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Why does the federal government tax corporations? Are these taxes necessary?

“. . . Whatever promises may be made with regard to the future of corporate taxation, the best that can be expected is an occasional reduction in rates — to be followed sooner or later by compensatory and, in all likelihood, more than proportionate increases.”

CORPORATE TAXES

By LEOPOLD KOHR

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EVERY student of public finance develops a mild form of schizophrenia when he begins to analyze the conflicting principles and purposes of a sound tax system. Among other things he learns that a tax system should be characterized by simplicity as well as diversity, a paradox, considering that the simple cannot be diverse and the diverse not simple.

Another paradox is reflected by the double requirement that a tax system should be both just and adequate, adequacy being measured in terms of the revenues necessary for the fulfillment of governmental functions, and justice in terms of an equal distribution of the financial burden among the citizens. To explain the latter, the social-benefit theory has been developed according to which the contribution of each should be determined by the benefit he derives from the services of government. To give sense to the former, the ability-to-pay theory was evolved according to which taxes can for obvious reasons be collected only from those who have the

funds to pay them irrespective of whether they derive a commensurate benefit or not.

These two examples illustrate the basic nature of all tax problems. They all arise from the simple fact that one ideal can be pursued only at the expense of another, explaining why in taxation there seem to be only problems but never solutions.

However, the picture need not be so contradictory as it usually appears if we realize that the various seemingly conflicting tax principles and theories characterize not one tax system but a variety of them, and that they have evolved not simultaneously but historically. One either succeeded or, more frequently, absorbed the other, slowly transforming the pattern from the simple to the complex — a process which, contrary to the belief of many, signifies not retardation but advance.

Thus, at a time when government was simple and its functions were few, one or two tax sources such as property or the act of importing goods from abroad were perfectly satisfactory and adequate. Simplicity then was a meaningful ideal. But when societies advanced and became more complex, the tax structure supporting the governmental organization of their progress had to undergo a similar development. Simplicity now no longer could serve its purpose, for an increasingly intensive utilization of the same few revenue

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sources to cover increasing public needs would soon have run into the barriers of the law of diminishing productivity. Ultimately, instead of yielding the required funds, it would have destroyed the sources.

This is when diversity suggested itself as a new ideal not in contradiction but in replacement of the concept of simplicity, gradually leading to the picture of complexity which characterizes most modern tax systems of our day. Biologists would call this process of improvement through diversity *adaptive radiation*. To customs duties and property taxes were added income and business taxes, highway and sales taxes, death and consumption taxes, general and specific taxes, all vast categories which are in turn broken down horizontally into classes and sub-classes, and vertically into gradations of lighter and heavier burdens.

Yet there is no reason why the complexity of a modern tax system should be viewed with greater apprehension than the complexity of specialization in a modern plant. In both cases it represents an advance from a less to a more flexible and efficient utilization of resources.

AN ANALYSIS

The purpose of this particular article is to analyze the galactic diversity of taxes generally known as business taxes or (since by far the most important form of business organization is the corporation) corporation taxes. The two concepts are not entirely identical since many businesses are organized as individual proprietorships or partnerships. However, since nearly 90 per cent of production and merchandising is done by corporations, the distinction has lost much of its previous significance, with the result that the corporation tax can without danger of error be called a *general business tax*.

The first question to be answered is: what is understood by the term corporation taxes? As in most fields in which classifications are made on the

basis of a great variety of criteria, meanings overlap. From one point of view we might say that all taxes paid by corporations are corporation taxes. This is clearly too broad a term as it would include property taxes or payroll taxes whose special purpose caused them to be ranged into different categories.

Or we might call corporation taxes all those imposed on corporations in their capacity as incorporated business entities in contrast to taxes imposed on non-incorporated business or natural persons. This might conceivably exclude the corporate income tax which was specifically created as an integral part of the personal income tax.

Or we might call corporation taxes all those imposed on corporations as legal persons provided that, like the property tax, they do not fall under separate headings. Whatever order we may adopt, the following are generally considered to qualify as corporation taxes by any standard.

