and under the combined corporate-personal tax system suggest different effects for each system on the distribution of stockholders' income. This section is given to a comparative analysis of this matter. (A reminder: both tax systems are interpreted as levies on the income of stockholders including their pro rata share of all corporate earnings—dividends, retentions, and corporate income taxes). The effect of each system is measured by comparing the degree of concentration in the distribution of stockholders' income on a pre-tax and post-tax basis.

On Chart 8 are plotted three Lorenz curves for each of the years 1947, 1949, 1950, and 1952. The solid line traces out the distribution

CHART 8—Comparison of the Equalization Effect of the Partnership Method and the Corporate-Personal Income Tax System on the Distribution of Stockholder Income, 1947, 1949, 1950, and 1952



of stockholders' imputed gross income, which includes their full pro rata share of net corporate earnings before being reduced by taxation. The other two lines on the chart, both of which lie closer to the diagonal which theoretically denotes complete "equality,"[31] show the distribution of stockholders' income after taxes. The dotted line plots

[31] The quotes (later omitted) emphasize the purely mathematical nature of this definition of equality. For an interesting analysis of some realistic qualifications that attach to this benchmark see George Garvy, "Inequality of Income: Causes and Measurements," *Studies in Income and Wealth, Volume Fifteen*, National Bureau of Economic Research, 1952.

the distribution of stockholders' income after taxes as levied by the existing corporate-personal income tax system; the dashed line, the distribution net of the tax liability associated with the partnership method.

Since both these lines bend away less from the diagonal than the pre-tax distribution, both tax systems tended to equalize the distribution of stockholders' income. It is apparent that in every one of these four years the partnership method would have exercised the more powerful equalizing effect.

A more precise indication of the degree of equalization is provided by use of Gini's ratio of concentration, which is a measure of inequality obtained by dividing the area between a Lorenz curve and the line of complete equality by the area denoting complete inequality, i.e., the area bounded by the 45 degree line on the chart and the vertical and horizontal axes. The value of this coefficient ranges between 1 (complete inequality) and 0 (complete equality).[32] The relevant values of the Gini coefficient are listed in Table 32. From them we can measure

TABLE 32

The Relative "Push toward Equality" of the Corporate-Personal Income Tax System and the Partnership Method, 1947, 1949, 1950, and 1952

	Gini coefficient for distribution of imputed gross income			*Push toward equality*	
YEAR	*Before taxes* (1)	*After corporate-personal tax liability* (2)	*After partnership method tax liability* (3)	*Corporate-personal income tax* (4)	*partnership method* (5)
1947	0.6084	0.5330	0.4686	12.4%	23.0%
1949	0.5683	0.4966	0.4730	12.6	16.8
1950	0.6131	0.5288	0.4961	13.7	19.1
1952	0.5575	0.4477	0.4333	19.7	22.3

the push toward equality exercised by each of the tax systems under analysis. In 1950, for example, by cutting the area of inequality from 61.31 per cent of the graph to 52.88 per cent the corporate-personal tax pushed the distribution of stockholders' income almost 14 per cent toward complete equality. The partnership method would have exercised a noticeably more powerful effect; the area of inequality would have been cut to 49.61 per cent of the graph, and the push toward

[32] Dwight B. Yntema, "Measures of the Inequality in the Personal Distribution of Wealth and Income," *Journal of the American Statistical Association*, December 1933, pp. 427-428.

equality would have been over 19 per cent. Similar results were obtained for the other three years (columns 4 and 5, Table 32).

This evidence also tells us something about the relative progressivity of these two tax systems. Musgrave and Thin have suggested that one of the more useful ways of defining progressivity is by reference to the degree to which taxation has equalized the distribution of income.[33] Since our calculations measured the degree to which two different tax systems equalized the same before-tax distribution of income, we may say that, according to Musgrave and Thin's definition of progressivity, in all four years we find that the combined corporate-personal income tax was *less* progressive than the tax that would have been levied on stockholders if corporate earnings had been currently and fully reached by the personal income tax alone. This conclusion tends to contradict the frequently voiced claim that the corporation income tax, whatever its merits or demerits on other grounds, does make the tax system more progressive. This analysis illuminates only one facet of the complex subject of progressivity, other aspects of which are dealt with in Chapter 5.

