
# Federal Business Taxation: The Current System, Its Effects, and Options for Reform

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# Summary

A foundation of the broad tax revisions implemented 22 years ago by the Tax Reform Act of 1986 was tax "neutrality"—the idea that economic efficiency and economic welfare are promoted if the distorting impact of taxes on business and other economic decisions is minimized. Based on this principle, the 1986 act broadened the tax base and reduced statutory tax rates set forth by the tax code. In time, however, the underlying thrust of tax policy has changed. Rather than neutrality and efficiency, recent business tax legislation has been guided more by a concern for promoting investment and capital formation, and by attention to the perceived impact of taxes on the ability of U.S. firms to compete with foreign companies. Further, recent interest in fundamental tax reform has been partly stimulated by these same concerns for capital formation and competitiveness.

Twenty two years after the 1986 act, business tax policy is thus potentially at a crossroads, and it is useful to take stock of where the system stands, the economic effects it is known to have, and the principal options for reform. Several data series show a similar pattern in the level of corporate taxes: corporate income taxes have generally declined over the post-World War II period. At the same time, however, significant disparities in the structure of business taxes have remained, suggesting a persistence of distortions caused by the tax system: corporate-sector investment remains heavily taxed compared to non-corporate business and owner-occupied housing; debt is favored over equity; and equipment is favored over structures.

The base of business taxation is the return to business investment; business taxes thus influence the economy through their impact on investment. In broad terms, business taxes can, at least in principle, reduce capital formation and thus impair long-term economic growth by making saving and investment less attractive. This effect, however, depends on a robust saving response to taxes, the presence of which is uncertain. Another impact is on the allocation of investment among different sectors and asset types. Here, business taxes likely distort investment decisions, reducing economic efficiency and economic welfare. In the case of equity, economic theory suggests that in the long run, the burden of business taxation is shared among all owners of capital and has a progressive effect on the tax system.

Various hypothetical alternatives exist for reforming the business tax system. One possibility is to move in the direction of the 1986 Tax Reform Act by broadening the existing tax base—that is, by eliminating tax benefits and preferences. Another possibility—and one that is favored by many economists—is to adopt some form of tax integration that would eliminate the double taxation of corporate income. A third option is to adopt a form of consumption tax, under which new business investment would be exempt from tax. Either corporate tax integration or a consumption tax could improve economic efficiency, but only if the design were to avoid the types of distortions present in the current system.

This report was originally written by David L. Brumbaugh, Specialist in Public Finance. It will be updated in the event of major changes in the business tax system.

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## Figures



## Contacts

Twenty-two years ago, the broad tax revisions implemented by the Tax Reform Act of 1986 (P.L. 99-514) were based on tax "neutrality"—the idea that economic efficiency and economic welfare are promoted if the distorting impact of taxes on business and other economic decisions is minimized. To this end, the 1986 act broadened the tax base for both businesses and individuals, scaling back various narrowly-applicable tax preferences and benefits, and reduced the statutory tax rate.

In time, however, the general thrust of business-tax policy began to change, and in recent years policy has been guided more by a concern for the level of investment and capital formation, as well as the perceived impact of taxes on U.S. competitiveness. Thus, measures designed to promote tax-consistency across investments and activities have been supplanted by provisions designed to stimulate investment and assist in the ability of U.S. firms to compete with foreign companies. Cases in point are the temporary "bonus depreciation" provisions enacted in 2002 and 2003 and the broad tax deduction for domestic production included in the omnibus business-tax bill passed in 2004.[1] At the same time, there has recently been renewed congressional and public interest in broad reform of the U.S. tax system. In contrast to 1986, however, much of the recent interest in reform has centered on a shift in the tax base to consumption rather than a comprehensive measure of income—a change in focus that is based, in part, on the same concerns for capital formation and competitiveness that underlie much of recent business-tax legislation.

Twenty-two years after the 1986 act, business taxation is thus potentially at a crossroads. Will the thrust of tax policy continue to shift away from the principles of efficiency and neutrality that guided tax reform two decades in the past? If fundamental tax reform is adopted in the near future, would it include a revamped system of business taxation? If so, what would business taxation look like? Regardless of the outcome, it is useful at this point to take stock; to pause and review the current system and its effects. The charts and discussions on the following pages are intended to assist in that exercise. The report follows with a discussion of the principal economic effects of business taxation. Its concluding sections review the various theoretical principles on which fundamental reform of business taxation might be based.

# Basic Structure of the Current System

Businesses can take a variety of forms, ranging from large, publicly held corporations, to more closely held corporations, to partnerships (large and small), to firms that are run by only a single self-employed owner. With some exceptions, the rules for determining taxable income—for example, how to calculate depreciation and other deductions—are the same, regardless of the type of business. The particular manner in which that income is taxed, however, does vary, depending on the type of business.

Income earned by large, publicly held corporations ("C" corporations, in tax parlance) is generally subject to the corporate income tax—one of the principal structural components of the federal tax system, along with the individual income tax, the estate and gift tax, excise taxes, and social security taxes. In conceptual terms, the present U.S. corporate income tax is sometimes

[1] Bonus depreciation was initially provided by the Job Creation and Worker Assistance Act of 2002 (JCWA; P.L. 107-147). It was increased by the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA; P.L. 108-27) but generally does not apply to property placed in service after 2004. The domestic production deduction was provided by the American Job Creation Act of 2004 (AJCA; P.L. 108-357).

described as a "classical" system that applies as though corporations were entities with an existence separate from their owners, the stockholders. The tax applies to taxable corporate income, corporate profits (after deducting interest) as defined by the tax code. It applies separately and in addition to the individual income tax's applicability to shareholder's dividends and capital gains. As discussed in more detail below (see the section on the economic effects of the tax), this means that income subject to the corporate income tax is generally taxed twice—once under the corporate income tax in the hands of corporations, and once under the individual income tax when stockholders receive dividends or realize capital gains. The double taxation does not occur, however, in the case of corporate income generated by debt-financed investment, since the return to such investment is paid to creditors as interest and is tax-deductible. Double taxation also does not apply in the case of income paid to tax-exempt stockholders—for example, pension funds.

Income earned by relatively closely held corporations—termed "S corporations" by the tax code—is not subject to the corporate income tax and so also is not taxed twice. Instead, an S corporation's income is "passed through" to the firm's stockholders and taxed to them under the individual income tax, regardless of whether the income is actually distributed. To qualify as an S corporation, a firm can have no more than 100 shareholders and must meet certain other requirements.

As with S-corporation profits, partnership taxable income is not subject to an entity-level tax such as the corporate income tax. Instead, each partner is taxed under the individual income tax on his or her share of the partnership's profit.[2] Individual income taxes also apply to business income earned by self-employed persons who operate sole proprietorships. As with partnerships and S corporations, no separate tax is applied at the entity (i.e., business) level.