One of the first to develop was the *corporate excess tax*, which should not be confused with the excess profits tax. This was an adaptation of the general property tax which corporations had to pay not as corporations but as property owners. However, the market value of a corporation as measured by the value of its capital stock was considered greater than the assessed value of its physical property. So the property tax in the last quarter of the Nineteenth Century was extended to embrace the additional or intangible value of a corporation over and above the rest of its taxable property. Since this additional value reflected not so much the worth of the *property* as of the *activity* of the corporation as a business, the corporate excess tax ceased to be a property tax and became in effect a business tax.

Other early corporate taxes which developed in the course of the Nineteenth Century and have since enjoyed increasing popularity in state tax systems are *organization* and *entrance taxes*, and *franchise* and *privilege taxes*. As the terms indicate, all have to do with

the organization of corporations and their privilege of doing business.

Organization taxes were originally mere fees charged for the service rendered by the state in connection with the incorporation of business, while entrance charges were imposed on foreign corporations seeking admission. Subsequently both assumed the character of taxes. Their rates were raised above the amounts justified by the service rendered by government and, as in the case of franchise and privilege taxes, capital stock was made the measure of the levy.

Franchise and privilege taxes, one imposed on domestic and the other on foreign corporations, are levied on the assumption that the privilege of operating as a corporation creates values not measured by either property holdings or income.

All these taxes are primarily levied by state governments. The most important corporate taxes, however, are levied by the federal government and include the *corporate net income tax*, the *excess profits tax*, and the *undistributed profits tax*. The *corporate net income tax* was originally nothing but a part of the personal income tax, used to collect the tax on dividends at the source. Soon after 1913, when the personal income tax was introduced in the federal tax system as a permanent fixture, the two began to follow separate courses as a result of different and higher rates being applied to income from dividends. Finally, in 1936, dividends were subjected to an additional tax in the hands of the individual recipients after the corporate tax had already been paid. At this time the corporate net income tax emerged to all intents and purposes as an independent tax in its own right. It still retained most of the features of the personal income tax, particularly as regards deductions made in the computation of net income and the idea of progressive rather than flat rates. The basic organic similarity between the two continues, however, since the corporation has been created as a *legal person in analogy to a natural person*.

The federal *excess profits tax* and the *undistributed profits tax* are significant since they are designed less to raise revenue than to produce certain adjustments. The excess profits tax seems to be strictly a war phenomenon, having been imposed in 1916 during World War I, in 1940 during World War II, and in 1950 during the Korean War, coming in each case to an end with the end of the crisis. Its purpose is largely moral, to prevent certain kinds of business thriving on war contracts from benefiting excessively from a condition of social misery.

The *undistributed profits tax* is in the United States not really a tax in the proper sense at the present time, but a penalizing rate based on the famous Section 102 of the Internal Revenue Code and designed to prevent unreasonable accumulations being retained in corporations for the sole purpose of enabling shareholders to evade the payment of personal taxes on dividends.

In addition to these general taxes on corporate enterprise, there could be mentioned a number of taxes imposed principally by state governments on special kinds of business, such as *gross earnings taxes* on railroads or public service corporations, *severance taxes* on firms extracting natural resources, *license taxes* on amusement, on racing, on merchandizing, on the sale of liquor, or *chainstore taxes*. However, for our present purposes the variety of taxes sketched above seems to convey a sufficient idea of what is understood by corporate taxes.

WHY CORPORATE TAXES?

What are the reasons for the inclusion of corporate business as a source of public funds after it had been neglected for so relatively long a time? In the first place, the functions of government had, as a result of the unprecedented growth of the population and power of the nation, experienced a qualitative and quantitative increase of such proportions that revenues derived from traditional sources were insufficient.

Secondly, corporations seemed to qualify to an eminent degree under the ability-to-pay principle. Thirdly, the success of corporate business was thought to depend largely on the privileges granted, and the services and protection provided, by government. As a result, corporate taxation was deemed justified also under the principles of the benefit theory.

