CBO TESTIMONY

Statement of
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The Untaxed Business Sector

before the
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Mr. Chairman and Members of the Committee, I am grateful for the opportunity to appear before you.

My testimony addresses several tax policy, budgetary, and economic issues that arise from the presence of economic entities whose revenue comes primarily from selling goods and services in direct competition with traditional for-profit firms and whose income is exempt from both the federal corporate and individual income taxes. In my discussion of the Congressional Budget Office's (CBO's) analysis of those issues, I will refer to such organizations individually as "business entities" and collectively as "the untaxed business sector." Three types of business entities have the characteristics noted above:

- Certain nonprofit institutions—for example, nonprofit hospitals that are wholly engaged in businesslike activity or universities that have undertaken "spinoff" business activities (such as research development partnerships with private firms);

- Cooperatives, including credit unions, which differ from other businesses primarily because their clients are their owners; and

- Business enterprises of state and local governments, such as municipally owned utilities, that are operated on a fee-for-service basis.

CBO's analysis—which was restricted to the exemption from federal income taxation and does not consider any other tax treatment received by these entities—leads to several conclusions:

- The ownership structure of untaxed business entities differs significantly from that of conventional for-profit firms in that there are no separate claimants, such as shareholders, for the entities' residual profits. The lack of owners in the usual sense is what primarily determines how any attempt to tax such entities is likely to affect federal revenues and the economy.

- Because of the absence of owner-claimants, managers of these entities have different incentives from those of managers of privately owned businesses. Instead of seeking to return profits to owners, the entities' managers have incentives to lower prices, increase costs, or bolster retained earnings.

- Accordingly, taxation of these entities might not generate as much revenue as initially anticipated. Taxation would bolster managers' incentives to reduce or eliminate entities' tax liabilities by using more of any surplus to cut prices, boost costs, or both. As a consequence of being taxed, however, those entities would retain fewer funds for expansion.

What Is an "Untaxed Business"?

Business activity can be thought of as the provision of goods and services for a price. Only those consumers who pay the price receive the goods or services, and the entities that provide them finance their production with the receipts from those private transactions. In the United States, most business activity is undertaken by privately owned for-profit firms. The government often provides and finances through taxation services that are not amenable to being provided by businesses, such as those whose benefits reach beyond the buyer or seller and benefit others as well.

There is no bright line, of course, between the kinds of goods and services that conventional businesses produce and those that have broad public benefits. Non-profit entities, which are deemed to serve a public purpose and for that reason are not taxed, provide a number of them. Some nonprofit entities, such as nursing homes and mental institutions, may be less likely than their for-profit counterparts to take advantage of consumers who have limited information. In the case of cooperatives and state and local government businesses, the tax benefit that they receive has been justified in the past as an offset to the monopoly power of for-profit firms, power that might cause prices to be too high. Tax exemption may also encourage the provision of services when there are too few customers in an area to motivate a for-profit entity to engage in business activity. Over time, however, economic growth, technological advances, and increases in population may have altered the circumstances that justified the formation of many of those entities in the past.

Many untaxed business entities sell goods and services that compete directly with those provided by traditional for-profit firms. The surplus generated by untaxed entities escapes the income tax system if it is passed on to retail customers in the form of lower prices or if it is retained for reinvestment. But the income tax system does capture surplus that is passed on to workers or managers as higher pay or to commercial customers as lower prices that then allow them to increase their profits.

The Internal Revenue Code subjects the surplus generated by most business activity to the income tax. Profits generated by firms that are organized under the tax code as C corporations are taxed once at the corporate level and a second time at the individual level, when they are received as dividends or capital gains. Firms organized as proprietorships, partnerships, limited liability companies, S corporations, and other so-called pass-through entities are not subject to the corporate tax. However, the surplus they generate is taxed at the individual level.

Which Businesses Make Up the Untaxed Sector?