According to recent estimates by the Congressional Budget Office, 62% of tangible business assets are owned by C corporations; the remainder (38%) is owned by other business entities (i.e., partnerships, sole proprietorships, and S corporations).[3]

As noted above, rules for determining taxable income are generally the same, regardless of the form of business organization.[4] The base of federal business income taxes is generally profits, net of interest payments. Profits, in turn, are gross receipts—for example, sales—minus deductible costs. Important categories of deductible costs include interest payments, wages, purchased materials and other inputs, and a depreciation allowance for the decline in value of tangible capital. Importantly, the tax code's definition of these elements frequently differs from how an economist or accountant might define them. For example, the tax code may fully or partly exempt certain types of income from inclusion in taxable income—a specific example is the partial deduction the tax code permits for income from domestic production activities. Or, the tax code may require the recognition of income at a different point in time than when economic theory indicates it is actually earned or permit a deduction to be claimed at a different time from when the cost is actually incurred. Regardless of the underlying provision, instances where taxable

[2] For a more detailed description of the taxation of passthrough entities, see CRS Report RL31538, *Passthrough Organizations Not Taxed As Corporations*, by Jack H. Taylor. See also CRS Report RL32254, *Small Business Tax Benefits: Overview and Economic Rationales*, by Gary Guenther.

[3] U.S. Congressional Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform* (Washington: GPO, 2005), p. 19.

[4] An exception is income earned by corporations subject to the alternative minimum tax (AMT). AMT rules in some cases apply differently to corporations compared to individuals.

income differs from economic income can provide either a tax benefit or tax penalty and (as described more fully below) influence how the economy's capital resources are allocated.

U.S. firms increasingly participate in international markets, and so an overview of the U.S. structure would be incomplete without including its international dimension. In the international context, the U.S. applies what is sometimes termed a "residence" based tax system, but with important exceptions. The United States generally applies its corporate income to the worldwide income of corporations chartered in (i.e., "resident" in) the United States. At the same time, however, U.S. firms can generally indefinitely postpone (defer) U.S. tax on foreign-source income as long as the income is earned by foreign-chartered subsidiary corporations and reinvested abroad. To alleviate double taxation, the United States permits its taxpayers to credit foreign taxes they pay against U.S. taxes they would otherwise owe, subject to the limitation that foreign taxes can only be credited against U.S. foreign- (and not U.S.-) source income.

Foreign businesses in the United States are generally subject to U.S. business taxes on their U.S.-source income. If a foreign firm operates in the United States through a U.S.-chartered subsidiary corporation, the subsidiary is generally subject to U.S. tax in its role as a resident U.S. corporation; like other U.S.-chartered corporations, it is subject to U.S. tax on its worldwide income, regardless of the nationality of its owner(s). If, on the other hand, the foreign firm operates in the United States through a branch of the foreign-chartered parent corporation, the foreign firm is subject to U.S. tax on its income from U.S., but not foreign, sources: the United States taxes foreign persons and corporations on their income from the active conduct of a U.S. trade or business. (The economic effects of international aspects of the federal tax system are discussed below.)

Another structural component of the system is the alternative minimum tax (AMT). The tax code provides both a corporate AMT and an individual AMT; a business may be subject to either, depending on whether it pays the corporate income tax or is taxed under the individual income tax as a sole proprietorship or passthrough entity. Both AMTs essentially require a taxpayer to pay either the regular tax or the AMT, whichever is higher. The two liabilities will ordinarily differ for a business because they are computed differently. The AMT is imposed at a lower statutory rate than the regular tax, and the base of the AMT is more inclusive than that of the regular tax, permitting fewer omissions and tax benefits. The purpose of the AMT is to ensure that few truly profitable corporations escape paying at least some tax.

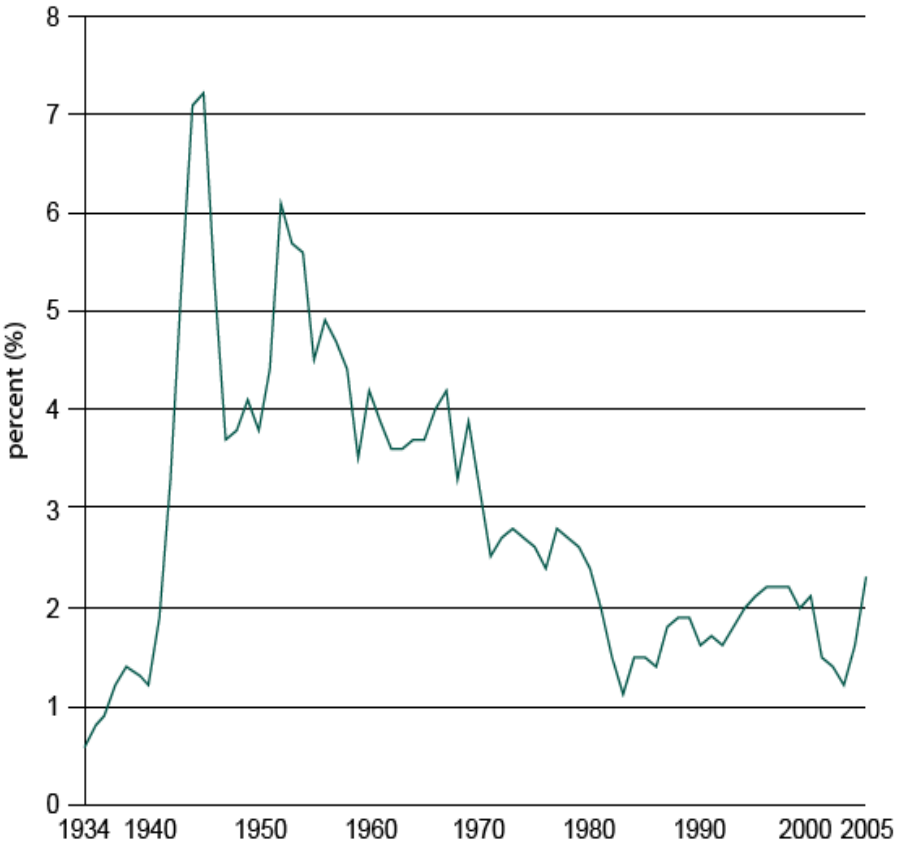
The importance of the AMT in the structure is difficult to quantify. Recent data on the share of corporate investment subject to the tax are not available. The numbers that are available show that prior to 1999, the AMT was important: in 1998, more than one-quarter of corporate assets were held by firms paying the AMT, and within the manufacturing sector over one-half of firms were AMT firms. Beginning in 1999, however, new, more generous AMT depreciation rules likely reduced the portion of investment affected by the AMT.

# Level of Corporate Taxes, Past and Present

What is the current level of business taxes, and how has it changed over time? This review of the data focuses primarily on the corporate income tax; there are a variety of ways to gauge its size. First, the general importance of the tax in terms of any economic effects it has can be assessed by looking at the level of the tax compared to the size of the economy—that is, by assessing corporate tax revenue as a percent of gross domestic product (GDP). **Figure 1**, below, presents

such data for fiscal years 1934 to 2005, thus showing the position of corporate revenues from well before World War II to the latest year available. Clearly, the chart shows that corporate tax revenues have declined from their peak during World War II (7% in FY1945) and from another peak that coincided with the Korean War (6.1% in FY1952). The chart also shows that they have declined from what might be termed an intermediate level of between 2% and 4% in the 1960s and 1970s to a level between 1% and 2% in recent years, but with an "uptick" in 2005.

