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Taxing the Untaxed Business Sector

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Notes

Unless otherwise indicated, all years referred to in this paper are calendar years.

Numbers in the text and tables may not add up to totals because of rounding.

Preface

Unlike the income of privately owned for-profit companies, income earned by nonprofit organizations, cooperatives, and business enterprises run by state or local governments is generally not subject to federal income taxes—either at the corporate or at the individual level. Critics argue that such differential tax treatment gives those untaxed entities, which frequently resemble private businesses, an unfair advantage over their for-profit competitors. This Congressional Budget Office (CBO) paper describes the entities that make up the untaxed business sector and examines the potential effects on federal revenue and the U.S. economy from taxing their income. It expands on the analysis that CBO presented in testimony before the House Ways and Means Committee on April 20, 2005. In keeping with CBO's mandate to provide objective analysis, this paper contains no recommendations.

Dennis Zimmerman and G. Thomas Woodward of CBO's Tax Analysis Division prepared the paper. Robert Dennis, Arlene Holen, and Robert Murphy of CBO provided helpful comments, as did Robert J. Yetman of the University of California, Davis. (The assistance of external participants implies no responsibility for the final product, which rests solely with CBO.)

Christian Spoor edited the manuscript, and John Skeen proofread it. Maureen Costantino prepared the paper for publication. Lenny Skutnik produced the printed copies, and Simone Thomas prepared the electronic version for CBO's Web site (www.cbo.gov).

Douglas Holtz-Eakin
Director

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Summary

In the United States, most goods and services are produced by private firms and paid for through private transactions, and most of the income from those transactions is subject to federal corporate or individual income taxes. Some institutions, however, are like private businesses in that they sell goods or services to generate revenue for their operations, but their income is not taxed by the federal government at either the corporate or the individual level. Those institutions include many nonprofit organizations (such as hospitals and universities), various types of cooperatives (including credit unions), and business enterprises owned by state or local governments (such as utilities). The tax treatment of that "untaxed business sector" has been a topic of considerable debate.

Subjecting the entities in that sector to corporate income taxes would be unlikely to raise as much revenue as the size of the sector suggests, mainly because those entities' organizational structure would allow them to avoid taxation in ways that for-profit companies find infeasible. Those tax-avoidance actions would reduce national income. They would also lower the entities' accumulation of internal capital, making them more dependent on external capital for growth.

Characteristics of the Untaxed Business Sector

Nonprofit organizations are exempt from income taxation if they are operated for charitable, religious, educational, or other purposes specified in section 501(c) of the Internal Revenue Code. Nevertheless, a number of nonprofit organizations are indistinguishable from businesses: they sell goods or services and use the receipts as the principal means of financing their activities. The two main types of nonprofits in that category are health care facilities and private colleges and universities. Even among nonprofit organizations that are less dependent on the sale of goods or services for their financing, a number supplement their funding with sales of goods or services that are unrelated to their mission. And although business income not related to a nonprofit's mission is subject to tax, much of it escapes taxation.

Cooperatives are businesses that are owned by their clients (whether producers, consumers, workers, or group purchasers). They include credit unions, some telephone and electric companies, and such nationally known firms as Land O'Lakes, Welch's, REI, and Ace Hardware. Cooperatives are exempt from taxation under several provisions of the tax code, including sections 501(c) and 1381.

State and local business enterprises include most public electric, water, and gas utilities, which appear to be akin to business entities, and numerous other state and local activities (such as operating liquor stores, lotteries, and municipal golf courses) that are financed primarily with charges and fees. Such enterprises are tax-exempt under section 115 of the tax code.

The value added to the economy by the untaxed business sector represents at least 5.3 percent of net national product, the Congressional Budget Office (CBO) estimates.[1] Of that amount, nonprofit organizations that provide private goods—and thus may not be providing social benefits in exchange for their tax exemption—account for about 3.4 percent of the economy's net value added. State and local business enterprises represent about 1.4 percent. And cooperatives in four industries—credit unions, water, electricity, and telephones (the only ones for which data are readily available)—account for about 0.5 percent of net value added.

Consequences of Taxing the Untaxed Business Sector

Some people believe it would be desirable to subject untaxed entities that resemble businesses to the same income taxation as their for-profit competitors. The probable consequences of such a policy for federal revenue and the economy stem from the organizational structure of those untaxed entities. In the case of for-profit firms, shareholders demand that any surplus income in excess of expenses be distributed to them as dividends or retained as accumulated earnings. Those firms react to taxes by trying to shift them to customers in the form of

1. Net national product is gross national product (or GNP) minus depreciation.

higher prices or to employees in the form of lower compensation. With untaxed entities, however, the absence of shareholders would give managers other options for avoiding income taxes: reducing their taxable surplus by lowering their prices and by increasing compensation or other costs.

Because of their structure, untaxed entities would be likely to yield less tax revenue than their share of economic activity might suggest. To shrink their surplus and avoid taxation, state and local business enterprises could assume the costs of closely related nontaxable entities; nonprofit organizations and cooperatives could increase borrowing and deduct the associated interest expenses; and all of those entities could distribute more of their surplus as price reductions and cost increases. The last two reactions might surprise both proponents and opponents of income taxation. For-profit firms that favor taxing untaxed entities as a way to level the competitive playing field might find that their competitors' prices were reduced even further. Similarly, people who oppose taxation on the grounds that it would cause untaxed entities to raise the prices of socially beneficial services might find those prices falling instead. People who favor taxation as a way to reduce waste might find some entities avoiding the tax by passing on more of their surplus in the form of above-market compensation or other expenses.

Those reactions by newly taxed entities could impose a broader economic cost. Price reductions could encourage excess consumption, and cost increases would mean that more resources than necessary were used to produce a good or service. Both outcomes would reduce national income by diverting resources away from goods and services with a higher value than those being provided by the newly taxed entities.

Over time, however, taxing the untaxed business sector might ultimately achieve its objectives. Additional price reductions or cost increases would reduce retained earnings, thus significantly curtailing the accumulation of internal capital. As a result, those entities' growth would be determined by their access to external capital.

A lesson from CBO's analysis is that the market presence and impact of the untaxed business sector do not result solely from the sector's exemption from income taxes—they also derive from the organizational structure of entities in the sector, especially the absence of shareholders who demand that any surplus be distributed as dividends or retained as earnings. And an entity's choice of organizational structure is made within a welter of state laws and regulations that are beyond the control of the federal government.