Three types of entities have the characteristics of businesses but are not subject to income taxation either at the “firm” level or through the pass-through mechanism. The three are nonprofit institutions, cooperatives, and state and local government enterprises.

Nonprofit Institutions

Many nonprofit institutions produce output that is sold to customers in much the same way that private businesses sell goods and services. The most prominent example is nonprofit hospitals that finance virtually all of their health care services with revenue from sales. On average, nonprofit health care institutions receive relatively few donations, garnering 92 percent of their income from program revenue (revenue from the sale of services). Those health care institutions alone represent about half of the total revenue of all nonprofit entities that must file financial information returns. (All nonprofit entities whose gross receipts exceed $25,000 must file financial information with the Internal Revenue Service.)

Many nonprofit institutions whose primary activity fulfills a public purpose also engage in substantial business activity. The tax code contains provisions to tax income from business activity that is unrelated to a nonprofit’s public purpose. In practice, however, much of that unrelated business income (such as income from royalties, payments from corporations for the right to associate their name with a nonprofit organization’s activities, and income from the sale of membership lists) has been classified under tax law as related to the entity’s public purpose and thus is not subject to taxation. Universities, for example, receive royalties from research development partnerships with private business and receive income from athletic events that compete with professional sports leagues.

CBO estimates that businesslike nonprofit institutions add roughly $314 billion of value to the economy, or 3.4 percent of net domestic product (see Table 1). That estimate is based on the share of each entity’s revenue that comes from payments made by customers. Of the revenue for all nonprofit institutions, 65 percent accrues to entities whose program revenue exceeds 75 percent of their total revenue. CBO assumed in its calculation that their share of net domestic product (the net value added to the economy) was proportional to their share of total revenue.

Cooperatives

A second type of untaxed entity is cooperatives—businesses whose owners are also its clients. Virtually all of the activity of cooperatives is conducted in a businesslike fashion—that is, their goods and services are sold to (or for) their

Table 1.

Estimated Size of the Untaxed Business Sector and Its Share of Net Domestic Product

Type of Entity	Billions of Dollars	Percentage of Total Net Domestic Product[a]
Nonprofit Institutions that Serve Households	314.0	3.4
Cooperatives (Four industries)[b]	32.1	0.5
State and Local Business Enterprises	127.4	1.4

Source: Congressional Budget Office based on data for 2000 through 2003 from a variety of sources including the national income and product accounts, Census of Governments, and the National Center for Charitable Statistics.

a. U.S. net domestic product in 2002 totaled $9,192 billion.

b. The four industries are credit unions and three types of utilities providing electric, telephone, and water services.

client-owners. They operate under several different sections of the tax code but, with only a few exceptions, are exempt from taxes on their income.

Many cooperatives are small and generate only a modest volume of sales, but some cooperatives are quite substantial enterprises. The larger credit unions compete effectively with segments of the commercial banking industry. Moreover, cooperatives include such large and well-known firms as Land O'Lakes, Southern States, and Welch's. Information on the size of the cooperative sector is not available, but in 2001 and 2002, four industries together—credit unions and three types of utilities providing electric, telephone, and water services—earned $77 billion in total revenue.

CBO estimates that cooperatives in those four industries added roughly $32 billion in value to the economy in 2002, or about 0.3 percent of net domestic product.[1] Again, CBO's estimate incorporated the assumption that those cooperatives' share of businesses' contribution to net domestic product was proportional to their share of businesses' total output.

State and Local Government Businesses

The third category of untaxed entities comprises firms owned by state and local governments that are operated on a fee-for-service basis but that are typically

1. Unless otherwise specified, all years are calendar years.

exempt from federal taxation under the doctrine of intergovernmental tax immunity. The most common of those entities are utilities—primarily electric, water, and gas—which have many private-sector analogues. Others, such as water and sewer services and solid waste collection, have fewer for-profit counterparts. States and localities also operate a number of transportation and recreation businesses. (Transportation enterprises include parking garages, ferry boats, wharves, and airports. Businesses related to recreation include swimming pools, golf courses, hotels, and motels.) Miscellaneous commercial activities undertaken by states include a commercial bank and a flour mill in North Dakota and the manufacture of vaccines by a public entity in Massachusetts. In addition, states and localities operate such businesses as liquor stores and lotteries to generate additional revenue.