**Figure 1. Corporate Taxes as a Percentage of GDP, FY1934—FY2005**




**Source:** U.S. Office of Management and Budget, *Historical Tables: Budget of the United States, Fiscal Year 2007* (Washington: GPO, 2005), pp. 33-34.

While corporate taxes have declined as a percentage of GDP, **Figure 2**, below, shows that corporate income-tax revenue likewise declined as a share of total federal revenue, and in roughly the same pattern. Corporate tax revenue's share of total federal revenue declined from a peak of 40% during World War II (FY1943), and a somewhat lower peak of 32% during the Korean War (FY1952), to levels of slightly above and below 10% after the late 1980s. Again, there was a surge in 2005.

**Figure 2. Corporate Tax Revenue as a Percentage of Total Federal Tax Revenue, FY1934-FY2005**


**Source:** U.S. Office of Management and Budget, *Historical Tables: Budget of the United States, Fiscal Year 2007* (Washington: GPO, 2005), pp. 31-32.

**Figure 3. Average Effective Corporate Tax Rates: Federal Corporate Taxes as a Percentage of Corporate Profits, FY1959-FY2005**


**Source:** CRS Report RL30469, *Average Effective Corporate Tax Rates: 1959 to 2005*, by Steven Maguire.

These broad measures of corporate taxes are useful as rough indicators of how the level of corporate taxes in the economy has changed, but lack precision in showing the burden of corporate taxes and the causes of the taxes' fluctuations. For example, a decline in the share of national income comprising corporate profits is partly responsible for the reductions shown in **Figures 1** and **2**. **Figure 3** corrects for this with a series that holds profits constant. It shows average effective corporate tax rates (AETRs), which are the ratio of federal corporate income taxes to before-tax corporate profits. According to the AETRs, the aggregate burden of corporate taxes steadily declined during the 1960s and 1970s, reaching a low of about 20% of corporate profits during the early 1980s before rising to a plateau of around 25% that has generally prevailed from 1986 to the present. The anomalous year in the last two decades was 2000, which registered a spike in the AETR to 34%.

Since AETRs hold the level of corporate profits constant, a principal determinant of variations in the rates is legislated changes, and several can be linked to the fluctuations in the AETRS. At least three factors are likely responsible for the decline in rates during the 1960s, 1970s, and early 1980s. First, during the 1970s and 1980s, several reductions in the statutory corporate tax rate that applies to taxable income were enacted. Second, while taxable corporate profits were artificially inflated during the 1970s by a rising price level, firms were also permitted to claim investment

tax credits. Third, the Economic Recovery Tax Act of 1981 provided accelerated depreciation deductions, which likely played a prominent role in the sharp drop in tax rates in the early 1980s. Following the reduction, rates increased again in the mid-1980s. Part of the increase was likely due to timing results from the 1981 act, but the Tax Reform Act of 1986 was also likely responsible for part of the increase. The act reduced statutory tax rates, but also repealed the investment credit and scaled back depreciation allowances.

AETRs have their own shortcoming as a gauge of the corporate tax burden. They provide only one-year snapshots of a firm's tax burden, while according to economic theory, taxes impose a burden on capital income by reducing the expected rate of return over the life of new investment. For example, the tax burden on an investment consists not only of taxes paid in its first year, but also those paid in, say, the fifth year of its life. In addition, because of discounting, the tax burden on investment depends partly on how taxes are distributed over an investment's life; a given amount of taxes matters more to a firm the sooner it is paid. The same is true of deductions, but in reverse; a given deduction is more valuable the sooner it is claimed.

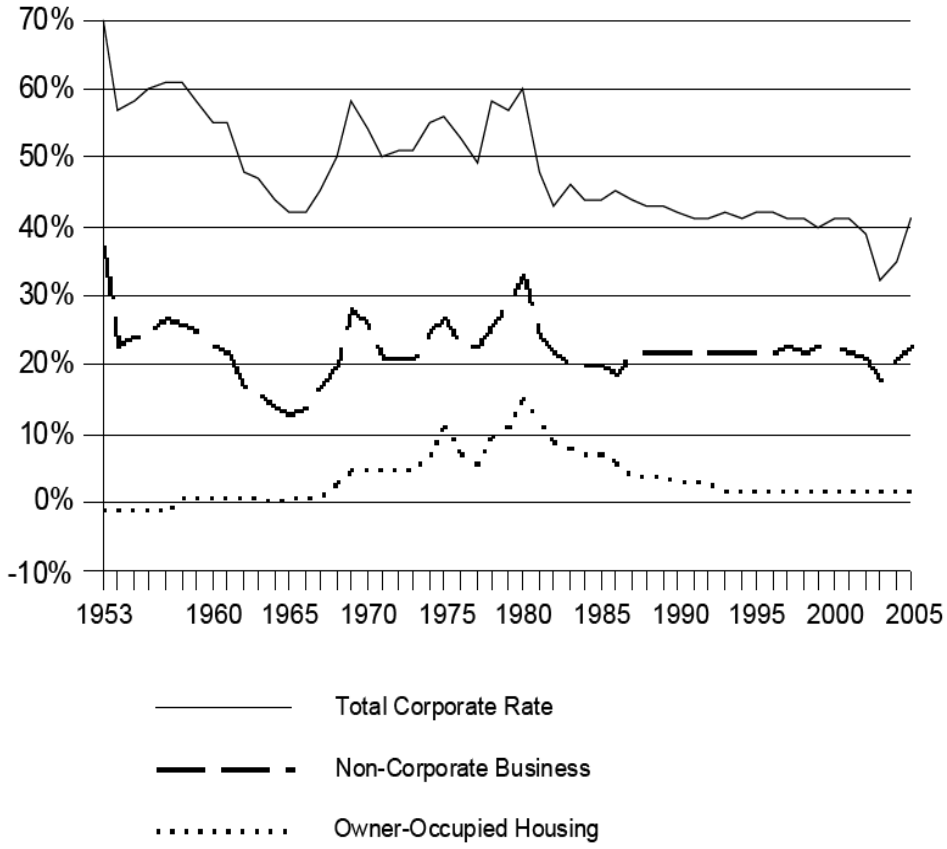
"Marginal" effective tax rates (METRs) take these factors into account, measuring the impact of taxes over a representative investment's entire lifetime as well as the timing of payments and deductions. Unlike AETRs, METRs can thus accurately register the impact of provisions such as accelerated depreciation, whose value depends crucially on timing. METRs also take into account the interaction of inflation and tax rules, statutory tax rates, and investment subsidies such as the investment tax credit. In general, a marginal effective tax rate is the difference between the pre-tax and after-tax return on prospective investment, divided by the pre-tax return.[5]