Taxing the Untaxed Business Sector

Nonprofit organizations, cooperatives, and enterprises owned by state and local governments are neither private nor conventional public entities, and all are exempt from federal taxation at the entity level. Those tax exemptions have been enacted for a variety of reasons, sometimes so long ago that the original circumstances have changed substantially. Regardless of the rationale, an exemption from taxation raises concerns about economic efficiency and fairness.

This paper describes the activities of the untaxed business sector and (insofar as possible) the degree to which the value added by that sector escapes taxation. The paper also examines the likely revenue and economic effects of taxing the income of that sector at the entity level.

The Tax Treatment of Different Kinds of Businesses

The Internal Revenue Code subjects the surplus (the value added from equity capital and entrepreneurship) generated by most business activity to the income tax. Firms that are organized under the tax code as C corporations have their profits taxed once at the corporate level and a second time at the individual level, when the profits are received as dividends or capital gains. Firms that are organized as proprietorships, partnerships, limited liability companies, S corporations, and other "pass-through" entities are not subject to the corporate tax. However, the surplus they generate is taxed at the individual level.[1] For the purposes of this analysis, untaxed entities are defined as those that receive an explicit exemption from corporate taxation without there being any mechanism to impose the individual income tax on the income that escapes taxation at the entity level.

1. The advantage that pass-through entities receive from that treatment is considerable. In 2003, for example, the effective tax rate on investments made at the corporate level was 32 percent (reflecting taxation at both the entity and individual levels), whereas the rate on investments made by unincorporated entities was 18 percent. See Jane G. Gravelle, *Historical Effective Marginal Tax Rates on Capital Income*, Report RS21706 (Congressional Research Service, January 12, 2004), p. 6.

No institution in the economy is totally exempt from federal taxation. For example, nonprofits, cooperatives, and even state and local governments nominally pay half of Medicare taxes, and sometimes Social Security taxes, for their employees. Indirectly, those institutions pay other, minor taxes, such as excise taxes, that are included in the prices of inputs they purchase.

Income from unincorporated businesses (such as proprietorships, partnerships, and limited liability companies) is generally comprehensively taxed.[2] All of the profits of such a business are attributed to the owners and taxed at the individual level, regardless of whether those profits are reinvested in the enterprise or paid back to owners for their immediate use. That comprehensive taxation of income is facilitated by the congruence of an unincorporated business and its owners: the owners *are* the business, and the income from such businesses is reported on individual income tax returns.

A corporation, by contrast, has a legal identity separate from its owners. It frequently retains some of its profits for reinvestment while distributing the rest to the owners as dividends. Reinvested profits typically increase the value of the business and become accrued capital gains (gains in the value of the ownership shares). Unless otherwise allowed for, only dividends distributed by the corporation are taxed by the individual income tax when they accrue. Partly as a consequence of that treatment, the corporation's profits are subject to their own income tax. If not for that corporate tax, retained earnings would avoid the income tax until shareholders sold their shares and realized a capital gain—an event that might never occur.

Some corporations may organize under subchapter S of the tax code, which establishes treatment similar to that for noncorporate entities. All profits are treated as distributed to the shareholders regardless of how much is retained. Analogous treatment exists for regulated investment companies (RICs) and real estate investment trusts (REITs).

2. This discussion ignores issues of compliance; it refers to legal tax liability, not actual taxes paid.

Whether an enterprise is an unincorporated business, C corporation, S corporation, RIC, or REIT, the tax code has mechanisms for imposing an income tax (however unevenly) on the value that institution adds to the economy. Provisions exist to ensure that income generated by businesses not subject to entity-level taxation is still taxed at the individual level as if it were entirely passed through to the owners.

Nonprofits, cooperatives, and state and local business enterprises are not subject to analogous taxing mechanisms.[3] As a result, they can engage in activities that generate business-like revenue that is reinvested without being taxed. For the purpose of this analysis, those entities' business activities are defined as the process of selling goods or services that are largely financed through voluntary consumer purchases—in contrast to government activity that is financed through taxes or private activity that is financed through voluntary donations.

Entities in the Untaxed Business Sector

This report focuses on tax-exempt nonprofits, cooperatives, and state and local government entities that are, in essential ways, indistinguishable from private businesses: they produce goods or services and sell them to customers for a fee, often in markets in which they face some direct competition from taxed businesses. Examples of such entities include nonprofit hospitals and universities, credit unions and other cooperative enterprises, and various state or local utilities.

Nonprofit Businesses

Nonprofit institutions are exempt from federal income taxation under section 501(c) of the Internal Revenue Code. (Some of the institutions spelled out in that section are classified as cooperatives; they are discussed below.) Nonprofits that qualify for tax exemption under section 501(c)(3)—those operated for religious, charitable, scientific, literary, or educational purposes; to conduct testing for public safety; to foster amateur sports competition; or to prevent cruelty to animals or children—benefit from other tax preferences as well. The contributions they receive from donors are deductible from the donors' taxable income, and in many cases, they have the authority to borrow by issuing bonds whose income is tax-exempt. Other subsections of 501(c) apply to civic and business leagues, clubs, and fraternal and veterans' organizations, among others. The only tax preference that those types of nonprofits receive, however, is exemption from income taxation.

Nonprofit institutions may be thought of as providing three types of goods or services.[4] The first type is those that are difficult to sell in private markets, such as the basic research performed in some university laboratories. The second type is goods or services that are the same as those sold in the private market but that nonprofits sell at a below-market price or provide for free, such as housing for low-income people. The third type is goods or services that nonprofits sell in the private market at market prices. The income earned from that commercial activity allows nonprofits to cross-subsidize their provision of the first two types of goods or services. When a nonprofit's income is deemed to be unrelated to the organization's exempt purpose, that income is subject to corporate income taxation under section 511 of the code. The tax generally applies even if the income is used to further the organization's exempt purpose.[5]

Hospitals. Nonprofit hospitals are not explicitly listed as tax-exempt organizations in section 501(c)(3); their exemption is based on their eligibility to receive charitable contributions as enumerated in section 170(b). The interpretation of charitable activity has evolved in response to changes in the practice of medicine, the financing of medical care, and the nature of health care institutions.[6] It remains a contentious issue.

A 1923 ruling by the Internal Revenue Service (IRS) defined the term "charitable" narrowly as the relief of poverty. In 1956, in the absence of a statutory definition

3. As explained later in the paper, earnings of some cooperatives are subject to taxation as though they were distributed. That provision is limited, however.

