Economic Effects of the 2003 Partial Integration Proposal in the United States

R. GLENN HUBBARD ∗

Columbia University; National Bureau of Economic Research, New York, NY 10027

rgh1@columbia.edu

Abstract

On January 7, 2003, President George W. Bush proposed a significant change in capital income taxation in the United States. In the context of a “jobs and growth” package, the President proposed to reduce substantially the double taxation of corporate-source income by eliminating investor-level taxes on dividends paid from earnings on which corporate tax had been paid. In addition, the President’s proposal would have reduced the tax on retained earnings by allowing a basis adjustment for accumulated previously taxed retained earnings. Taken together, these proposals would have moved the U.S. income tax much closer to an integrated tax system along the lines outlined by the Treasury Department in President George H.W. Bush’s administration a decade earlier.

Putting together the impacts of the President’s proposal on economic activity through greater capital accumulation and improved calculation, I estimate that the proposal, if it had been enacted in its original form, would yield a permanent increase of 0.48 percent in the U.S. economy’s potential output. This estimated gain does not include any gains made possible by improved corporate financial policy.

Keywords: integration, dividend taxes, capital gains taxes

JEL Code: H2, H6

1. Introduction

On January 7, 2003, President George W. Bush proposed a significant change in capital income taxation in the United States. In the context of a “jobs and growth” package, the President proposed to reduce substantially the double taxation of corporate-source income by eliminating investor-level taxes on dividends paid from earnings on which corporate tax had been paid. In addition, the President’s proposal would have reduced the tax on retained earnings by allowing a basis adjustment for accumulated previously taxed retained earnings. Taken together, these proposals would have moved the U.S. income tax much closer to an integrated tax system along the lines outlined by the Treasury Department in President George H.W. Bush’s administration a decade earlier.

The tax law change approved by the Congress and signed by President Bush in the spring of 2003 departed from the initial proposal, by providing temporary tax rate cuts on dividends and capital gains; the dividend rate cut was not conditional on prior payment of corporate tax. In what follows, I consider the economic effects of the President’s initial proposals, as

∗At the time of the integration proposal, the author was Chairman of the Council of Economic Advisers.
they are closer to a “textbook” integration experiment than the actual legislation. The paper is organized as follows. Section 2 revisits economic arguments for corporate tax integration. Section 3 describes the integration prototypes recommended by the Treasury Department (1992) that served as a model for President Bush’s proposal. In Section 4, I offer estimates of the economic effects of the President’s proposal. Section 5 concludes.

2. Arguments for Corporate Tax Integration

2.1. Background

Current U.S. income tax law treats corporations and their investors as separate entities. Under this so-called “classical” system of corporate taxation, two levels of tax are levied on earnings from investments in corporate equity. First, income earned by corporations is taxed at the corporate level. Second, when the corporation distributes dividends to shareholders, the income is taxed at the shareholder level as ordinary income. Undistributed earnings, which increase share values, are also double-taxed, because they are taxed at capital gains rates when shares are sold.

In contrast, investors who conduct business activity in noncorporate form, such as a sole proprietorship or partnership (or in corporate form through an S corporation), are taxed once on their earnings at their individual tax rate. Corporate earnings distributed as interest to suppliers of debt capital are generally taxed to U.S. taxpayers as ordinary income. However, interest paid is generally deductible by the corporation, and thus not subject to tax at the corporate level.

“Integration” of the corporate and individual income taxes refers to any plan in which corporate income is taxed only once, rather than taxed both when earned and when distributed to shareholders as dividends. Integration has many variants. In January 1992, the U.S. Treasury Department released a study of corporate tax integration, *Integration of the Individual and Corporate Tax Systems* (hereafter, “the Treasury Report”); the American Law Institute published a set of proposals the same year. The Treasury Report documents the economic distortions caused by the current two-tier tax system and the need to change the way in which the United States taxes corporations and their shareholders, and presents the issues involved with alternative approaches.

Despite their differences, the methods of integration studied in the Treasury Report and the American Law Institute Report reflect a common goal: To the extent practicable, fundamental economic considerations, not the tax structure, should guide investment, organizational, and financial decisions. Although the Tax Reform Act of 1986 reduced the effect of taxation on many business decisions, that reform did not directly address distortions in business organizational and financing decisions under current law. Thus integration can be viewed as the next logical step in tax reform.

2.2. The Corporate Tax and Economic Distortions

The classical corporate tax system distorts economic and financial decisions, including whether to: (1) invest in noncorporate rather than corporate form; (2) finance investments