**Figure 4**, below, presents a set of METRs for the period 1953 through 2003. The top line in the figure shows METRs for corporate investment. The second line is rates for non-corporate business and moves in tandem with corporate rates, but at a lower level. (The third line is the METR for the remaining broad category of capital investment: owner-occupied housing.) The series shows a decline in rates from the early 1950s to the mid-1960s—the result of accelerated depreciation, introduction of an investment tax credit, and reduced statutory tax rates. Rates then rose in the late 1960s and varied during the 1970s, a consequence of repeal and reintroduction of the investment tax credit as well as inflation. Rates declined sharply in 1981, reflecting the Economic Recovery Tax Act's accelerated depreciation provisions. METRs then remained relatively stable until 2001 to 2003, when reductions in shareholder-level taxes (including reduced tax rates on capital gains and dividends) as well as bonus depreciation caused a reduction in effective rates. Rates picked up again in 2005, with the expiration of bonus depreciation.[6]

[5] More precisely, METRs begin by assuming that investments must earn a particular return, after taxes, in order to attract funds from savers. The METR calculation then works backwards, and derives a pre-tax return investments must earn in order to generate the after-tax return required by savers. The difference between the pre-tax and after-tax returns is sometimes referred to as the "tax wedge." An investment's METR consists of the tax wedge divided by the pre-tax return.

[6] For a discussion of factors underlying the variation in METRs, see CRS Report RS21706, *Historical Effective Marginal Tax Rates on Capital Income*, by Jane G. Gravelle.

**Figure 4. Marginal Effective Tax Rates on Corporate and Other Investment, FY1953-FY2005**




**Source:** CRS Report RS21706, *Historical Effective Marginal Tax Rates on Capital Income*, by Jane G. Gravelle.

The preceding charts show four different measures of corporate taxes: taxes as a share of GDP, corporate tax revenues as a percentage of federal revenue, average effective corporate tax rates, and marginal effective tax rates. Each series shows the same general pattern in the period after World War II: a general decline in the level of corporate taxes. But before accepting this broad pattern as the conclusion of this look at corporate tax data, note the relative position of the three lines in **Figure 4**, denoting METRs for corporate investment, for non-corporate business, and for owner-occupied housing. In contrast to the general direction of each set of METRs—they have all declined, showing a decline in capital taxes in general—their relative position has remained the same. And importantly, it is the relative tax treatment of investment that affects the allocation of investment among different uses, and differences in the treatment of different investments that distort the allocation of capital. Thus, to the conclusion that business taxes have generally declined in the post-World War II period, there is an additional important result: corporate investment remains relatively heavily taxed compared to non-corporate business and (especially) owner-occupied housing.[7] The report's next section explores the implications of this result by discussing the economic effects of business taxes.

[7] Tax distortions among assets also persist within the corporate sector. While differential treatment of assets declined under the Tax Reform Act of 1986, subsequent changes in law have reintroduced significant differences in the treatment of equipment, structures, and inventories, with equipment being favored. See CRS Report RL32099, *Capital* (continued...)

# Economic Effects of Business Taxes

The base of the corporate income tax and of business taxes in general is income from capital investment. It is thus not surprising that business taxes exert their most direct effects through their impact on the return to new investment. By reducing the return to capital investment, business taxes—at least in principle—can affect the economy's commitment of resources to capital formation in general, although this effect may be muted. Business taxes can also affect the allocation of investment funds among different sectors, as suggested at the end of the preceding section. And while businesses are not people, the burden of business taxes is ultimately borne by individuals; business taxes thus have an impact on the fairness of the tax system.

## Business Taxes and Capital Formation

Because they apply to the return to investment, business taxes can potentially reduce the economy's overall level of investment and its stock of capital. There are indeed some who advocate cutting business taxes as a means of boosting capital formation: according to economic theory, an increase in the capital stock boosts long run growth, which, in turn, increases living standards and per capita income in the future.[8]

Yet business taxes do not necessarily have a pronounced effect on the aggregate level of capital in the economy. A key element is the economy's supply of saving, and there are indications that individual savers may not respond robustly to tax cuts by increasing their saving. Note first, however, that business taxes do likely have an impact on firms' investment demand. Taxes on business profits increase the rate of return a given asset must earn, before taxes, in order to generate the rate of return required to attract funds from savers. A tax on business investment thus encourages firms to forgo a range of less profitable investments they might otherwise undertake. And indeed, as described below, uneven application of business taxes results in less investment in heavily taxed areas and more investment in lightly taxed projects.

But investment demand is just one side of the market for capital; the other side is household saving. And if individual saving is unresponsive to changes in the after-tax rate of return, then changes in investment demand will have little impact on the overall stock of capital: boosts in demand will principally serve to increase the economy's real interest rate. For example, provision of a tax credit for businesses to undertake investment may indeed boost business demand for the particular type of investment in question, and firms may boost the rate of return they are willing to pay savers for each quantity of investment. But unless savers are willing to increase the quantity of funds they supply in response to the higher return, there will be no increase in the capital stock.

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(...continued)

*Income Tax Revisions and Effective Tax Rates*, by Jane G. Gravelle. See also U.S. Congressional Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform* (Washington: GPO, 2005), p. 8.

[8] Some economists have concluded that the distortions from taxing capital are so great that the optimal tax on capital from the point of view of economic efficiency and welfare is zero. Acceptance of this analysis, even in principle, requires a particular theoretical construct that includes, for example, an assumption that individuals have infinitely lived time horizons. But even if this analysis is accepted, it does not necessarily recommend a repeal of capital income taxation for a number of reasons: the unresponsiveness of saving may reduce any distortions; any tax that replaces a tax on capital likely has its own distortions; and the transition costs of moving to an alternative tax may be costly enough to offset any benefit.

Economic theory provides no unambiguous answer on how saving responds to its rate of return, after taxes, and is subject to countervailing effects. In isolation, a tax on investment income—that is, on saving—reduces the price of current consumption compared to future consumption, and may thus reduce saving. On the other hand, a tax on saving increases the amount of saving an individual must undertake before taxes in order to achieve a particular dollar amount, after taxes, and may thus increase saving. The answer to the question therefore depends on the empirical evidence. And while there have been numerous econometric studies of saving, their results differ.[9] This has led some to suggest that instead of providing tax incentives for saving and investment, a more certain approach to boosting aggregate national saving would be reducing government dissaving by reducing the government's budget deficit.[10]

## Business Taxes and Economic Efficiency

Not only does the amount of capital matter for economic performance, but so too does how that capital is employed. And while business taxes likely have little impact on long-run growth and capital formation, they do affect the allocation of investment among different uses and thus affect economic efficiency. Because taxes affect investment demand, they distort the allocation of investment where they apply unevenly, channeling funds to tax-favored assets and away from more heavily taxed assets. The results for economic efficiency follow: economic theory indicates that undistorted market prices and investment returns generally allocate resources to their most productive use so that capital and other resources produce the mix of output that consumers value most, and economic welfare is maximized. To the extent business taxes distort the allocation of resources, they reduce economic welfare.