4. See Burton A. Weisbrod, "The Nonprofit Mission and Its Financing: Growing Links Between Nonprofits and the Rest of the Economy," in Burton A. Weisbrod, ed., *To Profit or Not to Profit: The Commercial Transformation of the Nonprofit Sector* (Cambridge, England: Cambridge University Press, 1998), pp. 1-22.

5. Some unrelated income is tax-exempt, such as income from activities performed by volunteer labor, from the sale of merchandise received as a gift or contribution, from the operation of certain games of chance, and from business-sponsorship payments. All royalty income and investment income is also excluded from taxation, as is income earned from the sale of an organization's mailing list.

6. See Congressional Budget Office, *Health Care Trends and the Tax Treatment of Health Care Institutions* (August 1994), pp. 14-19.

of charitable, the IRS ruled that to qualify for tax exemption, a nonprofit hospital "must to the extent of its financial ability, be operated for those not able to pay for care. It may not be operated exclusively for those able to pay, and may not refuse patients who cannot pay for care."[7] In several instances, the IRS further ruled that hospitals that provided free treatment for less than 5 percent of their patients did not qualify for tax exemption. However, that financial-ability standard was typically interpreted broadly enough that a hospital might provide no charitable care (if there was no local demand for it) and still meet the operational test for tax exemption as long as the hospital did not refuse to admit anyone who was unable to pay.[8]

In 1969, the IRS replaced the financial-ability standard with a "community-benefit standard," which removed the requirement related to caring for patients at no charge or at below-cost rates and substituted the provision of benefits to a community as a whole (such as educating the community about health risks).[9] That ruling has been controversial. The following year, the Senate Finance Committee issued a staff report (which was never acted upon) recommending that the new standard be replaced with a financial-ability standard.[10] In 1973, patients who had been refused treatment because of inability to pay filed a lawsuit against nonprofit hospitals, challenging the community-benefit standard. The U.S. Court of Appeals for the D.C. Circuit concluded that the standard was founded on a permissible definition of charity and that the rationale for the previous, limited definition of charitable had been largely eliminated by the creation of Medicare and Medicaid, the growth of medical and hospital insurance, and state and local provision of nonemergency hospital and medical care for the poor.[11]

The issue of the community-benefit standard and its effect on nonprofit hospitals' provision of social benefits continues to spark debate. The House Ways and Means Committee revisited the issue in a hearing on May 26, 2005.[12] In testimony for that hearing, the Government Accountability Office (GAO) reported on its recent examination of whether the levels of uncompensated care and other community benefits provided by nonprofit hospitals differ from those of other hospitals. GAO concluded that nonprofit hospitals provide slightly more uncompensated care than for-profit hospitals but considerably less than government hospitals.[13]

During the past year, numerous lawsuits have been filed against nonprofit hospitals charging them with failing to fulfill their mission to provide charitable care in exchange for their exemption from federal income taxation. The lawsuits maintain that insured patients—generally those least in need of charitable care—are charged the full price, with a lesser amount (negotiated with insurers) accepted as full payment. In contrast, uninsured patients—generally those most in need of charitable care—are both charged and expected to pay the full price. Nonprofit hospitals count as charitable care not only uncollected amounts from uninsured patients but also the savings negotiated by insurers on behalf of insured (noncharity) patients. To date, those lawsuits have been unsuccessful.[14]

7. Revenue Ruling 56-185, 1956-1 C.B. 202, 203.

8. Note, "Federal Income Tax Exemption for Private Hospitals," *Fordham Law Review*, vol. 36, no. 4 (May 1968), p. 758.

9. Revenue Ruling 69-545, 1969-2 C.B. 117.

10. Senate Finance Committee, *Medicare and Medicaid: Problems, Issues, and Alternatives*, Report of the Staff, 91st Congress, 1st session (1970).

11. *Eastern Kentucky Welfare Rights Organization v. Simon*, 506 F. 2d 1278, 1287-1290 (D.C. Circuit, 1974), vacated on other grounds, 426 U.S. 26 (1976).

12. At the hearing, the Chairman of the Ways and Means Committee suggested that the advent of federally funded payments for indigent care through Medicaid and Medicare encouraged for-profit firms to enter the hospital industry, making it harder to distinguish between the activities of nonprofit and for-profit health care providers. Nonprofit hospitals now justify their tax-exempt status through the community-benefit standard's relatively broad definition of charity. See the statement of William Thomas, Chairman, before the House Ways and Means Committee, May 26, 2005; and "House Tax Panel Chairman Says Exemption for Hospitals Becoming Difficult to Justify," *Daily Report for Executives*, no. 102 (May 27, 2005), p. G-1.

13. Government Accountability Office, *Nonprofit, For-Profit, and Government Hospitals: Uncompensated Care and Other Community Benefits*, GAO-05-743T (May 26, 2005).

14. See, for example, *Washington v. Medical Center of Central Ga.*, 2005 U.S. Dist. LEXIS 2614 (M.D. Ga. 2005); *Peterson v. Fairview Health Services*, 2005 U.S. Dist. LEXIS 1962 (D. Minn. 2005); *Schmitt v. Protestant Memorial Med. Ctr.*, 2005 U.S. Dist. LEXIS 7449 (S.D. Ill. 2005); *Sabeta v. Baptist Hospital of Miami*, 2005 U.S. Dist. LEXIS 6132 (S.D. Fla. 2005); *Wright v. St. Dominic Health Services, Inc.*, 2005 U.S. Dist. LEXIS 8086 (S.D. Miss. Mar. 1, 2005); and *Quinn v. BJC Health Sys.*, 2005 U.S. Dist. LEXIS 7910 (E.D. Mo. Mar. 1, 2005).

Higher Education. Two business activities of nonprofit colleges and universities have received considerable attention: research in areas that may have substantial opportunities for licensing and patenting (rather than basic research whose results are available to everyone without compensation), and sports teams that compete with professional teams for the dollars of advertisers and sports fans.[15]

Amendments to the Patent and Trademark Act in 1980 paved the way for universities to profit from the research conducted by their faculty.[16] Those amendments allowed universities, nonprofit institutions, and small businesses to retain the property rights to inventions derived from federally funded research, making it easier and more desirable for them to treat university research as a profit-making opportunity.

