THE EFFECTS OF TAXATION ON BUSINESS

BY JOHN ZERVAS (New York)

This is a study which was undertaken by the Graduate School of Business Administration of Harvard University and was published in seven volumes from 1950 to 1953.

The whole project is a fact-finding investigation intended to present a realistic appraisal of the actual effects of taxation on certain aspects of businesses.

In presenting an evaluation of all books as a whole I believe that I must not be bound by the chronological order of their publication. I found it more expendient to divide the study into two parts and line up the books according to their internal relationship.

The first part embracing all books concerned with various direct effects of taxation on business operations is comprised of the following six books:

Effects of Taxation on Corporate Financial Policies.

Effects of Taxation on Corporate Mergers.

Effects of Taxation on Excecutives.

Effects of Taxation on Executive Compensation and Retirement Plans.

Effects of Taxation on Depreciation Adjustments for Price Changes, and

Effects of Taxation on Inventory Accounting.

The second part is concerned with the repercussions of taxation on the ability and willingness of private individuals to supply equity capital. The last book of the series titled «Effects of Taxation on Investments by Individuals» is the subject of this part.

The method which is being followed throughout the study is the empirical analysis. All volumes emphasize empirical rather than theoretical inquiry. The reason for this is that the theoretical aspects of the effects of taxation on business and on the economy as a whole have been explored much more intensively than have the empirical aspects.

Effects of Taxation on Corporate Financial Policies

This volume written by D.T. Smith, Professor of Finance at Harvard University, appeared fifth in the series.

The study is divided into two parts; the first part deals with widely owned corporations. The second part has as its subject the closely controlled corporations. The distinction has much significance as being the basis for major differences in points of view and financial policy. In the first group conflicts of interests are inevitable and they, therefore, complicate the problem of appraising the consequences of taxation. The owners of the second group think of their corporate interests in a highly personnel manner.

The effect of taxation on widely owned corporations depends to a certain extent upon the particular form their financing takes. Corporation financing is usually being made by debt or preferred stock, by new common stock or by retained earnings. Taxation is progressively effective when we move from the first case of debt financing to the last one of financing the corporation by retained earnings.

The effects of taxation on closely controlled Corporations can be estimated and compared fairly easily. The simplicity is derived from the fact that only a small group of investors is concerned and the enterprise is thought of as a venture in which each has his individual share of a joint activity.

The following topics are discussed and the influence of taxation in relation to them is analyzed.

Form of organization.

Capital structure of new corporations.

Growth through retention of earnings.

Sales or withdrawals of part interest without liquidation or merger.

The attractiveness of a corporate or partnership form of business as regards taxation depends on the :

Size and regularity of income of the company.

Size of the other incomes of the owners and the extent to which business income is to be retained in the company.

Capital structures can be used to creats tax advantages in closely controlled corporations. The existing tax law is not restrictive of such ventures. This makes investment in such corporations extremely attractive to high bracket investors.

The advantage for retained earnings in closely controlled corporations is obvious. The existing tax law permits such retention when there is no element of abuse. This, unquestionably, serves to avoid or postpone the individual income tax component of the double tax by not distributing earnings.

There are many devices which can be used and are being used in cases of sales of part interests. A recapitalization is frequently undertaken to provide a complex capital structure which will give to the selling party a favorable tax treatment.

Effects of Taxation on Corporate Mergers

This study was written by Professors J., Buttere, J. Lintner and W. Cary.

Corporate Mergers can be influenced by taxation in one or two ways :

Taxation may be a major factor in inducing the sellers to sell and the buyers to buy.

It may also influence the form of a transaction once a decision has been reached by the contracting parties.

The present book deals primarily with the first of these two aspects. Its scope is somewhat restricted, furthermore, by dealing only with closely held corporations.

It has been charged that taxation exercises perverse influence in forcing the sale of many well established and successful companies which are owned by a single family. That sale will take usually the form of a business merger which will affect the competitive structure and the degree of industrial concentration in the American economy. These critics are aware of the fact that the higth degree of industrial concentration which characterizes the American economy stems from the two waves of mergers which had as a result the formation of the Standard Oil Trust and later on of the United States Steel Corporation.