One prominent distortion posed by the U.S. tax system results from the double-taxation of corporate-source equity income—its taxation under both the corporate income tax and the individual income tax. As a result, investment is channeled away from the corporate sector into less heavily taxed areas such as owner-occupied housing and non-corporate business (see the effective tax rates in **Figure 4**, above). A second distortion posed by the corporate income tax is its favoring of debt over equity in the financing of investment. The return to debt-financed investment consists of corporate interest payments to creditors; the return to equity consists of dividends and capital gains. Since interest is tax-deductible at the corporate level but dividends and capital gains are not, firms are encouraged to use higher levels of debt than they otherwise would, increasing the risk of bankruptcy to an inefficiently high level.

Different types of business assets are also taxed at different rates, encouraging firms to invest more heavily in favored assets than they otherwise would. The depreciation allowances that apply to machines and equipment are relatively generous compared to depreciation allowances for structures and capital-recovery methods for inventory, leading to a relatively light tax burden for machines and equipment. Thus, firms' asset choices are distorted, encouraging more investment in machines and equipment and less in structures and inventory than is economically efficient.

[9] For a thorough survey of the empirical studies that have been conducted, see B. Douglas Bernheim, "Taxation and Saving," *Handbook of Public Economics*, vol. 3, Alan J. Auerbach and Martin Feldstein, eds., (Amsterdam: Elsevier, 2002), pp. 1173-1249. Note also that while investment incentives may not result in additional domestic saving, they may attract foreign capital into the domestic economy. The return to foreign capital, however, does not accrue to domestic residents.

[10] For a textbook presentation of this argument, see Andrew B. Abel and Ben S. Bernanke, *Macroeconomics*, 3rd ed. (Reading, MA: Addison-Wesley, 1998), p. 210.

Prior to the Tax Reform of Act of 1986, the differential tax burdens among assets were substantial—a consequence of a relatively high statutory tax rate, relatively high inflation, uneven depreciation rules, and the availability of an investment tax credit for equipment, but not other assets. The 1986 act altered depreciation rules, repealed the investment credit, and reduced the statutory corporate tax rate, thereby greatly diminishing inter-asset distortions. In recent years, however, both legislation and economic developments have reintroduced differential tax burdens, though not to the extent existent before 1986. Legislative changes included introduction of less-favorable depreciation for structures, bonus depreciation for equipment, and an increased statutory tax rate.[11]

As noted above, the corporate income tax distorts corporate financial policy, favoring debt finance. Another distortion of corporate financial policy results from individual rather than corporate income taxation, and the preferential treatment of capital gains. Specifically, since capital gains are not subject to individual income taxes until a stockholder sells stock and the gains are realized, taxes favor the corporate retention of earnings—which increases the value of corporate stock—over payout of dividends. Recent legislation has reduced the statutory tax rate on dividends to the same rate applicable to realized capital gains, which has reduced the difference between the effective tax rates of retentions and payouts. Nonetheless, a difference remains because capital gains are not taxed until realized while dividends are taxed on a current basis.

## Business Taxes and Equity

Corporations are not people; they are economic entities (firms) taking a particular legal form (incorporation). Thus, corporations cannot bear the burden of the corporate income tax in any real sense; it ultimately is borne by individuals. In the short run—that is, before economic actors have had a chance to adjust to the tax—the tax is thought to be borne by corporate stockholders

The long-run burden of the tax is more uncertain. The standard and most resilient economic model of the corporate income tax is that developed by Arnold Harberger in 1962.[12] While a number of challenges have been made to the model since its inception, its results have generally proved resilient.[13] The model concludes that if capital investment funds and labor are free to flow from one economic sector (e.g., the corporate sector) to another (and given certain other conditions), then wages, prices, rates of return, and the allocation of capital and labor adjust, in the long run, to the corporate income tax. Given the ability of economic actors to adjust, the burden of the corporate income tax spreads beyond corporate shareholders' sector to all owners of capital, including owners of corporate debt, non-corporate business, and owner-occupied housing.

This picture of the long-run burden of the corporate tax has implications for the vertical equity of the tax system—that is, its distribution across income classes. Because capital ownership is greater at upper-income levels, the corporate income tax is itself progressive and makes the overall tax system more progressive than it would otherwise be.

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[11] Jane G. Gravelle, "The Corporate Tax: Where Has it Been and Where is it Going?" *National Tax Journal*, vol. 57, Dec. 2004, p. 914.

[12] Arnold H. Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy*, vol. 70, June 1962, pp. 215-240.

[13] See the review of challenges to the Harberger model in Jane G. Gravelle, "The Corporate Income Tax: Economic Issues and Policy Options," *National Tax Journal*, vol. 48, June, 1995, pp. 267-277.

## Business Taxes and Competitiveness

A widely cited reason for reforming U.S. business taxation is to improve U.S. "competitiveness," where competitiveness is usually a loosely defined term generally meaning the ability of U.S. firms to compete with foreign businesses, whether by means of export sales or sales by U.S. firms who have invested abroad. Yet there are few areas in which economic theory and popular beliefs diverge more widely than in international economics and notions of "competitiveness." Given the prominence of competitiveness in the public debate, it is thus useful to examine the international dimension of business taxes' effects in some detail.

## Taxes and Trade

Contrary to popular arguments that are sometimes made, economic theory indicates that business taxes do not affect the nation's balance of trade—that is, the imposition of federal taxes on business profits does not increase the U.S. trade deficit by reducing U.S. exports or increasing imports. This conclusion may counter intuition at first—surely the imposition of a tax on the profits of a U.S. exporting firm will reduce its sales to foreigners and thus reduce aggregate U.S. exports. But economic theory's rebuttal is equally intuitive: just as an individual cannot consume more than he earns unless he borrows, a country cannot use more than it produces—cannot import more than it exports—unless it borrows to finance the difference by importing foreign investment. Thus, a country can only increase its trade deficit if it imports some additional amount of foreign investment; a country's net exports only increase if its net overseas investment also increases.[14]

In slightly more technical terms, a country's balance of trade (its balance on goods and services) mirrors its balance on capital account; the balance of trade changes only if the balance on capital account likewise changes. This relationship is an identity that holds whether or not the international economy is in equilibrium. The particular economic mechanism that enforces the identity under the current regime of flexible exchange rates is exchange rate adjustments. Even if a change in an exogenous variable (e.g., taxes) would otherwise increase net exports, exchange rates adjust to offset any change that would otherwise occur.

The implication of this analysis is that business taxes alter the balance of trade only if they also alter net flows of international investment (the balance on capital account). As an illustration, the United States recently repealed a tax benefit for exporting known as the extraterritorial income (ETI) benefit. While some observers feared that ETI's repeal would harm U.S. competitiveness, economic theory indicates its repeal will have no direct impact on the balance of trade. While some reduction of exports may initially occur, that reduction will stimulate a fall in the price of the dollar in currency markets below what would otherwise occur. The dollar's depreciation will mitigate the initial decline in exports and will also reduce imports. There will be no change in the trade balance (exports minus imports).