Educational institutions have responded to those incentives. Most research universities have an office responsible for encouraging and exploiting the commercial potential of faculty research. Industry funding for academic research grew from $264 million in 1980 to $2 billion in 2001. Moreover, in 2002, universities earned nearly $1 billion in licensing and royalty income from commercialized academic inventions.[17]

Many commentators have suggested that a more profit-oriented research agenda could compromise a university's tax-exempt educational mission. As expressed by two analysts:

> Changes that entail the use of market-based criteria (e.g. more focus on patenting and licensing) to evaluate the "merits" of research may, in unanticipated ways, lead to a corrosion of the mission of research universities, undercutting public trust in them. Such developments could, then, erode the very features that have made U.S. research universities unparalleled contributors to both intellectual and commercial advance.[18]

The role of sports in higher education has long been the subject of controversy. College football and basketball, in particular, are seen by many people as commercial enterprises. They compete for television time and advertising revenue with professional sports. When the IRS tried to tax universities' receipts from corporate title sponsorship (such as Mobil Corporation's payments to attach its name to the Cotton Bowl) as the sale of advertising that constituted unrelated taxable business activity, universities relied on their nonprofit status as pursuers of an educational exempt mission to successfully lobby the government to overturn the IRS's ruling.[19]

Cooperatives

A cooperative is a business that has an obligation to pay any surplus to the owners of its shares, who are usually its clients (whether suppliers, consumers, or employees). The most important class of cooperatives is credit unions, which have about 86 million members in the United States and assets of more than $600 billion. Federally chartered credit unions are exempt from entity-level taxation under section 501(c)(1) of the tax code.[20] State-chartered credit unions and other state-chartered mutual-style organizations that offer financial services are exempt under section 501(c)(14).[21]

Another major category of cooperatives is described in sections 1381(a)(2)(C) and 501(c)(12) of the tax code. It

15. Some people argue that even the basic "mission" of higher education—offering courses—represents the sale of a private good that benefits the student making the investment. Some 40 for-profit accredited institutions of higher education that grant degrees were listed on U.S. stock exchanges in 1999. The five largest enrolled a total of 187,500 students on 204 campuses. See Richard S. Ruch, *Higher Ed, Inc.: The Rise of the For-Profit University* (Baltimore: Johns Hopkins University Press, 2001), p. 28.

16. Public Law 96-517; 35 U.S.C. 18.

17. Jennifer Washburn, *University, Inc.: The Corporate Corruption of American Higher Education* (New York: Basic Books, 2005), pp. 139, 142.

18. Walter Powell and Jason Owen-Smith, "Universities as Creators and Retailers of Intellectual Property: Life-Sciences Research and Commercial Development," in Weisbrod, ed., *To Profit or Not to Profit*, p. 193.

19. Andrew Zimbalist, *Unpaid Professionals: Commercialism and Conflict in Big-Time College Sports* (Princeton, N.J.: Princeton University Press, 1999), p. 5.

20. The evolution and taxation of cooperatives is described in David J. Shakow, "From Rochdale Principles to LLCs: The Ongoing Evolution of the Cooperative Structure," *Tax Notes*, vol. 104, no. 5 (August 2, 2004), pp. 535-553.

21. Analogous mutual-type organizations that provide other services are covered under other sections, such as 501(c)(9) and 501(c)(13). Those organizations are of minor economic significance.

includes cooperative telephone companies, electric companies authorized under the Rural Electrification Act of 1936, and similar organizations. Those cooperatives' earnings are not taxed at the entity level as long as at least 85 percent of their income is collected from members. (Certain types of income, such as from renting the use of their utility poles, is not included in that calculation.)

In addition, various types of cooperatives are organized under subchapter T of the tax code. Consumer-owned cooperatives sell products to their owner-members. Examples include recreation equipment retailer REI (the nation's largest consumer cooperative, with more than 2 million members) and numerous local grocery cooperatives. Producer-owned cooperatives market a wide variety of their owners' goods or services; they encompass farmers selling dairy products (Land O' Lakes) or juice (Welch's) and artists selling their art work. Purchasing or shared-services cooperatives usually comprise independent retailers, such as ACE hardware stores or Southern States farm-supply stores, that join together to buy inputs. Employee-owned cooperatives include a variety of local businesses.

Provisions exist in the tax code to tax the surplus of cooperatives organized under subchapter T. Patronage earnings (those derived from members' business with the cooperative) are paid to the cooperative's patrons either as cash or as IOUs called "qualified written notices of allocation." The term "qualified" means that the patron agrees to include the allocation in his or her taxable income. Patronage earnings that are not disbursed as cash or qualified allocations are taxable to the cooperative, and patrons take a credit against that tax when the earnings are finally allocated. Nonpatronage earnings are taxed at the entity level (except in the case of some farmers' cooperatives) and also when distributed to members. Surplus returned in the form of lower prices to retail consumers, however, is not taxed. (That issue is discussed in more detail later in the paper.)

Businesses Owned by State and Local Governments

Section 115 of the tax code excludes from taxation the net income that state and local governments derive from operating any public utility or exercising any "essential governmental function." That provision, as interpreted and enforced by the IRS, allows state and local governments to engage in activities that are virtually indistinguishable from private businesses, except in their tax treatment. The most common examples are electric, water, and gas utilities, which have many analogues in the private sector, as well as sewer utilities and solid-waste collection services, which have fewer private counterparts.[22] Recently, some cities have also begun setting up utilities to provide Internet services.[23] In addition, states and localities operate a number of businesses related to transportation (parking garages, ferry boats, wharves, airports) and recreation (swimming pools, golf courses, hotels). States also engage in a variety of miscellaneous commercial activities. For example, the government of North Dakota owns and operates a commercial bank and a flour mill, and the state of Massachusetts owns a company that manufactures vaccines.

As with cooperatives, a relationship exists between the owners and patrons of government-run business enterprises. Elected officials and the managers of those enterprises must distribute any earnings to the citizen-members of the community, although that distribution does not take the form of explicit patronage allocations. Instead, earnings are distributed in the form of reduced prices for customers, increased employment and higher wages for managers and employees, and increased public services or reduced general-fund tax payments.

States and localities operate some businesses specifically to generate revenue to finance government activities. Those businesses—from liquor stores to lotteries—are set up to be operated as monopolies, and most of the resulting revenue resembles taxes more than business profits. Imposing a federal tax on those businesses would have the effect of imposing a federal tax on state excise taxes. For example, a state running a lottery makes money by prohibiting competing private lotteries and charging a higher price (by means of a lower payout ratio) than would be the case in a competitive market. It could achieve much

22. The issue of whether the public sector or the private sector should provide utility services has long been the subject of debate. See, for example, Edward W. Bemis, "Municipal Ownership of Gas in the United States," *Report of the Proceedings of the American Economic Association at the Fourth Annual Meeting* (Baltimore: American Economic Association, 1891), pp. 287-472. The House of Representatives issued a report on public enterprises in 1933: House of Representatives, *Report of the Special Committee Appointed to Investigate Government Competition with Private Enterprise*, Report 1985, 72nd Congress, 2nd session (1933).