The tax structure the authors say, definitely exerts strong pressure on the owners of many closely held businesses to sell out or to merge with other larger companies.

The reasons are twofold.

A closely held business may be sold out to lessen the impact of the estate tax, and

The sale may be made to enable the owners of closely held business to take their profits out of the business by the capital gains route rather than to have them distributed as dividends.

As to the importance of tax motivations for sale of business enterprise the authors found that many non-tax reasons for sale are so urgent that the sales would have been made without the further prodding of tax pressures. Other nontax reasons for selling, however, are much less impelling and would not lead to definite action by themselves.

As for the importance of tax motivation for the purchase of businesses it can be said with a degree of certainty that taxes are of no practical consequence.

As a general rule the recent merger activity in industry and mining has not substantially altered the basic competitive structure of industry in the United States. One big exemption can be found in the case of liquors and textiles. Furthermore, the initiative for recent mergers has come more from the owners of the selling companies than from the buyers. This can be stated as a proof that the recent mergers have not been characterized by a desire to restrict competition.

The great majority of mergers take the form of a purchase of the sellers' assets or stock with the means of payment being either cash or stock or both of the buying company. The problems which are involved here are manifold. However, for the sake of generalization it can be said. that the seller will benefit taxwise by selling his stock whereas the purchaser will benefit by acquiring the assets of the selling company.

Effects at Taxation on Executives

Producers have been subject to severe criticism and many times have been hated by their fellow-men. Emerson very appropriately wrote that «those who are most dear to men are not of the class which the economists call producers». Preferred to these, he goes on to say, are poets and philosophers.

However, the management of today has taken a more social view of its business activities. The alienation of business management from the ownership of business had, therefore, its beneficial effects.

It has been argued that taxation results in checking the initiative and the incentives of people for working and producing more. Progressive income tax rates tend to take out the greater portion of the income of an executive. Against this trend many devices have been invented to compensate the executives and stimulate their working capabilities. Stock options, bonuses, retirement benefits and expense accounts, are some of these devices. The book at hand deals, more precisely, with the influence of taxation on executives as it effects their choice of activities, the intensity and duration of their active business careers, their retirement, and their efforts to achieve personnal financial success.

The whole study is divided into three parts:

Part one deals with taxation and executive effort.

Part two is devoted to executive compensation.

Part three covers the executive investments.

The author found that the extent to which business executives have reduced their work and effort as a result of taxes has been much exaggerated. There has been relatively little visible with holding of effort in the day-to-day activities of the business.

Many reasons have been cited to show why effort has been sustained in spite of taxation. Nonfinancial incentives to work and compulsions of administrative organizations are the most important. Among small business owners, however, a certain amoint of work is being withheld because of taxes.

The high income tax rates tend to force compensation of executives to higher levels in order to have them maintain a high net income. Working on the opposite direction is the competition among the other factors of production for higher income. The result has been a general increase in executive compensation rates. The efforts, however, of companies to compensate their executives through direct salary increases have failed so far on account of high income tax rates. Therefore, the several companies employed several other devices to increase indirectly executives compensation. Such devices are discussed in another volume of this project which deals with «Executive Compensation and Retirement Plans».

Today, the owner-manager group has been replaced by the professional management class which depends for its subsistence upon a kind of salary compensation. It is, therefore, natural for them to look for more security in their investment.

Effects of Taxation on Executive Compensation and Retirement Plans

This is the third volume of the general study of the effects of taxation on business and it is written by Prof. C.A. Hall of Yale University.

What are the effects of taxation on corporations' policies regarding executive compensation? This is one of the two major topics of this study. The other question with which the book deals is what is the reaction of the executives to the various forms of tax-influenced compensation plans currently used.

The study has five main objectives :

What are the most common executive compensation plans?

What is the growth of deferred-type plans?

The reasons for the increase of deferred-type plans.

What are the effects of the growth of deferred-type compensation plans upon the employer company.

What are the effects of the same compensation plans on the economy as a whole.