[14] Note, however, that a country's general fiscal position can alter the trade balance. For example, if a country increases its government's budget deficit, real interest rates may rise, leading to an inflow of foreign capital and an expansion of its trade deficit. Thus, to the extent business taxes contribute to total government revenue and the government's overall fiscal stance, they can be said to have an impact on the trade deficit. In this sense, however, they are indistinguishable from other taxes.

While business taxes do not affect the trade balance, they can affect the composition of its trade. This outcome follows from one of the foundations of economic trade theory—the theory of comparative advantage. According to this theory, the composition of a country's exports and imports is determined not by how the costs of domestic goods compare to those of foreign goods, but rather by how the costs of domestic goods compare to each other. Under comparative advantage, a country exports what it can produce at lowest cost. The particular composition of its exports and imports thus depends on the particular pattern of costs across all of its products and potential products. Business taxes can alter this pattern of costs and thus alter the content of trade. For example, if taxes apply heavily to one item and fall lightly on another, they encourage the import of the first product and the export of the second.

But if business taxes cannot increase net exports and can only change the pattern of trade, this is not necessarily bad news. Standard economic trade theory indicates that countries gain economic welfare by exchanging exports for imports; the exchange enables each trading country to specialize in producing what it produces most efficiently while not sacrificing its use of the higher-cost goods that it imports. In short, a country's economic welfare is not enhanced by the mere act of exporting; it is the ability to exchange exports for imports that makes a country better off (that produces "gains from trade," in economic parlance).

Taxes can reduce economic welfare through their impact on trade in a number of ways. One is a reduction in economic efficiency similar to those described in preceding section, but translated to the international economy. If taxes apply unevenly, they may distort the pattern of costs within the economy and distort the composition of trade, thus encouraging a country to specialize in activities at which it is relatively inefficient. A second way taxes can reduce a country's economic welfare is to worsen its "terms of trade," or the quantity (in real terms) of exports it must give up to obtain a given quantity of imports. For example, if part of the benefit of an export subsidy (e.g., ETI) is passed on to foreign consumers in the form of lower prices, the subsidy worsens the subsidizing country's terms of trade; its exports are cheaper for foreign consumers. The subsidizing country's economic welfare is reduced because its own taxpayers are underwriting the price reduction for foreign consumers.

## Taxes and International Business Investment

Business taxes can have a direct impact on the extent to which U.S. firms invest abroad, and also the extent to which foreign firms invest in the United States. Here, the crucial factor is how taxes (both U.S. and foreign) on an investment in a foreign location compare to taxes on an identical investment undertaken in the United States. To the extent taxes in the foreign location are lower than those on the U.S. project, taxes encourage overseas investment; to the extent U.S. taxes are low relative to taxes on the overseas investment, they encourage domestic, over foreign, investment. If taxes are the same in either location, they have no impact (are "neutral" towards) on location choice.

According to traditional economic theory, taxes best promote economic efficiency by not distorting the location of investment; neutrality between overseas and domestic investment best promotes efficiency. But the overall impact of the U.S. system is uncertain. As described above, the United States in some situations taxes the overseas income of its firms on a current basis, while in other instances it permits an indefinite deferral of taxes on foreign-source income; foreign tax credits are provided to alleviate double taxation. The net result of this system for the relative tax burden on foreign and domestic investment is mixed; the system produces a patchwork of incentives, disincentives, and neutrality towards overseas investment that varies,

depending on factors such as the level of foreign taxes applied to the investment, the legal form of the investment, and the location and nature of a firm's other foreign investments. The efficiency effect of the system is thus not clear.

# Business Taxes and Tax Reform

The first section of this report outlined the current structure of federal business taxation—a separate tax on corporate profits imposed in addition to the individual income tax and net of interest; and taxation of unincorporated business on a current basis under the individual income tax. The report's section on business tax data indicated that while the level of business taxes has generally declined since World War II, important divergences remain in the way different types of investment are taxed. The section on economic effects indicated that these effects can impair economic efficiency, although they likely do not hinder U.S. competitiveness. With these pictures in mind, the report now turns to the principal options for reform that have been developed for business tax policy.

## Comprehensive Taxation of Business Income

Since corporations are economic and legal entities and not people, the question might be raised: why impose a separate corporate income tax at all? The question is made more pointed when the detrimental efficiency effects of a separate tax on corporate income are considered—effects such as the diversion of investment away from equity investment in the corporate sector. A number of arguments, however, can be mounted in favor of a separate tax on corporate income. First, since stock ownership in particular, and ownership of capital in general, is more prevalent among upper-income individuals, the corporate income tax adds an element of progressivity to the tax system; its repeal—absent compensating changes elsewhere in the system—would be, in isolation, a regressive policy change. Second, corporate managers may be able to exercise considerable independence from stockholders in their decisions about corporate investment. To the extent this occurs, corporations do have some existence separate from their stockholders. Third, without a corporate income tax (or tax integration plan, as outlined below), retained corporate earnings would receive favorable tax treatment. And finally, even if corporations are not people and have no existence separate from their stockholders, many individual taxpayers nonetheless compare the taxes they pay with those paid by large corporations and draw conclusions about fairness from that comparison. And even if such comparisons, from an economic standpoint, are not appropriate, they do affect perceptions about the fairness of the tax system—perceptions that are important to the acceptance of the tax system by the public at large.

While the current system does tax corporations as though they were separate entities, it does not do so on a comprehensive basis. Numerous important omissions from the tax base would exist if all corporate profits were taxed on the same basis. Thus, if the validity of a separate corporate income tax is accepted, one hypothetical direction that tax reform might take is to move in the direction of a more pure version of the "classical" system of taxing corporate income—to eliminate the various omissions in the tax base and non-neutralities embedded in the current system. Setting aside the distortions that result from the existence of the corporate income tax in the first place, such a reform would likely minimize the inefficiencies and distortions that exist within the classical system. As noted at the outset of the report, such was a guiding principle of the Tax Reform Act of 1986.

How much does the current system depart from a comprehensive tax on corporate income? One considerable departure is the omission of income from debt-financed investment from the tax base—an omission that occurs when interest payments are deducted. Income generated by debt-financed investment is income from capital just as surely as is income from equity investment. Debt's omission from the tax base distorts firms' financing choices, favoring debt over equity and enticing firms to accept a higher risk of bankruptcy than is economically efficient. Nonetheless, simple elimination of interest deductibility has rarely been proposed outside of a movement away from the classical system by adoption, for example, of tax integration (discussed below).[15]

Another important determinant of the corporate tax base is depreciation. One important element of the 1986 act's reform was its evening-out of depreciation allowances across assets. The act implemented depreciation allowances that were more closely aligned with actual economic depreciation. Together with the act's repeal of the investment tax credit, the depreciation revisions reduced prior law's general preference for equipment and relatively short-lived assets over structures. Since 1986, however, a wedge has reemerged between equipment and structures, although—setting aside the temporary bonus depreciation for equipment—this has been more a consequence of changed economic conditions (reduced inflation) and a lengthening of depreciation allowances for structures than reintroduction of accelerated depreciation.[16] Nonetheless, a likely ingredient of tax reform based on comprehensive income taxation would be a realignment of depreciation allowances with economic depreciation.

