

**Statement of
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**before the
Committee on Finance
United States Senate**

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NOTICE

**This statement is not available
for public release until it is
delivered at 10:00 a.m. (EDT),
Thursday, May 3, 1990.**

Mr. Chairman, I am pleased to have this opportunity to appear before the Committee. This morning I will review the recent performance of the corporate income tax, assess the effect on receipts of the Tax Reform Act of 1986 (TRA), and present the Congressional Budget Office's (CBO's) current estimates of corporate income tax receipts in 1990 and 1991. My statement makes the following three points.

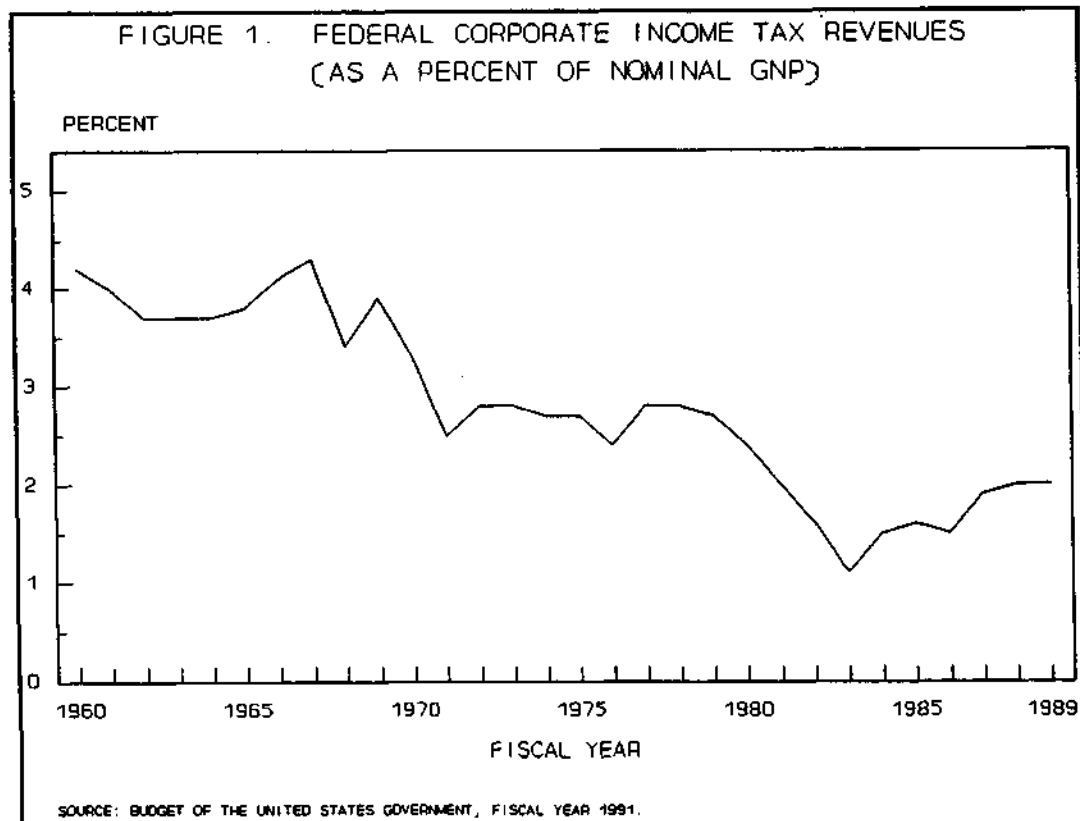
- o While corporate income tax receipts grew over the 1987-1989 period somewhat faster than the economy, receipts were below projected levels, primarily because corporate profits were lower than projected.
- o TRA boosted corporate receipts substantially over the 1987-1989 period, although it boosted them by less than originally estimated.
- o CBO estimates that total corporate income tax receipts will be flat this year and then resume growth in 1991, when they will increase at about the same rate as the economy at large.

SOME BACKGROUND ON CORPORATE INCOME TAXES

It is instructive to examine our recent experience with corporate income tax receipts in a longer-term context. While receipts have

continued to increase in dollar terms over the last three decades, their growth has failed to keep pace with the growth in the economy (see Figure 1). Corporate taxes measured 4 percent of gross national product (GNP) in 1960; by 1986, that amount had declined to 1.5 percent. Corporate receipts now contribute only 10 percent of total revenues compared with 20 percent in the 1960s. This long-term decline in GNP's share of corporate receipts reflects both economic conditions and legislated changes in liability.

First, corporate profits have not kept pace with the overall economy. For most of the 1960s, profits were about 10 percent to 11 percent of GNP; for most of the 1980s, they measured 6 percent to 7



percent of GNP. The reason for this decline is somewhat of a puzzle. One possible explanation is that the slower pace of technological progress, coupled with strong capital accumulation, has reduced the rate of return to capital. In addition, the portion of the return to capital that has been absorbed by interest payments, which reduce reported corporate profits, has increased over time as a result of both a higher volume of debt and higher interest rates.