23. See Sharon E. Gillett, William H. Lehr, and Carlos Osorio, *Local Government Broadband Initiatives*, Working Paper (Cambridge, Mass.: Massachusetts Institute of Technology, Program on Internet and Telecoms Convergence, December 3, 2003).

the same outcome by allowing private lotteries and imposing a tax on them. If a state chose to legalize and tax lotteries, the tax it collected would not be subject to federal taxation. Consequently, equivalent treatment for a state-run lottery would be to tax only that part of the state's revenue that corresponded to the profit that a private lottery would earn.

The Size of the Untaxed Business Sector

According to the national income and product accounts compiled by the Bureau of Economic Analysis, nonprofit institutions that serve households—most 501(c)(3) organizations and many other 501(c) entities—generated $483 billion of net value added in 2002, or 5.3 percent of net domestic product.[24] State and local governments generated $749 billion of net value added in that year, or 8.2 percent of net domestic product. Cooperatives' value added is not reported separately from the rest of the business sector's, which totaled $7,127 billion of net value added, or 77.5 percent of net domestic product. However, cooperatives undoubtedly account for only a small portion of that total.

The information below focuses not on the entire nonprofit, cooperative, and state and local sectors but only on untaxed entities that act very similarly to business entities.

Nonprofit Businesses

For-profit companies earn their money primarily from sales and some investment income; those amounts must exceed their expenditures if they are to make a profit. Nonprofit entities are different. Their revenue from selling goods or services related to their programs, plus their investment income, typically falls short of their program-service spending. That shortfall is usually made up by donations and grants.

The gap filled by donations and grants is sometimes not as large as might be expected, however.[25] According to data on the 240,000 section-501(c) nonprofits that filed information returns (form 990) with the IRS in 2001, health-related nonprofits as a whole received 92 percent of their $436 billion in revenue from selling program services (see Table 1). Education organizations received 54 percent of their $146 billion in revenue from such sales. Nonprofits working in the areas of housing, scientific research, mental health, and human services also received more than half of their revenue from selling program services, although their total revenue was much smaller.

Looking only at areas of activity with a high overall percentage of revenue from sales masks the fact that all areas contain some nonprofits that receive at least three-quarters of their revenue from selling program services. For example, although, as a whole, nonprofits working in the area of environmental quality, protection, and beautification received just 19 percent of their revenue from the sale of program services in 2001, 9 percent of the category's total revenue belonged to organizations that received at least 75 percent of their revenue from such sales (see Table 1).

For the purposes of this analysis, nonprofits with that high a proportion of program-service revenue are considered entities that may be performing tasks similar to ones in the for-profit sector. Those entities account for 65 percent of the revenue of the entire nonprofit sector. If their share of the sector's net value added is proportional to their share of total revenue, the value added by nonprofits that might be providing private-sector goods or services is $314 billion, or 3.4 percent of net domestic product.

Cooperatives

The value added by cooperatives is difficult to estimate because information about those entities is not reported separately in the national income and product accounts but rather is included as part of the business sector. The IRS also does not provide separate data on cooperatives. Therefore, the Congressional Budget Office (CBO) could not estimate cooperatives' total contribution to net domestic product.

Many cooperatives' income is taxed at the individual level. This analysis looked at four categories of coopera-

24. The numbers in this paragraph come from Charles Ian Mead, Clinton P. McCully, and Marshall B. Reinsdorf, "Income and Outlays of Households and of Nonprofit Institutions Serving Households," *Survey of Current Business* (April 2003), pp. 13-17, available at www.bea.gov/bea/ARTICLES/2003/04April/0403household.pdf.

25. Other analyses have also used donations as a filter to separate nonprofits that are providing public benefits from those that are providing private goods. See John D. Colombo, "Why Is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)," *Arizona Law Review* (Winter 1993).

Table 1.

Nonprofit Organizations' Revenue from Program Services as a Share of Total Revenue, 2001

Area of Activity[a]	All Nonprofits: Total Revenue (Billions of dollars)	All Nonprofits: Program Revenue as a Percentage of Total Revenue	Nonprofits Whose Program-Revenue Share Exceeds 75 Percent: Total Revenue (Billions of dollars)	Nonprofits Whose Program-Revenue Share Exceeds 75 Percent: Total Revenue as a Percentage of All Nonprofits' Total Revenue
Health Care	435.7	91.7	406.2	93.2
Housing and Shelter	11.9	60.8	6.3	52.6
Science and Technology Research Institutes and Services	8.5	60.3	4.2	48.8
Mental Health and Crisis Intervention	15.4	59.5	7.4	48.0
Human Services (Multipurpose and other)	75.8	53.7	33.5	44.3
Employment and Job-Related	7.9	48.8	3.1	39.6
Public and Societal Benefit (Multipurpose and other)	5.1	41.3	1.8	36.5
Recreation, Sports, Leisure, and Athletics	6.3	47.4	2.3	36.4
Religion-Related and Spiritual Development	9.8	39.8	3.4	34.7
Diseases, Disorders, and Medical Disciplines	11.1	40.9	3.7	33.6
Education	145.9	53.8	44.1	30.2
Crime and Legal-Related	4.5	27.6	1.0	22.6
Community Improvement and Capacity Building	11.6	27.6	2.3	19.5
Medical Research	6.7	24.9	1.3	19.5
Public Safety	1.1	25.7	0.2	18.4
Philanthropy, Voluntarism, and Grantmaking Foundations	0.4	24.5	0.1	15.2
Youth Development	4.9	23.1	0.5	10.4
Social Science Research Institutes and Services	1.8	20.7	0.2	10.0
Environmental Quality, Protection, and Beautification	5.2	19.0	0.5	8.8
Food, Agriculture, and Nutrition	3.9	14.0	0.3	8.5
Arts, Culture, and Humanities	22.5	26.7	1.8	8.2
International, Foreign Affairs, and National Security	7.3	10.2	0.6	7.9
Civil Rights, Social Action, and Advocacy	1.5	14.6	0.1	7.1
Animal-Related	3.4	21.5	0.1	3.6
Unknown	0.9	68.2	0.6	70.4
Total	**809.0**	**71.2**	**525.6**	**65.0**

Source: Congressional Budget Office based on data from Internal Revenue Service Form 990, as reported by the National Center for Charitable Statistics.

a. Classifications come from the National Taxonomy of Exempt Entities.