In the fourth place, even the ideal of simplicity, though with a slightly different connotation, seemed to find new application: corporation taxes, reaching income at the source, can be very easily collected. And finally, corporations are by the choice of their owners separate legal persons, bound like natural persons, after whom they were patterned, to carry an independent share of the burden of government.

Yet, in spite of the impressive arguments in support of corporate taxation, the problems surrounding it are legion. For this reason only the most significant complexities can be discussed here. There is, to begin with, the problem of *justice* arising not from the fact but the burden of corporate taxation. It manifests itself primarily in three forms: double taxation, discrimination and classification.

Double taxation is in itself a double problem. One relates to the fact that in every federal setup there are always at least two super-imposed governmental levels. As their scope spreads, these begin to crowd each other in competition for tax sources until they all draw from the same wells. But since we indulge in the luxury of a federal rather than a centralized form of state, we cannot at the same time complain that the price we have to pay for it is unjust.

The other relates to the idea that the income derived from corporate enterprise is taxed twice even by the same governments, first in the corporation and then in the hands of individuals after they have received their dividends. But here again the point is that the stockholders, instead of forming partnerships, have indulged in the luxury

of organizing their business as a corporation for the reason that the legal fiction of its separate personality provides them with such valuable compensatory advantages as limited liability or continuity of existence. But once a person is created, it cannot complain if it is treated as a separate entity also for tax purposes.

A similar reasoning answers the problem of *discrimination* arising from the fact that corporate taxes do not apply to unincorporated business. But if they are considered discriminatory, nothing is easier than to escape them. Just sell your stock and organize your business as a partnership or proprietorship.

Only *classification*—the application of different rates to sometimes arbitrarily chosen different classes of business—constitutes a genuine problem of justice. To solve the moral involvement, tax experts have supplied the ability-to-pay theory which derives the *justice* of a special tax or tax rate from *expedience*, two considerations which unfortunately cannot be reconciled.

More important, however, is the aspect of classification which enables the government to assume a broad regulatory function over the business world not originally assigned to it under the principles of free-enterprise capitalism. Frequently such regulatory classifications have conformed to a higher ideal of justice when their application has served the welfare of society as a whole as, for example, in the case of tax provisions dealing with narcotic trade, agricultural processing, the production of white phosphorous matches, firms employing child labor, or the anarchic note-issuing activities of state banks that were stopped as a result of the imposition of a 10 per cent federal tax in 1866. But now and then, as in the case of oleomargarine, classification has been used to impede competition, and there is no reason to assume that it could not some day be used as a tool to transform the entire structure of our economy from a free into a regulated system.

From a strictly economic point of view, the most significant problems of corporate taxation concern less the question of justice than the question of effect. There is, above all, the question in which the consumer is most interested: what effect has corporate taxation on the price of goods? And the question in which the businessman is most interested: what is its effect on incentives and, through them, on the capitalist business system as a whole?

As to the *price effect*, classical economists thought corporate taxes on net profits could not be shifted to the consumer. If business was competitive, it was assumed that price tended to equal the production cost of the last, and least efficient, firm whose output was needed to meet the requirements of demand. Since this marginal firm, whose costs were assumed to determine the price, had no net profit, it was not subject to a net income tax, with the result that no tax could be shifted. Any corporate income tax must consequently be absorbed by the more efficient firms.

If, on the other hand, business was monopolistic, the price was assumed to have been set at the point of maximum profit prior to the imposition of the tax so that again the price was left unchanged by a tax on profit.

Recent studies, however, have produced evidence to the effect that an increasing number of businesses tend to recover at least a part of corporate taxes by embodying them in advance in correspondingly higher prices, the degree of their success (and their desire to shift taxes) depending on such elements as the tax rate, the ratio of their sales to taxable income, or the nature of the demand for their particular product. But to the extent that corporate taxes are effectively translated into higher prices, they hit the very persons the government wanted to spare by taxing corporations in the first place—the individual consumers.

Intimately linked with the price effect is the effect of corporate taxation on *incentives*. For if the burden of the tax

cannot be shifted to the consumer, other means must be found to insure a reasonable return on invested capital, since without the hope of commensurate rewards the capitalist system cannot be maintained.