Second, tax legislation through 1981 reduced corporate taxes through the investment tax credit, accelerated asset cost recovery, reductions in the corporate tax rate, and the introduction or expansion of preferences for specific industries and types of transactions. The Tax Reform Act of 1986 repealed the investment credit, tightened cost recovery rules and reduced some preferences, and restored the corporate receipts share of GNP to its 1981 level. But it did not reverse the long-term trend, nor did it promise to do so.

RECENT EXPERIENCE WITH CORPORATE INCOME TAX RECEIPTS

Each year over the 1987-1989 period, corporate income tax receipts increased and reached an all-time high level of \$104 billion in 1989. However, receipts were below the levels estimated by CBO and the Administration in January 1987.

The Magnitude of the Revenue Shortfall

In January 1987, both CBO and the Administration projected extremely strong growth in receipts for fiscal year 1987. These projections assumed that profits would continue to make a strong recovery after a pause in growth in 1986 and that large revenue gains would accrue from the just-enacted Tax Reform Act of 1986. In fact, actual receipts fell \$17 billion below the January 1987 CBO estimate in fiscal year 1987, \$24 billion below this estimate in 1988, and \$22 billion below this estimate in 1989 (see Table 1).

Furthermore, the shortfall was even larger than these numbers suggest because the CBO and Administration projections did not

TABLE 1. THE CORPORATE INCOME TAX SHORTFALL: CBO AND ADMINISTRATION PROJECTIONS OF JANUARY 1987 COMPARED WITH ACTUAL RECEIPTS
(By fiscal year, in billions of dollars)

	1987	1988	1989
Projections of Corporate Receipts in January 1987			
CBO	101	119	126
Administration	105	116	127
Actual Receipts^a	84	95	104
Shortfall			
Actual less CBO ^a	-17	-24	-22
Actual less Administration ^a	-21	-21	-23

SOURCE: Congressional Budget Office.

a. Includes the effect on receipts of legislation enacted after January 1987.

include the effects of legislation passed in 1987 and 1988 that increased corporate receipts. Taken together, the Omnibus Budget Reconciliation Act of 1987 and the Technical and Miscellaneous Revenue Act of 1988 are estimated to have increased 1989 corporate receipts, for example, by about \$8 billion. Adjusting the apparent shortfall shown earlier for the expected increase in receipts stemming from the new legislation results in an even larger estimated shortfall: \$29 billion in 1988 and \$30 billion in 1989 (see Table 2).

TABLE 2. THE ROLE OF PROFITS IN THE SHORTFALL IN CORPORATE RECEIPTS (By fiscal year, in billions of dollars)

	1987	1988	1989
Shortfall ^a	-17	-24	-22
Alternative Shortfall Measure Assuming Constant January 1987 Tax Law ^b	-17	-29	-30
Factors in Shortfall			
Lower-than-projected profits	-12	-13	-19
All other factors ^c	-5	-17	-11

SOURCE: Congressional Budget Office.

- a. Includes the effect on receipts of legislation enacted after January 1987.
- b. Adjusted for the revenue increases enacted in the Omnibus Budget Reconciliation Act of 1987, the Technical and Miscellaneous Revenue Act of 1988, and the Omnibus Budget Reconciliation Act of 1989.
- c. The contributions of specific factors cannot be calculated. Factors include lower-than-projected revenues from the corporate base-broadeners in the Tax Reform Act as well as in legislation enacted in 1982, 1984, 1987, and 1988; unexpectedly high use of employee stock ownership plans; and increased dependence on the S corporation and partnership form of business organization.

The Shortfall in Profits

Approximately 58 percent of the shortfall in corporate income tax receipts over the 1987-1989 period is attributable to lower-than-projected profits. Corporate profits are volatile and, therefore, notoriously difficult to forecast. The Bureau of Economic Analysis's estimates of corporate profits in 1986, which underlay CBO's projections, were revised downward by almost \$20 billion after the projections were prepared. In addition, growth in corporate profits was weaker than CBO forecast for the 1987-1989 period. As a result, in 1987, economic profits, according to the National Income and Product Accounts (NIPA) measure of total corporate earnings, were \$22 billion below the CBO forecast; in 1988, they were \$11 billion below; and in 1989, they were \$65 billion below (see Table 3).

The NIPA measure of economic profits, however, is not a close approximation of the corporate income tax base, which was weaker than indicated by economic profits alone. Economic profits must be adjusted to exclude deductible amounts of accelerated depreciation and state and local corporate income taxes, and the earnings of the Federal Reserve System, which are not subject to the corporate income tax.