[33] R. A. Musgrave and Tun Thin, "Income Tax Progression, 1929-48," *Journal of Political Economy,* December 1948, pp. 498-514. The particular measure they suggest, effective progression, is defined as the ratio of the after-tax to the before-tax coefficient of equality. The coefficient of equality is the complement of the measure we have been using—the Gini concentration ratio.

ADDENDUM

THE PARTNERSHIP METHOD WITH CORPORATE LOSSES

Within the whole span of our income tax experience, the years for which revenue estimates are presented in this chapter were all "prosperous" years. The choice was in part dictated by limitation of suitable data; even semireliable estimates of this kind are impossible for the earlier period up to the mid-thirties. The choice of years was made also with sights trained on the goal of contributing something to our understanding of the outcome, in terms of federal revenue and individual income tax liabilities, of a possible alternative method of taxing corporate earnings. To this end the more immediate experience of the forties and early fifties seems more relevant. In the present political and institutional climate, these years are widely regarded as probably more likely to characterize our economic future.

The possibility, however, of a severe depression can never safely be ignored. It would be interesting, therefore, to examine the implications of the partnership method of taxing corporate earnings against the backdrop of experience in 1932. It must be emphasized that estimates for this year are necessarily rough and of a lower quality than those presented in the body of this chapter. The data do not permit a full-dress analysis in terms of rearraying stockholders into imputed gross income classes, but are treated more simply as averages derived by imputing corporate earnings to the average stockholder income in each of the adjusted gross income classes, with no attempt to work with an income class, dividend size cross-classification. Returns of individuals and fiducial institutions could not be treated separately.

Ours is a profit and loss system. Too frequently discussions of alternative methods of taxing corporate earnings, including the partnership method, concentrate on positive corporate earnings, often ignoring the reverse possibility. Since, under the partnership method positive corporate earnings would be fully attributed to individuals for personal income tax purposes, considerations of both logic and equity would call for the same treatment for losses. In 1932, in the aggregate, corporations experienced a net loss. The data for this year, therefore, indicate some of the revenue implications of large net corporate losses for the partnership method.

Use of the average stockholder experience in this analysis injects an element of unreality and, hence, inaccuracy. With 1932 corporate earnings negative on net balance, a negative amount of corporate earnings is imputed to the average stockholder in each income class.

In reality, varying degrees of positive corporate earnings were imputable to some stockholders, and greater than average negative corporate earnings were imputable to others. This existing diversity is obscured by use of a simple average for each income class. However, because losses in 1932 were generally sweeping they probably dominated the experience of the majority of stockholders.

If the partnership method of taxing corporate earnings had been instituted in 1932, what would have been the change in federal revenue?

The repeal of the corporate income tax would have meant a loss of revenue from this source of about $286 million.[34] In addition, permitted deduction of negative net corporate earnings from personal income would have caused less revenue from the personal income tax. Actual personal income tax liability was $330 million[35] after imputation of corporate losses to individuals, aggregate personal income tax liability would have been about $233 million less. Thus, while corporate and personal income tax assessments totalled about $616 million, under the partnership method the income tax in 1932 would have come to under $100 million, less than 20 per cent of the actual total.

In recent years, in addition to an economic climate very different from that of the early thirties, basic changes in the structure of the income tax have led to a distinctly different picture. The personal income tax now reaches far down the income pyramid, with a consequent decline in importance of dividends and in potential importance of corporate earnings as components of taxable income. But the evidence from the extreme conditions of 1932 serves as an illustration of a general point which emerges: the volatility of corporate earnings would have a stronger effect on the federal revenue under the partnership method than under the combined corporate-personal income tax system. One additional parenthetical observation follows from this material. The sharp annual fluctuations in corporate earnings suggest that the introduction of the partnership method of taxing corporate earnings on a personal basis would require a greater degree of averaging than the personal income tax now permits.

[34] *Statistics of Income for 1932,* p. 136 gives corporate tax liability as $285,576,000.
[35] *Ibid.,* p. 66.