Table 2.

Total Revenue of Cooperatives and State and Local Business Enterprises

	Total Revenue (Billions of dollars)
Cooperatives	
Electricity Cooperatives[a]	37.0
Credit Unions[b]	36.3
Telephone Cooperatives[a]	2.2
Water Cooperatives[c]	1.5
Total	**77.0**
Business Enterprises Run by State and Local Governments[d]	
Utilities	
Electricity	54.4
Water	33.2
Gas	5.8
Subtotal	93.4
Other Activities	
Hospitals	65.6
Higher education	61.4
Lotteries (Net revenue)	15.9
Air transport	12.3
Solid-waste management	11.2
Parks and recreation	7.0
Toll highways	6.0
Liquor stores	5.1
Special assessments	4.8
Water transport	2.7
Parking	1.4
Miscellaneous	0.4
Subtotal	193.8
Total	**287.2**

Source: Congressional Budget Office based on data from the Department of Commerce's Bureau of the Census, the Department of Energy's Energy Information Administration, the National Credit Union Administration, the National Telecommunications Cooperative Association, and the Environmental Protection Agency.

a. 2002 data.

b. 2003 data.

c. 2000 data.

d. Fiscal year 2002 data.

tives that are generally exempt from both entity-level and individual taxation: electricity cooperatives, credit unions, telephone cooperatives, and water cooperatives. Some information about those types of cooperatives is available from various associations and federal agencies. It indicates that, together, those entities earn about $77 billion in annual revenue (see Table 2), or 0.5 percent of the total output of U.S. industries. If those cooperatives' share of total industry value added is proportional to their share of total output, their value added amounted to $32.1 billion in 2002.[26]

Businesses Owned by State and Local Governments

The state and local sector received a total of $93 billion in sales revenue in fiscal year 2002 from operating water, electric, and gas utilities. All of that revenue arose from sales. State and local governments also received $419 billion in charges and miscellaneous revenue from such activities as operating hospitals, toll highways, lotteries, and solid-waste facilities, as well as $5 billion from liquor stores. On the basis of the nature of those activities, CBO estimates that $194 billion of that revenue arose from the sale of goods. That amount, plus the revenue from sales by utilities, totaled $287 billion (see Table 2)—or 17 percent of the sector's general revenue of $1,685 billion.

If those activities' share of state and local net value added is proportional to their share of total revenue, the value added by state and local entities that might be performing tasks similar to those in the for-profit sector is $127.4 billion (see Table 3). That figure represents 1.4 percent of net domestic product.

Revenue Consequences of Taxing the Untaxed Business Sector

Not all income generated by the untaxed business sector goes completely untaxed. Moreover, subjecting the institutions in that sector to an entity-level tax might raise less revenue than the size of the sector would suggest. To

26. In principle, cooperatives' value added might be calculated by determining their share of output in each of the four industries (as measured by revenue) and multiplying that share by the total value added in the particular industry. However, although the national income and product accounts provide sufficiently detailed data on industry output for such a calculation, the value-added data are not available at that level of detail.

Table 3.

The Untaxed Business Sector's Share of U.S. Net Domestic Product, 2002

Net Value Added	Entire Sector: Billions of Dollars	Entire Sector: Percentage of Net Domestic Product	Portion of Sector Providing Private Goods or Services[a]: Billions of Dollars	Portion of Sector Providing Private Goods or Services[a]: Percentage of Net Domestic Product
United States as a Whole (Net domestic product)	9,192.2	100.0	n.a.	n.a.
Untaxed Business Sector				
Nonprofits serving households[b]	483.1	5.3	314.0	3.4
Cooperatives (Four industries)[c]	n.a.	n.a.	32.1	0.5
State and local government	749.3	8.2	127.4	1.4

Source: Congressional Budget Office based on data from the national income and product accounts compiled by the Bureau of Economic Analysis and from the sources cited in Tables 1 and 2.

Note: n.a. = not applicable.

a. Defined in this analysis as nonprofit organizations that receive at least 75 percent of their revenue from sales of program services, all cooperatives in the four industries included here, and the state and local business activities shown in Table 2.

b. As defined in the national income and product accounts, nonprofits serving households comprise most nonprofit organizations that are exempt from federal income taxation under section 501(c)(3) of the tax code and many organizations that are tax-exempt under other parts of section 501(c).

c. Credit unions and electricity, telephone, and water cooperatives.

understand why, it is useful to examine the nature of the income in question, how it can be distributed, and how that distribution differs between for-profit firms and the untaxed business sector.

Income Generated by Entities in the Sector

Every successful business that sells a good or service generates value added, which is traceable to the contribution of nonborrowed capital and entrepreneurship to the production process. After a for-profit firm pays taxes on that profit, the pressures associated with competition and private ownership force it to either distribute the per-unit after-tax profit to its shareholders or retain (reinvest) that profit in the firm. It does not use the profit to lower its prices or increase its costs, because those actions would diminish the value of the firm to shareholders, who are in a position to oppose and prevent such actions.

An untaxed entity that charges the same prices and faces the same costs as its for-profit competitors must also decide what to do with its surplus. However, it is not beholden to shareholders. A nonprofit organization can do three things with its surplus: retain the surplus as savings, lower the prices or increase the availability of the goods or services it sells, or pay its managers and employees higher wages than they would otherwise receive. In other words, a nonprofit may retain some of its surplus just as a for-profit firm would, but it may also distribute that surplus to its workers or customers in a way that a for-profit company could not. The decision about how to divide the surplus among those three options will depend on their relative benefits to the organization.

In the case of cooperatives, the owners are also the clients. Consequently, a cooperative has the option to pass on its surplus to its owners through lower prices instead of through profits. In the case of state and local governments that own businesses, their constituency is members of the public who are simultaneously taxpaying "owners," rate-paying customers, and employees receiving compensation. Thus, those governments can retain any surplus in the business as savings or distribute it to customers as lower prices, to employees and managers as higher wages, or to voters as lower taxes.

Income Already Subject to Taxation

Because of how they can distribute their surplus, entities in the untaxed business sector have significant amounts of that surplus subject to federal income taxation. Any surplus that is distributed to employees as higher wages is taxed by the individual income tax.[27] Any that is distributed as lower prices is taxed by the corporate (or in some cases the individual) income tax to the extent that those lower prices reduce the costs of inputs for other businesses.

