SHOULD THERE BE AN INCOME TAX OFFSET FOR CORPORATE TAX PROPOSALS?

When revenue estimates for excise tax and employment tax proposals are produced, "income tax offsets" are included. The offsets are included to reflect the indirect effect that enactment of excise and employment tax proposals have on income tax receipts. For excise tax proposals, offsets are included to show that personal income would change (and, thus, income tax receipts would change) when excise taxes change and GDP is held constant. For employment tax proposals, offsets are included to show that wages would change (and, thus, income tax receipts would change) when an employer's share of employment taxes changes and total employee compensation is held constant.

In recent months, several people have asked if an individual tax offset should be applied to corporate tax changes. Presumably, the reasoning behind the questions is as follows. If after-tax corporate profits change, one of two events must occur. Either (1) dividends paid would change and hence individual income tax receipts would change, or (2) retained earnings would change, which presumably would change the value of a company's stock, thus changing future capital gains.

National Income and Product Accounts

The first step in determining if a individual tax offset is needed for a corporate tax change is to examine the National Income and Product Accounts (NIPA). Examining the NIPA allows us to determine the relationship between GDP, corporate profits, and dividends.

Simplifying the NIPA (Tables 1.9, 2.1, 6.11C, and 6.16C) enormously, we find that

  Wages
\- Contrib. to social insurance (employee share)
\+ Other labor income (e.g., employer contrib. to pensions)
\+ Proprietors' income (pre-tax)
\+ Transfer payments
\+ Personal dividend income
<u>+ Personal interest income</u>
= Personal income
\- Transfer payments
\+ Contrib. to social insurance (employee share)
\+ Contrib. to social insurance (employer share)
\- Personal dividend income
\- Personal interest income
<u>+ Corporate profits (pre-tax)</u>
= National income
\+ Excise tax receipts
<u>+ Customs duties</u>
= Net national product

+ Capital consumption allowances (depreciation)
= Gross domestic product

Eliminating the subtotal categories (e.g., personal income) and the categories that offset themselves (e.g., transfer payments), we find that

Wages
+ Other labor income (primarily employer contrib. to pensions)
+ Contrib. to social insurance (employer share)
+ Excise tax receipts
+ Customs duties
+ Proprietors' income (pre-tax)
+ Corporate profits (pre-tax)
+ Capital consumption allowances (depreciation)
= Gross domestic product

The first three items in the above equation comprise total employee compensation. A long-standing convention of revenue estimating is to assume that total employee compensation will be unchanged by any tax proposal. As a result, changes to pension contribution rules or social insurance tax rates (e.g. Social Security) can affect wages. This change in the mix of employee compensation can affect individual income tax receipts, because pension contributions and employer contributions to social insurance are not taxable to an employee whereas wages are taxable. The employment tax offset illustrates this effect.

The above equation shows why, given the constant GDP restriction, an income tax offset is included for proposals that change excise tax receipts or customs duties. If either of these two items changes, an "offsetting" change must occur in some other item (e.g., wages), given the constant GDP assumption.

An offset is not included for proposals that change capital consumption allowances because the change in allowances will be offset dollar-for-dollar by changes in proprietors' income or pre-tax corporate profits. For example, if capital consumption allowances are increased, the depreciation deductions taken by proprietors or corporations will increase by exactly the same amount. The increase in depreciation deductions will lower proprietors' income or pre-tax corporate profits by the same amount as the capital consumption allowances increase.

The other two components of the equation (pre-tax proprietors' income and pre-tax corporate profits) are generally assumed not to be changed by tax proposals, given the constant GDP assumption. (Broad proposals, however, can affect these items. For example, a proposal to significantly change the corporate tax rate will change pre-tax corporate profits because the number of firms that elect to be treated as corporations will change.)

The above equation also tells us that the constant GDP assumption (and the NIPA accounting framework) does not require an offset for a corporate tax change. In fact, none of the items held constant for revenue estimates (e.g., employee compensation) are affected by corporate tax changes.

Dividends

Nonetheless, if corporate tax changes cause corporations to lower dividends paid, the corporate tax change will affect personal income. The first equation shows this. When personal income changes (or the composition of personal income changes), individual income tax receipts can change. A change in individual tax receipts will occur when a taxable component of personal income changes. Because a portion of dividends paid are taxable, a corporate tax change could affect non-corporate tax receipts. The first equation tells us that a change in dividends paid of any magnitude can occur without any affect on GDP. (The change offsets itself in constructing GDP.)

Capital Gains

Changes in capital gains realizations do not enter into the NIPA. Thus, as was the case with dividends paid, a change in capital gains realizations of any magnitude can occur without any effect on GDP.

A change in individual tax receipts would occur if the corporate tax change caused (1) retained earnings to change, or (2) expectations of future dividend payouts to change. The result of the corporate tax change would then presumably be reflected through lower stock prices.

Who Bears the Corporate Tax?

The above discussion implicitly assumes that the owners of capital fully absorb the effects of changes in corporate taxes. But economists are divided on the issue of who bears the corporate tax. Because of the conventional revenue estimating assumptions, however, it seems that the owners of capital must be assumed to fully bear the corporate tax.

Generally, three groups are considered to absorb the corporate tax: (1) workers, (2) buyers, or (3) corporate owners. But, for revenue estimating purposes, workers cannot absorb the change in corporate tax caused by a legislative change because employee compensation is assumed to be fixed. Similarly, buyers could not absorb the change in corporate tax because the price level is assumed to be fixed. Thus, given the traditional assumptions behind revenue estimates, corporate owners must fully absorb the costs of the increased corporate tax. The two ways that capital owners can feel the effect are through dividends or capital gains.

How Large an Offset?

For the 1988-1991 period, about 75 percent of post-tax corporate profits were distributed as dividends (Table 1.16); the remaining 25 percent was retained as undistributed profits. If we assume that a corporate tax change would be passed through to shareholders in the same percentages, a $1-billion tax increase would result in a $750-million reduction in dividends and a $250 million reduction in retained earnings.

According to Treasury's best estimates, the marginal tax rate on a change in NIPA dividends is about 17 percent. (Some of the dividends would go to tax-exempt entities, e.g. pension funds. In theory, these dividends will ultimately be paid to individual taxpayers, but for simplicity sake, we will ignore these payouts.) Thus, the $750 million reduction in dividends will lead to a reduction of $127.5 billion in individual tax receipts.

The effect of $250 million reduction in retained earnings on individual receipts is much more difficult to determine because it depends on when the underlying corporate stock is sold. For simplicity, we will assume that capital gains are realized outside the budget window or that tax-exempt entities realize the gains. Thus, the revenue effect from a change in retained earnings is zero.

The net result of this analysis is that a $1-billion increase in corporate taxes would reduce individual tax receipts by $127.5 million. Thus, the individual income tax offset would obviously be 12.75 percent.