All three of these "wedges" were larger than CBO projected in January 1987, further reducing our measure of the corporate tax base, which we call "adjusted economic profits," below the CBO estimate (see

Table 3). Depreciation deductions were larger because TRA resulted in a larger-than-expected amount of up-front depreciation deductions for new investment. The higher Federal Reserve System earnings reflected higher-than-projected interest rates. When measured with these "wedges," adjusted economic profits were nearly \$100 billion less than expected in 1989.

An important cause of lower-than-projected profits during the 1987-1989 period was further increased reliance by corporations on debt financing instead of equity financing. Interest payments on this debt are deductible from gross corporate income and, therefore, reduce

TABLE 3. CBO BASELINE PROJECTIONS FOR CORPORATE PROFITS COMPARED WITH ACTUAL PROFITS
(By calendar year, in billions of dollars)

	1986	1987	1988	1989
Economic Profits				
Actual	282	299	329	301
January 1987 Baseline	<u>300</u>	<u>320</u>	<u>340</u>	<u>365</u>
Difference	-18	-22	-11	-65
Adjusted Economic Profits				
Actual	150	188	219	198
January 1987 Baseline	<u>168</u>	<u>235</u>	<u>251</u>	<u>296</u>
Difference	-18	-48	-32	-98

SOURCE: Congressional Budget Office.

measured economic profits. In addition, the deductions of corporations for interest paid were further boosted during the 1987-1989 period by higher-than-projected interest rates.

While corporate profits were overestimated in the January 1987 CBO forecast, wages and salaries were underestimated. Such misallocations are common because macroeconomic forecasters tend to be more accurate in forecasting total income than in forecasting the allocation of income among factors of production. This forecasting error had the opposite effect on receipts, raising individual income tax receipts above projected levels and offsetting some of the shortfall in corporate receipts.

Other Factors

While the corporate receipts shortfall was substantially attributable to lower profits, preliminary CBO calculations indicate that \$33 billion of the cumulative shortfall, or \$11 billion per year on average, was attributable to other factors (see Table 2). CBO has made a distinction in this respect between all other factors affecting corporate tax liability and economic conditions--in particular, corporate profitability--to highlight factors that are of potential interest to the Committee. However, it should be emphasized that corporate profitability and the other factors interact and, therefore, it is not possible to fully

disentangle the effects of different factors. For example, the increased reliance on corporate debt, which reflects the tax advantage of debt financing, directly reduces corporate profits. Furthermore, we lack the data necessary even to approximate the effect on receipts of some factors.

Other factors that reduce corporate liability and that were present during the 1987-1989 period include the unexpectedly high use by corporations of employee stock ownership plans (ESOPs), which reduce the tax liability of the corporation and of lenders to the ESOP. This drain has been curtailed by the Omnibus Budget Reconciliation Act of 1989. Among other factors are the lower-than-projected boosts in revenue from the Tax Reform Act of 1986 and other 1980s tax legislation.

In addition, during the 1987-1989 period, use of the S corporation and partnership forms of business organization increased. These forms of business avoid corporate-level taxes by "passing through" income to individual shareholders or partners, thereby avoiding taxation at the corporate level. Because S corporation profits are included in NIPA corporate profits, increased use of the S corporation reduces corporate tax liability without reducing measured profits. The more widespread use of the S corporation and partnership forms of organization is most likely an indirect effect of TRA, which lowered the top individual marginal tax rate below the top corporate rate for the first time.

Some of these factors increase personal income while reducing corporate profits. Personal business and interest income and capital gains were among the components of the individual income tax base that were higher than projected over the 1987-1989 period. This increase is consistent with tax-minimizing behavior by businesses, such as the increased use of S corporations and partnerships. Some of the tax liability lost to the corporate income tax through such behavior is eventually realized under the individual income tax. The size of the offset to the reduction in corporate income tax receipts in the form of increased individual income tax receipts is unclear. One recent estimate suggests the scale. Professor Lawrence R. Klein and his associates at the University of Pennsylvania estimated that, over the 1950-1988 period, "On balance, a dollar of taxes avoided in the corporate sector eventually ends up as 25 cents collected in the personal sector."

CORPORATE RECEIPTS AND THE TAX REFORM ACT OF 1986

The Tax Reform Act increased 1987-1989 corporate receipts substantially--by an estimated \$54 billion, or 24 percent (see CBO's estimate in Table 4). It temporarily reversed the long-term decline in GNP's share of corporate receipts, boosting 1987-1989 receipts to about 2.0 percent of GNP from an average of 1.5 percent of GNP during the 1982-1986 period. Without TRA, the share of receipts of GNP would

have remained essentially flat before settling further to 1.4 percent in 1990. This would have been the lowest revenue share of GNP since 1940, with the exception only of 1983, the year in which the 1981-1982 recession was reflected in corporate receipts.