Benefits received by retail customers in the form of lower prices generally escape taxation, but that is not true in all cases. For example, any surplus that is passed to the patrons of credit unions in the form of higher interest payments is taxed by the individual income tax. Some surplus of nonprofits that is passed on to consumers as lower prices, such as reduced hospital charges, may be taxed indirectly if those lower prices lessen the recipients' itemized medical deductions or reduce the share of workers' compensation that is made up of tax-exempt employer-paid health insurance. Likewise, any surplus used by a municipally owned utility to reduce local taxes that are deductible against federal taxable income will be taxed indirectly.[28]

Effects of Imposing an Entity-Level Tax

A standard for-profit business has an incentive to avoid paying taxes on its surplus and can be expected to modify its behavior toward that end. One strategy is to finance its activities with more debt, whose interest expenses are deductible, and with less equity, whose costs are not deductible. Another strategy is pass the tax forward to consumers (as higher prices) or backward to employees (as lower compensation). However, the options for avoiding taxes in a cost-effective manner will be limited by circumstances and competitive pressures, such as the need to deliver a profit to shareholders.

Firms without conventional ownership, by contrast, have the ability to react differently to the imposition of an income tax. State and local business enterprises might be able to shift costs from their many other nontaxable activities to their taxable entity, thereby eliminating the tax liability. (Nonprofits and cooperatives that were subject to taxation but lacked closely related nontaxable entities would not have that ability.) An income tax would alter the cost of the options for using the surplus: adding to retained earnings would become more expensive than reducing prices or raising costs (such as compensation). A newly taxed entity might increase borrowing and use the deductible interest costs to lower its tax liability, thus preserving the previous equilibrium between retained earnings, price reductions, and cost increases. However, borrowing more raises other issues, including the costs it imposes: an increase in fixed liabilities leaves the entity more vulnerable should its economic health decline.[29] In the absence of shareholder-owners to demand that the surplus be reserved for their benefit, entities might decide to absorb more of the remaining taxable profit by reducing prices or increasing expenses further. Thus, in response to a tax, the combination of borrowing, price reductions, cost increases, and cost shifting is likely to shrink the potential tax base represented by the amount of economic activity in the untaxed business sector.[30] (Those options are illustrated in Box 1, using the example of a hypothetical municipal golf course.)

Efforts to minimize taxation can already be seen across the spectrum of nonprofit entities. Nonprofits providing services that cannot be provided by the private sector—those entities that CBO excluded from its measure of the untaxed business sector—frequently engage in other activities of a commercial nature that are unrelated to their exempt purpose. They face corporate income tax (the unrelated business income tax) on the profits from those private goods, even if the profits are used to subsidize the entity's exempt mission. In reaction to the possibility of that taxation, such nonprofits shift costs from

27. Rexford E. Santerre and John A. Vernon, in *Hospital Ownership Mix Efficiency in the U.S.: An Exploratory Study*, Working Paper No. 11192 (Cambridge, Mass.: National Bureau of Economic Research, March 2005), estimate that the tendency of nonprofit hospitals to absorb their surplus as higher costs sometimes outweighs the social benefits they provide in the purchase of hospital services.

28. In 1973, municipally owned electric utilities in North Carolina used more than 50 percent of their profits to finance tax reductions for residents. The share of profits devoted to tax reduction increased with the size of the municipality. Those tax benefits appear to have distorted the price of public goods as well as possibly lowered the price of electricity. See Robert P. Strauss and Kenneth L. Wertz, "The Impact of Municipal Electric Profits on Local Public Finance," *National Tax Journal*, vol. 26, no. 1 (1976), pp. 22-30.

29. Gerald J. Wedig, Mahmud Hassan, and Michael A. Morrisey, "Tax-Exempt Debt and the Capital Structure of Nonprofit Organizations: An Application to Hospitals," *Journal of Finance*, vol. 51, no. 4 (1996), pp. 1247-1283.

30. The role of price reductions and cost increases in estimating the likely revenue from taxing the income of nonprofit hospitals is raised in William M. Gentry and John R. Pound, *The Tax Benefits of Not-for-Profit Hospitals*, Working Paper No. 6435 (Cambridge, Mass.: National Bureau of Economic Research, February 1998).

Box 1.

Taxing the Surplus from a Hypothetical Municipal Golf Course

To illustrate how entities in the untaxed business sector might react to the imposition of an income tax, imagine a municipal golf course that is run as efficiently as a private competitor and charges the same price—say, $40 per round. The golf course incurs costs of $36 per round, leaving a surplus of $4.

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 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 corporate income taxes (assumed in this example to be 30 percent, or $1.20 per round).

Should a corporate tax be imposed on the municipal golf course, rather than pay it, the course might distribute the surplus to its customers as a price cut and charge only $36 per round. Costs would equal revenue, and there would no longer be a surplus to 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 remain at $40, but costs would be increased to $40, again leaving no surplus to tax. In that case, however, the $4 former surplus would be subject to individual income taxes. If the individual tax rate was 20 percent, only 80 cents would be collected, rather than the $1.20 collected from the for-profit competitor. The golf course's books would show the activity this way: $40 = $40 + 0.

Another option would be for the local government that owned the course to effectively move the $4 surplus into its 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.

the nontaxable activities that fulfill their exempt mission to their taxable unrelated business activities, thus decreasing their taxable surplus.[31]

That behavior is demonstrated by information on the current unrelated business income tax. In tax year 2000, more than 11,000 nonprofit 501(c)(3) organizations reported a total of $4.8 billion in gross unrelated business income. Those organizations reported total business deductions of about the same amount, for a net loss of $49,000. Fewer than half reported profits subject to taxation. The tax collected on that income was only $4.1 million.