CBO estimates that the value added to the economy by state and local entities that might be performing tasks similar to those carried out in the for-profit sector is roughly $127 billion, or 1.4 percent of net domestic product. (Again, CBO assumed that the state and local government sector's share of net domestic product was proportional to its share of total revenue.) The state and local sector received a total of $93 billion in revenue from operating water, electric, and gas utilities in fiscal year 2002. Another $194 billion of charges and miscellaneous revenue is attributable to the sale of private goods, such as motel room rentals.

Issues Surrounding the Tax Treatment of Untaxed Businesses

Several objections have been raised to the differential tax treatment granted to these business entities. Competitors of tax-exempt businesses have objected that it is unfair, and analysts have been concerned about its effects on economic efficiency. Evaluating fairness is problematic. To begin with, such an exercise reflects the values of the observer. In addition, fairness is best evaluated with respect to the owners of firms; the institutions are merely legal constructs that exist to organize and facilitate production. But owners change over time, making it impossible to trace how former owners of competing or potentially competing firms were affected. Eliminating the differential tax benefit would not redress any past inequities and could introduce new ones.

Differential tax treatment could lead to inefficiency in several ways. Untaxed firms have the opportunity to use their surplus (which includes their tax savings) to offset any higher production costs they might incur and still compete with taxed firms on the basis of price. Consequently, the tax benefit may interfere with the market's discipline, which rewards efficient firms and penalizes inefficient ones. Alternatively, using the tax savings to reduce the price of the firm's output could shift the economy's mix of production toward less-valued goods and services.

The favored treatment of untaxed businesses, however, stems from their public-purpose nature, and the continuation of that treatment will depend on the judgments of policymakers.

The Tax Exemption and Forgone Receipts

The three categories of untaxed businesses have a significant attribute in common: the absence of conventional owners, which relieves them of the need to report and distribute profits in the usual sense. The incentives of managers of untaxed businesses thus differ from those of managers of commercial businesses. Not seeking to maximize profits or surplus, they have greater latitude with regard to their costs of production and prices. Indeed, the purpose of some untaxed entities in part is to sell output at prices lower than its costs. As a result, taxing the untaxed business sector may yield much less revenue than might be expected, given the scale of its activities.

The scope of tax-avoidance options available to for-profit firms is limited by the necessity to deliver a return to the firms' owners. The tax-avoidance strategies that nonprofit businesses, cooperatives, and state and local government enterprises can command are more numerous because of those entities' ownership structure. That statement is true regardless of whether the entity attempts to reduce the price and increase the availability of the good it sells or whether it takes less care to adopt lowest-cost methods of production and as a result pays its operators and employees higher wages than they would otherwise receive. Hence, if a tax was imposed, a nonprofit business entity could more easily distribute any surplus to its managers or customers than a for-profit firm could; a cooperative would have more latitude to deliver its surplus to its owner-clients as lower prices than to parcel it out; and state and local government businesses could distribute their surplus in several different ways without necessarily handing it over as explicit profits to the state or locality. (They could distribute it as lower prices to their customers, higher wages to employees and managers, or some combination of lower taxes and more public services to the voters who ultimately control those businesses.)

A surplus that is passed on in the form of lower prices or higher pay reduces profits. Without conventional owners and the necessity to distribute profits as dividends or retain them as earnings, untaxed business entities could avoid a tax by passing on the surplus and minimizing taxable profits (see Box 1).