The conclusions which the authors reached are based upon both field interviews and published information. A total of 87 interviews were taken among executives of 56 different firms.

a) The most common deferred-type compensation plans from the tax standpoint are :

Deferred distribution bonus plans;
Deferred distribution profit-sharing plans;
Retirement plans;
Deferred compensation plans;
Individual plans.

A distinction is made between qualified and nonqualified compensation plans. The qualification or nonqualification is from the standpoint of taxation (Section 165a of the Internal Revenue Code).

b) There are four types of deferred compensation plans which increased in use from 1935-1947 among large nonfinancial corporations. These are :

Deferred compensation;
Nonqualified bonus;
Qualified retirement, and
Qualified profit sharing.

c) The reasons for the growth of deferred-type compensation plans are given by several corporations as :

Increased personal and corporate taxation;
Increased competitive pressures in competing for executives;
Increased profits, and
Wage and salary stabilization in order to reduce the discrepancy in earnings between bourly paid employees and executives which are salary–paid.

d) A definite conclusion is not possible from the gathered data as regards the effect of these compensation plans upon the employer company. However, it is safe to observe that the qualified retirement and profit–sharing plans of large companies do not produce unreasonable discrimination in favor of officers, shareholder employees, supervisory employees, or highly compensated employees.

e) Each compensation plan produces a number of effects on the whole economy.

Qualified retirement plans increase the output of goods and services;

Qualified profit–sharing plans produce effects on output, prices, and savings, with a stress on output;

Deferred compensation plans reduce the output of goods and services if they are used to their present limited extent.

However, if they are used extensively tend to increase the output of goods and services. Similar to the above effects have the nonqualified bonus plans.

Effects of Taxation on Depreciation Adjustments for Price Changes

This is the sixth volume in the general study of the effects of taxation on business. It is written by Prof. E.C. Brown and deals with the problem of making proper adjustment for the gap between historical–costs and replacement–costs of capital assets in measuring depreciation and business income. The problem has a particular significance during periods of rising prices.

Depreciation is a reasonable allowance for the exhaustion wear and tear obsolescence of property... which may be deducted from gross income.

The problem which arises is what is the proper base from which to measure the depreciation charge. In this respect there are two methods for measuring depreciation. The historic–cost depreciation method and the replacement–cost depreciation. The latter method was introduced during the post war years for the first time by the U.S Steel Corporation in 1947. Following are the main conclusions which are more or less based on theoretical considerations.

The monetary value of inventories of the plant and the equipment is increased when prices rise. The same is not true for the accounts receivable, bonds, and other financial assets which are fixed in money terms.

The problem which arises in periods of rising prices is connected with the estimation of the true money profit which the businesses realize after allowance for depreciation. If they folow the historic–cost depreciation accounting method, the reported profits do not represent the true situation of the business because of the inclusion in the profit of an increment in monetary value of the fixed assets of the business.

On the other hand, there is the replacement–cost method of accounting which calculates depreciation at its replacement cost and not at the cost of the purchase of the asset.

It is estimated that in the post–war period the excess of replacement-cost depreciation over historic–cost depreciation for corporations has been between one and four million dollars. Some industries are affected more by the method of depreciation than others are. i.e. Public Utilities, using large amounts of fixed capital, would be affected greatly by the method of depreciation.

The findings of the author as regard the current practice of businesses can be summarized as follows:

Some of the firms moved in the direction of true current–cost depreciation. However, this movement has not be ancouraged by the accountants and the regulatory bodies. Generally speaking, the practice has not been uniform. Moreover, the methods which have been adopted seem to be arbitrary. The readjustment has been made for varied reasons among businesses. Some firms readjusted depreciation to accumulate funds for the future replacement of assets.

Others, were amortizing excess present costs against excess present revenues.

Is the present tax system fair in its treatment of the depreciation allowance or should be made fairer by permitting greater adjustments?

In the author's opinion the differences in real net worth that arise in periods of infation should be recognized for tax purposes.

The consequences on the American Economy of such readjustments are projected upon long–term growth of the economy and upon the economic fluctuations.