Another example of tax-avoidance behavior can be seen among nonprofit and state and local student loan authorities. Those agencies issue tax-exempt bonds and use the bond proceeds to make loans to students to finance their college educations. The amount of agencies' arbitrage earnings—the difference between the interest income they earn from the student loans and their interest expenses on the tax-exempt bonds—is restricted by law. When the interaction of the interest rate rules of the student loan program and the interest rate on tax-exempt bonds causes arbitrage earnings to exceed the allowable amount, the excess must be returned to the U.S. Treasury. That usually does not happen, however. Student loan agencies react by eliminating those earnings in order to

31. Form 990 and 990-T returns from the 1990s indicate that nonprofits do respond to tax incentives by increasing their commercial activities. Those returns also show that a rise in unrelated business income leads to only minimal additional compensation costs for the nonprofit as a whole but increases the compensation costs allocated to taxable income. See Joseph Cordes and Burton A. Weisbrod, "Differential Taxation of Nonprofits and the Commercialization of Nonprofit Revenues," in Weisbrod, ed., *To Profit or Not to Profit*; Richard Sansing, "The Unrelated Business Income Tax, Cost Allocation, and Productive Efficiency," *National Tax Journal*, vol. 51, no. 2 (1998), pp. 291-302; and Robert J. Yetman, "Tax-Motivated Expense Allocations by Nonprofit Organizations," *Accounting Review*, vol. 76 (2001), pp. 297-311.

stay within the limits set by law. Either they reduce the interest rate charged to students (explicitly by lowering the rate or implicitly by forgiving some loan principal), or they pay a premium to commercial banking institutions to purchase student loans from their portfolios. In effect, student loan agencies lower the price of their loans or increase the cost of acquiring loans—exactly what this analysis predicts that untaxed business entities would do if they were subject to income taxation.

Of course, that extreme reaction reflects the 100 percent tax rate on arbitrage earnings over the allowable amount, whereas retaining a dollar of surplus when facing a 30 percent tax rate would leave an entity with savings of 70 cents. Most nonprofit and cooperative entities would probably engage in some combination of borrowing and reduction of retained earnings through price decreases and cost increases.

Revenue Estimates for Taxing Some Untaxed Entities

Estimates of the revenues that might result from taxing the untaxed business sector exist for relatively few of the entities discussed in this report. No estimates have been made for nonprofit entities, but estimates have been made for cooperatives in a few industries. Most recently, the Joint Committee on Taxation (JCT) estimated that taxing large credit unions (those with assets greater than $10 million) in the same way as C corporations would raise $6.5 billion over the five years from 2006 to 2010.[32] An earlier estimate suggested that taxing cooperative electric and telephone utilities would raise $0.5 billion between 2004 and 2008.[33] No estimates are available for other types of cooperatives.

Less attention has been paid to the business enterprises of the state and local sector. JCT has estimated that taxing public electric utilities would raise $3.6 billion over the 2006-2010 period.[34] No estimates exist for the revenues that might result from taxing other state- or locally owned businesses. Together, those estimates amount to about $2 billion of revenue per year. More-comprehensive estimates would probably predict a larger revenue gain.

Economic Consequences of Taxing the Untaxed Business Sector

To minimize their tax liability by delivering their surplus in another form would require nonprofits, cooperatives, and state and local business enterprises to change their behavior, and that change in behavior would have economic effects. As a result, the more successful those institutions were in avoiding the tax, the greater would be the economic consequences of imposing the tax.

Those consequences can seen most clearly in terms of the competitive position of untaxed entities relative to their taxed competitors. Currently, entities in the untaxed business sector may be perceived as having an advantage over taxed for-profit businesses because they can be expected to sell for less (and sustain higher costs of production), thus gaining market share. Advocates of taxing those entities assert that imposing comparable tax treatment would level the competitive field.[35]

As noted above, however, those institutions' response to taxation could be expected to differ substantially from that of a privately owned for-profit firm. In the near term, that response could also be quite different from the results that both advocates and opponents of taxation expect. For-profit firms that favor taxing the institutions as a way to level the playing field might find their competitors' prices being reduced even further. Likewise, people who oppose taxation on the grounds that it would cause institutions to raise the prices of socially beneficial services might discover those prices being lowered. People who favor taxation as a means of reducing waste might find that institutions avoided the tax by passing on more of their surplus in the form of higher compensation.

32. Congressional Budget Office, *Budget Options* (February 2005), p. 301.

33. Congressional Budget Office, *Budget Options* (March 2003), p. 227.

34. Congressional Budget Office, *Budget Options* (February 2005), pp. 304-305.

35. Often, the issue of whether to tax those entities is viewed as a matter of fairness. However, evaluating unfairness is problematic. Fairness has meaning with respect to the owners of firms (the firms themselves 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 by the tax preferences given to untaxed entities. Eliminating the differential tax treatment would not redress past inequities and could introduce new ones.

The exemption from income tax is not the sole reason that nonprofit entities, cooperatives, and state and local business enterprises are able to reduce prices or sustain higher production costs. Those abilities would still exist even if the playing field was leveled and those entities were subject to the same tax as for-profit firms. The key source of the distortions they generate is their organizational form—the absence of shareholders who demand that any surplus be distributed as dividends or retained as accumulated earnings and reinvested.

Over time, however, the effects of taxation might conform more closely to expectations. A surplus would not be taxed if it was distributed as lower prices but would be taxed if it was retained for reinvestment (and borrowing was not increased enough to eliminate the tax liability). As a result, an income tax on those institutions would significantly affect their accumulation of internal capital and thus their growth in the long run. That effect would tend to be more important than it is for privately owned for-profit firms, which generally face taxation of their surplus regardless of how it is distributed to owners.

The effect on those entities' capital accumulation and growth could vary by type of institution. It might be particularly profound for cooperatives, which are limited to their client-owners for access to new capital and therefore are dependent on reinvested earnings for growth. State- and locally owned businesses would probably be least affected. Their cost-shifting options are greater, and their access to borrowed capital is constrained only by the willingness of taxpayers to pledge future taxes as security for debt issues (although that unwillingness might grow as an entity's reserves declined). Most nonprofit businesses would fall in between. They also have access to federally subsidized borrowing (through tax-exempt bonds), but that borrowing is dependent solely on the economic success of the borrower in selling its services and attracting contributions from donors.

The desirability or undesirability of the longer-term impact on the sector's growth would depend largely on the underlying public benefits associated with those entities and the goods or services they produce. For example, to the extent that cooperatives and state and local businesses promote competitive prices, and nonprofits produce services with public benefits, the fact that they would cut back on reinvested earnings in response to an income tax to a greater degree than privately owned for-profit firms do means that taxing them like for-profit businesses would reduce those desirable activities. Conversely, to the extent that those organizations are not effective producers of public benefits and instead provide substitutes for goods sold by for-profit firms, the economy might benefit by their slower growth. That would be particularly true with nonprofit businesses and state- and locally owned firms, which would be most apt to unnecessarily sustain higher production costs by passing on their value added in the form of higher compensation.

In summary, the market distortions created by the untaxed business sector cannot be eliminated by subjecting entities in that sector to income taxation. The fundamental source of the distortions is those entities' organizational structure: the lack of shareholders to demand that any surplus be distributed as dividends or retained as earnings. And a business's choice of organizational structure is made within a welter of state laws and regulations that are beyond the control of the federal government.