One method of diminishing the tax burden is to alter the capital structure of business firms. This is done by drawing excessively on borrowed rather than on equity capital in the financing of corporate activities since interest payments, in contrast to dividend payments, are deductible in arriving at taxable net income. However, while this diminishes the tax load, it intensifies the general burden of business when the latter can least afford it—in times of cyclical downswings. The reason for this is that, unlike dividends of equity capital, interest on borrowed capital must be paid irrespective of whether a firm earns profit or not. Indeed, excessive debt financing, induced by the inability to realize reasonable profit under high corporate taxes, may in times of business contraction lead to so many failures as a result of the impossibility of keeping up interest payments that it may mean the difference between a moderate recession and a severe depression—an effect hardly in line with the purpose of corporate taxation.

Another negative incentive effect of high corporate taxes is that they impede the growth of small and new enterprises while strengthening somewhat paradoxically the position of established and entrenched large business concentrations. The possibility of expansion of small and the establishment of new enterprise is the foundation on which an expanding capitalist economy rests. But the expansion of small enterprise rests, in turn, on its ability to retain a major part of its earnings for its own purposes. This is rendered impossible under tax rates as high as the ones prevailing since the end of World War II.

As a result, the incentive for remaining in an independent business bearing no hope for future development may ultimately wane even in the most

determined individualist. He may give way to the desire to sell out to large firms, whose expansionist capacity is less affected by high corporate taxes since they can resort to debt rather than equity financing more readily than small firms, and with less fear of dangerous consequences.

High corporate taxation may thus not only cause an unwholesome change in the financial structure of small firms struggling for reasonable returns; it may be an important contributing factor responsible for transforming the entire system of free enterprise from a small-unit competitive to a large-scale monopolistic form of capitalism. This means that few public measures might conceivably be more effective in securing a well balanced free enterprise system than a *significant* reduction of the corporate tax burden.

WHY TAXATION?

But if this is the case, why does it nevertheless seem unlikely that the structure of corporate taxation as we know it today could be altered to a significant degree? To answer this question, we must shift our point of reference. Until now we have viewed primarily the effect of taxes on business. In conclusion we must return to the more fundamental problem of the reason behind all taxation. This is not to aid business but to supply funds enabling government to fulfill its functions.

Originally, governmental functions were largely political and relatively insignificant. But with the unprecedented growth of our society, not only have the original functions such as those related to defense grown in a disproportionate way; a host of non-political functions have been added, functions which could be handed back to private forces only if the growth process of society could be reversed and we should content ourselves again with a freer, but nationally weaker and socially more primitive, existence.

The most important added function thrust upon government as a result of

the aging process hardening the arteries of societies which have outgrown their optimum limits is economic in nature and involves the task of insuring the people as a whole against the rigors of cyclical fluctuations and the accompanying misery of mass unemployment. To do this effectively on the large scale imposed by the giant size of modern great powers, government must keep in reserve a vast compensatory machinery which can be activated whenever the private economy goes into one of its seemingly necessary periodic declines.

But a machinery so vast to counteract effectively the slackening of private business is not only expensive to maintain; to avert an unjustifiable waste, it can obviously not just be kept in reserve once it has been created. Like any vast-scale investment, it is economical only if in constant use. This is why what was meant to be merely an emergency or reserve function of government has long become a part of its basic structure.

As a result, it seems that little can be done about reducing the volume of funds to be made available to government by those most capable of furnishing them—the income-earning citizen, and the profit-producing enterprise. True, in a *capitalist* society, the idea of great social power and the costly increase of the functions of government is not very appealing. But in a *large* society, no alternative seems conceivable since large societies cannot be held together by anything but *great* governmental power.

Thus, whatever promises may be made with regard to the future of corporate taxation, the best that can be expected is an occasional reduction in rates—to be followed sooner or later by compensatory and, in all likelihood, more than proportionate increases. The only way to reduce taxes permanently would be by permanently reducing the power of government, a thought that is enticing—until one remembers the continuously growing power of a government on the other side of the globe.