The long–run effects of replacement–cost depreciation depends largely on the prospects facing the American Economy in the future. If the future offers an inflationary price level, replacement–cost depreciation would probably increase the fraction of national income going into capital formation.

The general conclusion of the author is that historic–cost depreciation is more desirable than replacement–cost depreciation for tax determination. In his view «tax equity should be based on differences in real income. Replacement–cost depreciation ignores these differences by providing a special exemption for certain tax–payers». His analysis of the effects of the two methods on the stability of economic activity points to a slight favoring of historic–cost depreciation. From the long run view point, historic–cost depreciation in a period of inflation is likely to result in a smaller amount of capital formation than would replacement–cost depreciation.

Effects of Taxation on Inventory Accounting

The present volume written by Prof. J.K. Butters, is the first study of the series. The theoretical as well as the empirical method are employed to the project at hand. Federal taxation has been a major factor influencing inventory accounting procedures in many industries since the last–in first–out method, LIFO, was authorized in 1938.

The method of inventory estimation is particularly important in periods of fluctuating prices. The LIFO method of accounting means that valuation of inventory goods which are sold or used up in manufacturing is made according to the prices of the last acquired goods and not to the prices of the first ones. This has particular significance in periods of inlation; LIFO valuation will show smaller profit when prices are rising and a larger profit when prices are falling.

The book is divided into two parts. The first part, which I consider the most important, is dealing with the various methods of inventory accounting. The second part examines some technical problems having to do with inventories.

The first part of the book attempts to answer the following questions:

Importance of Inventory Profits,
What business is doing about them,
Economic Significance of different Inventory Methods,
Inventory aspects of general concepts of profits.

To the above questions the author gives some convincing answers based on theory as well as on the empirical study of the problem.

Statistics show that inventory profits and losses are very large in years of rapid price changes.

To the second question the author found from interviews with management officials that the most powerful motivation leading to the widespread use of LIFO during the past decade has been the opportunity to reduce tax liabilities.

The question which arises now is whether the several inventory methods of accounting promote a greater degree of stability in the economy as a whole.

The answer to this is not conclusive. The treatment of this topic is more or less theoretical. The author has not been able to give a definite answer based on the collected material.

Several criteria have frequently been used in deciding how inventories should be valued in measuring business profits. From the four main methods the author gives preference to the one in which sales and cost prices are stated in terms of the current price level. This method is preferable for an additional reason. viz. for the proper measurement of the national income which would be obscured by the element of price inflation or deflation which would be introduced by valuing beginning and ending inventories at different price levels.

Effects of Taxation on Investments by Individuals

This volume constitutes the final book in the series. It is written by Professors J. Butters, L. Thomson, and L. Bollinger. The analysis consists of an effort to answer three main questions :

1) Whose investment decisions are important.
2) How have taxes affected the investment capacity of these groups of investors.
3) How have taxes affected their investment policies.

The investigation conducted by the authors reveals that the investment decisions of individuals in the upper income and wealthy classes are of overwhelming importance. They estimate that the stock holdings of the top income and wealth groups measured cumulatively are as follows :

Individuals with incomes of & 50.000 and over hold about 35% of all marketable stocks owned by private investors;

Individual with incomes of & 25.000 and over hold about half of all stocks;

Those with incomes of & 15.000 and over hild about 65% of all stocks ;

Spending units of & 10.000 and over hold about 75% of allstocks.

The study indicates that there is a general disinclination of the lower nine-tenths of the population to invest in business equities. They prefer to keep their assets in some sort of liquidity form.

The findings of this survey do not differ basicaly from those of L. H. Kimmel of the Brookings Institution (1952) who estimates that as many as 4.750.000 family spending units and 6.490.000 individuals in the U.S. own shares in publicly owned stocks.

To the question of how have taxes affected the investment capacity of individuals the authors conclude that the changes in the tax structure over the past 15 to 20 years have substantially reduced the capacity of upper bracket individuals to accumulate new investable funds. However, their remaining capacity is still very large. The prevailling belief that the severe tax increases of recent years have wiped out the capacity of individuals with large incomes to save is not substantiated by the facts.

