Corporate Integration: Think Twice About the Possibilities

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President Bush recently announced that he was considering several tax initiatives as part of a potential recovery package. Among the items on that list was the elimination of the double taxation of corporate dividends -- a form of corporate-personal income tax integration. (For a related article, see Tax Notes, Sept. 16, 2002, p. 1629.) Congress responded by showing little interest on either side of the aisle. Meanwhile, critics were quick off the mark to state that this type of proposal was unacceptable as a short-run stimulus, could be budget-busting, and concentrated the money too much at the top of the income distribution (see, for instance, Tax Notes, Aug. 26, 2002, pp. 1175-7). None of those criticisms, however, means that integration represents bad tax policy, and there are ways to modify a proposal to deal with these other problems.

Macro-economic, budget, and distributional policy always are tied up with tax policy. Only seldom, as in 1986, is the focus of tax legislation on improving the tax laws to improve efficiency and to treat more equally taxpayers who should be treated the same (sometimes called equal justice or horizontal equity). This latter focus on good tax policy gets lost in the shuffle. The consequence is that we end up with tax systems (and expenditure systems, as well) that often do not work or make a lot of sense. After all, government doesn't engage in activities just so it can provide stimulus, eliminate its own budget deficit, or redistribute resources.

Now let's be realistic about the president's suggested policy prescriptions, which have not been provided in any detail. The amount of money that will be available to put into them probably will be trivial -- both because of the growing deficit and because of the administration's own priority of trying to make more permanent the 2001 tax cuts. Moreover, the main stimulus to the economy from fiscal policy comes from the shortfall in revenues that usually accompanies a slowdown. This time around, technical corrections related to drops in capital gains realizations and other activities has also led to a unexpectedly dramatic decline in receipts. Between January 2001 and August 2002, the combined effect can be seen in the Congressional Budget Office's drop in projections for 2002 receipts of $376 billion for that year alone. A few billion dollars a year in a new economic stimulus package -- about all that will probably be put on the table -- will pale in comparison.

Thus, there is little doubt that the prescription is partly an attempt simply to say to the public that “we care” and to show an activist orientation. It also represents an attempt to channel some of Congress's energy, not unlike many of the efforts of President Bush's predecessors.

My guess is that either the Treasury or the Council of Economic Advisers was asked for advice on what to put in a package, and they tried to put on the table some items that might represent good tax policy from an efficiency or equity standpoint. Certainly the double taxation of corporate income has long been on Treasury's list of inefficiencies and distortions in the tax system. Broader reform proposals from President Carter to President Reagan would usually suggest some form of integration as one remedy.

Of course, integration has failed in the past for a variety of reasons. Not the least is that businesses have often been only lukewarm in their support. One of the fascinating aspects of the reform process in 1986 is that business lobbyists tended to fight more for faster depreciation of assets than for corporate integration. When focus is concentrated on the budget for the next few years, as it was then, corporate integration usually results in a much greater reduction in long-term liabilities than the alternative of accelerated depreciation. Over a five-year budget window, their cost might be the same, but the latter can be shown to be only a loan from government (a deduction today that will be lost tomorrow). Hence it, will later be repaid, albeit at a zero percent interest rate. Thus, the lobbyists actually fought for higher taxes.

Despite past failures to achieve reform, a case can be made for integration, and it can be tied to many of the corporate problems that are surfacing recently. The double taxation of corporate income provides a strong incentive for debt over equity. This adds juice to the creation of phony or misleading partnerships as devices to build up debt without affecting debt-to-equity ratios.

But it also plays out in industries like airlines, which are perennially facing bankruptcy problems. With assets that can easily be sold off like airplanes, the industry is able to borrow more than other risky industries. Once highly leveraged, it often doesn't take very much change in the economic cycle, passenger usage, or level of competition to make some firms unprofitable. If larger percentages of their capital were in equity rather than debt, bankruptcy would be much less frequent.

In the case of highly leveraged firms, moreover, there develops a number of heads-I-win, tails-you-lose incentives. The turnaround executive with big payments in stock or stock options won't share in the losses that might develop from his decisions, as the value of the stock and stock options can't fall below zero. The executives' share of those losses, perhaps due to mismanagement, get shifted off to wage earners, bondholders, banks, and others. But if the firm succeeds for a few years, the executive will be likely to share more fully in the upside. This creates a lot of incentives for gambles that are not economic -- where there are expected losses for the activity but expected gains to some shareholders and top executives. In an extreme example, a 50-50 chance of making or losing $1 billion gets translated into a 50 percent chance of these stakeholders gaining $1 billion and a 50 percent chance of wage earners and banks losing $1 billion.

Thus, the administration's interest in corporate integration is meritorious, but it will have to step up to the plate and recognize that tradeoffs are required. In particular, there are ways to engage this type of reform without affecting either total revenues or the distribution of the tax burden, if those remain primary concerns. The Treasury's proposal for corporate integration in 1984 clearly recognized that by spending some money on corporate integration, a larger attack had to be made on tax shelters while the amount of rate reduction would be limited. But the gains in efficiency and equity were considered worth the cost. A similar logic could be applied here as well to pay for corporate integration today.

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