Another prominent departure from comprehensive taxation is the deduction for domestic production that was enacted by the American Jobs Creation Act of 2004 (P.L. 108-359). The deduction is 9% of income from domestic production activities; it cannot be applied to income from overseas investment. Other omissions from the tax base are more narrowly targeted tax benefits—for example, the section 179 expensing allowance from equipment investment of small businesses, the tax credit for research and experimentation, and various provisions applicable to the oil and gas industry. The Joint Committee on Taxation (JCT) maintains a list of "tax expenditures" or provisions that carve out special tax treatment for particular activities, income, or investments; a relatively comprehensive list of omissions from the corporate tax base can be obtained by consulting the JCT list.[17] A tax reform that moves in the direction of comprehensive income taxation would presumably scale back items included in the list of tax expenditures.

## Corporate Tax Integration

As described above in the section on the economic effects of business taxation, the current "classical" system of taxing corporate income results in a number of distortions in the allocation of investment, thus reducing economic efficiency and causing a concomitant reduction in economic welfare. For this reason, economists have long advocated some form of tax

[15] For example, even the initial, more theoretically pure, Treasury Department proposals that preceded the 1986 Tax Reform Act stopped short of straightforward taxation of the return to debt.

[16] For estimates of disparities in tax burdens across assets under current law, see CRS Report RL32099, *Capital Income Tax Revisions and Effective Tax Rates*, by Jane G. Gravelle.

[17] CRS has prepared for the Senate Budget Committee a compendium containing explanations and analyses of the various tax expenditures on a biannual basis. The most recent version is U.S. Congress, Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Indivdiual Provisions*, committee print, 108th Cong., 2nd sess. (Washington: GPO, Dec. 2004).

"integration"—a term that refers to eliminating double taxation of corporate income by altering the general system of taxing corporate-source income.

Integration proposals vary, but fall into two broad categories: those that apply to both retained earnings and dividends and thus all corporate profits ("full integration"), and those that change the treatment only of earnings that are distributed ("partial integration").

There are three basic approaches to full integration, which differ in whether double taxation is removed at the corporate level or at the individual level. The "shareholder allocation" method is similar to partnership taxation. The corporate income tax would be repealed, and corporate profits—whether retained or distributed—would be allocated among the firm's owners, who would pay individual income taxes on the corporate income. Thus, corporate income would be taxed once, in the hands of individuals.

A second approach is "shareholder credit" integration, under which the corporate income tax would be retained, but corporate stockholders would receive a tax credit for the corporate-level taxes paid by the paying corporation. An adjustment to the capital gains portion of the credit would be made to account for the capital gains resulting from both retained earnings (that have been subject to the corporate income tax) and other price appreciation. Under this approach, while relief would be provided at the individual level, taxes would be paid on the corporate income tax at individual income tax rates. Thus, the corporate income tax would function much like a withholding tax.

A third approach is to retain the corporate income tax, but exclude corporate-source income from individual income taxes—a relatively simple method to implement for distributed earnings, but difficult to administer for the portion of capital gains attributable to reinvested earnings. In the latter case, stockholders' basis in stock would have to be adjusted to reflect retained earnings, so as to exclude only gains attributable to retained earnings. In 1992, a U.S. Treasury report outlined a variant of this method, termed a "comprehensive business income tax" (CBIT), under which corporate-source income would not be taxed at the individual level. The corporate income tax would be retained, and interest deductions would not be permitted.

Partial integration by means of an exclusion for dividends received by stockholders would thus be relatively straightforward. Indeed, the reduced individual income tax rate that the Jobs and Growth Tax Relief Act of 2003 (JGTRRA) applied to dividend income can be viewed as a form of shareholder-level partial integration, akin to a shareholder exclusion that applies to only part of received dividends. Similarly, a shareholder-credit version of integration that would be restricted to dividends paid would be more straightforward than the full-integration version of a credit system. A partial-integration form of the shareholder credit method is the system used most frequently by European and other foreign countries that have adopted integration.

Each method of integration has its particular advantages and disadvantages. As suggested in the preceding discussion, partial integration is simpler and easier to administer than full integration; on the other hand, it does not achieve all the efficiency gains under full integration, since a part of corporate income would still be taxed twice. Also, the different plans differ in their revenue cost, with the full-integration methods generally losing more revenue than partial integration plans, and shareholder allocation methods reducing revenue more than other methods.[18]

[18] For a more comprehensive discussion and analysis of integration, see CRS Report RL31597, *The Taxation of* (continued...)

## Business Taxes under Consumption or Flat Taxes

Either tax integration or a tax based on a comprehensive measure of income would qualify as fundamental tax reform. Each would entail substantial changes to the current system and would use a tax base supported by a relatively consistent concept of income. In popular discussions, however, the term "fundamental tax reform" has frequently referred to a different type of tax change: replacing the current federal individual and corporate income taxes with a system that taxes consumption but exempts saving. Most taxonomies list three basic types of national-level consumption taxes: value-added taxes; a national sales tax; and a tax on individuals' consumed income. In addition, a prominent "flat tax" proposal would consist of a form of value-added tax imposed at the corporate level and a wage tax at the individual level.

The different forms of consumption taxes differ chiefly in their methods of collection and, as a result, their ease of administration and compliance costs. Their general effect on business taxes, however, would be the same: income from new business investment would be exempt from tax under each form. In the near term, however, income from investment in place at the time of transition would generally be taxed.

## National Sales Tax

Turning to specifics, a national retail sales tax would operate much as do the sales taxes imposed by most states: the tax would be imposed on final sales from businesses to consumers; businesses would collect the tax and remit it to the government. In general, business-to-business sales (sales of intermediate goods) would be exempt from the tax; the levy would be applied to imports, but exported goods would be exempt.

To the extent that business inputs are included in the base of a national sales tax, the product to which they contribute would be subject to multiple layers of tax; such cascading would carry the potential of inefficient distortions, diverting resources away from the heavily taxed products. Accordingly, an important task under a national sales tax would be distinguishing between business and non-business uses of purchased items, so as to exempt the former and tax the latter. One possible method of doing so would be to issue exemption certificates to businesses so as to remove their purchases from the tax base. Nonetheless, making the distinction would likely present significant administrative and compliance problems, particularly in the case of items that lend themselves to both business and personal use (e.g., many services). Compliance might also present a problem, given the high tax rate that would likely be necessary to avoid a revenue loss if income taxes were abolished.[19]

## Value-Added Tax and "Flat" Tax

As the term implies, value-added taxes (VAT) are levied on the value added by each firm in a good's production process. VATs thus differ in their point of collection from retail sales taxes, but

(...continued)

*Dividend Income: An Overview and Economic Analysis of the Issues*, by Gregg A. Esenwein and Jane G. Gravelle.