The CBO estimate of \$54 billion in revenue gains for TRA over the 1987-1989 period is \$19 billion below the estimate incorporated in the CBO baseline of January 1987. Macroeconomic data make important contributions to the revisions in the TRA estimate. For example, more

TABLE 4. COMPARISON OF CBO ESTIMATES OF CORPORATE PROVISIONS IN THE TAX REFORM ACT, BY MAJOR TYPE
(By fiscal year, in billions of dollars)

	1987	1988	1989	1990	1991
All Corporate Provisions					
January 1990	18	18	18	26	29
January 1987	27	25	21	23	25
By Major Type of Provision					
Rate Reduction					
January 1990	-5	-17	-22	-21	-22
January 1987	-6	-20	-28	-30	-33
Capital Cost Recovery					
January 1990	9	12	18	25	32
January 1987	16	19	24	30	38
All Other					
January 1990	15	23	22	22	19
January 1987	16	26	25	23	20

SOURCE: Congressional Budget Office estimates. The January 1987 estimates approximated the October 1986 estimates of the Joint Committee on Taxation.

recent NIPA data suggest that the depreciation deductions claimed under TRA rules are larger than originally estimated. In addition, more recent data on investment activity suggest that the estimates of pre-TRA investment tax credits and, therefore, the TRA revenue gain from repealing the credits, were too high. Revisions based on these data reduce the estimated pickup in revenue from the TRA capital cost recovery provisions. Most of the "other" TRA provisions CBO reestimated since 1987 are accounting provisions. Specifically, CBO research has led to downward revisions in the revenue pickup from the uniform capitalization rules, the completed contract accounting rules, and the bad debt rules for financial institutions.

Overall, CBO's revision of the estimated revenue gain from TRA is the result of offsetting revisions in estimates of different provisions: the base-broadening provisions are now credited with smaller revenue gains than originally estimated, while the tax rate reduction is charged with smaller revenue losses than originally estimated. Because CBO's estimate of the tax base is lower now than it was in 1987, the loss for the rate reduction is less. Overall, CBO revisions reduce the estimated TRA revenue gain over the 1987-1989 period, and raise it slightly in 1990 and beyond.

**THE OUTLOOK FOR CORPORATE
RECEIPTS IN 1990 AND 1991**

The CBO January 1990 baseline projection of corporate income taxes incorporates the delayed effect on payments of the drop in corporate profits in 1989. Corporate receipts are estimated to remain essentially flat in fiscal year 1990, totaling \$102 billion, compared with the \$104 billion collected in 1989 (see Table 5). Only in 1991 are economic profits projected to return to their 1988 level. Corporate receipts are projected to increase by 9 percent to \$111 billion in 1991. CBO projects that corporate receipts will not quite hold their own relative to GNP

TABLE 5. THE CBO JANUARY 1990 CORPORATE BASELINE
(In billions of dollars)

	Actual				Projection	
	1986	1987	1988	1989	1990	1991
Corporate Tax Receipts (Fiscal year)	63	84	95	104	102	111
Percentage Change	3.0	32.9	12.6	9.6	-1.7	9.2
Economic Profits (Calendar year)	282	299	329	301	308	335
Percentage Change	-0.1	5.9	10.0	-8.6	2.5	8.7
Adjusted Economic Profits (Calendar year)	150	188	219	198	226	262
Percentage Change	-3.9	25.3	16.3	-9.4	14.1	16.2

SOURCE: Congressional Budget Office.

NOTE: Adjusted economic profits most closely represent the corporate tax base.

over the period. They are estimated to claim 1.9 percent of GNP in 1990 and 1991, down slightly from 2.0 percent in 1988 and 1989.

The CBO baseline estimate is \$10 billion below the Administration's estimate for 1990 and \$18 billion below it for 1991. The lower CBO estimate is primarily attributable to the fact that CBO forecasts lower corporate profits than does the Administration (see Table 6).

Even the \$102 billion estimate for 1990 may prove to be too high. Daily and monthly data on tax collections, currently available through April 1990, show receipts running several billion dollars behind the baseline estimate of \$102 billion. While the tally of current fiscal year collections remains subject to significant swings through the final

TABLE 6. JANUARY 1990 CORPORATE INCOME TAX PROJECTIONS: CBO AND ADMINISTRATION
(By fiscal year, in billions of dollars)

	1990	1991
Administration Current Services Estimate	112	129
Source of Difference		
Economic forecast difference	-7	-13
All other factors	<u>-3</u>	<u>-4</u>
Total Difference	-10	-18
CBO Baseline Estimate	102	111

SOURCES: Congressional Budget Office; *Budget of the United States Government, Fiscal Year 1991*.

month of the year, we believe that this shortfall will persist unless profits recover sooner and more vigorously than the CBO economic forecast assumes.