THE PROGRESS REPORT / 2001

Corporations

By Fred E. Foldvary

There is nothing inherently morally wrong with corporations as such. The problem arises when government grants privileges or inflicts penalties on corporations.

A "corporation" is derived from the Latin term "corpus," meaning "body." When a group of people create a corporation (also known as joint stock companies or limited companies), they turn an organization into an artificial body or legal person, with legal rights and responsibilities similar to those of a natural person. The natural persons who own the company own shares and elect a board of directors to operate the firm.

If the corporation is a cooperative, then each member has one vote regardless of how many shares he has. Most corporations are organized for profit, in which case the owners vote in proportion to the number of shares they own. Some shares, such as preferred stock, may not have voting rights.

The law in the US and other countries grants the shareholders limited liability, meaning they are not personally responsible for the debts of the corporation. The most they can lose is their financial investment in shares. This protection is not unique to corporations, since with limited partnerships, most partners are limited partners, with limited liability, the general partners both running the firm and having liability for its debts. Likewise in a corporation, the members of the board of directors can be personally liable for the debts of the firm. Such liability is often covered by insurance. Limited liability enables a firm to raise large amounts of funds by issuing shares.

The owners of for-profit corporations obtain their share of the profits in two ways. First, the corporation can distribute some of the profit to the shareholders as dividends. Second, the firm may retain some of the profit and either invest it in expansion or buy back its own shares in order to make each share that much more valuable. The shares of stock trade in a stock market, where the prices are determined by the supply of shares offered for sale and the demand to bid for purchases. The price is ultimately founded on the number of total shares in existence, the expected profits or return on assets, long-term real interest rates, and taxes.

In the US, but not in the UK, corporate profits are subject to double taxation. Corporations pay an income tax on their profits, and then when the shareholders receive dividends, they must pay a personal income tax. To avoid this double taxation of the same income, some firms pay little or no dividends, and also borrow funds by issuing bonds instead of issuing more stock. Double taxation thus induces more corporate debt, which increases interest rates for everybody. Firms that are deeply in debt then become more vulnerable to a downturn in the economy.

Double taxation is an arbitrary penalty on the owners of shares of stock of corporations. Much of the gains from investments and production get taxed away at the corporate and personal levels, reducing incentives and stunting economic growth. The existence of such double taxation casts doubt on the power that many claim corporations have. Why, if they have so much clout, have the corporations not done away with taxing their income twice?

Critics of corporations point to limited liability as an unjust privilege held by corporations, unlike proprietorships, firms with a single personal owner, who is personally liable for the firm's debts. The same accusation would apply to limited partnerships. However, so long as the general partners are fully liable, the addition of one more limited partner does not inflict any harm. Consider Jane Smith who invests $1000 as a limited partner. She could have instead lent the $1000 to the partnership. As a lender, she would not incur liability; all she can lose are the funds loaned. So the limited partners are owners only in the sense that they have a right to a share of the profits; they are not owners in the sense of controlling the firm. The limited partners are really more like lenders who gain not a fixed percent of interest but a share of profits.

Likewise, owners of shares of stock of a corporation do not directly control the corporation. They too are somewhat like lenders than like owners. Their stocks entitle them to shares of the profits. They do also vote for the board and also vote for major policy decisions, but for the typical small shareholder, his tiny vote does not determine any outcomes. His main vote is whether or not to own the shares. We could convert most of the shareholders into bondholders paid from the profits rather than at a fixed rate, and the corporation would be little different.

But what if a corporation causes damage beyond the amount of its assets? This problem exists also with non-incorporated firms and individuals. Companies engaged in risky activities such as transporting oil and chemicals could be required to have insurance or post a bond to cover damages if the damage could be greater than its assets.

The real privilege is not the corporation as an institution, but from the privileges granted to enterprise in general. Companies world-wide are granted subsidies to destroy and use up natural resources, such as roads in forests paid for by government and dams financed by the World Bank. They are allowed to pollute, with taxpayers financing dysfunctional regulations. Much of their profit can consist of the rent of land that they did not create, and whose value derives from government services they do not pay for. Workers get low wages and suffer poor working conditions because their governments block off alternative opportunities and confiscate much of their meager gains with taxes on incomes, sales, and wealth. Harmful products are sold by fraud, with no consumer warnings or notices to buyers who mistakenly think government protects them.

The needed reforms apply to enterprise in general.

- First, enterprise is entitled to profits from their own investments but not from our natural heritage, so all land titles should be subject to paying to the relevant communities the economic rent of that land.

- Second, firms and individuals should be made to compensate society for any environmental damage, such as by pollution charges.

- Third, having paid community rent and environmental compensation, the true profits of corporations should be left untaxed, and dividends paid to shareholders should not be taxed.

- Fourth, there should be a "law of the market" stating that all products sold are known to be safe and effective, unless labeled otherwise, with large penalties for fraud. Fifth, laws against involuntary labor should be widely and strictly enforced.

So long as income taxes exist, corporate income should be treated the same as the income of partnerships. The total profit should flow through to the shareholders and only be taxed once, and the tax on the profits of both partnerships and corporations should be on any gains, whether realized in the sale of stocks or unrealized as gains from stocks still owned. There should be one flat tax rate on all income, to avoid basing financial decisions on taxes rather than on economics.

But of course the best reform would be to do away with general income taxes, and only tax, in form, explicit and implicit income from land rent. This is the "single tax" proposed by the French physiocrat economists of the 1700s, followers of Henry George in the 1800s and 1900s, and the public finance most suitable for the suave new world of the 21st century.

-- Fred Foldvary