The third question occupies the greater part of the book. An appraisal is made of the general investment objectives of individuals and of their attitudes toward specific types of investments such as marketable common stock, new issues, new ventures, family business, tax exempt bonds, and life insurance. The empirical findings of the authors are summarized as follows: The tax structure out substantially into the investment capacity of the upper income and wealth classes and decreased also the willingness of these investors in the aggregate to make equity-type investments. However, the combined impact of these effects fell far short of drying up the supply of equity capital which private investors were willing and able to make available to business.

Some Concluding Comments

The present study as a whole has not been subjected, as far as I know, to a critical review by any of the English language Economic Periodicals. Only scattered comments in praise of some of the books appeared in leading English and American Economic Magazines. However, an appraisal of the entire project as a unity may lead us to different conclusions as to its merits from those that the piece-meal reviews have presented.

A critical analysis of the voluminous study shows that the project fell short of the ambitions expectations of its sponsors. There has not been a complete and thorough examination of all aspects of the effects of taxation on business as the title of the study implies. The effects of Federal Taxation on specific aspects of business should be a more appropriate title for the project. The selection of topics has been more or less arbitrary and without an attempt to present the most important aspects of the problem. Prof. D.T. Smith, one of the principal architects of the project, admits that the most notable omission is the failure to analyse the effects of taxation on the timing and amounts of capital investment by business. The other disappointment which the students of Public Finance have felt is the scanty evidence there presented. Although the scope of the project has been to present a realistic appraisal on the actual effects of taxation on business and not a theoretical argument some of the authors indulge in theoretical analysis being apparently unable to reach conclusions on the basis of the empirical material they had un hand. Therefore, the actual effects of taxation on some aspects of business continue to remain to a great extent a «terra incognita».

The book which deals with the effects of taxation on corporate financial policy is primarily analytical in form and its conclusions are reached by the deductive method. The author attempts to show what businessmen are expected to do in response to the effects of taxes upon their costs. The second part of the book which deals with the financial policies of closely owned corporations is much superior to the first as far the construction and presentation of material is concerned. The subject of the first part is, unquestionably, extremely complex and this is a drawback which is not easy to overcome.

The effect of taxation on corporate mergers is not clear. The authors found that in almost all cases examined the combination of factors leading to mergers was such as to make it very difficult to isolate the tax factors and its influence upon business decisions. Such considerations as inability to find replacements for competent management, consolidation with a larger firm possesing specialized personnel and other considerations are among the factors which drive some firms into mergers.

The presentation of the effects of taxation on depreciation adjustments for price changes is purely theoretical in approach placing less emphasis upon the empirical aspect. This is a serious shortcoming and the author himself confesses that his findings are incoclusive whenever he deals with actual cases. If the study, however, is judged on its own theoretical level it will be found to be well constructed analytical treatise.

What is the impact upon business of the tax law which since 1938 permits them to use the LIFO method of inventory accounting? The author found that many large companies and especially meat macking, textiles, paper, petroleum, iron, steel and nonferrous metals, are using LIFO for the purpose of reducing tax liability. However, the study shows that the more LIFO is used the less reliable the balance sheet becomes since inventory values reflect prices of some period back and not those of today as the author would prefer.

The effects of taxes on the incentives of individuals to invest is a well constructed book based both on theory and empirical material. The authors utilize extensively the data which were collected by the «Survey Research Center of the University of Michigan» and by their own interviewers. The voluminous material, however, did not support their point of view all the time. Many of their conclusions are not founded upon the material which in some cases drives them nowhere. The authors, however, merit to be praised for the straightforwardness with which present their material and conclusions.

The whole study might not add much to our knowledge of business behavior in response to taxation; its contribution toward this direction, however, must not be overlooked. Two points must be stressed in conclusion. The whole project was conducted under the realm of the existing at that time Revenue Act. Moreover, the prevailing favorable general economic conditions had, undoubtedly, a definite influence upon the conclusions. Both these factors must be taken under consideration.