If a tax was imposed, previously untaxed business entities would probably choose among tax-avoidance strategies on the basis of their circumstances. For an electric utility owned by a state and local government, for example, the shares of the surplus received by individuals in the jurisdiction differ depending on whether the

Box 1.

Taxing the Surplus from a Hypothetical Municipal Golf Course

As an illustration, imagine a municipal golf course that is run as efficiently as a private competitor and priced the same—say, $40 per round. The municipal course incurs $36 in costs per round and generates a surplus of $4. The corporate tax rate is assumed to be 30 percent and the individual rate, 20 percent.

Presented as an equation, price ($40) = cost per round ($36) + before-tax profit per round ($4). In the absence of any taxes, the entire surplus of $4 per round can be paid to the untaxed municipal treasury to offset other costs of local government. In contrast, the private competitor must record the equivalent $4 per round as a profit and pay a 30 percent tax ($1.20).

Should a corporate tax be imposed on the municipal firm, rather than paying it, the firm might distribute the surplus to its customers as a price cut and charge only $36 per round. Costs would equal revenue, and the surplus would still escape the tax. The golf course's books would show the following: $36 = $36 + 0.

Alternatively, the golf course might pay its employees higher wages. The price per round would still be $40, but costs would be increased to $40, leaving no surplus to tax. In that case, however, the surplus would be subject to individual income taxes. If the individual rate was 20 percent, only 80 cents would be collected rather than the $1.20 that would be collected from a for-profit firm. The golf course's books would show the activity this way: $40 = $40 + 0.

Another option for the municipal firm would be to convert the $4 surplus to the local government's general fund by shifting $4 of its general fund costs to the golf course. No tax is collected on revenue that goes into the general funds of state and local governments. The golf course's books would, again, show the following: $40 = $40 + 0.

surplus is distributed as a lower price, higher pay, or reduced tax burden. Similarly, the shares of any surplus received by an individual owner-client of a cooperative will differ if the surplus is distributed as a reduction in prices instead of as profits. Regardless of the particular strategy an untaxed business entity chooses, the difference between its ownership structure and that of a private firm provides it with substantially more flexibility in undertaking measures to avoid taxes and still meet its objectives.

The opportunities for tax avoidance are even greater for secondary business activity carried on by untaxed entities whose primary activity is pursuing socially beneficial objectives. Profits from any business activity in which such an entity engages—whether related or unrelated to its main activity—are difficult to segregate from profits earned in the pursuit of its primary purpose. As a result, the taxation of any non-primary-activity profits becomes extremely difficult in the face of skillful management and accounting. In tax year 2000, a total of $4.8 billion of gross unrelated business income was reported by more than 11,000 organizations classified as 501(c)(3) under the tax code. The organizations reported total deductions for business expenses of about the same amount—for a net loss of $49,000. Fewer than half reported unrelated business income that was subject to taxation, and the revenues raised totaled only $4.1 million.

Because of those opportunities and incentives, any shift toward taxing the currently untaxed business sector can be expected to yield considerably less revenue than the size of the sector might otherwise suggest. The Joint Committee on Taxation has estimated that taxing some of the institutions in the sector in a manner analogous to the taxation of C corporations would yield about $2 billion in revenue a year. If the estimates covered more of the sector's businesses, the revenue gain would probably be larger. But it appears that the amounts involved are small relative to the size of the entire economy—and might in fact be even more modest if the estimates did not take into account the scope such firms have for tax avoidance.

The Economic Effect of Taxing the Untaxed Business Sector

Taxation of currently untaxed business entities would be unlikely to generate much revenue for the government, but it would have the economic consequence of constraining their growth. Taxation of their surplus would amplify the incentives they already have to lower their prices and incur higher costs, which could significantly reduce the amount of internal capital that those institutions accumulated. That constraining effect of taxation on growth would tend to be much stronger than it is for privately owned for-profit firms, which must pay tax on their profits but face strong incentives to retain the after-tax surplus or distribute it to owners.