[19] For more detailed discussions of how a national sales tax might operate in practice, see John L. Mikesell, "The American Retail Sales Tax: Considerations on Their Structure, Operations, and Potential as a Foundation for a Federal Sales Tax," *National Tax Journal*, vol. 50, Mar. 1997, pp. 149-165, and Martin Sullivan, *Flat Taxes and Consumption Taxes: A Guide to the Debate* (Washington: American Institute of Certified Public Accountants, 1995), pp. 11-18.

by the final stage of production the cumulative rate of the VAT on an item is the same as that of a sales tax (assuming each is applied uniformly).

There are two general methods by which VATs are administered: credit-invoice and subtraction. Under a credit-invoice method, a business is assessed VAT on its gross receipts, regardless of whether its sales are made to another business or to a final consumer. At the same time, the firms from which it has purchased its inputs provide it with invoices showing the VAT the suppliers have already paid with respect to the inputs. The purchasing firm claims the VAT shown on the invoice as a credit against the VAT on its own sales. As a result, for each firm, the VAT applies only to value added. Under a subtraction-method VAT, tax is levied on a firm's gross receipts after subtracting purchases from other firms. What is left, then, as the base of the tax is the return to capital (profits) and the return to labor (wages)—the value added by the taxed firm. Despite the difference in administration, a subtraction-method VAT and a credit-invoice VAT produce the same tax, assuming they are levied at the same rate. It should also be noted that, as with a sales tax, each is levied on imports, but exports are not included in taxable gross receipts. In the case of the credit-invoice method, an exporting firm receives a tax rebate for taxes paid with respect to its inputs.

A variation on the subtraction-method VAT is the so-called "flat tax"—sometimes termed the Hall-Rabushka proposal after its designers. Under the flat tax, a subtraction-method VAT would be imposed on business—that is, firms would pay a tax on gross receipts minus items purchased from other firms. In contrast to a pure VAT, however, firms would also be permitted to subtract wages from gross income, thus removing from the business-level tax base that portion of the firm's value-added contributed by labor. Individuals, however, would be assessed a tax on wages received, thus bringing the value added by labor back into the tax base, albeit at the individual level.

By the final stage of production, the cumulative rate of a VAT on an item is the same as that of a sales tax, assuming neither contains special allowances and benefits. Thus, their broad economic effects are the same. But since the two types of tax differ in how they are collected, there are differences in compliance and ease of administration. A VAT would impose a higher compliance burden on businesses in general than a retail sales tax; under a VAT, every business would be required to file a tax return, not just businesses in the retail sector. At the same time, a VAT avoids the administrative problem of distinguishing business use of items from personal use. Further, some analysts have argued that small businesses would likely encounter high compliance costs under a national sales tax, and small businesses are relatively numerous in the retail sector. Thus, compliance rates may be higher under a VAT.

## Consumed Income Tax

A third type of consumption tax is a tax on consumed income imposed at the individual rather than business level. Individual income consists of consumption plus saving. Thus, individuals would calculate their tax by subtracting saving from their income and paying tax on the residual. Business investments made by individuals would be characterized as saving, and thus an exempt use of income. Thus, for example, an individual's purchases of stock would be deducted from taxable income, as would, say, the purchase of a new machine by a small business owner. Note that an individual consumption tax is defined in terms of the uses of income rather than its source. Thus, it is business investment that is deductible rather than income generated by businesses. However, arithmetic dictates that deducting the cost of a capital investment at the time it is made ("expensing" the investment) produces a tax saving that is identical in present-value terms to

exempting the net income the investment produces as it is generated over the investment's lifetime. Thus, deducting business investment on the uses side of the income ledger is the same as exempting income from new investment on the sources side. New business investment bears no burden under an individual consumption tax.

## Effects of a Consumption Tax on Business

A consumption tax exempts from its coverage income that is saved, which is the equivalent of exempting investment income. In short, under any form of pure consumption tax—be it a sales tax, a VAT, or an individual consumption tax—business profits are ultimately exempt from tax. As a result, if it is assumed that a consumption tax would not contain its own preferences for special goods or services (an assumption that is perhaps heroic), the various non-neutralities existing under the current system of business taxation would be eliminated. As described in the preceding section on economic efficiency, these include current law's preference of non-corporate investment over the corporate sector, of corporate debt over equity, and of machines and equipment over inventory and structures. If these non-neutralities were eliminated under a consumption tax, business investment—especially corporate investment—could be expected to increase under a consumption tax, as well as equity finance and investment in assets other than equipment. Economic efficiency could potentially increase.

It is worth underlining, however, that it is not the taxation of capital per se that produces these non-neutralities, but the particular shape of capital income taxation that has gradually come into being in the current system. Under a consumption tax, non-neutralities affecting business might be implemented in a different way, but the result might still be distortions in the allocation in business investment. For example, a sales tax or VAT might exempt a particular type of good from taxation, which would favor investment in the sector producing that type of good.

The transition to a consumption tax would likely include significant effects in the short and medium term. Perhaps most importantly, a consumption tax would exempt the return to new investment, but would still apply to income produced by investment in place at the time of the tax's implementation. Note that under none of the types of consumption taxes outlined above would a firm be able to continue to recover the cost of capital in place at the time of transition, either through depreciation or other deductions. At the same time, revenue produced by old investments would be included in the tax base, producing a windfall loss for owners of existing capital. Firms affected most heavily by the taxation of old capital would be older, slow-growing firms. Also, if a uniform consumption tax were adopted and existing business distortions were consequently eliminated, as described above, transition effects would include a shift of resources away from previously favored investment. For example, business sectors where corporate production is intensive would benefit, as would firms with low debt-to-equity ratios and production processes favoring machines and equipment over structures.[20]

A frequently made popular argument for a consumption tax relates to its purported beneficial effects on competitiveness. As described above under the heading "Taxes and Trade," economic theory indicates taxes have little impact on competitiveness as it is popularly understood. However, a specific argument relating to "border tax adjustments" is frequently made in support of consumption taxes, so the argument is worth describing here. The argument—frequently made

[20] For a more detailed analysis of the impact of fundamental tax reform on business, see CRS Report RL32603, *The Flat Tax, Value-Added Tax, and National Retail Sales Tax: Overview of the Issues*, by Jane G. Gravelle.

by businesses—focuses on the fact that foreign firms in VAT countries receive a rebate of the VAT on exports to the United States and elsewhere. Thus, it is argued, foreign firms from VAT countries have a cost advantage over competing U.S. firms. As described in the section on competitiveness, however, taxes or tax-related mechanisms such as VAT rebates do not directly alter the balance of trade. In the particular case of VAT rebates, exchange rate adjustments in response to the rebates act to eliminate any impact on the balance of trade or "competitiveness."

# Conclusion

While the charts presented earlier in this report show that the level of the corporate tax has generally fallen in the decades since World War II, the basic structure has remained the same: a "classical" system under which the corporate income tax is superimposed on the individual income tax. In 1986, the far-reaching Tax Reform Act implemented reforms within the context of the existing system, broadening its base and reducing rates. In recent years, however, concern about the impact of the system on capital formation and U.S. performance in international markets has stimulated interest in a more substantial structural change, either by adopting tax integration or moving towards a consumption tax.

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